HMN FINANCIAL INC
Form 10-K
March 09, 2018
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

[x] **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2017

OR

[ ] **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from _____ to ______.

Commission file number: 0-24100.

HMN FINANCIAL, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**41-1777397** (I.R.S. Employer Identification No.)
1016 Civic Center Drive Northwest **Rochester, Minnesota** (Address of principal executive offices)	**55901** (Zip Code)

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

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

Title of each class	Name of each exchange on which registered

Common Stock, par value $.01 per share   Nasdaq Global Market

Securities registered pursuant to section 12(g) of the Act:

None
(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

YES [ ] NO [X]

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 [ ] NO [X]

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 [X] NO [   ]

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§229.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES [X] NO [   ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§232.405 of this chapter) is not contained herein, and will not be contained, to the best of 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. [X]

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

Large accelerated filer	[ ]	Accelerated filer	[ ]
Non-accelerated filer	[ ]	Smaller reporting company	[X]
(Do not check if a smaller reporting company)		Emerging growth company	[ ]

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

1

Table of Contents

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES [ ] NO [X]

As of June 30, 2017, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was $61.9 million based on the closing stock price of $17.55 on such date as reported on the Nasdaq Global Market.

As of February 19, 2018, the number of outstanding shares of common stock of the registrant was 4,504,234.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's annual report to stockholders for the year ended December 31, 2017 (Annual Report), are incorporated by reference in Parts I and II 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, 2017 are incorporated by reference in Part III of this Form 10-K.

Table of Contents

TABLE OF CONTENTS

Table of Contents

Forward-Looking Statements

The information presented or incorporated by reference in this Form 10-K contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 (the Exchange Act). These statements are often identified by such forward-looking terminology as “expect,” “intend,” “look,” “believe,” “anticipate,” “estimate,” “project,” “s “may,” “will,” “would,” “could,” “should,” “trend,” “target,” and “goal” or similar statements or variations of such terms and i but are not limited to, those relating to growing our core deposit relationships and loan balances, enhancing the financial performance of our core banking operations, maintaining credit quality, reducing non-performing assets, and generating improved financial results (including profitability); the extent of the positive impact of the lower federal tax rate on future earnings; the adequacy and amount of available liquidity and capital resources to the Bank; the Company’s liquidity and capital requirements; our expectations for core capital and our strategies and potential strategies for maintenance thereof; improvements in loan production; changes in the size of the Bank’s loan portfolio; the amount of the Bank’s non-performing assets and the appropriateness of the allowance therefor; anticipated future levels of the provision for loan losses; future losses on non-performing assets; the amount and composition of interest-earning assets; the amount of yield enhancements relating to non-accruing and purchased loans; the amount and composition of non-interest and interest-bearing liabilities; the availability of alternate funding sources; the payment of dividends by HMN; the future outlook for the Company; the amount of deposits that will be withdrawn from checking and money market accounts and how the withdrawn deposits will be replaced; the projected changes in net interest income based on rate shocks; the range that interest rates may fluctuate over the next twelve months; the net market risk of interest rate shocks; the future outlook for the issuer of the trust preferred securities held by the Bank; the ability of the Bank to pay dividends to HMN; the ability to remain well capitalized; the impact of new accounting pronouncements, and compliance by the Bank with regulatory standards generally (including the Bank’s status as “well-capitalized”) and other supervisory directives or requirements to which the Company or the Bank are or may become expressly subject, specifically, and possible responses of the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (FRB), the Bank, and the Company to any failure to comply with any such regulatory standard, directive or requirement.

A number of factors could cause actual results to differ materially from the Company’s assumptions and expectations. These include but are not limited to the adequacy and marketability of real estate and other collateral securing loans to borrowers; federal and state regulation and enforcement; possible legislative and regulatory changes, including additional changes to regulatory capital rules; the ability of the Bank to comply with other applicable regulatory capital requirements; enforcement activity of the OCC and FRB in the event of our non-compliance with any applicable regulatory standard or requirement; adverse economic, business and competitive developments such as shrinking interest margins, reduced collateral values, deposit outflows, changes in credit or other risks posed by the Company’s loan and investment portfolios; changes in costs associated with alternate funding sources, including changes in collateral advance rates and policies of the Federal Home Loan Bank (FHLB); technological, computer-related or operational difficulties; results of litigation; reduced demand for financial services and loan products; changes in accounting policies and guidelines, or monetary and fiscal policies of the federal government or tax laws; international economic developments; the Company’s access to and adverse changes in securities markets; the market for credit related assets; the future operating results, financial condition, cash flow requirements and capital spending priorities of the Company and the Bank; the availability of internal and, as required, external sources of funding; our ability to attract and retain employees; or other significant uncertainties. For additional discussion of the risks and uncertainties applicable to the Company, see the “Risk Factors” section of this Form 10-K. All forward-looking statements are qualified by, and should be considered in conjunction with, such cautionary statements.

All statements in this Form 10-K, including forward-looking statements, speak only as of the date they are made, and we undertake no duty to update any of the forward-looking statements after the date of this Form 10-K.

Table of Contents

PART I

ITEM 1. BUSINESS

General

HMN Financial, Inc. (HMN and, together with its subsidiaries, the Company) is a stock savings bank holding company that owns 100 percent of Home Federal Savings Bank (the Bank). The Bank has a community banking philosophy and operates retail banking and loan production facilities in Minnesota, Iowa and Wisconsin. The Bank has two wholly owned subsidiaries, Osterud Insurance Agency, Inc. (OIA), which does business as Home Federal Investment Services and offers financial planning products and services, and HFSB Property Holdings, LLC (HPH), which is currently inactive, but has acted in the past as an intermediary for the Bank in holding and operating certain foreclosed properties. HMN was incorporated in Delaware in 1994.

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 single 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 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 Dodge, Fillmore, Freeborn, Houston, Mower, Olmsted and Winona and portions of Goodhue, Steele and Wabasha through its corporate office located in Rochester, Minnesota and its eleven branch offices located in Albert Lea, Austin, Kasson (2), La Crescent, Rochester (4), 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 the Mayo Clinic, Hormel Foods (a food processing company) and IBM. The Company's market area is also the home of Winona State University, Rochester Community and Technical College, University of Minnesota - Rochester, Winona State University - Rochester Center and Austin’s Riverland Community College.

The Company serves Dakota County, in the southern portion of the Minneapolis and St. Paul metropolitan area, from its office located in Eagan, Minnesota. Major employers in this market area include Delta Airlines, Patterson Companies (dental and animal health), UTC (aerospace systems), CHS Cooperative, Flint Hills Resources LP (oil refinery), Unisys Corp (computer software), Blue Cross Blue Shield of Minnesota and West Group, a Thomson Reuters business (legal research).

The Company serves the Iowa county of Marshall through its branch office located in Marshalltown, Iowa. Major employers in the area include Swift & Company (pork processors), Emerson (automation solutions, and commercial and residential solutions), Lennox Industries (furnace and air conditioner manufacturing), Iowa Veterans Home (hospital care), Marshall Community School District (education) and UnityPoint Health (hospital care).

Table of Contents

Based upon information obtained from the U.S. Census Bureau for 2016 (the last year for which information is available), the population of the seven primary counties in the Company's southern Minnesota market area was estimated as follows: Dodge – 20,506; Fillmore – 21,003; Freeborn – 30,446; Houston – 18,814; Mower – 39,163; Olmsted – 153,102; and Winona – 50,948. For these same seven counties, the median household income from the U.S. Census Bureau for 2012-2016 ranged from $48,827 to $69,308. The population of Dakota County was 417,486 and the median household income was $77,321. With respect to Iowa, the population of Marshall County was 40,312 and the median household income was $54,193.

Table of Contents

Lending Activities

General. Historically, the Company has originated 15 and 30 year fixed rate mortgage loans secured by single family residences for its loan portfolio. Over the past 20 years, the Company has focused on managing interest rate risk and improving interest margins by increasing its investment in shorter term and generally higher yielding commercial real estate, commercial business and construction loans, while reducing its investment in longer term single family real estate loans. The Company continues to originate 15 and 30 year fixed rate mortgage loans and some shorter term fixed rate loans. The shorter term fixed rate loans and adjustable rate loans are generally placed into portfolio, while the majority of the 15 and 30 year fixed rate mortgage loans are sold in the secondary mortgage market. Mortgage interest rates continued to be at relatively low levels in 2017 and very few 15 and 30 year loans were placed into portfolio, as most were sold into the secondary market in order to manage the Company's interest rate risk position. The Company also offers an array of consumer loan products that include both open and closed end home equity loans. Home equity lines of credit have adjustable interest rates based upon the prime rate, as published in the Wall Street Journal, plus a margin. Refer to "*Note 5 Loans Receivable, Net*" and "*Note 6 Allowance for Loan Losses and Credit Quality Information*" in 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).

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

	2017		2016		2015		2014		2013	
(Dollars in thousands)	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Fixed rate Loans										
Real estate:										
Single family	$53,869	9.06 %	$55,143	9.83 %	$55,226	11.68 %	$46,288	12.39 %	$47,377	11.96 %
Multi-family	20,254	3.40	29,171	5.20	8,045	1.70	10,919	2.92	7,687	1.94
Commercial	179,755	30.22	159,195	28.38	117,790	24.91	104,178	27.89	109,387	27.62
Construction	26,715	4.49	13,438	2.40	27,381	5.79	7,361	1.97	2,645	0.67
Total real estate loans	280,593	47.17	256,947	45.81	208,442	44.08	168,746	45.17	167,096	42.19
Consumer loans:										
Automobile	2,894	0.49	3,036	0.54	2,885	0.61	1,124	0.30	971	0.25
Home equity	8,315	1.40	9,744	1.74	10,231	2.16	10,711	2.87	11,629	2.94
Recreational vehicle	13,181	2.21	7,553	1.35	2,650	0.56	0	0.00	0	0.00
Other	4,270	0.72	5,447	0.97	4,635	0.99	4,091	1.09	4,174	1.05
	28,660	4.82	25,780	4.60	20,401	4.32	15,926	4.26	16,774	4.24

Total consumer loans										
Commercial business loans	55,642	9.36	53,019	9.46	39,197	8.29	32,147	8.61	40,122	10.13
Total non-real estate loans	84,302	14.18	78,799	14.06	59,598	12.61	48,073	12.87	56,896	14.37
Total fixed rate loans	364,895	61.35	335,746	59.87	268,040	56.69	216,819	58.04	223,992	56.56
Adjustable rate Loans										
Real estate:										
Single family	53,136	8.93	48,112	8.58	35,719	7.55	23,553	6.31	29,090	7.34
Multi-family	8,395	1.41	7,606	1.36	4,279	0.90	4,781	1.28	426	0.11
Commercial	79,269	13.33	71,760	12.80	79,136	16.74	59,187	15.84	69,099	17.45
Construction	19,729	3.32	17,910	3.19	10,722	2.27	5,242	1.40	5,206	1.31
Total real estate loans	160,529	26.99	145,388	25.93	129,856	27.46	92,763	24.83	103,821	26.21
Consumer:										
Home equity line	36,869	6.20	40,476	7.22	38,561	8.16	36,832	9.86	36,178	9.13
Home equity	7,508	1.26	6,558	1.17	4,970	1.05	1,709	0.46	0	0.00
Other	730	0.12	469	0.08	483	0.10	458	0.12	471	0.12
Total consumer loans	45,107	7.58	47,503	8.47	44,014	9.31	38,999	10.44	36,649	9.25
Commercial business loans	24,267	4.08	32,157	5.73	30,909	6.54	24,975	6.69	31,587	7.98
Total non-real estate loans	69,374	11.66	79,660	14.20	74,923	15.85	63,974	17.13	68,236	17.23
Total adjustable rate loans	229,903	38.65	225,048	40.13	204,779	43.31	156,737	41.96	172,057	43.44
Total loans	594,798	100.00%	560,794	100.00%	472,819	100.00%	373,556	100.00%	396,049	100.00%
Less										
Unamortized discounts	19		20		16		14		33	
Net deferred loan (costs) fees	(463)		(300)		(91)		97		0	
Allowance for losses on loans	9,311		9,903		9,709		8,332		11,401	

Total loans receivable, net	$585,931	$551,171	$463,185	$365,113	$384,615

7

Table of Contents

The following table illustrates the interest rate maturities of the Company's loan portfolio at December 31, 2017. 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.

	Real Estate											
(Dollars in thousands)	Single family		Multi-family and Commercial		Construction		Consumer		Commercial Business		Total	
Due During Years Ending December 31,	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weigh Avera Rate
2018 [(1)]	$8,806	4.26%	$48,712	4.56%	$24,686	3.91%	$7,395	5.74%	$43,473	4.88%	$133,072	4.59
2019	9,239	4.09	39,359	4.55	1,684	4.78	5,302	5.67	10,656	4.68	66,240	4.60
2020	9,358	4.05	48,517	4.43	3,254	4.26	4,183	5.48	10,309	4.58	75,621	4.45
2021 through 2022	16,321	4.11	78,765	4.50	6,040	4.12	6,795	5.34	14,358	4.42	122,279	4.47
2023 through 2027	24,528	3.96	63,051	4.48	8,526	4.51	11,865	5.41	1,033	5.04	109,003	4.47
2028 through 2042	33,329	3.99	9,050	5.07	2,254	4.67	37,904	4.83	22	5.26	82,559	4.51
2043 and thereafter	5,424	3.67	219	5.69	0	0.00	323	0.00	58	0.00	6,024	3.51
	$107,005		$287,673		$46,444		$73,767		$79,909		$594,798	

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

The total amount of loans due after December 31, 2018 which have predetermined interest rates is $283.1 million, while the total amount of loans due after such date which have floating or adjustable interest rates is $178.6 million. Construction or development loans at December 31, 2017 were $23.1 million for single family dwellings, $11.6 million for multi-family and $11.7 million for nonresidential.

8

Table of Contents

The aggregate amount of loans and extensions of credit that the Bank is permitted to make to any one borrower is generally limited to 15% of unimpaired capital and surplus. In addition to the 15% limit, the Bank is permitted to lend an additional amount equal to 10% of unimpaired capital and surplus if the additional amount is fully secured by “readily marketable collateral” having a current market value of at least 100% of the loan or extension of credit. Similarly, the Bank is permitted to lend additional amounts equal to the lesser of 30% of unimpaired capital and surplus, or $30 million, for certain residential development loans. Applicable law establishes a number of rules for combining loans to separate borrowers. Loans or extensions of credit to one person may be attributed to other persons if: (i) the proceeds of a loan or extension of credit are used for the direct benefit of the other person; or (ii) a common enterprise is deemed to exist between persons. At December 31, 2017, based upon the 15% limitation, the Bank's regulatory limit for loans to one borrower was approximately $12.8 million and no loans to any one borrower exceeded this amount. At December 31, 2017, the Bank’s largest aggregate amount of loans to one borrower totaled $11.6 million. All of the loans for the largest borrower were performing in accordance with their terms as of December 31, 2017 and the borrower had no affiliation with the Bank other than its relationship as a borrower.

All of the Bank's lending is subject to its written underwriting standards and to loan origination procedures. Decisions on loan requests 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.

Single family loans are originated either for inclusion in the loan portfolio under the Bank’s Portfolio First loan program or for sale in the secondary market to the Federal National Mortgage Association (FNMA) on a servicing retained basis or to other third party investors on a servicing released basis. The limit for retail mortgages originated for sale on the secondary market was $424,100 and $417,000 for 2017 and 2016, respectively, and these loans require the approval of a designated secondary market underwriter.

Three levels of approval authority have been established for loans originated under the Portfolio First loan program. The three levels of authority include Approved Portfolio First Lenders, Market Presidents and Credit Administration positions with Portfolio First approval authority. Approved Portfolio First Lenders are select mortgage loan officers recommended for the Portfolio First program approval authority by their Market President and are approved by the Chief Operating Officer. The Credit Administration positions with Portfolio First approval authority include the Rochester Market President, Director of Retail Lending and Loan Servicing, Vice President of Credit Administration, Chief Credit Officer and the Chief Operating Officer.

Loans less than $350,000 require the approval of the Portfolio First Lender, the Market President and one Credit Administration individual with Portfolio First approval authority. Loans over $350,000 require the approval of the Portfolio First Lender, the Market President and two Credit Administration individuals with Portfolio First approval authority. Loans where the total aggregate amount of all loan obligations owed or guaranteed to the Bank plus the new obligation is greater than $2.0 million require the approval of a majority of the Senior Loan Committee, which is comprised of the Bank’s most experienced lending staff.

Loans that meet the underwriting guidelines of secondary market investors are approved by designated Credit Administration positions. The Credit Administration positions with secondary market approval authority include Retail Loan Underwriters, Director of Retail Lending and Servicing, Vice President of Credit Administration, Chief Credit officer and the Chief Operating Officer. Approval level authorities are granted by the Chief Credit Officer or Chief Operating Officer and confirmed by the Executive Loan Committee on an annual basis. Loans are originated based on the specific guidelines established by the secondary market investor.

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.

Table of Contents

Single Family Residential Real Estate Lending. At December 31, 2017, the Company's single family real estate loans, consisting of both fixed rate and adjustable rate loans, totaled $107.0 million, an increase of $3.7 million from $103.3 million at December 31, 2016. The increase in the single family loans in 2017 is the result of an increased emphasis on originating shorter term fixed rate and adjustable rate mortgage loans that were placed into the portfolio during 2017. The majority of the longer term loans that were originated during the year continued to be sold into the secondary market in order to manage the Company’s interest rate risk position.

The Company offers conventional fixed rate single 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 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 secondary market delivery rates, as well as other competitive factors. The Company also originates fixed rate loans with terms up to 30 years that are insured by the Federal Housing Administration (FHA), Veteran’s Administration (VA), Minnesota Housing Finance Agency, Iowa Finance Authority or United States Department of Agriculture-Guaranteed Housing (RD).

The Company also offers one year adjustable rate mortgages (ARMs) at a margin (generally 400 to 600 basis points) over the yield on the Average Weekly One Year U.S. Treasury Constant Maturity Index for terms of up to 30 years. The ARMs offered by the Company allow the borrower to select (subject to pricing) an initial period of one to seven 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. 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. Because of the low interest rate environment that has existed over the last few years, a limited number of ARM loans have been originated as consumers have generally opted for longer term fixed rate loans.

In underwriting single 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 single family residential real estate loans made by the Company are appraised by independent appraisers. The Company originates residential mortgage loans with loan-to-value ratios up to 100% for owner-occupied homes and up to 85% for non-owner-occupied homes; however, private mortgage insurance is generally required to reduce the Company's exposure to 80% or less of the value on most loans. The Company generally seeks to underwrite its loans in accordance with secondary market, FHA, VA or RD standards. However, the Company does originate shorter term fixed rate and adjustable rate single family loans for its portfolio that do not meet certain secondary market guidelines.

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.

At both December 31, 2017 and December 31, 2016, $0.9 million of the single family residential loan portfolio were non-performing.

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 a limited amount of participations in commercial real estate and multi-family loans originated by third parties. The commercial real estate and multi-family loan portfolio includes loans secured by motels, hotels, apartment buildings, churches, manufacturing plants, land developments, office buildings, business facilities, shopping malls, nursing homes, golf courses, restaurants, warehouses, convenience stores and other non-residential building properties primarily located in the upper Midwestern portion of the United States. At December 31, 2017, the Company's commercial and multi-family real estate loans totaled $287.7 million, an increase of $20.0 million from $267.7 million at December 31, 2016.

Table of Contents

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 another 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 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 qualified Bank employee or independent 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. 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.

Multi-family and commercial real estate loans generally present a higher level of risk than loans secured by single 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, 2017 and 2016, $1.4 million of loans in the commercial real estate portfolio were non-performing. The largest non-performing lending relationship in this category as of December 31, 2017 was a $1.2 million loan secured by a manufacturing facility located in the Bank’s primary market area.

Construction Lending. The Company makes construction loans to individuals for the construction of their residences and to builders for the construction of single family residences. It also makes a limited number of 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. These loans are made on the same terms as residential loans, except that during the construction phase, which typically lasts up to twelve months, the borrower pays interest only. Generally, the borrower also pays a construction fee at the time of origination 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 single family residences generally carry terms of one year or less.

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 90% 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.

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 clients and walk-in clients. The application process includes a submission to the Bank of accurate plans, specifications and costs of the project to be constructed. These items are one factor utilized in the determination of the appraised value of the subject property to be built.

Table of Contents

At December 31, 2017, construction loans totaled $46.4 million, an increase of $15.1 million from $31.3 million at December 31, 2016. Total construction loans included $23.1 million and $21.9 million of single family residential, $11.6 million and $2.6 million of multi-family residential and $11.7 million and $6.8 million of commercial real estate loans at December 31, 2017 and 2016, respectively. The nature of construction loans makes them more difficult to evaluate and monitor than loans on existing buildings. 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 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. At both December 31, 2017 and December 31, 2016, $0.1 million of construction loans in the commercial real estate portfolio were non-performing. The non-performing construction loans are loans to parties related through common ownership to construct model homes that when sold, or subject to a purchase agreement, are converted to performing loans and the interest is recognized.

Consumer Lending. The Company originates a variety of consumer loans, including home equity loans (open-end and closed-end), automobile, recreational vehicles, mobile home, lot loans, loans secured by deposit accounts and other loans for household and personal purposes. At December 31, 2017, the Company’s consumer loans totaled $73.8 million, an increase of $0.5 million from $73.3 million at December 31, 2016.

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 five 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, generally does not exceed 90% of the appraised value of the property or an internally established market value. Internal market values are established using current market data, including recent sales data, and are typically lower than third party appraised values. 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 and a 2 to 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 by making a withdrawal at the Bank, transferring funds through our online or mobile banking products 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 71.4% of the Company’s consumer loan portfolio at December 31, 2017.

The underwriting standards employed by the Company for consumer loans include a determination of the applicant's payment history on other debts and their 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, recreational vehicles 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 both December 31, 2017 and December 31, 2016 the consumer loan portfolio had $0.6 million of non-performing loans.

Table of Contents

Commercial Business Lending. The Company maintains a portfolio of commercial business loans to borrowers associated with the real estate industry as well as 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 may also purchase a limited amount of 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. At December 31, 2017, the Company’s commercial business loans totaled $79.9 million, a decrease of $5.3 million from $85.2 million at December 31, 2016.

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, 2017 and 2016, $0.3 million of loans in the commercial business loan portfolio were non-performing.

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

Real estate loans are generally originated by the Company's salaried loan officers. Mortgage and consumer loan officers may also receive a commission in addition to their base salary for meeting production and other branch goals. 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 client demand for loans in its markets. Demand for adjustable rate loans is affected by the interest rate environment. The number of adjustable rate loans remained low in 2017 due to the low long term fixed mortgage rates that existed during the year. The Company originated for its portfolio $7.8 million of single family adjustable rate loans during 2017, a decrease of $10.6 million from $18.4 million in 2016. The Company also originated for its portfolio $25.0 million of fixed rate single family loans during 2017, a decrease of $1.9 million from $26.9 million for 2016. The changes in the adjustable rate single family loans that were placed into the loan portfolio in 2017 are the result of customer’s preference to lock in fixed rate loans due to the low interest rate environment and the increased expectation of increased mortgage rates in the future. The slight decrease in fixed rate loans originated in 2017 compared to 2016 is the result of lower originations of fixed rate loans that did not meet secondary market criteria between the periods.

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 in managing interest rate risk than traditional single family fixed rate conventional loans. The Company originated $148.3 million of multi-family and commercial real estate, commercial business and consumer loans (which excludes commercial real estate loans for construction or development) during 2017, an increase of $7.8 million from originations of $140.5 million for 2016. The increase in originations primarily reflects the $18.6 million and $9.3 million increase in commercial business and commercial real estate loans, respectively, in 2017 compared to 2016. Multi-family loan originations decreased $16.5 million and consumer loan originations decreased $3.6 million between the periods.

Table of Contents

In order to supplement loan demand in the Company's market area and geographically diversify its loan portfolio, the Company, from time to time, purchases participations in real estate loans from selected sellers, with yields based upon then-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 has generally not experienced higher losses or credit quality issues with purchased participations than other loans originated by the Company. The Company purchased $7.2 million of loans during 2017, a decrease of $9.1 million from $16.3 million purchased during 2016. All of the loans purchased have terms and interest rates that are similar in nature to the Company's originated single family, commercial real estate, construction and development and commercial business portfolios. See *“Note 5 Loans Receivable, Net”* and *“Note 6 Allowance for Loan Losses and Credit Quality Information”* in 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 did not acquire any loans through an acquisition in 2017 but acquired loans totaling $12.0 million in an acquisition that occurred in the second quarter of 2016.

The Company has mortgage-backed and related securities that are held, based on investment intent, in the "available for sale" portfolio. The Company did not acquire any mortgage-backed securities in 2017 or 2016 through an acquisition. The Company purchased $5.1 million of mortgage-backed securities in 2017 and none were purchased in 2016. The limited amount of mortgage-backed securities purchased is because debt instruments issued by federal agencies, such as FNMA and the Federal Home Loan Mortgage Corporation (FHLMC), continued to be more appealing to purchase due to their shorter duration given the low interest rate environment that continued to exist in 2017. In 2017, the Company did not sell any mortgage backed securities and in 2016 it sold $30,000 of mortgage-backed securities that were previously acquired in an acquisition. The securities were sold due primarily to the small lot size of the individual securities. See “Investment Activities” below.

Table of Contents

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)	2017	2016	2015
Originations by type:			
Adjustable rate:			
Real estate -			
- single family	$7,833	18,442	12,111
- multi-family	1,167	9,246	0
- commercial	23,818	14,591	21,489
- construction or development	30,799	40,132	19,920
Non-real estate -			
- consumer	11,585	15,481	18,852
- commercial business	3,428	10,353	19,538
Total adjustable rate	78,630	108,245	91,910
Fixed rate:			
Real estate -			
- single family	25,016	26,948	27,612
- multi-family	3,718	12,107	4,042
- commercial	42,203	42,176	47,306
- construction or development	16,559	19,181	38,299
Non-real estate -			
- consumer	16,639	16,335	11,610
- commercial business	45,767	20,196	18,281
Total fixed rate	149,902	136,943	147,150
Total loans originated	228,532	245,188	239,060
Purchases:			
Real estate -			
- single family	203	0	2,800
- multi-family	0	750	0
- commercial	500	1,130	7,501
- construction or development	4,740	2,500	5,500
Non-real estate -			
- commercial business	1,756	11,949	2,600
Total loans purchased	7,199	16,329	18,401
Acquisition:			
Real estate -			
- single family	0	146	4,985
- multi-family	0	0	100
- commercial	0	5,808	7,712
Non-real estate -			

- consumer	0	3,536	5,226
- commercial business	0	2,546	6,037
Total loans acquired	0	12,036	24,060
<u>Sales, participations and repayments</u>:			
Real estate -			
- multi-family	0	4,500	0
- commercial	10,565	9,002	4,504
- construction or development	3,221	13,765	14,602
Non-real estate -			
- consumer	834	719	516
- commercial business	53,240	634	154
Total sales	67,860	28,620	19,776
Transfers to loans held for sale	9,047	15,002	8,125
Principal repayments	123,912	140,944	154,054
Total reductions	200,819	184,566	181,955
Decrease in other items, net	(908)	(1,012)	(303)
Net increase	$34,004	87,975	99,263

15

Table of Contents

LOANS HELD FOR SALE

	Year Ended December 31,		
(Dollars in thousands)	2017	2016	2015
Originations by type:			
Fixed rate:			
Real estate -			
- single family	78,751	79,783	69,941
Total fixed rate	78,751	79,783	69,941
Total loans originated	78,751	79,783	69,941
Sales and repayments:			
Real estate -			
- single family	83,475	88,355	71,992
Total sales	83,475	88,355	71,992
Transfers from loans held for investment	(4,558)	(6,822)	(3,778)
Principal repayments	6	20	24
Total reductions	78,923	81,553	68,238
Net (decrease) increase	$(172)	(1,770)	1,703

MORTGAGE-BACKED AND RELATED SECURITIES

	Year Ended December 31,		
(Dollars in thousands)	2017	2016	2015
Purchases:			
Fixed rate mortgage-backed securities	$5,055	0	2,343
CMOs and REMICs (1)	0	0	3,116
Total purchases	5,055	0	5,459
Sales:			
Fixed rate mortgage-backed securities	0	0	2,174
CMOs and REMICs	0	30	2,021
Total sales	0	30	4,195
Principal repayments	(993)	(1,247)	(1,890)
Net increase (decrease)	$4,062	(1,277)	(626)

(1) Collateralized mortgage obligations and real estate mortgage investment conduits

Classified Assets and Delinquencies

***Classification of Assets*.** Federal regulations require that each savings institution evaluate and classify its assets on a regular basis. In addition, in connection with examinations of savings institutions, the OCC and the Federal Deposit Insurance Corporation (FDIC) examiners may identify problem assets and, if appropriate, require them to be classified with an adverse rating. There are three adverse classifications: 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 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 specific allowances for loan losses. If an asset, or portion thereof, is classified as a loss, the institution charges off such amount. If an institution does not agree with an OCC or FDIC examiner's classification of an asset, it may appeal the determination to the OCC District Director or the appropriate FDIC personnel. On the basis of management's review of its assets, at December 31, 2017, the Bank classified a total of $17.3 million of its loans and real estate as follows:

(Dollars in thousands)	Single Family	Real Estate Construction or Development	Commercial and Multi-family	Consumer	Commercial Business	Real Estate	Total
Substandard	$2,154	120	7,950	631	5,506	627	16,988
Doubtful	44	0	0	119	0	0	163
Loss	0	0	0	130	0	0	130
Total	$						