HMN FINANCIAL INC
Form 10-Q
November 03, 2006

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 September 30, 2006

OR

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

For the transition period from _________ to _________

Commission File Number 0-24100

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

Delaware	41-1777397
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
1016 Civic Center Drive N.W., Rochester, MN	55901
(Address of principal executive offices)	(ZIP Code)
Registrant's telephone number, including area code:	(507) 535-1200

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

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

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

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

Class	Outstanding at October 23, 2006
Common stock, $0.01 par value	4,344,430

HMN FINANCIAL, INC.

CONTENTS

2

PART I - FINANCIAL STATEMENTS
Item 1: Financial Statements

HMN FINANCIAL, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	September 30, 2006 (unaudited)	December 31 2005
ASSETS		
Cash and cash equivalents	$ 71,239,159	47,268,79
Securities available for sale:		
Mortgage-backed and related securities (amortized cost $6,806,874 and $7,428,504)	6,220,609	6,879,75
Other marketable securities (amortized cost $139,850,065 and $113,749,841)	139,787,337	112,778,81
	146,007,946	119,658,56
Loans held for sale	4,216,500	1,435,14
Loans receivable, net	729,381,119	785,678,46
Accrued interest receivable	4,659,303	4,460,01
Real estate, net	1,033,111	1,214,62
Federal Home Loan Bank stock, at cost	7,955,700	8,364,60
Mortgage servicing rights, net	2,139,158	2,653,63
Premises and equipment, net	11,674,555	11,941,86
Investment in limited partnerships	118,989	141,04
Goodwill	3,800,938	3,800,93
Core deposit intangible	134,367	219,76
Prepaid expenses and other assets	6,697,618	1,854,94
Deferred tax asset	2,199,400	2,544,40
Total assets	$ 991,257,863	991,236,79
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits	$ 741,617,758	731,536,56
Federal Home Loan Bank advances	150,900,000	160,900,00
Accrued interest payable	1,434,822	2,085,57
Customer escrows	1,090,363	1,038,57
Accrued expenses and other liabilities	4,150,742	4,947,81
Total liabilities	899,193,685	900,508,52
Commitments and contingencies		
Stockholders' equity:		
Serial preferred stock: ($.01 par value) authorized 500,000 shares; issued and outstanding none	0	
Common stock ($.01 par value): authorized 11,000,000; issued shares 9,128,662	91,287	91,28
Additional paid-in capital	57,786,780	58,011,09

Retained earnings, subject to certain restrictions................	101,911,810	98,951,77
Accumulated other comprehensive loss..............................	(391,792)	(917,57
Unearned employee stock ownership plan shares.....................	(4,205,988)	(4,350,99
Unearned compensation restricted stock awards.....................	0	(182,52
Treasury stock, at cost 4,785,198 and 4,721,402 shares............	(63,127,919)	(60,874,79
Total stockholders' equity....................................	92,064,178	90,728,26
Total liabilities and stockholders' equity........................	$ 991,257,863	991,236,79

See accompanying notes to consolidated financial statements.

3

HMN FINANCIAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

(unaudited)

	Three Months Ended September 30, 2006	2005	Nine Months Septembe 2006
Interest income:			
Loans receivable............................	$14,962,250	14,385,320	44,746,541
Securities available for sale:			
Mortgage-backed and related.............	66,408	78,645	205,839
Other marketable........................	1,511,616	645,871	3,723,794
Cash equivalents............................	545,550	114,872	1,254,410
Other.......................................	89,337	13,525	238,142
Total interest income..................	17,175,161	15,238,233	50,168,726
Interest expense:			
Deposits....................................	5,813,416	4,456,305	16,197,525
Federal Home Loan Bank advances.............	1,659,472	1,836,269	5,130,207
Total interest expense..................	7,472,888	6,292,574	21,327,732
Net interest income.....................	9,702,273	8,945,659	28,840,994
Provision for loan losses........................	6,026,000	952,000	7,521,000
Net interest income after provision for loan losses.......................	3,676,273	7,993,659	21,319,994
Non-interest income:			
Fees and service charges....................	820,075	706,337	2,330,661
Mortgage servicing fees.....................	291,157	305,417	896,091
Securities gains, net.......................	0	0	48,122
Gain on sales of loans......................	481,209	624,947	1,029,794
Losses in limited partnerships..............	(6,500)	(6,500)	(22,059)
Other.......................................	149,479	90,957	705,106

Total non-interest income	1,735,420	1,721,158	4,987,715
Non-interest expense:			
Compensation and benefits	2,706,431	2,781,366	9,083,004
Occupancy	1,130,755	1,042,417	3,334,439
Deposit insurance premiums	23,348	34,679	79,337
Advertising	108,013	101,775	346,172
Data processing	306,542	278,880	882,300
Amortization of mortgage servicing rights, net	208,202	256,763	661,293
Other	956,490	1,053,536	2,756,276
Total non-interest expense	5,439,781	5,549,416	17,142,821
Income (loss) before income tax (benefit) expense	(28,088)	4,165,401	9,164,888
Income tax (benefit) expense	(101,600)	1,889,000	3,407,600
Net income	$ 73,512	2,276,401	5,757,288
Basic earnings per share	$ 0.02	0.59	1.50
Diluted earnings per share	$ 0.02	0.57	1.43

See accompanying notes to consolidated financial statements.

4

HMN FINANCIAL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME
FOR THE NINE-MONTH PERIOD ENDED SEPTEMBER 30, 2006
(unaudited)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Compreh-ensive Income (Loss)	Unearned Employee Stock Ownership Plan Shares	U Com Re Sto
Balance, December 31, 2005	$91,287	58,011,099	98,951,777	(917,577)	(4,350,999)	
Net income			5,757,288			
Other comprehensive income, net of tax:						
Change in net unrealized gains on securities available for sale				525,785		
Total comprehensive income						
Purchase of treasury stock						
Employee stock options exercised		(225,832)				
Tax benefits of exercised stock options		47,648				

Unearned compensation restricted stock awards		(337,193)				
Stock option compensation expense		48,317				
Reclassification for FAS 123R adoption		(182,521)				
Amortization of restricted stock awards		140,703				
Dividends paid			(2,797,255)			
Earned employee stock ownership plan shares		284,559			145,011	
Balance, September 30, 2006	$91,287	57,786,780	101,911,810	(391,792)	(4,205,988)	

See accompanying notes to consolidated financial statements.

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

	Nine Month Septembe 2006
Cash flows from operating activities:	
Net income	$ 5,757,288
Adjustments to reconcile net income to cash provided by operating activities:	
Provision for loan losses	7,521,000
Depreciation	1,433,281
Amortization of discounts, net	(1,189,588)
Amortization of deferred loan fees	(1,167,614)
Amortization of core deposit intangible	85,393
Amortization of mortgage servicing rights	661,293
Capitalized mortgage servicing rights	(146,816)
Deferred income taxes	0
Securities gains, net	(48,122)
Losses on sales of real estate	19,058
Gain on sales of loans	(1,029,794)
Proceeds from sales of real estate	347,457
Proceeds from sales of loans held for sale	59,652,131
Disbursements on loans held for sale	(58,735,276)
Amortization of restricted stock awards	140,703
Amortization of unearned ESOP shares	145,011
Earned employee stock ownership shares priced above original cost	284,559
Stock option compensation	48,317
Increase in accrued interest receivable	(199,289)
(Decrease) increase in accrued interest payable	(650,751)
Equity losses of limited partnerships	22,059
(Increase) decrease in other assets	(4,834,150)
(Decrease) increase in other liabilities	(779,815)
Other, net	89,477
Net cash provided by operating activities	7,425,812

Cash flows from investing activities:	
Proceeds from sales of securities available for sale	2,988,122
Principal collected on securities available for sale	617,428
Proceeds collected on maturities of securities available for sale	105,500,000
Purchases of securities available for sale	(132,998,325)
Purchase of Federal Home Loan Bank stock	0
Redemption of Federal Home Loan Bank stock	408,900
Net decrease (increase) in loans receivable	46,997,713
Purchases of premises and equipment	(1,188,532)
Net cash provided (used) by investing activities	22,325,306
Cash flows from financing activities:	
Increase in deposits	9,733,212
Purchase of treasury stock	(2,953,850)
Stock options exercised	137,703
Excess tax benefits from options exercised	47,648
Dividends to stockholders	(2,797,255)
Proceeds from Federal Home Loan Bank advances	0
Repayment of Federal Home Loan Bank advances	(10,000,000)
Proceeds from Federal Reserve Bank advances	1,000,000
Repayment of Federal Reserve Bank advances	(1,000,000)
Decrease in customer escrows	51,788
Net cash (used) provided by financing activities	(5,780,754)
Increase (decrease) in cash and cash equivalents	23,970,364
Cash and cash equivalents, beginning of period	47,268,795
Cash and cash equivalents, end of period	$ 71,239,159
Supplemental cash flow disclosures:	
Cash paid for interest	$ 21,978,483
Cash paid for income taxes	6,851,238
Supplemental noncash flow disclosures:	
Transfer of loans to real estate	251,812

See accompanying notes to consolidated financial statements.

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

SEPTEMBER 30, 2006 AND 2005

(1) HMN FINANCIAL, INC.

HMN Financial, Inc. (HMN or the Company) is a stock savings bank holding company that owns 100 percent of Home Federal Savings Bank (the Bank). The Bank has a community banking philosophy and operates retail banking and loan production offices in Minnesota and Iowa. The Bank has one wholly owned subsidiary, Osterud Insurance Agency, Inc. (OIA) which offers financial planning products and services. HMN has another wholly owned subsidiary, Security Finance Corporation (SFC) which acts as an intermediary for the Bank in transacting like-kind property exchanges for Bank customers. During the 2005 period for which financial information is presented in this Form 10-Q, the Bank had one other subsidiary that is no longer operating. Home Federal Holding, Inc. (HFH), a wholly owned subsidiary, was the holding company for Home Federal REIT, Inc. (HFREIT) which invested in real estate loans acquired from the Bank. HFH and HFREIT were both dissolved in 2005.

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

(2) BASIS OF PREPARATION

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-Q and therefore, do not include all disclosures necessary for a complete presentation of the consolidated balance sheets, consolidated statements of income, consolidated statement of stockholders' equity and consolidated statements of cash flows in conformity with generally accepted accounting principles. However, all normal recurring adjustments that are, in the opinion of management, necessary for the fair presentation of the interim financial statements have been included. The results of operations for the nine-month period ended September 30, 2006 are not necessarily indicative of the results which may be expected for the entire year.

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

(3) NEW ACCOUNTING STANDARDS

As of January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (FAS 123R) which requires companies to recognize in compensation expense the grant-date fair value of stock awards issued. The Company adopted FAS 123R using the modified prospective transition method. In accordance with the modified prospective transition method, the Company's Consolidated Financial Statements for prior periods have not been restated to reflect the impact of FAS 123R. As a result of applying FAS 123R, the Company recognized share-based compensation expense of $48,317 for the nine months ended September 30, 2006 (for additional information see Note 12).

In March 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 156, Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140. Effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006, an entity is required to recognize a servicing asset or liability each time it undertakes an obligation to service a financial asset. SFAS No. 156 requires that all separately recognized servicing assets and liabilities be initially measured at fair value and permits, but does not require, the subsequent measurement of servicing assets and liabilities at fair value. It also permits a one-time reclassification, at the time of initial adoption, of available-for-sale securities to trading securities by entities with recognized servicing rights, without calling into question the treatment of other

available-for-sale securities under Statement 115, provided that the available-for-sale securities are identified in some manner as offsetting the entity's exposure to changes in the fair value of servicing assets or liabilities that a servicer elects to subsequently measure at fair value. Separate presentation of servicing assets and liabilities subsequently measured at fair value are required to be disclosed in the statement of financial position. The impact of adopting SFAS No. 156 on January 1, 2007 is not anticipated to have a material impact on the Company's financial statements.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 requires companies to recognize in their financial statements the impact of a tax position, taken or expected to be taken, if it is more likely than not that the position will be sustained on audit based on the technical merits of the position. The provisions of FIN 48 are effective as of January 1, 2007 and are not anticipated to have a material impact on the Company's financial statements.

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

In September 2006, the FASB issued SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106, and 132(R). This Statement improves financial reporting by requiring an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. An employer with publicly traded equity securities is required to initially recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after December 15, 2006. Since the Company's only defined benefit pension plan is a multiemployer plan, the requirements of this statement do not apply and therefore it is not anticipated that the Statement will have a material impact on the Company's financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ("SAB 108"). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB 108 is effective for years ending on or after November 15, 2006. The Company does not anticipate that the application of SAB 108 will have a material impact on its financial statements.

(4) DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

The Company has commitments outstanding to extend credit that had not closed prior to the end of the quarter that it intends to sell after the loans are closed. These commitments are referred to as its mortgage pipeline. As commitments to originate loans enter the mortgage pipeline, the Company generally enters into commitments to sell the mortgage pipeline into the secondary market on a firm commitment or best efforts basis. The commitments to originate, purchase or sell loans on a firm commitment basis are derivatives. As a result of marking to market the mortgage pipeline and the related firm commitments to sell for the period ended September 30, 2006, the Company recorded an increase in other assets of $7,945, a decrease in other liabilities of $17,259 and a gain included in the gain on sales of loans of $25,203.

The current commitments to sell loans held for sale are derivatives that do not qualify for hedge accounting. As a result, these derivatives are marked to market and the related loans held for sale are recorded at the lower of cost

or market. The Company recorded a decrease in loans held for sale of $5,858 and an increase in other assets of $5,858 due to the mark to market adjustment on the commitments to sell loans held for sale.

(5) COMPREHENSIVE INCOME

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

	For the three months ended September 30,				
	2006			2005	
(Dollars in thousands)	Before tax	Tax effect	Net of tax	Before tax	Tax effec
Securities available for sale:					
Gross unrealized gains (losses) arising during the period	$ 801	317	484	(200)	(13
Reclassification of net gains included in net income	0	0	0	0	
Net unrealized gains (losses) arising during the period	801	317	484	(200)	(13
Other comprehensive income (loss)	$ 801	317	484	(200)	(13

	For the three months ended September 30,				
	2006			2005	
(Dollars in thousands)	Before tax	Tax effect	Net of tax	Before tax	Tax effec
Securities available for sale:					
Gross unrealized gains (losses) arising during the period	$ 919	362	557	(573)	(26
Reclassification of net gains included in income	48	17	31	0	
Net unrealized gains					

(losses) arising during the period	871	345	526	(573)	(26
Other comprehensive income (loss)	$ 871	345	526	(573)	(26

(6) SECURITIES AVAILABLE FOR SALE

The following table shows the gross unrealized losses and fair value for the securities available for sale portfolio, aggregated by investment category and length of time that individual securities have been in a continuous loss position at September 30, 2006.

	Less than twelve months			Twelve months or mo		
(Dollars in thousands)	# of Investments	Fair Value	Unrealized Losses	# of Investments	Fair Value	U
Mortgage backed securities:						
FHLMC	-	$ -	-	2	$ 2,591	
FNMA	-	-	-	3	3,287	
Other marketable debt securities:						
FNMA	3	14,760	(10)	1	4,981	
FHLMC	2	9,842	(2)	2	9,984	
FHLB	2	9,981	(14)	5	24,863	
Total temporarily impaired securities	7	$34,583	(26)	13	$ 45,706	

These fixed rate investments are temporarily impaired due to changes in interest rates and the Company has the ability and intent to hold to maturity or until the temporary loss is recovered. Mortgage backed securities in the table above had an average remaining life of less than six years and the other marketable securities had an average remaining life of less than one year at September 30, 2006. The Company has reviewed these securities and has concluded that the unrealized losses are temporary and no other-than-temporary impairment has occurred at September 30, 2006.

9

(7) INVESTMENT IN MORTGAGE SERVICING RIGHTS

A summary of mortgage servicing activity is as follows:

(Dollars in thousands)	Nine Months Sept. 30, 2006	Twelve Months ended ended Dec. 31, 200	Nine Months end Sept. 30, 2005
Mortgage servicing rights			

Balance, beginning of period.............	$ 2,654	3,231	3,23
Originations.............................	147	442	35
Amortization.............................	(662)	(1,019)	(76
Balance, end of period...................	2,139	2,654	2,81
Fair value of mortgage servicing rights...	$ 4,233	4,599	4,13

All of the loans being serviced were single-family loans serviced for FNMA under the mortgage-backed security program or individual loan sale program. The following is a summary of the risk characteristics of the loans being serviced at September 30, 2006.

(Dollars in thousands)	Loan Principal Balance	Weighted Average Interest Rate	Weighted Average Remaining Term	Number of Loans
Original term 30 year fixed rate	$ 205,545	5.93%	326	1,817
Original term 15 year fixed rate	183,442	5.28%	144	2,441
Adjustable rate	4,363	5.50%	317	40

(8) INTANGIBLE ASSETS

The gross carrying amount of intangible assets and the associated accumulated amortization at September 30, 2006 is presented in the table below. Amortization expense for intangible assets was $746,686 for the nine-month period ended September 30, 2006.

(Dollars in thousands)	Gross Carrying Amount	Accumulated Amortization	Unamortized Intangible Assets
Amortized intangible assets:			
Mortgage servicing rights	$ 4,221	(2,082)	2,139
Core deposit intangible	1,567	(1,433)	134
Total	$ 5,788	(3,515)	2,273

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

(Dollars in thousands)	Mortgage Servicing Rights	Core Deposit Intangible	Total
Year ending December 31,			
2006	$ 107	28	135

2007	380	106	486
2008	316	0	316
2009	262	0	262
2010	216	0	216

Projections of amortization are based on existing asset balances and the existing interest rate environment as of September 30, 2006. The Company's actual experience may be significantly different depending upon changes in mortgage interest rates and other market conditions.

10

(9) EARNINGS PER SHARE

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

	Three months ended September 30,		Ni
	2006	2005	
Weighted average number of common shares outstanding used in basic earnings per common share calculation	3,807,223	3,836,397	3,
Net dilutive effect of:			
Stock options	181,737	170,316	
Restricted stock awards	12,744	8,172	
Weighted average number of shares outstanding adjusted for effect of dilutive securities	4,001,704	4,014,885	4,
Income available to common shareholders	$ 73,512	2,276,401	5,
Basic earnings per common share	$ 0.02	0.59	
Diluted earnings per common share	$ 0.02	0.57	

(10) REGULATORY CAPITAL

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

Quantitative measures established by regulations to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of Tier I or Core capital and Risk-based capital (as defined in the regulations) to total assets (as defined). Management believes, as of September 30, 2006, that the Bank meets all capital adequacy requirements to which it is subject.

Management believes that based upon the Bank's capital calculations at September 30, 2006 and other conditions consistent with the Prompt Corrective Actions Provisions of the OTS regulations, the Bank would be categorized as well capitalized.

On September 30, 2006 the Bank's tangible assets and adjusted total assets were $983.4 million and its risk-weighted assets were $778.4 million. The following table presents the Bank's capital amounts and ratios at September 30, 2006 for actual capital, required capital and excess capital including ratios required to qualify as a well capitalized institution under the Prompt Corrective Actions regulations.

	Actual		Required to be Adequately Capitalized		Excess
(Dollars in thousands)	Amount	Percent of Assets(1)	Amount	Percent of Assets (1)	Amount
Bank stockholder's equity..................	$ 87,833				
Plus:					
Net unrealized loss on certain securities available for sale...........	392				
Less:					
Goodwill and core deposit intangibles....	(3,935)				
Disallowed assets.......................	(1,747)				
Tier I or core capital	82,543				
Tier I capital to adjusted total assets.................................		8.39%	$ 39,337	4.00%	$43,206
Tier I capital to risk-weighted assets.....		10.60%	$ 31,136	4.00%	$51,407
Plus:					
Allowable allowance for loan losses.................................	8,717				
Risk-based capital........................	$ 91,260		$ 62,273		$28,987
Risk-based capital to risk- weighted assets...................		11.72%		8.00%	

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

The tangible capital of the Bank was in excess of the minimum 2% required at

September 30, 2006 but is not reflected in the table above.

(11) COMMITMENTS AND CONTINGENCIES

The Bank issued standby letters of credit which guarantee the performance of customers to third parties. The outstanding standby letters of credit expire over the next 3 years and totaled approximately $24.5 million at September 30, 2006. The letters of credit were 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.

(12) STOCK-BASED COMPENSATION

The Company has a stock option and incentive plan for certain key employees and directors whereby shares of common stock have been reserved for awards in the form of stock options or restricted stock. Under the plan, the aggregate number of options and shares granted cannot exceed 400,000 shares with no more than 100,000 of shares issued in the form of restricted stock. The Compensation Committee of the Board of Directors grants options from the plan at prices equal to the fair value of the stock at the date of the grant. The options expire 10 years from the date of the grant and typically vest over a 3 to 5 year period from the date of grant.

The Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (FAS 123R) on January 1, 2006 using the modified prospective transition method. Under the modified prospective transition method, option awards that are granted, modified or settled beginning at the date of adoption are measured and accounted for in accordance with FAS 123R. In addition, expense is recognized in the statement of income for unvested option awards that were granted prior to the date of adoption based on the fair value of the award as determined at the grant date. The consolidated financial statements as of and for the nine months ended September 30, 2006 reflect $48,317 of additional compensation expense as a result of implementing FAS 123R. In accordance with the modified prospective transition method, the Consolidated Financial Statements for prior periods have not been restated. Therefore, the results for the third quarter and first nine months of 2006 are not directly comparable to the same periods in 2005.

12

Stock option information as of September 30, 2006 is as follows:

	Options	Weighted-Average Exercise Price	Weighted-Averag Remaining Contrac Term (years)
Options outstanding at September 30, 2006	339,040	$ 16.536	5.3
Options exercisable at September 30, 2006	137,600	14.565	4.0

At September 30, 2006, 154,127 shares were available for issuance under the plan. No stock options were granted and 11,726 options were exercised in the first nine months of 2006.

At September 30, 2006, there was $158,000 in unrecognized compensation cost for stock options granted under the plan. This cost is expected to be recognized over a weighted-average period of 2.75 years.

Prior to January 1, 2006, the Company applied the existing accounting rules under APB Opinion No. 25, which provided that no compensation expense was recorded for options granted at an exercise price equal to the market value of the underlying common stock on the date of the grant. Compensation for restricted stock awards continues to be recorded in accordance with APB Opinion No. 25 and compensation expense is recognized as the restricted stock awards are vested. If the fair value recognition provisions of FAS 123R had been applied to stock-based compensation for the three and nine months ended September 30, 2005, the Company's pro forma net income and earnings per share would have been as follows:

	Quarter Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income:		
As reported	$ 2,276,401	7,590,918
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects......	13,655	33,771
Pro forma	2,262,746	7,557,147
Earnings per common share:		
As reported:		
Basic	$ 0.59	1.98
Diluted	0.57	1.89
Pro forma:		
Basic	0.59	1.97
Diluted	0.57	1.89

The Company utilizes the Black-Scholes valuation model to determine the fair value of stock options on the date of grant. The model derives the fair value of stock options based on certain assumptions related to the expected stock price volatility, expected option life, risk-free rate of return and dividend yield of the stock. The expected lives of options granted are estimated based on historical employee exercise behavior. The risk-free rate of return coincides with the expected life of the options and is based on the 10 year Treasury note rate at the time the options are issued. The historical volatility levels of the Company's common stock are used to estimate the stock price volatility. The current dividend yield is used to estimate the expected dividend yield on the stock.

(13) BUSINESS SEGMENTS

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

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

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

(Dollars in thousands)	Home Federal Savings Bank	Other	Eliminat
AT OR FOR THE QUARTER ENDED SEPTEMBER 30, 2006:			
Interest income - external customers	$ 17,165	10	
Non-interest income - external customers	1,742	0	
Loss on limited partnerships	(6)	0	
Intersegment interest income	3	0	(
Intersegment non-interest income	34	223	(25
Interest expense	7,473	3	(
Amortization of mortgage servicing rights, net....	208	0	
Other non-interest expense	5,009	257	(3
Income tax expense (benefit)	(3)	(99)	
Net income	225	72	(22
Goodwill	3,801	0	
Total assets	986,694	92,742	(88,17
AT OR FOR THE QUARTER ENDED SEPTEMBER 30, 2005:			
Interest income - external customers	$ 15,224	14	
Non-interest income - external customers	1,727	0	
Loss on limited partnerships	(6)	0	
Intersegment interest income	0	10	(1
Intersegment non-interest income	34	2,441	(2,47
Interest expense	6,303	0	(1
Amortization of mortgage servicing rights, net....	257	0	
Other non-interest expense	5,150	176	(3
Income tax expense	1,876	13	
Net income	2,441	2,276	(2,44
Goodwill	3,801	0	
Total assets	979,706	88,667	(86,06
AT OR FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006:			
Interest income - external customers	$ 50,083	86	
Non-interest income - external customers	5,010	0	
Loss on limited partnerships	(22)	0	
Intersegment interest income	3	0	(
Intersegment non-interest income	101	6,052	(6,15
Interest expense	21,328	3	(
Amortization of mortgage servicing rights, net....	661	0	
Other non-interest expense	16,007	576	(10
Income tax expense (benefit)	3,603	(195)	

Net income (loss)	6,055	5,754	(6,05
Goodwill	3,801	0	
Total assets	986,694	92,742	(88,17
AT OR FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2005:			
Interest income - external customers	$ 44,159	48	
Non-interest income - external customers	4,743	0	
Loss on limited partnerships	(21)	0	
Intersegment interest income	0	26	(2
Intersegment non-interest income	101	7,821	(7,92
Interest expense	17,870	0	(2
Amortization of mortgage servicing rights, net....	767	0	
Other non-interest expense	15,193	502	(10
Income tax expense (benefit)	4,832	(194)	
Net income	7,825	7,587	(7,82
Goodwill	3,801	0	
Total assets	979,706	88,667	(86,06

14

HMN FINANCIAL, INC.

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

FORWARD-LOOKING INFORMATION

This quarterly report and other reports filed with the Securities and Exchange Commission may contain "forward-looking" statements that deal with future results, plans or performance. When used in this Form 10-Q, the words "anticipates", "believes", "estimates", "expects", "intends" and similar expressions, as they relate to the Company, the Bank and its management, are intended to identify such forward-looking statements. In addition, the Company's management may make such statements orally to the media, or to securities analysts, investors or others. Forward looking statements deal with matters that do not relate strictly to historical facts. The Company's future results may differ materially from historical performance and forward-looking statements about the Company's expected financial results or other plans are subject to a number of risks and uncertainties. These include but are not limited to possible legislative changes and adverse economic, business and competitive developments such as shrinking interest margins; deposit outflows; reduced demand for financial services and loan products; changes in accounting policies and guidelines, or monetary and fiscal policies of the federal government or tax laws; changes in credit and other risks posed by the Company's loan and investment portfolios; technological, computer-related or operational difficulties; adverse changes in securities markets; results of litigation or other significant uncertainties. For additional discussion of the risks and uncertainties applicable to the Company, see Item 1A. "Risk Factors" of Part I of the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

GENERAL

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

The earnings of financial institutions, such as the Bank, are significantly affected by prevailing economic and competitive conditions, particularly changes in interest rates, government monetary and fiscal policies, and regulations of various regulatory authorities. Lending activities are influenced by the demand for and supply of single family and commercial properties, competition among lenders, the level of interest rates and the availability of funds. Commercial real estate loan activity was down in the first nine months of 2006 when compared to the same period of 2005 due to increased rate competition on long term fixed rate loans and we expect this trend to continue. Deposit flows and costs of deposits are influenced by prevailing market rates of interest on competing investments, account maturities and the levels of personal income and savings. The interest rates charged by the FHLB on advances to the Bank also have a significant impact on the Bank's overall cost of funds.

CRITICAL ACCOUNTING POLICIES

Critical accounting policies are those policies that the Company's management believes are the most important to understanding the Company's financial condition and operating results. The Company has identified the following policies as being critical because they require difficult, subjective, and/or complex

judgments that are inherently uncertain. Therefore, actual financial results could differ significantly depending upon the estimates used.

Allowance for Loan Losses and Related Provision

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

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

Mortgage Servicing Rights

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

Income Taxes

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

NET INCOME

The Company's net income was $74,000 for the third quarter of 2006, down $2.2 million, or 96.8%, from net income of $2.3 million for the third quarter of 2005. The decrease in net income is due to a $5.1 million increase in the loan loss provision between the periods as a result of increased commercial real estate loan charge offs. Basic earnings per share for the third quarter of 2006 were $0.02, down $0.57, or 96.6%, from $0.59 for the same quarter of 2005. Diluted earnings per common share for the third quarter of 2006 were $0.02, down $0.55, or 96.5%, from $0.57 for the third quarter of 2005.

Net income was $5.8 million for the nine-month period ended September 30, 2006, a decrease of $1.8 million, or 24.2%, compared to $7.6 million for the nine-month period ended September 30, 2005. The decrease in net income is due to a $5.0 million increase in the loan loss provision between the periods as a result of increased commercial real estate loan charge offs. Basic earnings per share were $1.50 for the nine-months ended September 30, 2006, a decrease of $0.48, or 24.2%, from $1.98 for the same nine-month period of 2005. Diluted earnings per common share for the nine-month period in 2006 were $1.43, down $0.46, or 24.3%, from $1.89 for the same period in 2005.

NET INTEREST INCOME

Net interest income was $9.7 million for the third quarter of 2006, an increase of $757,000, or 8.5%, compared to $8.9 million for the third quarter of 2005. Interest income was $17.2 million for the third quarter of 2006, an increase of $2.0 million, or 12.7%, from $15.2 million for the same period in 2005. Interest income increased because of an increase in the average interest rates earned on loans and investments. Interest rates increased primarily because of the 150 basis point increase in the prime interest rate between the periods. Increases in the prime rate, which is the rate that banks charge their prime business customers, generally increase the rates on adjustable rate consumer and commercial loans in the portfolio and new loans originated. The increase in interest income due to increased rates was partially offset by a $59 million decrease in the average outstanding loan portfolio balance between the periods due to an increase in commercial loan prepayments and a decrease in loan originations. The average yield earned on interest-earning assets was 7.19% for the third quarter of 2006, an increase of 74 basis points from the 6.45% yield for the third quarter of 2005.

Interest expense was $7.5 million for the third quarter of 2006, an increase of $1.2 million, or 18.8%, compared to $6.3 million for the third quarter of 2005. Interest expense increased primarily because of higher interest rates paid on deposits which were caused by the 150 basis point increase in the federal funds rate between the periods. Increases in the federal funds rate, which is the rate that banks charge other banks for short term loans, generally increase the rates banks pay for deposits. The increase in deposit rates was partially offset by a change in the mix of funding sources between the periods. The average outstanding balances of brokered deposits and Federal Home Loan Bank advances of $86 million were replaced with other less expensive deposits. The average interest rate paid on interest-bearing liabilities was 3.34% for the third quarter of 2006, an increase of 52 basis points from the 2.82% paid for the third quarter of 2005.

Net interest margin (net interest income divided by average interest earning assets) for the third quarter of 2006 was 4.06%, an increase of 27 basis points, compared to 3.79% for the third quarter of 2005.

Net interest income was $28.8 million for the first nine months of 2006, an increase of $2.4 million, or 9.4%, from $26.4 million for the same period in 2005. Interest income was $50.2 million for the nine-month period ended September 30, 2006, an increase of $6.0 million, or 13.5%, from $44.2 million for the same period in 2005. Interest income increased primarily because of an increase in the average interest rates earned on loans and investments. Interest rates increased primarily because of the 150 basis point increase in the prime interest rate between the periods. The increase in interest income due to increased rates was partially offset by a $40 million decrease in the average outstanding loan portfolio balance between the periods due to an increase in commercial loan prepayments and a decrease in loan originations. The yield earned on interest-earning assets was 7.10% for the first nine months of 2006, an increase of 80 basis points from the 6.30% yield for the same period in 2005.

Interest expense was $21.3 million for the nine-month period ended September 30, 2006, an increase of $3.5 million, or 19.5%, from $17.8 million for the same period in 2005. Interest expense increased primarily because of higher interest rates paid on deposits which were caused by the 150 basis point increase in the federal funds rate between the periods. The increase in deposit rates was partially offset by a change in the mix of funding sources between the periods. The average outstanding balances of brokered deposits and Federal Home Loan Bank advances of $45 million were replaced with other less expensive deposits. The average interest rate paid on interest-bearing liabilities was 3.22% for the first nine-months of 2006, an increase of 53 basis points from the 2.69% paid for the same period of 2005.

Net interest margin (net interest income divided by average interest earning assets) for the first nine months of 2006 was 4.08%, an increase of 32 basis points, compared to 3.76% for the same period of 2005.

PROVISION FOR LOAN LOSSES

The provision for loan losses is recorded to bring the allowance for loan losses to a level deemed appropriate by management based on factors disclosed in the critical accounting policies previously discussed. The provision for loan losses was $6.0 million for the third quarter of 2006, an increase of $5.1 million, or 533.0%, from $952,000 for the third quarter of 2005. The provision for loan losses increased primarily because $7.4 million in related commercial real estate development loans were charged off during the quarter. Most of the charged off loans had been downgraded to substandard and classified as non-accruing in the second quarter of 2006 due to nonperformance. During the third quarter, it was determined that the properties securing the loans, primarily developed and undeveloped single family home lots and a golf course, would be sold at auction in order to liquidate the assets and repay the loans. These properties were sold late in the third quarter and the proceeds realized were substantially less than the recorded loan balance amounts due to an unanticipated decrease in the values of the properties. The loans are personally guaranteed and the Company is continuing to pursue repayment from the guarantors. The amounts charged off represent an estimate of the loss incurred after considering the auction proceeds and reviewing each guarantor's financial position and assessing their ability to repay their personal obligations. Of the $14.4 million aggregate principal balance of these loans at June 30, 2006, $4.2 million is recorded as non-accruing at September 30, 2006. The Company does not anticipate making any material future cash expenditures in connection with these loans except for those relating to possible collection costs associated with enforcement of the personal guarantees. The actual amount of such expenditures in the future could vary depending on the amount of professional assistance needed and the nature of any proceedings required to resolve this matter. The estimates used in determining the remaining non-accruing balance of these loans will continue to be reviewed in conjunction with our normal allowance for loan loss provision procedures and adjustments, if any, to the allowance for loan losses will be recorded in the period in which the need for such adjustments becomes known. The increase in the provision related to loan charge offs was partially offset by a $22 million decrease in outstanding commercial loans during the third quarter of 2006.

Total non-performing assets were $10.3 million at September 30, 2006, a decrease of $3.2 million, or 23.7%, from $13.5 million at June 30, 2006. Non-performing loans decreased $3.1 million and foreclosed, repossessed, and other assets decreased $96,000. The decrease in non-performing loans during the quarter relates primarily to the charge off of $6.9 million in commercial real estate development loans described above that were previously classified as non-performing. The decrease related to the charge offs was partially offset by an increase in other

non-performing commercial real estate loans of $1.3 million, a $524,000 increase in non-performing commercial business loans, an $895,000 increase in non-performing single family loans, and a $1.1 million increase in non-performing consumer loans.

The provision for loan losses was $7.5 million for the first nine-months of 2006, an increase of $5.0 million, or 201.4%, from $2.5 million for the same nine-month period in 2005. The provision for loan losses increased primarily because $7.4 million in related commercial real estate development loans were charged off during the third quarter as more fully described above in the third quarter provision for loan losses discussion. The increase in the provision related to loan charge offs was partially offset by the $45 million decrease in outstanding commercial loans during the first nine months of 2006. Total non-performing assets were $10.3 million at September 30, 2006, an increase of $6.4 million, or 165.1%, from $3.9 million at December 31, 2005. Non-performing loans increased $6.9 million and foreclosed, repossessed and other nonperforming assets decreased $477,000 during the first nine months of 2006. The increase in non-performing loans during the nine month period relates primarily to a $4.3 million increase in non-performing commercial real estate loans, a $573,000 increase in non-performing commercial business loans, a $583,000 increase in non-performing single-family mortgage loans, and a $880,000 increase in non-performing consumer loans.

A reconciliation of the Company's allowance for loan losses for the nine-month periods ended September 30, 2006 and 2005 is summarized as follows:

(in thousands)	2006	2005
Balance at January 1,	$ 8,778	$ 8,996
Provision	7,521	2,495
Charge offs:		
Commercial loans	(7,374)	(2,615)
Consumer loans	(234)	(195)
Single family mortgage loans	0	(231)
Recoveries	55	183
Balance at September 30,	$ 8,746	$ 8,633

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

NON-INTEREST INCOME

Non-interest income was $1.7 million for the third quarter of 2006, an increase of $14,000, or 0.8%, from $1.7 million for the same period in 2005. Fees and service charges increased $114,000 between the periods primarily because of increased retail deposit account activity and fees. Gains on sales of loans decreased $144,000 due to a decrease in the single-family mortgage loans that were sold and a decrease in the profit margins realized on the loans that were sold. Competition in the single-family loan origination market remained strong and profit margins were decreased in order to remain competitive. Other non-interest income increased $59,000 primarily because of a decrease in the losses on the sale of repossessed assets in the third quarter of 2006 when compared to the same period in 2005.

Non-interest income was $5.0 million for the first nine months of 2006, an increase of $265,000, or 5.6%, from $4.7 million for the same period in 2005. Fees and service charges increased $336,000 between the periods primarily because of increased retail deposit account activity and fees. Security gains increased $48,000 due to increased security sales. Gains on sales of loans decreased $212,000 between the periods due to a decrease in the number of single-family mortgage loans sold and a decrease in the profit margins realized on the loans that were sold. As noted above, competition in the single-family loan origination market remained strong and profit margins were lowered in order to remain competitive. Other non-interest income increased $100,000 primarily because of a decrease in the losses recognized on repossessed assets in the first nine months of 2006 when compared to the same period of 2005.

19

NON-INTEREST EXPENSE

Non-interest expense was $5.4 million for the third quarter of 2006, a decrease of $110,000, or 2.0%, from $5.5 million for the same period of 2005. Compensation expense decreased $75,000 between the periods due to a decrease in incentive compensation that was partially offset by increased pension costs and annual pay increases. Occupancy expense increased $88,000 primarily because of the additional costs associated with the new branch and loan origination offices opened in Rochester in the first quarter of 2006. Data processing costs increased $28,000 primarily because of an increase in internet and other banking services provided by a third party processor between the periods. Other operating expenses decreased $97,000 primarily because of decreased mortgage loan and commercial loan foreclosure costs in the third quarter of 2006 when compared to the same period in 2005.

Non-interest expense was $17.1 million for the first nine months of 2006, an increase of $781,000, or 4.8%, from $16.4 million for the same period in 2005. Compensation expense increased $743,000 primarily because of increases in payroll due to annual pay increases and pension costs. Occupancy expense increased $255,000 primarily because of the additional costs associated with new branch and loan origination offices opened in Rochester in the first quarter of 2006. Data processing costs increased $121,000 primarily because of an increase in internet and other banking services provided by a third party processor between the periods. Other non-interest expense decreased $269,000 primarily because of a decrease in mortgage loan expenses and professional fees.

INCOME TAX EXPENSE

Because of the pre-tax loss for the third quarter of 2006, an income tax benefit of $102,000 was recorded, a decrease of $2.0 million, or 105.4%, compared to $1.9 million in expense for the same period of 2005. Income tax expense was $3.4 million for the first nine months of 2006, a decrease of $1.2 million, or 26.5%, compared to $4.6 million for the same period of 2005. Income tax expense decreased primarily because of a decrease in taxable income.

NON-PERFORMING ASSETS

The following table sets forth the amounts and categories of non-performing assets in the Company's portfolio at September 30, 2006 and December 31, 2005.

(Dollars in thousands)	Sept. 30, 2006	Dec. 31, 2005
Non-Accruing Loans:		
One-to-four family real estate	$ 1,725	626
Commercial real estate	5,284	948
Consumer	1,376	496
Commercial business	832	259
Total	9,217	2,329
Other assets	44	178
Foreclosed and Repossessed Assets:		
One-to-four family real estate	383	565
Consumer	650	750
Commercial	0	61
Total non-performing assets	$ 10,294	$ 3,883
Total as a percentage of total assets	1.04%	0.39%
Total non-performing loans	$ 9,217	$ 2,329
Total as a percentage of total loans receivable, net	1.26%	0.30%
Allowance for loan loss to non-performing loans	94.89%	376.88%

Total non-performing assets were $10.3 million at September 30, 2006, an increase of $6.4 million, or 165.1%, from $3.9 million at December 31, 2005. Non-performing loans increased $6.9 million and foreclosed, repossessed and other nonperforming assets decreased $477,000 during the first nine months of 2006. The following activity occurred during the first nine months of 2006 related to non-performing assets: $17.3 million of previously performing loans were classified as non-performing, $66,000 in non-performing loans were

foreclosed or repossessed, $7.8 million in loans were charged off as a loss, $536,000 in foreclosed assets were sold, and $2.6 million in loans previously classified as non-performing were paid off or were reclassified to performing status.

DIVIDENDS

On October 24, 2006 the Company declared a cash dividend of $0.25 per share, payable on December 13, 2006 to shareholders of record on November 24, 2006.

The Company has declared and paid dividends during 2006 as follows:

Record date	Payable date	Dividend per share	Dividend Payout Ratio
February 17, 2006	March 7, 2006	$0.24	27.59%
May 19, 2006	June 7, 2006	$0.24	35.29%
August 25, 2006	September 8, 2006	$0.25	34.25%
November 24, 2006	December 13, 2006	$0.25	1250.00%

The annualized dividend payout ratio for the past four quarters, ending with the December 13, 2006 payment will be 42.61%.

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

LIQUIDITY

For the nine months ended September 30, 2006, the net cash provided by operating activities was $7.4 million. The Company collected $105.5 million from the maturities of securities, $3.0 million from the sale of securities, $617,000 from principal repayments on securities, and $52,000 of customer escrows. It purchased securities available for sale of $133.0 million, and premises and equipment of $1.2 million. Net loans receivable decreased $47.0 million due to commercial loan prepayments and a decrease in originations. The Company had a net increase in deposit balances of $9.7 million, received $1.0 million and repaid $11.0 million in FRB and FHLB advances and received $409,000 from the redemption of FHLB stock. The Company received $138,000 related to the exercise of stock options, received tax benefits relating to the exercise of options of $48,000, purchased $3.0 million of its own stock, and paid $2.8 million in dividends to its shareholders.

The Company has certificates of deposits with outstanding balances of $184.9 million that come due over the next 12 months. Based upon past experience, management anticipates that the majority of the deposits will renew for another term. The Company believes that deposits that do not renew will be replaced with deposits from other customers or brokers. FHLB advances or proceeds from the sale of securities could also be used to replace unanticipated outflows of deposits.

The Company has deposits of $153.8 million in checking and money market accounts with customers that have individual balances greater than $5 million. While these funds may be withdrawn at any time, management anticipates that the majority will remain on deposit with the Bank over the next twelve months. If these deposits were to be withdrawn, they would be replaced with deposits from other customers or brokers. FHLB advances or proceeds from the sale of securities could also be used to replace unanticipated outflows of large checking and money market deposits.

The Company has $100.9 million of FHLB advances which mature beyond September 30, 2007 but have call features that can be exercised by the FHLB during the next twelve months. The Company also has $40.0 million of FHLB advances that will mature during the next twelve months. As the advances mature or if the call features are exercised, the Company has the option of requesting any advance otherwise available to it pursuant to the Credit Policy of the FHLB.

MARKET RISK

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

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

The Company utilizes a model which uses the discounted cash flows from its interest-earning assets and its interest-bearing liabilities to calculate the current market value of those assets and liabilities. The model also calculates the changes in market value of the interest-earning assets and interest-bearing liabilities due to different interest rate changes. The Company believes that over the next twelve months interest rates could fluctuate in a range of 200 basis points up or down from where the interest rates were at September 30, 2006. The following table discloses the projected changes in market value to the Company's interest-earning assets and interest-bearing liabilities based upon incremental 100 basis point changes in interest rates from interest rates in effect on September 30, 2006.

Other than trading portfolio	Market Value			
(Dollars in thousands) Basis point change in interest rates	-200	-100	0	+100
Total market risk sensitive assets........	$1,005,356	998,852	989,696	977,808
Total market risk sensitive liabilities...	883,449	870,607	859,633	851,099
Off-balance sheet financial instruments...	133	63	0	(198)
Net market risk..........................	$ 122,040	128,308	130,063	126,511
Percentage change from current market value	(6.17)%	(1.35)%	0.00%	(2.73)%

The preceding table was prepared utilizing the following assumptions (Model Assumptions) regarding prepayment and decay ratios which were determined by management based upon their review of historical prepayment speeds and future prepayment projections. Fixed rate loans were assumed to prepay at annual rates of between 6% to 76%, depending on the note rate and the period to maturity. Adjustable rate mortgages (ARMs) were assumed to prepay at annual rates of between 11% and 30%, depending on the note rate and the period to maturity. Growing Equity Mortgage (GEM) loans 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 and Collateralized Mortgage Obligations (CMOs) were projected to have prepayments based upon the underlying collateral securing the instrument and the related cash flow priority of the CMO tranche owned. Certificate accounts were assumed not to be withdrawn until maturity. Passbook accounts were assumed to decay at an annual rate of 23%, money market accounts were assumed to decay at an annual rate of 32%, non-interest checking and NOW accounts were assumed to decay at annual rates of 33% and 17%, respectively. FHLB advances were projected to be called at the first call date where the projected interest rate on similar remaining term advances exceeded the interest rate on the Company's callable advance.

Certain shortcomings are inherent in the method of analysis presented in the foregoing table. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types of assets and liabilities may lag behind changes in market interest rates. The model assumes that the difference between the current interest rate being earned or paid compared to a treasury instrument or

22

other interest index with a similar term to maturity (Interest Spread) will remain constant over the interest changes disclosed in the table. Changes in Interest Spread could impact projected market value changes. Certain assets, such as ARMs, have features which restrict changes in interest rates on a short-term basis and over the life of the assets. The market value of the interest-bearing assets which are approaching their lifetime interest rate caps could be different from the values disclosed in the table. In the event of a change in interest rates, prepayment and early withdrawal levels may deviate significantly from those assumed in calculating the foregoing table. The ability of many borrowers to service their debt may decrease in the event of a substantial sustained interest rate increase.

ASSET/LIABILITY MANAGEMENT

The Company's management reviews the impact that changing interest rates will have on its net interest income projected for the twelve months following September 30, 2006 to determine if its current level of interest rate risk is acceptable. The following table projects the estimated annual impact on net interest income of immediate interest rate changes called rate shocks.

(Dollars in thousands)	Rate Shock in Basis Points	Projected Change in Net Interest Income	Percentage Change
	+200	$ (843)	(2.06)%
	+100	(282)	(0.69)
	0	0	0.00
	-100	(271)	(0.66)
	-200	(1,358)	(3.32)

The preceding table was prepared utilizing the Model Assumptions regarding prepayment and decay ratios which were determined by management based upon their review of historical prepayment speeds and future prepayment projections prepared by third parties.

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 sustained interest rate increase and could impact net interest income.

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

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

To the extent consistent with its interest rate spread objectives, the Bank attempts to manage its interest rate risk and has taken a number of steps to restructure its balance sheet in order to better match the maturities of its assets and liabilities. The Bank has primarily focused its fixed rate one-to-four family residential lending program on loans that are saleable to third parties but does place fixed rate loans that meet certain risk characteristics into its

loan portfolio. The Bank also places into portfolio adjustable rate single-family loans that reprice over one, three, or five-year period. The Bank's commercial loan production has primarily been in adjustable rate loans and the fixed rate commercial loans placed in portfolio have been shorter-term loans, usually with maturities of five years or less, in order to manage the Company's interest rate risk exposure.

ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Incorporated by reference to Item 2 "Management's Discussion and Analysis of Financial Condition and Results of Operations - Market Risk."

ITEM 4: CONTROLS AND PROCEDURES

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

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

HMN FINANCIAL, INC.
PART II - OTHER INFORMATION

ITEM 1. Legal Proceedings.

None.

ITEM 1A. Risk Factors

There have been no material changes in the risk factors disclosed in the Company's December 31, 2005 Form 10-K.

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

(a) and (b) Not applicable

(c) Information Regarding Share Repurchases

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	(d) Ma Approx Shares Yet Be Plans
July 1 through July 31, 2006	40,000	$ 36.05	40,000	
August 1 through August 31, 2006	0	0	0	
September 1 through September 30, 2006	0	0	0	
Total	40,000	$ 36.05	40,000	

ITEM 3. Defaults Upon Senior Securities.

Not applicable.

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

None.

ITEM 5. Other Information.

None.

ITEM 6. Exhibits.

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

25

SIGNATURES

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

HMN FINANCIAL, INC.
Registrant

Date: November 3, 2006 /s/ Michael McNeil

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

Date: November 3, 2006 /s/ Jon Eberle

Jon Eberle,
Chief Financial Officer
(Principal Financial Officer)

26

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

Regulation S-K Exhibit Number	Document Attached Hereto	Reference to Prior Filing or Exhibit Number	Seque Page Numb Where Att Exhibits Located in Form 10-Q
3.1	Amended and Restated Articles of Incorporation	*1	N/A
3.2	Amended and Restated By-laws	*2	N/A
4	Form of Common Stock Including indentures	*3	N/A
31.1	Rule 13a-14(a)/15d-14(a) Certification of CEO	31.1	Filed Electr
31.2	Rule 13a-14(a)/15d-14(a) Certification of CFO	31.2	Filed Electr
32	Section 1350 Certification of CEO and CFO	32	Filed Electr

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

*2 Incorporated by reference to Exhibit 3 to the Company's Current Report on Form 8-K dated February 22, 2005, filed on February 23, 2005 (File No. 0-24100).

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