

HMN FINANCIAL INC
Form 10-Q
August 07, 2012
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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, 2012

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)

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Delaware
(State or other jurisdiction of
incorporation or organization)

41-1777397
(I.R.S. Employer
Identification Number)

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

55901
(ZIP Code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

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

Class	Outstanding at July 18, 2012
Common stock, \$0.01 par value	4,423,589

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HMN FINANCIAL, INC.

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

<i>(Dollars in thousands)</i>	June 30, 2012 (unaudited)	December 31, 2011
Assets		
Cash and cash equivalents	\$ 65,618	67,840
Securities available for sale:		
Mortgage-backed and related securities (amortized cost \$14,035 and \$19,586)	14,869	20,645
Other marketable securities (amortized cost \$61,699 and \$105,700)	61,420	105,469
	76,289	126,114
Loans held for sale	2,601	3,709
Loans receivable, net	496,178	555,908
Accrued interest receivable	1,980	2,449
Real estate, net	12,732	16,616
Federal Home Loan Bank stock, at cost	4,063	4,222
Mortgage servicing rights, net	1,533	1,485
Premises and equipment, net	7,576	7,967
Prepaid expenses and other assets	1,744	2,262
Assets held for sale	0	1,583
Deferred tax asset, net	0	0
Total assets	\$ 670,314	790,155
Liabilities and Stockholders Equity		
Deposits	\$ 534,297	620,128
Deposits held for sale	0	36,048
Federal Home Loan Bank advances	70,000	70,000
Accrued interest payable	518	780
Customer escrows	713	933
Accrued expenses and other liabilities	5,255	5,205
Total liabilities	610,783	733,094
Commitments and contingencies		
Stockholders equity:		
Serial preferred stock (\$.01 par value): authorized 500,000 shares; issued shares 26,000	25,053	24,780
Common stock (\$.01 par value): authorized 11,000,000; issued shares 9,128,662	91	91
Additional paid-in capital	52,096	53,462
Retained earnings, subject to certain restrictions	45,532	42,983
Accumulated other comprehensive income	199	471
Unearned employee stock ownership plan shares	(3,094)	(3,191)
Treasury stock, at cost 4,705,073 and 4,740,711 shares	(60,346)	(61,535)

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Total stockholders' equity	59,531	57,061
Total liabilities and stockholders' equity	\$ 670,314	790,155

See accompanying notes to consolidated financial statements.

Table of Contents**HMN FINANCIAL, INC. AND SUBSIDIARIES****Consolidated Statements of Comprehensive Income (Loss)**

(unaudited)

<i>(Dollars in thousands, except per share data)</i>	Three Months Ended		Six Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Interest income:				
Loans receivable	\$ 7,523	9,301	15,319	19,204
Securities available for sale:				
Mortgage-backed and related	164	290	357	614
Other marketable	192	407	441	824
Cash equivalents	19	2	46	3
Other	54	45	64	114
Total interest income	7,952	10,045	16,227	20,759
Interest expense:				
Deposits	1,061	1,806	2,278	3,746
Federal Home Loan Bank advances	844	1,240	1,689	2,569
Total interest expense	1,905	3,046	3,967	6,315
Net interest income	6,047	6,999	12,260	14,444
Provision for loan losses	1,088	3,463	960	5,409
Net interest income after provision for loan losses	4,959	3,536	11,300	9,035
Non-interest income:				
Fees and service charges	834	925	1,663	1,849
Mortgage servicing fees	236	250	468	500
Gain on sales of loans	620	301	1,529	796
Gain on sale of branch office	0	0	552	0
Other	104	113	288	230
Total non-interest income	1,794	1,589	4,500	3,375
Non-interest expense:				
Compensation and benefits	3,219	3,512	6,632	7,072
Loss on real estate owned	174	143	97	190
Occupancy	839	916	1,721	1,856
Deposit insurance	305	407	575	811
Data processing	336	305	673	558
Other	1,485	2,209	2,903	3,797
Total non-interest expense	6,358	7,492	12,601	14,284
Income (loss) before income tax benefit	395	(2,367)	3,199	(1,874)
Income tax benefit	0	(76)	0	0

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Net income (loss)	395	(2,291)	3,199	(1,874)
Preferred stock dividends and discount	464	457	925	906
Net income (loss) available to common shareholders	\$ (69)	(2,748)	2,274	(2,780)
Other comprehensive income (loss), net of tax:				
Unrealized holding gains (losses) arising during the period	\$ (93)	438	(272)	324
Other comprehensive income (loss), net of tax	\$ (93)	438	(272)	324
Comprehensive income (loss) attributable to common shareholders	\$ (162)	(2,310)	2,002	(2,456)
Basic earnings (loss) per common share	\$ (0.02)	(0.72)	0.58	(0.73)
Diluted earnings (loss) per common share	\$ (0.02)	(0.72)	0.57	(0.73)

See accompanying notes to consolidated financial statements.

Table of Contents**HMN FINANCIAL, INC. AND SUBSIDIARIES****Consolidated Statement of Stockholders Equity****For the Six-Month Period Ended June 30, 2012**

(unaudited)

<i>(Dollars in thousands)</i>	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Unearned Employee Stock Ownership Plan Shares	Treasury Stock	Total Stock- Holders Equity
Balance, December 31, 2011	\$ 24,780	91	53,462	42,983	471	(3,191)	(61,535)	57,061
Net income				3,199				3,199
Other comprehensive loss					(272)			(272)
Preferred stock discount amortization	273		(273)					0
Stock compensation tax benefits			4					4
Unearned compensation restricted stock awards			(1,199)				1,199	0
Restricted stock awards forfeited			10				(10)	0
Amortization of restricted stock awards			133					133
Preferred stock dividends accrued				(650)				(650)
Earned employee stock ownership plan shares			(41)			97		56
Balance, June 30, 2012	\$ 25,053	91	52,096	45,532	199	(3,094)	(60,346)	59,531

See accompanying notes to consolidated financial statements.

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

(unaudited)

<i>(Dollars in thousands)</i>	Six Months Ended June 30,	
	2012	2011
Cash flows from operating activities:		
Net income (loss)	\$ 3,199	(1,874)
Adjustments to reconcile net income (loss) to cash provided by operating activities:		
Provision for loan losses	960	5,409
Depreciation	570	640
Amortization of premiums, net	65	166
Amortization of deferred loan fees	(169)	(294)
Amortization of mortgage servicing rights, net	348	213
Capitalized mortgage servicing rights	(396)	(147)
Loss on real estate	97	190
Gains on sales of loans	(1,529)	(796)
Proceeds from sale of loans held for sale	55,066	25,350
Disbursements on loans held for sale	(48,390)	(19,237)
Amortization of restricted stock awards	133	152
Amortization of unearned ESOP shares	97	97
Earned employee stock ownership shares priced below original cost	(41)	(38)
Stock option compensation	4	14
Decrease in accrued interest receivable	469	379
Decrease in accrued interest payable	(262)	(194)
Decrease in other assets	521	867
Increase (decrease) in accrued expenses and other liabilities	(2,355)	1,965
Other, net	99	119
Net cash provided by operating activities	8,486	12,981
Cash flows from investing activities:		
Principal collected on securities available for sale	5,556	6,635
Proceeds collected on maturities of securities available for sale	60,000	80,000
Purchases of securities available for sale	(16,000)	(69,028)
Purchase of Federal Home Loan Bank Stock	0	(17)
Redemption of Federal Home Loan Bank Stock	159	1,186
Proceeds from sales of real estate	4,219	2,463
Net decrease in loans receivable	54,508	45,473
Gain on sale of branch office	(552)	0
Payment on sale of branch office	(36,981)	0
Purchases of premises and equipment	(175)	(115)
Net cash provided by investing activities	70,734	66,597
Cash flows from financing activities:		
Decrease in deposits	(81,222)	(36,247)
Repayment of borrowings	0	(37,500)
Decrease in customer escrows	(220)	(88)
Net cash used by financing activities	(81,442)	(73,835)

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Increase (decrease) in cash and cash equivalents	(2,222)	5,743
Cash and cash equivalents, beginning of period	67,840	20,981
Cash and cash equivalents, end of period	\$ 65,618	26,724
Supplemental cash flow disclosures:		
Cash paid for interest	\$ 4,229	6,509
Cash paid for income taxes	10	0
Supplemental noncash flow disclosures:		
Transfer of loans to real estate	525	8,259
Loans transferred to loans held for sale	4,073	3,607
See accompanying notes to consolidated financial statements.		

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HMN FINANCIAL, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(unaudited)

June 30, 2012 and 2011

(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 is currently not actively engaged in any activities.

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

(2) Basis of Preparation

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-Q and therefore, do not include all disclosures necessary for a complete presentation of the consolidated balance sheets, consolidated statements of comprehensive income (loss), consolidated statement of stockholders' equity and consolidated statements of cash flows in conformity with U.S. generally accepted accounting principles. However, all normal recurring adjustments which are, in the opinion of management, necessary for the fair presentation of the interim financial statements have been included. The results of operations for the six-month period ended June 30, 2012 is not necessarily indicative of the results which may be expected for the entire year.

(3) New Accounting Standards

In April 2011, the FASB issued ASU 2011-03, *Transfers and Servicing (Topic 860), Reconsideration of Effective Control for Repurchase Agreements*. This ASU prescribes when an entity may or may not recognize a sale upon the transfer of financial assets subject to repurchase agreements. That determination is based, in part, on whether the entity has maintained effective control over the transferred assets. The amendments in this ASU removed from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (2) the collateral maintenance implementation guidance related to that criterion. Other criteria applicable to the assessment of effective control are not changed by the amendments in this ASU. This ASU is effective for the first interim or annual period beginning on or after December 15, 2011 and should be applied prospectively to transactions or modification of existing transactions that occur on or after the effective date. The adoption of this ASU in the first quarter of 2012 did not have a material impact on the Company's consolidated financial statements.

In May 2011, the FASB issued ASU 2011-04, *Fair Value Measurement (Topic 820), Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in this ASU change the wording used to describe the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements in order to improve consistency in wording between U.S. GAAP and IFRS. Also, the amendments in the ASU require that for each class of assets and liabilities not measured at fair value on the balance sheet but for which the fair value is disclosed, the Company shall disclose the fair value hierarchy for each asset and liability class. This ASU is effective for interim or annual period beginning on or after December 15, 2011. The adoption of this ASU in the first quarter of 2012 did not have a material impact on the Company's consolidated financial statements other than to change the disclosures relating to fair value measurements.

June 2011, the FASB issued ASU 2011-05, *Comprehensive Income (Topic 220), Presentation of Comprehensive Income*. Prior to this ASU, U.S. GAAP allowed reporting entities three alternatives for presenting other comprehensive income and its components in financial statements. The first two options were to present this information in a single continuous statement of comprehensive income or in two separate but consecutive statements. The third option, which was used by the Company, was to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. This ASU eliminates the third option and therefore the

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Company selected to present this information in a single continuous statement of comprehensive income. This ASU is effective for fiscal years, and interim periods beginning after December 15, 2011. The adoption of this ASU in the first quarter of 2012 did not have a material impact on the Company's consolidated financial statements other than to change the presentation of other comprehensive income as discussed above.

In December 2011, the FASB issued ASU 2011-11, *Balance Sheet (Topic 210)*. The objective of this ASU is to provide enhanced disclosures that will enable users of its financial statements to evaluate the effect or potential effect of rights of setoff associated with an entity's financial position. This includes the effect or potential effect of rights of setoff associated with an entity's recognized assets and recognized liabilities within the scope of this ASU. The amendments require enhanced disclosures by requiring improved information about financial instruments and derivative instruments that are either (1) offset in accordance with either Section 210-20-45 or Section 815-10-45 or (2) subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in accordance with either Section 210-20-45 or Section 815-10-45. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods with those annual periods. The adoption of this ASU in the first quarter of 2013 is not anticipated to have any impact on the Company's consolidated financial statements as it currently has no outstanding rights of setoff.

In December 2011, the FASB issued ASU 2011-12, *Comprehensive Income (Topic 220)*. The amendments in this ASU supersede certain pending paragraphs in ASU 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*, to effectively defer only those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments out of accumulated other comprehensive income. All other requirements in ASU 2011-05 are not affected by this ASU, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. The amendments in this ASU will be temporary to allow the FASB time to redeliberate the presentation requirements for reclassifications out of accumulated other comprehensive income for annual and interim financial statements for public, private, and non-profit entities. The adoption of this ASU in the first quarter of 2012 did not have a material impact on the Company's consolidated financial statements other than to change the presentation of other comprehensive income as discussed above.

(4) Derivative Instruments and Hedging Activities

The Company has commitments outstanding to extend credit to future borrowers that have not closed prior to the end of the quarter. The Company intends to sell these commitments, which are referred to as its mortgage pipeline. As commitments to originate or purchase loans enter the mortgage pipeline, the Company generally enters into commitments to sell the mortgage pipeline into the secondary market on a firm commitment or best efforts basis. The commitments to originate, purchase or sell loans on a firm commitment basis are derivatives. As a result of marking to market the mortgage pipeline and the related firm commitments to sell for the period ended June 30, 2012, the Company recorded an increase in other assets of \$1,000, an increase in other liabilities of \$2,000 and a loss included in the gain on sales of loans of \$1,000.

The current commitments to sell loans held for sale are derivatives that do not qualify for hedge accounting. As a result, these derivatives are marked to market and the related loans held for sale are recorded at the lower of cost or market. The Company recorded a decrease in other liabilities of \$30,000 and a gain included in the gain on sales of loans of \$30,000.

(5) Fair Value Measurements

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

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

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

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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, 2012 and December 31, 2011.

<i>(Dollars in thousands)</i>	Total	Carrying value at June 30, 2012		
		Level 1	Level 2	Level 3
Securities available for sale	\$ 76,289	146	76,143	0
Mortgage loan commitments	30	0	30	0
Total	\$ 76,319	146	76,173	0

<i>(Dollars in thousands)</i>	Total	Carrying value at December 31, 2011		
		Level 1	Level 2	Level 3
Securities available for sale	\$ 126,114	613	125,501	0
Mortgage loan commitments	(94)	0	(94)	0
Total	\$ 126,020	613	125,407	0

There were no transfers between Levels 1, 2, or 3 during the three or six month periods ended June 30, 2012.

The Company may also be required, from time to time, to measure certain other financial assets at fair value on a nonrecurring basis in accordance with generally accepted accounting principles. These adjustments to fair value usually result from the application of the lower-of-cost-or-market accounting or write-downs of individual assets.

For assets measured at fair value on a nonrecurring basis in the second quarter of 2012 that were still held at June 30, 2012, 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, 2012 and December 31, 2011

<i>(Dollars in thousands)</i>	Carrying value at June 30, 2012				Three	Six
	Total	Level 1	Level 2	Level 3	months	months
					ended	ended
					June	June
					30,	30,
					2012	2012
					Total	Total
					gains	gains
					(losses)	(losses)
Loans held for sale	\$ 2,601	0	2,601	0	26	(30)
Mortgage servicing rights	1,533	0	1,533	0	0	0
Loans ⁽¹⁾	41,983	0	41,983	0	(273)	(1,374)
Real estate, net ⁽²⁾	12,732	0	12,732	0	(303)	(442)

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Total	\$ 58,849	0	58,849	0	(550)	(1,846)
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Carrying value at December 31, 2011

<i>(Dollars in thousands)</i>	Total	Level 1	Level 2	Level 3	Year ended December 31, 2011 Total Gains (Losses)
Loans held for sale	\$ 3,709	0	3,709	0	129
Mortgage servicing rights	1,485	0	1,485	0	0
Loans ⁽¹⁾	38,162	0	38,162	0	(4,167)
Real estate, net ⁽²⁾	16,616	0	16,616	0	(2,690)
Assets held for sale	1,583	0	1,583	0	0
Deposits held for sale	36,048	0	36,048	0	0
Total	\$ 97,603	0	97,603	0	(6,728)

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

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Generally accepted accounting principles require interim reporting period disclosure about the fair value of financial instruments, including assets, liabilities and off-balance sheet items for which it is practicable to estimate fair value. The fair value hierarchy level for each asset and liability, as defined in note 5, have been included in the following table for June 30, 2012 as required by the adoption of ASU 2011-04 in the first quarter of 2012. 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, 2012 and December 31, 2011 are shown below.

	June 30, 2012			December 31, 2011					
	Carrying amount	Estimated fair value	Fair value hierarchy			Contract amount	Carrying amount	Estimated fair value	Contract Amount
(Dollars in thousands)			Level 1	Level 2	Level 3				
Financial assets:									
Cash and cash equivalents	\$ 65,618	65,618	65,618				67,840	67,840	
Securities available for sale	76,289	76,289	146	76,143			126,114	126,114	
Loans held for sale	2,601	2,601		2,601			3,709	3,709	
Loans receivable, net	496,178	505,096		505,096			555,908	566,266	
Federal Home Loan Bank stock	4,063	4,063		4,063			4,222	4,222	
Accrued interest receivable	1,980	1,980		1,980			2,449	2,449	
Assets held for sale	0	0					1,583	1,605	
Financial liabilities:									
Deposits	534,297	534,297		534,297			620,128	620,128	
Deposits held for sale	0	0					36,048	36,048	
Federal Home Loan Bank advances	70,000	74,296		74,296			70,000	74,433	
Accrued interest payable	518	518		518			780	780	
Off-balance sheet financial instruments:									
Commitments to extend credit	30	30				90,266	29	29	91,113
Commitments to sell loans	(67)	(67)				5,810	(94)	(94)	7,263
<i>Cash and Cash Equivalents</i>									

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

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The fair values of loans receivable were estimated for groups of loans with similar characteristics. 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. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by ASC 820, Fair Value Measurements and Disclosures.

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The carrying amount of FHLB stock approximates its fair value.

Accrued Interest Receivable

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

Deposits

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

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

Federal Home Loan Bank Advances

The fair values of advances with fixed maturities are estimated based on discounted cash flow analysis using as discount rates the interest rates charged by the FHLB for borrowings of similar remaining maturities.

Accrued Interest Payable

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

Commitments to Extend Credit

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

Commitments to Sell Loans

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

(7) Other Comprehensive Income (Loss)

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

<i>(Dollars in thousands)</i>	For the three months ended June 30,					
	Before tax	2012 Tax effect	Net of tax	Before tax	2011 Tax effect	Net of tax
Securities available for sale:						
Net unrealized gains (losses) arising during the period	\$ (93)	0	(93)	514	76	438

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Other comprehensive income (loss)	\$ (93)	0	(93)	514	76	438
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<i>(Dollars in thousands)</i>	For the six months ended June 30,					
	Before tax	2012 Tax effect	Net of tax	Before tax	2011 Tax effect	Net of tax
Securities available for sale:						
Net unrealized gains (losses) arising during the period	\$ (272)	0	(272)	324	0	324
Other comprehensive income (loss)	\$ (272)	0	(272)	324	0	324

(8) Securities Available For Sale

The following table shows the gross unrealized losses and fair value for the securities available for sale portfolio, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2012 and December 31, 2011.

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	Less than twelve months			June 30, 2012 Twelve months or more			Total	
	#	Fair	Unrealized	#	Fair	Unrealized	Fair	Unrealized
	of	Value	Losses	of	Value	Losses	Value	Losses
<i>(Dollars in thousands)</i>								
Other marketable securities:								
Corporate preferred stock	0	\$ 0	0	1	\$ 245	(455)	\$ 245	(455)
Total temporarily impaired securities	0	\$ 0	0	1	\$ 245	(455)	\$ 245	(455)

	Less than twelve months			December 31, 2011 Twelve months or more			Total	
	#	Fair	Unrealized	#	Fair	Unrealized	Fair	Unrealized
	of	Value	Losses	of	Value	Losses	Value	Losses
<i>(Dollars in thousands)</i>								
Other marketable securities:								
Corporate preferred stock	0	\$ 0	0	1	\$ 175	(525)	\$ 175	(525)
Total temporarily impaired securities	0	\$ 0	0	1	\$ 175	(525)	\$ 175	(525)

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

The unrealized losses reported for corporate preferred stock at June 30, 2012 and December 31, 2011 related to a single trust preferred security that was issued by the holding company of a small community bank. Typical of most trust preferred issuances, the issuer has the ability to defer interest payments for up to five years with interest payable on the deferred balance. In October 2009, the issuer elected to defer its scheduled interest payments as allowed by the terms of the security agreement. The issuer's subsidiary bank has incurred operating losses due to increased provisions for loan losses but still meets the regulatory requirements to be considered adequately 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, 2012. 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 and the deferral of interest by the issuer. 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, 2012 and December 31, 2011 is as follows:

<i>(Dollars in thousands)</i>	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
June 30, 2012:				
Mortgage-backed securities:				
FHLMC	\$ 8,201	438	0	8,639
FNMA	5,689	395	0	6,084
Collateralized mortgage obligations:				
FHLMC	145	1	0	146
	14,035	834	0	14,869

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Other marketable securities:

U.S. Government agency obligations	60,999	176	0	61,175
Corporate preferred stock	700	0	(455)	245
	61,699	176	(455)	61,420
	\$ 75,734	1,010	(455)	76,289

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<i>(Dollars in thousands)</i>	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
December 31, 2011:				
Mortgage-backed securities:				
FHLMC	\$ 11,310	553	0	11,863
FNMA	7,670	499	0	8,169
Collateralized mortgage obligations:				
FHLMC	335	4	0	339
FNMA	271	3	0	274
	19,586	1,059	0	20,645
Other marketable securities:				
U.S. Government agency obligations	105,000	294	0	105,294
Corporate preferred stock	700	0	(525)	175
	105,700	294	(525)	105,469
	\$125,286	1,353	(525)	126,114

The following table indicates amortized cost and estimated fair value of securities available for sale at June 30, 2012 based upon contractual maturity adjusted for scheduled repayments of principal and projected prepayments of principal based upon current economic conditions and interest rates.

<i>(Dollars in thousands)</i>	Amortized cost	Fair Value
Due less than one year	\$ 58,766	59,309
Due after one year through five years	16,063	16,518
Due after five years through ten years	205	217
Due after ten years	700	245
Total	\$ 75,734	76,289

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

(9) Loans Receivable, Net

A summary of loans receivable at June 30, 2012 and December 31, 2011 is as follows:

<i>(Dollars in thousands)</i>	June 30, 2012	December 31, 2011
1-4 family	\$ 107,495	119,066
Commercial real estate:		
Residential developments	54,707	52,746
Alternative fuels	15,193	18,882

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Other	196,845	218,286
	266,745	289,914
Consumer	57,027	62,161
Commercial business:		
Construction/development	602	4,786
Banking	1,942	4,899
Other	83,195	99,574
	85,739	109,259
Total loans	517,006	580,400
Less:		
Unamortized discounts	64	93
Net deferred loan fees	245	511
Allowance for loan losses	20,519	23,888
Total loans receivable, net	\$ 496,178	555,908

Table of Contents**(10) Allowance for Loan Losses and Credit Quality Information**

The following tables summarize the allowance for loan losses for the periods ending June 30, 2012 and 2011:

<i>(Dollars in thousands)</i>	1-4 Family	Commercial Real Estate	Consumer	Commercial Business	Total
For the three months ended June 30, 2012:					
Balance, March 31, 2012	\$ 3,748	11,049	1,122	5,505	21,424
Provision for losses	(83)	975	628	(432)	1,088
Charge-offs	0	(1,554)	(493)	(1,820)	(3,867)
Recoveries	0	1,083	11	780	1,874
Balance, June 30, 2012	\$ 3,665	11,553	1,268	4,033	20,519
For the six months ended June 30, 2012:					
Balance, December 31, 2011	3,718	13,622	1,159	5,389	23,888
Provision for losses	(53)	792	847	(626)	960
Charge-offs	0	(4,184)	(758)	(1,828)	(6,770)
Recoveries	0	1,323	20	1,098	2,441
Balance, June 30, 2012	\$ 3,665	11,553	1,268	4,033	20,519
Allocated to:					
Specific reserves	\$ 1,086	3,559	367	1,621	6,633
General reserves	2,632	10,063	792	3,768	17,255
Balance, December 31, 2011	\$ 3,718	13,622	1,159	5,389	23,888
Allocated to:					
Specific reserves	\$ 888	3,172	609	1,343	6,012
General reserves	2,777	8,381	659	2,690	14,507
Balance, June 30, 2012	\$ 3,665	11,553	1,268	4,033	20,519
Loans receivable at December 31, 2011:					
Individually reviewed for impairment	\$ 6,241	30,495	1,205	6,855	44,796
Collectively reviewed for impairment	112,825	259,419	60,956	102,404	535,604
Ending balance	\$ 119,066	289,914	62,161	109,259	580,400
Loans receivable at June 30, 2012:					
Individually reviewed for impairment	\$ 7,765	33,432	2,011	4,787	47,995
Collectively reviewed for impairment	99,730	233,313	55,016	80,952	469,011
Ending balance	\$ 107,495	266,745	57,027	85,739	517,006

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<i>(Dollars in thousands)</i>	1-4 Family	Commercial Real Estate	Consumer	Commercial Business	Total
For the three months ended June 30, 2011:					
Balance, March 31, 2011	\$ 2,498	17,558	1,023	13,874	34,953
Provision for losses	954	2,376	159	(26)	3,463
Charge-offs	(15)	(4,633)	(35)	(6,249)	(10,932)
Recoveries	0	66	7	207	280
Balance, June 30, 2011	\$ 3,437	15,367	1,154	7,806	27,764
For the six months ended June 30, 2011:					
Balance, December 31, 2010	2,145	24,590	924	15,169	42,828
Provision for losses	1,710	2,914	307	478	5,409
Charge-offs	(418)	(12,209)	(87)	(8,557)	(21,271)
Recoveries	0	72	10	716	798
Balance, June 30, 2011	\$ 3,437	15,367	1,154	7,806	27,764

The following table summarizes the amount of classified and unclassified loans at June 30, 2012 and December 31, 2011:

<i>(Dollars in thousands)</i>	Special Mention	June 30, 2012				Total	Unclassified Total	Total Loans
		Substandard	Doubtful	Loss	Classified			
1-4 family	\$ 800	18,105	738	0	19,643	87,852	107,495	
Commercial real estate:								
Residential developments	875	40,969	209	0	42,053	12,654	54,707	
Alternative fuels	0	0	0	0	0	15,193	15,193	
Other	5,435	18,690	75	0	24,200	172,645	196,845	
Consumer	0	1,639	151	220	2,010	55,017	57,027	
Commercial business:								
Construction/development	0	314	0	0	314	288	602	
Banking	0	1,942	0	0	1,942	0	1,942	
Other	2,116	9,188	296	0	11,600	71,595	83,195	
	\$ 9,226	90,847	1,469	220	101,762	415,244	517,006	

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<i>(Dollars in thousands)</i>	December 31, 2011						Total Loans
	Special Mention	Substandard	Doubtful	Loss	Total	Unclassified Total	
1-4 family	\$ 8,870	11,129	738	0	20,737	98,329	119,066
Commercial real estate:							
Residential developments	444	39,709	1,113	0	41,266	11,480	52,746
Alternative fuels	0	0	0	0	0	18,882	18,882
Other	5,789	19,607	0	0	25,396	192,890	218,286
Consumer	0	857	224	124	1,205	60,956	62,161
Commercial business:							
Construction/development	0	2,722	0	0	2,722	2,064	4,786
Banking	0	3,750	1,149	0	4,899	0	4,899
Other	3,203	8,056	0	0	11,259	88,315	99,574
	\$ 18,306	85,830	3,224	124	107,484	472,916	580,400

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

The aging of past due loans at June 30, 2012 and December 31, 2011 is summarized as follows:

<i>(Dollars in thousands)</i>	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current Loans	Total Loans	Loans 90 Days or More Past Due and Still Accruing
	<i>June 30, 2012</i>						
1-4 family	\$ 2,336	1,063	1,068	4,467	103,028	107,495	0
Commercial real estate:							
Residential developments	0	408	1,292	1,700	53,007	54,707	0
Alternative fuels	0	0	0	0	15,193	15,193	0
Other	38	1,077	1,112	2,227	194,618	196,845	0
Consumer	462	54	2	518	56,509	57,027	0
Commercial business:							
Construction/development	0	0	272	272	330	602	0
Banking	0	0	0	0	1,942	1,942	0
Other	286	2,564	1,443	4,293	78,902	83,195	0
	\$ 3,122	5,166	5,189	13,477	503,529	517,006	0

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<i>December 31, 2011</i>							
1-4 family	\$ 1,876	305	1,297	3,478	115,588	119,066	0
Commercial real estate:							
Residential developments	107	290	8,211	8,608	44,138	52,746	0
Alternative fuels	0	0	0	0	18,882	18,882	0
Other	350	79	5,184	5,613	212,673	218,286	0
Consumer	658	374	387	1,419	60,742	62,161	0
Commercial business:							
Construction/development	286	0	0	286	4,500	4,786	0
Banking	0	0	1,149	1,149	3,750	4,899	0
Other	351	112	2,877	3,340	96,234	99,574	0
	\$ 3,628	1,160	19,105	23,893	556,507	580,400	0

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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, 2012 and December 31, 2011:

<i>(Dollars in thousands)</i>	June 30, 2012			December 31, 2011		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
Loans with no related allowance recorded:						
1-4 family	\$ 4,016	4,337	0	2,651	2,972	0
Commercial real estate:						
Residential developments	11,536	16,418	0	6,900	9,855	0
Alternative fuels	0	0	0	0	0	0
Other	4,062	5,205	0	3,745	4,381	0
Consumer	317	317	0	489	489	0
Commercial business:						
Construction/development	0	0	0	340	2,311	0
Banking	0	0	0	1,149	3,248	0
Other	1,699	6,031	0	598	1,607	0
Loans with an allowance recorded:						
1-4 family	3,749	3,793	888	3,590	3,590	1,086
Commercial real estate:						
Residential developments	15,781	16,730	2,792	13,889	14,017	2,546
Alternative fuels	0	0	0	0	0	0
Other	2,053	2,108	380	5,961	8,272	1,013
Consumer	1,694	1,694	609	716	716	367
Commercial business:						
Construction/development	213	2,185	65	0	0	0
Banking	0	0	0	0	0	0
Other	2,875	3,547	1,278	4,768	7,145	1,621
Total:						
1-4 family	7,765	8,130	888	6,241	6,562	1,086
Commercial real estate:						
Residential developments	27,317	33,148	2,792	20,789	23,872	2,546
Alternative fuels	0	0	0	0	0	0
Other	6,115	7,313	380	9,706	12,653	1,013
Consumer	2,011	2,011	609	1,205	1,205	367
Commercial business:						
Construction/development	213	2,185	65	340	2,311	0
Banking	0	0	0	1,149	3,248	0
Other	4,574	9,578	1,278	5,366	8,752	1,621
	\$47,995	62,365	6,012	44,796	58,603	6,633

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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, 2012 and 2011:

	For the three months ended June 30, 2012		For the six months ended June 30, 2012	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
<i>(Dollars in thousands)</i>				
Loans with no related allowance recorded:				
1-4 family	\$ 4,092	21	3,611	48
Commercial real estate:				
Residential developments	12,085	83	10,356	320
Alternative fuels	0	0	0	0
Other	3,972	5	3,896	18
Consumer	339	2	389	2
Commercial business:				
Construction/development	111	0	187	0
Banking	575	0	766	0
Other	1,052	2	900	5
Loans with an allowance recorded:				
1-4 family	4,148	18	3,962	41
Commercial real estate:				
Residential developments	15,679	37	15,082	74
Alternative fuels	0	0	0	0
Other	4,013	1	4,662	3
Consumer	1,356	19	1,142	42
Commercial business:				
Construction/development	107	0	71	0
Banking	0	0	0	0
Other	4,228	8	4,408	29
Total:				
1-4 family	8,240	39	7,573	89
Commercial real estate:				
Residential developments	27,764	120	25,438	394
Alternative fuels	0	0	0	0
Other	7,985	6	8,558	21
Consumer	1,695	21	1,531	44
Commercial business:				
Construction/development	218	0	258	0
Banking	575	0	766	0
Other	5,280	10	5,308	34
	\$ 51,757	196	49,432	582

	For the three months ended June 30, 2011		For the six months ended June 30, 2011	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
<i>(Dollars in thousands)</i>				
Loans with no related allowance recorded:				
1-4 family	\$ 1,354	16	1,213	36
Commercial real estate:				
Residential developments	5,798	14	6,027	88
Alternative fuels	1,133	0	755	0

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Other	656	10	477	13
Consumer	132	0	123	2
Commercial business:				
Construction/development	345	2	263	4
Banking	987	0	658	0
Other	654	3	568	17
Loans with an allowance recorded:				
1-4 family	4,029	50	4,618	86
Commercial real estate:				
Residential developments	15,826	192	19,599	431
Alternative fuels	2,498	0	3,330	0
Other	6,406	40	6,381	59
Consumer	347	5	296	10
Commercial business:				
Construction/development	3,344	18	3,831	36
Banking	4,112	0	5,482	0
Other	11,366	63	12,020	147
Total:				
1-4 family	5,383	66	5,831	122
Commercial real estate:				
Residential developments	21,624	206	25,626	519
Alternative fuels	3,631	0	4,085	0
Other	7,062	50	6,858	72
Consumer	479	5	419	12
Commercial business:				
Construction/development	3,689	20	4,094	40
Banking	5,099	0	6,140	0
Other	12,020	66	12,588	164
	\$ 58,987	413	65,641	929

At June 30, 2012 and December 31, 2011, non-accruing loans totaled \$31.1 million and \$34.0 million, respectively, for which the related allowance for loan losses was \$4.3 million and \$5.2 million, respectively. The decrease in the related allowances is due primarily to full or partial charge-off of several non-accruing loans. 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 \$15.8 million and \$14.8 million, 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, 2012 and December 31, 2011 are summarized as follows:

<i>(Dollars in thousands)</i>	June 30, 2012	December 31, 2011
1-4 family	\$ 4,409	\$ 4,435
Commercial real estate:		
Residential developments	19,277	13,412
Alternative fuels	0	0
Other	3,045	9,246
Consumer	367	699
Commercial business:		
Construction/development	214	340
Banking	0	1,149
Other	3,779	4,712
	\$ 31,091	\$ 33,993

During the third quarter of 2011, the Company adopted Accounting Standards Update (ASU) 2011-02, *A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring (Topic 310)*, which modified guidance for identifying restructurings of receivables that constitute a TDR. At June 30, 2012 and December 31, 2011 there were loans included in loans receivable, net, with terms that had been modified in a troubled debt restructuring totaling \$38.2 million and \$29.2 million, respectively. For the loans that were restructured in the second quarter of 2012, \$1.2 million were classified but performing and \$0.1 million were non-performing at June 30, 2012.

The following table summarizes troubled debt restructurings at June 30, 2012 and December 31, 2011:

<i>(Dollars in thousands)</i>	June 30, 2012			December 31, 2011		
	Accrual	Non-Accrual	Total	Accrual	Non-Accrual	Total
1-4 Family	\$ 3,356	2,694	6,050	1,806	1,999	3,805
Commercial real estate	11,110	16,094	27,204	7,837	12,221	20,058
Consumer	1,643	71	1,714	507	71	578
Commercial business	795	2,465	3,260	653	4,110	4,763
	\$ 16,904	21,324	38,228	10,803	18,401	29,204

There were no material commitments to lend additional funds to customers whose loans were restructured or classified as nonaccrual at June 30, 2012 or December 31, 2011.

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

When a loan is modified as a TDR, there may be a direct, material impact on the loans within the balance sheet, as principal balances may be partially forgiven. The financial effects of TDRs are presented in the following 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, 2012.

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	Three Months Ended June 30, 2012			Six Months Ended June 30, 2012		
	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
<i>(Dollars in thousands)</i>						
Troubled debt restructurings:						
1-4 family	0	\$ 0	0	27	\$ 3,204	3,204
Commercial real estate:						
Residential developments	0	0	0	7	11,479	9,823
Alternative fuels	0	0	0	0	0	0
Other	1	321	150	6	2,814	2,586
Consumer	4	1,057	1,057	12	1,326	1,326
Commercial business:						
Construction/development	0	0	0	0	0	0
Banking	0	0	0	0	0	0
Other	1	80	80	3	324	324
Total	6	\$ 1,458	1,287	55	\$ 19,147	17,263

Loans that were restructured within the 12 months preceding June 30, 2012 and defaulted during the three and six months ended June 30, 2012 are presented in the table below.

	Three Months Ended June 30, 2012		Six Months Ended June 30, 2012	
	Number of Contracts	Outstanding Recorded Investment	Number of Contracts	Outstanding Recorded Investment
<i>(Dollars in thousands)</i>				
Troubled debt restructurings that subsequently defaulted:				
1-4 family	1	\$ 846	2	\$ 940
Commercial real estate:				
Residential developments	0	0	0	0
Alternative fuels	0	0	0	0
Other	0	0	2	159
Consumer	0	0	0	0
Commercial business:				
Construction/development	0	0	0	0
Banking	0	0	0	0
Other	0	0	3	2,777
Total	1	\$ 846	7	\$ 3,876

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 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 accruing 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.

TDR s are reviewed for impairment following the same methodology as other impaired loans. For loans that are collateral dependent, the value of the collateral is reviewed and additional reserves may be added as needed. Loans that are not collateral dependent may have additional reserves established if deemed necessary. The allowance for loan losses on TDR s was \$3.2 million, or 15.8%, of the total \$20.5 million in loan loss

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reserves at June 30, 2012 and \$3.5 million, or 14.6%, of the total \$23.9 million in loan loss reserves at December 31, 2011.

Table of Contents**(11) Investment in Mortgage Servicing Rights**

A summary of mortgage servicing activity is as follows:

<i>(Dollars in thousands)</i>	Six Months ended June 30, 2012	Twelve Months ended December 31, 2011	Six Months ended June 30, 2011
Mortgage servicing rights:			
Balance, beginning of period	\$ 1,485	1,586	1,586
Originations	396	461	147
Amortization	(348)	(562)	(213)
Balance, end of period	\$ 1,533	1,485	1,520
 Fair value of mortgage servicing rights	 \$ 1,929	 1,878	 2,297

All of the loans being serviced are single family loans serviced for the Federal National Mortgage Association (FNMA) under the mortgage-backed security program or the individual loan sale program. The following is a summary of the risk characteristics of the loans being serviced at June 30, 2012.

<i>(Dollars in thousands)</i>	Loan Principal Balance	Weighted Average Interest Rate	Weighted Average Remaining Term	Number of Loans
Original term 30 year fixed rate	\$ 197,514	4.89%	298	1,729
Original term 15 year fixed rate	104,789	4.08%	136	1,368
Adjustable rate	330	3.50%	307	7

The gross carrying amount of mortgage servicing rights and the associated accumulated amortization at June 30, 2012 is presented in the following table. Amortization expense was \$348,000 and \$213,000 for the six months ended June 30, 2012 and 2011, respectively.

<i>(Dollars in thousands)</i>	Gross Carrying Amount	Accumulated Amortization	Unamortized Intangible Assets
Mortgage servicing rights	\$ 2,191	(658)	1,533
 Total	 \$ 2,191	 (658)	 1,533

The following table indicates the estimated future amortization expense for amortized mortgage servicing rights:

(Dollars in thousands)

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	Mortgage Servicing Rights
Year ended December 31,	
2012	\$ 358
2013	345
2014	312
2015	265
2016	155
Thereafter	98
Total	\$ 1,533

Projections of amortization are based on existing asset balances and the existing interest rate environment as of June 30, 2012. The Company's actual experiences may be significantly different depending upon changes in mortgage interest rates and other market conditions.

Table of Contents**(12) Earnings (Loss) per Common Share**

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

<i>(Dollars in thousands, except per share data)</i>	Three Months Ended		Six Months Ended	
	June 30,	June 30,	June 30,	June 30,
	2012	2011	2012	2011
Weighted average number of common shares outstanding used in basic loss per common share calculation	3,936	3,841	3,925	3,829
Net dilutive effect of:				
Restricted stock awards	0	0	97	0
Weighted average number of shares outstanding adjusted for effect of dilutive securities	3,936	3,841	4,022	3,829
Income (loss) available to common shareholders	\$ (69)	(2,748)	2,274	(2,780)
Basic earnings (loss) per common share	\$ (0.02)	(0.72)	0.58	(0.73)
Diluted earnings (loss) per common share	\$ (0.02)	(0.72)	0.57	(0.73)

For the three months ended June 30, 2012 and June 30, 2011, there were 94,432 and 129,037 common share equivalents outstanding, respectively, that are not included in the calculation of diluted earnings per share as they are anti-dilutive. For the six months ended June 30, 2012 and June 30, 2011, there were 0 and 127,351 common share equivalents outstanding, respectively, that are not included in the calculation of diluted earnings per share as they are anti-dilutive.

(13) Regulatory Capital and Regulatory Oversight

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

The Bank entered into a written Supervisory Agreement with its primary regulator, the OTS, effective February 22, 2011 that primarily relates to the Bank's financial performance and credit quality issues. This agreement replaced the prior memorandum of understanding that the Bank entered into with the OTS on December 9, 2009. In accordance with the agreement, the Bank submitted a two year business plan in May of 2011 that the OCC (as defined below and as successor to the OTS) accepted with the expectation that the Bank would be in adherence with the OCC's Notification of Establishment of Higher Minimum Capital Ratios, dated August 8, 2011, also known as an individual minimum capital requirement or IMCR, which required the Bank to establish and maintain a minimum core capital ratio of 8.50% by December 31, 2011, as discussed more fully below. As required by the Supervisory Agreement, the Bank submitted an updated two year capital plan in January of 2012 that the OCC may make comments upon, and require revisions to. The Bank must operate within the parameters of the final business plan and is required to monitor and submit periodic reports on its compliance with the plan. The Bank also submitted a problem asset reduction plan that the OCC has accepted. The Bank must operate within the parameters of the final problem asset plan and is required to monitor and submit periodic reports on its compliance with the plan. The Bank has also revised its loan modification policies and its program for identifying, monitoring and controlling risk associated with concentrations of credit, and improved the documentation relating to the allowance for loan and lease losses as required by the agreement. In addition, without the consent of the OCC, the Bank may not declare or pay any cash dividends, increase its total assets during any quarter in excess of the amount of the net interest credited on deposit liabilities during the prior quarter, enter into any new contractual arrangement or renew or extend any existing arrangement related to compensation or benefits with any directors or officer, make any golden parachute payments, or enter into any significant contracts with a third party service provider. The Bank believes it was in compliance with all requirements of its Supervisory Agreement at June 30, 2012.

The Company also entered into a written Supervisory Agreement with the OTS effective February 22, 2011. This agreement replaced the prior memorandum of understanding that the Company entered into with the OTS on

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December 9, 2009. As required by the Supervisory Agreement, the Company submitted an updated two year capital plan in January of 2012 that the Federal Reserve Board (as successor to the OTS) may make comments upon, and to which it may require revisions. The Company must operate within the parameters of the final capital plan and is required to monitor and submit periodic reports on its compliance with the plan. In addition, without the consent of the Federal Reserve Board, the Company may not incur or issue any debt, guarantee the debt of any entity, declare or pay any cash dividends or repurchase any of the Company's capital stock, enter into any new contractual arrangement or renew or extend any existing arrangement related to compensation or benefits with any directors or officer, or make any golden parachute payments. The Company believes it was in compliance with all requirements of its Supervisory Agreement at June 30, 2012.

References to the OTS shall mean, with respect to the Company, beginning July 21, 2011, the Federal Reserve Board (FRB) and mean, with respect to the Bank, beginning July 21, 2011, the Office of the Comptroller of the Currency (OCC). On July 21, 2011, the OTS was integrated into the OCC and the primary banking regulator for the Company became the FRB.

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

The Bank's tangible assets were \$669.9 million and \$789.0 million, adjusted total assets were \$669.7 million and \$789.0 million, and its risk-weighted assets were \$486.8 million and \$586.0 million at June 30, 2012 and December 31, 2011, respectively. The following table presents the Bank's capital amounts and ratios at June 30, 2012 and December 31, 2011 for actual capital, required capital and excess capital, including ratios in order to qualify as being well capitalized under the Prompt Corrective Actions regulations.

(Dollars in thousands)

	Actual	Required to be Adequately Capitalized	Excess Capital	To Be Well Capitalized Under Prompt Corrective Actions Provisions
	Amount	Amount	Amount	Amount
	Percent of Assets (1)	Percent of Assets (1)	Percent of Assets (1)	Percent of Assets (1)
June 30, 2012				
Bank stockholder's equity	\$ 60,768			
Less:				
Net unrealized gains on certain securities available for sale	(199)			
	60,569			
Tier I or core capital				
Tier I capital to adjusted total assets	9.04%	\$ 26,787	\$ 33,782	\$ 33,484
Tier I capital to risk-weighted assets	12.44%	\$ 19,472	\$ 41,097	\$ 29,208
Plus:				
Allowable allowance for loan losses	6,263			
Risk-based capital	\$ 66,832	\$ 38,944	\$ 27,888	\$ 46,680
Risk-based capital to risk-weighted assets	13.73%	8.00%	5.73%	10.00%

(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.

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(Dollars in thousands)

	Actual	Percent	Required to be	Percent	Excess Capital	Percent	To Be Well	Percent
	Amount	of	Adequately	of	Amount	of	Capitalized Under	of
		Assets	Capitalized	Assets		Assets	Prompt Corrective	Assets
		(1)		(1)		(1)	Actions Provisions	(1)
December 31, 2011								
Bank stockholder's equity	\$ 57,454							
Less:								
Net unrealized gains on certain securities available for sale	(1,140)							
	56,314							
Tier I or core capital								
Tier I capital to adjusted total assets		7.14%	\$ 31,560	4.00%	\$ 24,754	3.14%	\$ 39,450	5.00%
Tier I capital to risk-weighted assets		9.61%	\$ 23,441	4.00%	\$ 32,873	5.61%	\$ 35,162	6.00%
Plus:								
Allowable allowance for loan losses	7,325							
Risk-based capital	\$ 63,639		\$ 46,883		\$ 16,756		\$ 58,603	
Risk-based capital to risk-weighted assets		10.86%		8.00%		2.86%		10.00%

(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.

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The OCC established an IMCR for the Bank. An IMCR requires a bank to establish and maintain levels of capital greater than those generally required for a bank to be classified as well-capitalized. Effective December 31, 2011, the Bank was required to establish, and subsequently maintain, core capital at least equal to 8.50% of adjusted total assets, which was in excess of the Bank's 7.14% core capital to adjusted total assets ratio at December 31, 2011. In February 2012, the Bank received a Notice of Failure to Maintain Minimum Capital Ratios from the OCC arising out of its failure to establish and maintain its IMCR of 8.50% core capital to adjusted total assets at December 31, 2011. Pursuant to the notice, the OCC required the Bank to submit by April 30, 2012 a further written capital plan of how it intended to achieve and maintain its IMCR, and a contingency plan in the event the IMCR was not achieved through the Bank's primary plan. Because of the improved financial results and the decrease in assets experienced during the six months of 2012, the Bank's core capital ratio improved to 8.50% at March 31, 2012 and 9.04% at June 30, 2012. In April 2012, the Bank submitted the required revised capital and contingency plan to the OCC. The OCC may make comments upon and require revisions to this plan.

The Bank's failure to comply with the terms of the IMCR at December 31, 2011 was, and its failure to continue to comply in the future can be, deemed an unsafe and unsound banking practice and could subject it to further limits on growth and such legal actions or sanctions as the OCC considers appropriate. There can be no assurance that the Bank will continue to maintain compliance with the IMCR in the future. Possible sanctions include among others (i) the imposition of one or more cease and desist orders requiring corrective action, which are enforceable directives that may address any aspect of the Company or Bank management, operations or capital, including requirements to change management, raise equity capital, dispose of assets or effect a change of control; (ii) civil money penalties; and (iii) downgrades in the capital adequacy status of the Company and the Bank. These regulatory actions may significantly restrict the ability of the Company and the Bank to take operating and strategic actions that may be in the best interests of stockholders or compel the Company and the Bank to take operating and strategic actions that are not potentially in the best interests of stockholders.

Management believes that, as of June 30, 2012, the Bank's capital ratios were in excess of those quantitative capital ratio standards set forth under the prompt corrective action regulations described above. The failure of the Bank to satisfy the IMCR at any time does not by itself affect the Bank's status as well-capitalized within the meaning of these prompt corrective action regulations. However, there can be no assurance that the Bank will continue to maintain such status in the future. The OCC has extensive discretion in its supervisory and enforcement activities, and can adjust the requirement to be well-capitalized in the future.

In order to improve its capital ratios and maintain compliance with its IMCR, the Bank is, among other things, working to improve its financial results, reduce non-performing assets, and decrease the asset size of the Bank. In March 2012, the Bank also sold substantially all of the assets and liabilities associated with its Toledo, Iowa branch. If capital conditions were to deteriorate, the Bank may also determine it to be necessary or prudent to dispose of other non-strategic assets. These actions may result in changes in the Bank's assets, liabilities and earnings, some of which may be material, during the period in which the action is taken or is consummated or over a longer period of time. Further, the Company may need, or be required by supervising banking regulators, to raise additional capital of which there can be no assurance that, if raised, it would be on terms favorable to the Company. If the Company raises capital through the issuance of additional shares of common stock or other equity securities, it would dilute the ownership interests of existing stockholders and, given our current common stock trading price, would be expected to dilute the per share book value of the Company's common stock and could result in a change of control of the Company and the Bank.

(14) Commitments and Contingencies

The Bank issued standby letters of credit which guarantee the performance of customers to third parties. The standby letters of credit issued and available at June 30, 2012 were approximately \$1.5 million, expire over the next two years, and are collateralized primarily with commercial real estate mortgages. Since the conditions under which the Bank is required to fund the standby letters of credit may not materialize, the cash requirements are expected to be less than the total outstanding commitments.

Table of Contents**(15) Business Segments**

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

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

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

<i>(Dollars in thousands)</i>	Home Federal Savings Bank	Other	Eliminations	Consolidated Total
At or for the six months ended June 30, 2012:				
Interest income - external customers	\$ 16,227	0	0	16,227
Non-interest income - external customers	4,500	0	0	4,500
Intersegment interest income	0	2	(2)	0
Intersegment non-interest income	93	3,582	(3,675)	0
Interest expense	3,969	0	(2)	3,967
Amortization of mortgage servicing rights, net	348	0	0	348
Other non-interest expense	11,957	389	(93)	12,253
Net income	3,586	3,195	(3,582)	3,199
Total assets	670,229	62,033	(61,948)	670,314
At or for the six months ended June 30, 2011:				
Interest income - external customers	\$ 20,759	0	0	20,759
Non-interest income - external customers	3,380	0	0	3,380
Intersegment interest income	0	2	(2)	0
Intersegment non-interest income	87	(1,292)	1,205	0
Interest expense	6,317	0	(2)	6,315
Amortization of mortgage servicing rights, net	213	0	0	213
Other non-interest expense	13,564	589	(87)	14,066
Net loss	(1,288)	(1,878)	1,292	(1,874)
Total assets	807,307	68,934	(68,867)	807,374
At or for the quarter ended June 30, 2012:				
Interest income - external customers	\$ 7,952	0	0	7,952
Non-interest income - external customers	1,794	0	0	1,794
Intersegment interest income	0	1	(1)	0
Intersegment non-interest income	46	558	(604)	0
Interest expense	1,906	0	(1)	1,905
Amortization of mortgage servicing rights, net	172	0	0	172
Other non-interest expense	6,066	166	(46)	6,186
Net income	560	393	(558)	395
Total assets	670,229	62,033	(61,948)	670,314
At or for the quarter ended June 30, 2011:				
Interest income - external customers	\$ 10,045	0	0	10,045
Non-interest income - external customers	1,592	0	0	1,592
Intersegment interest income	0	1	(1)	0
Intersegment non-interest income	44	(1,980)	1,936	0
Interest expense	3,047	0	(1)	3,046
Amortization of mortgage servicing rights, net	115	0	0	115

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Other non-interest expense	7,103	315	(44)	7,374
Net loss	(1,978)	(2,293)	1,980	(2,291)
Total assets	807,307	68,934	(68,867)	807,374

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Item 2:

HMN FINANCIAL, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS

OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-looking Information

This quarterly report and other reports filed by the Company with the Securities and Exchange Commission may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are often identified by such forward-looking terminology as expect, intent, look, believe, anticipate, estimate, project, seek, may, will, would, could, and goal or similar statements or variations of such terms and include, but are not limited to, those relating to increasing our core deposit relationships, reducing non-performing assets, reducing expense and generating improved financial results; the adequacy and amount of available liquidity and capital resources to the Bank; the Company's liquidity and capital requirements; our expectations for core capital and our strategies and potential strategies for improvement thereof; changes in the size of the Bank's loan portfolio; the recovery of the valuation allowance on deferred tax assets; the amount and mix of the Bank's non-performing assets and the appropriateness of the allowance therefor; future losses on non-performing assets; the amount of interest-earning assets; the amount and mix of brokered and other deposits (including the Company's ability to renew brokered deposits); the availability of alternate funding sources; the payment of dividends; the future outlook for the Company; the amount of deposits that will be withdrawn from checking and money market accounts and how the withdrawn deposits will be replaced; the projected changes in net interest income based on rate shocks; the range that interest rates may fluctuate over the next twelve months; the net market risk of interest rate shocks; the future outlook for the issuer trust preferred securities held by the Bank; and the Bank's compliance with regulatory standards generally (including the Bank's status as well-capitalized), and supervisory agreements, individual minimum capital requirements or other supervisory directives or requirements to which the Company or the Bank are or may become expressly subject, specifically, and possible responses of the OCC and FRB and the Bank and the Company to any failure to comply with any such regulatory standard, agreement or requirement. A number of factors could cause actual results to differ materially from the Company's assumptions and expectations. These include but are not limited to the adequacy and marketability of real estate and other collateral securing loans to borrowers; federal and state regulation and enforcement, including restrictions set forth in the supervisory agreements between each of the Company and Bank and the OCC and FRB; possible legislative and regulatory changes, including changes in the degree and manner of regulatory supervision, the ability of the Company and the Bank to establish and adhere to plans and policies relating to, among other things, capital, business, non-performing assets, loan modifications, documentation of loan loss allowance and concentrations of credit that are satisfactory to the OCC and FRB, as applicable, in accordance with the terms of the Company and Bank supervisory agreements and to otherwise manage the operations of the Company and the Bank to ensure compliance with other requirements set forth in the supervisory agreements; the ability of the Company and the Bank to obtain required consents from the OCC and FRB, as applicable, under the supervisory agreements or other directives; the ability of the Bank to comply with its individual minimum capital requirement and other applicable regulatory capital requirements; enforcement activity of the OCC and FRB in the event of our non-compliance with any applicable regulatory standard, agreement or requirement; adverse economic, business and competitive developments such as shrinking interest margins, reduced collateral values, deposit outflows, changes in credit or other risks posed by the Company's loan and investment portfolios, changes in costs associated with alternate funding sources, including changes in collateral advance rates and policies of the Federal Home Loan Bank, technological, computer-related or operational difficulties, results of litigation, and reduced demand for financial services and loan products; changes in accounting policies and guidelines, or monetary and fiscal policies of the federal government or tax laws; international economic developments; the Company's access to and adverse changes in securities markets; the market for credit related assets; 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 filing on Form 10-K 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, 2011 and Part II, Item 1A of this and previously filed Quarterly Reports on Form 10-Q.

Table of Contents***General***

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

Beginning with the Company's 2008 fiscal year, the Company's commercial business and commercial real estate loan portfolios have required significant allowances and charge offs due primarily to decreases in the estimated value of the underlying collateral supporting the loans, as many of these loans were made to borrowers in or associated with the real estate industry. The decrease in the estimated collateral value is primarily the result of reduced demand for real estate, particularly as it relates to single-family and commercial land developments. More stringent lending standards implemented by the mortgage industry in recent years have made it more difficult for some borrowers with marginal credit to qualify for a mortgage. This decrease in available credit and the overall weakness in the economy over the past several years reduced the demand for single family homes and the values of existing properties and developments where the Company's commercial loan portfolio has concentrations. Consequently, our level of non-performing assets and the related provision for loan losses increased significantly in the past several years, relative to periods before 2008. The increased levels of non-performing assets, related provisions for loan losses and write offs of or allowances against goodwill and deferred taxes arising from adverse results of operations, were the primary reasons for the net losses incurred by the Company in each of the years 2008 through 2011.

Critical Accounting Estimates

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

Allowance for Loan Losses and Related Provision

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

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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 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. 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. The methodology for establishing the allowance for loan losses takes into consideration probable losses that have been identified in connection with specific loans as well as probable losses in the loan portfolio for which additional specific reserves are not required. Although management believes that based on current conditions the allowance for loan losses is maintained at an appropriate amount to provide for probable loan losses inherent in the portfolio as of the balance sheet date, future conditions may differ substantially from those anticipated in determining the allowance for loan losses and adjustments may be required in the future.

Income Taxes

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

The Company maintains significant net deferred tax assets for deductible temporary differences, the largest of which relates to the allowance for loan and real estate losses and net operating loss carry forwards. For income tax purposes, only net charge-offs are deductible, not the entire provision for loan losses. Under 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 ability to implement tax planning strategies to accelerate taxable income recognition and the probability that taxable income will be generated in future periods. Negative evidence includes the Company's cumulative loss in the prior three year period, current financial performance, and the general business and economic trends. In the second quarter of 2010, the Company recorded a valuation allowance against the entire deferred tax asset balance and the Company continued to maintain a valuation reserve against the entire deferred tax asset balance at June 30, 2012. This determination was based primarily upon the existence of a three year cumulative loss position that is primarily attributable to significant provisions for loan losses incurred during the last three years. The creation of the valuation allowance, although it increased tax expense and similarly reduced tangible book value, does not have an effect on the Company's cash flows, and may be recoverable in subsequent periods if the Company were to realize certain sustained future taxable income. It is possible that future conditions may differ substantially from those anticipated in determining the need for a valuation allowance 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.

Table of Contents**RESULTS OF OPERATIONS FOR THE THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2012 COMPARED TO THE SAME PERIODS ENDED JUNE 30, 2011*****Net Income (Loss)***

Net income for the second quarter of 2012 was \$0.4 million, an improvement of \$2.7 million, or 117.2%, compared to a net loss of \$2.3 million for the second quarter of 2011. The net loss available to common shareholders was \$69,000 for the second quarter of 2012, an improvement of \$2.7 million, or 97.5%, from the net loss available to common shareholders of \$2.8 million for the second quarter of 2011. Diluted loss per common share for the second quarter of 2012 was \$0.02, an improvement of \$0.70, or 97.2%, from the diluted loss per common share of \$0.72 for the second quarter of 2011. The improvement in net income in the second quarter of 2012 was primarily due to a \$2.4 million decrease in the provision for loan losses and a \$1.1 million decrease in non-interest expenses between the periods. These changes to net income were partially offset by a \$1.0 million decrease in net interest income due primarily to the decrease in interest earning assets between the periods.

Net income was \$3.2 million for the six month period ended June 30, 2012, an improvement of \$5.1 million, or 270.7%, compared to the net loss of \$1.9 million for the six month period ended June 30, 2011. The net income available to common shareholders was \$2.3 million for the six month period ended June 30, 2012, an improvement of \$5.1 million, or 181.8%, compared to the net loss available to common shareholders of \$2.8 million for the same period of 2011. Diluted earnings per share for the six month period in 2012 was \$0.57, an improvement of \$1.30 per share compared to the diluted loss per share of \$0.73 for the same period in 2011. The improvement in net income for the six month period in 2012 was primarily due to a \$4.4 million decrease in the provision for loan losses, \$1.7 million decrease in non-interest expenses, \$0.7 million increase in the gains recognized on the sales of loans, and a \$0.6 million gain on sale of the Bank's Toledo, Iowa branch. These changes to net income were partially offset by a \$2.1 million decrease in net interest income due primarily to the decrease in interest earning assets between the periods.

Net Interest Income

Net interest income was \$6.0 million for the second quarter of 2012, a decrease of \$1.0 million, or 13.6%, compared to \$7.0 million for the second quarter of 2011. Interest income was \$8.0 million for the second quarter of 2012, a decrease of \$2.0 million, or 20.8%, from \$10.0 million for the same period in 2011. Interest income decreased between the periods primarily because of a \$152 million decrease in the average interest-earning assets and also because of a decrease in average yields between the periods. Average interest earning assets decreased between the periods primarily because of a decrease in the commercial loan portfolio, which occurred because of declining loan demand and the Company's focus on improving credit quality, managing net interest margin and improving capital ratios. The average yield earned on interest-earning assets was 4.90% for the second quarter of 2012, a decrease of 10 basis points from the 5.00% average yield for the second quarter of 2011. The decrease in average yield is due to the continued low interest rate environment that existed during the second quarter of 2012.

Interest expense was \$1.9 million for the second quarter of 2012, a decrease of \$1.1 million, or 37.5%, compared to \$3.0 million for the second quarter of 2011. Interest expense decreased primarily because of the \$157 million decrease in the average interest-bearing liabilities between the periods. The decrease in average interest-bearing liabilities is primarily the result of a decrease in the outstanding borrowings and brokered certificates of deposits between the periods and a decrease in other deposits as a result of the Bank's Toledo, Iowa branch sale that was completed in the first quarter of 2012. The decrease in borrowings and brokered deposits between the periods was the result of using the proceeds from loan principal payments to fund maturing borrowings and brokered certificates of deposits. Interest expense also decreased because of the lower interest rates paid on money market accounts and certificates of deposits. The decreased rates were the result of the low interest rate environment that continued to exist during the second quarter of 2012. The average interest rate paid on interest-bearing liabilities was 1.24% for the second quarter of 2012, a decrease of 34 basis points from the 1.58% average interest rate paid in the second quarter of 2011.

Net interest margin (net interest income divided by average interest earning assets) for the second quarter of 2012 was 3.72%, an increase of 24 basis points, compared to 3.48% for the second quarter of 2011.

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Net interest income was \$12.3 million for the first six months of 2012, a decrease of \$2.1 million, or 15.1%, from \$14.4 million for the same period in 2011. Interest income was \$16.2 million for the six month period ended June 30, 2012, a decrease of \$4.6 million, or 21.8%, from \$20.8 million for the same six month period in 2011. Interest income decreased between the periods primarily because of a \$139 million decrease in the average interest-earning assets and also because of a decrease in average yields between the periods. Average interest-earning assets decreased between the periods primarily because of a decrease in the commercial loan portfolio, which occurred because of declining loan demand and the Company's focus on improving credit quality, managing net interest margin and improving capital ratios. The average yield earned on interest-earning assets was 4.79% for the first six months of 2012, a decrease of 32 basis points