HMN FINANCIAL INC
Form 10-Q
May 04, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2007

OR

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

For the transition period from _________ to _________

Commission File Number 0-24100

HMN FINANCIAL, INC.
(Exact name of Registrant as specified in its Charter)

| | |
|---|---|
| Delaware<br>(State or other jurisdiction of incorporation or organization) | 41-1777397<br>(I.R.S. Employer Identification Number) |
| 1016 Civic Center Drive N.W., Rochester, MN<br>(Address of principal executive offices) | 55901<br>(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 [X]   No [ ]

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

Large accelerated filer [ ]   Accelerated filer [X]   Non-accelerated filer [ ]

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

Yes [ ]   No [X]

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

| Class | Outstanding at April 19 , 2007 |
|---|---|
| Common stock, $0.01 par value | 4,307,169 |

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PART I - FINANCIAL INFORMATION

ITEM 1 : FINANCIAL STATEMENTS

HMN FINANCIAL, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

| (dollars in thousands) | March 31, 2007 (unaudited) | December 31, 2006 |
|---|---|---|
| **ASSETS** | | |
| Cash and cash equivalents | $ 85,633 | 43,776 |
| Securities available for sale: | | |
| Mortgage-backed and related securities (amortized cost $11,445 and $6,671) | 11,110 | 6,178 |
| Other marketable securities (amortized cost $179,694 and $119,940) | 179,931 | 119,962 |
| | 191,041 | 126,140 |
| Loans held for sale | 1,412 | 1,493 |
| Loans receivable, net | 798,502 | 768,232 |
| Accrued interest receivable | 6,206 | 5,061 |
| Real estate, net | 5,127 | 2,072 |
| Federal Home Loan Bank stock, at cost | 7,511 | 7,956 |
| Mortgage servicing rights, net | 1,780 | 1,958 |
| Premises and equipment, net | 11,121 | 11,372 |
| Goodwill | 3,801 | 3,801 |
| Core deposit intangible, net | 77 | 106 |
| Prepaid expenses and other assets | 1,891 | 2,943 |
| Deferred tax asset, net | 2,941 | 2,879 |
| Total assets | $1,117,043 | 977,789 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| Deposits | $ 871,929 | 725,959 |
| Federal Home Loan Bank advances | 140,900 | 150,900 |
| Accrued interest payable | 2,203 | 1,176 |
| Customer escrows | 1,240 | 721 |
| Accrued expenses and other liabilities | 5,958 | 5,891 |
| Total liabilities | 1,022,230 | 884,647 |
| Commitments and contingencies | | |

| | | |
|---|---|---|
| Stockholders' equity: | | |
| Serial preferred stock ($.01 par value): | | |
| Authorized 500,000 shares; none issued and outstanding........ | 0 | 0 |
| Common stock ($.01 par value): | | |
| Authorized 11,000,000; issued shares 9,128,662................ | 91 | 91 |
| Additional paid-in capital........................................ | 57,537 | 57,914 |
| Retained earnings, subject to certain restrictions................. | 105,715 | 103,643 |
| Accumulated other comprehensive loss............................... | (59) | (284) |
| Unearned employee stock ownership plan shares...................... | (4,110) | (4,158) |
| Treasury stock, at cost 4,821,493 and 4,813,232 shares............. | (64,361) | (64,064) |
| Total stockholders' equity ............................ ....... | 94,813 | 93,142 |
| Total liabilities and stockholders' equity ................ ....... | $1,117,043 | 977,789 |

See accompanying notes to consolidated financial statements.

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HMN FINANCIAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(unaudited)

| | Three Months Ended March 31, | |
|---|---|---|
| (dollars in thousands) | 2007 | 2006 |
| Interest income: | | |
| Loans receivable ....................................... | $15,745 | 14,703 |
| Securities available for sale: | | |
| Mortgage-backed and related ...................... | 111 | 71 |
| Other marketable ................................. | 1,896 | 890 |
| Cash equivalents ....................................... | 443 | 256 |
| Other .................................................. | 84 | 63 |
| Total interest income ........................... | 18,279 | 15,983 |
| Interest expense: | | |
| Deposits ............................................... | 6,877 | 4,868 |
| Federal Home Loan Bank advances ........................ | 1,618 | 1,726 |
| Total interest expense .......................... | 8,495 | 6,594 |
| Net interest income ............................. | 9,784 | 9,389 |
| Provision for loan losses .................................. | 455 | 515 |
| Net interest income after provision for loan losses...................................... | 9,329 | 8,874 |
| Non-interest income: | | |
| Fees and service charges ............................... | 696 | 715 |
| Mortgage servicing fees ................................ | 271 | 303 |
| Gain on sales of loans ................................. | 796 | 246 |

| | | |
|---|---|---|
| Other | 305 | 222 |
| Total non-interest income | 2,068 | 1,486 |
| Non-interest expense: | | |
| Compensation and benefits | 3,361 | 3,259 |
| Occupancy | 1,084 | 1,100 |
| Advertising | 106 | 131 |
| Data processing | 295 | 289 |
| Amortization of mortgage servicing rights, net | 182 | 217 |
| Other | 922 | 944 |
| Total non-interest expense | 5,950 | 5,940 |
| Income before income tax expense | 5,447 | 4,420 |
| Income tax expense | 2,179 | 1,680 |
| Net income | $ 3,268 | 2,740 |
| Basic earnings per share | $ 0.87 | 0.71 |
| Diluted earnings per share | $ 0.82 | 0.68 |

See accompanying notes to consolidated financial statements.



HMN FINANCIAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME
FOR THE THREE MONTH PERIOD ENDED MARCH 31, 2007
(unaudited)

| (dollars in thousands) | Common Stock | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Loss |
|---|---|---|---|---|
| Balance, December 31, 2006 | 91 | 57,914 | 103,643 | (284) |
| Net income | | | 3,268 | |
| Other comprehensive income, net of tax: | | | | |
| Net unrealized gains on securities available for sale | | | | 225 |
| Total comprehensive income | | | | |
| Purchase of treasury stock | | | | |
| FIN 48 - Cumulative effect adjustment | | | (250) | |
| Employee stock options exercised | | (143) | | |
| Tax benefits of exercised stock options | | 58 | | |
| Unearned compensation restricted stock awards | | (469) | | |
| Stock compensation benefits | | 7 | | |
| Amortization of restricted stock awards | | 76 | | |
| Dividends paid | | | (946) | |

| | | | | |
|---|---|---|---|---|
| Earned employee stock ownership plan shares | | 94 | | |
| Balance, March 31, 2007 | 91 | 57,537 | 105,715 | (59) |

See accompanying notes to consolidated financial statements.



HMN FINANCIAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

| | Three Months March 31, | |
|---|---|---|
| (dollars in thousands) | 2007 | |
| **Cash flows from operating activities:** | | |
| Net income | $ 3,268 | |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Provision for loan losses | 455 | |
| Depreciation | 483 | |
| Amortization of discounts, net | (730) | |
| Amortization of deferred loan fees | (208) | |
| Amortization of core deposit intangible | 29 | |
| Amortization of mortgage servicing rights, net | 182 | |
| Capitalized mortgage servicing rights | (4) | |
| Gain on sales of real estate | (27) | |
| Gain on sales of loans | (796) | |
| Proceeds from sales of real estate | 361 | |
| Proceeds from sale of loans held for sale | 18,764 | 1 |
| Disbursements on loans held for sale | (7,556) | (1 |
| Amortization of restricted stock awards | 76 | |
| Amortization of unearned ESOP shares | 48 | |
| Earned employee stock ownership shares priced above original cost | 94 | |
| Stock option compensation | 7 | |
| Increase in accrued interest receivable | (1,145) | |
| Increase (decrease) in accrued interest payable | 1,027 | |
| Decrease (increase) in other assets | 617 | |
| Increase in other liabilities | 38 | |
| Other, net | 124 | |
| Net cash provided by operating activities | 15,107 | |
| **Cash flows from investing activities:** | | |
| Principal collected on securities available for sale | 275 | |
| Proceeds collected on maturities of securities available for sale | 45,000 | 3 |
| Purchases of securities available for sale | (109,193) | (3 |
| Purchases of Federal Home Loan Bank Stock | (720) | |
| Redemption of Federal Home Loan Bank Stock | 1,165 | |
| Net (increase) decrease in loans receivable | (44,351) | 1 |
| Purchases of premises and equipment | (238) | |
| Net cash (used) provided in investing activities | (108,062) | 1 |

| | | |
|---|---|---|
| Cash flows from financing activities: | | |
| Increase (decrease) in deposits | 146,090 | ( |
| Purchase of treasury stock | (997) | |
| Stock options exercised | 88 | |
| Excess tax benefit from options exercised | 58 | |
| Dividends to stockholders | (946) | |
| Proceeds from Federal Home Loan Bank advances | 22,500 | |
| Repayment of Federal Home Loan Bank advances | (32,500) | |
| Proceeds from Federal Reserve Bank advances | 2,000 | |
| Repayment of Federal Reserve Bank advances | (2,000) | ( |
| Increase in customer escrows | 519 | |
| Net cash provided (used) by financing activities | 134,812 | ( |
| Increase in cash and cash equivalents | 41,857 | |
| Cash and cash equivalents, beginning of period | 43,776 | 4 |
| Cash and cash equivalents, end of period | $ 85,633 | 5 |
| Supplemental cash flow disclosures: | | |
| Cash paid for interest | $ 7,468 | |
| Cash paid for income taxes | 1,010 | |
| Supplemental noncash flow disclosures: | | |
| Transfer of loans to real estate | 3,507 | |
| Loans transferred to loans held for sale | 10,327 | |

See accompanying notes to consolidated financial statements.



HMN FINANCIAL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

MARCH 31, 2007 AND 2006

## (1) HMN FINANCIAL, INC.

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

The consolidated financial statements included herein are for HMN, SFC, the Bank and the Bank's consolidated entities as described above. All significant intercompany accounts and transactions have been eliminated in consolidation.

## (2) BASIS OF PREPARATION

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-Q and therefore, do not include all disclosures necessary for a complete presentation of the consolidated balance sheets, consolidated statements of income, consolidated statement of stockholders' equity and comprehensive income and consolidated statements of cash flows in conformity with 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 statement of income for the three-month period ended March 31, 2007 is not necessarily indicative of the results which may be expected for the entire year.

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

(3) NEW ACCOUNTING STANDARDS

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 requires companies to recognize in their financial statements the impact of a tax position, taken or expected to be taken, if it is more likely than not that the position will be sustained on audit based on the technical merits of the position. The Interpretation requires the use of a cumulative probability methodology to determine the amounts and probabilities of all of the possible outcomes that could be realized upon the ultimate settlement of a tax position using the facts, circumstances, and information available at the reporting date. It also requires that interest expense be accrued on the difference between the tax position recognized in accordance with the Interpretation and the amount previously taken or expected to be taken in a tax return. The provisions of FIN 48 were adopted by the Company on January 1, 2007 and as a result, the Company recognized an increase in its liability recorded for tax exposure reserves. See Note 12 Income Taxes for additional FIN 48 disclosures.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about the use of fair value to measure assets and liabilities. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and for interim periods within those fiscal years. The impact of adopting SFAS No. 157 on January 1, 2008 is not anticipated to have a material impact on the Company's financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, Including an amendment of FASB Statement No. 115. This Statement permits entities to measure many



financial instruments and other items at fair value and most of the provisions of the Statement apply only to entities that elect the fair value option. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and for interim periods within those fiscal years. Early adoption is permitted as of the beginning of a fiscal year that begins prior to the effective date, provided the entity also elects to apply the provisions of FASB Statement No. 157, Fair Value Measurements. The impact of adopting SFAS No. 159 on January 1, 2008 is not anticipated to have a material impact on the Company's financial statements.

(4) DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

The Company has commitments outstanding to extend credit to future borrowers that had not closed prior to the end of the quarter. The Company intends to sell these commitments which are referred to as its mortgage pipeline. As commitments to originate or purchase loans enter the mortgage pipeline, the Company generally enters into commitments to sell the loans into the secondary market on a firm commitment or best efforts basis. The commitments to originate, purchase or sell loans on a firm commitment basis are derivatives. As a result of marking to market the mortgage pipeline and the related firm commitments to sell for the period ended March 31, 2007, the Company recorded an increase in other liabilities of $29,000 and a loss in the gain on sales of loans of $29,000.

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 at March 31, 2007. The Company recorded a decrease in loans held for sale of $24,000 and an increase in other assets of $24,000 due to the mark to market adjustment on the commitments to sell loans held for sale.

(5) COMPREHENSIVE INCOME

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

| | For the period ended March 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2007 | | | 2006 | | |
| (Dollars in thousands) | Before tax | Tax effect | Net of tax | Before tax | Tax effect | Net of tax |
| Securities available for sale: | | | | | | |
| Net unrealized gains arising during the period | $373 | 148 | 225 | 230 | 91 | 139 |
| Other comprehensive income | $373 | 148 | 225 | 230 | 91 | 139 |

(6) SECURITIES AVAILABLE FOR SALE

The following table shows the gross unrealized losses and fair value for the securities available for sale portfolio, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at March 31, 2007.

| | Less than twelve months | | | Twelve months or more | | |
|---|---|---|---|---|---|---|
| (Dollars in thousands) | # of Investments | Fair Value | Unrealized Losses | # of Investments | Fair Value | Unrealized Losses |
| Mortgage backed securities: | | | | | | |
| FHLMC | 0 | $ 0 | 0 | 2 | $2,732 | (196) |
| FNMA | 0 | 0 | 0 | 3 | 3,116 | (190) |
| Other marketable debt securities: | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| FNMA | 8 | 44,543 | (26) | 0 | 0 | 0 |
| FHLMC | 2 | 9,871 | (5) | 0 | 0 | 0 |
| FHLB | 7 | 44,817 | (41) | 0 | 0 | 0 |
| Total temporarily impaired securities | 17 | $99,231 | (72) | 5 | $5,848 | (386) |

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



table above had an average life of less than nine years and the other marketable securities had an average life of less than one year at March 31, 2007.

(7) INVESTMENT IN MORTGAGE SERVICING RIGHTS

A summary of mortgage servicing activity is as follows:

| (Dollars in thousands) | Three months ended March 31, 2007 | Twelve months ended December 31, 2006 | Three months ended March 31, 2006 |
|---|---|---|---|
| Mortgage servicing rights: | | | |
| Balance, beginning of period ....... | $1,958 | 2,654 | 2,654 |
| Originations ...................... | 4 | 152 | 48 |
| Amortization ...................... | (182) | (848) | (217) |
| Balance, end of period ............ | 1,780 | 1,958 | 2,485 |
| Mortgage servicing rights, net ..... | $1,780 | 1,958 | 2,485 |
| Fair value of mortgage servicing rights ......................... | $3,809 | 3,823 | 4,420 |

All of the loans being serviced were single family loans serviced for the Federal National Mortgage Association (FNMA) under the mortgage-backed security program or the individual loan sale program. The following is a summary of the risk characteristics of the loans being serviced at March 31, 2007.

| (Dollars in thousands) | Loan Principal Balance | Weighted Average Interest Rate | Weighted Average Remaining Term | Number of Loans |
|---|---|---|---|---|
| Original term 30 year fixed rate | $197,842 | 5.93% | 321 | 1,755 |
| Original term 15 year fixed rate | 170,004 | 5.27% | 139 | 2,335 |
| Adjustable rate | 4,095 | 5.70% | 312 | 38 |

(8) INTANGIBLE ASSETS

The gross carrying amount of intangible assets and the associated accumulated amortization at March 31, 2007 is presented in the table below. Amortization expense for intangible assets was $182,000 for the period ended March 31, 2007.

| (Dollars in thousands) | Gross Carrying Amount | Accumulated Amortization | Unamortized Intangible Assets |
|---|---|---|---|
| Amortized intangible assets: | | | |
| Mortgage servicing rights | $4,077 | (2,297) | 1,780 |
| Core deposit intangible | 1,567 | (1,490) | 77 |
| Total | $5,644 | (3,787) | 1,857 |

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

| (Dollars in thousands) | Mortgage Servicing Rights | Core Deposit Intangible | Total |
|---|---|---|---|
| Year ended December 31, | | | |
| 2007 | $445 | 77 | 522 |
| 2008 | 552 | 0 | 552 |
| 2009 | 406 | 0 | 406 |
| 2010 | 221 | 0 | 221 |
| 2011 | 107 | 0 | 107 |



Projections of amortization are based on existing asset balances and the existing interest rate environment as of March 31, 2007. The Company's actual experience may be significantly different depending upon changes in mortgage interest rates and other market conditions.

(9) EARNINGS PER SHARE

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

| | Three months ended March 31, | |
|---|---|---|
| | 2007 | 2006 |

| | | |
|---|---|---|
| Weighted average number of common shares outstanding used in basic earnings per common share calculation | 3,775,843 | 3,839,874 |
| Net dilutive effect of: | | |
| Options | 172,043 | 168,074 |
| Restricted stock awards | 19,541 | 12,877 |
| Weighted average number of shares outstanding adjusted for effect of dilutive securities | 3,967,427 | 4,020,825 |
| Income available to common shareholders | $3,268,000 | 2,740,000 |
| Basic earnings per common share | $ 0.87 | 0.71 |
| Diluted earnings per common share | $ 0.82 | 0.68 |

(10) REGULATORY CAPITAL

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

Quantitative measures established by regulations to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of Tier I or Core capital, and Risk-based capital (as defined in the regulations) to total assets (as defined). Management believes, as of March 31, 2007, that the Bank meets all capital adequacy requirements to which it is subject.

Management believes that based upon the Bank's capital calculations at March 31, 2007 and other conditions consistent with the Prompt Corrective Actions Provisions of the OTS regulations, the Bank would be categorized as well capitalized.

On March 31, 2007 the Bank's tangible assets and adjusted total assets were $1.1 billion and its risk-weighted assets were $844 million. The following table presents the Bank's capital amounts and ratios at March 31, 2007 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 | Exc |
|---|---|---|

| (Dollars in thousands) | Amount | Percent of Assets(1) | Amount | Percent of Assets (1) | Amoun |
|---|---|---|---|---|---|
| Bank stockholder's equity .................. | $90,278 | | | | |
| Less: | | | | | |
| Net unrealized losses on certain securities available for sale ......... | 59 | | | | |
| Goodwill and core deposit intangible ..... | (3,878) | | | | |
| Disallowed servicing and tax assets ...... | (2,519) | | | | |
| | 83,940 | | | | |
| Tier I or core capital | | | | | |
| Tier I capital to adjusted total assets .. | | 7.58% | 44,295 | 4.00% | 39,64 |
| Tier I capital to risk-weighted assets ... | | 9.95% | 33,750 | 4.00% | 50,19 |
| Plus: | | | | | |
| Allowable allowance for loan losses ......... | 9,404 | | | | |
| Risk-based capital ......................... | $93,344 | | 67,501 | | 25,84 |
| Risk-based capital to risk-weighted assets .. | | 11.06% | | 8.00% | |

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

The tangible capital of the Bank was in excess of the minimum 2% required at March 31, 2007 but is not reflected in the table above.

(11) COMMITMENTS AND CONTINGENCIES

The Bank issued standby letters of credit which guarantee the performance of customers to third parties. The standby letters of credit issued and available at March 31, 2007 were approximately $13.0 million, expire over the next two years, and are collateralized primarily with commercial real estate mortgages. Since the conditions under which the Bank is required to fund the standby letters of credit may not materialize, the cash requirements are expected to be less than the total outstanding commitments.

In February 2007, the Minnesota Department of Revenue (MDR) assessed a deficiency of $2.2 million against the Company's 2002 through 2004 Minnesota state tax payments. The deficiency relates to the tax treatment of the inter-company dividends paid to the Bank by a former subsidiary of the Company. The Company filed a Notice of Appeal in the Minnesota Tax Court challenging that assessment on March 2, 2007. The MDR has not yet filed a response to the Notice of Appeal.

(12) INCOME TAXES

On January 1, 2007, the Company adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). Implementation of FIN 48 resulted in a $250,000 cumulative effect adjustment to retained earnings as of the date of adoption. At January 1, 2007, the total amount of unrecognized tax benefits was $600,000, of which $390,000 related to tax benefits that if recognized, would impact the annual effective tax rate. We recognize both interest and penalties as a component of income tax expense. The liability for unrecognized tax benefits includes $69,000 of interest and no penalties. It is reasonably possible that the total unrecognized tax benefit as of January 1, 2007 could increase by $1.6 million or be reduced to zero within the next 12 month period. It is also reasonably possible that any benefit may be substantially offset by new matters arising during this same period. The Company files consolidated federal and state income tax returns. With few exceptions, we are not subject to federal income tax examinations for taxable years prior to 2003, or state examinations prior to 2002.

The adoption of FIN 48 may result in increased volatility to our annual effective tax rate because FIN 48 requires that any change in judgment or change in measurement of a tax position taken in a prior annual period be

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recognized as a discrete event in the period in which it occurs. The impact to the rate in the first quarter amounted to a $9,000 increase in income tax expense.

(13) BUSINESS SEGMENTS

The Bank has been identified as a reportable operating segment in accordance with the provisions of SFAS No. 131. SFC and HMN did not meet the quantitative thresholds for determining reportable segments and therefore are included in the "Other" category.

The Company evaluates performance and allocates resources based on the segments net income. 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 reconciliations of reported profit or loss and assets for each of the Company's reportable segments.

| (Dollars in thousands) | Home Federal Savings Bank | Other | Eliminations | Consolidated Total |
|---|---|---|---|---|
| AT OR FOR THE QUARTER ENDED MARCH 31, 2007: | | | | |
| Interest income - external customers...... | $ 18,258 | 21 | 0 | 18,279 |
| Non-interest income - external customers.. | 2,064 | 0 | 0 | 2,064 |
| Earnings on limited partnerships.......... | 4 | 0 | 0 | 4 |
| Intersegment interest income.............. | 0 | 41 | (41) | 0 |
| Intersegment non-interest income.......... | 44 | 3,325 | (3,369) | 0 |
| Interest expense.......................... | 8,536 | 0 | (41) | 8,495 |
| Amortization of mortgage servicing rights, net........................... | 182 | 0 | 0 | 182 |
| Other non-interest expense................ | 5,641 | 170 | (43) | 5,768 |
| Income tax expense (benefit).............. | 2,229 | (50) | 0 | 2,179 |
| Net income................................ | 3,327 | 3,267 | (3,326) | 3,268 |
| Goodwill.................................. | 3,801 | 0 | 0 | 3,801 |
| Total assets.............................. | 1,112,136 | 95,417 | (90,510) | 1,117,043 |
| AT OR FOR THE QUARTER ENDED MARCH 31, 2006: | | | | |
| Interest income - external customers...... | $ 15,940 | 43 | 0 | 15,983 |
| Non-interest income - external customers.. | 1,493 | 0 | 0 | 1,493 |
| Losses on limited partnerships............ | (7) | 0 | 0 | (7) |
| Intersegment non-interest income.......... | 34 | 2,808 | (2,842) | 0 |
| Interest expense.......................... | 6,594 | 0 | 0 | 6,594 |
| Amortization of mortgage servicing | | | | |

| | | | | |
|---|---|---|---|---|
| rights, net........................... | 217 | 0 | 0 | 217 |
| Other non-interest expense............... | 5,599 | 157 | (33) | 5,723 |
| Income tax expense (benefit)............. | 1,725 | (45) | 0 | 1,680 |
| Net income............................... | 2,810 | 2,739 | (2,809) | 2,740 |
| Goodwill................................. | 3,801 | 0 | 0 | 3,801 |
| Total assets............................. | 985,107 | 93,269 | (88,392) | 989,984 |



HMN FINANCIAL, INC.

ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD-LOOKING INFORMATION

This quarterly Report and other reports filed by the Company with the Securities and Exchange Commission may contain "forward-looking" statements that deal with future results, plans or performance. In addition, the Company's management may make such statements orally to the media, or to securities analysts, investors or others. Forward-looking statements deal with matters that do not relate strictly to historical facts. Words such as "anticipate", "believe", "expect", "intend", "would", "could" and similar expressions, as they relate to us, are intended to identify such forward-looking statements. The Company's future results may differ materially from historical performance and forward-looking statements about the Company's expected financial results or other plans are subject to a number of risks and uncertainties. These include but are not limited to possible legislative changes and adverse economic, business and competitive developments such as shrinking interest margins; deposit outflows; reduced demand for financial services and loan products; changes in accounting policies and guidelines, or monetary and fiscal policies of the federal government; changes in credit and other risks posed by the Company's loan and investment portfolios; changes in loan repayment and prepayment patterns; changes in loan terms and conditions; technological, computer-related or operational difficulties; adverse changes in securities markets; results of litigation or other significant uncertainties. For additional discussion of the risks and uncertainties applicable to the Company, see the "Risk Factors" section of the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

GENERAL

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

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

CRITICAL ACCOUNTING POLICIES

Critical accounting policies are those policies that the Company's management believes are the most important to understanding the Company's financial condition and operating results. The Company has



identified the following policies as being critical because they require difficult, subjective, and/or complex judgments that are inherently uncertain. Therefore, actual financial results could differ significantly depending upon the estimates used.

Allowance for Loan Losses and Related Provision

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

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

Mortgage Servicing Rights

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



volume increases and the value of MSRs decreases.

Income Taxes

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

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

NET INCOME

Net income for the first quarter of 2007 was $3.3 million, up $528,000, or 19.3%, from net income of $2.7 million for the first quarter of 2006. Diluted earnings per common share for the first quarter of 2007 were $0.82, up $0.14, or 20.6%, from $0.68 for the first quarter of 2006. The increase in net income was due primarily to increases in net interest income and the gains recognized on the sale of commercial loans.

NET INTEREST INCOME

Net interest income was $9.8 million for the first quarter of 2007, an increase of $395,000, or 4.2%, compared to $9.4 million for the first quarter of 2006. Interest income was $18.3 million for the first quarter of 2007, an increase of $2.3 million, or 14.4%, from $16.0 million for the first quarter of 2006. Interest income increased primarily because of an increase in the average interest rate earned on loans and investments. Interest rates increased primarily because of the 50 basis point increase in the prime interest rate between the periods. Increases in the prime rate, which is the rate that banks charge their prime business customers, generally increase the rates on adjustable rate consumer and commercial loans in the portfolio and on new loans originated. The average yield earned on interest-earning assets was 7.49% for the first quarter of 2007, an increase of 51 basis points from the 6.98% average yield for the first quarter of 2006. Interest income also increased because of the $61 million increase in the average interest earning assets between the periods.

Interest expense was $8.5 million for the first quarter of 2007, an increase of $1.9 million, or 28.8%, compared to $6.6 million for the first quarter of 2006. Interest expense increased because of the higher interest rates paid on deposits which were caused by the 50 basis point increase in the federal funds rate between the periods. Increases in the federal funds rate, which is the rate that banks charge other banks for short term loans, generally increase the rates banks pay for deposits. The average interest rate paid on interest-bearing liabilities was 3.69% for the first quarter of 2007, an increase of 62 basis points from the 3.07% average interest rate paid in the first quarter of 2006. The average rate on interest bearing liabilities increased more than the average yield on interest bearing assets primarily because most of the deposit growth between the periods was in higher rate money market accounts while the majority of the asset growth was in lower yielding investments.

Net interest margin (net interest income divided by average interest earning assets) for the first quarter of 2007 was 4.01%, a decrease of 9 basis points, compared to 4.10% for the first quarter of 2006.



PROVISION FOR LOAN LOSSES

The provision for loan losses was $455,000 for the first quarter of 2007, a decrease of $60,000, compared to $515,000 for the first quarter of 2006. The provision for loan losses decreased primarily because of a decrease in the number of commercial loan risk rating downgrades in the first quarter of 2007 when compared to the same period of 2006. The decrease in the provision due to fewer loan risk ratings downgrades was partially offset by the $33 million in loan growth that was experienced in the first quarter of 2007.

A reconciliation of the Company's allowance for loan losses for the quarters ended March 31, 2007 and 2006 is summarized as follows:

| (in thousands) | 2007 | 2006 |
|---|---|---|
| Balance at January 1, | $9,873 | $8,778 |
| Provision | 455 | 515 |
| Charge offs: | | |
| Commercial real estate | (42) | 0 |
| Consumer | (580) | (91) |
| Recoveries | 50 | 47 |
| Balance at March 31, | $9,756 | $9,249 |

The increase in consumer loan charge offs is primarily the result of a $508,000 charge off on a home equity loan in the first quarter of 2007 for which a reserve was established in the fourth quarter of 2006.

NON-INTEREST INCOME

Non-interest income was $2.1 million for the first quarter of 2007, an increase of $582,000, or 39.2%, from $1.5 million for the first quarter of 2006. Gain on sale of loans increased $550,000 between the periods due to a $612,000 increase in the gain recognized on the sale of government guaranteed commercial loans that was primarily the result of the gain recognized on the sale of an $8.7 million USDA loan. The increase in commercial loan sales was partially offset by a $62,000 decrease in the gain recognized on the sale of single family loans due to a decrease in the volume and profit margins on the loans that were sold. Competition in the single-family loan origination market continues to be very strong and profit margins were lowered in order to remain competitive and maintain origination volumes. Fees and service charges decreased $19,000 between the periods primarily because of decreased late fees. Loan servicing fees decreased $32,000 primarily because of a decrease in the number of single-family loans that are being serviced for others. Other non-interest income increased $83,000 primarily because of increased revenues from the sale of uninsured investment products.

NON-INTEREST EXPENSE

Non-interest expense was $6.0 million for the first quarter of 2007, an increase of $10,000, or 0.2%, from $5.9 million for the first quarter of 2006. Compensation expense increased $102,000 primarily because of annual payroll cost increases. Occupancy expense decreased $16,000 due primarily to a decrease in real estate taxes. Advertising expense decreased $25,000 between the periods primarily because of a decrease in the costs associated with promoting a new branch and the introduction of new checking account offerings that occurred in the first quarter of 2006. Mortgage servicing rights amortization decreased $35,000 between the periods because there are fewer mortgage loans being serviced.

INCOME TAX EXPENSE

Income tax expense increased $499,000 between the periods due to an increase in taxable income and an effective tax rate that increased from 38.0% for the first quarter of 2006 to 40.0% for the first quarter of 2007. The increase in the effective tax rate was the result of changes in state tax allocations, a decrease in low income tax credits and an increase in the federal tax rate due to increased income.



NON-PERFORMING ASSETS

The following table summarizes the amounts and categories of non-performing assets in the Bank's portfolio at March 31, 2007 and December 31, 2006.

| (Dollars in thousands) | March 31, 2007 | December 31, 2006 |
|---|---|---|
| Non-Accruing Loans: | | |
| One-to-four family real estate | $ 1,576 | $ 1,364 |
| Commercial real estate | 4,290 | 5,296 |
| Consumer | 843 | 1,254 |
| Commercial business | 814 | 394 |
| Total | 7,523 | 8,308 |
| Other assets | 44 | 44 |
| Foreclosed and Repossessed Assets: | | |
| One-to-four family real estate | 4,477 | 1,422 |
| Consumer | 14 | 0 |
| Commercial real estate | 650 | 650 |
| Total non-performing assets | $12,708 | $10,424 |
| Total as a percentage of total assets | 1.14% | 1.07% |
| Total non-performing loans | $ 7,523 | $ 8,308 |
| Total as a percentage of total loans receivable, net | 0.94% | 1.08% |

| | | |
|---|---|---|
| Allowance for loan loss to non-performing loans | 129.68% | 118.84% |

Total non-performing assets were $12.7 million at March 31, 2007, an increase of $2.3 million, from $10.4 million at December 31, 2006. Non-performing loans decreased $785,000 and foreclosed and repossessed assets increased $3.1 million during the period. Of the increase in foreclosed and repossessed assets, $1.8 million was the result of purchasing the first mortgage on a previously classified non-performing second mortgage loan in order to improve the Company's lien position.

DIVIDENDS

On April 24, 2007 the Company declared a cash dividend of $0.25 per share, payable on June 7, 2007 to shareholders of record on May 18, 2007.

During the first quarter of 2007, the Company declared and paid a dividend as follows:

| Record date | Payable date | Dividend per share | Dividend Payout Ratio |
|---|---|---|---|
| February 16, 2007 | March 7, 2007 | $0.25 | 37.31% |

The annualized dividend payout ratio for the past four quarters, ending with the June 7, 2007 payment will be 44.64%.

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

LIQUIDITY

For the quarter ended March 31, 2007, the net cash provided by operating activities was $15.1 million. The Company collected $45.3 million in principal repayments and maturities on securities during the quarter. It purchased $109.9 million in securities and FHLB stock, $238,000 in premises and equipment and funded $44.4 million relating to an increase in net loans receivable. The Company had a net increase in deposit balances of $146.1 million during the quarter, received $88,000 related to the exercise of HMN stock options, paid $946,000 in dividends to its shareholders and purchased $997,000 of treasury stock. It also received $24.5 million in



advance proceeds and paid off advances of $34.5 million.

The Company has certificates of deposits with outstanding balances of $335.4 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 which do not renew will be replaced with deposits from other customers or brokers. FHLB advances or proceeds from the sale of securities could also be used to replace unanticipated outflows of deposits.

The Company has deposits of $210.8 million in checking and money market accounts with customers that have individual balances greater than $5 million. While these funds may be withdrawn at any time, management anticipates that the majority will remain on deposit with the Bank over the next twelve months. If these deposits were to be withdrawn, they would be replaced with deposits from other customers or brokers. FHLB advances or proceeds from the sale of securities could also be used to replace unanticipated outflows of large checking and money market deposits.

The Company has $30.0 million of FHLB advances that mature during the next twelve months. The Company also has $100.9 million of FHLB advances that mature beyond March 31, 2008 but have call features that can be exercised by the FHLB during the next twelve months. If the call features are exercised, the Company has the option of requesting any advance otherwise available to it pursuant to the credit policy of the FHLB.

MARKET RISK

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

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

The Company utilizes a model that uses the discounted cash flows from its interest-earning assets and its interest-bearing liabilities to calculate the current market value of those assets and liabilities. The model also calculates the changes in market value of the interest-earning assets and interest-bearing liabilities due to different interest rate changes. The Company believes that over the next twelve months interest rates could fluctuate in a range of 200 basis points up or down from where the rates were at March 31, 2007. The following table discloses the projected changes in market value to the Company's interest-earning assets and interest-bearing liabilities based upon incremental 100 basis point changes in interest rates from interest rates in effect on March 31, 2007.

| (Dollars in thousands) | Market Value | | | |
| --- | --- | --- | --- | --- |
| Basis point change in interest rates | -200 | -100 | 0 | +100 |
| Total market risk sensitive assets............ | $1,115,368 | 1,106,364 | 1,095,120 | 1,081,824 |
| Total market risk sensitive liabilities....... | 1,009,481 | 996,866 | 986,299 | 978,297 |
| Off-balance sheet financial instruments....... | (13) | (2) | 0 | 111 |
| Net market risk.............................. | $ 105,900 | 109,500 | 108,821 | 103,416 |
| Percentage change from current market value... | (2.68)% | 0.62% | 0.00% | (4.97) |

========== ========= ========= =========

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 7% to 70%, depending on the note rate and the period to maturity. Adjustable rate mortgages (ARMs) were assumed to prepay at annual rates of between 10% and 31%, depending on the note rate and the period to maturity. Growing Equity Mortgage (GEM) loans were assumed to prepay at annual rates of between 6% and 49% depending on the note rate and the period to maturity. Mortgage-backed securities and Collateralized Mortgage Obligations (CMOs) were projected to have prepayments based upon the underlying collateral securing the instrument and the related cash flow priority of the CMO tranche owned. Certificate accounts were assumed not to be withdrawn until maturity. Passbook accounts were assumed to decay at an annual rate of 26% and money market accounts were assumed to decay at an annual rate of 31%. Non-interest checking accounts were assumed to decay at an annual rate of 33% and NOW accounts were assumed to decay at an annual rate of 17%. FHLB advances were projected to be called at the first call date where the projected interest rate on similar remaining term advances exceeded the interest rate on the callable advance.

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

ASSET/LIABILITY MANAGEMENT

The Company's management reviews the impact that changing interest rates will have on its net interest income projected for the twelve months following March 31, 2007 to determine if its current level of interest rate risk is acceptable. The following table projects the estimated annual impact on net interest income of immediate interest rate changes called rate shocks.

| (Dollars in thousands) | Rate Shock in Basis Points | Projected Change in Net Interest Income | Percentage Change |
|---|---|---|---|

| | | |
|---|---|---|
| +200 | $(1,717) | (4.36)% |
| +100 | (735) | (1.87)% |
| 0 | 0 | 0.00% |
| -100 | 18 | 0.05% |
| -200 | (753) | (1.91)% |

The preceding table was prepared utilizing the Model Assumptions. Certain shortcomings are inherent in the method of analysis presented in the foregoing table. In the event of a change in interest rates, prepayment and early withdrawal levels would likely deviate significantly from those assumed in calculating the foregoing table. The ability of many borrowers to service their debt may decrease in the event of a substantial increase in interest rates and could impact net interest income. The decrease in interest income in a rising rate environment is because some adjustable rate loans hit their interest rate ceilings and will not reprice higher. In addition, the model assumes that outstanding callable advances would be called in an up 100 basis point rate shock scenario, which would increase the Bank's cost of funds and reduce net interest income.

In an attempt to manage its exposure to changes in interest rates, management closely monitors interest rate risk. The Bank has an Asset/Liability Committee which meets frequently to discuss changes in the interest rate risk position and projected profitability. The Committee makes adjustments to the asset-liability position of the Bank, which are reviewed by the Board of Directors of the Bank. This Committee also reviews the Bank's portfolio,



formulates investment strategies and oversees the timing and implementation of transactions to assure attainment of the Board's objectives in the most effective manner. In addition, each quarter the Board reviews the Bank's asset/liability position, including simulations of the effect on the Bank's capital of various interest rate scenarios.

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

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

ITEM 4: CONTROLS AND PROCEDURES

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

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



HMN FINANCIAL, INC.

PART II - OTHER INFORMATION

ITEM 1. Legal Proceedings.

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

In February 2007, the Minnesota Department of Revenue (MDR) assessed a deficiency of $2.2 million against the Company's 2002 through 2004 Minnesota state tax payments. The deficiency relates to the tax treatment of the inter-company dividends paid to the Bank by a former subsidiary of the Company. The Company filed a Notice of Appeal in the Minnesota Tax Court challenging that assessment on March 2, 2007. The MDR has not yet filed a response to the Notice of Appeal.

ITEM 1A. Risk Factors.

No changes from risk factors previously disclosed in December 31, 2006 Form 10-K.

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

(a) and (b) Not applicable
(c) Information Regarding Share Repurchases

| Period | (a) Total Number of Shares Purchased | (b) Average Price Paid per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) Maxi of Shares Be Purchas Plans o |
|---|---|---|---|---|

| | | | | |
|---|---|---|---|---|
| January 1 through January 31, 2007 | 10,000 | $34.32 | 10,000 | 29 |
| February 1 through February 28, 2007 | 0 | N/A | 0 | 29 |
| March 1 through March 31, 2007 | 19,000 | 34.42 | 19,000 | 27 |
| Total | 29,000 | $34.37 | 29,000 | |

(1) On January 23, 2007, the Board of Directors authorized the repurchase of up to 300,000 shares of the Company's common stock. This program expires on July 23, 2008.

ITEM 3. Defaults Upon Senior Securities.

Not applicable.

ITEM 4. Submission of Matters to a Vote of Security Holders.

None.

ITEM 5. Other Information.

None.

ITEM 6. Exhibits.

See Index to Exhibits on page 24 of this report.



SIGNATURES

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

HMN FINANCIAL, INC.
Registrant

Date: May 4, 2007

/s/ Michael McNeil

Michael McNeil,
President and Chief Executive Officer
(Principal Executive Officer)
(Duly Authorized Representative)

Date: May 4, 2007

/s/ Jon Eberle

Jon Eberle,
Chief Financial Officer
(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 |
|---|---|---|---|
| 3.1 | Amended and Restated Articles of Incorporation | *1 | N/A |
| 3.2 | Amended and Restated By-laws | *2 | N/A |
| 4 | Form of Common Stock Certificates | *3 | N/A |
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification of CEO | 31.1 | Filed Electronically |
| 31.2 | Rule 13a-14(a)/15d14(a) Certification of CFO | 31.2 | Filed Electronically |
| 32 | Section 1350 Certification of CEO and CFO | 32 | Filed Electronically |

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

*2 Incorporated by reference Exhibit 3 to the Company's Current Report on Form 8-K dated February 22, 2005, filed on February 23, 2005 (File 0-24100).

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