HMN FINANCIAL INC
Form 10-Q
August 03, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2018

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	41-1777397
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1016 Civic Center Drive NW, Rochester, MN	55901
(Address of principal executive offices)	(Zip Code)

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

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

Yes No

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

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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
(Do not check if a 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

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

Class	Outstanding at July 27, 2018
Common stock, $0.01 par value	4,609,440

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HMN FINANCIAL, INC.

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Part I – FINANCIAL INFORMATION

Item 1: Financial Statements

HMN FINANCIAL, INC. AND SUBSIDIARIES Consolidated Balance Sheets

(Dollars in thousands)	June 30, 2018 (unaudited)	December 31, 2017
Assets		
Cash and cash equivalents	$ *31,710*	*37,564*
Securities available for sale:		
Mortgage-backed and related securities (amortized cost $9,145 and $5,148)	*8,895*	*5,068*
Other marketable securities (amortized cost $73,433 and $73,653)	*71,630*	*72,404*
	80,525	*77,472*
Loans held for sale	*3,624*	*1,837*
Loans receivable, net	*589,855*	*585,931*
Accrued interest receivable	*2,330*	*2,344*
Real estate, net	*701*	*627*
Federal Home Loan Bank stock, at cost	*867*	*817*
Mortgage servicing rights, net	*1,813*	*1,724*
Premises and equipment, net	*8,446*	*8,226*
Goodwill	*802*	*802*
Core deposit intangible	*305*	*355*
Prepaid expenses and other assets	*1,432*	*1,314*
Deferred tax asset, net	*3,875*	*3,672*
Total assets	$ *726,285*	*722,685*
Liabilities and Stockholders' Equity		
Deposits	$ *639,535*	*635,601*
Accrued interest payable	*264*	*146*
Customer escrows	*1,268*	*1,147*
Accrued expenses and other liabilities	*3,393*	*4,973*
Total liabilities	*644,460*	*641,867*

Commitments and contingencies		
Stockholders' equity:		
Serial-preferred stock: ($.01 par value) authorized shares 500,000; issued shares 0	*0*	*0*
Common stock ($.01 par value): authorized shares 16,000,000; issued shares 9,128,662	*91*	*91*
Additional paid-in capital	*46,950*	*50,623*
Retained earnings, subject to certain restrictions	*94,690*	*91,448*
Accumulated other comprehensive loss	*(1,479*)	*(957*)
Unearned employee stock ownership plan shares	*(1,933*)	*(2,030*)
Treasury stock, at cost 4,519,222 and 4,631,124 shares	*(56,494*)	*(58,357*)
Total stockholders' equity	*81,825*	*80,818*
Total liabilities and stockholders' equity	$ *726,285*	*722,685*

See accompanying notes to consolidated financial statements.

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HMN FINANCIAL, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

(unaudited)

(Dollars in thousands, except per share data)	Three Months Ended June 30, 2018	2017	Six Months Ended June 30, 2018	2017
Interest income:				
Loans receivable	$ *7,006*	*6,701*	*13,784*	*13,061*
Securities available for sale:				
Mortgage-backed and related	*54*	*5*	*96*	*12*
Other marketable	*285*	*283*	*557*	*551*
Other	*111*	*10*	*177*	*34*
Total interest income	*7,456*	*6,999*	*14,614*	*13,658*
Interest expense:				
Deposits	*526*	*329*	*994*	*622*
Federal Home Loan Bank advances and other borrowings	*0*	*132*	*2*	*247*
Total interest expense	*526*	*461*	*996*	*869*
Net interest income	*6,930*	*6,538*	*13,618*	*12,789*
Provision for loan losses	*295*	*269*	*170*	*(1)*
Net interest income after provision for loan losses	*6,635*	*6,269*	*13,448*	*12,790*
Non-interest income:				
Fees and service charges	*785*	*845*	*1,551*	*1,669*
Loan servicing fees	*297*	*306*	*598*	*607*
Gain on sales of loans	*679*	*488*	*1,123*	*1,007*
Other	*293*	*267*	*558*	*503*
Total non-interest income	*2,054*	*1,906*	*3,830*	*3,786*
Non-interest expense:				
Compensation and benefits	*3,678*	*3,780*	*7,502*	*7,724*
Occupancy and equipment	*1,072*	*1,026*	*2,169*	*2,065*
Data processing	*334*	*260*	*629*	*552*
Professional services	*298*	*417*	*547*	*676*
Other	*931*	*956*	*2,020*	*1,769*
Total non-interest expense	*6,313*	*6,439*	*12,867*	*12,786*
Income before income tax expense	*2,376*	*1,736*	*4,411*	*3,790*
Income tax expense	*649*	*712*	*1,239*	*1,553*
Net income	*1,727*	*1,024*	*3,172*	*2,237*
Other comprehensive (loss) income, net of tax	*(105)*	*173*	*(452)*	*361*
Comprehensive income available to common shareholders	$ *1,622*	*1,197*	*2,720*	*2,598*

Basic earnings per share	$*0.40*	*0.24*	*0.74*	*0.53*
Diluted earnings per share	$*0.36*	*0.21*	*0.66*	*0.46*

See accompanying notes to consolidated financial statements.

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HMN FINANCIAL, INC. AND SUBSIDIARIES

Consolidated Statement of Stockholders' Equity

For the Six-Month Period Ended June 30, 2018

(unaudited)

(Dollars in thousands)	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive (Loss)	Unearned Employee Stock Ownership Plan Shares	Treasury Stock	Total Stockholders' Equity
Balance, December 31, 2017	$ *91*	*50,623*	*91,448*	*(957)*	*(2,030)*	*(58,357)*	*80,818*
Net income			*3,172*				*3,172*
Accounts reclassified from accumulated other comprehensive loss			*70*	*(70)*			*0*
Other comprehensive loss				*(452)*			*(452)*
Stock warrants purchased		*(1,989)*					*(1,989)*
Stock warrants exercised		(1,674)				1,674	0
Stock compensation expense		*8*					*8*
Restricted stock awards		*(189)*				*189*	*0*
Amortization of restricted stock awards		*73*					*73*
Earned employee stock ownership plan shares		*98*			*97*		*195*
Balance, June 30, 2018	$ *91*	*46,950*	*94,690*	*(1,479)*	*(1,933)*	*(56,494)*	*81,825*

See accompanying notes to consolidated financial statements.

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HMN FINANCIAL, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(unaudited)

(Dollars in thousands)	Six Months Ended June 30, 2018	2017
Cash flows from operating activities:		
Net income	$ 3,172	2,237
Adjustments to reconcile net income to cash provided by operating activities:		
Provision for loan losses	170	(1)
Depreciation	528	464
Amortization of premiums, net	24	0
Amortization of deferred loan costs (fees)	15	(125)
Amortization of core deposit intangible	50	50
Amortization of other purchased fair value adjustments	(23)	(55)
Amortization of mortgage servicing rights	268	269
Capitalized mortgage servicing rights	(357)	(320)
Securities gains, net	(22)	0
Gain on sale of premises and equipment	0	(8)
Gain on sales of real estate	0	(7)
Gain on sales of loans	(1,123)	(1,007)
Proceeds from sale of loans held for sale	46,097	43,490
Disbursements on loans held for sale	(39,120)	(36,046)
Amortization of restricted stock awards	73	71
Amortization of unearned Employee Stock Ownership Plan shares	97	96
Earned Employee Stock Ownership Plan shares priced above original cost	98	72
Stock option compensation expense	8	21
Decrease in accrued interest receivable	14	18
Increase (decrease) in accrued interest payable	118	(23)
(Increase) decrease in other assets	(73)	233
Decrease in other liabilities	(1,625)	(1,103)
Other, net	(3)	46
Net cash provided by operating activities	8,386	8,372
Cash flows from investing activities:		
Principal collected on securities available for sale	893	416
Proceeds collected on maturities of securities available for sale	310	5,000
Purchases of securities available for sale	(4,888)	(4,999)
Purchase of Federal Home Loan Bank Stock	(322)	(3,255)
Redemption of Federal Home Loan Bank Stock	272	3,208
Proceeds from sales of real estate	0	42
Net increase in loans receivable	(11,825)	(45,415)
Proceeds from sale of premises and equipment	0	8

Purchases of premises and equipment	(746)	(498)
Net cash used by investing activities	(16,306)	(45,493)
Cash flows from financing activities:		
Increase in deposits	3,934	41,294
Warrants purchased	(1,989)	0
Stock awards withheld for tax withholding	0	(54)
Proceeds from borrowings	6,800	80,600
Repayment of borrowings	(6,800)	(80,600)
Increase in customer escrows	121	212
Net cash provided by financing activities	2,066	41,452
(Decrease) increase in cash and cash equivalents	(5,854)	4,331
Cash and cash equivalents, beginning of period	37,564	27,561
Cash and cash equivalents, end of period	$31,710	31,892
Supplemental cash flow disclosures:		
Cash paid for interest	$878	892
Cash paid for income taxes	2,852	1,766
Supplemental noncash flow disclosures:		
Loans transferred to loans held for sale	7,670	6,641
Loans held for sale transferred to loans	0	164
Transfer of loans to real estate	74	40

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.

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

(*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 *six*-month period ended *June 30, 2018* are *not* necessarily indicative of the results which *may* be expected for the entire year.

(*3*) *New Accounting Standards*

In *February 2016,* the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) *2016-02, Leases (Topic 842).* The amendments in the ASU create *Topic 842, Leases*, and supersede the lease requirements in *Topic 840, Leases*. The objective of this ASU is to establish the principles that lessees and lessors shall apply to report useful information to users of financial statements about the amount, timing, and uncertainty of cash flows arising from a lease. The main difference between previous GAAP and this ASU is the recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under previous GAAP. The amendment requires a lessee to recognize in the statement of financial position a liability to make lease payments (the lease liability) and the right-of-use asset representing its right to use the underlying asset for the lease term. The accounting applied by a lessor is largely unchanged from that applied under previous GAAP. In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. The modified retrospective approach includes a number of optional practical expedients that entities *may* elect to apply that will, in effect, continue to account for leases that commence before the effective date in accordance with previous GAAP unless the lease is modified. The amendments in the ASU, for public business entities, are effective for fiscal years beginning after *December 15, 2018,* including interim periods within those fiscal years. The adoption of this ASU in the *first* quarter of *2019* is *not* anticipated to have a material impact on the Company's consolidated financial statements.

In *June 2016,* the FASB issued 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, 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 impact that the adoption of this ASU in the *first* quarter of *2020* will have on the Company's consolidated financial statements.

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In *March 2017,* the FASB issued ASU *2017-08, Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities.* The amendments in this ASU shorten the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do *not* require an accounting change for securities held at a discount as discounts continue to be amortized to maturity. This ASU is intended to more closely align the amortization period of premiums and discounts to expectations incorporated in market pricing on the underlying securities. In most cases, market participants price securities to the call date that produces the worst yield when the coupon is above current market rates and price securities to maturity when the coupon is below market rates. As a result, the amendments more closely align interest income recorded on bonds held at a premium or a discount with the economics of the underlying instrument. This ASU is intended to reduce diversity in practice and is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after *December 15, 2018* with early adoption permitted. Upon adoption, the amendments should be applied using a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. Additionally, in the period of adoption, an entity should provide disclosures about a change in accounting principles. The adoption of this ASU in the *first* quarter of *2019* is *not* anticipated to have a material impact on the Company's consolidated financial statements.

(*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 and liabilities of the Company for which fair values are determined on a recurring basis as of *June 30, 2018* and *December 31, 2017.*

	Carrying value at June 30, 2018			
(Dollars in thousands)	Total	Level 1	Level 2	Level 3
Securities available for sale	$ *80,525*	*0*	*80,525*	*0*
Mortgage loan commitments	*74*	*0*	*74*	*0*
Total	$ *80,599*	*0*	*80,599*	*0*

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(Dollars in thousands)	Carrying value at December 31, 2017 Total	Level 1	Level 2	Level 3
Securities available for sale	$*77,472*	*0*	*77,472*	*0*
Mortgage loan commitments	*28*	*0*	*28*	*0*
Total	$*77,500*	*0*	*77,500*	*0*

There were *no* transfers between Levels *1, 2,* or *3* during the *three* or *six* month periods ended *June 30, 2018.*

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 held at *December 31, 2017* and at *June 30, 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 *June 30, 2018* and *December 31, 2017.*

	Carrying value at June 30, 2018				Three months ended	Six months ended
(Dollars in thousands)	Total	Level 1	Level 2	Level 3	June 30, 2018 total gains (losses)	June 30, 2018 total gains (losses)
Loans held for sale	$*3,624*	*0*	*3,624*	*0*	*16*	*17*
Mortgage servicing rights	*1,813*	*0*	*1,813*	*0*	*0*	*0*
Loans [(1)]	*3,181*	*0*	*3,181*	*0*	*(29*)	*(80*)
Real estate, net [(2)]	*701*	*0*	*701*	*0*	*0*	*0*
Total	$*9,319*	*0*	*9,319*	*0*	*(13*)	*(63*)

Carrying value at December 31, 2017				
Total	Level 1	Level 2	Level 3	Year ended

(Dollars in thousands)					December 31, 2017 total gains (losses)
Loans held for sale	$ *1,837*	*0*	*1,837*	*0*	*1*
Mortgage servicing rights, net	*1,724*	*0*	*1,724*	*0*	*0*
Loans[1]	*3,201*	*0*	*3,201*	*0*	*(413*)
Real estate, net[2]	*627*	*0*	*627*	*0*	*0*
Total	$ *7,389*	*0*	*7,389*	*0*	*(412*)

(*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.

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(5) *Fair Value of Financial Instruments*

Generally accepted accounting principles require interim reporting period disclosure about the fair value of financial instruments, including assets, liabilities and off-balance sheet items for which it is practicable to estimate fair value. The fair value hierarchy level for each asset and liability, as defined in Note *4,* have been included in the following table for *June 30, 2018* and *December 31, 2017.* The fair value estimates are made based upon relevant market information, if available, and upon the characteristics of the financial instruments themselves. Because *no* market exists for a significant portion of the Company's financial instruments, fair value estimates are based upon judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. The estimated fair value of the Company's financial instruments as of *June 30, 2018* and *December 31, 2017* are shown in the following table.

	June 30, 2018						December 31, 2017					
			Fair value hierarchy						Fair value hierarchy			
(Dollars in thousands)	Carrying amount	Estimated fair value	Level 1	Level 2	Level 3	Contract amount	Carrying amount	Estimated fair value	Level 1	Level 2	Level 3	Contract amount
Financial assets:												
Cash and cash equivalents	$*31,710*	*31,710*	*31,710*				*37,564*	*37,564*	*37,564*			
Securities available for sale	*80,525*	*80,525*		*80,525*			*77,472*	*77,472*		*77,472*		
Loans held for sale	*3,624*	*3,624*		*3,624*			*1,837*	*1,837*		*1,837*		
Loans receivable, net	*589,855*	*588,794*		*588,794*			*585,931*	*585,494*		*585,494*		
Federal Home Loan Bank stock	*867*	*867*		*867*			*817*	*817*		*817*		
Accrued interest receivable	*2,330*	*2,330*		*2,330*			*2,344*	*2,344*		*2,344*		
Financial liabilities:												
Deposits	*639,535*	*633,844*		*633,844*			*635,601*	*635,905*		*635,905*		
Accrued interest payable	*264*	*264*		*264*			*146*	*146*		*146*		

Off-balance sheet financial instruments:						
Commitments to extend credit	*74*	*74*	*242,267*	*28*	*28*	*173,64*
Commitments to sell loans	*(28)*	*(28)*	*11,321*	*(11)*	*(11)*	*5,629*

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 as required upon adoption of ASU *2016-01, Financial Instruments – Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities* beginning in the *first* quarter of *2018.*

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 as required upon adoption of ASU *2016-01, Financial Instruments – Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities* beginning in the *first* quarter of *2018.*

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

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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)*

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:

	For the three months ended June 30,					
(Dollars in thousands)	2018			2017		
Securities available for sale:	Before tax	Tax effect	Net of tax	Before tax	Tax effect	Net of tax
Net unrealized (losses) gains arising during the period	$*(146)*	*(41)*	*(105)*	*286*	*113*	*173*
Other comprehensive income (loss)	$*(146)*	*(41)*	*(105)*	*286*	*113*	*173*

	For the six months ended June 30,					
(Dollars in thousands)	2018			2017		
Securities available for sale:	Before tax	Tax effect	Net of tax	Before tax	Tax effect	Net of tax
Net unrealized (losses) gains arising during the period	$*(625)*	*(175)*	*(452)*	*599*	*238*	*361*

Other comprehensive income (loss)	$(625)	(175)	(452)	599	238	361

(7) *Securities Available For Sale*

The following table shows the gross unrealized losses and fair value for the securities available for sale portfolio, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at *June 30, 2018* and *December 31, 2017.*

(Dollars in thousands)	Less Than Twelve Months			Twelve Months or More			Total	
	# of Investments	Fair Value	Unrealized Losses	# of Investments	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
June 30, 2018								
Mortgage-backed securities:								
Federal National Mortgage Association (FNMA)	*2*	$*4,201*	*(168)*	*0*	$*0*	*0*	$*4,201*	*(168)*
Federal Home Loan Mortgage Corporation (FHLMC)	*1*	*4,468*	*(72)*	*0*	*0*	*0*	*4,468*	*(72)*
Collateralized mortgage obligations:								
FNMA	*1*	*202*	*(10)*	*0*	*0*	*0*	*202*	*(10)*
Other marketable securities:								
U.S. Government agency obligations	*2*	*9,678*	*(306)*	*12*	*58,606*	*(1,377)*	*68,284*	*(1,683)*
Municipal obligations	*13*	*2,272*	*(11)*	*0*	*0*	*0*	*2,272*	*(11)*
Corporate obligations	*1*	*200*	*(4)*	*0*	*0*	*0*	*200*	*(4)*
Corporate preferred stock	*0*	*0*	*0*	*1*	*595*	*(105)*	*595*	*(105)*
Total temporarily impaired securities	*20*	$*21,021*	*(571)*	*13*	$*59,201*	*(1,482)*	$*80,222*	*(2,053)*

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(Dollars in thousands)	Less Than Twelve Months			Twelve Months or More			Total	
	# of Investments	Fair Value	Unrealized Losses	# of Investments	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2017								
Mortgage-backed securities:								
FNMA	*2*	$*4,703*	*(78*)	*0*	$*0*	*0*	$*4,703*	*(78*)
Collateralized mortgage obligations:								
FNMA	*1*	*218*	*(5*)	*0*	*0*	*0*	*218*	*(5*)
Other marketable securities:								
U.S. Government agency obligations	*2*	*9,819*	*(163*)	*12*	*58,942*	*(1,038*)	*68,761*	*(1,201*)
Municipal obligations	*14*	*2,268*	*(8*)	*0*	*0*	*0*	*2,268*	*(8*)
Corporate obligations	*1*	*233*	*(1*)	*0*	*0*	*0*	*233*	*(1*)
Corporate preferred stock	*0*	*0*	*0*	*1*	*560*	*(140*)	*560*	*(140*)
Total temporarily impaired securities	*20*	$*17,241*	*(255*)	*13*	$*59,502*	*(1,178*)	$*76,743*	*(1,433*)

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 U.S. Government agency obligations are the result of changes in interest rates. The unrealized losses reported for the corporate preferred stock at *June 30, 2018* relates to a single trust preferred security that was issued by the holding company of a small community bank. As of *June 30, 2018* 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 *June 30, 2018.* The Company does *not* intend to sell the preferred stock and has the intent and ability to hold it for a period of time sufficient to recover the temporary loss. Management believes that the Company will receive all principal and interest payments contractually due on the security and that the decrease in the market value is primarily due to a lack of liquidity in the market for trust preferred securities. Management will continue to monitor the credit risk of the issuer and *may* be required to recognize other-than-temporary impairment charges on this security in future periods.

A summary of securities available for sale at *June 30, 2018* and *December 31, 2017* is as follows:

(Dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
June 30, 2018				
Mortgage-backed securities:				
FHLMC	$ *4,564*	*0*	*(72)*	*4,492*
FNMA	*4,369*	*0*	*(168)*	*4,201*
Collateralized mortgage obligations:				
FNMA	*212*	*0*	*(10)*	*202*
	9,145	*0*	*(250)*	*8,895*
Other marketable securities:				
U.S. Government agency obligations	*69,967*	*0*	*(1,683)*	*68,284*
Municipal obligations	*2,383*	*0*	*(11)*	*2,372*
Corporate obligations	*204*	*0*	*(4)*	*200*
Corporate preferred stock	*700*	*0*	*(105)*	*595*
Corporate equity	*179*	*0*	*0*	*179*
	73,433	*0*	*(1,803)*	*71,630*
	$ *82,578*	*0*	*(2,053)*	*80,525*

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(Dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
December 31, 2017				
Mortgage-backed securities:				
FHLMC	$ *91*	*2*	*0*	*93*
FNMA	*4,834*	*1*	*(78*)	*4,757*
Collateralized mortgage obligations:				
FNMA	*223*	*0*	*(5*)	*218*
	5,148	*3*	*(83*)	*5,068*
Other marketable securities:				
U.S. Government agency obligations	*69,962*	*0*	*(1,201*)	*68,761*
Municipal obligations	*2,699*	*2*	*(8*)	*2,693*
Corporate obligations	*234*	*0*	*(1*)	*233*
Corporate preferred stock	*700*	*0*	*(140*)	*560*
Corporate equity	*58*	*99*	*0*	*157*
	73,653	*101*	*(1,350*)	*72,404*
	$ *78,801*	*104*	*(1,433*)	*77,472*

The following table indicates amortized cost and estimated fair value of securities available for sale at *June 30, 2018* based upon contractual maturity adjusted for scheduled repayments of principal and projected prepayments of principal based upon current economic conditions and interest rates.

(Dollars in thousands)	Amortized Cost	Fair Value
Due less than one year	$ *1,921*	*1,878*
Due after one year through five years	*76,660*	*74,842*
Due after five years through ten years	*3,036*	*2,953*
Due after ten years	*782*	*673*
No stated maturity	*179*	*179*
Total	$ *82,578*	*80,525*

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

(8) Loans Receivable, Net

A summary of loans receivable at *June 30, 2018* and *December 31, 2017* is as follows:

(Dollars in thousands)	June 30, 2018	December 31, 2017
Single family	$*107,203*	*107,005*
Commercial real estate:		
Real estate rental and leasing	*188,751*	*175,177*
Other	*149,409*	*158,940*
	338,160	*334,117*
Consumer	*72,290*	*73,767*
Commercial business	*81,130*	*79,909*
Total loans	*598,783*	*594,798*
Less:		
Unamortized discounts	*20*	*19*
Net deferred loan costs	*(420*)	*(463*)
Allowance for loan losses	*9,328*	*9,311*
Total loans receivable, net	$*589,855*	*585,931*

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

The allowance for loan losses is summarized as follows:

(Dollars in thousands)	Single Family	Commercial Real Estate	Consumer	Commercial Business	Total
For the three months ended June 30, 2018:					
Balance, March 31, 2018	$ 809	5,198	1,423	1,699	9,129
Provision for losses	72	(147)	254	116	295
Charge-offs	0	0	(56)	(255)	(311)
Recoveries	0	191	2	22	215
Balance, June 30, 2018	$ 881	5,242	1,623	1,582	9,328
For the six months ended June 30, 2018:					
Balance, December 31, 2017	$ 900	5,073	1,630	1,708	9,311
Provision for losses	4	(29)	109	86	170
Charge-offs	(23)	0	(125)	(255)	(403)
Recoveries	0	198	9	43	250
Balance, June 30, 2018	$ 881	5,242	1,623	1,582	9,328
Allocated to:					
Specific allowance	$ 192	441	263	177	1,073
General allowance	708	4,632	1,367	1,531	8,238
Balance, December 31, 2017	$ 900	5,073	1,630	1,708	9,311
Allocated to:					
Specific allowance	$ 110	437	173	74	794
General allowance	771	4,805	1,450	1,508	8,534
Balance, June 30, 2018	$ 881	5,242	1,623	1,582	9,328
Loans receivable at December 31, 2017:					
Individually reviewed for impairment	$ 1,523	1,364	880	507	4,274
Collectively reviewed for impairment	105,482	332,753	72,887	79,402	590,524
Ending balance	$ 107,005	334,117	73,767	79,909	594,798
Loans receivable at June 30, 2018:					
Individually reviewed for impairment	$ 1,294	1,432	984	265	3,975
Collectively reviewed for impairment	105,909	336,728	71,306	80,865	594,808
Ending balance	$ 107,203	338,160	72,290	81,130	598,783

	Single	Commercial	Consumer	Commercial	Total

(Dollars in thousands)	Family	Real Estate		Business	
For the three months ended June 30, 2017:					
Balance, March 31, 2017	$ *1,110*	*4,958*	*1,332*	*2,190*	*9,590*
Provision for losses	*(106*)	*452*	*224*	*(301*)	*269*
Charge-offs	*0*	*0*	*(17*)	*0*	*(17*)
Recoveries	*0*	*80*	*5*	*118*	*203*
Balance, June 30, 2017	$ *1,004*	*5,490*	*1,544*	*2,007*	*10,045*
For the six months ended June 30, 2017:					
Balance, December 31, 2016	$ *1,186*	*4,953*	*1,613*	*2,151*	*9,903*
Provision for losses	*(182*)	*363*	*116*	*(298*)	*(1*)
Charge-offs	*0*	*0*	*(218*)	*0*	*(218*)
Recoveries	*0*	*174*	*33*	*154*	*361*
Balance, June 30, 2017	$ *1,004*	*5,490*	*1,544*	*2,007*	*10,045*

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The following table summarizes the amount of classified and unclassified loans at *June 30, 2018* and *December 31, 2017:*

	June 30, 2018						
	Classified					Unclassified	
(Dollars in thousands)	Special Mention	Substandard	Doubtful	Loss	Total	Total	Total Loans
Single family	$ *108*	*2,061*	*43*	*0*	*2,212*	*104,991*	*107,203*
Commercial real estate:							
Real estate rental and leasing	*7,031*	*5,095*	*0*	*0*	*12,126*	*176,625*	*188,751*
Other	*1,768*	*8,751*	*0*	*0*	*10,519*	*138,890*	*149,409*
Consumer	*0*	*828*	*51*	*105*	*984*	*71,306*	*72,290*
Commercial business	*8,350*	*4,364*	*0*	*0*	*12,714*	*68,416*	*81,130*
	$ *17,257*	*21,099*	*94*	*105*	*38,555*	*560,228*	*598,783*

	December 31, 2017						
	Classified					Unclassified	
(Dollars in thousands)	Special Mention	Substandard	Doubtful	Loss	Total	Total	Total Loans
Single family	$ *77*	*2,154*	*44*	*0*	*2,275*	*104,730*	*107,005*
Commercial real estate:							
Real estate rental and leasing	*5,022*	*3,813*	*0*	*0*	*8,835*	*166,342*	*175,177*
Other	*9,135*	*4,257*	*0*	*0*	*13,392*	*145,548*	*158,940*
Consumer	*0*	*631*	*119*	*130*	*880*	*72,887*	*73,767*
Commercial business	*5,781*	*5,506*	*0*	*0*	*11,287*	*68,622*	*79,909*
	$ *20,015*	*16,361*	*163*	*130*	*36,669*	*558,129*	*594,798*

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 *June 30, 2018* and *December 31, 2017* is summarized as follows:

(Dollars in thousands)	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current Loans	Total Loans	Loans 90 Days or More Past Due and Still Accruing
June 30, 2018							
Single family	$*380*	*455*	*82*	*917*	*106,286*	*107,203*	*0*
Commercial real estate:							
Real estate rental and leasing	*459*	*0*	*0*	*459*	*188,292*	*188,751*	*0*
Other	*0*	*0*	*22*	*22*	*149,387*	*149,409*	*0*
Consumer	*245*	*136*	*278*	*659*	*71,631*	*72,290*	*0*
Commercial business	*25*	*0*	*0*	*25*	*81,105*	*81,130*	
	$*1,109*	*591*	*382*	*2,082*	*596,701*	*598,783*	*0*
December 31, 2017							
Single family	$*727*	*294*	*669*	*1,690*	*105,315*	*107,005*	*0*
Commercial real estate:							
Real estate rental and leasing	*0*	*0*	*0*	*0*	*175,177*	*175,177*	*0*
Other	*0*	*0*	*0*	*0*	*158,940*	*158,940*	*0*
Consumer	*734*	*117*	*235*	*1,086*	*72,681*	*73,767*	*0*
Commercial business	*34*	*0*	*180*	*214*	*79,695*	*79,909*	*0*
	$*1,495*	*411*	*1,084*	*2,990*	*591,808*	*594,798*	*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 *June 30, 2018* and *December 31, 2017:*

	June 30, 2018			December 31, 2017		
(Dollars in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
Loans with no related allowance recorded:						
Single family	$*416*	*416*	*0*	*415*	*415*	*0*
Commercial real estate:						

Real estate rental and leasing	*34*	*34*	*0*	*35*	*51*	*0*
Other	*165*	*1,821*	*0*	*25*	*1,682*	*0*
Consumer	*607*	*607*	*0*	*414*	*414*	*0*
Loans with an allowance recorded:						
Single family	*878*	*878*	*110*	*1,108*	*1,108*	*192*
Commercial real estate:						
Other	*1,233*	*1,233*	*437*	*1,304*	*1,304*	*441*
Consumer	*377*	*393*	*173*	*466*	*483*	*263*
Commercial business	*265*	*817*	*74*	*507*	*1,358*	*177*
Total:						
Single family	*1,294*	*1,294*	*110*	*1,523*	*1,523*	*192*
Commercial real estate:						
Real estate rental and leasing	*34*	*34*	*0*	*35*	*51*	*0*
Other	*1,398*	*3,054*	*437*	*1,329*	*2,986*	*441*
Consumer	*984*	*1,000*	*173*	*880*	*897*	*263*
Commercial business	*265*	*817*	*74*	*507*	*1,358*	*177*
	$*3,975*	*6,199*	*794*	*4,274*	*6,815*	*1,073*

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The following table summarizes the average recorded investment and interest income recognized on impaired loans for the *three* and *six* months ended *June 30, 2018* and *2017:*

	For the three months ended June 30, 2018		For the six months ended June 30, 2018	
(Dollars in thousands)	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Loans with no related allowance recorded:				
Single family	$*425*	*4*	*421*	*10*
Commercial real estate:				
Real estate rental and leasing	*35*	*15*	*35*	*15*
Other	*165*	*24*	*118*	*48*
Consumer	*506*	*4*	*475*	*9*
Loans with an allowance recorded:				
Single family	*809*	*0*	*908*	*0*
Commercial real estate:				
Other	*1,279*	*0*	*1,287*	*0*
Consumer	*416*	*2*	*433*	*5*
Commercial business	*373*	*2*	*417*	*4*
Total:				
Single family	*1,234*	*4*	*1,329*	*10*
Commercial real estate:				
Real estate rental and leasing	*35*	*15*	*35*	*15*
Other	*1,444*	*24*	*1,405*	*48*
Consumer	*922*	*6*	*908*	*14*
Commercial business	*373*	*2*	*417*	*4*
	$*4,008*	*51*	*4,094*	*91*

	For the three months ended June 30, 2017		For the six months ended June 30, 2017	
(Dollars in thousands)	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Loans with no related allowance recorded:				
Single family	$*529*	*3*	*425*	*6*
Commercial real estate:				
Real estate rental and leasing	*39*	*0*	*39*	*0*
Other	*26*	*24*	*26*	*48*
Consumer	*398*	*3*	*369*	*7*
Commercial business	*113*	*0*	*167*	*0*
Loans with an allowance recorded:				
Single family	*867*	*4*	*874*	*6*
Commercial real estate:				

Real estate rental and leasing	*259*	*0*	*172*	*0*
Other	*1,812*	*7*	*1,812*	*15*
Consumer	*388*	*2*	*468*	*3*
Commercial business	*399*	*3*	*389*	*8*
Total:				
Single family	*1,396*	*7*	*1,299*	*12*
Commercial real estate:				
Real estate rental and leasing	*298*	*0*	*211*	*0*
Other	*1,838*	*31*	*1,838*	*63*
Consumer	*786*	*5*	*837*	*10*
Commercial business	*512*	*3*	*556*	*8*
	$*4,830*	*46*	*4,741*	*93*

At *June 30, 2018* and *December 31, 2017,* non-accruing loans totaled *$3.0* million and *$3.1* million, respectively, for which the related allowance for loan losses was *$0.7* million and *$0.9* million, respectively. All of the interest income that was recognized for non-accruing loans was recognized using the cash basis method of income recognition. Non-accruing loans for which *no* specific allowance has been recorded, because management determined that the value of the collateral was sufficient to repay the loan, totaled *$0.6* million and *$0.4* million at *June 30, 2018* and *December 31, 2017,* respectively. Non-accrual loans also include certain loans that have had terms modified in a TDR.

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The non-accrual loans at *June 30, 2018* and *December 31, 2017* are summarized as follows:

(Dollars in thousands)	June 30, 2018	December 31, 2017
Single family	$ *960*	*949*
Commercial real estate:		
Real estate rental and leasing	*34*	*35*
Other	*1,398*	*1,329*
Consumer	*551*	*553*
Commercial business	*73*	*278*
	$ *3,016*	*3,144*

At *June 30, 2018* and *December 31, 2017* there were loans included in loans receivable, net, with terms that had been modified in a TDR totaling *$2.6* million and *$3.0* million, respectively. For the loans that were restructured in the *second* quarter of *2018, $0.2* million were classified but performing and *$26,000* were non-performing at *June 30, 2018.* For the loans that were restructured in the *second* quarter of *2017, $0.1* million were classified but performing and *$0.2* million were non-performing at *June 30, 2017.*

The following table summarizes TDRs at *June 30, 2018* and *December 31, 2017:*

	June 30, 2018			December 31, 2017		
(Dollars in thousands)	Accruing	Non-Accrual	Total	Accruing	Non-Accrual	Total
Single family	$ *334*	*149*	*483*	*573*	*112*	*685*
Commercial real estate	*0*	*1,177*	*1,177*	*0*	*1,210*	*1,210*
Consumer	*433*	*209*	*642*	*327*	*431*	*758*
Commercial business	*192*	*61*	*253*	*229*	*162*	*391*
	$ *959*	*1,596*	*2,555*	*1,129*	*1,915*	*3,044*

As of *June 30, 2018,* the Bank had commitments to lend an additional *$1.2* 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, 2017,* there were commitments to lend additional funds of *$0.8* 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 *12* months if the loan was modified at a market rate of interest for comparable risk loans, and the loan is performing in accordance with the terms of the restructured agreement for the entire *12* month period. All loans classified as TDRs are considered to be impaired.

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When a loan is modified as a TDR, there *may* be a direct, material impact on the loans within the balance sheet, as principal balances *may* be partially forgiven. The financial effects of TDRs are presented in the following table and represent the difference between the outstanding recorded balance pre-modification and post-modification, for the *three* month and *six* month periods ending *June 30, 2018* and *June 30, 2017.*

	Three Months Ended June 30, 2018			Six Months Ended June 30, 2018		
(Dollars in thousands)	Number of Contracts	Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment	Number of Contracts	Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment
Troubled debt restructurings:						
Single family	*0*	$ *0*	*0*	*1*	$ *55*	*58*
Commercial real estate:						
Real estate rental and leasing	*0*	*0*	*0*	*1*	*54*	*54*
Other	*1*	*244*	*244*	*2*	*1,518*	*1,518*
Consumer	*4*	*216*	*216*	*8*	*334*	*334*
Commercial business	*0*	*0*	*0*	*1*	*70*	*70*
Total	*5*	$ *460*	*460*	*13*	$ *2,031*	*2,034*

	Three Months Ended June 30, 2017			Six Months Ended June 30, 2017		
(Dollars in thousands)	Number of Contracts	Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment	Number of Contracts	Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment
Troubled debt restructurings:						
Single family	*0*	$ *0*	*0*	*3*	$ *282*	*514*
Consumer	*5*	*314*	*315*	*7*	*358*	*360*

Total	*5*	$ *314*	*315*	*10*	$ *640*	*874*

The following tables summarize the loans that were restructured in the *12* months preceding *June 30, 2018* and *June 30, 2017* and subsequently defaulted during the *three* and *six* months ended *June 30, 2018* and *June 30, 2017.*

	Three Months Ended June 30, 2018		Six Months Ended June 30, 2018	
(Dollars in thousands)	Number of Contracts	Pre-modification Outstanding Recorded Investment	Number of Contracts	Pre-modification Outstanding Recorded Investment
Troubled debt restructurings that subsequently defaulted:				
Commercial business	*1*	$ *116*	*1*	$ *116*
Total	*1*	$ *116*	*1*	$ *116*

	Three Months Ended June 30, 2017		Six Months Ended June 30, 2017	
(Dollars in thousands)	Number of Contracts	Pre-modification Outstanding Recorded Investment	Number of Contracts	Pre-modification Outstanding Recorded Investment
Troubled debt restructurings that subsequently defaulted:				
Single family	*2*	$ *60*	*2*	$ *60*
Total	*2*	$ *60*	*2*	$ *60*

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.

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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 to specific reserves 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 *6.8%,* of the total *$9.3* million in loan loss reserves at *June 30, 2018* and *$0.9* million, or *9.8%,* of the total *$9.3* million in loan loss reserves at *December 31, 2017.*

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

(Dollars in thousands)	Contractual Principal Receivable	Accretable Difference	Net Carrying Amount
Purchased performing loans:			
Balance at March 31, 2018	$ *9,447*	*(218*)	*9,229*
Change due to payments/refinances	*(891*)	*12*	*(879*)
Balance at June 30, 2018	$ *8,556*	*(206*)	*8,350*

(Dollars in thousands)	Contractual Principal Receivable	Non-Accretable Difference	Net Carrying Amount
Purchased credit impaired loans:			
Balance at March 31, 2018	$ *400*	*(37*)	*363*
Change due to payments/refinances	*(4*)	*1*	*(3*)
Balance at June 30, 2018	$ *396*	*(36*)	*360*

As a result of acquisitions, 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 *June 30, 2018* was *$0.4* million.

No material provision for loan losses was recognized during the *three* and *six* month periods ended *June 30, 2018* 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 mortgage servicing rights, core deposit intangibles, and goodwill. A summary of mortgage servicing activity is as follows:

(Dollars in thousands)	Six Months ended June 30, 2018	Twelve Months ended December 31, 2017	Six Months ended June 30, 2017
Balance, beginning of period	$ *1,724*	*1,604*	*1,604*
Originations	*357*	*675*	*320*
Amortization	*(268*)	*(555*)	*(269*)
Balance, end of period	$ *1,813*	*1,724*	*1,655*
Fair value of mortgage servicing rights	$ *3,620*	*3,196*	*3,027*

All of the loans being serviced were single family loans 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 *June 30, 2018.*

(Dollars in thousands)	Loan Principal Balance	Weighted Average Interest Rate	Weighted Average Remaining Term (months)	Number of Loans
Original term 30 year fixed rate	$ *284,802*	*4.10* %	*307*	*2,213*
Original term 15 year fixed rate	*100,131*	*3.14*	*133*	*1,026*
Adjustable rate	*54*	*4.38*	*275*	*2*

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The gross carrying amount of intangible assets and the associated accumulated amortization at *June 30, 2018* and *2017* is presented in the following tables. *No* amortization expense relating to goodwill is recorded as generally accepted accounting principles do *not* allow goodwill to be amortized but require that it is tested for impairment at least annually, or sooner, if there are indications that impairment *may* exist. Amortization expense for amortizing intangible assets was *$0.3* million for both the *six* months ended *June 30, 2018* and *2017.*

	June 30, 2018		
(Dollars in thousands)	Gross Carrying Amount	Accumulated Amortization	Unamortized Amount
Mortgage servicing rights	$*4,394*	*(2,581*)	*1,813*
Core deposit intangible	*574*	*(269*)	*305*
Goodwill	*802*	*0*	*802*
Total	$*5,770*	*(2,850*)	*2,920*

	June 30, 2017		
(Dollars in thousands)	Gross Carrying Amount	Accumulated Amortization	Unamortized Amount
Mortgage servicing rights	$*4,106*	*(2,451*)	*1,655*
Core deposit intangible	*574*	*(170*)	*404*
Goodwill	*802*	*0*	*802*
Total	$*5,482*	*(2,621*)	*2,861*

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

(Dollars in thousands)	Mortgage Servicing Rights	Core Deposit Intangible	Total Amortizing Intangible Assets
Year ending December 31,			
2018	$ *239*	*50*	*289*
2019	*421*	*99*	*520*
2020	*350*	*99*	*449*
2021	*304*	*47*	*351*
2022	*242*	*10*	*252*

Thereafter	*257*	*0*	*257*
Total	$ *1,813*	*305*	*2,118*

Projections of amortization are based on existing asset balances and the existing interest rate environment as of *June 30, 2018.* The Company's actual experiences *may* be significantly different depending upon changes in mortgage interest rates and other market conditions.

(*11*) *Earnings per Common Share*

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

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands, except per share data)	2018	2017	2018	2017
Weighted average number of common shares outstanding used in basic earnings per common share calculation	*4,291*	*4,211*	*4,264*	*4,208*
Net dilutive effect of:				
Restricted stock awards, options, and warrants	*457*	*648*	*561*	*651*
Weighted average number of shares outstanding adjusted for effect of dilutive securities	*4,748*	*4,859*	*4,825*	*4,859*
Income available to common shareholders	$*1,727*	*1,024*	*3,172*	*2,237*
Basic earnings per common share	$*0.40*	*0.24*	*0.74*	*0.53*
Diluted earnings per common share	$*0.36*	*0.21*	*0.66*	*0.46*

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(*12*) *Regulatory Capital and Oversight*

The Company and the Bank are subject to the regulatory requirements of the Basel III capital reforms. The Basel III requirements, among other things, (i) apply a strengthened 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) revise the 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 are being phased in incrementally, with full implementation scheduled for *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 their 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.

The Board of Governors of the Federal Reserve System (FRB) amended its Policy Statement, to exempt small bank holding companies from the above capital requirements, by raising the asset size threshold for determining applicability from *$500* million to *$1* billion. 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 met 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 quarter ended *June 30, 2018* were *$725.9* million, its adjusted total assets were *$724.2* million, and its risk-weighted assets were *$620.0* million. The following table presents the Bank’s capital amounts and ratios at *June 30, 2018* for actual capital, required capital, and excess capital, including ratios in order to qualify as being well capitalized under the prompt corrective action regulations.

	Actual	Required to be Adequately Capitalized	Excess Capital	To Be Well Capitalized Under Prompt Corrective

(Dollars in thousands)	Amount	Percent of Asset	Amount	Percent of Assets	Amount	Percent of Assets	Action Provisions Amount	Percent of Assets
June 30, 2018								
Common equity tier 1 capital	$*79,826*	*12.88* %	$*27,900*	*4.50* %	$*51,926*	*8.38* %	$*40,300*	*6.50* %
Tier 1 capital leverage	*79,826*	*11.02*	*28,968*	*4.00*	*50,858*	*7.02*	*36,210*	*5.00*
Tier 1 risk-based capital	*79,826*	*12.88*	*37,200*	*6.00*	*42,626*	*6.88*	*49,600*	*8.00*
Total risk-based capital	*87,595*	*14.13*	*49,600*	*8.00*	*37,995*	*6.13*	*62,000*	*10.00*

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. For *2018,* the capital conservation buffer is *1.875%* and in *2019* the buffer amount will increase to *2.50%* and be fully phased in. Management believes that, as of *June 30, 2018,* 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.

(*13*) *Stockholders' Equity*

The Company's certificate of incorporation authorizes the issuance of up to *500,000* shares of preferred stock, and on *December 23, 2008,* the Company completed the sale of *26,000* shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the Preferred Stock) to the U.S. Department of the Treasury (Treasury). The Preferred Stock had a liquidation value of *$1,000* per share and a related warrant was also issued to purchase *833,333* shares of HMN common stock at an exercise price of *$4.68* per share (the Warrant). The transaction was part of the Treasury's Capital Purchase Program under the Emergency Economic Stabilization Act of *2008.*

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On *February 17, 2015,* the Company redeemed the final *10,000* shares of outstanding Preferred Stock. On *May 21, 2015,* the Treasury sold the Warrant at an exercise price of *$4.68* per share to *three* unaffiliated *third* party investors for an aggregate purchase price of *$5.7* million. Two of the investors received a warrant to purchase *277,777.67* shares and *one* investor received a warrant to purchase *277,777.66* shares.

On *May 21, 2018,* the Company entered into a Warrant Repurchase Agreement (Repurchase Agreement) with *one* of the warrant holders. Pursuant to the terms of the Repurchase Agreement, the Company agreed to repurchase from the warrant holder, at a purchase price of *$14.32* per warrant, *138,888.66* warrants to purchase common stock of the Company, resulting in an aggregate purchase price of *$1,988,886.* The warrant repurchase price reflects the difference between the exercise price of the warrants and the closing market price of the Company's common stock on the date the Repurchase Agreement was executed. The warrant repurchase was completed on *May 22, 2018* and the *138,888.66* warrants purchased by the Company were cancelled.

Simultaneously with the execution of the Repurchase Agreement, the warrant holder exercised its right to exercise, on a cashless basis, the remaining *138,889* warrants at an exercise price of *$4.68* per share. After taking into account the shares withheld to satisfy the cashless exercise option, the Company issued *104,678* shares of common stock to the warrant holder out of treasury stock.

The warrants held by the remaining *two* investors to purchase a total of *555,555.34* shares of the Company's common stock at an exercise price of *$4.68* were still outstanding as of *June 30, 2018* and *may* be exercised at any time prior to their expiration date of *December 23, 2018.*

(*14*) *Other Borrowings*

On *December 15, 2014,* the Company entered into a Loan Agreement with an unrelated *third* party, providing for a term loan of up to *$10.0* million that was evidenced by a promissory note (the Note) with an interest rate of *6.50%* per annum. The principal balance of the loan was payable in consecutive equal annual installments of *$1.0* million on each anniversary of the date of the Loan Agreement, commencing on *December 15, 2015,* with the balance due on *December 15, 2021.* The Company had the option to voluntarily prepay the Note in whole or in part without penalty. The Company made the scheduled *$1.0* million principal payment on *December 15, 2015,* a *$2.0* million payment on *December 15, 2016,* and on *August 31, 2017* paid off the remaining principal balance of *$7.0* million. There was *no* outstanding loan balance at *June 30, 2018* and the loan balance was *$7.0* million at *June 30, 2017.*

(*15*) *Commitments and Contingencies*

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 *June 30, 2018* were approximately *$4.7* million, expire over the next *50* months, and are collateralized primarily with commercial real estate mortgages. Since the conditions under which the Bank is required to fund the standby letters of credit *may not* materialize, the cash requirements are expected to be less than the total outstanding commitments.

(*16*) *Business Segments*

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

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

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

(Dollars in thousands)	Home Federal Savings Bank	Other	Eliminations	Consolidated Total
At or for the six months ended June 30, 2018:				
Interest income - external customers	$ *14,614*	*0*	*0*	*14,614*
Non-interest income - external customers	*3,830*	*0*	*0*	*3,830*
Intersegment non-interest income	*105*	*3,464*	*(3,569*)	*0*
Interest expense	*996*	*0*	*0*	*996*
Other non-interest expense	*12,616*	*356*	*(105*)	*12,867*
Income tax expense	*1,303*	*(64*)	*0*	*1,239*
Net income	*3,464*	*3,172*	*(3,464*)	*3,172*
Total assets	*726,121*	*81,590*	*(81,426*)	*726,285*
At or for the six months ended June 30, 2017:				
Interest income - external customers	$ *13,658*	*0*	*0*	*13,658*
Non-interest income - external customers	*3,786*	*0*	*0*	*3,786*
Intersegment non-interest income	*105*	*2,636*	*(2,741*)	*0*
Interest expense	*640*	*229*	*0*	*869*
Other non-interest expense	*12,529*	*362*	*(105*)	*12,786*
Income tax expense	*1,745*	*(192*)	*0*	*1,553*
Net income	*2,636*	*2,237*	*(2,636*)	*2,237*
Total assets	*724,407*	*84,826*	*(84,050*)	*725,183*
At or for the quarter ended June 30, 2018:				
Interest income - external customers	$ *7,456*	*0*	*0*	*7,456*
Non-interest income - external customers	*2,054*	*0*	*0*	*2,054*
Intersegment non-interest income	*52*	*1,870*	*(1,922*)	*0*
Interest expense	*526*	*0*	*0*	*526*
Other non-interest expense	*6,191*	*174*	*(52*)	*6,313*
Income tax expense	*680*	*(31*)	*0*	*649*
Net income	*1,870*	*1,727*	*(1,870*)	*1,727*
Total assets	*726,121*	*81,590*	*(81,426*)	*726,285*
At or for the quarter ended June 30, 2017:				
Interest income - external customers	$ *6,999*	*0*	*0*	*6,999*
Non-interest income - external customers	*1,906*	*0*	*0*	*1,906*
Intersegment non-interest income	*52*	*1,221*	*(1,273*)	*0*
Interest expense	*345*	*116*	*0*	*461*
Other non-interest expense	*6,316*	*175*	*(52*)	*6,439*
Income tax expense	*806*	*(94*)	*0*	*712*
Net income	*1,221*	*1,024*	*(1,221*)	*1,024*
Total assets	*724,407*	*84,826*	*(84,050*)	*725,183*

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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 Securities and Exchange Commission may contain forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements are often identified by such forward-looking terminology as “expect,” “intend,” “look,” “believe,” “anticipate,” “estimate,” “project,” “seek,” “may,” “will,” “would,” “could,” “should,” “trend,” “ta similar statements or variations of such terms and include, but are not limited to, those relating to growing our core deposit relationships and loan balances, enhancing the financial performance of our core banking operations, maintaining or improving 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 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 alternate funding sources, including changes in collateral advance rates and policies of the 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 Securities and Exchange Commission. All forward-looking statements are qualified by, and should be considered in conjunction with, such cautionary statements. For additional discussion of the risks and uncertainties applicable to the Company, see the “Risk Factors” sections of the Company’s Annual Report on Form 10-K for the year ended December 31, 2017 and Part II, Item 1A of its subsequently filed quarterly reports on Form 10-Q.

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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.

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 fees earned 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. 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 THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2018 COMPARED TO THE SAME PERIODS ENDED JUNE 30, 2017

Net Income

Net income for the second quarter of 2018 was $1.7 million, an increase of $0.7 million, compared to net income of $1.0 million for the second quarter of 2017. Diluted earnings per share for the second quarter of 2018 was $0.36, an increase of $0.15 from the diluted earnings per share of $0.21 for the second quarter of 2017. The increase in net income between the periods was primarily because of the $0.4 million increase in net interest income, a $0.2 million increase in the gain on sales of loans between the periods due primarily to an increase in single family loan sales, and a $0.1 million decrease in income tax expense as a result of the reduced federal corporate income tax rate for 2018.

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Net income was $3.2 million for the six month period ended June 30, 2018, an increase of $1.0 million, or 41.8%, compared to net income of $2.2 million for the six month period ended June 30, 2017. Diluted earnings per share for the six month period ended June 30, 2018 was $0.66, an increase of $0.20 per share compared to diluted earnings per share of $0.46 for the same period in 2017. The increase in net income between the periods was primarily because of the $0.8 million increase in net interest income, a $0.3 million decrease in income tax expense as a result of the reduced federal corporate income tax rate for 2018, and a $0.1 million increase in the gain on sales of loans between the periods due primarily to an increase in single family loan sales. These increases in net income were partially offset by a $0.2 million increase in the provision for loan losses between the periods due primarily to an increase in the amount reserved on certain consumer loan categories and changes in the classification of certain commercial loans.

Net Interest Income

Net interest income was $6.9 million for the second quarter of 2018, an increase of $0.4 million, or 6.0%, from $6.5 million for the second quarter of 2017. Interest income was $7.5 million for the second quarter of 2018, an increase of $0.5 million, or 6.53%, from $7.0 million for the second quarter of 2017. Interest income increased between the periods primarily because of an increase in the average interest-earning assets, a change in the composition of the average interest-earning assets, and an increase in the federal funds rate between the periods which resulted in higher earnings on cash and investment balances. While the average interest-earning assets increased $42.3 million between the periods, the average interest-earning assets held in higher yielding loans increased $17.0 million and the amount of average interest-earning assets held in lower yielding cash and investments increased $25.3 million between the periods. The increase in the average outstanding loans between the periods was primarily the result of an increase in the commercial loan portfolio, which occurred because of a reduction in loan payoffs between the periods. The average yield earned on interest-earning assets was 4.27% for the second quarter of 2018, an increase of 1 basis point from 4.26% for the second quarter of 2017.

Interest expense was $0.5 million for the second quarter of 2018, the same as the second quarter of 2017. The average interest rate paid on non-interest and interest-bearing liabilities was 0.33% for the second quarter of 2018, an increase of 2 basis points from 0.31% for the second quarter of 2017. The average interest rate paid increased between the periods due to an increase in the rates paid on certain money market accounts and certificates of deposit that was partially offset by a change in the composition of the average non-interest and interest-bearing liabilities held between the periods. While the average non-interest and interest-bearing liabilities increased $34.8 million between the periods, the average amount held in higher rate premium money market accounts increased $20.3 million, the average amount held in lower rate checking, savings, and money market accounts increased $13.9 million, and the average amount held in higher rate borrowings and certificates of deposit increased $0.6 million between the periods.

Net interest margin (net interest income divided by average interest-earning assets) for the second quarter of 2018 was 3.97%, a decrease of 1 basis point, compared to 3.98% for the second quarter of 2017.

Net interest income was $13.6 million for the first six months of 2018, an increase of $0.8 million, or 6.5%, from $12.8 million for the same period in 2017. Interest income was $14.6 million for the six month period ended June 30, 2018, an increase of $0.9 million, or 7.0%, from $13.7 million for the same six month period in 2017. Interest income increased between the periods primarily because of an increase in the average interest-earning assets, a change in the composition of the average interest-earning assets, and an increase in the federal funds rate between the periods which resulted in higher earnings on cash and investment balances. While the average interest-earning assets increased $40.0 million between the periods, the average interest-earning assets held in higher yielding loans increased $24.7 million and the amount of average interest-earning assets held in lower yielding cash and investments increased $15.3 million between the periods. The increase in the average outstanding loans between the periods was primarily the result of an increase in the commercial loan portfolio, which occurred because of a reduction in loan payoffs between the periods. The average yield earned on interest-earning assets was 4.25% for the first six months of 2018, an increase of 4 basis points from 4.21% for the first six months of 2017.

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Interest expense was $1.0 million for the first six months of 2018, an increase of $0.1 million, or 14.6%, compared to $0.9 million in the first six months of 2017. The average interest rate paid on non-interest and interest-bearing liabilities was 0.32% for the first six months of 2018, an increase of 3 basis points from 0.29% for the first six months of 2017. The average interest rate paid increased between the periods due to an increase in the rates paid on certain money market accounts and certificates of deposit that was partially offset by a change in the composition of the average non-interest and interest-bearing liabilities held between the periods. While the average non-interest and interest-bearing liabilities increased $32.1 million between the periods, the average amount held in higher rate premium money market accounts increased $20.5 million, the average amount held in lower rate checking, savings, and money market accounts increased $9.7 million, and the average amount held in higher rate borrowings and certificates of deposit increased $1.9 million between the periods.

Net interest margin (net interest income divided by average interest-earning assets) for the first six months of 2018 was 3.96%, an increase of 2 basis points, compared to 3.94% for the first six months of 2017.

A summary of the Company’s net interest margin for the three and six month periods ended June 30, 2018 and 2017 is as follows:

	For the three month period ended					
	June 30, 2018			June 30, 2017		
(Dollars in thousands)	Average Outstanding Balance	Interest Earned/ Paid	Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Yield/ Rate)
Interest-earning assets:						
Securities available for sale	$80,263	339	1.69 %	$76,515	288	1.51 %
Loans held for sale	2,389	27	4.51	2,014	25	5.01
Mortgage loans, net	110,939	1,137	4.11	115,173	1,136	3.96
Commercial loans, net	405,553	4,957	4.90	383,417	4,662	4.88
Consumer loans, net	72,070	885	4.92	73,369	878	4.80
Cash equivalents	28,486	106	1.49	6,740	5	0.28
Federal Home Loan Bank stock	867	5	2.47	1,043	5	1.75
Total interest-earning assets	700,567	7,456	4.27	658,271	6,999	4.26
Interest-bearing liabilities and non-interest bearing deposits:						
NOW accounts	88,327	11	0.05	87,219	22	0.10
Savings accounts	78,850	16	0.08	78,679	16	0.08
Money market accounts	199,279	203	0.41	168,610	125	0.30
Certificates	115,871	296	1.02	102,841	166	0.65
Advances and other borrowings	0	0	0.00	12,637	132	4.19
Total interest-bearing liabilities	482,327			449,986		

Non-interest checking	154,323			152,159		
Other non-interest bearing deposits	1,448			1,199		
Total interest-bearing liabilities and non-interest bearing deposits	$638,098	526	0.33	$603,344	461	0.31
Net interest income		$6,930			$6,538	
Net interest rate spread			3.94 %			3.95 %
Net interest margin			3.97 %			3.98 %

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	For the six month period ended					
	June 30, 2018			June 30, 2017		
(Dollars in thousands)	Average Outstanding Balance	Interest Earned/ Paid	Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Yield/ Rate
Interest-earning assets:						
Securities available for sale	$79,274	653	1.66 %	$76,357	563	1.49 %
Loans held for sale	1,730	38	4.47	1,836	43	4.76
Mortgage loans, net	112,268	2,259	4.06	112,632	2,247	4.02
Commercial loans, net	403,035	9,726	4.87	377,319	9,047	4.84
Consumer loans, net	72,229	1,761	4.92	72,816	1,724	4.77
Cash equivalents	24,324	167	1.39	11,859	28	0.47
Federal Home Loan Bank stock	855	10	2.53	915	6	1.34
Total interest-earning assets	693,715	14,614	4.25	653,734	13,658	4.21
Interest-bearing liabilities and non-interest bearing deposits:						
NOW accounts	88,982	21	0.05	89,627	42	0.09
Savings accounts	78,017	31	0.08	76,986	31	0.08
Money market accounts	194,871	388	0.40	165,592	231	0.28
Certificates	113,798	554	0.98	102,398	318	0.63
Advances and other borrowings	283	2	1.71	10,033	247	4.96
Total interest-bearing liabilities	475,951			444,636		
Non-interest checking	153,796			153,277		
Other non-interest bearing deposits	1,494			1,268		
Total interest-bearing liabilities and non-interest bearing deposits	$631,241	996	0.32	$599,181	869	0.29
Net interest income		$13,618			$12,789	
Net interest rate spread			3.93 %			3.92 %
Net interest margin			3.96 %			3.94 %

Provision for Loan Losses

The provision for loan losses was $0.3 million for the second quarter of 2018, the same as the second quarter of 2017. The provision for loan losses was $0.2 million for the first six months of 2018, an increase of $0.2 million compared to the first six months of 2017. The provision amounts for the periods were primarily the result of an increase in the amount reserved on certain consumer loan categories and changes in the classification of certain commercial loans.

A reconciliation of the Company's allowance for loan losses for the three and six month periods ended June 30, 2018 and 2017 is summarized as follows:

(Dollars in thousands)	Three Months Ended June 30, 2018	2017
Balance at March 31,	$9,129	9,590
Provision	295	269
Charge offs:		
Consumer	(56)	(17)
Commercial business	(255)	0
Recoveries	215	203
Balance at June 30,	$9,328	10,045
Allocated to:		
Specific allowance	$794	741
General allowance	8,534	9,304
	$9,328	10,045

(Dollars in thousands)	Six Months Ended June 30, 2018	2017
Balance at January 1,	$9,311	9,903
Provision	170	(1)
Charge offs:		
Consumer	(125)	(218)
Commercial business	(255)	0
Single Family	(23)	0
Recoveries	250	361
Balance at June 30,	$9,328	10,045

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Non-Interest Income

Non-interest income was $2.1 million for the second quarter of 2018, an increase of $0.2 million, or 7.8%, from $1.9 million for the same period of 2017. Gain on sales of loans increased $0.2 million between the periods primarily because of an increase in single family loan sales. Other non-interest income increased slightly due to an increase in the sale of uninsured investment products between the periods. These increases in non-interest income were partially offset by a $0.1 million decrease in fees and service charges earned between the periods due primarily to a decrease in overdraft fees. Loan servicing income decreased slightly between the periods because of a decrease in commercial loan servicing fees.

Non-interest income was $3.8 million for the first six months of 2018, the same as in the first six months of 2017. Gain on sales of loans increased $0.1 million between the periods primarily because of an increase in single family loan sales. Other non-interest income increased $0.1 million due to an increase in the sale of uninsured investment products between the periods. These increases in non-interest income were partially offset by a $0.1 million decrease in fees and service charges earned between the periods due primarily to a decrease in overdraft fees. Loan servicing income decreased slightly between the periods primarily because of a decrease in commercial loan servicing fees.

Non-Interest Expense

Non-interest expense was $6.3 million for the second quarter of 2018, a decrease of $0.1 million, or 2.0%, from $6.4 million for the second quarter of 2017. Professional services expense decreased $0.1 million due primarily to a decrease in legal expenses between the periods. Compensation and benefits expense decreased $0.1 million primarily because of a decrease in employees between the periods. Other non-interest expense decreased slightly due to a decrease in the losses incurred on deposit accounts between the periods. These decreases in non-interest expense were partially offset by a $0.1 million increase in data processing expense primarily related to an increase in mobile banking and on-line banking costs between the periods. Occupancy and equipment costs increased slightly between the periods due to an increase in depreciation and maintenance costs.

Non-interest expense was $12.9 million for the first six months of 2018, an increase of $0.1 million, or 0.6%, from $12.8 million for the same period of 2017. Other non-interest expense increased $0.3 million due primarily to increases in deposit insurance costs and the losses incurred on deposit accounts between the periods. Occupancy and equipment costs increased $0.1 million between the periods due to an increase in depreciation and maintenance costs. Data processing expense increased $0.1 million primarily related to an increase in mobile and on-line banking costs between the periods. These increases in non-interest expense were partially offset by a $0.2 million decrease in compensation and benefits expense primarily because of a decrease in employees between the periods and a $0.1 million decrease in professional services expense due primarily to a decrease in legal expenses between the periods.

Income Taxes

Income tax expense was $0.6 million for the second quarter of 2018, a decrease of $0.1 million from $0.7 million for the second quarter of 2017. Income tax expense was $1.2 million for the first six months of 2018, a decrease of $0.4 million from $1.6 million for the first six months of 2017. The decrease in income tax expense between the periods is primarily the result of a decrease in the federal corporate income tax rate due to the tax law changes that were enacted in the fourth quarter of 2017.

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FINANCIAL CONDITION

Non-Performing Assets

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

(Dollars in thousands)	June 30, 2018	March 31, 2018	December 31, 2017
Non-Performing Loans:			
Single family	$960	$839	$949
Commercial real estate	1,432	1,524	1,364
Consumer	551	632	553
Commercial business	73	269	278
Total	3,016	3,264	3,144
Foreclosed and Repossessed Assets:			
Single family	74	74	0
Commercial real estate	627	627	627
Consumer	15	0	0
Total non-performing assets	$3,732	$3,965	$3,771
Total as a percentage of total assets	0.51 %	0.55 %	0.52 %
Total non-performing loans	$3,016	$3,264	$3,144
Total as a percentage of total loans receivable, net	0.51 %	0.55 %	0.54 %
Allowance for loan loss to non-performing loans	309.31 %	279.69 %	296.11 %
Delinquency Data:			
Delinquencies [(1)]			
30+ days	$1,585	$1,280	$1,789
90+ days	0	0	0
Delinquencies as a percentage of loan portfolio [(1)]			
30+ days	0.26 %	0.21 %	0.30 %
90+ days	0.00 %	0.00 %	0.00 %

[(1)] Excludes non-accrual loans.

Total non-performing assets were $3.7 million at June 30, 2018, a decrease of $0.3 million, or 5.9%, from $4.0 million at March 31, 2018. Non-performing loans decreased $0.3 million and foreclosed and repossessed assets remained the same during the second quarter of 2018.

Total non-performing assets were $3.7 million at June 30, 2018, a decrease of $0.1 million, or 1.1%, from $3.8 million at December 31, 2017. Non-performing loans decreased $0.2 million and foreclosed and repossessed assets increased $0.1 million during the first six months of 2018.

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, projected asset growth, 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 ended June 30, 2018.

LIQUIDITY AND CAPITAL RESOURCES

For the six months ended June 30, 2018, the net cash provided by operating activities was $8.4 million. The Company collected $0.3 million from maturing securities, $0.9 million from principal repayments on securities, and $0.3 million from the redemption of FHLB stock. The Company purchased securities of $4.9 million, purchased $0.3 million in FHLB stock, and paid out $0.7 million for premises and equipment. Net loans receivable increased $11.8 million. The Company had a net increase in deposit balances of $3.9 million and customer escrows increased $0.1 million. The Company also received and repaid $6.8 million in borrowings and paid $2.0 million to repurchase outstanding warrants.

The Company has certificates of deposits with outstanding balances of $74.6 million that mature 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 outflow from certificates that do not renew will be replaced with other deposits or FHLB advances. Federal Reserve Bank borrowings or proceeds from the sale of securities could also be used to fund unanticipated outflows of certificates of deposits.

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The Company had five deposit customers that individually had aggregate deposits greater than $5.0 million as of June 30, 2018. The $64.9 million in funds held by these customers may be withdrawn at any time, but management believes 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. Federal Reserve Bank borrowings or proceeds from the sale of securities could also be used to replace unanticipated outflows of large checking and money market deposits.

The Company had the ability to borrow $168.6 million from the FHLB at June 30, 2018, 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 Federal Reserve Bank and the Bank could borrow additional funds from the Federal Reserve Bank based on the increased collateral levels or obtain additional deposits.

The Company’s primary source of cash is dividends from the Bank. At June 30, 2018, the Company had $1.4 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 to the Company's interest-earning assets and interest-bearing liabilities based upon incremental 100 basis-point changes in interest rates from interest rates in effect on June 30, 2018.

	Market Value			
(Dollars in thousands)				
Basis point change in interest rates	-100	0	+100	+200
Total market risk sensitive assets	$727,120	716,289	702,920	690,096
Total market risk sensitive liabilities	611,933	572,165	538,371	508,664
Off-balance sheet financial instruments	(245)	0	4	44
Net market risk	$115,432	144,124	164,545	181,388
Percentage change from current market value	(19.91)%	0.00%	14.17%	25.86%

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 37%, depending on the note rate and the period to maturity. Adjustable rate mortgages (ARMs) were assumed to prepay at annual rates of between 5% and 47%, 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 18% and 2%, respectively. Retail checking accounts were assumed to decay at an annual rate of 14%. Commercial checking and money market accounts were assumed to decay at annual rates of 33% and 1% to 31%, respectively. Callable investments were projected to be called at the first call date where the projected interest rate on similar remaining term instruments is less than the interest rate on the callable advance or 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 the Company’s 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 June 30, 2019 of immediate interest rate changes called rate shocks.

(Dollars in thousands)

Rate Shock in Basis Points	Projected Change in Net Interest Income	Percentage Change
+200	$ 3,178	11.22 %
+100	1,591	5.62
0	0	0.00
-100	(1,770)	(6.25)

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 the Company’s 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 Securities and Exchange Commission rules and forms.

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

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HMN FINANCIAL, INC.

PART II - OTHER INFORMATION

ITEM 1. Legal Proceedings.

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

ITEM 1A. Risk Factors.

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, 2017. 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, 2017.

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

(a) Not applicable.

(b) Not applicable.

(c) Not applicable.

ITEM 3. Defaults Upon Senior Securities.

None.

ITEM 4. Mine Safety Disclosures.

Not applicable.

ITEM 5. Other Information.
None.

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ITEM 6. Exhibits.

INDEX TO EXHIBITS

Exhibit Number	Exhibit	Filing Status
10.1	Warrant Repurchase Agreement by and between the Company and EJF Financial Services Fund, L.P., dated May 21, 2018	Incorporated by Reference [1]
31.1	Rule 13a-14(a)/15d-14(a) Certification of CEO	Filed Electronically
31.2	Rule 13a-14(a)/15d-14(a) Certification of CFO	Filed Electronically
32	Section 1350 Certifications of CEO and CFO	Filed Electronically
101	Financial statements from the Quarterly Report on Form 10-Q of the Company for the period ended June 30, 2018, filed with the Securities and Exchange Commission on August 3, 2018, formatted in Extensible Business Reporting Language (XBRL); (i) the Consolidated Balance Sheets at June 30, 2018 and December 31, 2017, (ii) the Consolidated Statements of Comprehensive Income for the Three Months and Six Months Ended June 30, 2018 and 2017, (iii) the Consolidated Statement of Stockholders' Equity for the Six-Month Period Ended June 30, 2018, (iv) the Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2018 and 2017, and (v) Notes to Consolidated Financial Statements.	Filed Electronically

[1] Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K dated May 21, 2018, filed on May 22, 2018 (File No. 000-24100).

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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:	August 3, 2018	/s/ Bradley Krehbiel Bradley Krehbiel, President and Chief Executive Officer (Principal Executive Officer)
Date:	August 3, 2018	/s/ Jon Eberle Jon Eberle, Senior Vice President and Chief Financial Officer (Principal Financial Officer)