

HMN FINANCIAL INC  
Form 10-Q  
August 01, 2008

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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, 2008**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

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

(Exact name of Registrant as specified in its Charter)

Delaware

41-1777397

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification Number)

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

55901

(Address of principal executive offices)

(ZIP Code)

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

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller Reporting Company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

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

| Class                          | Outstanding at July 22, 2008 |
|--------------------------------|------------------------------|
| Common stock, \$0.01 par value | 4,167,799                    |

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

| <i>(Dollars in thousands)</i>  | June 30,<br>2008<br>(unaudited) | December<br>31,<br>2007 |
|--|---------------------------------|-------------------------|
| <b>Assets</b>  |                                 |                         |
| Cash and cash equivalents  | \$ 14,475                       | 23,718                  |
| Securities available for sale:   |                                 |                         |
| Mortgage-backed and related securities (amortized cost \$17,063 and \$18,786)                    | 16,659                          | 18,468                  |
| Other marketable securities (amortized cost \$105,468 and \$165,430)                             | 107,167                         | 167,720                 |
|  | 123,826                         | 186,188                 |
| Loans held for sale  | 3,699                           | 3,261                   |
| Loans receivable, net  | 895,713                         | 865,088                 |
| Accrued interest receivable  | 6,199                           | 6,893                   |
| Real estate, net   | 4,272                           | 2,214                   |
| Federal Home Loan Bank stock, at cost  | 7,460                           | 6,198                   |
| Mortgage servicing rights, net   | 957                             | 1,270                   |
| Premises and equipment, net  | 12,585                          | 12,024                  |
| Goodwill   | 0                               | 3,801                   |
| Prepaid expenses and other assets  | 1,981                           | 1,680                   |
| Deferred tax asset   | 4,996                           | 4,719                   |
| Total assets   | \$ 1,076,163                    | 1,117,054               |
| <b>Liabilities and Stockholders Equity</b>   |                                 |                         |
| Deposits   | \$ 832,316                      | 888,118                 |
| Federal Home Loan Bank advances  | 137,900                         | 112,500                 |
| Accrued interest payable   | 6,607                           | 9,515                   |
| Customer escrows   | 965                             | 866                     |
| Accrued expenses and other liabilities   | 3,323                           | 7,927                   |
| Total liabilities  | 981,111                         | 1,018,926               |
| Commitments and contingencies  |                                 |                         |
| Stockholders equity:   |                                 |                         |
| Serial preferred stock (\$.01 par value): authorized 500,000 shares; issued and outstanding none | 0                               | 0                       |
| Common stock (\$.01 par value): authorized 11,000,000; issued shares 9,128,662                   | 91                              | 91                      |
| Additional paid-in capital   | 57,820                          | 58,049                  |
| Retained earnings, subject to certain restrictions   | 108,572                         | 110,943                 |

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|  |              |           |
|--|--------------|-----------|
| Accumulated other comprehensive income                 | 766          | 1,167     |
| Unearned employee stock ownership plan shares          | (3,867)      | (3,965)   |
| Treasury stock, at cost 4,960,863 and 4,953,045 shares | (68,330)     | (68,157)  |
| Total stockholders' equity                             | 95,052       | 98,128    |
| Total liabilities and stockholders' equity             | \$ 1,076,163 | 1,117,054 |

See accompanying notes to consolidated financial statements.

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

|  | Three Months Ended |               | Six Months Ended |               |
|--|--------------------|---------------|------------------|---------------|
|  | June 30,           |               | June 30,         |               |
| <i>(Dollars in thousands, except per share data)</i>       | 2008               | 2007          | 2008             | 2007          |
| Interest income:   |                    |               |                  |               |
| Loans receivable   | \$ 14,419          | 16,629        | 29,939           | 32,374        |
| Securities available for sale:                             |                    |               |                  |               |
| Mortgage-backed and related                                | 213                | 171           | 437              | 282           |
| Other marketable   | 1,507              | 2,417         | 3,417            | 4,313         |
| Cash equivalents   | 61                 | 279           | 118              | 722           |
| Other  | 53                 | 132           | 133              | 216           |
| <b>Total interest income</b>                               | <b>16,253</b>      | <b>19,628</b> | <b>34,044</b>    | <b>37,907</b> |
| Interest expense:  |                    |               |                  |               |
| Deposits   | 6,839              | 8,346         | 14,709           | 15,223        |
| Federal Home Loan Bank advances                            | 1,239              | 1,427         | 2,476            | 3,045         |
| <b>Total interest expense</b>                              | <b>8,078</b>       | <b>9,773</b>  | <b>17,185</b>    | <b>18,268</b> |
| Net interest income  | 8,175              | 9,855         | 16,859           | 19,639        |
| Provision for loan losses                                  | 1,130              | 1,028         | 2,690            | 1,483         |
| <b>Net interest income after provision for loan losses</b> | <b>7,045</b>       | <b>8,827</b>  | <b>14,169</b>    | <b>18,156</b> |
| Non-interest income:                                       |                    |               |                  |               |
| Fees and service charges                                   | 998                | 781           | 1,791            | 1,477         |
| Loan servicing fees  | 240                | 265           | 482              | 536           |
| Gains on sales of loans                                    | 228                | 189           | 384              | 985           |
| Other  | 290                | 57            | 617              | 362           |
| <b>Total non-interest income</b>                           | <b>1,756</b>       | <b>1,292</b>  | <b>3,274</b>     | <b>3,360</b>  |
| Non-interest expense:                                      |                    |               |                  |               |
| Compensation and benefits                                  | 3,036              | 3,262         | 6,396            | 6,623         |
| Occupancy  | 1,161              | 1,112         | 2,293            | 2,196         |
| Advertising  | 92                 | 195           | 216              | 301           |
| Data processing  | 336                | 321           | 678              | 616           |
| Amortization of mortgage servicing rights, net             | 154                | 189           | 314              | 371           |
| Goodwill impairment charge                                 | 3,801              | 0             | 3,801            | 0             |
| Other  | 1,220              | 1,070         | 2,354            | 1,992         |

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|   |            |       |        |        |
|---|------------|-------|--------|--------|
| Total non-interest expense              | 9,800      | 6,149 | 16,052 | 12,099 |
| Income (loss) before income tax expense | (999)      | 3,970 | 1,391  | 9,417  |
| Income tax expense                      | 1,026      | 1,520 | 1,928  | 3,699  |
| Net income (loss)                       | \$ (2,025) | 2,450 | (537)  | 5,718  |
| Basic earnings (loss) per share         | \$ (0.56)  | 0.65  | (0.15) | 1.52   |
| Diluted earnings (loss) per share       | \$ (0.56)  | 0.62  | (0.15) | 1.45   |

See accompanying notes to consolidated financial statements.

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

| <i>(Dollars in thousands)</i>                             | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Unearned<br>Employee<br>Stock<br>Ownership<br>Plan<br>Shares | Treasury<br>Stock | Total<br>Stock-<br>Holders<br>Equity |
|---|-----------------|----------------------------------|----------------------|---|--|-------------------|--------------------------------------|
| Balance, December 31, 2007                                | \$91            | 58,049                           | 110,943              | 1,167   | (3,965)  | (68,157)          | 98,128                               |
| Net loss  |                 |                                  | (537)                |   |  |                   | (537)                                |
| Other comprehensive income<br>(loss), net of tax:         |                 |                                  |                      |   |  |                   |                                      |
| Net unrealized losses on securities<br>available for sale |                 |                                  |                      | (401)   |  |                   | (401)                                |
| Total comprehensive loss                                  |                 |                                  |                      |   |  |                   | (938)                                |
| Purchase of treasury stock                                |                 |                                  |                      |   |  | (723)             | (723)                                |
| Unearned compensation restricted<br>stock awards          |                 | (550)                            |                      |   |  | 550               | 0                                    |
| Stock compensation tax benefits                           |                 | 17                               |                      |   |  |                   | 17                                   |
| Amortization of restricted stock<br>awards                |                 | 205                              |                      |   |  |                   | 205                                  |
| Dividends paid  |                 |                                  | (1,834)              |   |  |                   | (1,834)                              |
| Earned employee stock ownership<br>plan shares            |                 | 99                               |                      |   | 98   |                   | 197                                  |
| Balance, June 30, 2008                                    | \$91            | 57,820                           | 108,572              | 766   | (3,867)  | (68,330)          | 95,052                               |

See accompanying notes to consolidated financial statements.



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

| <i>(Dollars in thousands)</i>  | Six Months Ended<br>June 30, |           |
|--|------------------------------|-----------|
|  | 2008                         | 2007      |
| Cash flows from operating activities:  |                              |           |
| Net income (loss)  | \$ (537)                     | 5,718     |
| Adjustments to reconcile net income (loss) to cash provided by operating activities: |                              |           |
| Provision for loan losses  | 2,690                        | 1,483     |
| Depreciation   | 872                          | 959       |
| Amortization of discounts, net   | (477)                        | (1,510)   |
| Amortization of deferred loan fees   | (421)                        | (478)     |
| Amortization of core deposit intangible  | 0                            | 57        |
| Amortization of mortgage servicing rights  | 314                          | 371       |
| Capitalized mortgage servicing rights  | (1)                          | (10)      |
| Loss (gain) on sales of real estate  | (225)                        | 133       |
| Gains on sales of loans  | (384)                        | (985)     |
| Proceeds from sale of real estate  | 3,916                        | 1,557     |
| Proceeds from sale of loans held for sale  | 34,513                       | 34,883    |
| Disbursements on loans held for sale   | (32,497)                     | (26,616)  |
| Amortization of restricted stock awards  | 205                          | 165       |
| Amortization of unearned ESOP shares   | 98                           | 97        |
| Earned employee stock ownership shares priced above original cost                    | 99                           | 189       |
| Stock option compensation  | 17                           | 22        |
| Decrease (increase) in accrued interest receivable                                   | 694                          | (2,051)   |
| Increase (decrease) in accrued interest payable                                      | (2,908)                      | 3,230     |
| Goodwill impairment charge   | 3,801                        | 0         |
| Decrease (increase) in other assets  | (291)                        | 437       |
| Decrease in accrued expenses and other liabilities                                   | (4,588)                      | (1,447)   |
| Other, net   | 30                           | 115       |
| Net cash provided by operating activities  | 4,920                        | 16,319    |
| Cash flows from investing activities:  |                              |           |
| Principal received on securities available for sale                                  | 1,741                        | 967       |
| Proceeds from maturities of securities available for sale                            | 60,000                       | 75,000    |
| Purchases of securities available for sale   | 0                            | (153,376) |
| Purchase of Federal Home Loan Bank Stock   | (4,539)                      | (999)     |
| Redemption of Federal Home Loan Bank Stock   | 3,277                        | 2,543     |
| Net increase in loans receivable   | (40,752)                     | (90,743)  |
| Purchases of premises and equipment  | (1,453)                      | (562)     |
| Net cash provided (used) by investing activities                                     | 18,274                       | (167,170) |
| Cash flows from financing activities:  |                              |           |
| Increase (decrease) in deposits  | (55,380)                     | 199,815   |

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|  |           |           |
|--|-----------|-----------|
| Purchase of treasury stock                                   | (723)     | (2,194)   |
| Stock options exercised                                      | 0         | 139       |
| Excess tax benefits from options exercised                   | 0         | 99        |
| Dividends to stockholders                                    | (1,834)   | (1,886)   |
| Proceeds from borrowings                                     | 234,701   | 113,100   |
| Repayment of borrowings                                      | (209,300) | (166,500) |
| Increase in customer escrows                                 | 99        | 94        |
| Net cash provided (used) by financing activities             | (32,437)  | 142,667   |
| Decrease in cash and cash equivalents                        | (9,243)   | (8,184)   |
| Cash and cash equivalents, beginning of period               | 23,718    | 43,776    |
| Cash and cash equivalents, end of period                     | \$ 14,475 | 35,592    |
| Supplemental cash flow disclosures:                          |           |           |
| Cash paid for interest                                       | \$ 20,093 | 15,038    |
| Cash paid for income taxes                                   | 4,059     | 5,206     |
| Supplemental noncash flow disclosures:                       |           |           |
| Transfer of loans to real estate                             | 5,760     | 4,438     |
| Loans transferred to loans held for sale                     | 2,097     | 10,309    |
| See accompanying notes to consolidated financial statements. |           |           |

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

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

HMN Financial, Inc. (HMN or the Company) is a stock savings bank holding company that owns 100 percent of Home Federal Savings Bank (the Bank). The Bank has a community banking philosophy and operates retail banking and loan production offices in Minnesota and Iowa. The Bank has one wholly owned subsidiary, Osterud Insurance Agency, Inc. (OIA) which offers financial planning products and services. HMN has another wholly owned subsidiary, Security Finance Corporation (SFC) which acts as an intermediary for the Bank in transacting like-kind property exchanges for Bank customers.

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

***(2) Basis of Preparation***

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-Q and therefore, do not include all disclosures necessary for a complete presentation of the consolidated balance sheets, consolidated statements of income, consolidated statement of stockholders' equity and comprehensive income and consolidated statements of cash flows in conformity with U.S. generally accepted accounting principles. However, all normal recurring adjustments which are, in the opinion of management, necessary for the fair presentation of the interim financial statements have been included. The consolidated statement of income for the six-month period ended June 30, 2008 is not necessarily indicative of the results which may be expected for the entire year.

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

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

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

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

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities-an amendment of FASB Statement No. 133*. This Statement applies to all entities and requires enhanced disclosures about an entity's derivative and hedging activities including how and why an entity uses derivative

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instruments, how derivative instruments and related hedged items are accounted for under Statement 133, and how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. This Statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008 and is not anticipated to have a material impact on the Company's consolidated financial statements.

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

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

The Company has commitments outstanding to extend credit to future borrowers that had not closed prior to the end of the quarter. The Company intends to sell these commitments, which are referred to as its mortgage pipeline. As commitments to originate 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, 2008, the Company recorded a decrease in other liabilities of \$17,000, an increase in other assets of \$3,000 and a gain included in the gain on sales of loans of \$20,000.

The current commitments to sell loans held for sale are derivatives that do not qualify for hedge accounting. As a result, these derivatives are marked to market and the related loans held for sale are recorded at the lower of cost or market. The Company recorded a decrease in loans held for sale of \$7,000 and an increase in other assets of \$7,000 due to the mark to market adjustment on the commitments to sell loans held for sale.

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

On January 1, 2008, the Company adopted SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 establishes a framework for measuring the fair value of assets and liabilities using a hierarchy system consisting of three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

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

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

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

The following table summarizes the assets of the Company for which fair values are determined on a recurring

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basis as of June 30, 2008.

| <i>(Dollars in thousands)</i> | Carrying value at June 30, 2008 |               |                |          |
|-------------------------------|---------------------------------|---------------|----------------|----------|
|                               | Total                           | Level 1       | Level 2        | Level 3  |
| Securities available for sale | \$ 123,826                      | 13,253        | 110,573        | 0        |
| Mortgage loan commitments     | 3                               | 0             | 3              | 0        |
| <b>Total</b>                  | <b>\$ 123,829</b>               | <b>13,253</b> | <b>110,576</b> | <b>0</b> |

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 2008 that were still held at June 30, 2008, the following table provides the level of valuation assumptions used to determine each adjustment and the carrying value of the related individual assets or portfolios at June 30, 2008.

| <i>(Dollars in thousands)</i>   | Carrying value at June 30, 2008 |          |               |          | Three months ended<br>June 30, 2008 |
|---------------------------------|---------------------------------|----------|---------------|----------|-------------------------------------|
|                                 | Total                           | Level 1  | Level 2       | Level 3  |                                     |
| Loans held for sale             | \$ 3,699                        | 0        | 3,699         | 0        | (7)                                 |
| Mortgage servicing rights       | 957                             | 0        | 957           | 0        | 0                                   |
| Loans <sup>(1)</sup>            | 44,230                          | 0        | 44,230        | 0        | (2,731)                             |
| Real estate, net <sup>(2)</sup> | 4,272                           | 0        | 4,272         | 0        | (21)                                |
| <b>Total</b>                    | <b>\$ 53,158</b>                | <b>0</b> | <b>53,158</b> | <b>0</b> | <b>(2,759)</b>                      |

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

(2) Represents the fair value and

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

**(6) Comprehensive Income (Loss)**

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

| <i>(Dollars in thousands)</i>                   | For the three months ended June 30, |                 |            |            |                 |            |
|---|-------------------------------------|-----------------|------------|------------|-----------------|------------|
|   | Before tax                          | 2008 Tax effect | Net of tax | Before tax | 2007 Tax effect | Net of tax |
| Securities available for sale:                  |                                     |                 |            |            |                 |            |
| Net unrealized losses arising during the period | \$ (2,706)                          | (1,105)         | (1,601)    | (1,242)    | (492)           | (750)      |
| Other comprehensive loss                        | \$ (2,706)                          | (1,105)         | (1,601)    | (1,242)    | (492)           | (750)      |

| <i>(Dollars in thousands)</i>                   | For the six months ended June 30, |                 |            |            |                 |            |
|---|-----------------------------------|-----------------|------------|------------|-----------------|------------|
|   | Before tax                        | 2008 Tax effect | Net of tax | Before tax | 2007 Tax effect | Net of tax |
| Securities available for sale:                  |                                   |                 |            |            |                 |            |
| Net unrealized losses arising during the period | \$ (677)                          | (276)           | (401)      | (869)      | (344)           | (525)      |
| Other comprehensive loss                        | \$ (677)                          | (276)           | (401)      | (869)      | (344)           | (525)      |

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

The following table shows the gross unrealized losses and fair value for the securities available for sale portfolio, aggregated by investment category and length of time that individual securities have been in a continuous loss position at June 30, 2008.

| <i>(Dollars in thousands)</i>         | Less than twelve months |            |                   | Twelve months or more |            |                   | Total      |                   |
|---------------------------------------|-------------------------|------------|-------------------|-----------------------|------------|-------------------|------------|-------------------|
|                                       | # of Investments        | Fair Value | Unrealized Losses | # of Investments      | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Mortgage backed securities:           |                         |            |                   |                       |            |                   |            |                   |
| FHLMC                                 | 0                       | \$ 0       | 0                 | 1                     | \$ 2,450   | (406)             | \$ 2,450   | (406)             |
| FNMA                                  | 0                       | 0          | 0                 | 3                     | 2,628      | (166)             | 2,628      | (166)             |
| Other marketable securities:          |                         |            |                   |                       |            |                   |            |                   |
| Other debt                            | 1                       | 350        | (350)             | 0                     | 0          | 0                 | 350        | (350)             |
| Total temporarily impaired securities | 1                       | \$ 350     | (350)             | 4                     | \$ 5,078   | (572)             | \$ 5,428   | (922)             |

These fixed rate investments are temporarily impaired due to changes in interest rates. The Company has the ability and intent to hold these investments to maturity or until the temporary loss is recovered.

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

A summary of mortgage servicing activity is as follows:

| <i>(Dollars in thousands)</i>           | Six Months ended | Twelve Months ended | Six Months ended |
|---|------------------|---------------------|------------------|
|   | June 30, 2008    | December 31, 2007   | June 30, 2007    |
| Mortgage servicing rights:              |                  |                     |                  |
| Balance, beginning of period            | \$ 1,270         | 1,958               | 1,958            |
| Originations                            | 1                | 18                  | 10               |
| Amortization                            | (314)            | (706)               | (371)            |
| Balance, end of period                  | \$ 957           | 1,270               | 1,597            |
| Fair value of mortgage servicing rights | \$ 2,915         | 3,261               | 3,810            |

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

| <i>(Dollars in thousands)</i>    | Loan                 | Weighted              | Weighted               | Number of      |
|----------------------------------|----------------------|-----------------------|------------------------|----------------|
|                                  | Principal            | Average Interest Rate | Average Remaining Term |                |
| Original term 30 year fixed rate | Balance<br>\$203,211 | Rate<br>5.87%         | Term<br>288            | Loans<br>1,897 |

|                                  |         |       |     |       |
|----------------------------------|---------|-------|-----|-------|
| Original term 15 year fixed rate | 108,427 | 5.17% | 110 | 1,745 |
| Adjustable rate                  | 2,586   | 5.80% | 298 | 22    |

**(9) Intangible Assets**

The gross carrying amount of intangible assets and the associated accumulated amortization at June 30, 2008 is presented in the table below. Amortization expense for intangible assets was \$314,000 and \$428,000 for the six month periods ended June 30, 2008 and 2007, respectively.

| <i>(Dollars in thousands)</i> | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Unamortized<br>Intangible<br>Assets |
|-------------------------------|-----------------------------|-----------------------------|-------------------------------------|
| Amortized intangible assets:  |                             |                             |                                     |
| Mortgage servicing rights     | \$ 3,853                    | (2,896)                     | 957                                 |
| Total                         | \$ 3,853                    | (2,896)                     | 957                                 |



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The following table indicates the estimated future amortization expense for the next five years for amortized intangible assets:

| <i>(Dollars in thousands)</i> | Mortgage<br>Servicing<br>Rights |
|-------------------------------|---------------------------------|
| Year ended December 31,       |                                 |
| 2008                          | \$244                           |
| 2009                          | 368                             |
| 2010                          | 201                             |
| 2011                          | 97                              |
| 2012                          | 38                              |

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

**(10) Earnings (loss) per Share**

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

|  | Three Months Ended June |             | Six Months Ended June |             |
|--|-------------------------|-------------|-----------------------|-------------|
|  | 2008                    | 30,<br>2007 | 2008                  | 30,<br>2007 |
| <i>(dollars in thousands, except per share data)</i>   |                         |             |                       |             |
| Weighted average number of common shares outstanding used in basic earnings per common share calculation | 3,647                   | 3,752       | 3,649                 | 3,764       |
| Net dilutive effect of:  |                         |             |                       |             |
| Options  | 0                       | 161         | 0                     | 165         |
| Restricted stock awards  | 0                       | 21          | 0                     | 20          |
| Weighted average number of shares outstanding adjusted for effect of dilutive securities                 | 3,647                   | 3,934       | 3,649                 | 3,949       |
| Income (loss) available to common shareholders   | \$ (2,025)              | 2,450       | (537)                 | 5,718       |
| Basic earnings (loss) per common share   | \$ (0.56)               | 0.65        | (0.15)                | 1.52        |
| Diluted earnings (loss) per common share   | \$ (0.56)               | 0.62        | (0.15)                | 1.45        |

**(11) Regulatory Capital**

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

Quantitative measures established by regulations to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of Tier I or core capital, and risk-based capital (as defined in the regulations) to total assets (as defined in the regulations). Management believes, as of June 30, 2008, 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, 2008 and other conditions consistent with the Prompt Corrective Actions Provisions of the OTS regulations, the Bank would be categorized as well capitalized.

On June 30, 2008, the Bank's tangible assets and adjusted total assets were \$1.1 billion and its risk-weighted assets were \$867 million. The following table presents the Bank's capital amounts and ratios at June 30, 2008 for actual capital, required capital and excess capital, including ratios in order to qualify as being well capitalized under the Prompt Corrective Actions regulations.

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|   | Actual                | Required to be        | Excess Capital        | To Be Well            |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
|   | Percent               | Adequately            | Percent               | Capitalized           |
|   | of                    | Capitalized           | Percent               | Under Prompt          |
|   | Assets <sup>(1)</sup> | Percent               | of                    | Corrective            |
|   | Amount                | of                    | Assets <sup>(1)</sup> | Actions Provisions    |
| <i>(Dollars in thousands)</i>                                 | Amount                | Assets <sup>(1)</sup> | Amount                | Percent               |
|   | Amount                | Assets <sup>(1)</sup> | Amount                | Assets <sup>(1)</sup> |
| Bank stockholder's equity                                     | \$ 92,569             |                       |                       |                       |
| Less:   |                       |                       |                       |                       |
| Net unrealized gains on certain securities available for sale | (971)                 |                       |                       |                       |
| Tier I or core capital  | 91,598                |                       |                       |                       |
| Tier I capital to adjusted total assets                       | 8.52%                 | \$ 42,982             | 4.00%                 | \$ 48,616             |
|   |                       |                       |                       | 4.52%                 |
|   |                       |                       |                       | \$ 53,728             |
|   |                       |                       |                       | 5.00%                 |
| Tier I capital to risk-weighted assets                        | 10.56%                | \$ 34,686             | 4.00%                 | \$ 56,912             |
|   |                       |                       |                       | 6.56%                 |
|   |                       |                       |                       | \$ 52,029             |
|   |                       |                       |                       | 6.00%                 |
| Plus:   |                       |                       |                       |                       |
| Allowable allowance for loan losses                           | 8,674                 |                       |                       |                       |
| Risk-based capital  | \$ 100,272            | \$ 69,372             | \$ 30,900             | \$ 86,715             |
| Risk-based capital to risk-weighted assets                    | 11.56%                |                       | 8.00%                 | 3.56%                 |
|   |                       |                       |                       | 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.

**(12) Commitments and Contingencies**

The Bank issued standby letters of credit which guarantee the performance of customers to third parties. The standby letters of credit outstanding at June 30, 2008 were approximately \$7.0 million, expire over the next two years and are

collateralized primarily with commercial real estate mortgages. Since the conditions under which the Bank is required to fund the standby letters of credit may not materialize, the cash requirements are expected to be less than the total outstanding commitments.

In February 2007, the Minnesota Department of Revenue (MDR) assessed a deficiency of \$2.2 million against the Company's 2002 through 2004 Minnesota state tax payments. The deficiency relates to the tax treatment of the inter-company dividends paid to the Bank by a former subsidiary of the Company. The Company filed a Notice of Appeal in the Minnesota Tax Court challenging that assessment and a hearing has been scheduled for the fourth quarter of 2008.

**(13) Business Segments**

The Bank has been identified as a reportable operating segment in accordance with the provisions of SFAS No. 131. SFC and HMN, the holding company, did not meet the quantitative thresholds for 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. 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 |         |              | Consolidated<br>Total |
|--|--------------|---------|--------------|-----------------------|
|  | Savings Bank | Other   | Eliminations |                       |
| <b>At or for the six months ended June 30, 2008:</b> |              |         |              |                       |
| Interest income external customers                   | \$ 34,030    | 14      | 0            | 34,044                |
| Non-interest income external customers               | 3,273        | 0       | 0            | 3,273                 |
| Earnings (loss) on limited partnerships              | 1            | 0       | 0            | 1                     |
| Intersegment interest income                         | 0            | 51      | (51)         | 0                     |
| Intersegment non-interest income                     | 87           | (367)   | 280          | 0                     |
| Interest expense                                     | 17,236       | 0       | (51)         | 17,185                |
| Amortization of mortgage servicing rights, net       | 314          | 0       | 0            | 314                   |
| Other non-interest expense                           | 15,468       | 357     | (87)         | 15,738                |
| Goodwill impairment charge                           | 3,801        | 0       | 0            | 3,801                 |
| Income tax expense (benefit)                         | 2,047        | (119)   | 0            | 1,928                 |
| Net loss   | (364)        | (540)   | 367          | (537)                 |
| Total assets   | 1,075,128    | 95,950  | (94,915)     | 1,076,163             |
| <b>At or for the six months ended June 30, 2007:</b> |              |         |              |                       |
| Interest income external customers                   | \$ 37,869    | 38      | 0            | 37,907                |
| Non-interest income external customers               | 3,360        | 0       | 0            | 3,360                 |
| Intersegment interest income                         | 0            | 58      | (58)         | 0                     |
| Intersegment non-interest income                     | 87           | 5,866   | (5,953)      | 0                     |
| Interest expense                                     | 18,326       | 0       | (58)         | 18,268                |
| Amortization of mortgage servicing rights, net       | 371          | 0       | 0            | 371                   |
| Other non-interest expense                           | 11,456       | 359     | (87)         | 11,728                |
| Income tax expense (benefit)                         | 3,810        | (111)   | 0            | 3,699                 |
| Net income   | 5,869        | 5,715   | (5,866)      | 5,718                 |
| Goodwill   | 3,801        | 0       | 0            | 3,801                 |
| Total assets   | 1,124,354    | 95,369  | (92,297)     | 1,127,426             |
| <b>At or for the quarter ended June 30, 2008:</b>    |              |         |              |                       |
| Interest income external customers                   | \$ 16,243    | 10      | 0            | 16,253                |
| Non-interest income external customers               | 1,760        | 0       | 0            | 1,760                 |
| Earnings (loss) on limited partnerships              | (4)          | 0       | 0            | (4)                   |
| Intersegment interest income                         | 0            | 8       | (8)          | 0                     |
| Intersegment non-interest income                     | 43           | (1,928) | 1,885        | 0                     |
| Interest expense                                     | 8,086        | 0       | (8)          | 8,078                 |
| Amortization of mortgage servicing rights, net       | 154          | 0       | 0            | 154                   |
| Other non-interest expense                           | 9,509        | 180     | (43)         | 9,646                 |
| Goodwill impairment charge                           | 3,801        | 0       | 0            | 3,801                 |
| Income tax expense (benefit)                         | 1,090        | (64)    | 0            | 1,026                 |
| Net loss   | (1,927)      | (2,026) | 1,928        | (2,025)               |

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|   |           |        |          |           |
|---|-----------|--------|----------|-----------|
| Total assets                                      | 1,075,128 | 95,950 | (94,915) | 1,076,163 |
| <b>At or for the quarter ended June 30, 2007:</b> |           |        |          |           |
| Interest income external customers                | \$ 19,611 | 17     | 0        | 19,628    |
| Non-interest income external customers            | 1,296     | 0      | 0        | 1,296     |
| Earnings (loss) on limited partnerships           | (4)       | 0      | 0        | (4)       |
| Intersegment interest income                      | 0         | 17     | (17)     | 0         |
| Intersegment non-interest income                  | 43        | 2,541  | (2,584)  | 0         |
| Interest expense                                  | 9,790     | 0      | (17)     | 9,773     |
| Amortization of mortgage servicing rights,<br>net | 189       | 0      | 0        | 189       |
| Other non-interest expense                        | 5,815     | 189    | (44)     | 5,960     |
| Income tax expense (benefit)                      | 1,581     | (61)   | 0        | 1,520     |
| Net income  | 2,542     | 2,448  | (2,540)  | 2,450     |
| Goodwill  | 3,801     | 0      | 0        | 3,801     |
| Total assets                                      | 1,124,354 | 95,369 | (92,297) | 1,127,426 |

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**Item 2:**

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

***Forward-looking Information***

This quarterly Report and other reports filed by the Company with the Securities and Exchange Commission may contain forward-looking statements that deal with future results, plans or performance. In addition, the Company's management may make such statements orally to the media, or to securities analysts, investors or others.

Forward-looking statements deal with matters that do not relate strictly to historical facts. Words such as anticipate, believe, expect, intend, would, could, estimate, project and similar expressions, as they relate to us, are intended to identify such forward-looking statements. The Company's future results may differ materially from historical performance and forward-looking statements about the Company's expected financial results or other plans are subject to a number of risks and uncertainties. These include but are not limited to possible legislative changes and adverse economic, business and competitive developments such as shrinking interest margins; reduced collateral values; deposit outflows; reduced demand for financial services and loan products; changes in accounting policies and guidelines, or monetary and fiscal policies of the federal government or tax laws; changes in credit or other risks posed by the Company's loan and investment portfolios; changes in loan repayment and prepayment patterns; changes in loan terms and conditions; technological, computer-related or operational difficulties; adverse changes in securities markets; results of litigation or other significant uncertainties. For additional discussion of the risks and uncertainties applicable to the Company, see the Risk Factors section of the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

***General***

The earnings of the Company are primarily dependent on the Bank's net interest income, which is the difference between interest earned on loans and investments, and the interest paid on interest-bearing liabilities such as deposits and Federal Home Loan Bank (FHLB) advances. The difference between the average rate of interest earned on assets and the average rate paid on liabilities is the interest rate spread. Net interest income is produced when interest-earning assets equal or exceed interest-bearing liabilities and there is a positive interest rate spread. Net interest income and net interest rate spread are affected by changes in interest rates, the volume and mix of interest-earning assets and interest-bearing liabilities and the level of non-performing assets. The Company's net income is also affected by the generation of non-interest income, which consists primarily of gains or losses from the sale of securities, gains from the sale of loans, fees for servicing mortgage loans, and the generation of fees and service charges on deposit accounts. The Bank incurs expenses in addition to interest expense in the form of salaries and benefits, occupancy expenses, provisions for loan losses and amortization and valuation adjustments on mortgage servicing assets. The increased emphasis on commercial real estate loans over the past several years has increased the credit risk inherent in the loan portfolio and the provision for loan losses has increased due to commercial loan charge offs and risk rating downgrades as a result of a decrease in the demand for housing and building lots.

The earnings of financial institutions, such as the Bank, are significantly affected by prevailing economic and competitive conditions, particularly changes in interest rates, government monetary and fiscal policies and regulations of various regulatory authorities. Lending activities are influenced by the demand for and supply of single family and commercial properties, competition among lenders, the level of interest rates and the availability of funds. Deposit flows and costs of deposits are influenced by prevailing market rates of interest on competing investments, account maturities and the levels of personal income and savings. The interest rates charged by the FHLB on advances to the Bank also have a significant impact on the Bank's overall cost of funds.

***Critical Accounting Policies***

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





**Table of Contents***Allowance for Loan Losses and Related Provision*

The allowance for loan losses is based on periodic analysis of the loan portfolio. In this analysis, management considers factors including, but not limited to, specific occurrences of loan impairment, changes in the size of the portfolios, national and regional economic conditions such as unemployment data, loan portfolio composition, loan delinquencies, local construction permits, development plans, local economic growth rates, historical experience and observations made by the Company's ongoing internal audit and regulatory exam processes. Loans are charged off to the extent they are deemed to be uncollectible. The Company has established separate components of its overall methodology to determine the adequacy of the loan loss allowance for its homogeneous single-family and consumer loan portfolios and its non-homogeneous loan portfolios. The determination of the allowance for the non-homogeneous commercial, commercial real estate, and multi-family loan portfolios involves assigning standardized risk ratings and loss factors that are periodically reviewed. The loss factors are estimated using a combination of the Company's own loss experience and external industry data and are generally assigned to all loans that are on performing status. The Company also performs an individual analysis of impairment on each non-performing loan that is based on the expected cash flows or the value of the assets collateralizing the loans. The determination of the allowance on the homogeneous single-family and consumer loan portfolios is calculated on a pooled basis with individual determination of the allowance of all non-performing loans.

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

*Mortgage Servicing Rights*

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

*Income Taxes*

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective

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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.

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109* (FIN 48). The Company adopted FIN 48 effective January 1, 2007. FIN 48 requires the use of estimates and management's best judgment to determine the amounts and probabilities of all of the possible outcomes that could be realized upon the ultimate settlement of a tax position using the facts, circumstances, and information available. The application of FIN 48 requires significant judgment in arriving at the amount of tax benefits to be recognized in the financial statements for a given tax position. It is possible that the tax benefits realized upon the ultimate resolution of a tax position may result in tax benefits that are significantly different from those estimated.

***Net Income (Loss)***

Net loss for the second quarter of 2008 was \$2.0 million, down \$4.5 million, or 182.7%, from net income of \$2.5 million for the second quarter of 2007. Basic loss per common share for the second quarter of 2008 was (\$0.56), down \$1.21, or 186.2%, from basic earnings per share of \$0.65 for the second quarter of 2007. Diluted loss per common share for the second quarter of 2008 was (\$0.56), down \$1.18, or 190.3%, from diluted earnings per share of \$0.62 for the second quarter of 2007. The decrease is primarily the result of a \$3.8 million non-cash goodwill impairment charge that was recorded during the quarter. Net income was also adversely affected by a \$1.7 million decrease in net interest income in the second quarter of 2008 when compared to the same period of 2007. The goodwill impairment charge, which was required by generally accepted accounting principles as a result of the Company's stock trading at a discount to book value, has no impact on the Company's liquidity, cash flows or regulatory capital.

Net loss was \$537,000 for the six month period ended June 30, 2008, a decrease of \$6.3 million, or 109.4 %, from \$5.7 million in net income for the six month period ended June 30, 2007. Basic loss per common share for the six month period of 2008 was (\$0.15), down \$1.67, or 109.9%, from basic earnings per share of \$1.52 for the same period of 2007. Diluted loss per share for the six month period in 2008 was (\$0.15), down \$1.60, or 110.3%, from \$1.45 of diluted earnings per share for the same period in 2007. The decrease in net income for the six month period is primarily the result of a \$3.8 million non-cash goodwill impairment charge that was recorded in the second quarter of 2008. Net income was also adversely affected by a \$2.8 million decrease in net interest income in the first six months of 2008 when compared to the same period of 2007.

***Net Interest Income***

Net interest income was \$8.2 million for the second quarter of 2008, a decrease of \$1.7 million, or 17.0%, compared to \$9.9 million for the second quarter of 2007. Interest income was \$16.3 million for the second quarter of 2008, a decrease of \$3.3 million, or 17.2%, from \$19.6 million for the same period in 2007. Interest income decreased primarily because of a decrease in the average yields earned on loans and investments. Interest yields decreased primarily because of the 325 basis point decrease in the prime interest rate between the periods. Decreases in the prime rate, which is the rate that banks charge their prime business customers, generally decrease the rates on adjustable rate consumer and commercial loans in the portfolio and on new loans originated. Adjustable rate loans accounted for 65% of the Company's total loan portfolio at June 30, 2008. The average yield earned on interest-earning assets was 6.26% for the second quarter of 2008, a decrease of 121 basis points from the 7.47% average yield for the second quarter of 2007.

Interest expense was \$8.1 million for the second quarter of 2008, a decrease of \$1.7 million, or 17.3%, compared to \$9.8 million for the second quarter of 2007. Interest expense decreased primarily because of the lower interest rates paid on money market accounts and certificates of deposits. The decreased rates were the result of the 325 basis point decrease in the federal funds rate that occurred between the periods. Decreases in the federal funds rate, which is the

rate that banks charge other banks for short term loans, generally have a lagging effect and

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decrease the rates banks pay for deposits. The lagging effect of deposit rate changes is because many of the Bank's deposits are in the form of certificates of deposit which do not re-price immediately when the federal funds rate changes. The decrease in deposit rates was also impacted by escrowed money market account balances that were replaced with higher cost brokered deposits. The average interest rate paid on interest-bearing liabilities was 3.33% for the second quarter of 2008, a decrease of 61 basis points from the 3.94% average interest rate paid in the second quarter of 2007.

Net interest margin (net interest income divided by average interest earning assets) for the second quarter of 2008 was 3.15%, a decrease of 60 basis points, compared to 3.75% for the second quarter of 2007.

Net interest income was \$16.9 million for the first six months of 2008, a decrease of \$2.7 million, or 14.2%, from \$19.6 million for the same period in 2007. Interest income was \$34.0 million for the six month period ended June 30, 2008, a decrease of \$3.9 million, or 10.2%, from \$37.9 million for the same six month period in 2007. Interest income decreased primarily because of the 325 basis point decrease in the prime interest rate between the periods. The average yield earned on interest-earning assets was 6.49% for the first six months of 2008, a decrease of 99 basis points from the 7.48% average yield for the first six months of 2007.

Interest expense was \$17.2 million for the first six months of 2008, a decrease of \$1.1 million, or 5.9%, compared to \$18.3 million for the first six months of 2007. Interest expense decreased primarily because of the lower interest rates paid on money market accounts and certificates of deposits. The decreased rates were the result of the 325 basis point decrease in the federal funds rate that occurred between the periods. The average interest rate paid on interest-bearing liabilities was 3.52% for the first six months of 2008, a decrease of 30 basis points from the 3.82% average interest rate paid in the first six months of 2007.

Net interest margin (net interest income divided by average interest earning assets) for the first six months of 2008 was 3.21%, a decrease of 67 basis points, compared to 3.88% for the first six months of 2007.

A summary of the Company's net interest margin for the six month period ended June 30, 2008 and June 30, 2007 is as follows:

|                                      | For the six month period ending |                      |             |                             |                      |             |
|--------------------------------------|---------------------------------|----------------------|-------------|-----------------------------|----------------------|-------------|
|                                      | June 30, 2008                   |                      |             | June 30, 2007               |                      |             |
| <i>(Dollars in thousands)</i>        | Average Outstanding Balance     | Interest Earned/Paid | Yield/Rate  | Average Outstanding Balance | Interest Earned/Paid | Yield/Rate  |
| <b>Interest-earning assets:</b>      |                                 |                      |             |                             |                      |             |
| Securities available for sale        | \$ 153,123                      | 3,853                | 5.06%       | \$ 180,616                  | 4,595                | 5.13%       |
| Loans held for sale                  | 2,484                           | 73                   | 5.88        | 2,316                       | 71                   | 6.21        |
| Mortgage loans, net                  | 161,743                         | 5,019                | 6.22        | 139,721                     | 4,309                | 6.22        |
| Commercial loans, net                | 632,565                         | 21,875               | 6.95        | 578,852                     | 24,304               | 8.47        |
| Consumer loans, net                  | 83,324                          | 2,973                | 7.17        | 84,933                      | 3,690                | 8.76        |
| Cash equivalents                     | 15,172                          | 118                  | 1.57        | 27,867                      | 722                  | 5.23        |
| Federal Home Loan Bank stock         | 6,462                           | 133                  | 4.14        | 7,541                       | 216                  | 5.78        |
| <b>Total interest-earning assets</b> | <b>1,054,873</b>                | <b>34,044</b>        | <b>6.49</b> | <b>1,021,846</b>            | <b>37,907</b>        | <b>7.48</b> |
| <b>Interest-bearing liabilities:</b> |                                 |                      |             |                             |                      |             |
| Noninterest checking                 | 53,603                          | 0                    | 0.00        | 55,079                      | 0                    | 0.00        |
| NOW accounts                         | 124,305                         | 988                  | 1.59        | 110,918                     | 1,723                | 3.13        |
| Savings accounts                     | 41,287                          | 239                  | 1.16        | 40,750                      | 273                  | 1.35        |
| Money market accounts                | 142,134                         | 1,800                | 2.54        | 223,058                     | 4,226                | 3.82        |
| Certificates                         | 245,068                         | 5,177                | 4.25        | 235,205                     | 5,092                | 4.37        |

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|   |           |           |       |           |           |       |
|---|-----------|-----------|-------|-----------|-----------|-------|
| Brokered deposits   | 269,270   | 6,505     | 4.86  | 162,837   | 3,909     | 4.84  |
| Federal Home Loan Bank<br>advances  | 106,364   | 2,476     | 4.68  | 135,679   | 3,045     | 4.53  |
| Other   | 1,103     | 0         | 0.00  | 959       | 0         | 0.00  |
| Total interest-bearing<br>liabilities   | 983,134   | 17,185    | 3.52  | 964,485   | 18,268    | 3.82  |
| Net interest income   |           | \$ 16,859 |       |           | \$ 19,639 |       |
| Net interest rate spread  |           |           | 2.98% |           |           | 3.66% |
| Net earning assets  | \$ 71,739 |           |       | \$ 57,361 |           |       |
| Net interest margin   |           |           | 3.21% |           |           | 3.88% |
| Average interest-earning<br>assets to average<br>interest-bearing liabilities |           | 107.30%   |       |           | 105.95%   |       |

**Table of Contents*****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 \$1.1 million for the second quarter of 2008, an increase of \$102,000, or 9.9%, from \$1.0 million for the second quarter of 2007. The provision for loan losses was \$2.7 million for the first six months of 2008, an increase of \$1.2 million, or 81.4%, from the \$1.5 million for the same six month period in 2007. The provision for loan losses increased primarily because of an increase in the allowance required for risk rated commercial real estate loans in the first six months of 2008 when compared to the same period of 2007. The increase was due primarily to decreases in the estimated value of the real estate collateral supporting the \$24.8 million in residential development loans classified as non-performing at June 30, 2008.

A rollforward of the Company's allowance for loan losses for the six month periods ended June 30, 2008 and June 30, 2007 is summarized as follows:

| <i>(Dollars in thousands)</i> | 2008      | 2007      |
|-------------------------------|-----------|-----------|
| Balance at January 1,         | \$ 12,438 | \$ 9,873  |
| Provision                     | 2,690     | 1,483     |
| Charge offs:                  |           |           |
| Commercial                    | (24)      | (17)      |
| Commercial real estate        | (75)      | (70)      |
| Mortgage                      | (60)      | 0         |
| Consumer                      | (69)      | (632)     |
| Recoveries                    | 24        | 88        |
| Balance at June 30,           | \$ 14,924 | \$ 10,725 |

The decrease in consumer loan charge offs was primarily the result of a \$508,000 charge off on a home equity loan in the first quarter of 2007.

***Non-Interest Income***

Non-interest income was \$1.8 million for the second quarter of 2008, an increase of \$464,000, or 35.9%, from \$1.3 million for the same period in 2007. Other non-interest income increased \$233,000 primarily because of increased gains recognized on the sale of repossessed and foreclosed assets. Fees and services charges increased \$217,000 between the periods primarily because of increased overdraft and debit card fees. Gain on sales of loans increased \$39,000 between the periods due primarily to a \$31,000 increase in the gains recognized on the sale of government guaranteed commercial loans between the periods. Loan servicing fees decreased \$25,000 between the periods because there were fewer mortgage loans being serviced.

Non-interest income was \$3.3 million for the first six months of 2008, a decrease of \$86,000, or 2.6%, from \$3.4 million for the same period in 2007. Gain on sales of loans decreased \$601,000 between the periods primarily because of the \$706,000 decrease in the gain recognized on the sale of government guaranteed commercial loans between the periods that was partially offset by an \$105,000 increase in the gain recognized on the sale of single family loans. Mortgage servicing fees decreased \$54,000 because fewer loans were being serviced. Fees and service charges increased \$314,000 between the periods primarily because of increased overdraft and debit card fees. Other non-interest income increased \$255,000 primarily because of increased gains recognized on the sale of repossessed and foreclosed assets.

***Non-Interest Expense***

Non-interest expense was \$9.8 million for the second quarter of 2008, an increase of \$3.7 million, or 59.4%, from \$6.1 million for the same period of 2007. A goodwill impairment charge of \$3.8 million was recorded in the second quarter of 2008 as goodwill related to a 1997 acquisition was deemed to be impaired and fully written off due to the trading of the Company's common stock at a discount to book value. Other non-interest expense increased \$150,000 primarily because of increased Federal Deposit Insurance Corporation (FDIC) insurance costs and legal fees primarily

related to an ongoing state tax assessment challenge. Data processing costs increased \$15,000 due to increases in the internet and other banking services provided by the Bank's third party processor



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between the periods. Compensation expense decreased \$226,000 between the periods primarily because of decreased employee incentive accruals and pension costs. Advertising expense decreased \$103,000 between the periods primarily due to a decrease in event sponsorships and less general advertising. Mortgage servicing rights amortization decreased \$35,000 between the periods because there were fewer mortgage loans being serviced.

Non-interest expense was \$16.1 million for the first six months of 2008, an increase of \$4.0 million, or 32.7%, from \$12.1 million for the same period of 2007. A goodwill impairment charge of \$3.8 million was recorded in the second quarter of 2008 as goodwill related to a 1997 acquisition was deemed to be impaired and fully written off due to the trading of the Company's common stock at a discount to book value. Other non-interest expense increased \$362,000 primarily because of increased FDIC insurance costs and legal fees primarily related to an ongoing state tax assessment challenge. Occupancy expense increased \$97,000 due primarily to increased real estate taxes and costs associated with the Eagan branch that was opened in the third quarter of 2007. Data processing costs increased \$62,000 due to increases in the internet and other banking services provided by the Bank's third party processor between the periods. Compensation expense decreased \$227,000 between the periods primarily because of decreased employee incentive accruals and pension costs. Advertising expense decreased \$85,000 between the periods primarily due to a decrease in event sponsorships and less general advertising. Mortgage servicing rights amortization decreased \$57,000 between the periods because there were fewer mortgage loans being serviced.

***Income Tax Expense***

Income tax expense was \$1.0 million for the second quarter of 2008, a decrease of \$494,000, or 32.5%, compared to \$1.5 million for the second quarter of 2007. Income tax expense was \$1.9 million for the first six months of 2008, a decrease of \$1.8 million, or 47.9%, compared to \$3.7 million for the same period in 2007. Income tax expense decreased between the periods due to a decrease in taxable income and an effective tax rate that decreased from 39.3% for the first six months of 2007 to 37.1% for the first six months of 2008 without giving effect to the goodwill impairment charge. The goodwill impairment charge recorded in the second quarter of 2008 is not tax deductible and therefore no tax benefit was realized related to the impairment charge. The decrease in the effective tax rate was primarily the result of decreased pre-tax income and a higher percentage of tax exempt income.

**Table of Contents****Non-Performing Assets**

The following table sets forth the amounts and categories of non-performing assets in the Bank's portfolio and loan delinquency data at June 30, 2008, March 31, 2008 and December 31, 2007.

| <i>(Dollars in thousands)</i>   | June 30,<br>2008 | March 31,<br>2008 | December<br>31,<br>2007 |
|---|------------------|-------------------|-------------------------|
| <b>Non-Accruing Loans:</b>  |                  |                   |                         |
| One-to-four family real estate  | \$ 1,046         | \$ 802            | \$ 1,196                |
| Commercial real estate  | 39,221           | 17,983            | 15,641                  |
| Consumer  | 1,439            | 1,380             | 1,094                   |
| Commercial business   | 2,500            | 3,830             | 1,723                   |
| <b>Total</b>  | <b>44,206</b>    | <b>23,995</b>     | <b>19,654</b>           |
| Other assets  | 25               | 34                | 34                      |
| <b>Foreclosed and Repossessed Assets:</b>                                       |                  |                   |                         |
| One-to-four family real estate  | 2,731            | 2,852             | 901                     |
| Consumer  | 19               | 19                | 33                      |
| Commercial real estate  | 1,541            | 1,332             | 1,313                   |
| <b>Total non-performing assets</b>  | <b>\$ 48,522</b> | <b>\$ 28,232</b>  | <b>\$ 21,935</b>        |
| <b>Total as a percentage of total assets</b>                                    | <b>4.50%</b>     | <b>2.56%</b>      | <b>1.96%</b>            |
| <b>Total non-performing loans</b>   | <b>\$ 44,206</b> | <b>\$ 23,995</b>  | <b>\$ 19,654</b>        |
| <b>Total as a percentage of total loans receivable, net</b>                     | <b>4.94%</b>     | <b>2.73%</b>      | <b>2.27%</b>            |
| <b>Allowance for loan loss to non-performing loans</b>                          | <b>33.76%</b>    | <b>57.98%</b>     | <b>63.28%</b>           |
| <b>Delinquency Data:</b>  |                  |                   |                         |
| <b>Delinquencies <sup>(1)</sup></b>   |                  |                   |                         |
| 30+ days  | \$ 2,491         | \$ 8,203          | \$ 6,416                |
| 90+ days  | 0                | 55                | 0                       |
| <b>Delinquencies as a percentage of loan and lease portfolio <sup>(1)</sup></b> |                  |                   |                         |
| 30+ days  | 0.27%            | 0.92%             | 0.73%                   |
| 90+ days  | 0.00%            | 0.01%             | 0.00%                   |

(1) Excludes non-accrual loans.

Total non-performing assets were \$48.5 million at June 30, 2008, an increase of \$26.6 million, from \$21.9 million at December 31, 2007. Non-performing loans increased \$24.6 million and foreclosed and repossessed assets increased \$2.0 million during the period. The non-performing loan activity for the first six months of 2008 was as follows:

classified \$30.4 million in loans as non-accruing, received \$1.5 million in principal payments on non-accruing loans, reclassified \$2.7 million in loans as accruing, transferred \$1.3 million to real estate owned, and charged off \$325,000. The increase in non-performing loans was primarily related to three residential development loans totaling \$13.7 million, a loan on a commercial manufacturing facility for \$5.0 million, and a loan on a hotel property for \$5.0 million that were classified as non-accruing during the first six months of 2008 due to lack of performance. The estimated values of the underlying collateral supporting non-performing loans were determined based on appraisals or estimated cash flows and specific reserves have been established, where required.

**Dividends**

On July 22, 2008, the Company declared a cash dividend of \$0.25 per share, payable on September 8, 2008 to shareholders of record on August 25, 2008.

The Company has declared and paid dividends during 2008 as follows:

| Record date       | Pay date | Dividend per share | Dividend Payout Ratio |
|-------------------|----------|--------------------|-----------------------|
|                   | March    | \$ 0.25            | 34.25%                |
| February 15, 2008 | 7, 2008  |                    |                       |
|                   | June 6,  | \$ 0.25            | 64.10%                |
| May 16, 2008      | 2008     |                    |                       |

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

The declaration of dividends is subject to, among other things, the Company's financial condition and results of operations, the Bank's compliance with its regulatory capital requirements including risk based capital requirements, tax considerations, industry standards, economic conditions, regulatory restrictions, general business practices and other factors.

***Liquidity***

For the six months ended June 30, 2008, the net cash provided by operating activities was \$4.9 million. The Company collected \$60.0 million from the maturities of securities, \$3.3 million from the redemption of Federal Home Loan Bank stock, and \$1.7 million from principal repayments on securities. It purchased Federal Home Loan Bank stock of \$4.5 million and premises and equipment of \$1.5 million. Net loans receivable increased \$40.8 million due primarily to increased commercial loan production. The Company had a net decrease in deposit balances of \$55.4 million (primarily from scheduled escrow account disbursements), received \$234.7 million in advance proceeds and \$100,000 in customer escrows. The Company repaid \$209.3 million on advances, paid \$723,000 to purchase treasury stock, and paid \$1.8 million in dividends to its shareholders.

The Company has certificates of deposits with outstanding balances of \$390.1 million that come due over the next 12 months. Based upon past experience management anticipates that the majority of the deposits will renew for another term. The Company believes that deposits that do not renew will be replaced with deposits from other customers or brokers. FHLB advances or proceeds from the sale of securities could also be used to replace unanticipated outflows of deposits.

The Company has deposits of \$64.2 million in checking and money market accounts with customers that have individual balances greater than \$5 million. These funds may be withdrawn at any time and management anticipates that \$13.8 million of these deposits will be withdrawn from the Bank over the next twelve months as they relate to escrow deposits that are scheduled for disbursement. These withdrawals will be funded primarily with FHLB advances. Management anticipates that the majority of the remaining large checking and money market deposits will remain on deposit with the Bank. If these deposits were to be withdrawn, they would be replaced with deposits from other customers or brokers. FHLB advances 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 \$87.5 million of FHLB advances which mature beyond June 30, 2009 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.

***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 Company believes that over the next twelve months interest rates could fluctuate in a range of 100 basis points down or 200 basis points up from where the rates were at June 30, 2008. The following table

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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, 2008.

| <i>(Dollars in thousands)</i>               | Basis point change in interest rates |           |           |           |
|---|--------------------------------------|-----------|-----------|-----------|
|   | -100                                 | 0         | +100      | +200      |
| Total market risk sensitive assets          | \$ 1,069,313                         | 1,052,224 | 1,033,969 | 1,013,506 |
| Total market risk sensitive liabilities     | 969,700                              | 958,279   | 947,261   | 936,240   |
| Off-balance sheet financial instruments     | (121)                                | 0         | 151       | 290       |
| Net market risk                             | \$ 99,734                            | 93,945    | 86,557    | 76,976    |
| Percentage change from current market value | 6.16%                                | 0.00%     | (7.86)%   | (18.06)%  |

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 7% to 77%, depending on the note rate and the period to maturity. Adjustable rate mortgages (ARMs) were assumed to prepay at annual rates of between 11% and 33%, depending on the note rate and the period to maturity. Growing Equity Mortgage loans were assumed to prepay at annual rates of between 6% and 50% 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 28% and money market accounts were assumed to decay at an annual rate of 30%.

Non-interest checking accounts were assumed to decay at an annual rate of 33% and NOW accounts were assumed to decay at an annual rate of 29%. Commercial NOW accounts and MMDA accounts were assumed to decay at annual rates of 21% and 29%, respectively. FHLB advances were projected to be called at the first call date where the projected interest rate on similar remaining term advances exceeded the interest rate on the 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, 2008 to determine if its current level of interest rate risk is acceptable. The following table projects the estimated annual impact on net interest income of immediate interest rate changes called rate shocks.

| Rate Shock | Projected              |            |
|------------|------------------------|------------|
|            | Change in Net Interest | Percentage |
| in Basis   |                        |            |

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*(Dollars in thousands)*

| Points | Income | Change  |
|--------|--------|---------|
| +200   | (143)  | (0.46)% |
| +100   | (246)  | (0.79)% |
| 0      | 0      | 0.00%   |
| -100   | (246)  | (0.79)% |

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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 decrease in net interest income in a rising rate environment is because at June 30, 2008 we had more deposits than loans 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. This Committee makes adjustments to the asset-liability position of the Bank, which are reviewed by the Board of Directors of the Bank. This Committee also reviews the Bank's portfolio, formulates investment strategies and oversees the timing and implementation of transactions to assure attainment of the Board's objectives in the most effective manner. In addition, each quarter the Board reviews the Bank's asset/liability position, including simulations of the effect on the Bank's capital of various interest rate scenarios.

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

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

**Off-Balance Sheet Arrangements**

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

**Item 4: Controls and Procedures**

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

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

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

**Item 1. Legal Proceedings.**

From time to time, the Bank and the Company are involved as plaintiff or defendant in various legal proceedings arising in the normal course of its business. While the ultimate outcome of these various legal proceedings cannot be predicted with certainty, it is the opinion of management that the resolution of these legal actions should not have a material effect on the Company's consolidated financial condition or results of operations. However, if the Company were to lose its tax assessment challenge with the Minnesota Department of Revenue, it could have a material effect on the Company's consolidated financial statements.

**Item 1A. Risk Factors**

No changes from the risk factors previously disclosed in the Company's December 31, 2007 Form 10-K.

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

(a) and (b) Not applicable

(c) Information Regarding Share Repurchases

| Period                         | (a) Total        |    | (b) Average Price Paid per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) Maximum Number of Shares that May Be Purchased Under the Plans or Programs (1) |
|--------------------------------|------------------|----|----------------------------------|--|--|
|                                | Number of Shares |    |                                  |  |  |
| April 1 through April 30, 2008 | 0                |    | N/A                              | 0  | 106,000  |
| May 1 through May 31, 2008     | 0                |    | N/A                              | 0  | 106,000  |
| June 1 through June 30, 2008   | 0                |    | N/A                              | 0  | 106,000  |
| Total                          | 0                | \$ | N/A                              | 0  |  |

(1) On July 22, 2008 the Board of Directors authorized the repurchase of up to 300,000 shares of the Company's common stock. This program expires on January 26, 2010.

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

Not applicable.

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

The Annual Meeting of Stockholders of the Company was held on April 22, 2008 at 10:00 a.m.

The following is a record of the votes cast in the election of directors of the Company:

Terms expiring in 2011:

|                 | For       | Withhold |
|-----------------|-----------|----------|
| Allan DeBoer    | 2,659,501 | 263,415  |
| Timothy Geisler | 2,688,998 | 233,918  |
| Karen Himle     | 2,706,496 | 216,420  |

Accordingly the individuals named above were duly elected directors of the Company for terms to expire as stated above.





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The following directors have terms of office that expire at dates following the 2008 annual meeting held April 22, 2008 and continued in office:

| Director         | Term of Office Expires |
|------------------|------------------------|
| Michael McNeil   | 2009                   |
| Duane Benson     | 2009                   |
| Mahlon Schneider | 2009                   |
| Michael Fogarty  | 2010                   |
| Malcolm McDonald | 2010                   |
| Susan Kolling    | 2010                   |

The following is a record of the votes cast in respect of the proposal to ratify the appointment of KPMG LLP as the Company's independent registered public accounting firm for the fiscal year ending December 31, 2008.

|                 | NUMBER<br>OF VOTES | PERCENTAGE OF<br>VOTES ACTUALLY<br>CAST |
|-----------------|--------------------|---|
| FOR             | 2,810,940          | 96.17%                                  |
| AGAINST         | 61,539             | 2.11%                                   |
| ABSTAIN         | 50,437             | 1.73%                                   |
| BROKER NON-VOTE | 0                  | 0.00%                                   |

Accordingly, the proposal described above was declared to be duly adopted by the stockholders of the Company.

**Item 5. Other Information.**

None.

**Item 6. Exhibits.**

See Index to Exhibits on page 26 of this report

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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 1, 2008

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

Date: August 1, 2008

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<br>S-K<br>Exhibit<br>Number | Document Attached Hereto                       | Reference<br>to Prior<br>Filing or<br>Exhibit<br><br>Number | Sequential<br>Page Numbering<br>Where Attached<br>Exhibits Are<br><br>Located in This<br>Report |
|--|--|---|---|
| 3.1                                    | Amended and Restated Articles of Incorporation | *1  | N/A   |
| 3.2                                    | Amended and Restated By-laws                   | *2  | N/A   |
| 4                                      | Form of Common Stock Including indentures      | *3  | N/A   |
| 31.1                                   | Rule 13a-14(a)/15d-14(a) Certification of CEO  | 31.1  | Filed<br>electronically   |
| 31.2                                   | Rule 13a-14(a)/15d-14(a) Certification of CFO  | 31.2  | Filed<br>electronically   |
| 32                                     | Section 1350 Certification of CEO and CFO      | 32  | Filed<br>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 the same numbered exhibit to the Company's Quarterly Report on Form 10-Q for the period ended

June 30, 2007  
(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).

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