

HMN FINANCIAL INC
Form 10-Q
November 05, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2014

OR

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

For the transition period from _____ to _____

Commission File Number 0-24100

HMN FINANCIAL, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or organization)

41-1777397
(I.R.S. Employer Identification No.)

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1016 Civic Center Drive N.W., Rochester, MN
(Address of principal executive offices)

55901
(ZIP Code)

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

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

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

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

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

Yes No

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

| Class | Outstanding at October 20, 2014 |
|--------------------------------|---------------------------------|
| Common stock, \$0.01 par value | 4,470,339 |

HMN FINANCIAL, INC.

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

| <i>(Dollars in thousands)</i> | September 30, 2014 (unaudited) | December 31, 2013 |
|--|---|-------------------------|
| Assets | | |
| Cash and cash equivalents | \$ 57,177 | 120,686 |
| Securities available for sale: | | |
| Mortgage-backed and related securities (amortized cost \$3,176 and \$4,899) | 3,361 | 5,213 |
| Other marketable securities (amortized cost \$137,780 and \$103,788) | 137,180 | 102,743 |
| | 140,541 | 107,956 |
| Loans held for sale | 1,235 | 1,502 |
| Loans receivable, net | 365,572 | 384,615 |
| Accrued interest receivable | 1,786 | 1,953 |
| Real estate, net | 3,445 | 6,898 |
| Federal Home Loan Bank stock, at cost | 777 | 784 |
| Mortgage servicing rights, net | 1,542 | 1,708 |
| Premises and equipment, net | 6,833 | 6,711 |
| Prepaid expenses and other assets | 540 | 698 |
| Deferred tax asset, net | 14,985 | 15,111 |
| Total assets | \$ 594,433 | 648,622 |
| Liabilities and Stockholders' Equity | | |
| Deposits | \$ 504,908 | 553,930 |
| Accrued interest payable | 101 | 146 |
| Customer escrows | 1,293 | 614 |
| Accrued expenses and other liabilities | 7,520 | 8,257 |
| Total liabilities | 513,822 | 562,947 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Serial preferred stock (\$.01 par value): authorized 500,000 shares; issued and outstanding shares 16,000 and 26,000 | 16,000 | 26,000 |
| Common stock (\$.01 par value): authorized 16,000,000; issued shares 9,128,662 | 91 | 91 |
| Additional paid-in capital | 50,126 | 51,175 |

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| | | |
|--|------------|-----------|
| Retained earnings, subject to certain restrictions | 76,486 | 72,211 |
| Accumulated other comprehensive loss | (372) | (674) |
| Unearned employee stock ownership plan shares | (2,659) | (2,804) |
| Treasury stock, at cost 4,658,323 and 4,704,313 shares | (59,061) | (60,324) |
| Total stockholders' equity | 80,611 | 85,675 |
| Total liabilities and stockholders' equity | \$ 594,433 | 648,622 |

See accompanying notes to consolidated financial statements.

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

(unaudited)

| | Three Months Ended | | Nine Months Ended | |
|--|-----------------------|---------|-----------------------|----------|
| | September 30, 2014 | 2013 | September 30, 2014 | 2013 |
| <i>(Dollars in thousands, except per share data)</i> | | | | |
| Interest income: | | | | |
| Loans receivable | \$4,669 | 5,492 | 14,398 | 17,023 |
| Securities available for sale: | | | | |
| Mortgage-backed and related | 38 | 66 | 131 | 242 |
| Other marketable | 378 | 156 | 889 | 443 |
| Cash equivalents | 45 | 12 | 157 | 80 |
| Other | 1 | 3 | 3 | 51 |
| Total interest income | 5,131 | 5,729 | 15,578 | 17,839 |
| Interest expense: | | | | |
| Deposits | 297 | 404 | 937 | 1,426 |
| Federal Home Loan Bank advances | 0 | 0 | 0 | 1,485 |
| Total interest expense | 297 | 404 | 937 | 2,911 |
| Net interest income | 4,834 | 5,325 | 14,641 | 14,928 |
| Provision for loan losses | (989) | (4,330) | (4,777) | (4,850) |
| Net interest income after provision for loan losses | 5,823 | 9,655 | 19,418 | 19,778 |
| Non-interest income: | | | | |
| Fees and service charges | 903 | 929 | 2,627 | 2,601 |
| Mortgage servicing fees | 263 | 267 | 787 | 772 |
| Gain on sales of loans | 804 | 433 | 1,480 | 1,813 |
| Other | 224 | 194 | 710 | 498 |
| Total non-interest income | 2,194 | 1,823 | 5,604 | 5,684 |
| Non-interest expense: | | | | |
| Compensation and benefits | 3,193 | 3,009 | 9,944 | 9,188 |
| Gain on real estate owned | (78) | (282) | (1,130) | (607) |
| Occupancy | 896 | 867 | 2,654 | 2,543 |
| Deposit insurance | 74 | 172 | 328 | 680 |
| Data processing | 240 | 340 | 735 | 1,047 |
| Other | 1,100 | 1,180 | 3,055 | 3,799 |
| Total non-interest expense | 5,425 | 5,286 | 15,586 | 16,650 |
| Income before income tax expense | 2,592 | 6,192 | 9,436 | 8,812 |
| Income tax expense | 1,054 | 158 | 3,736 | 238 |
| Net income | \$1,538 | 6,034 | 5,700 | 8,574 |

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| | | | | |
|--|--------|--------|----------|----------|
| Preferred stock dividends and discount | (360) | (523) | (1,417) | (1,546) |
| Net income for common shareholders | 1,178 | 5,511 | 4,283 | 7,028 |
| Other comprehensive income (loss), net of tax | (70) | 473 | 302 | (1,045) |
| Comprehensive income attributable to common shareholders | 1,108 | 5,984 | 4,585 | 5,983 |
| Basic earnings per common share | \$0.29 | 1.38 | 1.06 | 1.76 |
| Diluted earnings per common share | \$0.25 | 1.27 | 0.93 | 1.65 |

See accompanying notes to consolidated financial statements.

HMN FINANCIAL, INC. AND SUBSIDIARIES**Consolidated Statement of Stockholders' Equity****For the Nine-Month Period Ended September 30, 2014**

(unaudited)

| | Serial Preferred Stock | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Loss | Unearned Employee Stock Ownership Plan Shares | Treasury Stock | Total Stock- Holders' Equity |
|--|------------------------------|-----------------|----------------------------------|----------------------|---|--|-------------------|---------------------------------------|
| <i>(Dollars in thousands)</i> | | | | | | | | |
| Balance, December 31, 2013 | \$26,000 | 91 | 51,175 | 72,211 | (674) | (2,804) | (60,324) | 85,675 |
| Net income | | | | 5,700 | | | | 5,700 |
| Other comprehensive income | | | | | 302 | | | 302 |
| Redemption of preferred stock | (10,000) | | | | | | | (10,000) |
| Stock compensation tax benefits | | | 1 | | | | | 1 |
| Restricted stock awards | | | (1,263) | | | | 1,263 | 0 |
| Amortization of restricted stock awards | | | 176 | | | | | 176 |
| Dividends on preferred stock | | | | (1,425) | | | | (1,425) |
| Earned employee stock ownership plan shares | | | 37 | | | 145 | | 182 |
| Balance, September 30, 2014 | \$16,000 | 91 | 50,126 | 76,486 | (372) | (2,659) | (59,061) | 80,611 |

See accompanying notes to consolidated financial statements.

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

(unaudited)

| | Nine Months Ended September 30, | |
|---|------------------------------------|-----------|
| | 2014 | 2013 |
| <i>(Dollars in thousands)</i> | | |
| Cash flows from operating activities: | | |
| Net income | \$5,700 | 8,574 |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Provision for loan losses | (4,777) | (4,850) |
| Depreciation | 416 | 751 |
| Amortization of premiums, net | 7 | 67 |
| Amortization of deferred loan fees | (175) | (238) |
| Amortization of mortgage servicing rights, net | 385 | 463 |
| Capitalized mortgage servicing rights | (219) | (500) |
| Gain on sales of real estate | (1,130) | (607) |
| Gain on sales of loans | (1,480) | (1,813) |
| Proceeds from sale of loans held for sale | 42,724 | 74,298 |
| Disbursements on loans held for sale | (29,032) | (60,407) |
| Amortization of restricted stock awards | 176 | 101 |
| Amortization of unearned ESOP shares | 145 | 145 |
| Cancellation of vested restricted stock awards | 0 | (119) |
| Earned employee stock ownership shares priced above (below) original cost | 37 | (27) |
| Stock option compensation | 1 | 3 |
| Decrease in accrued interest receivable | 167 | 201 |
| Decrease in accrued interest payable | (46) | (120) |
| Decrease in other assets | 170 | 830 |
| Increase in other liabilities | 3,508 | 251 |
| Other, net | 388 | 221 |
| | 16,965 | 17,224 |
| Net cash provided by operating activities | | |
| Cash flows from investing activities: | | |
| Principal collected on securities available for sale | 1,726 | 4,206 |
| Proceeds collected on maturities of securities available for sale | 55,000 | 11,000 |
| Purchases of securities available for sale | (89,000) | (20,092) |
| Redemption of Federal Home Loan Bank Stock | 7 | 3,279 |
| Proceeds from sales of real estate and premises | 4,382 | 3,655 |
| Net decrease in loans receivable | 11,898 | 53,583 |
| Purchases of premises and equipment | (538) | (310) |
| | (16,525) | 55,321 |
| Net cash (used) provided by investing activities | | |
| Cash flows from financing activities: | | |
| Decrease in deposits | (49,024) | (29,051) |
| Redemption of preferred stock | (10,000) | 0 |
| Dividends to preferred stockholders | (5,604) | 0 |

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| | | |
|--|-----------|----------|
| Proceeds from borrowings | 0 | 12,000 |
| Repayment of borrowings | 0 | (82,000) |
| Increase in customer escrows | 679 | 498 |
| Net cash used by financing activities | (63,949) | (98,553) |
| Decrease in cash and cash equivalents | (63,509) | (26,008) |
| Cash and cash equivalents, beginning of period | 120,686 | 83,660 |
| Cash and cash equivalents, end of period | \$57,177 | 57,652 |
| Supplemental cash flow disclosures: | | |
| Cash paid for interest | \$983 | 3,031 |
| Cash paid for income taxes | 0 | 205 |
| Supplemental noncash flow disclosures: | | |
| Transfer of loans to real estate | 142 | 1,563 |
| Loans transferred to loans held for sale | 11,954 | 10,665 |

See accompanying notes to consolidated financial statements.

HMN FINANCIAL, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(unaudited)

September 30, 2014 and 2013

(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 facilities in Minnesota and Iowa. The Bank has two wholly owned subsidiaries, Osterud Insurance Agency, Inc. (OIA), which offers financial planning products and services, and HFSB Property Holdings, LLC (HPH), which acts as an intermediary for the Bank in holding and operating certain foreclosed properties.

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

(2) Basis of Preparation

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-Q and, therefore, do not include all disclosures necessary for a complete presentation of the consolidated balance sheets, consolidated statements of comprehensive income, consolidated statement of stockholders' equity and consolidated statements of cash flows in conformity with U.S. generally accepted accounting principles. However, all normal recurring adjustments which are, in the opinion of management, necessary for the fair presentation of the interim financial statements have been included. The results of operations for the nine-month period ended September 30, 2014 are not necessarily indicative of the results which may be expected for the entire year.

(3) New Accounting Standards

In January 2014, the FASB issued ASU 2014-04, *Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40) Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*. The amendments in this ASU clarify when a repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan. Under the amendment, physical possession occurs, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar

legal agreement. The ASU is intended to reduce diversity in practice and is effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The adoption of this ASU in the first quarter of 2015 is not anticipated to have a material impact on the Company's consolidated financial statements.

In August 2014, the FASB issued ASU 2014-14, *Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40) Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure*. The amendments in this ASU require that a mortgage loan be derecognized and that a separate other receivable be recognized upon foreclosure of a government-guaranteed loan if certain conditions are met. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. The ASU is intended to reduce diversity in practice and is effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The adoption of this ASU in the first quarter of 2015 is not anticipated to have a material impact on the Company's consolidated financial statements.

In August 2014, the FASB issued ASU 2014-15, *Presentation of Financial Statements – Going Concern (Subtopic 205-40) Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*. The amendments in this ASU provide guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide certain related footnote disclosures. The ASU is intended to reduce diversity in the timing and content of footnote disclosures and is effective for all entities for the annual period ending after December 15, 2016 and for annual and interim periods thereafter. The adoption of this ASU in the fourth quarter of 2016 is not anticipated to have a material impact on the Company's consolidated financial statements.

(4) Derivative Instruments and Hedging Activities

The Company had commitments outstanding to extend credit to future borrowers that had not closed prior to the end of the quarter. The Company intends to sell these commitments, which are referred to as its mortgage pipeline. As commitments to originate or purchase loans enter the mortgage pipeline, the Company generally enters into commitments to sell the mortgage pipeline into the secondary market on a firm commitment or best efforts basis. The commitments to originate, purchase or sell loans on a firm commitment basis are derivatives and are recorded at market value. As a result of marking to market the mortgage pipeline and the related firm commitments to sell at September 30, 2014, the Company recorded an increase in other assets of \$11,000, an increase in other liabilities of \$12,000 and a loss included in the gain on sales of loans of \$1,000.

The current commitments to sell loans held for sale are derivatives that do not qualify for hedge accounting. As a result, these derivatives are marked to market and the related loans held for sale are recorded at the lower-of-cost-or-market. The Company recorded a decrease in other liabilities of \$4,000 and a gain included in the gain on sales of loans of \$4,000.

(5) Fair Value Measurements

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

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

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

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

The following table summarizes the assets and liabilities of the Company for which fair values are determined on a recurring basis as of September 30, 2014 and December 31, 2013.

Carrying value at September 30,
2014

| <i>(Dollars in thousands)</i> | Total | Level 1 | Level 2 | Level 3 |
|-------------------------------|------------|------------|---------|------------|
| Securities available for sale | \$ 140,541 | 0 | 140,541 | 0 |
| Mortgage loan commitments | 13 | 0 | 13 | 0 |
| Total | \$ 140,554 | 0 | 140,554 | 0 |

Carrying value at December 31,
2013

| <i>(Dollars in thousands)</i> | Total | Level 1 | Level 2 | Level 3 |
|-------------------------------|------------|------------|---------|------------|
| Securities available for sale | \$ 107,956 | 0 | 107,956 | 0 |
| Mortgage loan commitments | 2 | 0 | 2 | 0 |
| Total | \$ 107,958 | 0 | 107,958 | 0 |

There were no transfers between Levels 1, 2, or 3 during the three or nine-month periods ended September 30, 2014.

The Company may also be required, from time to time, to measure certain other financial assets at fair value on a nonrecurring basis in accordance with generally accepted accounting principles. These adjustments to fair value usually result from the application of the lower-of-cost-or-market accounting or write-downs of individual assets. For assets measured at fair value on a nonrecurring basis in the third quarter of 2014 that were still held at September 30, 2014, the following table provides the level of valuation assumptions used to determine each adjustment and the carrying value of the related individual assets or portfolios at September 30, 2014 and December 31, 2013.

| <i>(Dollars in thousands)</i> | Carrying value at September 30, 2014 | | | | Three months ended | Nine months ended |
|---------------------------------|---|------------|---------|------------|----------------------------|----------------------------|
| | Total | Level 1 | Level 2 | Level 3 | September 30, 2014 | September 30, 2014 |
| | | | | | Total gains (losses) | Total gains (losses) |
| Loans held for sale | \$1,235 | 0 | 1,235 | 0 | (67) | (3) |
| Mortgage servicing rights | 1,542 | 0 | 1,542 | 0 | 0 | 0 |
| Loans ⁽¹⁾ | 11,499 | 0 | 11,499 | 0 | 934 | 590 |
| Real estate, net ⁽²⁾ | 3,445 | 0 | 3,445 | 0 | (8) | (222) |
| Total | \$17,721 | 0 | 17,721 | 0 | 859 | 365 |

| <i>(Dollars in thousands)</i> | Carrying value at December 31, 2013 | | | | Year ended |
|---------------------------------|---|------------|---------|------------|--|
| | Total | Level 1 | Level 2 | Level 3 | December 31, 2013 Total gains (losses) |
| Loans held for sale | \$1,502 | 0 | 1,502 | 0 | 21 |
| Mortgage servicing rights | 1,708 | 0 | 1,708 | 0 | 0 |
| Loans ⁽¹⁾ | 17,498 | 0 | 17,498 | 0 | (1,728) |
| Real estate, net ⁽²⁾ | 6,898 | 0 | 6,898 | 0 | (429) |
| Total | \$27,606 | 0 | 27,606 | 0 | (2,136) |

- (1) Represents the carrying value and related specific reserves on loans for which adjustments are based on the appraised value of the collateral. The carrying value of loans fully charged-off is zero.
- (2) Represents the fair value and related losses of foreclosed real estate and other collateral owned that were measured at fair value subsequent to their initial classification as foreclosed assets.

(6) Fair Value of Financial Instruments

Generally accepted accounting principles require interim reporting period disclosure about the fair value of financial instruments, including assets, liabilities and off-balance sheet items for which it is practicable to estimate fair value. The fair value hierarchy level for each asset and liability, as defined in note 5, have been included in the following table for September 30, 2014. The fair value estimates are made based upon relevant market information, if available, and upon the characteristics of the financial instruments themselves. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based upon judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. The estimated fair value of the Company's financial instruments as of September 30, 2014 and December 31, 2013 are shown below.

| (Dollars in thousands) | September 30, 2014 | | | | | December 31, 2013 | | | | |
|-------------------------------|--------------------|----------------------|----------------------|---------|---------|-------------------|----------------------|----------------------|---------|---------|
| | Carrying amount | Estimated fair value | Fair value hierarchy | | | Carrying amount | Estimated fair value | Fair value hierarchy | | |
| | | | Level 1 | Level 2 | Level 3 | | | Level 1 | Level 2 | Level 3 |
| Financial assets: | | | | | | | | | | |
| Cash and cash equivalents | \$57,177 | 57,177 | 57,177 | | | 120,686 | 120,686 | 120,686 | | |
| Securities available for sale | 140,541 | 140,541 | | 140,541 | | 107,956 | 107,956 | | 107,956 | |
| Loans held for sale | 1,235 | 1,235 | | 1,235 | | 1,502 | 1,502 | | 1,502 | |
| Loans receivable, net | 365,572 | 365,017 | | 365,017 | | 384,615 | 388,263 | | 388,263 | |
| Federal Home Loan Bank stock | 777 | 777 | | 777 | | 784 | 784 | | 784 | |
| Accrued interest receivable | 1,786 | 1,786 | | 1,786 | | 1,953 | 1,953 | | 1,953 | |
| Financial liabilities: | | | | | | | | | | |
| Deposits | 504,908 | 504,908 | | 504,908 | | 553,930 | 553,930 | | 553,930 | |
| | 101 | 101 | | 101 | | 146 | 146 | | 146 | |

Accrued
interest
payable

Off-balance
sheet
financial
instruments:

Commitments
to extend credit

Commitments
to sell loans

13 13

184,568 2 2

126,8

(31) (31)

3,320 (22) (22)

2,025

Cash and Cash Equivalents

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

Securities Available for Sale

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

Loans Held for Sale

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

Loans Receivable, net

The fair value of the loan portfolio was calculated by discounting the scheduled cash flows through the estimated maturity using anticipated prepayment speeds and using discount rates that reflect the credit and interest rate risk inherent in each loan portfolio.

Federal Home Loan Bank Stock

The carrying amount of FHLB stock approximates its fair value.

Accrued Interest Receivable

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

Deposits

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

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

Accrued Interest Payable

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

Commitments to Extend Credit

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

Commitments to Sell Loans

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

(7) Other Comprehensive Income (Loss)

Other comprehensive income (loss) is defined as the change in equity during a period from transactions and other events from nonowner sources. Comprehensive income (loss) is the total of net income and other comprehensive income (loss), which for the Company is comprised of unrealized gains and losses on securities available for sale. The components of other comprehensive income (loss) and the related tax effects for the quarter and nine-months ended September 30, 2014 and 2013 were as follows:

| <i>(Dollars in thousands)</i> | For the three months ended September 30, | | | | | |
|---|--|------------|------------|------------|------------|------------|
| | 2014 | | | 2013 | | |
| Securities available for sale: | Before tax | Tax effect | Net of tax | Before tax | Tax effect | Net of tax |
| Net unrealized gains (losses) arising during the period | \$(234) | (164) | (70) | 473 | 0 | 473 |
| Other comprehensive income (loss) | \$(234) | (164) | (70) | 473 | 0 | 473 |

| <i>(Dollars in thousands)</i> | For the nine months ended September 30, | | | | | |
|---|---|------------|------------|------------|------------|------------|
| | 2014 | | | 2013 | | |
| Securities available for sale: | Before tax | Tax effect | Net of tax | Before tax | Tax effect | Net of tax |
| Net unrealized gains (losses) arising during the period | \$317 | 15 | 302 | (1,045) | 0 | (1,045) |
| Other comprehensive income (loss) | \$317 | 15 | 302 | (1,045) | 0 | (1,045) |

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

(8) Securities Available For Sale

The following table shows the gross unrealized losses and fair value for the securities available for sale portfolio, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2014 and December 31, 2013.

| | September 30, 2014 | | | | | | | Unrealized Losses |
|---------------------------------------|-------------------------|------------|-------------------|-----------------------|------------|-------------------|-------------------|-------------------|
| | Less than twelve months | | | Twelve months or more | | | Total Fair Value | |
| (Dollars in thousands) | # of Investments | Fair Value | Unrealized Losses | # of Investments | Fair Value | Unrealized Losses | | |
| Other marketable securities: | | | | | | | | |
| U.S. Government agency obligations | 14 | \$66,690 | \$ (310) | 2 | \$9,971 | \$ (51) | \$76,661 \$ (361) | |
| Corporate preferred stock | 0 | 0 | 0 | 1 | 420 | (280) | 420 (280) | |
| Total temporarily impaired securities | 14 | \$66,690 | \$ (310) | 3 | \$10,391 | \$ (331) | \$77,081 \$ (641) | |

| | December 31, 2013 | | | | | | | Unrealized Losses |
|---------------------------------------|-------------------------|------------|-------------------|-----------------------|------------|-------------------|---------------------|-------------------|
| | Less than twelve months | | | Twelve months or more | | | Total Fair Value | |
| (Dollars in thousands) | # of Investments | Fair Value | Unrealized Losses | # of Investments | Fair Value | Unrealized Losses | | |
| Other marketable securities: | | | | | | | | |
| U.S. Government agency obligations | 20 | \$93,390 | \$ (637) | 0 | \$0 | \$0 | \$93,390 \$ (637) | |
| Corporate preferred stock | 0 | 0 | 0 | 1 | 280 | (420) | 280 (420) | |
| Total temporarily impaired securities | 20 | \$93,390 | \$ (637) | 1 | \$280 | \$ (420) | \$93,670 \$ (1,057) | |

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

The unrealized losses reported for corporate preferred stock at September 30, 2014 was related to a single trust preferred security that was issued by the holding company of a small community bank. Typical of most trust preferred issuances, the issuer has the ability to defer interest payments for up to five years with interest payable on the deferred balance. In October 2009, the issuer elected to defer its scheduled interest payments as allowed by the terms of the security agreement. In September 2014, the issuer paid all deferred interest that was due and the note was current as of

September 30, 2014. The issuer's subsidiary bank has incurred operating losses due to increased provisions for loan losses but still meets the regulatory requirements to be considered "well capitalized" based on its most recent regulatory filing. Based on a review of the issuer, it was determined that the trust preferred security was not other-than-temporarily impaired at September 30, 2014. The Company does not intend to sell the preferred stock and has the intent and ability to hold it for a period of time sufficient to recover the temporary loss. Management believes that the Company will receive all principal and interest payments contractually due on the security and that the decrease in the market value is primarily due to a lack of liquidity in the market for trust preferred securities. Management will continue to monitor the credit risk of the issuer and may be required to recognize other-than-temporary impairment charges on this security in future periods.

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A summary of securities available for sale at September 30, 2014 and December 31, 2013 is as follows:

(Dollars in thousands)

| | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| <u>September 30, 2014:</u> | | | | |
| Mortgage-backed securities: | | | | |
| Federal Home Loan Mortgage Corporation (FHLMC) | \$ 1,656 | 105 | 0 | 1,761 |
| Federal National Mortgage Association (FNMA) | 1,520 | 80 | 0 | 1,600 |
| | 3,176 | 185 | 0 | 3,361 |
| Other marketable securities: | | | | |
| U.S. Government agency obligations | 137,022 | 35 | (361) |) 136,696 |
| Corporate equity | 58 | 6 | 0 | 64 |
| Corporate preferred stock | 700 | 0 | (280) |) 420 |
| | 137,780 | 41 | (641) |) 137,180 |
| | \$ 140,956 | 226 | (641) |) 140,541 |

(Dollars in thousands)

| | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
|------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| <u>December 31, 2013:</u> | | | | |
| Mortgage-backed securities: | | | | |
| FHLMC | \$ 2,749 | 183 | 0 | 2,932 |
| FNMA | 2,150 | 131 | 0 | 2,281 |
| | 4,899 | 314 | 0 | 5,213 |
| Other marketable securities: | | | | |
| U.S. Government agency obligations | 103,030 | 1 | (637) |) 102,394 |
| Corporate equity | 58 | 11 | 0 | 69 |
| Corporate preferred stock | 700 | 0 | (420) |) 280 |
| | 103,788 | 12 | (1,057) |) 102,743 |
| | \$ 108,687 | 326 | (1,057) |) 107,956 |

The following table indicates amortized cost and estimated fair value of securities available for sale at September 30, 2014 based upon contractual maturity adjusted for scheduled repayments of principal and projected prepayments of principal based upon current economic conditions and interest rates.

(Dollars in thousands)

| | Amortized Cost | Fair Value |
|------------------------|-------------------|---------------|
| Due less than one year | \$ 113,306 | 113,182 |

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| | | |
|--|------------|---------|
| Due after one year through five years | 26,892 | 26,875 |
| Due after five years through ten years | 0 | 0 |
| Due after ten years | 700 | 420 |
| No stated maturity | 58 | 64 |
| Total | \$ 140,956 | 140,541 |

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

(9) Loans Receivable, Net

A summary of loans receivable at September 30, 2014 and December 31, 2013 is as follows:

| <i>(Dollars in thousands)</i> | September 30, 2014 | December 31, 2013 |
|-------------------------------|--------------------------|-------------------------|
| 1-4 family | \$ 69,353 | 76,467 |
| Commercial real estate: | | |
| Residential developments | 23,832 | 32,984 |
| Other | 164,303 | 161,466 |
| Consumer | 188,135 54,809 | 194,450 53,423 |
| Commercial business: | | |
| Construction industry | 6,112 | 6,334 |
| Other | 55,041 61,153 | 65,375 71,709 |
| Total loans | 373,450 | 396,049 |
| Less: | | |
| Unamortized discounts | 17 | 33 |
| Net deferred loan costs | (62) | 0 |
| Allowance for loan losses | 7,923 | 11,401 |
| Total loans receivable, net | \$ 365,572 | 384,615 |

(10) Allowance for Loan Losses and Credit Quality Information

The allowance for loan losses for the three and nine months ended September 30, 2014 and 2013 is summarized as follows:

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| <i>(Dollars in thousands)</i> | 1-4 Family | Commercial Real Estate | Consumer | Commercial Business | Total |
|---|---------------|---------------------------|----------|------------------------|----------|
| <u>For the three months ended September 30, 2014:</u> | | | | | |
| Balance, June 30, 2014 | \$2,085 | 3,823 | 1,164 | 1,624 | 8,696 |
| Provision for losses | (489) | 14 | (16) | (498) | (989) |
| Charge-offs | 0 | 0 | (15) | (55) | (70) |
| Recoveries | 0 | 229 | 10 | 47 | 286 |
| Balance, September 30, 2014 | \$1,596 | 4,066 | 1,143 | 1,118 | 7,923 |
| <u>For the nine months ended September 30, 2014:</u> | | | | | |
| Balance, December 31, 2013 | \$1,628 | 6,458 | 1,106 | 2,209 | 11,401 |
| Provision for losses | 60 | (3,588) | 83 | (1,332) | (4,777) |
| Charge-offs | (92) | (936) | (75) | (56) | (1,159) |
| Recoveries | 0 | 2,132 | 29 | 297 | 2,458 |
| Balance, September 30, 2014 | \$1,596 | 4,066 | 1,143 | 1,118 | 7,923 |
| Allocated to: | | | | | |
| Specific reserves | \$404 | 2,403 | 382 | 589 | 3,778 |
| General reserves | 1,224 | 4,055 | 724 | 1,620 | 7,623 |
| Balance, December 31, 2013 | \$1,628 | 6,458 | 1,106 | 2,209 | 11,401 |
| Allocated to: | | | | | |
| Specific reserves | \$277 | 384 | 431 | 180 | 1,272 |
| General reserves | 1,319 | 3,682 | 712 | 938 | 6,651 |
| Balance, September 30, 2014 | \$1,596 | 4,066 | 1,143 | 1,118 | 7,923 |
| <u>Loans receivable at December 31, 2013:</u> | | | | | |
| Individually reviewed for impairment | \$1,888 | 17,190 | 917 | 1,281 | 21,276 |
| Collectively reviewed for impairment | 74,579 | 177,260 | 52,506 | 70,428 | 374,773 |
| Ending balance | \$76,467 | 194,450 | 53,423 | 71,709 | 396,049 |
| <u>Loans receivable at September 30, 2014:</u> | | | | | |
| Individually reviewed for impairment | \$1,341 | 9,714 | 942 | 769 | 12,766 |
| Collectively reviewed for impairment | 68,012 | 178,421 | 53,867 | 60,384 | 360,684 |
| Ending balance | \$69,353 | 188,135 | 54,809 | 61,153 | 373,450 |

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| <i>(Dollars in thousands)</i> | 1-4 Family | Commercial Real Estate | Consumer | Commercial Business | Total |
|---|---------------|---------------------------|----------|------------------------|----------|
| <u>For the three months ended September 30, 2013:</u> | | | | | |
| Balance, June 30, 2013 | \$2,059 | 14,089 | 1,431 | 2,780 | 20,359 |
| Provision for losses | (675) | (3,512) | (58) | (85) | (4,330) |
| Charge-offs | 0 | (2) | (374) | (50) | (426) |
| Recoveries | 0 | 711 | 14 | 177 | 902 |
| Balance, September 30, 2013 | \$1,384 | 11,286 | 1,013 | 2,822 | 16,505 |
| <u>For the nine months ended September 30, 2013:</u> | | | | | |
| Balance, December 31, 2012 | \$2,821 | 13,588 | 1,146 | 4,053 | 21,608 |
| Provision for losses | (1,250) | (2,646) | 256 | (1,210) | (4,850) |
| Charge-offs | (200) | (911) | (475) | (606) | (2,192) |
| Recoveries | 13 | 1,255 | 86 | 585 | 1,939 |
| Balance, September 30, 2013 | \$1,384 | 11,286 | 1,013 | 2,822 | 16,505 |

The following table summarizes the amount of classified and unclassified loans at September 30, 2014 and December 31, 2013:

| <i>(Dollars in thousands)</i> | September 30, 2014 | | | | | Unclassified | |
|-------------------------------|----------------------------------|-------------|----------|------|--------|--------------|----------------|
| | Classified Special Mention | Substandard | Doubtful | Loss | Total | Total | Total Loans |
| 1-4 family | \$ 0 | 5,010 | 213 | 0 | 5,223 | 64,130 | 69,353 |
| Commercial real estate: | | | | | | | |
| Residential developments | 0 | 10,080 | 0 | 0 | 10,080 | 13,752 | 23,832 |
| Other | 274 | 8,844 | 0 | 0 | 9,118 | 155,185 | 164,303 |
| Consumer | 0 | 496 | 148 | 298 | 942 | 53,867 | 54,809 |
| Commercial business: | | | | | | | |
| Construction industry | 35 | 442 | 0 | 0 | 477 | 5,635 | 6,112 |
| Other | 810 | 1,596 | 0 | 0 | 2,406 | 52,635 | 55,041 |
| | \$ 1,119 | 26,468 | 361 | 298 | 28,246 | 345,204 | 373,450 |
| | December 31, 2013 | | | | | Unclassified | |
| <i>(Dollars in thousands)</i> | Classified Special Mention | Substandard | Doubtful | Loss | Total | Total | Total Loans |

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| | | | | | | | |
|--------------------------|---------|--------|-----|-----|--------|---------|---------|
| 1-4 family | \$738 | 6,987 | 322 | 0 | 8,047 | 68,420 | 76,467 |
| Commercial real estate: | | | | | | | |
| Residential developments | 0 | 19,229 | 0 | 0 | 19,229 | 13,755 | 32,984 |
| Other | 5,337 | 13,092 | 0 | 0 | 18,429 | 143,037 | 161,466 |
| Consumer | 0 | 524 | 152 | 240 | 916 | 52,507 | 53,423 |
| Commercial business: | | | | | | | |
| Construction industry | 0 | 401 | 0 | 0 | 401 | 5,933 | 6,334 |
| Other | 1,419 | 6,433 | 0 | 0 | 7,852 | 57,523 | 65,375 |
| | \$7,494 | 46,666 | 474 | 240 | 54,874 | 341,175 | 396,049 |

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

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The aging of past due loans at September 30, 2014 and December 31, 2013 is summarized as follows:

| <i>(Dollars in thousands)</i> | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or More Past Due | Total Past Due | Current Loans | Total Loans | Loans 90 Days or More Past Due and Still Accruing |
|-------------------------------|------------------------------|------------------------------|---|----------------------|------------------|----------------|--|
| <i>September 30, 2014</i> | | | | | | | |
| 1-4 family | \$774 | 723 | 375 | 1,872 | 67,481 | 69,353 | 0 |
| Commercial real estate: | | | | | | | |
| Residential developments | 0 | 0 | 0 | 0 | 23,832 | 23,832 | 0 |
| Other | 439 | 126 | 0 | 565 | 163,738 | 164,303 | 0 |
| Consumer | 170 | 116 | 111 | 397 | 54,412 | 54,809 | 0 |
| Commercial business: | | | | | | | |
| Construction industry | 31 | 0 | 0 | 31 | 6,081 | 6,112 | 0 |
| Other | 134 | 0 | 0 | 134 | 54,907 | 55,041 | 0 |
| | \$1,548 | 965 | 486 | 2,999 | 370,451 | 373,450 | 0 |
| <i>December 31, 2013</i> | | | | | | | |
| 1-4 family | \$1,542 | 128 | 322 | 1,992 | 74,475 | 76,467 | 0 |
| Commercial real estate: | | | | | | | |
| Residential developments | 0 | 1,426 | 0 | 1,426 | 31,558 | 32,984 | 0 |
| Other | 0 | 0 | 0 | 0 | 161,466 | 161,466 | 0 |
| Consumer | 418 | 256 | 57 | 731 | 52,692 | 53,423 | 0 |
| Commercial business: | | | | | | | |
| Construction industry | 0 | 1,934 | 0 | 1,934 | 4,400 | 6,334 | 0 |
| Other | 800 | 104 | 0 | 904 | 64,471 | 65,375 | 0 |

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\$2,760 3,848 379 6,987 389,062 396,049 0

Impaired loans include loans that are non-performing (non-accruing) and loans that have been modified in a troubled debt restructuring (TDR). The following table summarizes impaired loans and related allowances as of September 30, 2014 and December 31, 2013:

| <i>(Dollars in thousands)</i> | September 30, 2014 | | | December 31, 2013 | | |
|---|---------------------|--------------------------|-------------------|---------------------|--------------------------|-------------------|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| Loans with no related allowance recorded: | | | | | | |
| 1-4 family | \$303 | 303 | 0 | 88 | 88 | 0 |
| Commercial real estate: | | | | | | |
| Residential developments | 7,586 | 10,239 | 0 | 8,257 | 13,636 | 0 |
| Other | 50 | 228 | 0 | 52 | 52 | 0 |
| Consumer | 469 | 473 | 0 | 487 | 491 | 0 |
| Commercial business: | | | | | | |
| Construction industry | 84 | 223 | 0 | 93 | 296 | 0 |
| Other | 0 | 0 | 0 | 0 | 0 | 0 |
| Loans with an allowance recorded: | | | | | | |
| 1-4 family | 1,038 | 1,038 | 277 | 1,800 | 1,844 | 404 |
| Commercial real estate: | | | | | | |
| Residential developments | 1,216 | 1,217 | 223 | 7,994 | 12,725 | 2,260 |
| Other | 862 | 862 | 161 | 888 | 888 | 143 |
| Consumer | 473 | 490 | 431 | 429 | 429 | 382 |
| Commercial business: | | | | | | |
| Construction industry | 0 | 0 | 0 | 0 | 0 | 0 |
| Other | 685 | 1,237 | 180 | 1,188 | 1,984 | 589 |
| Total: | | | | | | |

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| | | | | | | |
|--------------------------|----------|--------|-------|--------|--------|-------|
| 1-4 family | 1,341 | 1,341 | 277 | 1,888 | 1,932 | 404 |
| Commercial real estate: | | | | | | |
| Residential developments | 8,802 | 11,456 | 223 | 16,251 | 26,361 | 2,260 |
| Other | 912 | 1,090 | 161 | 940 | 940 | 143 |
| Consumer | 942 | 963 | 431 | 916 | 920 | 382 |
| Commercial business: | | | | | | |
| Construction industry | 84 | 223 | 0 | 93 | 296 | 0 |
| Other | 685 | 1,237 | 180 | 1,188 | 1,984 | 589 |
| | \$12,766 | 16,310 | 1,272 | 21,276 | 32,433 | 3,778 |

The following tables summarize average recorded investment and interest income recognized on impaired loans during the three and nine months ended September 30, 2014 and 2013.

| <i>(Dollars in thousands)</i> | For the three months ended September 30, 2014 | | For the nine months ended September 30, 2014 | |
|---|---|------------------------|--|------------------------|
| | Average Recorded Investment | Interest Recognized | Average Recorded Investment | Interest Recognized |
| Loans with no related allowance recorded: | | | | |
| 1-4 family | \$234 | 3 | 352 | 6 |
| Commercial real estate: | | | | |
| Residential developments | 7,691 | 102 | 7,688 | 112 |
| Other | 51 | 5 | 51 | 5 |
| Consumer | 456 | 8 | 468 | 10 |
| Commercial business: | | | | |
| Construction industry | 86 | 0 | 89 | 0 |
| Other | 0 | 0 | 0 | 0 |
| Loans with an allowance recorded: | | | | |
| 1-4 family | 1,606 | 6 | 1,651 | 13 |
| Commercial real estate: | | | | |
| Residential developments | 1,153 | 0 | 3,521 | 0 |
| Other | 866 | 9 | 874 | 24 |
| Consumer | 489 | 3 | 479 | 9 |
| Commercial business: | | | | |
| Construction industry | 0 | 0 | 0 | 0 |
| Other | 981 | 8 | 990 | 23 |

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Total:

| | | | | |
|--------------------------|----------|-----|--------|-----|
| 1-4 family | 1,840 | 9 | 2,003 | 19 |
| Commercial real estate: | | | | |
| Residential developments | 8,844 | 102 | 11,209 | 112 |
| Other | 917 | 14 | 925 | 29 |
| Consumer | 945 | 11 | 947 | 19 |
| Commercial business: | | | | |
| Construction industry | 86 | 0 | 89 | 0 |
| Other | 981 | 8 | 990 | 23 |
| | \$13,613 | 144 | 16,163 | 202 |

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| <i>(Dollars in thousands)</i> | For the three months ended September 30, 2013 | | For the nine months ended September 30, 2013 | |
|---|---|----------------------------------|--|----------------------------------|
| | Average Recorded Investment | Interest Income Recognized | Average Recorded Investment | Interest Income Recognized |
| Loans with no related allowance recorded: | | | | |
| 1-4 family | \$1,589 | 31 | 1,608 | 46 |
| Commercial real estate: | | | | |
| Residential developments | 9,127 | 29 | 9,338 | 43 |
| Other | 335 | 16 | 424 | 18 |
| Consumer | 309 | 5 | 315 | 8 |
| Commercial business: | | | | |
| Construction industry | 98 | 0 | 90 | 0 |
| Other | 0 | 0 | 9 | 0 |
| Loans with an allowance recorded: | | | | |
| 1-4 family | 2,272 | 6 | 2,571 | 19 |
| Commercial real estate: | | | | |
| Residential developments | 12,031 | 27 | 13,519 | 41 |
| Other | 1,856 | 228 | 2,249 | 232 |
| Consumer | 998 | 7 | 1,221 | 18 |
| Commercial business: | | | | |
| Construction industry | 0 | 0 | 36 | 0 |
| Other | 1,332 | 17 | 1,791 | 28 |
| Total: | | | | |
| 1-4 family | 3,861 | 37 | 4,179 | 65 |
| Commercial real estate: | | | | |

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

At September 30, 2014 and December 31, 2013, non-accruing loans totaled \$10.4 million and \$17.5 million, respectively, for which the related allowance for loan losses was \$0.9 million and \$3.4 million, respectively. The decrease in the related allowances is due primarily to two commercial real estate loans that were paid off during the third quarter of 2014. All of the interest income that was recognized for non-accruing loans was recognized using the cash basis method of income recognition. Non-accruing loans for which no specific allowance has been recorded, because management determined that the value of the collateral was sufficient to repay the loan, totaled \$7.7 million and \$7.8 million at September 30, 2014 and December 31, 2013, respectively. Non-accrual loans also include certain loans that have had terms modified in a TDR.

The non-accrual loans at September 30, 2014 and December 31, 2013 are summarized as follows:

| <i>(Dollars in thousands)</i> | September 30, 2014 | December 31, 2013 |
|-------------------------------|-----------------------|----------------------|
| 1-4 family | \$ 984 | \$ 1,602 |
| Commercial real estate: | | |
| Residential developments | 8,310 | 14,146 |
| Other | 420 | 403 |
| Consumer | 533 | 737 |
| Commercial business: | | |
| Construction industry | 84 | 93 |
| Other | 63 | 515 |
| | \$ 10,394 | \$ 17,496 |

At September 30, 2014 and December 31, 2013 there were loans included in loans receivable, net, with terms that had been modified in a TDR totaling \$11.5 million and \$19.2 million, respectively. There were no loans modified in the third quarter of 2014. Of the \$0.5 million in loans that were restructured in the third quarter of 2013, no loans were classified but performing, and \$0.5 million were non-performing at September 30, 2013.

The following table summarizes TDRs at September 30, 2014 and December 31, 2013:

| <i>(Dollars in thousands)</i> | September 30, 2014 | | | December 31, 2013 | | |
|-------------------------------|--------------------|-------------|--------|-------------------|-------------|--------|
| | Accrual | Non-Accrual | Total | Accrual | Non-Accrual | Total |
| 1-4 Family | \$357 | 84 | 441 | 285 | 624 | 909 |
| Commercial real estate | 984 | 8,472 | 9,456 | 2,642 | 13,817 | 16,459 |
| Consumer | 409 | 332 | 741 | 180 | 533 | 713 |
| Commercial business | 622 | 199 | 821 | 673 | 475 | 1,148 |
| | \$2,372 | 9,087 | 11,459 | 3,780 | 15,449 | 19,229 |

There were no material commitments to lend additional funds to customers whose loans were restructured or classified as nonaccrual at September 30, 2014 or December 31, 2013.

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

When a loan is modified as a TDR, there may be a direct, material impact on the loans within the balance sheet, as principal balances may be partially forgiven. The financial effects of TDRs are presented in the following tables and represent the difference between the outstanding recorded balance pre-modification and post-modification, for the three month and nine month periods ended September 30, 2014 and 2013.

| <i>(Dollars in thousands)</i> | Three Months Ended | | | Nine Months Ended | | |
|-------------------------------|---|--|--|---|--|--|
| | September 30, 2014 | | | September 30, 2014 | | |
| | Pre-modification Number of Recorded Contracts Investment | Post-modification Outstanding Recorded Investment | | Pre-modification Number of Recorded Contracts Investment | Post-modification Outstanding Recorded Investment | |

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| | | | | | | |
|-------------------------------|---|----|---|----|---|-----------------|
| Troubled debt restructurings: | | | | | | |
| 1-4 family | 0 | \$ | 0 | \$ | 0 | 2 \$ 760 \$ 760 |
| Commercial real estate: | | | | | | |
| Residential developments | 0 | | 0 | | 0 | 0 |
| Other | 0 | | 0 | | 0 | 0 |
| Consumer | 0 | | 0 | | 4 | 155 140 |
| Commercial business: | | | | | | |
| Construction industry | 0 | | 0 | | 0 | 0 |
| Other | 0 | | 0 | | 0 | 0 |
| Total | 0 | \$ | 0 | \$ | 0 | 6 \$ 915 \$ 900 |

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

Loans that were restructured within the 12 months preceding September 30, 2014 that defaulted during the three and nine month periods ended September 30, 2014 are presented in the following table:

| <i>(Dollars in thousands)</i> | Three Months Ended | | Nine Months Ended | |
|---|---------------------|---------------------------------|---------------------|---------------------------------|
| | September 30, 2014 | | September 30, 2014 | |
| | Number of Contracts | Outstanding Recorded Investment | Number of Contracts | Outstanding Recorded Investment |
| Troubled debt restructurings that subsequently defaulted: | | | | |
| 1-4 family | 0 | \$ 0 | 1 | \$ 640 |
| Commercial real estate: | | | | |

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| | | | | |
|--------------------------|---|------|---|--------|
| Residential developments | 0 | 0 | 0 | 0 |
| Other | 0 | 0 | 0 | 0 |
| Consumer | 0 | 0 | 0 | 0 |
| Commercial business: | | | | |
| Construction industry | 0 | 0 | 0 | 0 |
| Other | 0 | 0 | 0 | 0 |
| Total | 0 | \$ 0 | 1 | \$ 640 |

None of the loans that were restructured within the 12 months preceding September 30, 2013 defaulted during the three and nine months ended September 30, 2013.

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

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

TDRs are reviewed for impairment following the same methodology as other impaired loans. For loans that are collateral dependent, the value of the collateral is reviewed and additional reserves may be added as needed. Loans that are not collateral dependent may have additional reserves established if deemed necessary. The allowance for loan losses on TDRs was \$0.6 million, or 7.9%, of the total \$7.9 million in loan loss reserves at September 30, 2014 and \$2.9 million, or 25.6%, of the total \$11.4 million in loan loss reserves at December 31, 2013.

(11) Investment in Mortgage Servicing Rights

A summary of mortgage servicing rights activity is as follows:

| <i>(Dollars in thousands)</i> | Nine Months ended | Twelve Months ended | Nine Months ended |
|---|-------------------------|---------------------------|-------------------------|
| | September 30, 2014 | December 31, 2013 | September 30, 2013 |
| Mortgage servicing rights: | | | |
| Balance, beginning of period | \$ 1,708 | 1,732 | 1,732 |
| Originations | 219 | 568 | 500 |
| Amortization | (385) | (592) | (463) |
| Balance, end of period | \$ 1,542 | 1,708 | 1,769 |
| Fair value of mortgage servicing rights | \$ 2,661 | 2,801 | 2,919 |

All of the loans being serviced are single family loans serviced for the Federal National Mortgage Association (FNMA) under the individual loan sale program. The following is a summary of the risk characteristics of the loans being serviced at September 30, 2014.

| <i>(Dollars in thousands)</i> | Loan Principal Balance | Weighted Average Interest Rate | Weighted Average Remaining Term (months) | Number of Loans |
|----------------------------------|------------------------------|---|--|-----------------------|
| Original term 30 year fixed rate | \$203,193 | 4.33 | 299 | 1,746 |
| Original term 15 year fixed rate | 112,657 | 3.38 | 141 | 1,272 |
| Adjustable rate | 185 | 3.90 | 319 | 4 |

The gross carrying amount of mortgage servicing rights and the associated accumulated amortization at September 30, 2014 and 2013 is presented in the table below.

| | |
|--------------------|-------------|
| September 30, 2014 | |
| Gross | Unamortized |

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| <i>(Dollars in thousands)</i> | Carrying Amount | Accumulated Amortization | | Mortgage Servicing Rights |
|-------------------------------|-----------------|--------------------------|---|---------------------------|
| Mortgage servicing rights | \$3,597 | (2,055 |) | 1,542 |
| Total | \$3,597 | (2,055 |) | 1,542 |

| | September 30, 2013 | | | Unamortized |
|-------------------------------|--------------------|--------------------------|---|---------------------------|
| <i>(Dollars in thousands)</i> | Carrying Amount | Accumulated Amortization | | Mortgage Servicing Rights |
| Mortgage servicing rights | \$2,585 | (816 |) | 1,769 |
| Total | \$2,585 | (816 |) | 1,769 |

Amortization expense for mortgage servicing rights was \$385,000 and \$463,000 respectively, for the nine-month periods ended September 30, 2014 and 2013. The following table indicates the estimated future amortization expense for mortgage servicing rights:

| <i>(Dollars in thousands)</i> | Mortgage Servicing Rights |
|-------------------------------|---------------------------|
| Year ended December 31, | |
| 2014 | \$ 107 |
| 2015 | 417 |
| 2016 | 372 |
| 2017 | 286 |
| 2018 | 187 |
| Thereafter | 173 |
| | \$ 1,542 |

Projections of amortization are based on existing asset balances and the existing interest rate environment as of September 30, 2014. The Company's actual experience may be significantly different depending upon changes in mortgage interest rates and other market conditions.

(12) Earnings per Common Share

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|--|-------|---------------------------------------|-------|
| | 2014 | 2013 | 2014 | 2013 |
| <i>(Dollars in thousands, except per share data)</i> | | | | |
| Weighted average number of common shares outstanding used in basic earnings per common share calculation | 4,067 | 4,000 | 4,053 | 3,996 |
| Net dilutive effect of: | | | | |
| Options | 520 | 310 | 499 | 221 |
| Restricted stock awards | 62 | 31 | 57 | 40 |
| Weighted average number of shares outstanding adjusted for effect of dilutive securities | 4,649 | 4,341 | 4,609 | 4,257 |
| Income available to common shareholders | \$1,178 | 5,511 | 4,283 | 7,028 |
| Basic earnings per common share | \$0.29 | 1.38 | 1.06 | 1.76 |
| Diluted earnings per common share | \$0.25 | 1.27 | 0.93 | 1.65 |

(13) Regulatory Capital and Regulatory Oversight

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

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

The Bank entered into a written Supervisory Agreement with the OTS, effective February 22, 2011, that primarily related to the Bank's financial performance and credit quality issues. In addition, the OCC established an Individual Minimum Capital Requirement (IMCR) for the Bank, effective December 31, 2011. An IMCR requires a bank to establish and maintain levels of capital greater than those generally required for a bank to be classified as "well-capitalized." Effective February 11, 2014, the OCC terminated the Supervisory Agreement and the IMCR to which the Bank was subject.

The Company also entered into a written Supervisory Agreement with the OTS effective February 22, 2011. As required by the Supervisory Agreement, the Company submitted an updated two year consolidated capital plan in January of 2014. The Company was required to operate within the parameters of that capital plan and was required to monitor and submit periodic reports on its compliance with the plan. In addition, without the consent of the FRB, the Company could not incur or issue any debt, guarantee the debt of any entity, declare or pay any cash dividends or repurchase any of the Company's capital stock, enter into any new contractual arrangement or renew or extend any existing arrangement related to compensation or benefits with any director or officer, or make any golden parachute payments. Effective May 1, 2014, the FRB terminated the Supervisory Agreement to which the Company was subject.

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

On September 30, 2014, the Bank's tangible assets were \$593.2 million, its adjusted total assets were \$582.5 million, and its risk-weighted assets were \$395.1 million. The following table presents the Bank's capital amounts and ratios at September 30, 2014 for actual capital, required capital and excess capital, including ratios in order to qualify as being well capitalized under the Prompt Corrective Actions regulations.

| | Actual | | Required to be Adequately Capitalized | | Excess Capital | | To Be Well Capitalized Under Prompt Corrective Actions Provisions ⁽¹⁾ | |
|---|----------|----------------------------------|---------------------------------------|----------------------------------|----------------|----------------------------------|--|----------------------------------|
| | Amount | Percent of Assets ⁽²⁾ | Amount | Percent of Assets ⁽²⁾ | Amount | Percent of Assets ⁽²⁾ | Amount | Percent of Assets ⁽²⁾ |
| <i>(Dollars in thousands)</i> | | | | | | | | |
| Bank stockholder's equity | \$78,557 | | | | | | | |
| Plus: | | | | | | | | |
| Net unrealized losses on certain securities available for sale and cash flow hedges | 372 | | | | | | | |
| Less: | | | | | | | | |
| Disallowed servicing and tax assets | (11,032) | | | | | | | |
| Tier I or core capital | 67,897 | | | | | | | |
| Tier I capital to adjusted total assets | | 11.66 % | \$23,300 | 4.00 % | \$44,596 | 7.66 % | \$29,125 | 5.00 % |
| Tier I capital to risk-weighted assets | | 17.18 % | \$15,805 | 4.00 % | \$52,092 | 13.18 % | \$23,707 | 6.00 % |
| Plus: | | | | | | | | |
| Allowable allowance for loan losses | 4,975 | | | | | | | |
| Risk-based capital | \$72,872 | | \$31,610 | | \$41,263 | | \$39,512 | |
| Risk-based capital to risk-weighted assets | | 18.44 % | | 8.00 % | | 10.44 % | | 10.00 % |

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

Management believes that, as of September 30, 2014, the Bank's capital ratios were in excess of those quantitative capital ratio standards set forth under the current prompt corrective action regulations described above. However, there can be no assurance that the Bank will continue to maintain such status in the future, under the current rules or new rules described below. The OCC has extensive discretion in its supervisory and enforcement activities, and can adjust the requirement to be "well-capitalized" in the future.

The capital requirements of the Company and the Bank will be affected in the future by regulatory changes approved in the final rules issued in July 2013 by the FRB and the OCC to establish an integrated regulatory capital framework for implementing the Basel III reforms of the Basel Committee on Banking Supervision for the Bank of International Settlements. The new requirements, which will be effective beginning on January 1, 2015, will, among other things, apply a strengthened set of capital requirements to both the Bank and the Company, including new requirements relating to common equity as a component of core capital and as a "capital conservation buffer" against risk, and a higher minimum core capital requirement, and will revise the rules for calculating risk-weighted assets for purposes of such requirements. The final rules make corresponding revisions to the prompt corrective action framework. Under the final rules, certain changes including the new capital ratio and buffer requirements will be phased in incrementally, with full implementation scheduled for January 1, 2019. The Company believes that the impact that these new capital standards will have on the Bank's and Company's capital positions will not be material when they are implemented on January 1, 2015.

(14) Preferred Stock

The Company's certificate of incorporation authorizes the issuance of up to 500,000 shares of preferred stock, and on December 23, 2008, the Company completed the sale of 26,000 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the "Preferred Stock") to the United States Treasury. The Preferred Stock has a liquidation value of \$1,000 per share and a related warrant was also issued to purchase 833,333 shares of HMN common stock at an exercise price of \$4.68 per share. The transaction was part of the United States Treasury's Capital Purchase Program under the Emergency Economic Stabilization Act of 2008. Under the terms of the certificate of designations for the Preferred Stock, dividend payments may be deferred, but the dividend is cumulative and compounds quarterly during the deferral period. In addition, if the Company fails to pay dividends for six quarters, whether or not consecutive, the holders of the Preferred Stock have the right to appoint two representatives to the Company's board of directors. While dividends on the Preferred Stock are in arrears, no dividend may be paid on the common stock of the Company.

On May 15, 2014, the Company paid a dividend of \$201.71 per share on the Company's outstanding Preferred Stock. The amount of the dividend represented all accrued and unpaid dividends on the Preferred Stock for all past dividend periods and for the dividend period ended on May 14, 2014. On May 15, 2014, the Company also redeemed 10,000 shares of outstanding Preferred Stock on a pro rata basis at \$1,000 per share. Following the redemption, 16,000 shares of Preferred Stock remained outstanding. On August 15, 2014, the Company paid a dividend of \$22.50 per share on the Company's outstanding Preferred Stock. The amount of the dividend represented all accrued and unpaid dividends on the Preferred Stock for the dividend period ended on August 14, 2014. The Company did not pay any dividends on or redeem any shares of the Preferred Stock during the nine months ended September 30, 2013.

On October 9, 2014, the Company announced that its Board of Directors declared a dividend of \$22.50 per share on the Company's outstanding Preferred Stock. The amount of the dividend represents all accrued and unpaid dividends on the Preferred Stock for the dividend period ending on November 14, 2014. The dividend will be payable on November 17, 2014 to holders of record of the Preferred Stock on October 7, 2014. Also on October 9, 2014, the Company announced that it will redeem 6,000 shares of the Preferred Stock on a pro rata basis from holders of record of the Preferred Stock on October 7, 2014. The effective date of the redemption will be November 17, 2014. Giving effect to the dividend to be paid on the same date, the redemption price per share will be \$1,000. Following the redemption, 10,000 shares of Preferred Stock will remain outstanding. The Company has requested and received all applicable approvals from regulatory authorities to pay the Preferred Stock dividend and effect the Preferred Stock redemption.

The reduction in the number of outstanding shares of Preferred Stock will, from and after November 15, 2014, reduce the quarterly Preferred Stock dividend accrual from \$360,000 to \$225,000.

Treasury continues to hold the warrant to purchase 833,333 shares of the Company's common stock at an exercise price of \$4.68, which Treasury may sell in its discretion at any time, subject to applicable securities laws and the Company's right to repurchase the warrant at fair market value under the terms of the Company's agreements with Treasury. The warrant may be exercised at any time over its ten-year term, which expires on December 23, 2018, and Treasury has agreed not to exercise any voting rights received by acquiring common stock on the exercise of the warrant.

(15) Commitments and Contingencies

The Bank issued standby letters of credit which guarantee the performance of customers to third parties. The standby letters of credit issued and available at September 30, 2014 were approximately \$2.2 million, expire over the next twenty-one months, 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.

(16) Business Segments

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

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

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

| <i>(Dollars in thousands)</i> | Home Federal Savings Bank | Other | Eliminations | Consolidated Total |
|--|------------------------------------|--------|--------------|-----------------------|
| At or for the nine months ended September 30, 2014: | | | | |
| Interest income - external customers | \$15,578 | 0 | 0 | 15,578 |
| Non-interest income - external customers | 5,604 | 0 | 0 | 5,604 |
| Intersegment interest income | 0 | 1 | (1 |) 0 |
| Intersegment non-interest income | 135 | 5,923 | (6,058 |) 0 |
| Interest expense | 938 | 0 | (1 |) 937 |
| Non-interest expense | 15,135 | 586 | (135 |) 15,586 |
| Income tax expense | 4,098 | (362 |) 0 | 3,736 |
| Net income | 5,923 | 5,700 | (5,923 |) 5,700 |
| Total assets | 593,474 | 80,873 | (79,914 |) 594,433 |
| At or for the nine months ended September 30, 2013: | | | | |
| Interest income - external customers | \$17,839 | 0 | 0 | 17,839 |
| Non-interest income - external customers | 5,684 | 0 | 0 | 5,684 |
| Intersegment interest income | 0 | 1 | (1 |) 0 |
| Intersegment non-interest income | 137 | 9,390 | (9,527 |) 0 |
| Interest expense | 2,912 | 0 | (1 |) 2,911 |
| Non-interest expense | 16,205 | 582 | (137 |) 16,650 |
| Income tax expense | 0 | 238 | 0 | 238 |
| Net income | 9,393 | 8,571 | (9,390 |) 8,574 |
| Total assets | 562,541 | 71,731 | (71,707 |) 562,565 |
| At or for the quarter ended September 30, 2014: | | | | |
| Interest income - external customers | \$5,131 | 0 | 0 | 5,131 |
| Non-interest income - external customers | 2,194 | 0 | 0 | 2,194 |
| Intersegment non-interest income | 45 | 1,608 | (1,653 |) 0 |
| Interest expense | 297 | 0 | 0 | 297 |
| Non-interest expense | 5,283 | 187 | (45 |) 5,425 |
| Income tax expense | 1,171 | (117 |) 0 | 1,054 |
| Net income | 1,608 | 1,538 | (1,608 |) 1,538 |
| Total assets | 593,474 | 80,873 | (79,914 |) 594,433 |

At or for the quarter ended September 30, 2013:

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

Item 2:

HMN FINANCIAL, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS

OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-looking Information

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

A number of factors could cause actual results to differ materially from the Company’s assumptions and expectations. These include but are not limited to the adequacy and marketability of real estate and other collateral securing loans to borrowers; federal and state regulation and enforcement; possible legislative and regulatory changes, including changes to regulatory capital rules; the ability of the Bank to comply with other applicable regulatory capital requirements; enforcement activity of the OCC and FRB in the event of our non-compliance with any applicable regulatory standard, agreement or requirement; adverse economic, business and competitive developments such as shrinking interest margins, reduced collateral values, deposit outflows, changes in credit or other risks posed by the Company’s loan and investment portfolios, changes in costs associated with alternate funding sources, including changes in collateral advance rates and policies of the Federal Home Loan Bank, technological, computer-related or operational difficulties, results of litigation, and reduced demand for financial services and loan products; changes in

accounting policies and guidelines, or monetary and fiscal policies of the federal government or tax laws; international economic developments; the Company's access to and adverse changes in securities markets; the market for credit related assets; the future operating results, financial condition, cash flow requirements and capital spending priorities of the Company and the Bank; the availability of internal and, as required, external sources of funding; or other significant uncertainties. Additional factors that may cause actual results to differ from the Company's assumptions and expectations include those set forth in the Company's most recent filings on Forms 10-K and 10-Q with the Securities and Exchange Commission. All forward-looking statements are qualified by, and should be considered in conjunction with, such cautionary statements. For additional discussion of the risks and uncertainties applicable to the Company, see the "Risk Factors" sections of the Company's Annual Report on Form 10-K for the year ended December 31, 2013 and Part II, Item 1A of its subsequently filed Quarterly Reports on Form 10-Q.

All statements in this quarterly report on Form 10-Q, including forward-looking statements, speak only as of the date they are made, and we undertake no duty to update any of the forward-looking statements after the date of this quarterly report on Form 10-Q.

General

The earnings of the Company are primarily dependent on the Bank's net interest income, which is the difference between interest earned on loans and investments, and the interest paid on interest-bearing liabilities such as deposits, FHLB advances, and FRB borrowings. The difference between the average rate of interest earned on assets and the average rate paid on liabilities is the "interest rate spread." Net interest income is produced when interest-earning assets equal or exceed interest-bearing liabilities and there is a positive interest rate spread. Net interest income and net interest rate spread are affected by changes in interest rates, the volume and mix of interest-earning assets and interest-bearing liabilities, and the level of non-performing assets. The Company's net income is also affected by the generation of non-interest income, which consists primarily of gains or losses from the sale of securities, gains from the sale of loans, fees for servicing mortgage loans, and the generation of fees and service charges on deposit accounts. The Bank incurs expenses in addition to interest expense in the form of salaries and benefits, occupancy expenses, provisions for loan losses, and amortization of mortgage servicing assets. The earnings of financial institutions, such as the Bank, are also significantly affected by prevailing economic and competitive conditions, particularly changes in interest rates, government monetary and fiscal policies, and regulations of various regulatory authorities. Lending activities are influenced by the demand for and supply of business credit, single family and commercial properties, competition among lenders, the level of interest rates and the availability of funds. Deposit flows and costs of deposits are influenced by prevailing market rates of interest on competing investments, account maturities and the levels of personal income and savings.

Between 2008 and 2011, the Company's commercial business and commercial real estate loan portfolios required significant charge-offs due primarily to decreases in the estimated value of the underlying collateral supporting the loans and the related provision for loan losses increased significantly during these years, relative to prior periods. Beginning in 2012 and continuing into 2014, the economy improved, commercial real estate values stabilized and fewer charge-offs were recorded than in the corresponding periods prior to 2012. In addition, non-performing assets and expenses associated with real estate owned declined during this period, which had a positive effect on earnings.

Critical Accounting Estimates

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

Allowance for Loan Losses and Related Provision

The allowance for loan losses is based on periodic analysis of the loan portfolio. In this analysis, management considers factors including, but not limited to, specific occurrences of loan impairment, changes in the size of the portfolios, national and regional economic conditions such as unemployment data, loan portfolio composition, loan delinquencies, local economic growth rates, historical experience and observations made by the Company's ongoing

internal audit and regulatory exam processes. Loans are charged-off to the extent they are deemed to be uncollectible. The Company has established separate processes to determine the appropriateness of the loan loss allowance for its homogeneous single-family and consumer loan portfolios and its non-homogeneous loan portfolios. The determination of the allowance on the homogeneous single-family and consumer loan portfolios is calculated on a pooled basis with individual determination of the allowance of all non-performing loans. The determination of the allowance for the non-homogeneous commercial, commercial real estate, and multi-family loan portfolios involves assigning standardized risk ratings and loss factors that are periodically reviewed. The loss factors are estimated based on the Company's own loss experience and are assigned to all loans without identified credit weaknesses. For each non-performing loan, the Company also performs an individual analysis of impairment that is based on the expected cash flows or the value of the assets collateralizing the loans and establishes any necessary reserves or charges off all loans or portions thereof that are deemed uncollectable.

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

Income Taxes

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

The Company maintains significant net deferred tax assets for deductible temporary differences, the largest of which relates to the allowance for loan and real estate losses and net operating loss carry forwards. For income tax purposes, only net charge-offs are deductible, not the entire provision for loan losses. Under U.S. generally accepted accounting principles, a valuation allowance is required to be recognized if it is “more likely than not” that the deferred tax asset will not be realized. The determination of whether the deferred tax assets are realizable is highly subjective and dependent upon management’s judgment and evaluation of both positive and negative evidence, including the forecasts of future income, tax planning strategies and assessments of the current and future economic and business conditions. The Company considers both positive and negative evidence regarding the ultimate realization of deferred tax assets. Positive evidence includes the Company’s cumulative net income in the prior three years period, the ability to implement tax planning strategies to accelerate taxable income recognition, and the probability that taxable income will be generated in future periods. Negative evidence includes the general business and economic environment. In the second quarter of 2010, the Company recorded a valuation allowance against the entire deferred tax asset balance and the Company continued to maintain a valuation reserve against the entire deferred tax asset balance until December 31, 2013, when the entire valuation reserve was eliminated. The determination to eliminate the valuation reserve was based primarily upon the existence of a three-year cumulative net income and expectations of future taxable income. It is possible that future conditions may differ substantially from those anticipated in eliminating the valuation allowance on deferred tax assets and adjustments may be required in future periods.

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

**RESULTS OF OPERATIONS FOR THREE AND NINE MONTH PERIODS ENDED SEPTEMBER 30, 2014
COMPARED TO THE SAME PERIODS ENDED SEPTEMBER 30, 2013**

Net Income

Net income was \$1.5 million for the third quarter of 2014, a decrease of \$4.5 million compared to net income of \$6.0 million for the third quarter of 2013. Net income available to common shareholders was \$1.2 million for the third quarter of 2014, a decrease of \$4.3 million from the net income available to common shareholders of \$5.5 million for the third quarter of 2013. Diluted earnings per common share for the third quarter of 2014 was \$0.25, a decrease of \$1.02 from the diluted earnings per common share of \$1.27 for the third quarter of 2013. The decrease in net income for the third quarter of 2014 is due primarily to a \$3.3 million reduction in the credit to the provision for loan losses between the periods. The change in the provision was primarily because there were fewer positive changes in the values of the underlying collateral supporting commercial real estate loans in the third quarter of 2014 when compared to the same period of 2013. The smaller increases in the market values of the properties resulted in less recapture of established allowances in the third quarter of 2014 when compared to the same period of 2013. Income tax expense increased \$0.9 million between the periods due to the recapture of the deferred tax asset valuation reserve in the fourth quarter of 2013, which resulted in regular income tax expense being recorded in the third quarter of 2014. Net interest income decreased \$0.5 million due primarily to a change in the mix of assets held between the periods. The gain on sale of real estate owned decreased \$0.2 million due to the decreased amount of real estate sold between the periods. These decreases in net income were partially offset by a \$0.4 million increase in gain on sales of loans due primarily to the increase in the gains recognized on the sale of commercial government guaranteed loans between the periods.

Net income was \$5.7 million for the nine-month period ended September 30, 2014, a decrease of \$2.9 million, or 33.5%, compared to net income of \$8.6 million for the nine-month period ended September 30, 2013. The net income available to common shareholders was \$4.3 million for the nine-month period ended September 30, 2014, a decrease of \$2.7 million, or 39.1%, compared to the net income available to common shareholders of \$7.0 million for the same period of 2013. Diluted earnings per common share for the first nine months of 2014 was \$0.93, a decrease of \$0.72 per share compared to the diluted earnings per common share of \$1.65 for the same period in 2013. The decrease in net income for the first nine months of 2014 as compared to the same period of 2013 is due primarily to a \$3.5 million increase in income tax expense between the periods. The increase in income tax expense is due to the recapture of the deferred tax asset valuation reserve in the fourth quarter of 2013, which resulted in regular income tax expense being recorded in the first nine months of 2014. Net interest income also decreased \$0.3 million due primarily to a change in the mix of assets held between the periods. These decreases in net income were partially offset by a \$0.5 million increase in gains on real estate owned and a \$0.7 million decrease in other non-interest operating expenses primarily because of decreased legal and other expenses related to non-performing assets.

Net Interest Income

Net interest income was \$4.8 million for the third quarter of 2014, a decrease of \$0.5 million, or 9.2%, compared to \$5.3 million for the third quarter of 2013. Interest income was \$5.1 million for the third quarter of 2014, a decrease of \$0.6 million, or 10.4%, from \$5.7 million for the same period of 2013. Interest income decreased between the periods primarily because of a change in the mix of average interest-earning assets held and also because of a decrease in the average yields earned between the periods. While the average interest-earning assets increased \$64.0 million between the periods, the average interest-earning assets held in lower yielding cash and investments increased \$100.9 million and the amount of average interest-earning assets held in higher yielding loans decreased \$36.9 million between the periods. The decrease in the average outstanding loans between the periods was primarily the result of a decrease in the commercial loan portfolio, which occurred primarily because of loan prepayments and non-renewals as a result of the Company's focus on improving credit quality, decreasing loan concentration, and managing net interest margin. The average yield earned on interest-earning assets was 3.51% for the third quarter of 2014, a decrease of 90 basis points from 4.41% for the third quarter of 2013. The decrease in average yield is due to the change in the mix of assets held and the continued low short-term interest rate environment that existed during the third quarter of 2014.

Interest expense was \$0.3 million for the third quarter of 2014, a decrease of \$0.1 million, or 26.5 %, compared to \$0.4 million for the third quarter of 2013. Interest expense decreased primarily because of the change in the mix of the average interest-bearing liabilities held between the periods and also because of a decrease in the average rate. While the average interest-bearing liabilities increased \$56.1 million between the periods, the amount held in higher rate borrowings and certificates of deposits decreased \$32.9 million and the amount of interest-bearing liabilities held in other lower rate deposit accounts increased \$89.0 million between the periods. The decrease in borrowings and certificates of deposits between the periods was the result of using the proceeds from loan principal payments to fund maturing borrowings and certificates of deposits. The decreased average rates paid were the result of the change in the mix of liabilities held and the low interest rate environment that continued to exist during the third quarter of 2014. The average interest rate paid on interest-bearing liabilities was 0.23% for the third quarter of 2014, a decrease of 11 basis points from the 0.34% average interest rate paid in the third quarter of 2013.

Net interest margin (net interest income divided by average interest earning assets) for the third quarter of 2014 was 3.31%, a decrease of 79 basis points, compared to 4.10% for the third quarter of 2013.

Net interest income was \$14.6 million for the first nine months of 2014, a decrease of \$0.3 million, or 1.9%, from \$14.9 million for the same period of 2013. Interest income was \$15.6 million for the nine-month period ended September 30, 2014, a decrease of \$2.2 million, or 12.7%, from \$17.8 million for the same period of 2013. Interest income decreased between the periods primarily because of a change in the mix of average interest-earning assets held and also because of a decrease in the average yields earned between the periods. While the average interest-earning assets increased \$20.4 million between the periods, the average interest-earning assets held in lower yielding cash and investments increased \$67.5 million and the amount of average interest-earning assets held in higher yielding loans decreased \$47.1 million between the periods. The decrease in the average outstanding loans between the periods was primarily the result of a decrease in the commercial loan portfolio, which occurred primarily because of loan prepayments and non-renewals as a result of the Company's focus on improving credit quality, decreasing loan concentration, and managing net interest margin. The average yield earned on interest-earning assets was 3.58% for the first nine months of 2014, a decrease of 67 basis points from 4.25% for the same period of 2013. The decrease in average yield is due to the change in the mix of assets held and the continued low short-term interest rate environment that existed during the first nine months of 2014.

Interest expense was \$0.9 million for the nine-month period ended September 30, 2014, a decrease of \$2.0 million, or 67.8%, from \$2.9 million for the same period in 2013. Interest expense decreased primarily because of the change in the mix of the average interest-bearing liabilities held between the periods and also because of a decrease in the average rate. While the average interest-bearing liabilities increased \$8.7 million between the periods, the amount held in higher rate borrowings and certificates of deposits decreased \$83.7 million and the amount of interest-bearing liabilities held in other lower rate deposit accounts increased \$92.4 million between the periods. The decrease in borrowings and certificates of deposits between the periods was the result of using the proceeds from loan principal payments to fund maturing borrowings and certificates of deposits. The decreased average rates paid were the result of the change in the mix of liabilities held and the low interest rate environment that continued to exist during the first nine months of 2014. The average interest rate paid on interest-bearing liabilities was 0.24% for the first nine months of 2014, a decrease of 51 basis points from the 0.75% average interest rate paid in the first nine months of 2013.

Net interest margin (net interest income divided by average interest earning assets) for the first nine months of 2014 was 3.36%, a decrease of 20 basis points, compared to 3.56% for the first nine months of 2013.

A summary of the Company's net interest margin for the three and nine-month periods ended September 30, 2014 and September 30, 2013 is as follows:

| | For the three month period ended | | | | | |
|-------------------------------|----------------------------------|----------|--------|--------------------|----------|--------|
| | September 30, 2014 | | | September 30, 2013 | | |
| | Average | Interest | Yield/ | Average | Interest | Yield/ |
| | Outstanding | Earned/ | Rate | Outstanding | Earned/ | Rate |
| | Balance | Paid | | Balance | Paid | |
| <i>(Dollars in thousands)</i> | | | | | | |

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| | | | | | | | |
|--|-----------|---------|--------|-----------|---------|--------|--|
| Interest-earning assets: | | | | | | | |
| Securities available for sale | \$137,503 | 416 | 1.20 % | \$90,499 | 222 | 0.97 % | |
| Loans held for sale | 2,253 | 21 | 3.70 | 1,970 | 20 | 4.03 | |
| Mortgage loans, net | 70,580 | 835 | 4.69 | 81,219 | 921 | 4.50 | |
| Commercial loans, net | 237,404 | 3,106 | 5.19 | 265,097 | 3,853 | 5.77 | |
| Consumer loans, net | 54,378 | 707 | 5.16 | 53,275 | 698 | 5.20 | |
| Cash equivalents | 76,224 | 45 | 0.23 | 22,297 | 12 | 0.21 | |
| Federal Home Loan Bank stock | 777 | 1 | 0.51 | 796 | 3 | 1.50 | |
| Total interest-earning assets | 579,119 | 5,131 | 3.51 | 515,153 | 5,729 | 4.41 | |
| Interest-bearing liabilities: | | | | | | | |
| NOW accounts | 70,311 | 3 | 0.02 | 67,277 | 3 | 0.02 | |
| Savings accounts | 47,953 | 8 | 0.07 | 43,934 | 8 | 0.07 | |
| Money market accounts | 171,329 | 107 | 0.25 | 117,193 | 87 | 0.29 | |
| Certificates | 108,029 | 179 | 0.66 | 131,358 | 273 | 0.82 | |
| Brokered deposits | 0 | 0 | 0.00 | 9,327 | 33 | 1.40 | |
| Advances and other borrowings | 0 | 0 | 0.00 | 283 | 0 | 0.00 | |
| Total interest-bearing liabilities | 397,622 | | | 369,372 | | | |
| Non-interest checking | 125,751 | | | 97,937 | | | |
| Other non-interest bearing deposits | 1,200 | | | 1,123 | | | |
| Total interest-bearing liabilities and non-interest bearing deposits | \$524,573 | 297 | 0.23 | \$468,432 | 404 | 0.34 | |
| Net interest income | | \$4,834 | | | \$5,325 | | |
| Net interest rate spread | | | 3.28 % | | | 4.07 % | |
| Net interest margin | | | 3.31 % | | | 4.10 % | |

| <i>(Dollars in thousands)</i> | For the nine month period ended | | | | | |
|--|-----------------------------------|-----------------------------|----------------|-----------------------------------|-----------------------------|----------------|
| | September 30, 2014 | | | September 30, 2013 | | |
| | Average Outstanding Balance | Interest Earned/ Paid | Yield/ Rate | Average Outstanding Balance | Interest Earned/ Paid | Yield/ Rate |
| Interest-earning assets: | | | | | | |
| Securities available for sale | \$120,632 | 1,020 | 1.13 % | \$91,744 | 685 | 1.00 % |
| Loans held for sale | 1,520 | 45 | 3.96 | 2,215 | 58 | 3.50 |
| Mortgage loans, net | 73,572 | 2,483 | 4.51 | 87,479 | 3,061 | 4.68 |
| Commercial loans, net | 244,197 | 9,777 | 5.35 | 276,889 | 11,817 | 5.71 |
| Consumer loans, net | 53,563 | 2,093 | 5.22 | 53,397 | 2,087 | 5.23 |
| Cash equivalents | 87,474 | 157 | 0.24 | 46,963 | 80 | 0.23 |
| Federal Home Loan Bank stock | 779 | 3 | 0.51 | 2,666 | 51 | 2.56 |
| Total interest-earning assets | 581,737 | 15,578 | 3.58 | 561,353 | 17,839 | 4.25 |
| Interest-bearing liabilities: | | | | | | |
| NOW accounts | 70,861 | 11 | 0.02 | 69,754 | 12 | 0.02 |
| Savings accounts | 47,259 | 24 | 0.07 | 44,215 | 27 | 0.08 |
| Money market accounts | 163,319 | 307 | 0.25 | 114,856 | 270 | 0.31 |
| Certificates | 113,200 | 583 | 0.69 | 145,530 | 997 | 0.92 |
| Brokered deposits | 1,109 | 12 | 1.45 | 11,675 | 120 | 1.37 |
| Advances and other borrowings | 0 | 0 | 0.00 | 40,681 | 1,485 | 4.88 |
| Total interest-bearing liabilities | 395,748 | | | 426,711 | | |
| Non-interest checking | 128,759 | | | 89,023 | | |
| Other non-interest bearing deposits | 983 | | | 1,099 | | |
| Total interest-bearing liabilities and non-interest bearing deposits | \$525,490 | 937 | 0.24 | \$516,833 | 2,911 | 0.75 |
| Net interest income | | \$14,641 | | | \$14,928 | |
| Net interest rate spread | | | 3.34 % | | | 3.50 % |
| Net interest margin | | | 3.36 % | | | 3.56 % |

Provision for Loan Losses

The provision for loan losses was (\$1.0) million for the third quarter of 2014, a reduction in the amount credited to the provision of \$3.3 million, compared to (\$4.3) million for the third quarter of 2013. The provision for loan losses changed primarily because there were fewer positive changes in the values of the underlying collateral supporting commercial real estate loans in the third quarter of 2014 when compared to the same period of 2013. The smaller increases in the market values of the properties resulted in less recapture of established allowances for loan losses in the third quarter of 2014 when compared to the same period of 2013. The credit provision also decreased between the periods because of changes in the reserve percentages on certain risk classifications as a result of an internal analysis of the loan portfolio.

The credit provision for loan losses was (\$4.8) million for the first nine months of 2014, a decrease of \$0.1 million, from (\$4.9) million for the same nine-month period of 2013. The decrease in the size of the commercial loan portfolio and the continued improvement in the credit quality of the loan portfolio in the first nine months of 2014 and 2013 resulted in lower reserves being required in the allowance for loan losses. The reduction in the allowance for loan losses was the primary reason for the large credits in the provision for loan losses for the first nine months of 2014 and 2013.

A reconciliation of the Company's allowance for loan losses for the three and nine-month periods ended September 30, 2014 and September 30, 2013 is summarized as follows:

| <i>(Dollars in thousands)</i> | For the three months ended | |
|-------------------------------|-------------------------------|-----------------------|
| | September 30, 2014 | September 30, 2013 |
| Balance at June 30, | \$8,696 | \$ 20,359 |
| Provision | (989) | (4,330) |
| Charge offs: | | |
| One-to-four family | 0 | 0 |
| Consumer | (15) | (374) |
| Commercial business | (55) | (2) |
| Commercial real estate | 0 | (50) |
| Total charge offs | (70) | (426) |
| Recoveries | 286 | 902 |
| Balance at September 30, | \$7,923 | \$ 16,505 |
| General allowance | \$6,651 | \$ 9,953 |
| Specific allowance | 1,272 | 6,552 |
| | \$7,923 | \$ 16,505 |

| <i>(Dollars in thousands)</i> | For the nine months ended | |
|-------------------------------|------------------------------|-----------------------|
| | September 30, 2014 | September 30, 2013 |
| Balance at January 1, | \$11,401 | \$ 21,608 |
| Provision | (4,777) | (4,850) |
| Charge offs: | | |
| One-to-four family | (92) | (200) |
| Consumer | (75) | (475) |
| Commercial business | (56) | (606) |
| Commercial real estate | (936) | (911) |
| Total charge offs | (1,159) | (2,192) |
| Recoveries | 2,458 | 1,939 |
| Balance at September 30, | \$7,923 | \$ 16,505 |

Non-Interest Income

Non-interest income was \$2.2 million for the third quarter of 2014, an increase of \$0.4 million, or 20.4%, from \$1.8 million for the same period of 2013. Gain on sales of loans increased \$0.4 million primarily because of an increase in the gains recognized on the sale of commercial government guaranteed loans between the periods due to an increase in originations of these types of loans in the third quarter of 2014 when compared to the same period of 2013.

Non-interest income was \$5.6 million for the first nine months of 2014, a decrease of \$0.1 million, or 1.4%, from \$5.7 million for the same period in 2013. Gain on sales of loans decreased \$0.3 million between the periods primarily because of a decrease in single family loan originations due to the decrease in refinance activity in the first nine months of 2014 when compared to the same period of 2013. This decrease was partially offset by an increase of \$0.2 million in other income as a result of increased rental income and income from the sale of uninsured investment products.

Non-Interest Expense

Non-interest expense was \$5.4 million for the third quarter of 2014, an increase of \$0.1 million, or 2.6%, from \$5.3 million for the same period of 2013. The gain on real estate owned decreased \$0.2 million primarily because of a decrease in the gains recognized on the properties sold. Compensation and benefits expense increased \$0.2 million primarily because of an increase in pension benefit plan costs and employee incentives. These increases in non-interest expense were partially offset by a \$0.1 million decrease in deposit insurance costs due to a decrease in insurance rates between the periods. Data processing costs decreased \$0.1 million due to a decrease in hardware and software depreciation expense. Other non-interest expense decreased \$0.1 million between the periods primarily because of a decrease in legal and other expenses related to non-performing assets.

Non-interest expense was \$15.6 million for the first nine months of 2014, a decrease of \$1.1 million, or 6.4%, from \$16.7 million for the same period in 2013. Other non-interest expense decreased \$0.7 million primarily because of decreased legal and other expenses related to non-performing assets. The gain on real estate owned increased \$0.5 million primarily because of an increase in the gains recognized on the properties sold. Deposit insurance costs decreased \$0.4 million primarily because of a decrease in insurance rates between the periods and data processing costs decreased \$0.3 million due to a decrease in hardware and software depreciation expense. These decreases in non-interest expense were partially offset by a \$0.7 million increase in compensation and benefits expense between the periods due primarily to increases in salaries and pension related expenses. Occupancy expense also increased \$0.1 million due to increases in non-capitalized software costs.

Income Tax Expense

Income tax expense was \$1.1 million for the third quarter of 2014, an increase of \$0.9 million, from \$0.2 for the third quarter of 2013. Income tax expense was \$3.7 million for the first nine months of 2014, an increase of \$3.5 million, from \$0.2 million for the same period in 2013. In the second quarter of 2010, the Company recorded a deferred tax asset valuation reserve against its entire deferred tax asset balance and the Company continued to maintain a valuation reserve against the entire deferred tax asset balance at September 30, 2013. Since the valuation reserve was established against the entire deferred tax asset balance, no regular income tax expense was recorded for the first nine months of 2013. The income tax expense that was recorded in the first nine months of 2013 related to alternative minimum tax amounts that were due since only a portion of the outstanding net operating loss carry forwards could be used to offset current income under the alternative minimum tax rules. In the fourth quarter of 2013, the valuation reserve against the deferred tax asset was eliminated and regular income tax expense of \$3.7 million was recorded in the first nine months of 2014.

Net Income Available to Common Shareholders

Net income available to common shareholders was \$1.2 million for the third quarter of 2014, a decrease of \$4.3 million from the \$5.5 million net income available to common shareholders in the third quarter of 2013. The net income available to common shareholders was \$4.3 million for the first nine months of 2014, a decrease of \$2.7 million from the \$7.0 million net income available to common shareholders in the same period of 2013. The net income available to common shareholders decreased primarily because of the decrease in net income between the periods.

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

The following table summarizes the amounts and categories of non-performing assets, which consist of non-performing loans and foreclosed and repossessed assets, in the Bank's portfolio and loan delinquency information as of the end of the two most recently completed quarters and December 31, 2013.

| | September 30, 2014 | June 30, 2014 | December 31, 2013 | | | |
|---|--------------------------|------------------|-------------------------|----------|--|--|
| <i>(Dollars in thousands)</i> | | | | | | |
| Non-Performing Loans: | | | | | | |
| One-to-four family real estate | \$ 984 | \$2,056 | \$ 1,602 | | | |
| Commercial real estate | 8,730 | 8,803 | 14,549 | | | |
| Consumer | 533 | 707 | 737 | | | |
| Commercial business | 147 | 725 | 608 | | | |
| Total | 10,394 | 12,291 | 17,496 | | | |
| Foreclosed and Repossessed Assets: | | | | | | |
| One-to-four family real estate | 134 | 111 | 0 | | | |
| Commercial real estate | 3,311 | 3,365 | 6,898 | | | |
| Total non-performing assets | \$ 13,839 | \$ 15,767 | \$ 24,394 | | | |
| Total as a percentage of total assets | 2.33 | % 2.59 | % 3.76 | % | | |
| Total non-performing loans | \$ 10,394 | \$ 12,291 | \$ 17,496 | | | |
| Total as a percentage of total loans receivable, net | 2.84 | % 3.34 | % 4.55 | % | | |
| Allowance for loan losses to non-performing loans | 76.23 | % 70.75 | % 65.17 | % | | |
| Delinquency Data: | | | | | | |
| Delinquencies ⁽¹⁾ | | | | | | |
| 30+ days | \$ 2,334 | \$ 1,635 | \$ 6,370 | | | |
| 90+ days ⁽²⁾ | 0 | 0 | 0 | | | |
| Delinquencies as a percentage of Loan and lease portfolio ⁽¹⁾ | | | | | | |
| 30+ days | 0.62 | % 0.43 | % 1.33 | % | | |
| 90+ days | 0.00 | % 0.00 | % 0.00 | % | | |

⁽¹⁾ Excludes non-accrual loans.

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

Total non-performing assets were \$13.8 million at September 30, 2014, a decrease of \$2.0 million, or 12.2 %, from \$15.8 million at June 30, 2014. Non-performing loans decreased \$1.9 million and foreclosed and repossessed assets decreased \$0.1 million during the third quarter of 2014. The non-performing loan and foreclosed and repossessed asset activity for the quarter was as follows:

(Dollars in thousands)

| Non-performing loans | | Foreclosed and repossessed assets | |
|----------------------------------|-----------|--|----------|
| June 30, 2014 | \$ 12,291 | June 30, 2014 | \$ 3,476 |
| Classified as non-performing | 862 | Transferred from non-performing loans | 31 |
| Charge offs | (70) |) Real estate sold | (134) |
| Principal payments received | (2,057) |) Net gain on sale of assets | 86 |
| Classified as accruing | (601) |) Write downs | (14) |
| Transferred to real estate owned | (31) |) Other foreclosures/repossessions | 0 |
| September 30, 2014 | \$ 10,394 | September 30, 2014 | \$ 3,445 |

The decrease in non-performing loans during the third quarter of 2014 relates primarily to principal payments received and loans being classified as accruing during the period. Of the \$2.1 million in principal payments received, \$0.6 million related to the payoff of a non-performing one-to-four family loan that was refinanced with another financial institution, \$0.6 million related to the payoff of three construction loans as a result of home sales, and \$0.5 million related to the payoff of a non-performing commercial loan.

Total non-performing assets were \$13.8 million at September 30, 2014, a decrease of \$10.6 million, or 43.3%, from \$24.4 million at December 31, 2013. Non-performing loans decreased \$7.1 million and foreclosed and repossessed assets decreased \$3.5 million during the first nine months of 2014. The non-performing loan and foreclosed and repossessed asset activity for the first nine months of 2014 was as follows:

(Dollars in thousands)

| Non-performing loans | | Foreclosed and repossessed assets | |
|----------------------------------|-----------|--|----------|
| December 31, 2013 | \$ 17,496 | December 31, 2013 | \$ 6,898 |
| Classified as non-performing | 3,994 | Transferred from non-performing loans | 114 |
| Charge offs | (1,159) |) Other foreclosures/repossessions | 28 |
| Principal payments received | (6,822) |) Real estate sold | (4,457) |
| Classified as accruing | (3,001) |) Net gain on sale of assets | 1,351 |
| Transferred to real estate owned | (114) |) Write downs | (234) |
| | | Other payments received on real estate | (255) |
| September 30, 2014 | \$ 10,394 | September 30, 2014 | \$ 3,445 |

The decrease in non-performing loans during the first nine months of 2014 relates primarily to principal payments received. Of the \$6.8 million in principal payments received during the period, \$2.5 million was received on a residential development loan as settlement of the outstanding debt, \$1.5 million related to the payoff of non-performing single family construction loans as a result of the houses being sold, \$1.2 million related to the payoff of two non-performing one-to-four family loans that were refinanced with other financial institutions, \$0.6 million related to additional principal payments received from various developers as a result of land or lot sales, and \$0.5 million related to the payoff of a non-performing commercial loan.

The following table summarizes the number of lending relationships and types of commercial real estate loans that were non-performing as of the end of the two most recently completed quarters and December 31, 2013.

| <i>(Dollars in thousands)</i> | # of relationships | Principal | # of relationships | Principal | # of relationships | Principal |
|-------------------------------|--------------------|-----------------------------|--------------------|------------------------|--------------------|----------------------------|
| | | Amount of | | Amount of | | Amount of |
| Property Type | | Loans at September 30, 2014 | | Loans at June 30, 2014 | | Loans at December 31, 2013 |
| Developments/land | 3 | \$ 8,730 | 3 | \$ 8,803 | 9 | \$ 14,549 |

The decrease in the non-performing commercial real estate loans from June 30, 2014 is due primarily to principal payments received on construction and development loans during the quarter as a result of various building lot sales.

Dividends

On May 15, 2014, the Company paid a dividend of \$201.71 per share on the Company's outstanding Preferred Stock. The amount of the dividend represented all accrued and unpaid dividends on the Preferred Stock for all past dividend periods and for the dividend period ended on May 14, 2014. On May 15, 2014, the Company also redeemed 10,000 shares of outstanding Preferred Stock on a pro rata basis at \$1,000 per share. Following the redemption, 16,000 shares of Preferred Stock remained outstanding. On August 15, 2014, the Company paid a dividend of \$22.50 per share on the Company's outstanding Preferred Stock. The amount of the dividend represented all accrued and unpaid dividends on the Preferred Stock for the dividend period ended on August 14, 2014. The Company did not pay any dividends on or redeem any shares of the Preferred Stock during the nine months ended September 30, 2013.

On October 9, 2014, the Company announced that its Board of Directors declared a dividend of \$22.50 per share on the Company's outstanding Preferred Stock. The amount of the dividend represents all accrued and unpaid dividends on the Preferred Stock for the dividend period ending on November 14, 2014. The dividend will be payable on November 17, 2014 to holders of record of the Preferred Stock on October 7, 2014. Also on October 9, 2014, the Company announced that it will redeem 6,000 shares of the Preferred Stock on a pro rata basis from holders of record of the Preferred Stock on October 7, 2014. The effective date of the redemption will be November 17, 2014. Giving effect to the dividend to be paid on the same date, the redemption price per share will be \$1,000. Following the redemption, 10,000 shares of Preferred Stock will remain outstanding. The Company has requested and received all applicable approvals from regulatory authorities to pay the Preferred Stock dividend and effect the Preferred Stock redemption. The reduction in the number of outstanding shares of Preferred Stock will, from and after November 15, 2014, reduce the quarterly Preferred Stock dividend accrual from \$360,000 to \$225,000.

LIQUIDITY AND CAPITAL RESOURCES

For the nine months ended September 30, 2014, the net cash provided by operating activities was \$17.0 million. The Company collected \$55.0 million from the maturities of securities, \$1.7 million from principal repayments on securities, and \$4.4 million in proceeds from the sale of real estate. The Company purchased securities of \$89.0 million and purchased premises and equipment of \$0.5 million. Net loans receivable decreased \$11.9 million due primarily to commercial loan prepayments and non-renewals. The Company had a net decrease in deposit and customer escrow balances of \$48.3 million, redeemed \$10.0 million of outstanding Preferred Stock, and paid \$5.6 million in Preferred Stock dividends.

The Company has certificates of deposits with outstanding balances of \$70.7 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 funded with existing cash balances or replaced with deposits from other customers or FHLB advances. Federal Reserve Bank borrowings or proceeds from the sale of securities could also be used to fund unanticipated outflows of deposits.

The Company had five deposit customers with aggregate deposits greater than \$5.0 million as of September 30, 2014. The \$71.2 million in funds held by these customers may be withdrawn at any time and management anticipates that the majority of these deposits will be withdrawn from the Bank over the next twelve months due to the anticipated cash needs of the customers. If these deposits are withdrawn, it is anticipated that they would be funded with available cash or replaced with deposits from other customers or FHLB advances. Federal Reserve borrowing or proceeds from the sale of securities could also be used to replace unanticipated outflows of large checking and money market deposits.

The credit policy of the FHLB relating to the collateral value of the loans collateralizing the outstanding advances with the FHLB may change such that the current collateral pledged to secure future advances is no longer acceptable or the formulas for determining the excess pledged collateral may change. The FHLB could also reduce the amount of funds it will lend to the Bank. It is not anticipated that the Bank will need to find alternative funding sources in the next twelve months to replace the available borrowings from the FHLB. However, if needed, excess collateral currently pledged to the FHLB could be pledged to the FRB and the Bank could borrow additional funds from the FRB based on the increased collateral levels or obtain additional deposits.

The Company's primary source of cash is dividends from the Bank. At September 30, 2014, the Company had \$1.3 million in cash and other assets that could readily be turned into cash. The primary use of cash by the Company is the payment of expenses and dividends on the Preferred Stock.

On October 9, 2014, the Company announced that its Board of Directors declared a dividend of \$360,000 on the Company's outstanding Preferred Stock and a redemption of 6,000 shares of Preferred Stock at an aggregate price of

\$6.0 million. The dividend will be paid and the redemption will occur on November 17, 2014. The dividend and redemption will be funded through internally available funds generated through a dividend from the Bank to HMN. For more information regarding the Preferred Stock dividend and partial redemption, see “Financial Condition – Dividends” above.

The Company also serves as a source of capital, liquidity and financial support to the Bank. Depending upon the operating performance of the Bank and the Company’s other liquidity and capital needs, including potentially Company-level expenses, payment of dividends on the Company’s Preferred Stock, and further redemptions of the Preferred Stock, the Company may find it prudent, subject to prevailing capital market conditions and other factors, to raise additional capital or pursue other strategic alternatives, in each case through, in whole or in part, the issuance of indebtedness or additional shares of common stock or other equity securities. In addition, regulators have placed increasing emphasis on the amount of common equity as a component of core bank capital, and revised capital regulations (described below) incorporating specific levels of common equity capital both at the Bank and the Company. Additional capital would also potentially permit the Company to implement a strategy of growing Bank assets. Depending on the circumstances, if it were to raise capital, the Company may deploy it to the Bank for general banking purposes, or may retain some or all of it for use by the Company.

If the Company issues additional shares of common stock or other equity securities, it would dilute the ownership interests of existing stockholders, and, if issued at a price less than the Company's book value, could dilute the per share book value of the Company's common stock, dilute the Company's earnings per share, and could result in a change in control of the Company and the Bank. New investors may also have rights, preferences and privileges senior to the Company's current stockholders, which may adversely impact the Company's current stockholders. The Company's ability to issue equity securities, if deemed prudent, will depend on, among other factors, conditions in the capital markets at that time, which are outside of its control, and on the Company's financial performance and plans. Accordingly, the Company may not be able to issue capital, if deemed prudent, on favorable economic terms, or other terms acceptable to it. If the Company or the Bank cannot satisfactorily address their respective capital needs as they arise, the Company's ability to maintain or expand its operations, maintain compliance with the regulatory capital requirements, to pay dividends on the Company's outstanding Preferred Stock, to operate without additional regulatory or other restrictions, and its operating results, could be materially adversely affected.

The capital requirements of the Company and the Bank will be affected by regulatory capital changes issued in July 2013 by the FRB, the FDIC and the OCC. The changes establish an integrated regulatory capital framework for implementing the Basel Committee on Banking Supervision's Basel III regulatory capital reforms and implement the changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The new capital requirements are effective for the Company beginning January 1, 2015, and among other things, apply a strengthened set of capital requirements to both the Bank and the Company and revise the rules for calculating risk-weighted assets for purposes of such requirements. The Company believes that the impact that these new capital standards will have on the Bank's and Company's capital positions will not be material when they are implemented on January 1, 2015. See "Item 1 – Business – Regulation and Supervision" in our Form 10-K for the fiscal year ended December 31, 2013 for additional information on the new regulatory capital rules.

Market Risk

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

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

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

interest rate changes.

The following table discloses the projected changes in market value to the Company's interest-earning assets and interest-bearing liabilities based upon incremental 100 basis point changes in interest rates from interest rates in effect on September 30, 2014.

| Other than trading portfolio (Dollars in thousands) | Market Value | | | |
|--|--------------|---------|---------|---------|
| | -100 | 0 | +100 | +200 |
| Basis point change in interest rates | | | | |
| Total market risk sensitive assets | \$583,099 | 577,358 | 566,955 | 554,327 |
| Total market risk sensitive liabilities | 492,648 | 465,899 | 448,191 | 431,436 |
| Off-balance sheet financial instruments | (138) | 0 | 25 | 72 |
| Net market risk | \$90,589 | 111,459 | 118,739 | 122,819 |
| Percentage change from current market value | (18.72)% | 0.00 % | 6.53 % | 10.19 % |

The preceding table was prepared utilizing the following assumptions (the Model Assumptions) regarding prepayment and decay ratios, which were determined by management based upon their review of historical prepayment speeds and future prepayment projections. Fixed rate loans were assumed to prepay at annual rates of between 4% to 60%, depending on the note rate and the period to maturity. Adjustable rate mortgages (ARMs) were assumed to prepay at annual rates of between 18% and 138%, depending on the note rate and the period to maturity. Mortgage-backed securities were projected to have prepayments based upon the underlying collateral securing the instrument. Certificate accounts were assumed not to be withdrawn until maturity. Passbook accounts were assumed to decay at an annual rate of 6% and money market accounts were assumed to decay at an annual rate of 9%. Non-interest checking and NOW accounts were assumed to decay at an annual rate of 4%. Commercial NOW accounts and MMDA accounts were assumed to decay at an annual rate of 9% and 14%, respectively. Commercial non-interest checking accounts were assumed to decay at an annual rate of 9%. Callable investments were projected to be called at the first call date where the projected interest rate on similar remaining term advances exceeded the interest rate on the callable advance or investment.

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

Asset/Liability Management

The Company's management reviews the impact that changing interest rates will have on its net interest income projected for the next twelve months to determine if its current level of interest rate risk is acceptable. The following table projects the estimated annual impact on net interest income during the 12 month period ending September 30, 2015 of immediate interest rate changes called rate shocks.

(Dollars in thousands)

| Rate Shock in | Projected Change in Net Interest Income | Percentage |
|---------------|---|------------|
| Basis Points | | Change |
| +200 | \$2,093 | 11.28 % |
| +100 | 1,112 | 5.99 |
| 0 | 0 | 0.00 |
| -100 | (1,999) | (10.78) |

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

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

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

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

Off-Balance Sheet Arrangements

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

Item 3: Quantitative and Qualitative Disclosures about Market Risk

Not applicable.

Item 4: Controls and Procedures

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

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

HMN FINANCIAL, INC.

PART II - OTHER INFORMATION

ITEM 1. Legal Proceedings.

From time to time, the Company is party to legal proceedings arising out of its lending and deposit operations. The Company is, and expects to become, engaged in a number of foreclosure proceedings and other collection actions as part of its collection activities. Based on our current understanding of these pending legal proceedings, management does not believe that judgments or settlements, if any and if determined adversely to the Company, arising from pending legal matters individually or in the aggregate, would have a material adverse effect on the consolidated financial position, operating results or cash flows of the Company. Litigation is often unpredictable and the actual results of litigation cannot be determined with any certainty.

ITEM 1A. Risk Factors.

Other than as noted below, there have been no material changes to the Company's risk factors contained in its Annual Report on Form 10-K for the year ended December 31, 2013. For a further discussion of our Risk Factors, see Part I, Item 1.A. of the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

Our capital has not been adequate to meet all our needs and requirements. We have taken a number of steps, and may be required to take additional steps, to meet our capital needs. These actions may further reduce our base of earning assets and core deposits and may dilute our shareholders or result in a change of control of the Company or the Bank. There can be no assurance that we will satisfactorily meet our required capital needs.

We are required by federal regulatory authorities to maintain adequate levels of capital to support our operations and protect depositors of the Bank. As a result of significant losses in recent years, elevated levels of nonperforming and other classified assets, regulatory requirements, and other capital demands, such as our Preferred Stock dividend requirement of 9%, it has been necessary for us to increase the Bank's capital and core capital ratio. In order to improve and maintain its capital ratios and comply with the recently terminated Bank IMCR and Supervisory Agreements, the Bank has, among other things, been working to improve its financial results, reduce non-performing assets, and decrease the asset size of the Bank. From December 31, 2008 to December 31, 2013, our assets decreased \$496 million, from \$1,145 million to \$649 million. These reductions reduce the amount of net interest income we are able to earn.

Depending upon the operating performance of the Bank, the need for continued compliance with applicable regulatory requirements, and our other liquidity and capital needs, we may find it prudent subject to prevailing market conditions and other factors, to raise additional capital or pursue other strategic alternatives, in each case through, in whole or in part, the issuance of indebtedness or additional shares of common stock or other equity securities. New capital regulations place increasing emphasis on the amount of common equity as a component of core bank capital and specifically include minimum levels of common equity capital. These regulations also will require regulatory capital to meet required levels on a consolidated basis. Additional capital would also potentially permit the Company to return to a strategy of growing Bank assets. Depending on circumstances, if we were to raise capital, we may deploy it to the Bank for general banking purposes, or may retain some or all of such capital for use by the Company.

If the Company issues additional shares of common stock or other equity securities, it would dilute the ownership interests of existing stockholders, potentially could dilute the Company's earnings per share, and, if issued at a price less than the Company's book value, would dilute the per share book value of our common stock, and could result in a change in control of the Company and the Bank. New investors may also have rights, preferences and privileges senior to our current stockholders which may adversely impact our current stockholders. Our ability to issue equity securities, if deemed prudent, would depend on conditions in the capital markets at that time, which are outside of our control, and on our financial performance. It may also depend potentially on our ability to make changes to our Certificate of Incorporation requiring stockholder approval that may be needed to accommodate a significant investment by a person or group. Accordingly, we may not be able to issue capital, if needed, at all, on favorable economic terms, or other terms acceptable to us.

There can be no assurance that these or other actions we may take will be sufficient and timely in order to address our consolidated and Bank capital requirements, as needed. If we cannot satisfactorily address our capital needs as they arise, our ability to maintain or expand our operations, to pay dividends on our outstanding Preferred Stock, to operate without additional regulatory sanctions or other restrictions, and our operating results, could be materially adversely affected.

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

The Company and the Bank are subject to extensive examination, supervision and comprehensive regulation by federal bank regulatory agencies. Banking regulations are primarily intended to protect depositors' funds, federal deposit insurance funds, and the banking system and the financial system as a whole, and not holders of our common stock. These regulations affect our lending practices, capital structure, investment practices, dividend policy, and growth, among other things. See Item 1 "Business – Regulation and Supervision" in the Company's Annual Report on Form 10-K for the year ended December 31, 2013 incorporated by reference herein for information regarding regulation affecting the Bank and the Company.

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

The Dodd-Frank Act requires various federal agencies, including the FRB, the OCC and the CFPB, to adopt a broad range of new implementing rules and regulations. The federal agencies were given significant discretion in drafting the implementing rules and regulations, and many of the requirements called for in the Dodd-Frank Act are being implemented over the course of several years. These changes and other changes in the regulatory landscape may significantly impact the profitability of business activities, require material changes to certain business practices, impose more stringent capital, liquidity and leverage requirements or otherwise adversely affect our business.

The capital requirements of the Company and the Bank are affected by regulatory changes approved in final rules issued in July 2013 by the FRB and the OCC to establish an integrated regulatory capital framework for implementing Basel III and changes required by the Dodd-Frank Act. The new requirements become effective beginning January 1, 2015, with respect to the Company and the Bank. The new requirements, among other things, apply a strengthened set of capital requirements to both the Bank and the Company, including new requirements relating to common equity as a component of core capital and as a “capital conservation buffer” against risk, and a higher minimum core capital requirement, and revise the rules for calculating risk-weighted assets and capital for purposes of such requirements. The final rules make corresponding revisions to the prompt corrective action framework. The application of formal capital requirements to the Company, and more stringent capital requirements to the Bank, could, among other things, result in lower returns on invested capital, require the raising of additional capital, and result in regulatory actions if the Company or the Bank are unable to comply with such requirements or if they foresee that they may be unable to comply in the future. The Basel III Rules’ changes to methods of calculating assets and capital, including changes to risk weightings and the elements of (and deductions from) regulatory capital, could result in management modifying its business strategy and could further limit the Company’s ability to make distributions, including paying dividends or repurchasing shares of stock.

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

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

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

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

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

Further, our regulators have significant discretion and authority to prevent or remedy unsafe or unsound practices or violations of laws by financial institutions and holding companies in the performance of their supervisory and enforcement duties. Examples include limits on payment of dividends by banks and regulations governing compensation. Regulation of dividends may limit the liquidity of the Company and restrictions on compensation may adversely affect our ability to attract and retain employees. See the other risk factors included herein and incorporated by reference for a discussion of other restrictions to which the Company and the Bank are subject.

We have a recent history of losses and earning asset contraction, our continued high level of classified and nonperforming assets, accruing Preferred Stock dividends and regulatory restrictions make the sustainability of our return to profitability and ability to grow uncertain.

We had net income in the years ended December 31, 2013 and 2012, but experienced net losses in each of the previous four calendar years during the four-year period ended December 31, 2011. These losses have been primarily due to loan losses in our commercial loan portfolios. We continue to have relatively high levels of nonperforming and other classified assets that pose a risk to our interest income, capital and liquidity. Accruing dividends on our outstanding Preferred Stock have significantly reduced the net income available to common stockholders since February 2011. In addition, in order to improve our capital ratios, we have significantly contracted the size of the Bank through reductions in assets, primarily loans, and in liabilities, primarily brokered deposits and advances. Total assets have decreased \$232 million and brokered deposits and advances decreased \$222 million in the three year period ended December 31, 2013. These reductions in assets and liabilities have correspondingly reduced the base of earning assets from which we realize our primary source of income, net interest income.

Our compensation expense may increase materially following Treasury's sale of the Preferred Stock and termination of the Company Supervisory Agreement.

As a result of our participation in the Capital Purchase Program, among other things, during the period Treasury owned the Preferred Stock, we were subject to Treasury's standards for executive compensation and corporate governance. As a result of Treasury's sale of the Preferred Stock, these executive compensation and corporate governance standards are no longer applicable. In addition, the Company Supervisory Agreement that was terminated on May 1, 2014 restricted our ability to revise compensation arrangements with our executive officers without the prior consent of the FRB. As a result of the Treasury's sale of the Preferred Stock and termination of the Company's Supervisory Agreement, our compensation expense for our executive officers and other senior employees may increase materially, subject to other factors, including earnings and cash flow.

Our ability to pay dividends on or repurchase our common stock is significantly restricted; we have not paid a dividend on our common stock since 2008 and our current financial condition and results of operations and our preferred stock dividend payment obligations make payment of any such dividend unlikely in the foreseeable future.

We are a stock savings bank holding company and our operations are conducted primarily by our banking subsidiary, Home Federal Savings Bank. Since we receive substantially all of our revenue from dividends from our banking subsidiary, our ability to pay dividends on our common stock depends on our receipt of dividends from our banking subsidiary. Dividend payments from our banking subsidiary are subject to legal and regulatory limitations. The ability of our banking subsidiary to pay dividends to us is also subject to its profitability, financial condition, capital expenditures and other cash flow requirements. There is no assurance that our banking subsidiary will be able to pay dividends to us in the future or that we will generate adequate cash flow to pay dividends in the future. The inability to receive dividends from our banking subsidiary could have an adverse effect on our business and financial condition.

On October 20, 2008, we announced that our board of directors had decided to suspend the payment of quarterly cash dividends on shares of Company common stock.

In addition, so long as any shares of our Preferred Stock remain outstanding, unless all accrued and unpaid dividends for all prior dividend periods have been paid or are contemporaneously declared and paid in full on our Preferred Stock, we may not pay or declare any dividend on our common stock or other junior stock, other than a dividend payable solely in common stock. Holders of shares of Preferred Stock are entitled to receive cumulative compounding cash dividends at a stated rate per annum of 9% per share on a liquidation preference of \$1,000 per share of Preferred Stock with respect to each dividend period after February 15, 2014.

These factors make payment of any common stock dividend or distribution unlikely in the foreseeable future.

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

None.

ITEM 3. Defaults Upon Senior Securities.

None.

ITEM 4. Mine Safety Disclosures.

Not applicable.

ITEM 5. Other Information.

None.

ITEM 6. Exhibits.

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

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SIGNATURES

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

HMN FINANCIAL, INC.

Registrant

Date: November 5, 2014

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

Date: November 5, 2014

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

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

| Regulation S-K Exhibit Number | Document Attached Hereto | Reference to Prior Filing or Exhibit Number | Sequential Page Numbering Where Attached Exhibits Are Located in This Form 10-Q Report |
|--|---|---|---|
| 10.1 | HMN Financial, Inc. Senior Management Incentive Plan, incorporated by reference to Exhibit 10.1 to the Company's current report on Form 8-K, dated July 22, 2014 (File No. 000-24100). | 10.1 | N/A |
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification of CEO | 31.1 | Filed Electronically |
| 31.2 | Rule 13a-14(a)/15d-14(a) Certification of CFO | 31.2 | Filed Electronically |
| 32 | Section 1350 Certifications of CEO and CFO | 32 | Filed Electronically |
| 101 | Financial statements from the Quarterly Report on Form 10-Q of the Company for the period ended September 30, 2014, filed with the SEC on November 5, 2014, formatted in eXtensible Business Reporting Language (XBRL); (i) the Consolidated Balance Sheets at September 30, 2014 and December 31, 2013, (ii) the Consolidated Statements of Comprehensive Income (Loss) for the Three Month and Nine Month Periods Ended September 30, 2014 and 2013, (iii) the Consolidated Statement of Stockholders' Equity for the Nine Month Period Ended September 30, 2014, (iv) the Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2014 and 2013, and (v) Notes to Consolidated Financial Statements. | 101 | Filed Electronically |