

HMN FINANCIAL INC  
Form 10-Q  
May 03, 2019

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

**(Mark One)**

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

For the quarterly period ended **March 31, 2019**

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.)

**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**

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class      Trading Symbol(s)

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|                     |             |   |
|---------------------|-------------|---|
| <b>Common Stock</b> | <b>HMNF</b> | Name of Each Exchange on Which<br>Registered<br><b>NASDAQ</b> |
|---------------------|-------------|---|

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 every Interactive Data File required to be submitted 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 such files). Yes No

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

|                           |                         |                       |
|---------------------------|-------------------------|-----------------------|
| Large accelerated filer   | Accelerated filer       | Non-accelerated filer |
| Smaller reporting company | Emerging growth company |                       |

If an emerging growth company, indicate by checkmark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

**APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS:**

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes No

**APPLICABLE ONLY TO CORPORATE ISSUERS**

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

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| Class                          | Outstanding at April 24, 2019 |
|--------------------------------|-------------------------------|
| Common stock, \$0.01 par value | 4,843,822                     |

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HMN FINANCIAL, INC.

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Consolidated Balance Sheets**

| <i>(Dollars in thousands)</i>  | March 31,<br>2019<br>(unaudited) | December<br>31,<br>2018 |
|--|----------------------------------|-------------------------|
| <b>Assets</b>  |                                  |                         |
| Cash and cash equivalents  | \$ 15,121                        | 20,709                  |
| Securities available for sale:   |                                  |                         |
| Mortgage-backed and related securities (amortized cost \$7,748 and \$8,159)    | 7,743                            | 8,023                   |
| Other marketable securities (amortized cost \$73,035 and \$73,343)             | 72,189                           | 71,957                  |
|  | 79,932                           | 79,980                  |
| Loans held for sale  | 3,292                            | 3,444                   |
| Loans receivable, net  | 599,462                          | 586,688                 |
| Accrued interest receivable  | 2,326                            | 2,356                   |
| Real estate, net   | 444                              | 414                     |
| Federal Home Loan Bank stock, at cost  | 853                              | 867                     |
| Mortgage servicing rights, net   | 1,831                            | 1,855                   |
| Premises and equipment, net  | 9,551                            | 9,635                   |
| Goodwill   | 802                              | 802                     |
| Core deposit intangible  | 231                              | 255                     |
| Prepaid expenses and other assets  | 6,446                            | 2,668                   |
| Deferred tax asset, net  | 2,454                            | 2,642                   |
| Total assets   | \$ 722,745                       | 712,315                 |
| <b>Liabilities and Stockholders' Equity</b>                                    |                                  |                         |
| Deposits   | \$ 626,592                       | 623,352                 |
| Accrued interest payable   | 332                              | 346                     |
| Customer escrows   | 2,637                            | 1,448                   |
| Accrued expenses and other liabilities   | 7,834                            | 4,022                   |
| Total liabilities  | 637,395                          | 629,168                 |
| Commitments and contingencies  |                                  |                         |
| Stockholders' equity:  |                                  |                         |
| Serial-preferred stock: (\$.01 par value) authorized 500,000 shares; issued 0  | 0                                | 0                       |
| Common stock (\$.01 par value): authorized 16,000,000 shares; issued 9,128,662 | 91                               | 91                      |
| Additional paid-in capital   | 40,076                           | 40,090                  |
| Retained earnings, subject to certain restrictions                             | 101,374                          | 99,754                  |
| Accumulated other comprehensive loss   | (612 )                           | (1,096 )                |

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|  |            |           |
|--|------------|-----------|
| Unearned employee stock ownership plan shares          | (1,788 )   | (1,836 )  |
| Treasury stock, at cost 4,286,516 and 4,292,838 shares | (53,791 )  | (53,856 ) |
| Total stockholders' equity                             | 85,350     | 83,147    |
| Total liabilities and stockholders' equity             | \$ 722,745 | 712,315   |

See accompanying notes to consolidated financial statements.

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

|  | Three Months<br>Ended |        |
|--|-----------------------|--------|
|  | March 31,             |        |
| <i>(Dollars in thousands, except per share data)</i> | 2019                  | 2018   |
| Interest income:                                     |                       |        |
| Loans receivable                                     | \$7,268               | 6,778  |
| Securities available for sale:                       |                       |        |
| Mortgage-backed and related                          | 46                    | 42     |
| Other marketable                                     | 292                   | 272    |
| Other  | 126                   | 66     |
| Total interest income                                | 7,732                 | 7,158  |
| Interest expense:                                    |                       |        |
| Deposits   | 690                   | 468    |
| Advances and other borrowings                        | 0                     | 2      |
| Total interest expense                               | 690                   | 470    |
| Net interest income                                  | 7,042                 | 6,688  |
| Provision for loan losses                            | 27                    | (125 ) |
| Net interest income after provision for loan losses  | 7,015                 | 6,813  |
| Non-interest income:                                 |                       |        |
| Fees and service charges                             | 700                   | 766    |
| Loan servicing fees                                  | 315                   | 301    |
| Gain on sales of loans                               | 379                   | 444    |
| Other  | 297                   | 265    |
| Total non-interest income                            | 1,691                 | 1,776  |
| Non-interest expense:                                |                       |        |
| Compensation and benefits                            | 3,910                 | 3,824  |
| Occupancy and equipment                              | 1,060                 | 1,097  |
| Data processing                                      | 301                   | 295    |
| Professional services                                | 272                   | 249    |
| Other  | 903                   | 1,089  |
| Total non-interest expense                           | 6,446                 | 6,554  |
| Income before income tax expense                     | 2,260                 | 2,035  |



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|   |         |        |
|---|---------|--------|
| Income tax expense                                    | 640     | 590    |
| Net income  | 1,620   | 1,445  |
| Other comprehensive income (loss), net of tax         | 484     | (346 ) |
| Comprehensive income available to common shareholders | \$2,104 | 1,099  |
| Basic earnings per share                              | \$0.35  | 0.34   |
| Diluted earnings per share                            | \$0.35  | 0.29   |

See accompanying notes to consolidated financial statements.

Table of Contents**HMN FINANCIAL, INC. AND SUBSIDIARIES****Consolidated Statement of Stockholders' Equity****For the Three Month Period Ended March 31, 2019 and 2018**

(unaudited)

| <i>(Dollars in thousands)</i>               | Common<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Unearned<br>Employee<br>Stock<br>Ownership<br>Plan<br>Shares | Treasury<br>Stock | Total<br>Stock-<br>Holders'<br>Equity |
|---|-----------------|----------------------------------|----------------------|---|--|-------------------|---------------------------------------|
| Balance, December 31, 2018                  | \$ 91           | 40,090                           | 99,754               | (1,096 )                                      | (1,836 )   | (53,856 )         | 83,147                                |
| Net income                                  |                 |                                  | 1,620                |   |  |                   | 1,620                                 |
| Other comprehensive income                  |                 |                                  |                      | 484   |  |                   | 484                                   |
| Restricted stock awards                     |                 | (110 )                           |                      |   |  | 110               | 0                                     |
| Stock awards withheld for tax withholding   |                 |                                  |                      |   |  | (45 )             | (45 )                                 |
| Amortization of restricted stock awards     |                 | 42                               |                      |   |  |                   | 42                                    |
| Earned employee stock ownership plan shares |                 | 54                               |                      |   | 48   |                   | 102                                   |
| Balance, March 31, 2019                     | \$ 91           | 40,076                           | 101,374              | (612 )  | (1,788 )   | (53,791 )         | 85,350                                |

See accompanying notes to consolidated financial statements.

| <i>(Dollars in thousands)</i>                                  | Common<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Unearned<br>Employee<br>Stock<br>Ownership<br>Plan<br>Shares | Treasury<br>Stock | Total<br>Stock-<br>Holders'<br>Equity |
|--|-----------------|----------------------------------|----------------------|---|--|-------------------|---------------------------------------|
| Balance, December 31, 2017                                     | \$ 91           | 50,623                           | 91,448               | (957 )  | (2,030 )   | (58,357 )         | 80,818                                |
| Amounts reclassified from accumulated other comprehensive loss |                 |                                  | 71                   | (71 )   |  |                   | 0                                     |
| Net income   |                 |                                  | 1,445                |   |  |                   | 1,445                                 |
| Other comprehensive loss                                       |                 |                                  |                      | (346 )  |  |                   | (346 )                                |
| Stock compensation expense                                     |                 | 4                                |                      |   |  |                   | 4                                     |
| Restricted stock awards  |                 | (174 )                           |                      |   |  | 174               | 0                                     |

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|   |       |        |        |        |   |        |   |          |        |
|---|-------|--------|--------|--------|---|--------|---|----------|--------|
| Amortization of restricted stock awards     |       | 39     |        |        |   |        |   | 39       |        |
| Earned employee stock ownership plan shares |       | 48     |        |        |   | 48     |   | 96       |        |
| Balance, March 31, 2018                     | \$ 91 | 50,540 | 92,964 | (1,374 | ) | (1,982 | ) | (58,183) | 82,056 |

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

(unaudited)

|   | Three Months<br>Ended |          |
|---|-----------------------|----------|
|   | March 31,<br>2019     | 2018     |
| <i>(Dollars in thousands)</i>   |                       |          |
| Cash flows from operating activities:   |                       |          |
| Net income  | \$1,620               | 1,445    |
| Adjustments to reconcile net income to cash provided by operating activities: |                       |          |
| Provision for loan losses   | 27                    | (125 )   |
| Depreciation  | 273                   | 258      |
| Amortization of (discounts) premiums, net                                     | (4 )                  | 28       |
| Amortization of deferred loan fees  | 13                    | 19       |
| Amortization of core deposit intangible                                       | 24                    | 25       |
| Amortization of purchased loan fair value adjustments                         | (8 )                  | (12 )    |
| Amortization of mortgage servicing rights                                     | 140                   | 126      |
| Capitalized mortgage servicing rights   | (116 )                | (126 )   |
| Securities gains  | (24 )                 | (18 )    |
| Gain on sales of loans  | (379 )                | (444 )   |
| Proceeds from sale of loans held for sale                                     | 13,599                | 17,291   |
| Disbursements on loans held for sale  | (12,370)              | (13,558) |
| Amortization of restricted stock awards                                       | 42                    | 39       |
| Amortization of unearned employee stock ownership plan shares                 | 48                    | 48       |
| Earned employee stock ownership plan shares priced above original cost        | 54                    | 48       |
| Stock option compensation expense   | 0                     | 4        |
| Decrease in accrued interest receivable                                       | 30                    | 240      |
| (Decrease) increase in accrued interest payable                               | (14 )                 | 51       |
| Decrease (increase) in other assets   | 668                   | (457 )   |
| Decrease in other liabilities   | (572 )                | (616 )   |
| Other, net  | 1                     | (4 )     |
| Net cash provided by operating activities                                     | 3,052                 | 4,262    |
| Cash flows from investing activities:   |                       |          |
| Principal collected on securities available for sale                          | 443                   | 384      |
| Proceeds collected on maturities of securities available for sale             | 300                   | 310      |
| Purchases of securities available for sale                                    | 0                     | (4,888 ) |
| Purchase of Federal Home Loan Bank stock                                      | 0                     | (322 )   |
| Redemption of Federal Home Loan Bank stock                                    | 14                    | 272      |
| Net increase in loans receivable  | (13,592)              | (9,580 ) |
| Purchases of premises and equipment   | (189 )                | (378 )   |
| Net cash used by investing activities   | (13,024)              | (14,202) |

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|  |          |          |
|--|----------|----------|
| Cash flows from financing activities:            |          |          |
| Increase (decrease) in deposits                  | 3,240    | (1,796 ) |
| Stock awards withheld for tax withholding        | (45 )    | 0        |
| Proceeds from borrowings                         | 0        | 6,800    |
| Repayment of borrowings                          | 0        | (6,800 ) |
| Increase in customer escrows                     | 1,189    | 748      |
| Net cash provided (used) by financing activities | 4,384    | (1,048 ) |
| Decrease in cash and cash equivalents            | (5,588 ) | (10,988) |
| Cash and cash equivalents, beginning of period   | 20,709   | 37,564   |
| Cash and cash equivalents, end of period         | \$15,121 | 26,576   |
| Supplemental cash flow disclosures:              |          |          |
| Cash paid for interest                           | \$704    | 420      |
| Cash paid for income taxes                       | 0        | 427      |
| Supplemental noncash flow disclosures:           |          |          |
| Loans transferred to loans held for sale         | 759      | 3,719    |
| Transfer of loans to real estate                 | 30       | 74       |
| Right to use assets and lease obligations        | 4,387    | 0        |

See accompanying notes to consolidated financial statements.

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**HMN FINANCIAL, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

(unaudited)

***(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, Iowa and Wisconsin. The Bank has two wholly owned subsidiaries, Osterud Insurance Agency, Inc. (OIA), which does business as Home Federal Investment Services and offers financial planning products and services, and HFSB Property Holdings, LLC (HPH), which is currently inactive but has acted in the past 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 (GAAP). 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 three month period ended March 31, 2019 are not necessarily indicative of the results which may be expected for the entire year.

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

In June 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-13, *Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The amendments in this ASU affect all entities that measure credit losses on financial instruments including loans, debt securities, trade receivables, net investments in leases, off-balance sheet credit exposures, reinsurance receivables, and any other financial asset that has a contractual right to receive cash that is not specifically excluded. The main objective of this ASU is to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity

at each reporting date. To achieve this objective, the amendments in this ASU replace the incurred loss impairment methodology required in current GAAP with a methodology that reflects expected credit losses that requires consideration of a broader range of reasonable and supportable information to estimate credit losses. The amendments in this ASU will affect entities to varying degrees depending on the credit quality of the assets held by the entity, the duration of the assets held, and how the entity applies the current incurred loss methodology. The amendments in this ASU, for public business entities that are filers with the Securities and Exchange Commission (SEC), are effective for fiscal years beginning after December 15, 2019, including interim periods within those annual periods. All entities may adopt the amendments in the ASU early as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Amendments should be applied using a modified retrospective transition method by means of a cumulative-effect adjustment to equity as of the beginning of the period in which the guidance is adopted. Management has accumulated the charge off information necessary to calculate the appropriate life of loan loss percentages for the various loan categories, has identified several key metrics to help identify and project anticipated changes in the credit quality of our loan portfolio upon enactment, and is in the process of evaluating the determination of potential qualitative reserve amounts and the impact that the adoption of this ASU in the first quarter of 2020 will have on the Company's consolidated financial statements.

In August 2018, the FASB issued ASU 2018-13, *Fair Value Measurement (Topic 820), Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement*. The Amendments in this ASU apply to all entities that are required, under existing GAAP, to make disclosures about recurring or nonrecurring fair value measurements and modify the disclosure requirements on fair value measurements in *Topic 820, Fair Value Measurement*, including the consideration of costs and benefits. The ASU removed, modified, and added various disclosure requirements in Topic 820. The amendments also eliminate *at a minimum* from the phrase *an entity shall disclose at a minimum* to promote the appropriate exercise of discretion by entities when considering fair value measurement disclosures and to clarify that materiality is an appropriate consideration of entities and their auditor when evaluating disclosure requirements. The amendments in the ASU are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. An entity is permitted to early adopt the implementation of any removed or modified disclosures upon issuance of the ASU and delay adoption of the additional disclosures until their effective date. The Company has not opted to early adopt any portion of this ASU and the adoption in the first quarter of 2020 is not anticipated to have a material impact on the Company's consolidated financial statements.

Table of Contents**(4) 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 of the Company for which fair values are determined on a recurring basis as of March 31, 2019 and December 31, 2018.

|                               | Carrying value at March 31,<br>2019 |            |         |            |
|-------------------------------|-------------------------------------|------------|---------|------------|
|                               | Total                               | Level<br>1 | Level 2 | Level<br>3 |
| <i>(Dollars in thousands)</i> |                                     |            |         |            |
| Securities available for sale | \$79,932                            | 0          | 79,932  | 0          |
| Mortgage loan commitments     | 99                                  | 0          | 99      | 0          |
| Total                         | \$80,031                            | 0          | 80,031  | 0          |

|                               | Carrying value at December 31,<br>2018 |            |         |            |
|-------------------------------|--|------------|---------|------------|
|                               | Total                                  | Level<br>1 | Level 2 | Level<br>3 |
| <i>(Dollars in thousands)</i> |  |            |         |            |



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|                               |          |   |        |   |
|-------------------------------|----------|---|--------|---|
| Securities available for sale | \$79,980 | 0 | 79,980 | 0 |
| Mortgage loan commitments     | 40       | 0 | 40     | 0 |
| Total                         | \$80,020 | 0 | 80,020 | 0 |

There were no transfers between Levels 1, 2, or 3 during the three months ended March 31, 2019.

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 GAAP. 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 that were still held at March 31, 2019 and December 31, 2018, 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 March 31, 2019 and December 31, 2018.

Carrying value at March 31,  
2019

Three  
months  
ended

| Total | Level<br>1 | Level<br>2 | Level<br>3 | March<br>31,<br>2019 |
|-------|------------|------------|------------|----------------------|
|-------|------------|------------|------------|----------------------|

*(Dollars in thousands)*

Total  
losses

|                                 |         |   |       |   |       |
|---------------------------------|---------|---|-------|---|-------|
| Loans held for sale             | \$3,292 | 0 | 3,292 | 0 | (2 )  |
| Mortgage servicing rights, net  | 1,831   | 0 | 1,831 | 0 | 0     |
| Loans <sup>(1)</sup>            | 2,671   | 0 | 2,671 | 0 | (87 ) |
| Real estate, net <sup>(2)</sup> | 444     | 0 | 444   | 0 | 0     |
| Total                           | \$8,238 | 0 | 8,238 | 0 | (89 ) |

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|                                 | Carrying value at December<br>31, 2018 |            |            |            | Year<br>ended              |
|---------------------------------|--|------------|------------|------------|----------------------------|
|                                 | Total                                  | Level<br>1 | Level<br>2 | Level<br>3 | December<br>31, 2018       |
| <i>(Dollars in thousands)</i>   |  |            |            |            | Total<br>gains<br>(losses) |
| Loans held for sale             | \$3,444                                | 0          | 3,444      | 0          | 45                         |
| Mortgage servicing rights, net  | 1,855                                  | 0          | 1,855      | 0          | 0                          |
| Loans <sup>(1)</sup>            | 2,902                                  | 0          | 2,902      | 0          | (97 )                      |
| Real estate, net <sup>(2)</sup> | 414                                    | 0          | 414        | 0          | 0                          |
| Total                           | \$8,615                                | 0          | 8,615      | 0          | (52 )                      |

(1) Represents carrying value and related write-downs of 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.

**(5) Fair Value of Financial Instruments**

ASC 825, *Disclosures about Fair Values of Financial Instruments* requires interim reporting period disclosure about the fair value of financial instruments, including assets, liabilities and off-balance sheet items for which it is practicable to estimate fair value. The fair value estimates are made as of March 31, 2019 and December 31, 2018 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 March 31, 2019 and December 31, 2018 are shown below.

| <i>(Dollars in<br/>thousands)</i> | March 31, 2019     |                            |                      |         |                                  | December 31, 2018  |                            |                      |         |                                  |
|-----------------------------------|--------------------|----------------------------|----------------------|---------|----------------------------------|--------------------|----------------------------|----------------------|---------|----------------------------------|
|                                   | Carrying<br>amount | Estimated<br>fair<br>value | Fair value hierarchy |         | Contract<br>Level<br>3<br>amount | Carrying<br>amount | Estimated<br>fair<br>value | Fair value hierarchy |         | Contract<br>Level<br>3<br>amount |
|                                   |                    |                            | Level 1              | Level 2 |                                  |                    |                            | Level 1              | Level 2 |                                  |

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|  |           |         |         |         |         |         |         |
|--|-----------|---------|---------|---------|---------|---------|---------|
| Financial assets:                        |           |         |         |         |         |         |         |
| Cash and cash equivalents                | \$ 15,121 | 15,121  | 15,121  |         | 20,709  | 20,709  | 20,709  |
| Securities available for sale            | 79,932    | 79,932  | 79,932  |         | 79,980  | 79,980  | 79,980  |
| Loans held for sale                      | 3,292     | 3,292   | 3,292   |         | 3,444   | 3,444   | 3,444   |
| Loans receivable, net                    | 599,462   | 593,230 | 593,230 |         | 586,688 | 578,978 | 578,978 |
| Federal Home Loan Bank stock             | 853       | 853     | 853     |         | 867     | 867     | 867     |
| Accrued interest receivable              | 2,326     | 2,326   | 2,326   |         | 2,356   | 2,356   | 2,356   |
| Financial liabilities:                   |           |         |         |         |         |         |         |
| Deposits                                 | 626,592   | 620,967 | 620,967 |         | 623,352 | 617,722 | 617,722 |
| Accrued interest payable                 | 332       | 332     | 332     |         | 346     | 346     | 346     |
| Off-balance sheet financial instruments: |           |         |         |         |         |         |         |
| Commitments to extend credit             | 99        | 99      |         | 157,000 | 40      | 40      | 146,977 |
| Commitments to sell loans                | (54 )     | (54 )   |         | 9,757   | (56 )   | (56 )   | 7,289   |

*Cash and Cash Equivalents*

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

*Securities Available for Sale*

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

*Loans Held for Sale*

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

*Loans Receivable, net*

The fair value of the loan portfolio, with the exception of the adjustable rate portfolio, was calculated by discounting the scheduled cash flows through the estimated maturity using anticipated prepayment speeds and using discount rates that reflect the credit and interest rate risk inherent in each loan portfolio. The fair value of the adjustable loan portfolio was estimated by grouping the loans with similar characteristics and comparing the characteristics of each group to the prices quoted for similar types of loans in the secondary market. The fair value disclosures for both the fixed and adjustable rate portfolios were adjusted to reflect the exit price amount anticipated to be received from the sale of the portfolio in an open market transaction.

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*Federal Home Loan Bank Stock*

The carrying amount of Federal Home Loan Bank (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. The fair value disclosures for all of the deposits were adjusted to reflect the exit price amount anticipated to be received from the sale of the deposits in an open market transaction.

*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.

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

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

| <i>(Dollars in thousands)</i>                           | For the period ended March 31, |           |            |           |        |       |
|---|--------------------------------|-----------|------------|-----------|--------|-------|
|   | 2019                           |           | 2018       |           |        |       |
|   | Before Tax                     | Net<br>of | Before Tax | Net<br>of |        |       |
| Securities available for sale:                          | tax                            | effect    | tax        | tax       | effect | tax   |
| Net unrealized gains (losses) arising during the period | \$671                          | 187       | 484        | (479)     | (133)  | (346) |
| Other comprehensive income (loss)                       | \$671                          | 187       | 484        | (479)     | (133)  | (346) |

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

The following table shows the gross unrealized losses and fair values 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, 2019 and December 31, 2018.

*(Dollars in thousands)*

|  | Less Than Twelve Months |            |                   | Twelve Months or More |            |                   | Total      |                   |
|--|-------------------------|------------|-------------------|-----------------------|------------|-------------------|------------|-------------------|
|  | # of                    | Fair Value | Unrealized Losses | # of                  | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| <b>March 31, 2019</b>                        |                         |            |                   |                       |            |                   |            |                   |
| Mortgage backed securities:                  |                         |            |                   |                       |            |                   |            |                   |
| Federal National Mortgage Association (FNMA) | 0                       | \$ 0       | 0                 | 2                     | \$3,657    | (37)              | \$3,657    | (37)              |
| Collateralized mortgage obligations:         |                         |            |                   |                       |            |                   |            |                   |
| FNMA   | 0                       | 0          | 0                 | 1                     | 191        | (3)               | 191        | (3)               |
| Other marketable securities:                 |                         |            |                   |                       |            |                   |            |                   |
| U.S. Government agency obligations           | 0                       | 0          | 0                 | 14                    | 69,233     | (740)             | 69,233     | (740)             |
| Municipal obligations                        | 0                       | 0          | 0                 | 6                     | 1,240      | (4)               | 1,240      | (4)               |
| Corporate obligations                        | 0                       | 0          | 0                 | 1                     | 140        | (1)               | 140        | (1)               |
| Corporate preferred stock                    | 0                       | 0          | 0                 | 1                     | 595        | (105)             | 595        | (105)             |
| Total temporarily impaired securities        | 0                       | \$ 0       | 0                 | 25                    | \$75,056   | (890)             | \$75,056   | (890)             |

*(Dollars in thousands)*

|  | Less Than Twelve Months |            |                   | Twelve Months or More |            |                   | Total      |                   |
|--|-------------------------|------------|-------------------|-----------------------|------------|-------------------|------------|-------------------|
|  | # of                    | Fair Value | Unrealized Losses | # of                  | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| <b>December 31, 2018</b>                       |                         |            |                   |                       |            |                   |            |                   |
| Mortgage backed securities:                    |                         |            |                   |                       |            |                   |            |                   |
| FNMA   | 0                       | \$0        | 0                 | 2                     | \$3,769    | (117)             | \$3,769    | (117)             |
| Federal Home Loan Mortgage Corporation (FHLMC) | 1                       | 4,060      | (10)              | 0                     | 0          | 0                 | 4,060      | (10)              |
| Collateralized mortgage obligations:           |                         |            |                   |                       |            |                   |            |                   |
| FNMA   | 0                       | 0          | 0                 | 1                     | 190        | (9)               | 190        | (9)               |
| Other marketable securities:                   |                         |            |                   |                       |            |                   |            |                   |
| U.S. Government agency obligations             | 0                       | 0          | 0                 | 14                    | 68,735     | (1,236)           | 68,735     | (1,236)           |
| Municipal obligations                          | 3                       | 498        | (2)               | 8                     | 1,467      | (8)               | 1,965      | (10)              |
| Corporate obligations                          | 0                       | 0          | 0                 | 1                     | 172        | (1)               | 172        | (1)               |
| Corporate preferred stock                      | 0                       | 0          | 0                 | 1                     | 560        | (140)             | 560        | (140)             |
| Total temporarily impaired securities          | 4                       | \$4,558    | (12)              | 27                    | \$74,893   | (1,511)           | \$79,451   | (1,523)           |

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 on impaired securities other than the corporate preferred stock are the result of changes in interest rates. The unrealized losses reported for the corporate preferred stock at March 31, 2019 relates to a single trust preferred security that was issued by the holding company of a small community bank. As of March 31, 2019 all payments were current on the trust preferred security and the issuer's subsidiary bank was considered to be "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 March 31, 2019 as the Company does not intend to sell 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 March 31, 2019 and December 31, 2018 is as follows:

| <i>(Dollars in thousands)</i>        | Amortized<br>cost | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses | Fair<br>value |
|--------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| <u>March 31, 2019</u>                |                   |                              |                               |               |
| Mortgage-backed securities:          |                   |                              |                               |               |
| FNMA                                 | \$ 3,694          | 0                            | (37                           | ) 3,657       |
| FHLMC                                | 3,860             | 35                           | 0                             | 3,895         |
| Collateralized mortgage obligations: |                   |                              |                               |               |
| FNMA                                 | 194               | 0                            | (3                            | ) 191         |
|                                      | 7,748             | 35                           | (40                           | ) 7,743       |
| Other marketable securities:         |                   |                              |                               |               |
| U.S. Government agency obligations   | 69,973            | 0                            | (740                          | ) 69,233      |
| Municipal obligations                | 2,075             | 4                            | (4                            | ) 2,075       |
| Corporate obligations                | 142               | 0                            | (1                            | ) 141         |
| Corporate preferred stock            | 700               | 0                            | (105                          | ) 595         |
| Corporate equity                     | 145               | 0                            | 0                             | 145           |
|                                      | 73,035            | 4                            | (850                          | ) 72,189      |
|                                      | \$ 80,783         | 39                           | (890                          | ) 79,932      |
| <u>December 31, 2018</u>             |                   |                              |                               |               |
| Mortgage-backed securities:          |                   |                              |                               |               |
| FNMA                                 | \$ 3,886          | 0                            | (117                          | ) 3,769       |
| FHLMC                                | 4,074             | 0                            | (10                           | ) 4,064       |
| Collateralized mortgage obligations: |                   |                              |                               |               |
| FNMA                                 | 199               | 0                            | (9                            | ) 190         |
|                                      | 8,159             | 0                            | (136                          | ) 8,023       |
| Other marketable securities:         |                   |                              |                               |               |
| U.S. Government agency obligations   | 69,971            | 0                            | (1,236                        | ) 68,735      |
| Municipal obligations                | 2,378             | 1                            | (10                           | ) 2,369       |
| Corporate obligations                | 173               | 0                            | (1                            | ) 172         |
| Corporate preferred stock            | 700               | 0                            | (140                          | ) 560         |
| Corporate equity                     | 121               | 0                            | 0                             | 121           |
|                                      | 73,343            | 1                            | (1,387                        | ) 71,957      |
|                                      | \$ 81,502         | 1                            | (1,523                        | ) 79,980      |

The following table indicates amortized cost and estimated fair value of securities available for sale at March 31, 2019 based upon contractual maturity adjusted for scheduled repayments of principal and projected prepayments of principal based upon current economic conditions and interest rates.

| <i>(Dollars in thousands)</i>          | Amortized Fair |        |
|--|----------------|--------|
|  | Cost           | Value  |
| Due less than one year                 | \$ 7,356       | 7,303  |
| Due after one year through five years  | 70,258         | 69,568 |
| Due after five years through ten years | 2,257          | 2,255  |
| Due after ten years                    | 767            | 661    |
| No stated maturity                     | 145            | 145    |
| Total                                  | \$ 80,783      | 79,932 |

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 expected 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.

Table of Contents**(8) Loans Receivable, Net**

A summary of loans receivable at March 31, 2019 and December 31, 2018 is as follows:

|                                | March<br>31, | December<br>31, |
|--------------------------------|--------------|-----------------|
| <i>(Dollars in thousands)</i>  | 2019         | 2018            |
| Single family                  | \$ 109,210   | 110,698         |
| Commercial real estate:        |              |                 |
| Real estate rental and leasing | 198,379      | 195,564         |
| Other                          | 151,485      | 140,566         |
|                                | 349,864      | 336,130         |
| Consumer                       | 73,085       | 72,532          |
| Commercial business            | 75,485       | 75,496          |
| Total loans                    | 607,644      | 594,856         |
| Less:                          |              |                 |
| Unamortized discounts          | 16           | 17              |
| Net deferred loan costs        | (507 )       | (535 )          |
| Allowance for loan losses      | 8,673        | 8,686           |
| Total loans receivable, net    | \$ 599,462   | 586,688         |

**(9) Allowance for Loan Losses and Credit Quality Information**

The allowance for loan losses is summarized as follows:

|                               | Single<br>Family | Commercial<br>Real Estate | Consumer | Commercial<br>Business | Total  |
|-------------------------------|------------------|---------------------------|----------|------------------------|--------|
| <i>(Dollars in thousands)</i> |                  |                           |          |                        |        |
| Balance, December 31, 2018    | \$ 833           | 4,869                     | 1,622    | 1,362                  | 8,686  |
| Provision for losses          | 100              | 13                        | 3        | (89 )                  | 27     |
| Charge-offs                   | 0                | 0                         | (39 )    | (43 )                  | (82 )  |
| Recoveries                    | 0                | 10                        | 2        | 30                     | 42     |
| Balance, March 31, 2019       | \$ 933           | 4,892                     | 1,588    | 1,260                  | 8,673  |
| Balance, December 31, 2017    | \$ 900           | 5,073                     | 1,630    | 1,708                  | 9,311  |
| Provision for losses          | (68 )            | 118                       | (145 )   | (30 )                  | (125 ) |
| Charge-offs                   | (23 )            | 0                         | (69 )    | 0                      | (92 )  |
| Recoveries                    | 0                | 7                         | 7        | 21                     | 35     |
| Balance, March 31, 2018       | \$ 809           | 5,198                     | 1,423    | 1,699                  | 9,129  |

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|                            |       |       |       |       |       |
|----------------------------|-------|-------|-------|-------|-------|
| Allocated to:              |       |       |       |       |       |
| Specific reserves          | \$98  | 451   | 172   | 73    | 794   |
| General reserves           | 735   | 4,418 | 1,450 | 1,289 | 7,892 |
| Balance, December 31, 2018 | \$833 | 4,869 | 1,622 | 1,362 | 8,686 |

|                         |       |       |       |       |       |
|-------------------------|-------|-------|-------|-------|-------|
| Allocated to:           |       |       |       |       |       |
| Specific reserves       | \$123 | 453   | 153   | 90    | 819   |
| General reserves        | 810   | 4,439 | 1,435 | 1,170 | 7,854 |
| Balance, March 31, 2019 | \$933 | 4,892 | 1,588 | 1,260 | 8,673 |

|  |           |         |        |        |         |
|--|-----------|---------|--------|--------|---------|
| Loans receivable at December 31, 2018: |           |         |        |        |         |
| Individually reviewed for impairment   | \$1,226   | 1,311   | 856    | 303    | 3,696   |
| Collectively reviewed for impairment   | 109,472   | 334,819 | 71,676 | 75,193 | 591,160 |
| Ending balance                         | \$110,698 | 336,130 | 72,532 | 75,496 | 594,856 |

|                                      |           |         |        |        |         |
|--------------------------------------|-----------|---------|--------|--------|---------|
| Loans receivable at March 31, 2019:  |           |         |        |        |         |
| Individually reviewed for impairment | \$1,247   | 1,276   | 620    | 347    | 3,490   |
| Collectively reviewed for impairment | 107,963   | 348,588 | 72,465 | 75,138 | 604,154 |
| Ending balance                       | \$109,210 | 349,864 | 73,085 | 75,485 | 607,644 |

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The following table summarizes the amount of classified and unclassified loans at March 31, 2019 and December 31, 2018:

|                                | March 31, 2019 |             |          |      |        | Unclassified |         |
|--------------------------------|----------------|-------------|----------|------|--------|--------------|---------|
|                                | Classified     |             |          |      | Total  | Total        | Total   |
|                                | Special        | Substandard | Doubtful | Loss |        |              |         |
| <i>(Dollars in thousands)</i>  | Mention        |             |          |      |        |              | Loans   |
| Single family                  | \$571          | 1,152       | 95       | 0    | 1,818  | 107,392      | 109,210 |
| Commercial real estate:        |                |             |          |      |        |              |         |
| Real estate rental and leasing | 8,101          | 2,730       | 0        | 0    | 10,831 | 187,548      | 198,379 |
| Other                          | 5,201          | 5,039       | 0        | 0    | 10,240 | 141,245      | 151,485 |
| Consumer                       | 0              | 476         | 36       | 105  | 617    | 72,468       | 73,085  |
| Commercial business            | 5,639          | 2,670       | 0        | 0    | 8,309  | 67,176       | 75,485  |
|                                | \$19,512       | 12,067      | 131      | 105  | 31,815 | 575,829      | 607,644 |

|                                | December 31, 2018 |             |          |      |        | Unclassified |         |
|--------------------------------|-------------------|-------------|----------|------|--------|--------------|---------|
|                                | Classified        |             |          |      | Total  | Total        | Total   |
|                                | Special           | Substandard | Doubtful | Loss |        |              |         |
| <i>(Dollars in thousands)</i>  | Mention           |             |          |      |        |              | Loans   |
| Single family                  | \$150             | 1,771       | 40       | 0    | 1,961  | 108,737      | 110,698 |
| Commercial real estate:        |                   |             |          |      |        |              |         |
| Real estate rental and leasing | 5,564             | 4,805       | 0        | 0    | 10,369 | 185,195      | 195,564 |
| Other                          | 4,879             | 5,118       | 0        | 0    | 9,997  | 130,569      | 140,566 |
| Consumer                       | 0                 | 709         | 41       | 106  | 856    | 71,676       | 72,532  |
| Commercial business            | 6,647             | 2,761       | 0        | 0    | 9,408  | 66,088       | 75,496  |
|                                | \$17,240          | 15,164      | 81       | 106  | 32,591 | 562,265      | 594,856 |

Classified loans represent special mention, substandard (performing and non-performing), and non-performing loans categorized as doubtful and loss. Loans classified as special mention are loans that have potential weaknesses that, if left uncorrected, may result in deterioration of the repayment prospects for the asset or in the Bank's credit position at some future date. 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. Substandard loans 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 essentially uncollateralized and/or considered uncollectible and of such little value that continuance as an asset on the balance sheet may not be 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 March 31, 2019 and December 31, 2018 are summarized as follows:

| <i>(Dollars in thousands)</i>  | 30-59               | 60-89               | 90                                | Total<br>Past<br>Due | Current<br>Loans | Total<br>Loans | Loans 90  |
|--------------------------------|---------------------|---------------------|-----------------------------------|----------------------|------------------|----------------|---|
|                                | Days<br>Past<br>Due | Days<br>Past<br>Due | Days<br>or<br>More<br>Past<br>Due |                      |                  |                | Days or<br>More<br>Past Due<br>and<br>Still<br>Accruing |
| <i>March 31, 2019</i>          |                     |                     |                                   |                      |                  |                |   |
| Single family                  | \$798               | 0                   | 91                                | 889                  | 108,321          | 109,210        | 0   |
| Commercial real estate:        |                     |                     |                                   |                      |                  |                |   |
| Real estate rental and leasing | 198                 | 0                   | 0                                 | 198                  | 198,181          | 198,379        | 0   |
| Other                          | 273                 | 0                   | 0                                 | 273                  | 151,212          | 151,485        | 0   |
| Consumer                       | 301                 | 180                 | 78                                | 559                  | 72,526           | 73,085         | 0   |
| Commercial business            | 55                  | 0                   | 80                                | 135                  | 75,350           | 75,485         | 0   |
|                                | \$1,625             | 180                 | 249                               | 2,054                | 605,590          | 607,644        | 0   |
| <i>December 31, 2018</i>       |                     |                     |                                   |                      |                  |                |   |
| Single family                  | \$680               | 325                 | 77                                | 1,082                | 109,616          | 110,698        | 0   |
| Commercial real estate:        |                     |                     |                                   |                      |                  |                |   |
| Real estate rental and leasing | 0                   | 0                   | 0                                 | 0                    | 195,564          | 195,564        | 0   |
| Other                          | 0                   | 0                   | 0                                 | 0                    | 140,566          | 140,566        | 0   |
| Consumer                       | 391                 | 100                 | 279                               | 770                  | 71,762           | 72,532         | 0   |
| Commercial business            | 21                  | 0                   | 0                                 | 21                   | 75,475           | 75,496         | 0   |
|                                | \$1,092             | 425                 | 356                               | 1,873                | 592,983          | 594,856        | 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 March 31, 2019 and December 31, 2018:

| <i>(Dollars in thousands)</i>             | March 31, 2019                                 |        |                      | December 31, 2018                              |        |                      |
|---|--|--------|----------------------|--|--------|----------------------|
|   | Recorded<br>Principal<br>Investment<br>Balance | Unpaid | Related<br>Allowance | Recorded<br>Principal<br>Investment<br>Balance | Unpaid | Related<br>Allowance |
| Loans with no related allowance recorded: |  |        |                      |  |        |                      |
| Single family                             | \$438  | 457    | 0                    | 458  | 477    | 0                    |

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|                                   |         |       |     |       |       |     |
|-----------------------------------|---------|-------|-----|-------|-------|-----|
| Commercial real estate:           |         |       |     |       |       |     |
| Other                             | 25      | 1,681 | 0   | 25    | 1,682 | 0   |
| Consumer                          | 382     | 382   | 0   | 515   | 515   | 0   |
| Loans with an allowance recorded: |         |       |     |       |       |     |
| Single family                     | 809     | 809   | 123 | 768   | 768   | 98  |
| Commercial real estate:           |         |       |     |       |       |     |
| Real estate rental and leasing    | 199     | 199   | 21  | 201   | 201   | 21  |
| Other                             | 1,052   | 1,052 | 432 | 1,085 | 1,085 | 430 |
| Consumer                          | 238     | 238   | 153 | 341   | 341   | 172 |
| Commercial business               | 347     | 899   | 90  | 303   | 854   | 73  |
| Total:                            |         |       |     |       |       |     |
| Single family                     | 1,247   | 1,266 | 123 | 1,226 | 1,245 | 98  |
| Commercial real estate:           |         |       |     |       |       |     |
| Real estate rental and leasing    | 199     | 199   | 21  | 201   | 201   | 21  |
| Other                             | 1,077   | 2,733 | 432 | 1,110 | 2,767 | 430 |
| Consumer                          | 620     | 620   | 153 | 856   | 856   | 172 |
| Commercial business               | 347     | 899   | 90  | 303   | 854   | 73  |
|                                   | \$3,490 | 5,717 | 819 | 3,696 | 5,923 | 794 |



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The following table summarizes the average recorded investment and interest income recognized on impaired loans during the three months ended March 31, 2019 and 2018:

|   | March 31, 2019                    |                                  | March 31, 2018                    |                                  |
|---|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|   | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
| <i>(Dollars in thousands)</i>             |                                   |                                  |                                   |                                  |
| Loans with no related allowance recorded: |                                   |                                  |                                   |                                  |
| Single family                             | \$448                             | 4                                | 424                               | 6                                |
| Commercial real estate:                   |                                   |                                  |                                   |                                  |
| Real estate rental and leasing            | 0                                 | 0                                | 35                                | 0                                |
| Other                                     | 25                                | 30                               | 95                                | 24                               |
| Consumer                                  | 449                               | 2                                | 409                               | 2                                |
| Loans with an allowance recorded:         |                                   |                                  |                                   |                                  |
| Single family                             | 789                               | 3                                | 924                               | 0                                |
| Commercial real estate:                   |                                   |                                  |                                   |                                  |
| Real estate rental and leasing            | 200                               | 0                                | 0                                 | 0                                |
| Other                                     | 1,069                             | 0                                | 1,314                             | 0                                |
| Consumer                                  | 290                               | 3                                | 461                               | 3                                |
| Commercial business                       | 325                               | 1                                | 494                               | 2                                |
| Total:                                    |                                   |                                  |                                   |                                  |
| Single family                             | 1,237                             | 7                                | 1,348                             | 6                                |
| Commercial real estate:                   |                                   |                                  |                                   |                                  |
| Real estate rental and leasing            | 200                               | 0                                | 35                                | 0                                |
| Other                                     | 1,094                             | 30                               | 1,409                             | 24                               |
| Consumer                                  | 739                               | 5                                | 870                               | 5                                |
| Commercial business                       | 325                               | 1                                | 494                               | 2                                |
|   | \$3,595                           | 43                               | 4,156                             | 37                               |

At March 31, 2019 and December 31, 2018, non-accruing loans totaled \$2.5 million and \$2.7 million, respectively, for which the related allowance for loan losses was \$0.7 million for both quarters. All of the interest income 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 \$0.3 million and \$0.4 million, at March 31, 2019 and December 31, 2018, respectively. Non-accrual loans also include certain loans that have had terms modified in a TDR.

The non-accrual loans at March 31, 2019 and December 31, 2018 are summarized as follows:

|                                | March<br>31, | December<br>31, |
|--------------------------------|--------------|-----------------|
| <i>(Dollars in thousands)</i>  | 2019         | 2018            |
| Single family                  | \$751        | \$ 730          |
| Commercial real estate:        |              |                 |
| Real estate rental and leasing | 199          | 201             |
| Other                          | 1,077        | 1,110           |
| Consumer                       | 283          | 489             |
| Commercial business            | 212          | 148             |
|                                | \$2,522      | \$ 2,678        |

At March 31, 2019 and December 31, 2018, there were loans included in loans receivable, net, with terms that had been modified in a TDR totaling \$2.4 million and \$2.5 million, respectively. Loans that were restructured in the first quarter of 2019 were not material. Of the loans that were restructured in the first quarter of 2018, \$0.1 million were classified but performing, and \$1.3 million were non-performing at March 31, 2018.

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The following table summarizes TDRs at March 31, 2019 and December 31, 2018:

| <i>(Dollars in thousands)</i> | March 31, 2019 |             |       | December, 31, 2018 |             |       |
|-------------------------------|----------------|-------------|-------|--------------------|-------------|-------|
|                               | Accruing       | Non-Accrual | Total | Accruing           | Non-Accrual | Total |
| Single family                 | \$496          | 158         | 654   | 496                | 140         | 636   |
| Commercial real estate        | 0              | 1,077       | 1,077 | 0                  | 1,110       | 1,110 |
| Consumer                      | 337            | 171         | 508   | 367                | 155         | 522   |
| Commercial business           | 135            | 49          | 184   | 155                | 53          | 208   |
|                               | \$968          | 1,455       | 2,423 | 1,018              | 1,458       | 2,476 |

As of March 31, 2019, the Bank had commitments to lend an additional \$0.8 million to a borrower who has TDR and non-accrual loans. These additional funds are for the construction of single family homes with a maximum loan-to-value ratio of 75%. These loans are secured by the home under construction. At December 31, 2018, there were commitments to lend additional funds of \$0.9 million to this same borrower.

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 twelve 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 twelve month period. All loans classified as TDRs are considered to be impaired.

When a loan is modified in a TDR, there may be a direct, material impact on the loans within the consolidated balance sheets, as principal balances may be partially forgiven. The financial effects of TDRs are presented in the following table and represent the difference between the outstanding recorded balance pre-modification and post-modification, for the three months ended March 31, 2019 and March 31, 2018.

| <i>(Dollars in thousands)</i> | Three Months Ended    |                   |    |            | Three Months Ended    |                   |  |  |
|-------------------------------|-----------------------|-------------------|----|------------|-----------------------|-------------------|--|--|
|                               | March 31, 2019        |                   |    |            | March 31, 2018        |                   |  |  |
|                               | Pre-Modification      | Post-Modification |    |            | Pre-Modification      | Post-Modification |  |  |
|                               | Number of Outstanding | Outstanding       |    |            | Number of Outstanding | Outstanding       |  |  |
|                               | Recorded Contracts    | Recorded          |    |            | Recorded Contracts    | Recorded          |  |  |
| Investment                    | Investment            |                   |    | Investment | Investment            |                   |  |  |
| Troubled debt restructurings: |                       |                   |    |            |                       |                   |  |  |
| Single family                 | 1                     | \$ 21             | 24 | 1          | \$ 55                 | 58                |  |  |

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|                                |   |       |    |   |          |       |
|--------------------------------|---|-------|----|---|----------|-------|
| Commercial real estate:        |   |       |    |   |          |       |
| Real estate rental and leasing | 0 | 0     | 0  | 1 | 54       | 54    |
| Other                          | 0 | 0     | 0  | 1 | 1,274    | 1,274 |
| Consumer                       | 2 | 26    | 26 | 4 | 117      | 118   |
| Commercial business            | 0 | 0     | 0  | 1 | 70       | 70    |
| Total                          | 3 | \$ 47 | 50 | 8 | \$ 1,570 | 1,574 |

There were no loans that were restructured within the twelve months preceding March 31, 2019 and March 31, 2018 that defaulted during the three months ended March 31, 2019 and March 31, 2018.

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 reserves for TDRs were \$0.6 million, or 7.0%, of the total \$8.7 million in loan loss reserves at March 31, 2019 and \$0.6 million, or 7.2%, of the total \$8.7 million in loan loss reserves at December 31, 2018.

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The following is additional information with respect to loans acquired through acquisitions:

| <i>(Dollars in thousands)</i>     | Contractual | Accretable | Net      |
|-----------------------------------|-------------|------------|----------|
|                                   | Principal   | Difference | Carrying |
|                                   | Receivable  |            | Amount   |
| Purchased performing loans:       |             |            |          |
| Balance at December 31, 2018      | \$ 7,313    | (182 )     | 7,131    |
| Change due to payments/refinances | (203 )      | 9          | (194 )   |
| Balance at March 31, 2019         | \$ 7,110    | (173 )     | 6,937    |

| <i>(Dollars in thousands)</i>     | Contractual | Non-Accretable | Net      |
|-----------------------------------|-------------|----------------|----------|
|                                   | Principal   | Difference     | Carrying |
|                                   | Receivable  |                | Amount   |
| Purchased credit impaired loans:  |             |                |          |
| Balance at December 31, 2018      | \$ 188      | (6 )           | 182      |
| Change due to payments/refinances | (2 )        | 1              | (1 )     |
| Balance at March 31, 2019         | \$ 186      | (5 )           | 181      |

The Company has loans for which there was at acquisition evidence of deterioration of credit quality since origination and for which it was probable at acquisition that all contractually required payments would not be collected. The carrying amount of those loans as of March 31, 2019 was \$0.2 million.

No provision for loan losses was recognized during the period ended March 31, 2019 related to acquired loans as there was no significant change to the credit quality of those loans.

**(10) Intangible Assets**

The Company's intangible assets consist of core deposit intangibles, goodwill, and mortgage servicing rights. A summary of mortgage servicing activity is as follows:

| <i>(Dollars in thousands)</i> | Three  | Twelve | Three  |
|-------------------------------|--------|--------|--------|
|                               | Months | Months | Months |
|                               | ended  | ended  | ended  |

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|   | March<br>31,<br>2019 | December<br>31, 2018 | March<br>31,<br>2018 |
|---|----------------------|----------------------|----------------------|
| Balance, beginning of period            | \$ 1,855             | 1,724                | 1,724                |
| Originations                            | 116                  | 682                  | 126                  |
| Amortization                            | (140 )               | (551 )               | (126 )               |
| Balance, end of period                  | \$ 1,831             | 1,855                | 1,724                |
| Fair value of mortgage servicing rights | \$ 3,702             | 3,901                | 3,458                |

All of the loans sold where the Company continues to service the loans are serviced for FNMA under the individual loan sale program. The following is a summary of the risk characteristics of the loans being serviced for FNMA at March 31, 2019.

|                                  | Loan<br>Principal<br>Balance | Weighted<br>Average<br>Interest<br>Rate | Weighted<br>Average<br>Remaining<br>Term<br>(months) | Number<br>of<br>Loans |
|----------------------------------|------------------------------|---|--|-----------------------|
| <i>(Dollars in thousands)</i>    |                              |   |  |                       |
| Original term 30 year fixed rate | \$304,600                    | 4.19 %                                  | 306  | 2,333                 |
| Original term 15 year fixed rate | 91,584                       | 3.19                                    | 128  | 951                   |
| Adjustable rate                  | 53                           | 4.38                                    | 266  | 2                     |

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The gross carrying amount of intangible assets and the associated accumulated amortization at March 31, 2019 and 2018 is presented in the following table. Amortization expense for intangible assets was \$164,000 and \$151,000 for the three month periods ended March 31, 2019 and 2018, respectively.

|                               | March 31, 2019 |              |   |             |
|-------------------------------|----------------|--------------|---|-------------|
|                               | Gross          |              |   | Unamortized |
|                               | Carrying       | Accumulated  |   | Intangible  |
| <i>(Dollars in thousands)</i> | Amount         | Amortization |   | Assets      |
| Mortgage servicing rights     | \$4,565        | (2,734)      | ) | 1,831       |
| Core deposit intangible       | 574            | (343)        | ) | 231         |
| Goodwill                      | 802            | 0            |   | 802         |
| Total                         | \$5,941        | (3,077)      | ) | 2,864       |

|                               | March 31, 2018 |              |   |             |
|-------------------------------|----------------|--------------|---|-------------|
|                               | Gross          |              |   | Unamortized |
|                               | Carrying       | Accumulated  |   | Intangible  |
| <i>(Dollars in thousands)</i> | Amount         | Amortization |   | Assets      |
| Mortgage servicing rights     | \$4,282        | (2,558)      | ) | 1,724       |
| Core deposit intangible       | 574            | (244)        | ) | 330         |
| Goodwill                      | 802            | 0            |   | 802         |
| Total                         | \$5,658        | (2,802)      | ) | 2,856       |

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

|                               | Mortgage  | Core       | Total      |
|-------------------------------|-----------|------------|------------|
|                               | Servicing | Deposit    | Intangible |
| <i>(Dollars in thousands)</i> | Rights    | Intangible | Assets     |
| Year ending December 31,      |           |            |            |
| 2019                          | \$ 355    | 75         | 430        |
| 2020                          | 402       | 99         | 501        |
| 2021                          | 358       | 47         | 405        |
| 2022                          | 299       | 10         | 309        |
| 2023                          | 222       | 0          | 222        |
| Thereafter                    | 195       | 0          | 195        |
| Total                         | \$ 1,831  | 231        | 2,062      |

Projections of amortization are based on existing asset balances and the existing interest rate environment as of March 31, 2019. The Company's actual experience may be significantly different depending upon changes in mortgage interest rates and other market conditions.

**(11) Leases**

On January 1, 2019, the Company adopted *ASU 2016-02, Leases (Topic 842)* and a \$4.5 million right-of-use asset and an offsetting lease payment obligation liability were recorded on the consolidated balance sheet in other assets and other liabilities, respectively.

Operating lease right-of-use assets represent our right to use an underlying asset during the lease term and operating lease liabilities represent our obligation to make lease payments arising from the lease. Right-of-use assets and operating lease liabilities are recognized at lease commencement based on the present value of the remaining lease payments using a discount rate that represents the Company's incremental borrowing rate at the lease commencement date. Because the Company only has operating leases and the right-of-use asset is offset by a lease payment obligation liability, the lease payments are the only amount that is recorded in occupancy expense in the consolidated statements of comprehensive income.

The Company's leases relate to office space and bank branches with remaining lease terms between 1 and 6 years. Certain leases contain extension options which typically range from 3 to 10 years. Because these extension options are not considered reasonably certain of exercise, they are not included in the lease term. As of March 31, 2019, right-of-use assets and operating lease liabilities were \$4.4 million.

The table below summarizes our net lease cost:

|                               |        |
|-------------------------------|--------|
|                               | Three  |
|                               | Months |
|                               | Ended  |
| <i>(Dollars in thousands)</i> | March  |
|                               | 31,    |
|                               | 2019   |
| Operating lease cost.         | \$ 225 |



The table below summarizes other information related to our operating leases:

| <i>(Dollars in thousands)</i>  | Three<br>Months<br>Ended<br>March<br>31,<br>2019 |
|--|--|
| Cash paid for amounts included in the measurement of lease liabilities |  |
| Operating cash flows from operating leases                             | \$ 225   |
| Weighted-average remaining lease term – operating leases, in years     | 5.4  |
| Weighted-average discount rate – operating leases                      | 2.60 %   |

The table below summarizes the maturity of remaining lease liabilities:

| <i>(Dollars in thousands)</i>      | March<br>31,<br>2019 |
|------------------------------------|----------------------|
| 2019                               | \$ 662               |
| 2020                               | 858                  |
| 2021                               | 853                  |
| 2022                               | 889                  |
| 2023                               | 764                  |
| 2024 and thereafter                | 685                  |
| Total lease payments               | 4,711                |
| Less: Interest                     | (324 )               |
| Present value of lease liabilities | \$4,387              |

### ***(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 common share:

| <i>(Dollars in thousands, except per share data)</i> | Three months ended<br>March 31,    March 31, |
|--|--|
|--|--|

|  | 2019      | 2018      |
|--|-----------|-----------|
| Weighted average number of common shares outstanding used in basic earnings per common share calculation | 4,598,234 | 4,236,861 |
| Net dilutive effect of:  |           |           |
| Restricted stock awards, options, and warrants   | 28,503    | 665,389   |
| Weighted average number of shares outstanding adjusted for effect of dilutive securities                 | 4,626,737 | 4,902,250 |
| Income available to common shareholders  | \$1,620   | 1,445     |
| Basic earnings per common share  | \$0.35    | 0.34      |
| Diluted earnings per common share  | \$0.35    | 0.29      |

### ***(13) Regulatory Capital and Oversight***

The Company and the Bank are subject to the Basel III regulatory capital requirements. The Basel III requirements, among other things, (i) apply a set of capital requirements to the Bank (the Company is exempt, pursuant to the Small Bank Holding Company Policy Statement (Policy Statement) described below), including requirements relating to common equity as a component of core capital, (ii) implement a “capital conservation buffer” against risk and a higher minimum Tier 1 capital requirement, and (iii) set forth rules for calculating risk-weighted assets for purposes of such requirements. The rules made corresponding revisions to the prompt corrective action framework and include capital ratios and buffer requirements which became fully phased in on January 1, 2019. 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 its assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

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The Board of Governors of the Federal Reserve System (FRB) amended its Policy Statement, to exempt small bank holding companies with assets less than \$3 billion from the above capital requirements. The Policy Statement was also expanded to include savings and loan holding companies that meet the Policy Statement's qualitative requirements for exemption. The Company currently meets the qualitative exemption requirements, and therefore, is exempt from the above capital requirements.

Quantitative measures established by regulations to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table and defined in the regulation) of Common Equity Tier 1 capital to risk weighted assets, Tier 1 capital to adjusted total assets, Tier 1 capital to risk weighted assets, and total capital to risk weighted assets.

The Bank's average total assets for the first quarter of 2019 were \$723.0 million, its adjusted total assets were \$721.8 million, and its risk-weighted assets were \$622.7 million. The following table presents the Bank's capital amounts and ratios at March 31, 2019 for actual capital, required capital and excess capital, including ratios in order to qualify as being well capitalized under the Prompt Corrective Actions regulations.

| <i>(Dollars in thousands)</i> | Actual   |                                  | Required to be Adequately Capitalized |                                  | Excess Capital |                                  | To Be Well Capitalized Under Prompt Corrective |                                  | Action Provisions |                                  |
|-------------------------------|----------|----------------------------------|---------------------------------------|----------------------------------|----------------|----------------------------------|--|----------------------------------|-------------------|----------------------------------|
|                               | Amount   | Percent of Assets <sup>(1)</sup> | Amount                                | Percent of Assets <sup>(1)</sup> | Amount         | Percent of Assets <sup>(1)</sup> | Amount   | Percent of Assets <sup>(1)</sup> | Amount            | Percent of Assets <sup>(1)</sup> |
|                               |          |                                  |                                       |                                  |                |                                  |  |                                  |                   |                                  |
| <b>March 31, 2019</b>         |          |                                  |                                       |                                  |                |                                  |  |                                  |                   |                                  |
| Common equity Tier 1 capital  | \$81,340 | 13.06 %                          | \$28,020                              | 4.50 %                           | \$53,320       | 8.56 %                           | \$40,473                                       | 6.50 %                           |                   |                                  |
| Tier 1 leverage               | 81,340   | 11.27                            | 28,871                                | 4.00                             | 52,469         | 7.27                             | 36,089   | 5.00                             |                   |                                  |
| Tier 1 risk-based capital     | 81,340   | 13.06                            | 37,360                                | 6.00                             | 43,980         | 7.06                             | 49,813   | 8.00                             |                   |                                  |
| Total risk-based capital      | 89,134   | 14.31                            | 49,813                                | 8.00                             | 39,321         | 6.31                             | 62,267   | 10.00                            |                   |                                  |

<sup>(1)</sup> Based upon the Bank's adjusted total assets for the purpose of the Tier 1 leverage capital ratio and risk-weighted assets for the purpose of the risk-based capital ratios.

The Bank must maintain a capital conservation buffer composed of common equity Tier 1 capital above its minimum risk-based capital requirements in order to avoid limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers. On January 1, 2019, the capital conservation buffer

amount increased to 2.50% and is fully phased in. Management believes that, as of March 31, 2019, the Bank's capital ratios were in excess of those quantitative capital ratio standards set forth under the current prompt corrective action regulations, including the capital conservation buffer described above. However, there can be no assurance that the Bank will continue to maintain such status in the future. The Office of the Comptroller of the Currency has extensive discretion in its supervisory and enforcement activities, and can adjust the requirement to be "well-capitalized" in the future.

**(14) *Stockholders' Equity***

The Company may repurchase up to \$6 million of its common stock under the existing share repurchase program. The Company did not repurchase any shares of its common stock in the open market under the share repurchase program or pay any dividends on its common stock during the first quarter of 2019.

**(15) *Commitments***

The Bank issues standby letters of credit which guarantee the performance of customers to third parties. The standby letters of credit issued and available at March 31, 2019 were approximately \$3.2 million, expire over the next 42 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.

Table of Contents**(16) Business Segments**

The Bank has been identified as a reportable operating segment in accordance with the provisions of ASC 280. HMN, the holding company, did not meet the quantitative thresholds for a reportable segment 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 return on average equity. Each corporation is managed separately with its own officers and board of directors.

The following table sets forth certain information about the reconciliations of reported profit and assets for each of the Company’s reportable segments.

| <i>(Dollars in thousands)</i>                      | Home<br>Federal<br><br>Savings<br>Bank | Other  | Eliminations | Consolidated<br><br>Total |
|--|--|--------|--------------|---------------------------|
| <b>At or for the quarter ended March 31, 2019:</b> |  |        |              |                           |
| Interest income - external customers               | \$7,732                                | 0      | 0            | 7,732                     |
| Non-interest income - external customers           | 1,691                                  | 0      | 0            | 1,691                     |
| Intersegment non-interest income                   | 59                                     | 1,762  | (1,821 )     | 0                         |
| Interest expense                                   | 690                                    | 0      | 0            | 690                       |
| Non-interest expense                               | 6,332                                  | 173    | (59 )        | 6,446                     |
| Income tax expense (benefit)                       | 671                                    | (31 )  | 0            | 640                       |
| Net income   | 1,762                                  | 1,620  | (1,762 )     | 1,620                     |
| Total assets                                       | 721,736                                | 85,546 | (84,537 )    | 722,745                   |
| <b>At or for the quarter ended March 31, 2018:</b> |  |        |              |                           |
| Interest income - external customers               | \$7,158                                | 0      | 0            | 7,158                     |
| Non-interest income - external customers           | 1,776                                  | 0      | 0            | 1,776                     |
| Intersegment non-interest income                   | 53                                     | 1,594  | (1,647 )     | 0                         |
| Interest expense                                   | 470                                    | 0      | 0            | 470                       |
| Non-interest expense                               | 6,425                                  | 182    | (53 )        | 6,554                     |
| Income tax expense (benefit)                       | 623                                    | (33 )  | 0            | 590                       |
| Net income   | 1,594                                  | 1,445  | (1,594 )     | 1,445                     |
| Total assets                                       | 722,158                                | 83,309 | (83,128 )    | 722,339                   |



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**HMN FINANCIAL, INC.**

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

*Forward-looking Information*

Safe Harbor Statement

This quarterly report and other reports filed by the Company with the SEC 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,” “target,” and “goal” or similar statements or such terms and include, but are not limited to, those relating to growing our core deposit relationships and loan balances, enhancing the financial performance of our core banking operations, maintaining credit quality, reducing non-performing assets, and generating improved financial results (including profitability); the adequacy and amount of available liquidity and capital resources to the Bank; the Company’s liquidity and capital requirements; our expectations for core capital and our strategies and potential strategies for maintenance thereof; improvements in loan production; changes in the size of the Bank’s loan portfolio; the amount of the Bank’s non-performing assets and the appropriateness of the allowance therefor; anticipated future levels of the provision for loan losses; future losses on non-performing assets; the amount and composition of interest-earning assets; the amount of yield enhancements relating to non-accruing and purchased loans; the amount and composition of non-interest and interest-bearing liabilities; the availability of alternate funding sources; the payment of dividends by HMN; 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 of the trust preferred securities held by the Bank; the anticipated results of litigation and our assessment of the impact on our financial statements; the ability of the Bank to pay dividends to HMN; the ability to remain well capitalized; the impact of new accounting pronouncements; and compliance by 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), Board of Governors of the Federal Reserve System (FRB), the Bank, and the Company to any failure to comply with any such regulatory standard, directive 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 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 traditional and alternate funding sources, including changes in collateral advance rates and policies of the Federal Home Loan Bank (FHLB); technological, computer-related or operational difficulties; results of litigation; 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; our ability to attract and retain employees; or other significant uncertainties. Additional factors that may cause actual results to differ from the Company's assumptions and expectations include those set forth in the Company's most recent filings on Form 10-K and 10-Q with the SEC. 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" section of the Company's Annual Report on Form 10-K for the year ended December 31, 2018 and Part II, Item 1A. of its subsequently filed quarterly reports on Form 10-Q. All statements in this 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.



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### ***General***

HMN Financial, Inc. (HMN or the Company) is the stock savings bank holding company for Home Federal Savings Bank (the Bank), which operates community banking and loan production offices in Minnesota, Iowa and Wisconsin. 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 other 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 composition of interest-earning assets and interest-bearing liabilities, and the level of non-performing assets. The Company's net earnings are also affected by the generation of non-interest income, which consists primarily of gains from the sale of loans and real estate owned, fees for servicing loans, commissions on the sale of uninsured investment products, and service charges on deposit accounts. The Bank incurs expenses in addition to interest expense in the form of compensation and benefits, occupancy and equipment expenses, provisions for loan losses, professional services, deposit insurance, amortization expense on mortgage servicing assets, data processing costs and income taxes. 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.

### **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 and is maintained at an amount considered to be appropriate by management to provide for probable losses inherent in the loan portfolio as of the balance sheet dates. In this analysis, management considers factors including, but not limited to, specific occurrences of loan impairment, actual and anticipated changes in the size of the portfolios, national and regional economic conditions such as unemployment data, loan delinquencies, local economic conditions, demand for single family homes, demand for commercial real estate and building lots, loan portfolio composition, historical loss 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 for 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 uncollectible.

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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 fair market value of collateral dependent loans is typically based on the appraised value of the property less estimated selling costs. 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 its allowance for loan losses by charging the provision for loan losses against income and by receiving recoveries of previously charged off loans. The Company decreases its allowance by crediting the provision for loan losses and recording loan charge-offs. 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 that have not been specifically identified. 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 dates, 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 assets and 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. For tax purposes only the net charge-offs are deductible while the entire provision for loan losses is used to determine book income. A deferred tax asset is created because of the timing difference of when the expense is recognized for book and tax purposes. Under generally accepted accounting principles, a valuation allowance is required to be recognized if it is "more likely than not" that the deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon management's judgment and evaluation of both positive and negative evidence, including the forecasts of future income, tax planning strategies, and assessments of the current and future economic and business conditions. The Company considers both positive and negative evidence regarding the ultimate realizability of deferred tax assets. Positive evidence includes the Company's cumulative net income in the prior three year 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. The Company could not currently identify any negative evidence. It is possible that future conditions may differ substantially from those anticipated in determining that no valuation allowance was required on deferred tax assets, and adjustments may be required in the future.

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

## **RESULTS OF OPERATIONS FOR THE QUARTER ENDED MARCH 31, 2019 COMPARED TO THE QUARTER ENDED MARCH 31, 2018**

### ***Net Income***

Net income was \$1.6 million for the first quarter of 2019, an increase of \$0.2 million compared to net income of \$1.4 million for the first quarter of 2018. Diluted earnings per share for the first quarter of 2019 was \$0.35, an increase of \$0.06 from diluted earnings per share of \$0.29 for the first quarter of 2018. The increase in net income between the periods was due primarily to the \$0.3 million increase in net interest income that was partially offset by a \$0.1 million increase in the provision for loan losses. Net interest income increased primarily because of the higher interest amounts earned on loans and cash balances as a result of the increase in the federal funds rate between the periods. The provision for loan losses increased between the periods primarily because of an increase in loan growth that was partially offset by the overall improved credit quality of the loan portfolio.

Table of Contents***Net Interest Income***

Net interest income was \$7.0 million for the first quarter of 2019, an increase of \$0.3 million, or 5.3%, compared to \$6.7 million for the first quarter of 2018. Interest income was \$7.7 million for the first quarter of 2019, an increase of \$0.5 million, or 8.0%, from \$7.2 million for the first quarter of 2018. Interest income increased primarily because of the higher interest amounts earned on loans and cash balances as a result of the increase in the federal funds rate between the periods and a \$7.5 million increase in the average interest-earning assets held between the periods. The average yield earned on interest-earning assets was 4.52% for the first quarter of 2019, an increase of 29 basis points from 4.23% for the first quarter of 2018.

Interest expense was \$0.7 million for the first quarter of 2019, an increase of \$0.2 million, or 46.8%, compared to \$0.5 million for the first quarter of 2018. The average interest rate paid on non-interest and interest-bearing liabilities was 0.45% for the first quarter of 2019, an increase of 14 basis points from 0.31% for the first quarter of 2018. The increase in the interest paid on non-interest and interest-bearing liabilities was primarily because of the increase in the federal funds rate between the periods, which increased the cost of deposits, and a \$6.2 million increase in the average non-interest and interest-bearing liabilities held between the periods.

Net interest margin (net interest income divided by average interest-earning assets) for the first quarter of 2019 was 4.11%, an increase of 16 basis points, compared to 3.95% for the first quarter of 2018. The increase in the net interest margin is primarily related to the increase in interest income as a result of the increase in the federal funds rate between the periods.

A summary of the Company's net interest margin for the three-month periods ended March 31, 2019 and 2018 is as follows:

| <i>(Dollars in thousands)</i> | For the three-month period ended |          |        |                |          |        |
|-------------------------------|----------------------------------|----------|--------|----------------|----------|--------|
|                               | March 31, 2019                   |          |        | March 31, 2018 |          |        |
|                               | Average                          | Interest | Yield/ | Average        | Interest | Yield/ |
|                               | Outstanding                      | Earned/  | Rate   | Outstanding    | Earned/  | Rate   |
|                               | Balance                          | Paid     |        | Balance        | Paid     |        |
| Interest-earning assets:      |                                  |          |        |                |          |        |
| Securities available for sale | \$78,794                         | 338      | 1.74 % | \$78,274       | 314      | 1.63 % |
| Loans held for sale           | 1,187                            | 12       | 4.17   | 1,063          | 11       | 4.38   |
| Mortgage loans, net           | 115,854                          | 1,261    | 4.41   | 113,612        | 1,122    | 4.00   |
| Commercial loans, net         | 400,905                          | 5,060    | 5.12   | 400,488        | 4,768    | 4.83   |
| Consumer loans, net           | 72,572                           | 935      | 5.22   | 72,390         | 877      | 4.91   |
| Other                         | 25,008                           | 126      | 2.04   | 20,958         | 66       | 1.28   |
| Total interest-earning assets | 694,320                          | 7,732    | 4.52   | 686,785        | 7,158    | 4.23   |

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|  |           |         |        |           |         |        |
|--|-----------|---------|--------|-----------|---------|--------|
| Interest-bearing liabilities:  |           |         |        |           |         |        |
| Checking   | 97,692    | 24      | 0.10   | 94,472    | 10      | 0.04   |
| Savings  | 78,496    | 15      | 0.08   | 77,174    | 15      | 0.08   |
| Money market   | 181,570   | 270     | 0.60   | 185,585   | 186     | 0.41   |
| Certificates   | 114,196   | 381     | 1.35   | 111,702   | 257     | 0.93   |
| Advances and other borrowings  | 0         | 0       | 0.00   | 569       | 2       | 1.71   |
| Total interest-bearing liabilities                                   | 471,954   |         |        | 469,502   |         |        |
| Non-interest checking  | 156,454   |         |        | 153,266   |         |        |
| Other non-interest bearing deposits                                  | 2,062     |         |        | 1,541     |         |        |
| Total interest-bearing liabilities and non-interest bearing deposits | \$630,470 | 690     | 0.45   | \$624,309 | 470     | 0.31   |
| Net interest income  |           | \$7,042 |        |           | \$6,688 |        |
| Net interest rate spread   |           |         | 4.07 % |           |         | 3.92 % |
| Net interest margin  |           |         | 4.11 % |           |         | 3.95 % |

Table of Contents***Provision for Loan Losses***

The provision for loan losses was \$27,000 for the first quarter of 2019, an increase of \$0.1 million compared to (\$0.1) million for the first quarter of 2018. The provision for loan losses increased between the periods primarily because of the increased loan growth that was experienced in the first quarter of 2019 when compared to the first quarter of 2018. The increase in the provision related to loan growth in the first quarter of 2019 was partially offset by a reduction in the required reserves due to the improved credit quality of the loan portfolio.

A reconciliation of the Company's allowance for loan losses for the first quarters of 2019 and 2018 is as follows:

| <i>(Dollars in thousands)</i> | 2019    | 2018   |
|-------------------------------|---------|--------|
| Balance at January 1,         | \$8,686 | 9,311  |
| Provision                     | 27      | (125 ) |
| Charge offs:                  |         |        |
| Consumer                      | (39 )   | (68 )  |
| Single family                 | 0       | (24 )  |
| Commercial business           | (43 )   | 0      |
| Recoveries                    | 42      | 35     |
| Balance at March 31,          | \$8,673 | 9,129  |
| General allowance             | \$7,854 | 8,181  |
| Specific allowance            | 819     | 948    |
|                               | \$8,673 | 9,129  |

***Non-Interest Income***

Non-interest income was \$1.7 million for the first quarter of 2019, a decrease of \$0.1 million, or 4.8%, from \$1.8 million for the first quarter of 2018. Fees and service charges decreased \$0.1 million between the periods due primarily to a decrease in debit card and overdraft fees. Gain on sales of loans decreased \$0.1 million between the periods primarily because of a decrease in the gains recognized on the sale of commercial government guaranteed loans due to a decrease in originations and sales. These decreases in non-interest income were partially offset by a slight increase in other income related to the increase in the fees earned on the sales of uninsured investment products between the periods and a slight increase in loan servicing fees earned on single family loans that were serviced for others.

***Non-Interest Expense***

Non-interest expense was \$6.4 million for the first quarter of 2019, a decrease of \$0.2 million, or 1.6%, from \$6.6 million for the first quarter of 2018. Other non-interest expenses decreased \$0.2 million due primarily to a decrease in the losses incurred on deposit accounts between the periods. Occupancy and equipment expense decreased slightly between the periods due to a decrease in non-capitalized equipment purchases. These decreases in non-interest expense were partially offset by a \$0.1 million increase in compensation and benefits expense due to annual salary increases and a slight increase in professional services expense due to an increase in legal expenses

*Income Taxes*

Income tax expense was \$0.6 million for both the first quarter of 2019 and the first quarter of 2018.



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

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

|  | March<br>31,<br>2019 | December<br>31,<br>2018 |  |  |
|--|----------------------|-------------------------|--|--|
| <i>(Dollars in thousands)</i>                                  |                      |                         |  |  |
| Non-performing loans:  |                      |                         |  |  |
| Single family  | \$751                | \$ 730                  |  |  |
| Commercial real estate   | 1,276                | 1,311                   |  |  |
| Consumer   | 283                  | 489                     |  |  |
| Commercial business  | 212                  | 148                     |  |  |
| Total  | 2,522                | 2,678                   |  |  |
| Foreclosed and repossessed assets:                             |                      |                         |  |  |
| Single family  | \$30                 | 0                       |  |  |
| Commercial real estate   | 414                  | 414                     |  |  |
| Total non-performing assets                                    | \$2,966              | \$ 3,092                |  |  |
| Total as a percentage of total assets                          | 0.41 %               | 0.43 %                  |  |  |
| Total non-performing loans                                     | \$2,522              | \$ 2,678                |  |  |
| Total as a percentage of total loans receivable, net           | 0.42 %               | 0.46 %                  |  |  |
| Allowance for loan losses to non-performing loans              | 343.90%              | 324.27 %                |  |  |
| Delinquency data:  |                      |                         |  |  |
| Delinquencies <sup>(1)</sup>                                   |                      |                         |  |  |
| 30+ days   | \$1,554              | \$ 1,453                |  |  |
| 90+ days   | 0                    | 0                       |  |  |
| Delinquencies as a percentage of loan portfolio <sup>(1)</sup> |                      |                         |  |  |
| 30+ days   | 0.25 %               | 0.24 %                  |  |  |
| 90+ days   | 0.00 %               | 0.00 %                  |  |  |

<sup>(1)</sup> Excludes non-accrual loans.

Total non-performing assets were \$3.0 million at March 31, 2019, a decrease of \$0.1 million, or 4.1%, from \$3.1 million at December 31, 2018. Non-performing loans decreased \$156,000 and foreclosed and repossessed assets increased \$30,000 during the first quarter of 2019.

### *Dividends*

The declaration of dividends is subject to, among other things, the Company's financial condition and results of operations, the Bank's compliance with regulatory capital requirements and other regulatory restrictions, tax considerations, industry standards, economic conditions, general business practices and other factors. The Company has not made any dividend payments to common stockholders during the three year period ending March 31, 2019.

### **LIQUIDITY AND CAPITAL RESOURCES**

For the quarter ended March 31, 2019, the net cash provided by operating activities was \$3.1 million. The Company collected \$0.7 million in principal repayments and maturities on securities during the quarter and received \$1.2 million related to increases in customer escrows. The Company had a net increase in deposit balances of \$3.2 million during the quarter. It also purchased \$0.2 million of premises and equipment and loans receivable increased \$13.6 million.

The Company has certificates of deposit with outstanding balances of \$69.5 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 cash outflows from deposits that do not renew will be replaced with a combination of other customer's deposits or FHLB advances. FRB borrowings or proceeds from the sale of securities could also be used to fund unanticipated outflows of certificates of deposit.

The Company had two deposit customers with aggregate deposits greater than \$5.0 million as of March 31, 2019. The \$31.4 million in funds held by these customers may be withdrawn at any time, but management anticipates that the majority of these deposits will not be withdrawn from the Bank over the next twelve months. If these deposits are withdrawn, it is anticipated that they would be replaced with deposits from other customers or FHLB advances. FRB borrowings or proceeds from the sale of securities could also be used to replace unanticipated outflows of large checking and money market deposits.

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The Company had the ability to borrow \$170.7 million from the FHLB at March 31, 2019 based on the collateral value of the loans pledged. The credit policy of the FHLB relating to the collateral value of the loans collateralizing the available line of credit 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, in excess of the \$64.7 million that was available from the FRB at March 31, 2019, based on the increased collateral levels.

The Company's primary source of cash is dividends from the Bank. At March 31, 2019, the Company had \$2.5 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 operating expenses.

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 Company level expenses, the Company may find it prudent, subject to prevailing capital market conditions and other factors, to raise additional capital through issuance of its common stock or other equity securities. 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 were to raise capital through the issuance of 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, would dilute the per share book value of the Company's 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 the Company's current stockholders, which may adversely impact the Company's current stockholders. The Company's ability to raise additional capital through the issuance of 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.

***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 following Asset/Liability Management section of this report 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 under different interest rate changes.

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The following table discloses the projected changes in the market value of 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, 2019.

|   | Market Value |           |         |         |         |
|---|--------------|-----------|---------|---------|---------|
|   | -200         | -100      | 0       | +100    | +200    |
| <i>(Dollars in thousands)</i>               |              |           |         |         |         |
| Basis point change in interest rates        | -200         | -100      | 0       | +100    | +200    |
| Total market risk sensitive assets          | \$727,794    | 715,095   | 702,462 | 689,235 | 675,920 |
| Total market risk sensitive liabilities     | 664,721      | 622,788   | 584,503 | 550,894 | 522,053 |
| Off-balance sheet financial instruments     | (58 )        | (37 )     | 0       | (158 )  | (338 )  |
| Net market risk                             | \$63,131     | 92,344    | 117,959 | 138,499 | 154,205 |
| Percentage change from current market value | (46.48 )%    | (21.72 )% | 0.00 %  | 17.41 % | 30.73 % |

The preceding table was prepared utilizing a model using the following assumptions (the Model Assumptions) regarding prepayment and decay ratios that were determined by management based upon their review of historical prepayment speeds and future prepayment projections. Fixed rate loans were assumed to prepay at annual rates of between 1% to 41%, depending on the note rate and the period to maturity. Adjustable rate mortgages (ARMs) were assumed to prepay at annual rates of between 4% and 58%, 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 and money market accounts were assumed to decay at an annual rate of 3%, and 1%, respectively. Retail checking accounts, commercial checking accounts and money market accounts were assumed to decay at annual rates of 0%, 28% and 32%, respectively. Callable investments were projected to be called at the first call date where the projected interest rate on similar remaining term instruments was less than the interest rate on the callable investment.

Certain shortcomings are inherent in the method of analysis presented in the above 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 that are approaching their lifetime interest rate caps could be different from the values disclosed in the table. Certain liabilities, such as certificates of deposit, have fixed rates that restrict interest rate changes until maturity. 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 also decrease in the event of a substantial sustained increase in interest rates.

***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 impact on net interest income during the twelve month period ending March 31, 2019 of immediate interest rate changes called rate shocks:

*(Dollars in thousands)*

| Projected                     |  |                      |    |
|-------------------------------|--|----------------------|----|
| Rate Shock in<br>Basis Points | Change<br>in Net<br>Interest<br>Income | Percentage<br>Change |    |
| +200                          | \$ 2,007                               | 6.93                 | %  |
| +100                          | 1,009                                  | 3.49                 | %  |
| 0                             | 0                                      | 0.00                 | %  |
| -100                          | (1,204 )                               | (4.16                | )% |
| -200                          | (2,792 )                               | (9.65                | )% |

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 there are more adjustable rate loans that would re-price to higher interest rates than there are deposits that would re-price in the next twelve months.

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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 that meets frequently to discuss changes in the interest rate risk position and projected profitability. This Committee makes adjustments to the asset-liability position of the Bank that 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 as intended to assure attainment of the Bank's objectives in an 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 composition, 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 long-term fixed rate loans were placed into the single family loan portfolio. In recent years, the Bank has continued to focus its 30 year fixed rate single family residential lending program on loans that are saleable to third parties and generally places only adjustable rate or shorter-term fixed rate loans that meet certain risk characteristics into its loan portfolio. A significant portion of the Bank's commercial loan production continues to be in adjustable rate loans that reprice every one, two or three years.

### ***Off-Balance Sheet Arrangements***

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

### **Item 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 (the 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 SEC 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.



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**HMN FINANCIAL, INC.**

**PART II - OTHER INFORMATION**

**ITEM 1. Legal Proceedings.**

From time to time, the Company is party to legal proceedings arising out of its lending and deposit operations. The Company is, and expects to become, engaged in foreclosure proceedings, collection actions, and other litigation as part of its normal banking activities. Among the various current litigation matters, the Company is involved in a bankruptcy litigation claim where the bankruptcy trustee is attempting to recover \$3.9 million related to the principal and interest payments made to the Bank prior to the bankruptcy filing of a former customer of the Bank. Based on the Company's current understanding of all of the outstanding legal matters, management does not believe that judgments or settlements arising from any pending or threatened litigation, individually or in the aggregate, would have a material adverse effect on the consolidated financial condition or results of operations. However, litigation is unpredictable and the actual results of litigation cannot be determined with any certainty. Therefore, the ultimate aggregate resolution of any, or all, of the current outstanding legal matters could have a material adverse effect on the Company's results of operations in the future.

**ITEM 1A. Risk Factors.**

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, 2018. For a further discussion of our Risk Factors, see Part I, Item 1A. of the Company's Annual Report on Form 10-K for the year ended December 31, 2018.

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

(a) Not applicable.

(b) Not applicable.

(c) On November 28, 2018, the Board of Directors announced a new share repurchase program pursuant to which the Company may purchase shares of its common stock for an aggregate purchase price not to exceed \$6 million. The share repurchase program does not obligate the Company to purchase any shares and has no set expiration date. No shares were repurchased by the Company during the first quarter of 2019.

**ITEM 3. Defaults Upon Senior Securities.**

None.

**ITEM 4. Mine Safety Disclosures.**

Not applicable.

**ITEM 5. Other Information.**

None.

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Table of Contents**ITEM 6. Exhibits.****INDEX TO EXHIBITS**

| Exhibit<br>Number Exhibit |  | Filing Status           |
|---------------------------|--|-------------------------|
| 31.1                      | <u>Rule 13a-14(a)/15d-14(a) Certification of CEO</u>   | Filed<br>Electronically |
| 31.2                      | <u>Rule 13a-14(a)/15d-14(a) Certification of CFO</u>   | Filed<br>Electronically |
| 32                        | <u>Section 1350 Certifications of CEO and CFO</u>  | Filed<br>Electronically |
| 101                       | Financial statements from the Quarterly Report on Form 10-Q of the Company for the period ended March 31, 2019, filed with the Securities and Exchange Commission on May 3, 2019, formatted in Extensible Business Reporting Language (XBRL); (i) the Consolidated Balance Sheets at March 31, 2019 and December 31, 2018, (ii) the Consolidated Statements of Comprehensive Income for the Three Months Ended March 31, 2019 and 2018, (iii) the Consolidated Statement of Stockholders' Equity for the Three Month Periods Ended March 31, 2019 and 2018, (iv) the Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2019 and 2018, and (v) Notes to Consolidated Financial Statements. | Filed<br>Electronically |

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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: May 3, 2019

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

Date: May 3, 2019

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