HMN FINANCIAL INC
Form 10-K
March 02, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K

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

For the fiscal year ended December 31, 2006

OR

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

For the transition period from ______ to ______.

Commission file number: 0-24100.

HMN FINANCIAL, INC.

(Exact Name of Registrant as Specified in its Charter)

Delaware	**41-1777397**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
1016 Civic Center Drive Northwest, PO Box 6057	**55901**
Rochester, Minnesota	(Zip Code)
(Address of Principal Executive Offices)	

(507) 535-1200

Registrant s telephone number, including area code

Securities Registered Pursuant to Section 12(b) of the Act: Common Stock, par value $.01 per share (Title of each class)

Securities Registered Pursuant to Section 12(g) of the Act: None

Name of each exchange on which registered: NASDAQ stock exchange

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES o NO þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. YES o NO þ

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 requirements for the past 90 days. YES þ NO o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best or registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by checkmark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and Large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

As of June 30, 2006, the aggregate market value of the registrant s common stock held by non-affiliates of the registrant was $116.6 million based on the closing stock price of $34.80 on such date as reported on the NASDAQ National Market (now the NASDAQ Global Market).

As of February 12, 2007 the number of outstanding shares of common stock of the registrant was 4,319,395.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s annual report to stockholders for the year ended December 31, 2006, are incorporated by reference in Parts I, II and IV of this Form 10-K. Portions of the registrant s definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the close of the registrant s fiscal year ended December 31, 2006 are incorporated by reference in Part III of this Form 10-K.

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Forward-Looking Statements

The information presented or incorporated by reference in this Annual Report on Form 10-K under the headings Item 1. Business and Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934. Words such as anticipate , believe , expect , intend , would , could and similar expressions, as they relate to us, a intended to identify such forward-looking statements. These statements are subject to risks and uncertainties, including those discussed under Risk Factors on pages 29-31 of this Form 10-K, that could cause actual results to differ materially from those projected. Because actual results may differ, we caution you not to place undue reliance on these forward-looking statements.

PART I

ITEM 1. BUSINESS

General

HMN Financial, Inc. (HMN or the Company) is a stock savings bank holding company that owns 100 percent of Home Federal Savings Bank (the Bank). The Bank has a community banking philosophy and operates retail banking and loan production facilities in Minnesota and Iowa. The Bank has one wholly owned subsidiary, Osterud Insurance Agency, Inc. (OIA) which offers financial planning products and services. HMN has another wholly owned subsidiary, Security Finance Corporation (SFC) which acts as an intermediary for the Bank in transacting like-kind property exchanges for Bank customers. During the period for which financial information is presented in this Form 10-K, the Bank had two other subsidiaries that are no longer operating. Home Federal Holding, Inc. (HFH), a wholly owned subsidiary, was the holding company for Home Federal REIT, Inc. (HFREIT), which invested in real estate loans acquired from the Bank. HFH and HFREIT were both dissolved in 2005. Federal Title Services, LLC (FTS), which was 80% owned by the Bank, performed mortgage title services for Bank customers and was dissolved in 2004.

As a community-oriented financial institution, the Company seeks to serve the financial needs of communities in its market area. The Company s business involves attracting deposits from the general public and businesses and using such deposits to originate or purchase one-to-four family residential, commercial real estate, and multi-family mortgage loans as well as consumer, construction, and commercial business loans. The Company also invests in mortgage-backed and related securities, U.S. government agency obligations, and other permissible investments. The executive offices of the Company are located at 1016 Civic Center Drive Northwest, Rochester, Minnesota 55901. Its telephone number at that address is (507) 535-1200. The Company s website is located at www.hmnf.com. Information contained on the Company s website is expressly not incorporated by reference into this Form 10-K.

Market Area

The Company serves the southern Minnesota counties of Fillmore, Freeborn, Houston, Mower, Olmsted and Winona and portions of Steele, Dodge, Goodhue and Wabasha through its corporate office located in Rochester, Minnesota and its nine branch offices located in Albert Lea, Austin, LaCrescent, Rochester, Spring Valley and Winona, Minnesota. The portion of the Company s southern Minnesota market area consisting of Rochester and the contiguous communities is composed of primarily urban and suburban communities, while the balance of the Company s southern Minnesota market area consists primarily of rural areas and small towns. Primary industries in the Company s southern Minnesota market area include manufacturing, agriculture, health care, wholesale and retail trade, service industries and education. Major employers include IBM, Mayo Clinic and Hormel (a food processing company). The Company s market area is also the home of Winona State University, Rochester Community and Technical College, University of Minnesota Rochester Center, Winona State University Rochester Center and Austin s Riverland Community College.

The Company serves the Iowa counties of Marshall and Tama through its branch offices located in Marshalltown and Toledo. Major industries in the area are Swift & Company (pork processors), Fisher Controls International (valve and regulator manufacturing), Lennox Industries (furnace and air conditioner manufacturing), Iowa Veterans Home (hospital care), Marshall Community School District (education), Marshall Medical & Surgical Center (hospital care) and Meskwaki Casino (gaming operations).

Based upon information obtained from the U.S. Census Bureau for 2005 (the last year for which information is available), the population of the six primary counties in the Bank s southern Minnesota market area was estimated as follows: Fillmore 21,368; Freeborn 31,946; Houston - 19,941; Mower 38,799; Olmsted 135,189; and Winona 49,276. The median household income for these six counties ranged from $38,291 to $56,721. With respect to Iowa, the population of Marshall County was 39,418 and the population of Tama County was 17,919. The median household income of these two counties ranged from $38,939 to $39,887.

The Company also serves a diverse high net worth customer base primarily in the seven county metropolitan area of Minneapolis and St. Paul from Eagle Crest Capital Bank, a division of the Bank, located in Edina, Minnesota.

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The Company serves a similar group of individuals and businesses in Olmsted county from its Eagle Crest Capital Bank locations in Rochester, Minnesota.

Lending Activities

General. Historically, the Company has originated 15 and 30-year, fixed rate mortgage loans secured by one-to-four family residences for its loan portfolio. More recently, the Company has focused on managing interest rate risk and increasing interest income by increasing its investment in shorter term and generally higher yielding commercial real estate, commercial business, consumer, and construction loans and reducing its investment in longer term one-to-four family real estate loans. The Company continues to originate 15 and 30 year fixed rate mortgage loans, including growing equity mortgage (GEM) loans that have a fixed rate, but payments that increase after the first year, and adjustable rate mortgage loans that are fixed for an initial period of one, three or five years and some shorter term fixed rate loans that have certain characteristics. The shorter term fixed and adjustable rate loans are placed into portfolio. The majority of the 15 and 30-year fixed rate mortgage loans are sold in the secondary mortgage market. In 2006 a larger percentage of 15 and 30 year loans were placed into portfolio in order to maintain the single family portfolio and to offset the decline in outstanding commercial loan balances. The Company also offers an array of consumer loan products that include both open lines and closed end home equity loans. The home equity line of credit has an adjustable interest rate based upon the prime rate as published in the Wall Street Journal plus a margin. Refer to Note 4 of the Notes to Consolidated Financial Statements in the Annual Report for more information on the loan portfolio (incorporated by reference in Item 8. of Part II of this Form 10-K).

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The following table shows the composition of the Company s loan portfolio by fixed and adjustable rate loans as of December 31:

	2006		2005		2004		2003		2002	
(Dollars in thousands)	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Fixed rate Loans										
Real Estate:										
One-to-four family										
GEM	$ 13,335	1.70%	$ 14,812	1.84%	$ 16,133	2.01%	$ 13,387	1.89%	$ 17,394	3.18%
Other	62,184	7.92	55,700	6.94	59,937	7.48	65,004	9.17	74,510	13.63
Total one-to-four family	75,519	9.62	70,512	8.78	76,070	9.49	78,391	11.06	91,904	16.81
Multi-family	6,193	0.79	5,956	0.74	6,387	0.79	6,471	0.91	6,588	1.20
GEM multi-family	45	0.01	51	0.01	57	0.01	61	0.01	64	0.01
Commercial	100,562	12.80	89,905	11.19	51,390	6.41	52,563	7.42	37,878	6.93
Construction or development	6,640	0.84	12,919	1.61	27,557	3.44	17,215	2.43	17,234	3.15
Total fixed rate real estate loans	188,959	24.06	179,343	22.33	161,461	20.14	154,701	21.83	153,668	28.10
Consumer loans:										
Savings	814	0.10	605	0.07	454	0.06	494	0.07	534	0.10
Automobile	3,093	0.39	5,462	0.68	9,496	1.18	14,754	2.08	11,062	2.02
Home equity	21,181	2.70	19,289	2.40	20,019	2.50	18,742	2.65	21,049	3.85
Mobile home	2,052	0.26	2,299	0.29	2,896	0.36	3,665	0.52	4,534	0.83
Land/Lot Loans	1,426	0.18	1,234	0.15	818	0.10	754	0.11	781	0.15
Other	2,192	0.28	2,569	0.32	3,134	0.39	3,105	0.43	3,299	0.60
Total consumer loans	30,758	3.91	31,458	3.91	36,817	4.59	41,514	5.86	41,259	7.55
Commercial business loans	65,347	8.32	49,297	6.14	69,671	8.69	51,609	7.28	42,272	7.73
Total other loans	96,105	12.23	80,755	10.05	106,488	13.28	93,123	13.14	83,531	15.28
Total fixed rate loans	285,064	36.29	260,098	32.38	267,949	33.42	247,824	34.97	237,199	43.38
Adjustable rate Loans										
Real estate:										
One-to-four family	58,751	7.48	56,563	7.04	62,938	7.85	65,924	9.30	59,662	10.91
Multi-family	23,624	3.01	34,745	4.33	35,478	4.43	25,008	3.53	9,113	1.67
Commercial	193,928	24.69	170,363	21.21	173,554	21.65	146,603	20.69	92,539	16.92
Construction or development	53,538	6.82	67,424	8.39	70,841	8.84	78,131	11.02	44,102	8.07
Total adjustable rate real estate loans	329,841	42.00	329,095	40.97	342,811	42.77	315,666	44.54	205,416	37.57

Consumer (home equity and other)	54,328	6.91	60,853	7.57	67,154	8.38	54,425	7.68	52,131	9.53
Land/Lot loans	4,076	0.52	8,197	1.02	10,754	1.34	9,732	1.38	2,809	0.52
Other	686	0.09	390	0.05	248	0.03	234	0.03	222	0.04
Total consumer loans	59,090	7.52	69,440	8.64	78,156	9.75	64,391	9.09	55,162	10.09
Commercial business loans	111,423	14.19	144,665	18.01	112,698	14.06	80,808	11.40	48,989	8.96
Total other loans	170,513	21.71	214,105	26.65	190,854	23.81	145,199	20.49	104,151	19.05
Total adjustable rate loans	500,354	63.71	543,200	67.62	533,665	66.58	460,865	65.03	309,567	56.62
Total loans	785,418	100.00%	803,298	100.00%	801,614	100.00%	708,689	100.00%	546,766	100.00%
Less										
Loans in process	5,252		7,008		7,561		11,298		6,826	
Unamortized discounts	40		190		63		166		142	
Net deferred loan fees	2,021		1,644		1,781		1,334		1,068	
Allowance for losses on loans	9,873		8,778		8,996		6,940		4,824	
Total loans receivable, net	$ 768,232		$ 785,678		$ 783,213		$ 688,951		$ 533,906	

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The following table illustrates the interest rate maturities of the Company s loan portfolio at December 31, 2006. Loans which have adjustable or renegotiable interest rates are shown as maturing in the period during which the contract is due. Scheduled repayments of principal are reflected in the year in which they are scheduled to be paid. The schedule does not reflect the effects of possible prepayments or enforcement of due-on-sale clauses.

	One-to-four family		Real Estate Multi-family and Commercial		Construction		Consumer		Commercial Business		Total	
e During Years ding December 31,	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weight Averag Rate
07 (1)	$ 6,747	6.13%	$ 69,478	8.64%	$ 39,682	8.95%	$ 14,394	9.19%	$ 95,587	8.34%	$ 225,888	8.5
08	6,782	6.33	65,870	8.16	612	7.25	10,575	8.55	26,591	8.16	110,430	8.0
09	5,744	5.76	37,402	7.93	439	6.31	9,408	8.72	20,653	7.99	73,646	7.8
10 through 2011	12,344	5.75	42,837	7.62	1,207	6.93	18,595	8.98	20,307	8.32	95,290	7.7
12 through 2016	29,318	5.88	66,798	7.42	10,060	8.32	28,769	9.22	11,194	7.33	146,139	7.5
17 through 2031	57,392	5.97	41,967	7.35	6,749	6.36	8,100	8.67	2,405	6.74	116,613	6.6
32 and following	15,943	5.96	0	0.00	1,429	5.92	7	3.64	33	8.00	17,412	5.9
	$ 134,270		$ 324,352		$ 60,178		$ 89,848		$ 176,770		$ 785,418	

(1) Includes demand loans, loans having no stated maturity, overdraft loans and education loans.

The total amount of loans due after December 31, 2007 that have predetermined interest rates is $210.5 million, while the total amount of loans due after such date that have floating or adjustable interest rates is $349 million. Construction or development loans were $36.1 million for one to four family dwellings, $4.5 million for multifamily and $19.6 million for nonresidential.

Under the Financial Institutions Reform, Recovery and Enforcement Act of 1989, the aggregate amount of loans that the Bank is permitted to make to any one borrower is generally limited to 15% of unimpaired capital and surplus (25% if the security for such loan has a readily ascertainable value or 30% for certain residential development loans). At December 31, 2006, based upon the 15% limitation, the Bank s regulatory limit for loans to one borrower was approximately $13.7 million. At December 31, 2006, the dollar amount of outstanding loans to three different groups of related borrowers exceeded this amount, but some of the loans included in these loan totals were exempt from the lending limit under the direct benefit and common enterprise rules of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, as a portion of these loans did not benefit the same individual borrowers. The largest of these borrowing relationships is secured by a manufacturing facility, commercial real estate and equipment and was performing in accordance with its terms at December 31, 2006. The total loans outstanding to this borrower at December 31, 2006 were $16.7 million. The amount outstanding, excluding those loans that were exempt from the loans to one borrower limits because of the direct benefit and common enterprise rules was $12.4 million.

All of the Bank s lending is subject to its written underwriting standards and to loan origination procedures. Decisions on loan applications are made on the basis of detailed applications and property valuations determined by an independent appraiser. The loan applications are designed primarily to determine the borrower s ability to repay. The more significant items on the application are verified through the use of credit reports, financial statements, tax returns or confirmations. The Bank also offers the Home Credit Plus Program which relies on the credit score of the loan applicant instead of income, asset and employment verification procedures. The Bank also offers other loan programs with low or alternative documentation underwriting procedures that conform to Federal National Mortgage Association (FNMA) underwriting guidelines.

The Bank s Mortgage and Consumer Loan Committee is responsible for reviewing and approving all loans over the Federal Home Loan Mortgage Corporation/FNMA conforming loan dollar limit originated by the Bank that are not sold in the secondary loan market. This limit was $417,000 for 2006 and $359,650 for 2005. Approval of at least one member of the Mortgage and Consumer Loan Committee was obtained on all loans above this limit.

The Bank s Commercial Loan Committee is responsible for reviewing and approving individual commercial loans or loans to borrowers with aggregate lending relationships ranging from $1.0 million to $7.5 million. The Bank s individual commercial loan officers have the authority to approve loans that meet the guidelines established by the Bank s commercial loan policy for loans up to $250,000, subject to specific loan officer authority limits. The Bank s Commercial Loan Officers Committee has the authority to approve loans that meet the commercial loan policy guidelines that are less than $1.0 million. Individual loans of $7.5 million or more, and loans to borrowers with aggregate lending relationships that exceed that amount, must be approved by the Company s Board of Directors or its Executive Commercial Loan Committee.

The Bank generally requires title insurance on its mortgage loans as well as fire and extended coverage casualty insurance in amounts at least equal to the principal amount of the loan or the value of improvements on the property. The Bank also requires flood insurance to protect the property securing its interest when the property is located in a flood plain.

One-to-Four Family Residential Real Estate Lending. At December 31, 2006 the Company s one-to-four family real estate loans, consisting of both fixed rate and adjustable rate loans, totaled $134.3 million, an increase of $7.2 million, from $127.1 million at December 31, 2005. The increase in the one-to-four family loans in 2006 is the result of placing more loans into the portfolio in order to offset the decline that was experienced in the commercial loan portfolio. The Company s long term strategy is to maintain the single family loan portfolio and to increase the amount of shorter term commercial real estate and commercial business loan portfolios.

The Company offers conventional fixed rate one-to-four family loans that have maximum terms of 30 years. In order to manage interest rate risk, the Company typically sells the majority of fixed rate loan originations or refinances with terms to maturity of 15 years or greater that are eligible for sale in the secondary market. The interest rates charged on the fixed rate loan products are based on the FNMA delivery rates, as well as other competitive factors. The Company also originates a limited number of fixed rate loans with terms up to 30 years that are insured by the Federal Housing Authority, Veterans Administration, Minnesota Housing Finance Agency or Iowa Finance Authority.

The Company also offers one-year adjustable rate mortgages (ARMs) at a margin (generally 275 to 375 basis points) over the yield on the Average Monthly One Year U.S. Treasury Constant Maturity Index for terms of up to 30 years. The ARM loans offered by the Company allow the borrower to select (subject to pricing) an initial period of one year, three years, or five years between the loan origination and the date the first interest rate change occurs. The ARMs generally have a 200 basis point annual interest rate change cap and a lifetime cap of 600 basis points over or under the initial rate. Initial interest rates offered on the ARM loans during 2006 ranged from 100 basis points below the fully indexed loan rate to 100 basis points over that rate. All borrowers are qualified for the loan at the fully indexed rate. The Company s originated ARMs do not permit negative amortization of principal, generally do not contain prepayment penalties and are not convertible into fixed rate loans.

In underwriting one-to-four family residential real estate loans, the Company evaluates the borrower s credit history; ability to make principal, interest and escrow payments; the value of the property that will secure the loan; and debt to income ratios. Properties securing one-to-four family residential real estate loans made by the Company are appraised by independent fee appraisers. The Company originates residential mortgage loans with loan-to-value ratios up to 100% for owner-occupied homes and up to 90% for non-owner occupied homes; however, private mortgage insurance is generally required to reduce the Company s exposure to 80% of value or less on most loans. The Company generally seeks to underwrite its loans in accordance with secondary market standards.

The Company s residential mortgage loans customarily include due-on-sale clauses giving it the right to declare the loan immediately due and payable in the event that, among other things, the borrower sells or otherwise disposes of the property subject to the mortgage.

Fixed rate loans in the Company s portfolio include both GEM loans and conventional fixed rate loans. The GEM loans require payments that increase after the first year. Under the GEM loans, the monthly payments required for the first year are established based on a 30-year amortization schedule. Depending upon the program selected, the payments may increase in the succeeding years by amounts ranging from 0% to 6.2%. Most of the GEM loans originated by the Company provide for at least four annual payment increases over the first five years of the loan. The increased payments required under GEM loans are applied to principal and have the effect of shortening the term to maturity; the GEM loans do not permit negative amortization. The Company currently offers one GEM product with a contractual maturity of approximately 15 years. The GEMs are generally priced based upon loans with similar contractual maturities. The GEMs are popular with consumers who anticipate future increases in income and who desire an amortization schedule of less than 30 years. Low mortgage interest rates over the past several years have decreased the demand for GEM loans as consumers have opted for shorter term fixed rate loans.

Commercial Real Estate and Multi-Family Lending. The Company originates permanent commercial real estate and multi-family loans secured by properties located primarily in its market area. It also purchases participations in commercial real estate and multi-family loans originated by third parties on properties outside of its market area. The commercial real estate and multi-family loan portfolio includes loans secured by motels, hotels, apartment buildings, churches, ethanol plants, manufacturing plants, office buildings, business facilities, shopping malls, nursing homes, golf courses, entertainment facilities, warehouses and other non-residential building properties primarily located in the upper Midwest part of the United States.

Permanent commercial real estate and multi-family loans are generally originated for a maximum term of 10 years and may have longer amortization periods with balloon maturity features. The interest rates may be fixed for the term of the loan or have adjustable features that are tied to the prime rate or a published index. Commercial real estate and multi-family loans are generally written in amounts up to 80% of the lesser of the appraised value of the property or the purchase price and generally have a debt service coverage ratio of at least 120%. The debt service coverage ratio is the ratio of net cash from operations to debt service payments. The Company may

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originate construction loans secured by commercial or multi-family real estate, or may purchase participation interests in third party originated construction loans secured by commercial or multi-family real estate.

Appraisals on commercial real estate and multi-family real estate properties are performed by independent appraisers prior to the time the loan is made. For transactions less than $250,000, the Company may use an internal valuation. All appraisals on commercial and multi-family real estate are reviewed and approved by a commercial loan officer, credit manager, commercial department manager, or a qualified third party. The Bank s underwriting procedures require verification of the borrower s credit history, income and financial statements, banking relationships and income projections for the property. All commercial real estate and multi-family loans over $1.0 million must be approved by a majority of the Commercial Loan Committee prior to closing. The commercial loan policy generally requires personal guarantees from the proposed borrowers. An initial on-site inspection is generally required for all collateral properties for loans with balances in excess of $250,000. Independent annual reviews are performed for aggregate commercial lending relationships that exceed $500,000. The reviews cover financial performance, documentation completeness and accuracy of loan risk ratings.

At December 31, 2006, the Company s two largest commercial real estate loans totaled $11.6 million and $11.7 million. These loans are secured by a golf course housing development in southeastern Minnesota and a commercial land development in the Minneapolis/St. Paul metro area. Both loans were performing at December 31, 2006.

Multi-family and commercial real estate loans generally present a higher level of risk than loans secured by one-to-four family residences. This greater risk is due to several factors, including the concentration of principal in a limited number of loans and borrowers, the effects of general economic conditions on income producing properties and the increased difficulty of evaluating and monitoring these types of loans. Furthermore, the repayment of loans secured by multi-family and commercial real estate is typically dependent upon the successful operation of the related real estate project. If the cash flow from the project is reduced (for example, if leases are not obtained or renewed), the borrower s ability to repay the loan may be impaired. At December 31, 2006, $5.3 million of loans in the commercial real estate portfolio were nonperforming, with the largest relationship being $4.2 million in related loans that were secured by a golf course development that was sold in 2006 after being partially charged off. The guaranteed portion of these notes was nonperforming at December 31, 2006. There can be no assurance that the amount of nonperforming loans will not increase in the future.

Construction Lending. The Company makes construction loans to individuals for the construction of their residences and to builders for the construction of one-to-four family residences. It also makes some loans to builders for houses built on speculation. Construction loans also include commercial real estate loans.

Almost all loans to individuals for the construction of their residences are structured as permanent loans. Such loans are made on the same terms as residential loans, except that during the construction phase, which typically lasts up to nine months, the borrower pays interest only. Generally, the borrower also pays a construction fee at the time of origination equal to the origination fee plus other costs associated with processing the loan. Residential construction loans are underwritten pursuant to the same guidelines used for originating residential loans on existing properties. Construction loans to builders or developers of one-to-four family residences generally carry terms of one year or less and may permit the payment of interest from loan proceeds.

Construction loans to owner occupants are generally made in amounts up to 95% of the lesser of cost or appraised value, but no more than 85% of the loan proceeds can be disbursed until the building is completed. The Company generally limits the loan-to-value ratios on loans to builders to 80%. Prior to making a commitment to fund a construction loan, the Company requires a valuation of the property, financial data, and verification of the borrower s income. The Company obtains personal guarantees for substantially all of its construction loans to builders. Personal financial statements of guarantors are also obtained as part of the loan underwriting process. Construction loans are generally located in the Company s market area.

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Construction loans are obtained principally through continued business from builders and developers who have previously borrowed from the Bank, as well as referrals from existing customers and walk-in customers. The application process includes a submission to the Bank of accurate plans, specifications and costs of the project to be constructed. These items are used as a basis to determine the appraised value of the subject property to be built.

At December 31, 2006 construction loans totaled $60.2 million, of which one-to-four family residential totaled $36.1 million, multi-family residential totaled $4.5 million and commercial real estate totaled $19.6 million.

The nature of construction loans makes them more difficult to evaluate and monitor. The risk of loss on a construction loan is dependent largely upon the accuracy of the initial estimate of the property s value upon completion of the project, experience of the builder, and the estimated cost (including interest) of the project. If the estimate of value proves to be inaccurate, the Company may be confronted, at or prior to the maturity of the loan, with a project having a value that is insufficient to assure full repayment and/or the possibility of having to make substantial investments to complete and sell the project. Because defaults in repayment may not occur during the construction period, it may be difficult to identify problem loans at an early stage. In these cases, the Company may be required to modify the terms of the loan.

Consumer Lending. The Company originates a variety of consumer loans, including home equity loans (open-end and closed-end), automobile, home improvement, mobile home, lot loans, loans secured by deposit accounts and other loans for household and personal purposes.

Consumer loan terms vary according to the type and value of collateral, length of contract and creditworthiness of the borrower. The Company s consumer loans are made at fixed or adjustable interest rates, with terms up to 20 years for secured loans and up to three years for unsecured loans.

The Company s home equity loans are written so that the total commitment amount, when combined with the balance of any other outstanding mortgage liens, may not exceed 100% of the appraised value of the property. The closed-end home equity loans are written with fixed or adjustable rates with terms up to 15 years. The open-end home equity lines are written with an adjustable rate with a 10 year draw period that requires interest only payments followed by a 10-year repayment period that fully amortizes the outstanding balance. The consumer may access the open-end home equity line either by making a withdrawal at the Bank or writing a check on the home equity line of credit account. Open and closed-end equity loans, which are generally secured by second mortgages on the borrower s principal residence, represented 84.0% of the consumer loan portfolio at December 31, 2006.

The underwriting standards employed by the Bank for consumer loans include a determination of the applicant s payment history on other debts and ability to meet existing obligations and payments on the proposed loan. Although creditworthiness of the applicant is of primary consideration, the underwriting process also includes a comparison of the value of the security, if any, in relation to the proposed loan amount. Consumer loans may entail greater credit risk than do residential mortgage loans, particularly in the case of consumer loans that are unsecured or are secured by rapidly depreciable assets, such as automobiles or mobile homes. In these cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. In addition, consumer loan collections are dependent on the borrower s continuing financial stability, and thus are more likely to be affected by adverse personal circumstances. Furthermore, the application of various Federal and state laws, including bankruptcy and insolvency laws, may limit the amount that can be recovered on such loans. At December 31, 2006, $1.3 million of the consumer loan portfolio was non-performing. There can be no assurance that the amount of nonperforming loans will not increase in the future.

Commercial Business Lending. In order to satisfy the demand for financial services to individuals and businesses in its market area, the Company maintains a portfolio of commercial business loans primarily to retail, manufacturing operations and professional firms. The Company s commercial business loans generally have terms ranging from six months to five years and may have either fixed or variable interest rates. The Company s commercial business loans generally include personal guarantees and are usually, but not always, secured by business assets such as inventory, equipment, leasehold interests in equipment, fixtures, real estate and accounts receivable. The underwriting process for commercial business loans includes consideration of the borrower s financial statements, tax returns, projections of future business operations and inspection of the subject collateral, if any. The Company also purchases participation interests in commercial business loans originated outside of the Company s market area from third party originators. These loans generally have underlying collateral of inventory or equipment and repayment periods of less than ten years.

Unlike residential mortgage loans, which generally are made on the basis of the borrower s ability to make repayment from his or her income, and which are secured by real property with more easily ascertainable value, commercial business loans are of higher risk and typically are made on the basis of the borrower s ability to make repayment from the cash flow of the borrower s business. As a result, the availability of funds for the repayment of commercial business loans may be substantially dependent on the success of the business itself. Furthermore, the collateral securing the loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business. At December 31, 2006, $394,000 of loans in the commercial business loan portfolio were non-performing. There can be no assurance that the amount of nonperforming loans will not increase in the future.

Originations, Purchases and Sales of Loans and Mortgage-Backed and Related Securities

Real estate loans are generally originated by the Company s staff of salaried and commissioned loan officers. Loan applications are taken in all branch and loan production offices.

The Company originates both fixed and adjustable rate loans, however, its ability to originate loans is dependent upon the relative customer demand for loans in its markets. Demand for adjustable rate loans is affected by the interest rate environment. The Company originated for its portfolio $13.5 million of one-to-four family adjustable rate loans during 2006, an increase of $400,000, from $13.1 million in 2005, compared to $16.8 million in 2004. The Company also originated for its portfolio $14.7 million of fixed rate one-to-four family loans during 2006, an increase of $13.1 million, from $1.6 million for 2005, compared to $5.7 million for 2004.

During the past several years, the Company has focused its portfolio loan origination efforts on commercial real estate, commercial business and consumer loans because these loans have terms to maturity and adjustable interest rate characteristics that are generally more beneficial to the Company than single family fixed rate conventional loans. In 2006, more fixed rate single family loans were placed in portfolio in order to maintain the single family loan portfolio and to offset the decline in the commercial loan portfolio. The Company originated $292.0 million of multi-family and commercial real estate, commercial business and consumer loans (which excludes commercial real estate loans in construction or development) during 2006, an increase of $5.8 million, from originations of $286.2 million for 2005, compared to $204.4 million for 2004.

In order to supplement loan demand in the Company s market area and geographically diversify its loan portfolio, the Company purchases participations in real estate loans from selected sellers, with yields based upon current market rates. The Company reviews and underwrites all loans purchased to ensure that they meet the Company s underwriting standards and the seller generally continues to service the loans. The Company purchased $27.5 million of loans during 2006, a decrease of $4.8 million, from $32.3 million during 2005, compared to $91.8 million during 2004. The purchased commercial real estate and commercial business loans have terms and interest rates that are similar in nature to the Company s originated commercial and business portfolio. Refer to Note 4 of the Notes to Consolidated Financial Statements in the Annual Report for more information on purchased loans (incorporated by reference in Item 8 of Part II of this Form 10-K).

The Company has some mortgage-backed and related securities that are held, based on investment intent, in the available for sale portfolio. The Company did not purchase or sell any mortgage-backed securities during 2006, 2005 or 2004. See Investment Activities.

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The following table shows the loan and mortgage-backed and related securities origination, purchase, acquisition, sale and repayment activities of the Company for the periods indicated.

LOANS HELD FOR INVESTMENT

	Year Ended December 31,		
(Dollars in thousands)	2006	2005	2004
Originations by type:			
Adjustable rate:			
Real estate -			
- one-to-four family	$ 13,493	13,064	16,840
- multi-family	0	258	2,391
- commercial	76,797	70,742	44,046
- construction or development	159,278	45,551	84,328
Non-real estate -			
- consumer	11,607	12,964	13,822
- commercial business	94,603	91,697	50,467
Total adjustable rate	355,778	234,276	211,894
Fixed rate:			
Real estate -			
- one-to-four family	14,671	1,587	5,738
- multi-family	0	35	1,418
- commercial	31,635	41,534	17,544
- construction or development	5,691	10,144	38,731
Non-real estate -			
- consumer	23,127	27,421	28,347
- commercial business	54,261	41,535	46,414
Total fixed rate	129,385	122,256	138,192
Total loans originated	485,163	356,532	350,086
Purchases:			
Real estate -			
- one-to-four family	0	130	0
- commercial	8,874	16,823	4,125
- construction or development	9,700	11,900	56,798
Non-real estate -			
- commercial business	8,885	3,412	30,862
Total loans purchased	27,459	32,265	91,785
Sales, Participations and repayments:			
Real estate -			
- commercial	21,588	23,974	2,400

- construction or development	107,649	21,646	34,800
Non-real estate -			
- consumer	2,416	1,248	0
- commercial business	15,912	8,813	9,000
Total sales	147,565	55,681	46,200
Transfers to (from) loans held for sale	5,994	7,373	(2,437)
Principal repayments	373,953	320,869	300,407
Total reductions	527,512	383,923	344,170
Decrease in other items, net	(2,990)	(3,190)	(4,776)
Net (decrease) increase	$ (17,880)	1,684	92,925

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LOANS HELD FOR SALE

(Dollars in thousands)	Year Ended December 31, 2006	2005	2004
Originations by type:			
Adjustable rate:			
Real estate -			
- one-to-four family	$ 1,400	1,389	851
- construction or development	0	0	225
Total adjustable rate	1,400	1,389	1,076
Fixed rate:			
Real estate -			
- one-to-four family	57,277	77,924	83,469
- construction or development	1,340	1,093	2,896
Total fixed rate	58,617	79,017	86,365
Total loans originated	60,017	80,406	87,441
Sales and repayments:			
Real estate -			
- one-to-four family	65,951	89,089	88,808
Total sales	65,951	89,089	88,808
Transfers to (from) loans held for investment	(5,994)	(7,373)	2,437
Total reductions	59,957	81,716	91,245
Net (increase) decrease	$ 60	(1,310)	(3,804)

MORTGAGE-BACKED AND RELATED SECURITIES

(Dollars in thousands)	Year Ended December 31, 2006	2005	2004
Purchases:			
Mortgage-backed securities:			
CMOs and REMICs (1)	$ 0	0	0
Total purchases	0	0	0
Sales:			
Mortgage-backed securities:			
CMOs and REMICs	0	0	0

Total sales	0	0	0
Principal repayments	(702)	(2,271)	(3,898)
Net decrease	$ (702)	(2,271)	(3,898)

(1) Collateralized Mortgage Obligations and Real Estate Mortgage Investment Conduits

Classified Assets and Delinquencies

***Classification of Assets*.** Federal regulations require that each savings institution classify its assets on a regular basis. In addition, in connection with examinations of savings institutions, the Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation (FDIC) examiners may identify problem assets and, if appropriate, require them to be classified. There are three classifications for problem assets: substandard, doubtful and loss. Assets classified as substandard have one or more defined weaknesses and are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have the weaknesses of those classified as substandard, with additional characteristics that make collection or liquidation in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss. An asset classified as loss is considered uncollectible and of such little value that continuance as an asset on the balance sheet of the institution is not warranted. Assets classified as substandard or doubtful require the institution to establish prudent general allowances for loan losses. If an asset, or portion thereof, is classified as loss, the institution must either establish specific allowances for loan losses in the amount of 100% of the portion of the asset classified as loss, or charge off such amount. If an institution does not agree with an OTS or FDIC examiner s classification of an asset, it may appeal the determination to the OTS District Director or the

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appropriate FDIC personnel, depending on the regulator. On the basis of management s review of its assets, at December 31, 2006, the Bank classified a total of $15.6 million of its loans and other assets as follows:

(Dollars in thousands)	One-to-Four Family	Commercial and Multi-family	Consumer	Commercial Business	Other Assets	Total
Substandard	$ 946	11,387	142	551	1,422	14,448
Doubtful	0	0	1,112	0	44	1,156
Loss	0	0	0	0	0	0
Total	$ 946	11,387	1,254	551	1,466	15,604

The Bank s classified assets consist of non-performing loans and loans and other assets of concern discussed herein. As of the date of this report, these asset classifications are materially consistent with those of the OTS and FDIC.

Delinquency Procedures. When a borrower fails to make a required payment on a loan, the Company attempts to cure the delinquency by contacting the borrower. A late notice is sent on all loans over 16 days delinquent. Additional written and verbal contacts are made with the borrower between 30 and 60 days after the due date. If the loan is contractually delinquent 90 days, the Company sends a 30-day demand letter to the borrower and after the loan is contractually delinquent 120 days, institutes appropriate action to foreclose on the property. If foreclosed, the property is sold at a sheriff s sale and may be purchased by the Company. Delinquent consumer loans are generally handled in a similar manner. The Company s procedures for repossession and sale of consumer collateral are subject to various requirements under state consumer protection laws.

Real estate acquired by the Company as a result of foreclosure or by deed in lieu of foreclosure is classified as real estate in judgment for six to twelve months and thereafter as real estate owned until it is sold. When property is acquired or expected to be acquired by foreclosure or deed in lieu of foreclosure, it is recorded at the lower of cost or estimated fair value, less the estimated cost of disposition. After acquisition, all costs incurred in maintaining the property are expensed. Costs relating to the development and improvement of the property, however, are capitalized to the extent of fair value less disposition cost.

The following table sets forth the Company s loan delinquencies by loan type, amount and percentage of type at December 31, 2006.

	Loans Delinquent For:						Total Delinquent Loans		
	60-89 Days			90 Days and Over					
(Dollars in thousands)	Number	Amount	Percent of Loan Category	Number	Amount	Percent of Loan Category	Number	Amount	Percent of Loan Category
One-to-four family real estate	3	$ 327	0.24%	4	$ 946	0.71%	7	$ 1,273	0.95%
Nonresidential	3	1,413	0.48	1	162	0.05	4	1,575	0.53
Consumer	8	178	0.20	6	1,254	1.40	14	1,432	1.60
Total	14	$ 1,918	0.24%	11	$ 2,362	0.30%	25	$ 4,280	0.54%

Investment Activities

The Company and the Bank utilize the available for sale securities portfolio in virtually all aspects of asset/liability management. In making investment decisions, the Investment-Asset/Liability Committee considers, among other things, the yield and interest rate objectives, the credit risk position, and the Bank s liquidity and projected cash flow requirements.

Securities. Federally chartered savings institutions have the authority to invest in various types of liquid assets, including United States Treasury obligations, securities of various federal agencies, certain certificates of deposit of insured banks and savings institutions, certain bankers acceptances, repurchase agreements and federal funds.

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Subject to various restrictions, the holding company of a federally chartered savings institution may also invest its assets in commercial paper, investment grade corporate debt securities and mutual funds whose assets conform to the investments that a federally chartered savings institution is otherwise authorized to make directly.

The investment strategy of the Company and the Bank has been directed toward a mix of high-quality assets (primarily government agency obligations) with short and intermediate terms to maturity. At December 31, 2006, the Company did not own any investment securities of a single issuer that exceeded 10% of the Company s stockholder s equity other than U.S. government agency obligations.

The Bank invests a portion of its liquid assets in interest-earning overnight deposits of the Federal Home Loan Bank of Des Moines (FHLB), other banks and money market mutual funds. Other investments include high grade medium-term (up to three years) federal agency notes, and a variety of other types of mutual funds that invest in adjustable rate, mortgage-backed securities, asset-backed securities, repurchase agreements and U.S. Treasury and agency obligations. The Company invests in the same type of investment securities as the Bank and also invests in taxable and tax exempt municipal obligations and corporate equities such as preferred and common stock. Refer to Note 3 of the Notes to Consolidated Financial Statements in the Annual Report for additional information regarding the Company s securities portfolio (incorporated by reference in Item 8 of Part II of this Form 10-K).

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The following table sets forth the composition of the Company s securities portfolio, excluding mortgage-backed and related securities, at the dates indicated.

	2006				2005				2004			
	Amort Cost	Adjusted To	Market Value	% of Total	Amort Cost	Adjusted To	Market Value	% of Total	Amort Cost	Adjusted To	Market Value	% of Total
Securities available for sale:												
U.S. Government agency obligations	$ 119,240	22	119,262	74.68%	$ 110,110	(971)	109,139	71.61%	$ 91,371	(575)	90,796	77.42%
Municipal obligations	0	0	0	0.00	0	0	0	0.00	65	0	65	0.06
Corporate equity [(1)]	700	0	700	0.44	700	0	700	0.46	700	0	700	0.60
Preferred stock of federal agencies [(1)]	0	0	0	0.00	2,940	0	2,940	1.93	2,961	0	2,961	2.52
Subtotal	119,940		119,962	75.12	113,750		112,779	74.00	95,097		94,522	80.60
Federal Home Loan Bank stock	7,956		7,956	4.98	8,365		8,365	5.49	9,293		9,293	7.92
Total investment securities and Federal Home Loan Bank stock	127,896		127,918	80.10	122,115		121,144	79.49	104,390		103,815	88.52
Average remaining life of investment securities excluding Federal Home Loan Bank stock	1.1 years				0.7 years				1.5 years			
Other interest earning assets:												

Cash equivalents	31,776	31,776	19.90	31,269	31,269	20.51	13,467	13,467	11.48
Total	$ 159,672	159,694	100.00%	$ 153,384	152,413	100.00%	$ 117,857	117,282	100.00%
Average remaining life or term to repricing of investment securities and other interest earning assets, excluding Federal Home Loan Bank stock	0.8 years			0.5 years			1.3 years		

(1) Average life assigned to corporate equity holdings and preferred stock of federal agencies is five years.

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The composition and maturities of the investment securities portfolio, excluding Federal Home Loan Bank stock, mortgage-backed and related securities, are indicated in the following table.

	December 31, 2006							
(Dollars in thousands)	1 Year or Less Amortized Cost	After 1 through 5 Years Amortized Cost	After 5 through 10 Years Amortized Cost	Over 10 Years Amortized Cost	No Stated Maturity Amortized Cost	Total Securities Amortized Cost	Adjusted To	Market Value
Securities available for sale:								
U.S. government agency securities	$ 64,478	54,762	0	0	0	119,240	(22)	119,262
Corporate equity	0	0	0	0	700	700	0	700
Total stock	$ 64,478	54,762	0	0	700	119,940	(22)	119,962
Weighted average yield [1]	4.87%	5.09%	0.00%	0.00%	7.80%	4.99%		

[1] Yields are computed on a tax equivalent basis.

Mortgage-Backed and Related Securities. In order to supplement loan production and achieve its asset/liability management goals, the Company invests in mortgage-backed and related securities. All of the mortgage-backed and related securities owned by the Company are issued, insured or guaranteed either directly or indirectly by a federal agency or are rated AA or higher. The Company had $6.2 million of mortgage-backed and related securities classified as available for sale at December 31, 2006, compared to $6.9 million at December 31, 2005 and $9.2 million at December 31, 2004.

The contractual maturities of the mortgage-backed and related securities portfolio without any prepayment assumptions at December 31, 2006 are as follows:

(Dollars in thousands)	5 Years or Less	5 to 10 Years	10 to 20 Years	Over 20 Years	Dec. 31, 2006 Balance Outstanding
Securities available for sale:					
Federal Home Loan Mortgage Corporation	$ 27	139	0	0	166
Government National Mortgage Association	0	10	0	0	10
Collateralized Mortgage Obligations	139	0	3,209	2,654	6,002
Total	$ 166	149	3,209	2,654	6,178
Weighted average yield	6.58%	7.12%	3.69%	4.00%	3.96%

At December 31, 2006, the Company did not have any non-agency mortgage-backed or related securities in excess of 10% of its stockholders equity.

Collateralized Mortgage Obligations (CMOs) are securities derived by reallocating the cash flows from mortgage-backed securities or pools of mortgage loans in order to create multiple classes, or tranches, of securities with coupon rates and average lives that differ from the underlying collateral as a whole. The terms to maturity of any particular tranche is dependent upon the prepayment speed of the underlying collateral as well as the structure of the particular CMO. Although a significant proportion of the Company s CMOs are in tranches which have been structured (through the use of cash flow priority and support tranches) to give somewhat more predictable cash flows, the cash flow and hence the value of CMOs is subject to change.

At December 31, 2006, the Company had $22,000 invested in CMOs that have floating interest rates that change either monthly or quarterly, compared to $34,000 at December 31, 2005 and $52,000 at December 31, 2004.

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Mortgage-backed and related securities can serve as collateral for borrowings and, through sales and repayments, as a source of liquidity. In addition, mortgage-backed and related securities available for sale can be sold to respond to changes in economic conditions.

Sources of Funds

General. The Bank s primary sources of funds are retail and brokered deposits, payments of loan principal, interest earned on loans and securities, repayments and maturities of securities, borrowings and other funds provided from operations.

Deposits. The Bank offers a variety of deposit accounts having a wide range of interest rates and terms. The Bank s deposits consist of passbook, negotiable order of withdrawal (NOW), money market, non-interest bearing checking and certificate accounts (including individual retirement accounts) to retail and commercial business customers. The Bank relies primarily on competitive pricing policies and customer service to attract and retain these deposits.

The variety of deposit accounts offered by the Bank has allowed it to be competitive in obtaining funds and to respond with flexibility to changes in consumer demand. As customers have become more interest rate conscious, the Bank has become more susceptible to short-term fluctuations in deposit flows. The Bank manages the pricing of its deposits in keeping with its asset/liability management, profitability and growth objectives. Based on its experience, the Bank believes that its passbook and NOW accounts are relatively stable sources of deposits. However, the ability of the Bank to attract and maintain certificate deposits and money market accounts, and the rates paid on these deposits, has been and will continue to be significantly affected by market conditions.

The following table sets forth the savings flows at the Bank during the periods indicated.

	Year Ended December 31,		
(Dollars in thousands)	2006	2005	2004
Opening balance	$ 731,537	698,902	551,688
Deposits	4,861,548	4,202,022	3,750,395
Withdrawals	(4,889,449)	(4,185,251)	(3,613,887)
Interest credited	22,323	15,864	10,706
Ending balance	725,959	731,537	698,902
Net increase (decrease)	$ (5,578)	32,635	147,214
Percent increase (decrease)	(0.76)%	4.67%	26.68%

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The following table sets forth the dollar amount of deposits in the various types of deposit programs offered by the Bank as of December 31:

	2006		2005		2004	
(Dollars in thousands)	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
Transaction and Savings Deposits[1]:						
Non-interest checking	$ 68,990	9.50%	$ 58,430	7.99%	$ 42,777	6.12%
NOW Accounts 2.54%[2]	87,074	12.00	101,942	13.94	95,294	13.63
Passbook Accounts 1.37%[3]	40,445	5.57	84,858	11.60	47,416	6.78
Money Market Accounts 3.31%[4]	178,694	24.61	96,947	13.25	129,098	18.47
Total Non-Certificates	$ 375,203	51.68%	$ 342,177	46.78%	$ 314,585	45.00%
Certificates:						
0.00 - 0.99%	$ 532	0.08%	$ 651	0.09%	$ 883	0.13%
1.00 - 1.99%	157	0.02	5,846	0.80	62,833	8.99
2.00 - 2.99%	25,700	3.54	118,723	16.23	160,829	23.01
3.00 - 3.99%	126,409	17.41	211,019	28.84	108,938	15.59
4.00 - 4.99%	119,376	16.45	52,319	7.15	49,449	7.08
5.00 - 5.99%	78,582	10.82	797	0.11	1,266	0.20
6.00 - 6.99%	0	0.00	5	0.00	5	0.00
7.00 - 7.99%	0	0.00	0	0.00	114	0.00
Total Certificates	350,756	48.32	389,360	53.22	384,317	55.00
Total Deposits	$ 725,959	100.00%	$ 731,537	100.00%	$ 698,902	100.00%

(1) Reflects rates paid on transaction and savings deposits at December 31, 2006.

(2) The rate on NOW Accounts for 2005 was 2.08% and 2004 was 1.09%.

(3) The rate on Passbook Accounts for 2005 was 2.04%

and 2004 was 0.19%.

(4) The rate on Money Market Accounts for 2005 was 2.59% and 2004 was 1.72%.

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The following table shows rate and maturity information for the Bank s certificates of deposit as of December 31, 2006.

(Dollars in thousands)	0.00-0.99%	1.00-1.99%	2.00-2.99%	3.00-3.99%	4.00-4.99%	5.00-5.99%	Total	Percent of Total
Certificate accounts maturing in quarter ending:								
March 31, 2007	$ 56	141	5,678	38,353	20,822	1,283	66,333	18.91%
June 30, 2007	45	11	4,816	29,699	28,546	2,781	65,898	18.79
September 30, 2007	75	3	6,125	23,117	21,642	13,465	64,427	18.36
December 31, 2007	42	0	1,974	11,771	25,483	48,266	87,536	24.96
March 31, 2008	34	0	884	3,584	4,170	5,756	14,428	4.11
June 30, 2008	20	0	620	3,221	2,910	2,053	8,824	2.52
September 30, 2008	9	0	1,070	3,634	2,589	3,706	11,008	3.14
December 31, 2008	17	0	1,444	8,238	1,516	258	11,473	3.27
March 31, 2009	1	0	1,301	427	1,447	39	3,215	0.92
June 30, 2009	5	0	933	500	1,267	254	2,959	0.84
September 30, 2009	5	0	104	1,137	1,407	271	2,924	0.83
December 31, 2009	11	2	103	850	1,012	299	2,277	0.65
Thereafter	212	0	648	1,878	6,565	151	9,454	2.70
Total	$ 532	157	25,700	126,409	119,376	78,582	350,756	100.00%
Percent of total	0.15%	0.04%	7.34%	36.04%	34.03%	22.40%	100.00%	

The following table indicates the amount of the Bank s certificates of deposit and other deposits by time remaining until maturity as of December 31, 2006.

	Maturity				
(Dollars in thousands)	3 Months or Less	Over 3 to 6 Months	Over 6 to 12 Months	Over 12 Months	Total
Certificates of deposit less than $100,000	$ 34,000	37,138	65,340	40,509	176,987
Certificates of deposit of $100,000 or more	31,452	27,965	81,885	26,050	167,352
Public funds less than $100,000[1]	238	74	291	3	606
Public funds of $100,000 or more[1]	643	721	4,447	0	5,811
Total certificates of deposit	$ 66,333	65,898	151,963	66,562	350,756
Passbook of $100,000 or more	$ 13,573	0	0	0	13,573
Accounts of $100,000 or more	$ 45,668	28,686	86,332	26,050	186,736

(1) Deposits from governmental and other public entities.

For additional information regarding the composition of the Bank s deposits, see Note 11 of the Notes to Consolidated Financial Statements in the Annual Report (incorporated by reference in Item 8 of Part II of this Form 10-K). For additional information on certificate maturities and the impact on the Company s liquidity see Management s Discussion and Analysis of Financial Condition and Results of Operations -Liquidity and Capital Resources of the Annual Report (incorporated by reference in Item 7 of Part II of this Form 10-K).

Borrowings. The Bank s other available sources of funds include advances from the FHLB and other borrowings. As a member of the FHLB, the Bank is required to own capital stock in the FHLB and is authorized to apply for advances. Each FHLB credit program has its own interest rate, which may be fixed or variable, and range of maturities. The FHLB may prescribe the acceptable uses for these advances, as well as limitations on the size of the advances and repayment provisions. Consistent with its asset/liability management strategy, the Bank has utilized FHLB advances from time to time to fund loan demand and extend the term to maturity of its liabilities. The Bank also uses short-term FHLB borrowings to offset short term cash needs due to deposit outflows or loan fundings. At December 31, 2006, the Bank had $150.9 million of FHLB advances outstanding. On such date, the Bank had a collateral pledge arrangement with the FHLB of Des Moines pursuant to which the Bank may borrow up to an additional $13.3 million for liquidity purposes. Refer to Note 12 of the Notes to Consolidated Financial Statements in the Annual Report for more information on FHLB advances (incorporated by reference in Item 8 of Part II of this Form 10-K).

The Company had a $5.0 million revolving line of credit established with a bank that was not drawn at December 31, 2006.

Service Corporations of the Bank

As a federally chartered savings bank, the Bank is permitted by OTS regulations to invest up to 2% of its assets in the stock of, or loans to, service corporation subsidiaries, and may invest an additional 1% of its assets in service corporations where these additional funds are used for inner-city or community development purposes. In addition to investments in service corporations, federal institutions are permitted to invest an unlimited amount in operating subsidiaries engaged solely in activities in which a federal savings bank may engage directly.

OIA is a Minnesota corporation that was organized in 1983 and operated as an insurance agency until 1986 when its assets were sold. OIA remained inactive until 1993 when it began offering credit life insurance, annuity and mutual fund products to the Bank s customers and others.

HFH was a wholly owned Delaware corporation that was formed in 2002, and had its principal office in Grand Cayman Islands. HFH was the holding company for HFREIT which invested in real estate loans acquired from the Bank. HFH and HFREIT were both dissolved in 2005.

The Bank owned an 80% interest in FTS, a Minnesota limited liability company formed in 2003 to operate a mortgage title services business located in Minnetonka, Minnesota. FTS stopped accepting title orders in the third quarter of 2004 and was dissolved.

Competition

The Bank faces strong competition both in originating real estate, commercial and consumer loans and in attracting deposits. Competition in originating loans comes primarily from mortgage bankers, commercial banks, credit unions and other savings institutions, which have offices in the Bank s market area and those that operate through Internet banking operations throughout the United States. The Bank competes for loans principally on the basis of the interest rates and loan fees it charges, the types of loans it originates and the quality of services it provides to borrowers. Competition for deposits is principally from mutual funds, securities firms, commercial banks, credit unions and other savings institutions located in the same communities and those that operate through Internet banking operations throughout the United States. The ability of the Bank to attract and retain deposits depends on its ability to provide an investment opportunity that satisfies the requirements of investors as to rate of return, liquidity, risk, convenience and other factors. The Bank competes for these deposits by offering a variety of deposit accounts at competitive rates, convenient business hours and a customer oriented staff.

Other Corporations Owned by the Company

HMN has one other wholly owned subsidiary, SFC, which acts as an intermediary for the Bank in transacting like kind property exchanges for Bank customers.

Employees

At December 31, 2006 the Company had a total of 223 employees, including part-time employees. None of the employees of the Company or its subsidiaries are represented by any collective bargaining unit. Management considers its employee relations to be good.

Regulation and Supervision

The banking industry is highly regulated. As a savings and loan holding company, the Company is subject to regulation by the Office of Thrift Supervision (OTS). The Bank, a federally-chartered savings association, is subject to extensive regulation and examination by the OTS, which is the Bank s primary federal regulator. The FDIC also has some authority to regulate the Bank. Subsidiaries of the Company and the Bank may also be subject to state regulation and/or licensing in connection with certain insurance and investment activities. The Company and the Bank are subject to numerous laws and regulations. These laws and regulations impose restrictions on activities, set minimum capital requirements, impose lending and deposit restrictions and establish other restrictions. References in this section to applicable statutes and regulations are brief and incomplete summaries only. You should consult the statutes and regulations for a full understanding of the details of their operation. Changes in statutes, regulation or regulatory policies applicable to the Bank or the Company, including interpretation or implementation thereof, could have a material effect on the Company s business.

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Holding Company Regulation

An entity that owns a savings association is a savings and loan holding company (SLHC). If a holding company owns more than one savings association, it is a multiple SLHC; if it owns only one savings association, it is a unitary SLHC. HMN is a unitary SLHC. The Home Owners Loan Act (HOLA) historically limited multiple SLHCs and their non-association subsidiaries to financial activities and services and to activities authorized for bank holding companies, but unitary SLHCs, in the past, were not subject to restrictions on the activities that could be conducted by holding companies or their affiliates.

In November of 1999 the Gramm-Leach-Bliley Act (the GLB Act) was signed into law. The GLB Act made significant changes to laws regulating the financial services industry. Changes included: (1) a new framework in which bank holding companies can own securities firms, insurance companies and other financial companies; (2) prohibitions on new unitary SLHCs from engaging in non-financial activities or affiliating with non-financial entities; (3) new consumer protections associated with the transfer and use of non-public personal information by financial institutions; and (4) modifications to the Federal Home Loan Bank System. Unitary SLHCs, such as HMN, that were in existence or had an application filed with the OTS on or before May 4, 1999, are not subject to the new restrictions on unitary SLHCs. As a result, the GLB Act did not affect HMN s ability to control non-financial firms or engage in non-financial activities.

Acquisitions by Savings and Loan Holding Companies. Acquisition of a savings association or a savings and loan holding company is generally subject to OTS approval and the public must have an opportunity to comment on the proposed acquisition. Without prior approval from the OTS, HMN may not acquire, directly or indirectly, control of another savings association.

Examination and Reporting. Under HOLA and OTS regulations HMN, as a SLHC, must file periodic reports with the OTS. In addition, HMN must comply with OTS record keeping requirements and is subject to holding company examination by the OTS. The OTS may take enforcement action if the activities of a SLHC constitute a serious risk to the financial safety, soundness or stability of a subsidiary savings association.

Affiliate Transactions. The Bank, as a holding company subsidiary that is a depository institution, is subject to both qualitative and quantitative limitations on transactions with HMN and HMN s other subsidiaries. See Transactions with Affiliates and Insiders .

Capital Adequacy. HMN is not currently subject to regulatory capital requirements, the Bank is subject to various capital requirements. See Capital Requirements .

Bank Regulation

As a federally-chartered savings association, the Bank is subject to regulation and supervision by the OTS. Federal law authorizes the Bank as a federal savings association, to conduct, subject to various conditions and limitations, business activities that include: accepting deposits and paying interest on them; making and buying loans secured by residential and other real estate; making a limited amount of consumer loans; making a limited amount of commercial loans; investing in corporate obligations, government debt securities, and other securities; and offering various banking, trust, securities and insurance agency services to its customers.

OTS regulations place limits on the Bank s lending and investment powers. Savings associations are expected to conduct lending activities in a prudent, safe and sound manner. OTS regulations set aggregate limits on certain types of loans including commercial, commercial real estate, and consumer loans. OTS regulations also establish limits on loans to a single borrower. As of December 31, 2006, the Bank s lending limit to one borrower was approximately $13.7 million. A federal savings association generally may not invest in noninvestment-grade debt securities. A federal savings association may establish subsidiaries to conduct any activity the association is authorized to conduct and may establish service corporation subsidiaries for limited preapproved activities.

Qualified Thrift Lender Test. Savings associations, including the Bank, must be qualified thrift lenders (QTLs). A savings association generally satisfies the QTL requirement if at least 65% of a specified asset base consists of things such as loans to small businesses and loans to purchase or improve domestic residential real estate. Savings associations may qualify as QTLs in other ways. Savings associations that do not qualify as QTLs are subject to significant restrictions on their operations. If the Bank fails to meet QTL requirements the Bank and HMN would face certain limitations, including limits on HMN s ability to control non-financial firms. As of December 31, 2006, the Bank met the QTL test.

OTS Assessments. HOLA authorizes the OTS to charge assessments to recover the costs of examining savings associations, holding companies, and their affiliates. The assessment is done semi-annually. The OTS bases the assessment on three factors: 1) asset size; 2) condition; and 3) complexity of the institution. The Bank s and Holding Company s OTS assessments for the year ended December 31, 2006, were approximately $217,000.

Transactions with Affiliates and Insiders. Banks and savings associations are subject to affiliate and insider transaction restrictions. The restrictions prohibit or limit a savings association from extending credit to, or entering into certain transactions with affiliates, principal stockholders, directors and executive officers of the savings association and its affiliates. The term affiliate generally includes a holding company, such as HMN, and any company under common control with the savings association. Federal law limits transactions between the Bank and any one affiliate to 10% of the Bank s capital and surplus and with all affiliates in the aggregate to 20%. In addition, the federal law governing unitary savings and loan holding companies prohibits the Bank from making any loan to any affiliate whose activity is not permitted for a subsidiary of a bank holding company. This law also prohibits the Bank from making any equity investment in any affiliate that is not its subsidiary. The Bank is currently in compliance with these requirements.

Dividend Restrictions. Federal law limits the ability of a depository institution, such as the Bank, to pay dividends or make other capital distributions. The Bank, as a subsidiary of a savings and loan holding company, must file a notice with the OTS before payment of a dividend or approval of a proposed capital distribution by its board of directors and must obtain prior approval from the OTS if it fails to meet certain regulatory conditions. The Bank declared and distributed dividends to HMN of $8.0 million in 2006.

Deposit Insurance

The FDIC insures the deposits of the Bank through the Deposit Insurance Fund (DIF). The DIF is funded by assessments of FDIC members such as the Bank. The FDIC applies a risk-based system for setting deposit insurance assessments. Under the risk-based assessment system, an institution s insurance assessments vary according to the level of capital the institution holds and the degree to which it is the subject of supervisory concern. In addition, regardless of the potential risk to the DIF, federal law requires the FDIC to establish assessment rates that will maintain DIF s ratio of reserves to insured deposits at a ratio, determined by the FDIC, of between $1.15 and $1.50 per $100. During 2006, the assessment rate for deposits ranged from zero to 0.27 basis points on covered deposits. The Bank qualified for the lowest rate and thus paid $0 in 2006. In 2007, the assessment rate for deposits will range from 5 and 43 basis points for every $100 of qualifying deposits. Many financial institution will be eligible for a one-time credit against the 2007 assessment which will offset some, or all of the assessment. The Bank anticipates that it will be eligible for the one-time credit of $663,000.

In addition to deposit insurance assessments, the FDIC is authorized to collect assessments against insured deposits to be paid to the Financing Corporation (FICO) to service FICO debt incurred in the 1980s. The FICO assessment rate is adjusted quarterly. In 2006 the Bank paid an assessment of approximately $92,000.

Capital Requirements

The federal bank regulatory agencies, including the OTS, have a risk-based capital framework in place. The regulators use a combination of risk-based guidelines and leverage ratios to evaluate capital adequacy.

The following table sets forth the current regulatory requirement for capital ratios for savings associations as compared with the Bank s capital ratios at December 31, 2006:

	Core or Tier 1 Capital to Adjusted Total Assets	Tangible Capital to Assets	Core or Tier 1 Capital to Risk-Weighted Assets	Total Capital to Risk-Weighted Assets
Regulatory Minimum	3.00%(1)	1.50%	4.00%	8.00%
The Bank s Actual	8.34%	8.34%	10.19%	11.33%

(1) Savings associations are required to maintain a leverage ratio of 4.00% or more to be considered adequately capitalized.

Capital Categories and Prompt Corrective Action

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) created a statutory framework that increased the importance of meeting applicable capital requirements. FDICIA established five capital categories: (1) well-capitalized; (2) adequately capitalized; (3) undercapitalized; (4) significantly undercapitalized; and (5) critically undercapitalized. The activities in which a depository institution may engage and regulatory responsibilities of federal bank regulatory agencies vary depending upon whether an institution is well-capitalized, adequately capitalized or under capitalized. Under capitalized institutions are subject to various restrictions such as limitations on dividends and growth. A depository institution s category depends upon where its capital levels are in relation to relevant capital measures, which include a risk-based capital measure and certain other factors. The federal banking agencies (including the OTS) adopted regulations that implement this statutory framework. Under these regulations, an institution is generally treated as well-capitalized if its ratio of total capital to risk-weighted assets is 10.00% or more, its ratio of core capital to risk-weighted assets is 6.00% or more, its ratio of core capital to adjusted total assets (leverage ratio) is 5.00% or more, and it is not subject to any federal supervisory order or directive to meet a specific capital level. In order to be adequately capitalized, an institution must have a total risk-based capital ratio of not less than 8.00%, a Tier 1 risk-based capital ratio of not less than 4.00%, and a leverage ratio of not less than 4.00%. Any institution that is neither well capitalized nor adequately capitalized will be considered undercapitalized. The Bank currently is considered well capitalized.

Other Regulations and Examination Authority

The FDIC has adopted regulations to protect the deposit insurance funds and depositors, including regulations governing the deposit insurance of various forms of accounts. Federal regulation of depository institutions is intended for the protection of depositors (and the BIF and the SAIF), and not for the protection of stockholders or other creditors. In addition, federal law requires that in any liquidation or other resolution of any FDIC-insured depository institution, claims for administrative expenses of the receiver and for deposits in U.S. branches (including claims of the FDIC as subrogee of the insured institution) shall have priority over the claims of general unsecured creditors.

The OTS may sanction any OTS-regulated bank that does not operate in accordance with OTS regulations, policies and directives. The FDIC has additional authority to terminate insurance of accounts, after notice and hearing, upon a finding that the insured institution is or has engaged in any unsafe or unsound practice that has not been corrected, is operating in an unsafe or unsound condition, or has violated any applicable law, regulation, rule, or order of or condition imposed by the FDIC.

Federal Home Loan Bank (FHLB) System

The Bank is a member of the FHLB of Des Moines, which is one of the 12 regional Federal Home Loan Banks (FHBs). The primary purpose of the FHBs is to provide funding to their saving association members in support of the home financing credit function of the members. Each FHB serves as a reserve or central bank for its members within its assigned region. FHBs are funded primarily from proceeds derived from the sale of consolidated obligations of the FHLB System. FHBs make loans or advances to members in accordance with policies and procedures established by the board of directors of the FHB. These policies and procedures are subject to the regulation and oversight of the Federal Housing Financing Board. All advances from an FHB are required to be fully secured by sufficient collateral as determined by the FHB. Long-term advances are required to be used for residential home financing and small business and agricultural loans.

As a member, the Bank is required to purchase and maintain stock in the FHLB of Des Moines. As of December 31, 2006, the Bank had $8.0 million in FHB stock, which was in compliance with this requirement. The Bank receives dividends on its FHB stock and over the past five calendar years dividends have averaged approximately 3.04% and averaged 3.83% in 2006.

Federal Reserve Regulation

Under Federal Reserve Board regulations, the Bank is required to maintain reserves against transaction accounts (primarily interest-bearing and noninterest-bearing checking accounts). Because reserves must generally be maintained in cash or in noninterest-bearing accounts, the effect of the reserve requirements is to increase an institution s cost of funds. These regulations generally require that the Bank maintain reserves against net transaction accounts. The reserve levels are subject to adjustment by the Federal Reserve Board. A savings association, like other depository institutions maintaining reservable accounts, may, under certain conditions, borrow from the Federal Reserve Bank discount window.

Numerous other regulations promulgated by the Federal Reserve Board or the OTS affect the business operations of the Bank. These include regulations relating to privacy, equal credit access, electronic fund transfers, collection of checks, lending and savings disclosures, and availability of funds.

Community Reinvestment Act

The Community Reinvestment Act (CRA) requires financial institutions regulated by the federal financial supervisory agencies to ascertain and help meet the credit needs of their delineated communities, including low-to moderate-income neighborhoods within those communities, while maintaining safe and sound banking practices. The regulatory agency assigns one of four possible ratings to an institution s CRA performance and is required to make public an institution s rating and written evaluation. The four possible ratings of meeting community credit needs are outstanding, satisfactory, needs improvement and substantial noncompliance. Under regulations that apply to all CRA performance evaluations after July 1, 1997, many factors play a role in assessing a financial institution s CRA performance. The institution s regulator must consider its financial capacity and size, legal impediments, local economic conditions and demographics, including the competitive environment in which it operates. The evaluation does not rely on absolute standards, and the institutions are not required to perform specific activities or to provide specific amounts or types of credit. The Bank maintains a CRA statement for public viewing, as well as an annual CRA highlights document. These documents describe the Bank s credit programs and services, community outreach activities, public comments and other efforts to meet community credit needs. The Bank s last CRA exam was September 28, 2004 and the Bank received a Satisfactory rating.

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Bank Secrecy Act

The Bank Secrecy Act (BSA) requires financial institutions to verify the identity of customers, keep records and file reports that are determined to have a high degree of usefulness in criminal, tax and regulatory matters, and to implement counter-money laundering programs and compliance procedures. The impact on Bank operations from the BSA depends on the types of customers served by the Bank.

EXECUTIVE OFFICERS

Officers are chosen by and serve at the discretion of the Board of Directors of the Company and the Bank. There are no family relationships among any of the directors or officers of the Company and the Bank. The business experience of each executive officer of both the Company and the Bank is set forth below.

Michael McNeil*, age 59.* Mr. McNeil has been a director of the Company since 1999, the President of the Company since 2000 and the Chief Executive Officer of the Company since 2004. Mr. McNeil has been the President and Chief Executive Officer of the Bank since 1999 and a director of the Bank since 1998. From April 1998 through December 1998, Mr. McNeil was the Senior Vice President of Business Development of the Bank. Prior to joining the Bank, Mr. McNeil was the President and a director of Stearns Bank, N.A. in St. Cloud, Minnesota from 1991 to 1998.

Jon J. Eberle*, age 41.* Mr. Eberle is Chief Financial Officer, Senior Vice President and Treasurer of the Company and the Bank. Mr. Eberle has held such positions since 2003. Prior to that he served as a Vice President since 2000 and as the Controller since 1998. From 1994 to 1998, he served as the Director of Internal Audit for the Company and the Bank.

Dwain C. Jorgensen*, age 58.* Mr. Jorgensen has served as Senior Vice President of Operations of the Company and the Bank since 1998. From 1989 to 1998, he served as Vice President, Controller and Chief Accounting Officer of the Company and the Bank. From 1983 to 1989, Mr. Jorgensen was an Assistant Vice President and Operations Officer for the Bank.

Susan K. Kolling*, age 55.* Ms. Kolling has been a director of the Company since 2001. Ms. Kolling served as a Vice President of the Bank from 1992 to 1994 and has served as a Senior Vice President of the Bank since 1995. In addition, from 1997 to 2003, Ms. Kolling was an owner of Kolling Family Corp. which does business as Valley Home Improvement, a retail lumber yard. Ms. Kolling became a director of Kolling Family Corp. in 2004.

Bradley C. Krehbiel*, age 48.* Mr. Krehbiel is Executive Vice President of the Bank, a position he has held since 2004. Mr. Krehbiel joined the Bank as Vice President of Business Banking in 1998. Prior to his employment at the Bank, Mr. Krehbiel held several positions in the financial services industry, including six years as a private banking consultant.

Available Information

The Company s website is www.hmnf.com. The Company makes available, free of charge, through its website its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) of the Securities Exchange Act of 1934, as soon as reasonably practicable after it electronically files these materials with, or furnishes them to, the Securities and Exchange Commission (the SEC).

Members of the public may read and copy any materials the Company files with the SEC at the SEC s Public Reference Room at 100 F Street, NE, Washington, DC 20549. Information on the operation of the Public

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Reference Room is available by calling the SEC at 1-800-SEC-0330. The SEC maintains a website that contains reports, proxy and information statements and other information about us and other issuers that file electronically at www.sec.gov.

ITEM 1A. RISK FACTORS

Like all financial companies, the Company s business and results of operations are subject to a number of risks, many of which are outside of the Company s control. In addition to the other information in this report, readers should carefully consider that the following important factors, among others, could materially impact the Company s business and future results of operations.

Changes in interest rates could negatively impact the Company s results of operations.

The earnings of the Company are primarily dependent on net interest income, which is the difference between interest earned on loans and investments, and interest paid on interest-bearing liabilities such as deposits and borrowings. Interest rates are highly sensitive to many factors, including government monetary and fiscal policies and domestic and international economic and political conditions. Conditions such as inflation, recession, unemployment, money supply, government borrowing and other factors beyond management s control may also affect interest rates. If the Company s interest-earning assets mature, reprice or prepay more quickly than interest-bearing liabilities in a given period, a decrease in market interest rates could adversely affect net interest income. Likewise, if interest-bearing liabilities mature or reprice, or, in the case of deposits, are withdrawn by the accountholder, more quickly than interest-earning assets in a given period, an increase in market interest rates could adversely affect net interest income. Given the Company s current mix of assets and liabilities, a declining interest rate environment would negatively impact the Company s results of operations.

Fixed rate loans increase the Company s exposure to interest rate risk in a rising rate environment because interest-bearing liabilities would be subject to repricing before assets become subject to repricing. Adjustable rate loans decrease the risks to a lender associated with changes in interest rates but involve other risks. As interest rates rise, the payment by the borrower rises to the extent permitted by the terms of the loan, and the increased payment increases the potential for default. At the same time, for secured loans, the marketability of the underlying collateral may be adversely affected by higher interest rates. In a declining interest rate environment, there is likely to be an increase in prepayment activity on loans as the borrowers refinance their loans at lower interest rates. Under these circumstances, the Company s results of operations could be negatively impacted.

Changes in interest rates also can affect the value of loans, investments and other interest-rate sensitive assets including mortgage servicing rights, and the Company s ability to realize gains on the sale or resolution of assets. This type of income can vary significantly from quarter-to-quarter and year-to-year based on a number of different factors, including the interest rate environment. An increase in interest rates that adversely affects the ability of borrowers to pay the principal or interest on loans may lead to an increase in non-performing assets and increased loan loss reserve requirements that could have a material adverse effect on the Company s results of operations.

The Company has increased its commercial real estate loan originations, increasing the risk in its loan portfolio.

In order to enhance the yield and shorten the term-to-maturity of its loan portfolio, the Company has expanded its commercial real estate lending during recent years. Commercial real estate lending has increased as a percentage of the Company s total loan portfolio from 23.9% at December 31, 2002 to 37.5% at December 31, 2006. Much of the increase in the Company s commercial real estate portfolio over this period has been in land development loans. Commercial real estate loans generally, and especially land development loans, present a higher level of risk than loans secured by one-to-four family residences. This greater risk is due to several factors, including the concentration of principal in a limited number of loans and borrowers, the effects of general economic conditions on income producing properties and the increased difficulty of evaluating and monitoring these types of loans. Furthermore, the repayment of loans secured by commercial real estate is typically dependent upon the successful operation of the related real estate project. If the cash flow from the project is reduced (for example, if leases are not obtained or renewed), the borrower s ability to repay the loan may be impaired. In 2006, the Company charged off $7.4 million in commercial loans relating to a real estate and golf course development. If the Company s commercial real estate loan portfolio fails to perform, the Company s results of operations and financial condition could be adversely affected.

Changes in interest rates or prepayment speeds could negatively impact the value of capitalized mortgage servicing rights.

The capitalization, amortization and impairment of mortgage servicing rights are subject to significant estimates. These estimates are based upon loan types, note rates and prepayment speed assumptions. Changes in interest rates or prepayment speeds may have a material effect on the net carrying value of mortgage servicing rights. In a declining interest rate environment, prepayment speed assumptions will increase and result in an acceleration in the amortization of the mortgage servicing rights as the assumed underlying portfolio declines and also may result in impairment as the value of the mortgage servicing rights declines.

Regional economic changes in the Company s markets could adversely impact results from operations.

Like all banks, the Company is subject to the effects of any economic downturn, and in particular a significant decline in home values or reduced commercial development in the Company s markets could have a negative effect on results of operations. The Company s success depends primarily on the general economic conditions in the counties in which the Company conducts business, and in the southern Minnesota and northern Iowa area in general. Unlike larger banks that are more geographically diversified, the Company provides banking and financial services to customers primarily in the southern Minnesota counties of Fillmore, Freeborn, Houston, Mower, Olmsted and Winona and portions of Steele, Dodge, Goodhue and Wabasha counties, as well as Marshall and Tama counties in Iowa. The local economic conditions in these market areas have a significant impact on the Company s ability to originate loans, the ability of the borrowers to repay these loans and the value of the collateral securing these loans. A significant decline in the general economic conditions caused by inflation, recession, unemployment or other factors beyond the Company s control would affect these local economic conditions and could adversely affect the Company s financial condition and results of operations. Additionally, because the Company has a significant amount of commercial real estate loans, decreases in tenant occupancy may also have a negative effect on the ability of many of the Company s borrowers to make timely repayments of their loans, which would have an adverse impact on the Company s earnings. A significant decline in home values would likely lead to increased delinquencies and defaults in both the consumer home equity loan and residential real estate loan portfolios and result in increased losses in these portfolios.

New or revised tax, accounting and other laws, regulations, rules and standards could significantly impact strategic initiatives, results of operations and financial condition.

The financial services industry is highly regulated and laws and regulations may sometimes impose significant limitations on operations. These limitations, and sources of potential liability for the violation of such laws and regulations, are described in Item 1 of Part I of this report under the heading Business Regulation and Supervision. These regulations, along with the currently existing tax and accounting laws, regulations, rules and standards, control the methods by which financial institutions conduct business; implement strategic initiatives, as well as past, present, and contemplated tax planning; and govern financial disclosures. These laws, regulations, rules, and standards are constantly evolving and may change significantly over time. The nature, extent, and timing of the adoption of significant new laws, changes in existing laws, or repeal of existing laws may have a material impact on the Company s results of operations and financial condition, the effects of which are impossible to predict at this time.

In January 2007, the Company received notification that the Minnesota Department of Revenue was proposing adjustments of $2.2 million to the Company s 2002 through 2004 Minnesota state tax liability. The proposed adjustments relate to the tax treatment of the inter-company dividends paid to the Bank by Home Federal Holding. The Company intends to challenge the proposed adjustments. A tax exposure reserve has been established based on a range of probable outcomes, however, the final liability may exceed the amount of the reserve. If the final resolution of the proposed adjustment exceeds the tax exposure reserve established by the Company, the Company s results of operations could be adversely affected.

The extended disruption of vital infrastructure could negatively impact the Company s results of operations and financial condition.

The Company s operations depend upon, among other things, its technological and physical infrastructure, including its equipment and facilities. Extended disruption of its vital infrastructure by fire, power loss, natural disaster, telecommunications failure, computer hacking and viruses, terrorist activity or the domestic and foreign response to such activity, or other events outside of the Company s control, could have a material adverse impact either on the financial services industry as a whole, or on the Company s business, results of operations, and financial condition.

Strong competition within the Company s market area may limit profitability.

The Company faces significant competition both in attracting deposits and in the origination of loans, as described under the heading Business Competition. Mortgage bankers, commercial banks, credit unions and other savings institutions, which have offices in the Bank s market area have historically provided most of the Company s competition for deposits; however, the Company also competes with financial institutions that operate through Internet banking operations throughout the United States. In addition, and particularly in times of high interest rates, the Company faces additional and significant competition for funds from money market and mutual funds, securities firms, commercial banks, credit unions and other savings institutions located in the same communities and those that operate through Internet banking operations throughout the United States. Many competitors have substantially greater financial and other resources than the Company. Moreover, the Company may face increased competition in the origination of loans if competing thrift institutions convert to stock form, because such converting thrifts would likely seek to invest their new capital into loans. Finally, credit unions do not pay federal or state income taxes and are subject to fewer regulatory constraints than savings banks and as a result, they may enjoy a competitive advantage over the Company. The Bank competes for loans principally on the basis of the interest rates and loan fees it charges, the types of loans it originates and the quality of services it provides to borrowers. This advantage places significant competitive pressure on the prices of loans and deposits.

Loss of large checking and money market deposit customers could increase cost of funds and have a negative effect on results of operations.

The Company has a number of large deposit customers that maintain balances in checking and money market accounts at the Bank. The ability to attract these types of deposits has a positive effect on the Company s net interest margin as they provide a relatively low cost of funds to the Company compared to certificates of deposits or advances. If these depositors were to withdraw these funds and the Bank were not able to replace them with similar types of deposits, the Banks cost of funds would increase and the Company s results of operation would be negatively impacted.

This report, other reports filed by the Company with the Securities and Exchange Commission, and the Company s proxy statement may contain forward-looking statements that deal with future results, plans or

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

Because of the limited size of the Company, losses on a few large loans or lending relationships can cause significant volatility in earnings.

Due to the Company s limited size, individual loan values can be large relative to the Company s earnings for a particular period. If one or a few relatively large loans become non-performing in a period and the Company is required to increase its loss reserves, or to write off principal or interest relative to such loans, the operating results of that period could be significantly adversely affected. The effect on results of operations for any given period from a change in the performance of a small number of loans may be disproportionately larger than the impact of such loans on the quality of the Company s overall loan portfolio. In each of the third and fourth quarters of 2006, the Company incurred losses on individual loans or lending relationships that significantly impacted operating results for the relevant periods.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The Company leases the corporate office in Rochester, Minnesota and owns the buildings and land for 9 of its 12 full service branches. The remaining three full service branches are leased, as well as the Eagle Crest Capital Bank locations. The Bank uses all properties and they are all located in Minnesota, except for two full service branches located in Iowa.

ITEM 3. LEGAL PROCEEDINGS

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

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

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PART II

ITEM 5. MARKET FOR THE REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The information on page 20 under the caption Dividends , page 42 in paragraphs 1, 2, 3, 5 and 6 under the caption Note 17 Stockholders Equity , and page 52 under the caption Common Stock Information and the inside back cover page of the Annual Report to Security Holders for the year ended December 31, 2006 is incorporated herein by reference.

Set forth below is information concerning purchases of the Company s common stock made by or on behalf of the Company during the quarter ended December 31, 2006:

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
October 1 through October 31, 2006	30,000	$ 33.55	30,000	82,000
November 1 through November 30, 2006	0	0	0	82,000
December 1 through December 31, 2006	0	0	0	82,000
Total	30,000	$ 33.55	30,000	

On February 24, 2004, the Company announced a program to repurchase up to 350,000 shares of the Company s common stock. As of December 31, 2006, there were 82,000 shares authorized for repurchase under the stock repurchase program, which was set to expire on February 25, 2007. On January 23, 2007, the Company s Board of Directors extended the stock repurchase program to July 23, 2008 and increased the number of shares authorized for future repurchases to 300,000 shares.

STOCKHOLDER RETURN PERFORMANCE PRESENTATION

The following graph compares the total cumulative stockholders return on the Company s Common Stock to the NASDAQ U.S. Stock Index (NASDAQ Composite), which includes all NASDAQ traded stocks of U.S. companies, the SNL Bank NASDAQ Index, and the SNL Securities Midwest Thrift Index (the SNL Midwest Index), which includes publicly traded financial institutions located in selected Midwestern states with assets of $500 million to $1 billion, for the period of December 31, 2001 through December 31, 2006. Those Midwestern states include Indiana, Minnesota, Missouri, Ohio and South Dakota. The graph assumes that $100 was invested on December 31, 2001 and that all dividends were reinvested. The index was changed from the customized SNL Midwest Index to the SNL Bank NASDAQ Index in 2006 as the SNL Bank NASDAQ Index is more readily available.

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Total Return Performance

Index	*Period Ending* 12/31/01	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06
HMN Financial, Inc.	100.00	113.02	169.52	237.34	218.57	263.24
NASDAQ Composite	100.00	68.76	103.67	113.16	115.57	127.58
SNL Bank NASDAQ Index	100.00	102.85	132.76	152.16	147.52	165.62
SNL Midwest Index	100.00	126.11	171.38	193.64	193.66	195.18

ITEM 6. SELECTED FINANCIAL DATA

The information on page 5 under the caption Five Year Consolidated Financial Highlights of the Annual Report to Security Holders for the year ended December 31, 2006 is incorporated herein by reference.

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The information on pages 6 through 23 under the caption Management s Discussion and Analysis of Financial Condition and Results of Operations , other than the section captioned Market Risk , of the Annual Report to Security Holders for the year ended December 31, 2006 is incorporated herein by reference.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

The information on pages 21 through 23 under the captions Market Risk and Asset/Liability Management of the Annual Report to Security Holders for the year ended December 31, 2006 is incorporated herein by reference.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements (including the notes to the financial statements) on pages 24 through 48, other than the sections captioned Other Financial Data and Common Stock Information , of the Annual Report to Security Holders for the year ended December 31, 2006 is incorporated herein by reference.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures. An evaluation was carried out under the supervision and with the participation of the Company s management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company s disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms.

Management s Annual Report on Internal Control over Financial Reporting. The Company s management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Internal control over financial reporting includes those policies and procedures that pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company; provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are only being made in accordance with authorizations of management and directors of the Company; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company s assets that could have a material effect on the financial statements.

Any control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. The design of a control system inherently has limitations, and the benefits of controls must be weighed against their costs. Additionally, controls can be circumvented by the individual acts of some persons by collusion of two or more people, or by management override of the control. Therefore, no assessment of a cost-effective system of internal controls can provide absolute assurance that all control issues and instances of fraud, if any, will be detected.

Under the supervision and with the participation of management, including the principal executive officer and principal financial officer, the Company conducted an evaluation of the effectiveness of its internal control over financial reporting based on the framework in Internal Control-Integrated Framework issued by the Committee of

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Sponsoring Organizations of the Treadway Commission. Based on the Company s evaluation under this framework, the Company s management concluded that the Company s internal control over financial reporting was effective as of December 31, 2006.

Attestation Report of the Registered Public Accounting Firm. Management s assessment of the effectiveness of the Company s internal control over financial reporting as of December 31, 2006 has been audited by KPMG LLP, an independent registered public accounting firm, as stated in their report that follows:

Report of Independent Registered Public Accounting Firm

The Board of Directors
HMN Financial, Inc.:

We have audited management s assessment, included in the accompanying Management s Annual Report on Internal Control over Financial Reporting , that HMN Financial, Inc. maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). HMN Financial, Inc. s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management s assessment that HMN Financial, Inc. maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, HMN Financial, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal*

Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of HMN Financial Inc. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income, stockholders equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2006, and our report dated March 1, 2007 expressed an unqualified opinion on those consolidated financial statements.

KPMG LLP
Minneapolis, Minnesota
March 1, 2007

Changes in internal controls. No change in the Company s internal control over financial reporting was identified in connection with the evaluation required by Rule 13a-15(d) of the Exchange Act that occurred during the period covered by this report and that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information required by this Item is incorporated by reference from the information under the caption Executive Officers in Part I of this report and under the captions Director Nominees, Directors continuing in office after Annual Meeting, Directors Emeritus, Board Meetings and Committees (excluding any information not related to the audit committee) and Section 16(a) Beneficial Ownership Reporting Compliance in the Company s definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the close of the Company s fiscal year ended December 31, 2006.

The Company has adopted a Code of Ethics that applies to its principal executive officer, principal financial and accounting officer, controller and other persons performing similar functions. The Company has posted the Code of Ethics on its website located at www.hmnf.com. The Company intends to post on its website any amendment to, or waiver from, a provision of the Code of Ethics that applies to its principal executive officer, principal financial and accounting officer, controller or other persons performing similar functions within five business days following the date of such amendment or waiver.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated by reference from the information under the caption Executive Compensation (excluding information under caption Compensation Committee Report on Executive Compensation), Compensation Committee Interlocks and Insider Participation and Director Compensation

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in the Company s definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the close of the Company s fiscal year ended December 31, 2006.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this Item is incorporated by reference from the information under the captions Security Ownership of Management and Certain Beneficial Owners in the Company s definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the close of the Company s fiscal year ended December 31, 2006.

The following table provides information as of December 31, 2006 for compensation plans under which equity securities may be issued.

Plan Category	(a) Number of Securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (1)
Equity compensation plans approved by stockholders	356,181	$ 16.55	154,127
Equity compensation plans not approved by stockholders	0	0	0
Total	356,181	$ 16.55	154,127

(1) Includes securities available for future issuance under stockholder approved compensation plans other than upon the exercise of an option, warrant or right, as follows: 154,127 shares under the Company s 2001 Omnibus Stock Plan.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this Item is incorporated by reference from the information under the captions Certain Transactions in the Company s definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the close of the Company s fiscal year ended December 31, 2006.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item is incorporated by reference from the information under the caption Independent Auditor Fees in the Company s definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the close of the Company s fiscal year ended December 31, 2006.

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

1. Financial Statements

The following financial statements appearing in the Company s Annual Report to Security Holders for the year ended December 31, 2006, are incorporated herein by reference.

Annual Report Section	Pages in 2006 Annual Report
Consolidated Balance Sheets December 31, 2006 and 2005	24
Consolidated Statements of Income Each of the Years in the Three-Year Period Ended December 31, 2006	25
Consolidated Statements of Stockholders Equity and Comprehensive Income Each of the Years in the Three-Year Period Ended December 31, 2006	26
Consolidated Statements of Cash Flows Each of the Years in the Three-Year Period Ended December 31, 2006	27
Notes to Consolidated Financial Statements	28
Report of Independent Registered Public Accounting Firm	49

2. Financial Statement Schedules

All financial statement schedules have been omitted as this information is not required under the related instructions, is not applicable or has been included in the Notes to Consolidated Financial Statements.

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3. Exhibits

Exhibit Number	Exhibit
3.1	Amended and Restated Certificate of Incorporation (1)
3.2	Amended and Restated By-laws (2)
4	Form of Common Stock Certificate (3)
10.1	Change in Control Agreement with Michael McNeil dated as of March 1, 2004(4)
10.2	Employment Agreement with Michael McNeil dated as of January 1, 2002 (5)
10.3	Form of Change in Control Agreement with executive officers (6)
10.4	Directors Deferred Compensation Plan (7)
10.5	Amended and Restated HMN Financial, Inc. Stock Option and Incentive Plan dated July 29, 1998 (8)
10.6	HMN Financial, Inc. 2001 Omnibus Stock Plan (9)
10.7	Form of Incentive Stock Option Agreement for HMN Financial, Inc. 2001 Omnibus Stock (10)
10.8	Form of Non-Statutory Stock Option Agreement for HMN Financial, Inc. 2001 Omnibus Stock (11)
10.9	Form of Restricted Stock Agreement for HMN Financial, Inc. 2001 Omnibus Stock*
10.10	Description of Michael McNeil 2007 Bonus Plan (12)
13	Portions of Annual Report to Security Holders incorporated by reference*
14	Code of Business Conduct and Ethics(13)
21	Subsidiaries of Registrant*
23	Consent of KPMG LLP*
24	Powers of Attorney (included with signatures to this Annual Report on Form 10-K)*
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer*
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer*
32	Section 1350 Certifications*

Management contract or compensatory arrangement

* Filed herewith

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

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

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

4 Incorporated by reference to Exhibit 10.1 to the Company s Annual Report on Form 10-K for the period

ending December 31, 2004 (File No. 0-24100).

5 Incorporated by reference to Exhibit 10.1 to the Company s Quarterly Report on Form 10-Q for the period ended June 30, 2002 (File No. 0-24100).

6 Incorporated by reference to Exhibit 10 to the Company s Quarterly Report on Form 10-Q for the period ended June 30, 2004 (File No. 0-24100).

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7 Incorporated by reference to the same numbered exhibit to the Company s Annual Report on Form 10-K for the period ended December 31, 1994 (File No. 0-24100).

8 Incorporated by reference to Exhibit 10.1(b) to the Company s Quarterly Report on Form 10-Q for the period ended September 30, 1998 (File No. 0-24100).

9 Incorporated by reference to Exhibit B to the Company s Proxy Statement for its Annual Meeting of Stockholders held on April 24, 2001 (File no. 0-24100).

10 Incorporated by reference to Exhibit 10.1 to the Company s Quarterly Report on Form 10-Q for the period ended September 30, 2004 (File

No. 0-24100).

11 Incorporated by reference to Exhibit 10.3 to the Company s Quarterly Report on Form 10-Q for the period ended September 30, 2004 (File No. 0-24100).

12 Incorporated by reference to Exhibit 10.1 to the Company s Current Report on Form 8-K dated January 22, 2007, filed on January 26, 2007 (File No. 0-24100).

13 Incorporated by reference to Exhibit 14 to the Company s Quarterly Report on Form 10-Q for the period ended September 30, 2005 (File No. 0-24100).

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

HMN FINANCIAL, INC.

Date: March 1, 2007

By: */s/ Michael McNeil*
Michael McNeil,
President and Chief Executive Officer

Each of the undersigned hereby appoints Michael McNeil and Jon J. Eberle, and each of them (with full power to act alone), as attorneys and agents for the undersigned, with full power of substitution, for and in the name, place and stead of the undersigned, to sign and file with the Securities and Exchange Commission under the Securities Act of 1934, as amended, any and all amendments and exhibits to this Annual Report on Form 10-K and any and all applications, instruments, and other documents to be filed with the Securities and Exchange Commission pertaining to this Annual Report on Form 10-K or any amendments thereto, with full power and authority to do and perform any and all acts and things whatsoever requisite and necessary or desirable. Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the registrant and in the capacities indicated on March 1, 2007.

Name	Title
/s/ Michael McNeil Michael McNeil	President, Chief Executive Officer and Director (Principal Executive Officer)
/s/ Jon J. Eberle Jon J. Eberle	Senior Vice President, Chief Financial Officer and Treasurer (Principal Financial and Accounting Officer)
/s/ Timothy R. Geisler Timothy R. Geisler	Chairman of the Board
/s/ Allan R. DeBoer Allan R. DeBoer	Director
/s/ Duane D. Benson Duane D. Benson	Director
/s/ Michael J. Fogarty Michael J. Fogarty	Director
/s/ Karen L. Himle Karen L. Himle	Director

/s/ Susan K. Kolling	Director
Susan K. Kolling	
/s/ Malcolm W. McDonald	Director
Malcolm W. McDonald	
/s/ Mahlon C. Schneider	Director
Mahlon C. Schneider	

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INDEX TO EXHIBITS

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10.7	Form of Incentive Stock Option Agreement for HMN Financial, Inc. 2001 Omnibus Stock	Incorporated by Reference
10.8	Form of Non-Statutory Stock Option Agreement for HMN Financial, Inc. 2001 Omnibus Stock	Incorporated by Reference
10.9	Form of Restricted Stock Agreement for HMN Financial, Inc. 2001 Omnibus Stock	Filed Electronically
10.10	Description of Michael McNeil 2007 Bonus Plan	Incorporated by Reference
13	Portions of Annual Report to Security Holders incorporated by reference	Filed Electronically
14	Code of Business Conduct and Ethics	Incorporated by Reference
21	Subsidiaries of Registrant	Filed Electronically
23	Consent of KPMG LLP	Filed Electronically
24	Powers of Attorney	Included with Signatures
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer	Filed Electronically

31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer	Filed Electronically
32	Section 1350 Certifications	Filed Electronically