HMN FINANCIAL INC
Form 10-Q/A
November 13, 2001

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

FORM 10-Q/A

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2001

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) FOR THE

SECURITIES EXCHANGE ACT OF 1934

For the transition period from _________ to _________

Commission File Number 0-24100

HMN FINANCIAL, INC.

(Exact name of Registrant as specified in its Charter)

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

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

Yes (X) No ( )

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

Class	Outstanding at November 5, 2001
Common stock, $0.01 par value	4,474,633

HMN FINANCIAL, INC.

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PART I - FINANCIAL INFORMATION

PART I - FINANCIAL STATEMENTS

HMN FINANCIAL, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

(unaudited)

		September 30, 2001	December 31, 2000
Assets			
Cash and cash equivalents	$	21,323,890	14,416,861
Securities available for sale:			
Mortgage-backed and related securities			
(amortized cost $68,980,417 and $76,199,237)		68,585,161	75,379,719
Other marketable securities			
(amortized cost $27,733,590 and $66,392,057)		27,323,650	63,826,770
		95,908,811	139,206,489
Loans held for sale		66,649,654	7,861,029
Loans receivable, net		499,543,166	518,765,209
Accrued interest receivable		3,653,459	4,311,747
Federal Home Loan Bank stock, at cost		12,245,000	12,245,000
Mortgage servicing rights, net		1,683,435	1,188,928
Premises and equipment, net		10,449,188	9,459,710
Investment in limited partnerships		2,313,844	2,838,364
Goodwill		3,845,947	3,980,974
Core deposit intangible		708,561	794,363
Prepaid expenses and other assets		3,102,120	947,201
Total assets	$	721,427,075	716,015,875
Liabilities and Stockholders' Equity			
Deposits	$	429,413,828	421,690,548
Federal Home Loan Bank advances		209,800,000	221,900,000
Accrued interest payable		1,100,370	1,575,521
Advance payments by borrowers for taxes and insurance		1,162,086	650,348
Accrued expenses and other liabilities		6,616,418	3,355,110
Deferred tax liabilities		1,062,200	218,700
Total liabilities		649,154,902	649,390,227
Commitments and contingencies			
Minority interest		(27,665)	0

Stockholders' equity:			
Serial preferred stock: ($.01 par value)			
authorized 500,000 shares; issued and outstanding none		0	0
Common stock ($.01 par value):			
authorized 11,000,000; issued shares 9,128,662		91,287	91,287
Additional paid-in capital		59,201,120	59,584,176
Retained earnings, subject to certain restrictions		76,918,955	73,380,588
Accumulated other comprehensive loss		(672,730)	(2,037,005)
Unearned employee stock ownership plan shares		(5,173,036)	(5,318,067)
Unearned compensation restricted stock awards		(7,350)	(9,800)
Treasury stock, at cost 4,654,029 and 4,737,521 shares		(58,058,408)	(59,065,531)
Total stockholders' equity		72,299,838	66,625,648
Total liabilities and stockholders' equity	$	721,427,075	716,015,875

See accompanying notes to consolidated financial statements.

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HMN FINANCIAL, INC. AND SUBSIDIARIES

Consolidated Statements of Income

(unaudited)

		Three Months Ended		Nine Months Ended	
		September 30,		September 30,	
		2001	2000	2001	2000
Interest income:					
Loans receivable	$	11,057,446	10,384,591	33,605,383	29,780,905
Securities available for sale:					
Mortgage-backed and related		893,913	1,680,791	3,171,869	5,138,967
Other marketable		441,500	1,186,633	1,931,904	3,532,915
Cash equivalents		65,571	54,957	137,107	158,198
Other		117,777	218,536	414,505	614,471

Total interest income	12,576,207	13,525,508	39,260,768	39,225,456
Interest expense:				
Deposits	4,636,529	4,999,104	14,607,907	13,857,269
Federal Home Loan Bank advances	2,851,114	3,564,404	9,199,980	10,406,426
Other borrowed money	0	4,615	0	4,615
Total interest expense	7,487,643	8,568,123	23,807,887	24,268,310
Net interest income	5,088,564	4,957,385	15,452,881	14,957,146
Provision for loan losses	300,000	45,000	750,000	135,000
Net interest income after provision for loan losses	4,788,564	4,912,385	14,702,881	14,822,146
Non-interest income:				
Fees and service charges	417,116	356,045	1,131,667	960,988
Mortgage servicing fees	113,908	95,570	328,139	251,477
Securities gains (losses), net	71,338	(5,305)	(260,958)	(39,106)
Gain on sales of loans	473,857	337,921	2,670,563	814,498
Earnings (losses) in limited Partnerships	104,896	(40,974)	(523,643)	77,873
Unrealized gains on derivatives	118,024	0	62,750	0
Other	119,908	120,829	449,859	422,701
Total non-interest income	1,419,047	864,086	3,858,377	2,488,431
Non-interest expense:				
Compensation and benefits	1,924,282	1,482,346	5,879,340	4,666,664
Occupancy	528,192	490,653	1,607,983	1,380,970
Federal deposit insurance premiums	19,841	20,784	60,613	63,018
Advertising	94,914	92,944	295,057	225,329

Data processing		238,728	202,655	710,482	579,284
Amortization of mortgage servicing rights, net of valuation adjustments and servicing costs		157,850	84,246	493,888	229,526
Other		812,812	622,901	2,302,096	1,826,191
Total noninterest expense		3,776,619	2,996,529	11,349,459	8,970,982
Income before income tax expense		2,430,992	2,779,942	7,211,799	8,339,595
Income tax expense		571,285	1,076,500	2,356,185	3,226,300
Income before minority interest		1,859,707	1,703,442	4,855,614	5,113,295
Minority interest		(163,373)	0	(30,493)	0
Net income	$	2,023,080	1,703,442	4,886,107	5,113,295
Basic earnings per share	$	0.53	0.45	1.30	1.32
Diluted earnings per share	$	0.50	0.44	1.23	1.28

See accompanying notes to consolidated financial statements.

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HMN FINANCIAL, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

(unaudited)

	Three Months Ended September 30,	
	2001	2000

Net income	$			2,023,080			1,703,442
Other comprehensive income, net of tax:							
Unrealized losses on hedging valuation		(218,985)			0		
Less: minority interest in hedging valuation		(91,484)			0		
Net unrealized losses on hedging valuation			(127,501)			0	
Unrealized gains (losses) on securities:							
Unrealized holding (losses) gains arising during period		(555,035)			419,982		
Less: reclassification adjustment for gains (losses)							
included in net income		43,038			(3,261)		
Net unrealized (losses) gains on securities			(598,073)			423,243	
Other comprehensive income (loss)				(725,574)			423,243
Comprehensive income	$			1,297,506			2,126,685

		Nine Months Ended September 30,	
		2001	2000
Net income	$	4,886,107	5,113,295

Other comprehensive income, net of tax:						
Unrealized losses on hedging valuation	(300,606)			0		
Less: minority interest in hedging valuation	(122,173)			0		
Net unrealized losses on hedging valuation		(178,433)			0	
Unrealized gains (losses) on securities:						
Unrealized holding gains (losses) arising during period	1,388,158			(260,448)		
Less: reclassification adjustment for gains (losses) included in net income	(154,550)			(24,039)		
Net unrealized gains (losses) on securities		1,542,708			(236,409)	
Other comprehensive income (loss)			1,364,275			(236,409)
Comprehensive income	$		6,250,381			4,876,886

See accompanying notes to consolidated financial statements.

HMN FINANCIAL, INC. AND SUBSIDIARIES

Consolidated Statement of Stockholders' Equity

For the Nine Month Period Ended September 30, 2001

(unaudited)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Unearned Employee Stock Ownership Plan Shares	Unearned Compensation Restricted Stock Awards	Treasury Stock	Total Stock-Holders' Equity
Balance, December 31, 2000	$ 91,287	59,584,176	73,380,588	(2,037,005)	(5,318,067)	(9,800)	(59,065,531)	66,625,648
Net income			4,886,107					4,886,107
Other comprehensive income				1,364,275				1,364,275
Treasury stock purchases							(74,152)	(74,152)
Employee stock options								
exercised		(605,689)					1,081,275	475,586
Tax benefits of exercised								
stock options		148,262						148,262
Tax expenses of restricted								
stock awards		(2,479)						(2,479)
Amortization of restricted								
stock awards						2,450		2,450
Dividends paid			(1,347,740)					(1,347,740)
Earned employee stock								
ownership plan shares		76,850			145,031			221,881
	$ 91,287	59,201,120	76,918,955	(672,730)	(5,173,036)	(7,350)	(58,058,408)	72,299,838

Balance,
September 30,
2001

See accompanying notes to consolidated financial statements.

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HMN FINANCIAL, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(unaudited)

		Nine Months Ended September 30,	
		2001	2000
Cash flows from operating activities:			
Net income	$	4,886,107	5,113,295
Adjustments to reconcile net income to cash provided (used) by operating activities:			
Provision for loan losses		750,000	135,000
Depreciation		754,227	671,768
Amortization of (discounts) premiums, net		72,127	(47,077)
Amortization of deferred loan fees		(390,794)	(146,612)
Amortization of goodwill		135,027	135,018
Amortization of core deposit intangible		85,802	174,330
Amortization of other purchase accounting adjustments		9,025	(43,833)
Amortization of mortgage servicing rights and net valuation adjustments		493,829	205,301
Capitalized mortgage servicing rights		(990,324)	(266,704)
Deferred income taxes		125,000	80,500

Securities losses, net	260,958	39,106
Gain on sales of real estate	(17,293)	0
Gain on sales of loans	(2,670,653)	(814,498)
Proceeds from sale of loans held for sale	568,937,142	80,680,103
Disbursements on loans held for sale	(623,170,040)	(81,166,406)
Unrealized gains on derivatives	(62,750)	0
Principal collected on loans held for sale	154,425	23,797
Amortization of restricted stock awards	2,450	84,871
Amortization of unearned ESOP shares	145,031	145,368
Earned employee stock ownership shares priced above original cost	76,850	38,144
Decrease (increase) in accrued interest receivable	658,288	(183,668)
Increase (decrease) in accrued interest payable	(475,151)	570,914
Equity (earnings) losses of limited partnerships	523,643	(77,873)
Equity losses of minority interest	(30,493)	0
Increase in other assets	(2,214,259)	(381,108)
Increase in other liabilities	2,044,898	955,042
Other, net	(33,054)	16,593
Net cash provided (used) by operating activities	(49,939,982)	5,941,371
Cash flows from investing activities:		
Proceeds from sales of securities available for sale	19,135,721	28,005,499
Principal collected on securities available for sale	13,667,575	6,220,154
Proceeds collected on maturity of securities available for sale	12,695,000	7,500,000
Purchases of securities available for sale	0	(15,855,692)
Proceeds from sales of loans receivable	12,156	204,264
Purchase of Federal Home Loan Bank stock	0	(775,000)
Net decrease (increase) in loans receivable	17,585,021	(41,350,562)
Proceeds from sale of real estate	316,797	0
Purchases of premises and equipment	(1,743,705)	(1,338,082)
Net cash provided (used) by investing activities	61,668,565	(17,389,419)
Cash flows from financing activities:		
Increase in deposits	7,588,014	23,391,689

Purchase of treasury stock	(74,152)	(5,091,726)
Stock options exercised	475,586	601,144
Dividends to stockholders	(1,347,740)	(1,217,963)
Proceeds from Federal Home Loan Bank advances	259,700,000	162,800,000
Repayment of Federal Home Loan Bank advances	(271,800,000)	(164,300,000)
Minority interest in mortgage services	125,000	0
Increase in advance payments by borrowers for taxes and insurance	511,738	172,961
Net cash (used) provided by financing activities	(4,821,554)	16,356,105
Increase in cash and cash equivalents	6,907,029	4,908,057
Cash and cash equivalents, beginning of period	14,416,861	9,051,380
Cash and cash equivalents, end of period	$ 21,323,890	13,959,437
Supplemental cash flow disclosures:		
Cash paid for interest	$ 24,283,038	23,697,396
Cash paid for income taxes	2,168,000	1,720,800
Supplemental noncash flow disclosures:		
Loans securitized and transferred to securities available for sale	0	11,129,146
Loans transferred to loans held for sale	1,216,509	1,029,517
Transfer of loans to real estate	86,123	244,258
Transfer of real estate to loans	0	50,140

See accompanying notes to consolidated financial statements.

HMN FINANCIAL, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

(unaudited)

September 30, 2001 and 2000

(1) HMN Financial, Inc.

HMN Financial, Inc.(HMN) is a stock savings bank holding company which owns 100 percent of Home Federal Savings Bank (the Bank or Home Federal). Home Federal has a community banking philosophy and operates retail banking facilities in Minnesota and Iowa. The Bank has one wholly owned subsidiary, Osterud Insurance Agency, Inc. (OAI), doing business as Home Federal Investment Services, which offers financial planning products and services. HMN has another wholly owned subsidiary, Security Finance Corporation (SFC). Prior to 2000, SFC invested in commercial loans and commercial real-estate loans located throughout the United States which were originated by third parties. During 2000 SFC sold many of its assets to the Bank and discontinued investing in commercial loans. The Bank has another subsidiary, Home Federal Mortgage Services, LLC (HFMS), which is a mortgage banking and mortgage brokerage business located in Brooklyn Park, Minnesota. Prior to 2001 the business was operated as a wholly owned subsidiary of HMN and was known as HMN Mortgage Services, Inc. (MSI). In January 2001, HMN sold 100% of the MSI stock to the Bank. The Bank formed HFMS and merged MSI into HFMS. Effective February 1, 2001 the business sold a 49% membership interest in HFMS to two individuals.

The consolidated financial statements included herein are for HMN, SFC, MSI, through January 31, 2001, the Bank and the Bank's subsidiaries, OAI and HFMS. All significant intercompany accounts and transactions have been eliminated in consolidation.

(2) Basis of Preparation

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-Q and therefore, do not include all disclosures necessary for a complete presentation of the consolidated balance sheets, consolidated statements of income, consolidated statements of comprehensive income, consolidated statements of stockholders' equity and consolidated statements of cash flows in conformity with generally accepted accounting principles. However, all adjustments consisting of only normal recurring adjustments which are, in the opinion of management, necessary for the fair presentation of the interim financial statements have been included. The statement of income for the three month and nine month periods ended September 30, 2001 are not necessarily indicative of the results which may be expected for the entire year.

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

(3) New Accounting Standards

In July 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations*, and SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001 as well as all purchase method business combinations completed after June 30, 2001. SFAS No. 141 also specifies criteria intangible assets acquired in a purchase method business combination must meet to be recognized and reported apart from goodwill, noting that any purchase price allocable to an assembled workforce may not be accounted for separately. SFAS No. 142 will require that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead tested for

impairment at least annually in accordance with the provisions of SFAS No. 142. SFAS No. 142 will also require that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*.

HMN is required to adopt the provisions of SFAS No. 141 immediately and it will adopt SFAS No. 142 effective January 1, 2002. Furthermore, any goodwill and any intangible asset determined to have an indefinite useful life that are acquired in a purchase business combination completed after June 30, 2001 will not be amortized, but will continue to be evaluated for impairment in accordance with the appropriate pre-SFAS No. 142 accounting literature. Goodwill and intangible assets acquired in business combinations completed before July 1, 2001 will continue to be amortized prior to the adoption of SFAS No. 142.

SFAS No. 141 will require upon adoption of SFAS No. 142, that HMN evaluate its existing intangible assets and goodwill that were acquired in a prior purchase business combination, and to make any necessary reclassifications in order to conform with the new criteria in SFAS No. 141 for recognition apart from goodwill. Upon adoption of SFAS No. 142, HMN will be required to reassess the useful lives and residual values of all intangible assets acquired in purchase business combinations, and make any necessary amortization period adjustments by the end of the first interim period after adoption. In addition, to the extent an intangible asset is identified as having an indefinite useful life, HMN will be required to test the intangible asset for impairment in accordance with the provisions of SFAS No. 142 within the first interim period. Any impairment loss will be measured as of the date of adoption and recognized as the cumulative effect of a change in accounting principle in the first interim period.

In connection with the transitional goodwill impairment evaluation, SFAS No. 142 will require HMN to perform an assessment of whether there is an indication that goodwill [and equity-method goodwill] is impaired as of the date of adoption. To accomplish this HMN must identify its reporting units and determine the carrying value of each reporting unit by assigning the assets and liabilities, including the existing goodwill and intangible assets, to those reporting units as of the date of adoption. HMN will then have up to six months from the date of adoption to determine the fair value of each reporting unit and compare it to the reporting unit's carrying amount. To the extent a reporting unit's carrying amount exceeds its fair value, an indication exists that the reporting unit's goodwill may be impaired and HMN must perform the second step of the transitional impairment test. In the second step, HMN must compare the implied fair value of the reporting unit's goodwill, determined by allocating the reporting unit's fair value to all of it assets (recognized and unrecognized) and liabilities in a manner similar to a purchase price allocation in accordance with SFAS No. 141, to its carrying amount, both of which would be measured as of the date of adoption. This second step is required to be completed as soon as possible, but no later than the end of the year of adoption. Any transitional impairment loss will be recognized as the cumulative effect of a change in accounting principle in HMN's income statement.

And finally, any unamortized negative goodwill and negative equity-method goodwill existing at the date SFAS No. 142 is adopted must be written off as the cumulative effect of a change in accounting principle.

On January 1, 2002 the adoption date, HMN expects to have unamortized goodwill in the amount of $3,800,938, unamortized identifiable intangible assets in the amount of $685,509 and no unamortized negative goodwill , all of which will be subject to the transition provisions of SFAS No. 141 and 142. Amortization expense related to goodwill was $180,024 and $135,027 for the year ended December 31, 2000 and the nine months ended September 30, 2001, respectively. Because of the extensive effort needed to comply with adopting SFAS No. 141 and 142, it is not practicable to reasonably estimate the impact of adopting these Statements on HMN's financial statements at the date of this report, including whether any transitional impairment losses will be required to be recognized as the cumulative effect of a change in accounting principle.

In August 2001, the FASB issued SFAS No. 144, *Accounting for the Impairment of Disposal of Long-Lived Assets*. This Statement supersedes FASB Statement No. 121*, Accounting for the Impairment of Long-Lived Assets to Be Disposed Of,* and the accounting and reporting provisions of APB Opinion No. 30, *Reporting the Results of Operations--Reporting the Effects of Disposal of a Segment of a Business, And Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, for the disposal of a segment of a business (as previously defined in that Opinion). The Statement also amends ARB No. 51, *Consolidated Financial Statements,* to eliminate the exception to consolidation for a subsidiary for which control is likely to be temporary. The Statement is effective for financial statements issued for fiscal years beginning after December 15, 2001. Management is currently studying the impact of adopting SFAS No. 144.

(4) Derivative Instruments and Hedging Activities

HMN adopted SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, in the first quarter of 2001 when it had an outstanding interest rate swap of $10 million. A transition adjustment of $75,637 was recorded on January 1, 2001 as a debit to other assets and also as a credit to the related certificate of deposit.

The swap for $10 million was called in July 2001, and HMN simultaneously called the CD relating to that swap. In July HMN entered into another interest rate swap for $15 million. Under the new interest rate swap, HMN pays interest based upon the three month London Inter-Bank Offer Rate (LIBOR) and receives interest payments based upon a fixed rate of 6.0% on a notional value of $15 million in a fair value hedge with no ineffectiveness. The hedge is offsetting a callable certificate of deposit for $15 million that was issued by HMN. On September 30, 2001 the interest rate swap was marked to a market value of $135,266 which is included in other assets and the corresponding certificate of deposit was adjusted to the same value and is reflected in deposits in the consolidated balance sheet of HMN. The interest rate swap was deemed to be totally effective and therefore no gain or loss was recorded in the income statement.

HMN originates and purchases single family residential loans for sale into the secondary market and enters into commitments to sell or securitize those loans in order to mitigate the interest rate risk associated with holding the loans until they are sold. At the beginning of the second quarter, commitments to sell Loans Held for Sale were designated as a cash flow hedge of a forecasted transaction and were accounted for in accordance with SFAS No. 133. On September 30, 2001, the carrying value of the derivatives were marked to market by a $493,600 credit to Loans Held for Sale, a deferred tax asset was established for $193,000 and other comprehensive loss was debited for $300,600. The derivative adjustment in the balance sheet is a consolidated number that is partially owned by a minority interest. The adjustment to other comprehensive loss was $122,200 related to the minority interest and therefore the net adjustment to other comprehensive loss for HMN was $178,400.

As the Loans Held for Sale are ultimately sold, the losses currently in accumulated other comprehensive income will be reclassified in the gains and losses on sale of loans in the income statement. It is estimated that all of the Loans Held for Sale at September 30, 2001 will be sold in the next three months.

HMN has commitments outstanding to extend credit to future borrowers or to purchase loans that had not closed prior to the end of the quarter which it refers to as its mortgage pipeline. As commitments to originate or purchase loans enter into the mortgage pipeline, HMN simultaneously enters into commitments to sell the mortgage pipeline into the secondary market. As a result of marking the mortgage pipeline and the related commitments to sell to market during the third quarter of 2001, HMN recorded a debit to Loans Held for Sale of $1,192,000, a credit to Other Liabilities of $1,074,000 and an unrealized gain on derivatives of $118,000. As a result of marking the mortgage pipeline and the related commitments to sell to market during the nine month period ended September 30, 2001, HMN recorded a debit to Loans Held for Sale of $759,000, a credit to Other Liabilities of $696,000 and an unrealized gain on derivatives of $63,000.

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(5) Comprehensive Income

Comprehensive income is defined as the change in equity during a period from transactions and other events from nonowner sources. Comprehensive income is the total of net income and other comprehensive income, which for

HMN is comprised of unrealized gains and losses on securities available for sale and unrealized gains and losses on hedging activity for loans held for sale and certificates of deposit with matching interest rate swaps.

The gross unrealized losses in hedging valuation for the third quarter of 2001 was $362,000, the income tax benefit would have been $143,000 and therefore, the net loss was $219,000. The gross minority interest in hedging valuation for the third quarter of 2001 was $151,000, the income tax benefit would have been $60,000 and therefore, the net loss was $91,000. There was no hedging valuation in the third quarter of 2000. The gross unrealized holding loss on securities for the third quarter of 2001 was $906,000, the income tax benefit would have been $351,000 therefore, the net loss was $555,000. The gross reclassification adjustment for the third quarter of 2001 was $71,000, the income tax expense would have been $28,000 and therefore the net gain was $43,000. The gross unrealized holding gains on securities for the third quarter of 2000 was $673,000, the income tax expense would have been $253,000 and therefore, the net gain was $420,000. The gross reclassification adjustment in the third quarter of 2000 was $5,000, the income tax benefit would have been $2,000 and therefore, the net reclassification adjustment was a loss of $3,000. The gross unrealized losses in hedging valuation for the nine month period ended September 30, 2001 was $494,000, the income tax benefit would have been $193,000 and therefore, the net loss was $301,000. The gross minority interest in hedging valuation for the nine month period ended September 30, 2001 was $201,000, the income tax benefit would have been $79,000 and therefore, the net loss was $122,000. There was no hedging valuation in the nine month period ended September 30, 2000. The gross unrealized holding gains on securities for the nine month period ended September 30, 2001 was $2,319,000, the income tax expense would have been $931,000 and therefore, the net gain was $1,388,000. The gross reclassification adjustment in the nine month period ended September 30, 2001 was $261,000, the income tax benefit would have been $106,000 and therefore, the net reclassification adjustment was $155,000. The gross unrealized holding losses on securities for the nine month period ended September 30, 2000 was $435,000, the income tax benefit would have been $175,000 and therefore, the net loss was $260,000. The gross reclassification adjustment in the nine month period ended September 30, 2000 was $39,000, the income tax benefit would have been $15,000 and therefore, the net reclassification adjustment was $24,000.

(6) Cash Dividend

On October 23, 2001 HMN's Board of Directors announced a cash dividend of $0.14 per share, payable on December 12, 2001 to stockholders of record on November 23, 2001.

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(7) Investment in Mortgage Servicing Rights

A summary of mortgage servicing activity is as follows:

	Nine Months	Twelve Months	Nine Months

		ended Sept. 30, 2001	ended Dec. 31, 2000	ended Sept. 30, 2000
Mortgage servicing rights				
Balance, beginning of period	$	1,188,928	1,148,774	1,148,774
Originations		990,324	367,531	266,704
Amortization		(493,829)	(327,377)	(230,401)
Balance, end of period		1,685,423	1,188,928	1,185,077
Valuation reserve				
Balance, beginning of period		0	(25,100)	(25,100)
Additions		(1,988)	0	0
Reductions		0	25,100	25,100
Balance, end of period		(1,988)	0	0
Mortgage servicing rights, net	$	1,683,435	1,188,928	1,185,077
Fair value of mortgage servicing rights	$	1,842,000	1,476,000	1,497,000

All of the loans being serviced were single family loans serviced for FNMA under the mortgage-backed security program or the individual loan sale program. The following is a summary of the risk characteristics of the loans being serviced at September 30, 2001.

	Loan Principal Balance	Weighted Average Interest Rate	Weighted Average Remaining Term	Number of Loans

Original term 30 year fixed rate	$	96,639,000	7.35 %	336	1,147
Original term 15 year fixed rate		100,287,000	6.74 %	160	1,569
Seven year balloon		219,000	7.04 %	318	3
Adjustable rate		3,424,000	7.61 %	310	25

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(8) Investment in Limited Partnerships

Investments in limited partnerships were as follows:

Primary partnership activity		September 30, 2001	December 31, 2000
Mortgage servicing rights	$	1,774,921	2,257,941
Common stock of financial institutions		264,401	285,524
Low to moderate income housing		274,522	294,899
	$	2,313,844	2,838,364

During the third quarter of 2001 HMN's proportionate revenue from a mortgage servicing partnership was $126,000, its proportionate share of losses from common stock investments in financial institutions was $14,500 and it recognized $6,500 of losses on low income housing partnerships. During 2001 HMN anticipates receiving low income housing credits totaling $84,000, of which $21,000 were credited to current income tax benefits in the third quarter. During the third quarter of 2000 HMN's proportionate revenue from a mortgage servicing partnership (which included the reduction of previously established impairment reserves of $146,500) was zero, its proportionate share of losses from the common stock investments in financial institutions was $37,400 and it recognized $6,500 of losses on the low income housing partnerships. During 2000 HMN received low income housing credits totaling $84,000, of which $21,000 were credited to current income tax benefits in the third quarter of 2000.

During the nine month period ended September 30, 2001, HMN's proportionate losses from a mortgage servicing partnership was $483,000, its proportionate share of losses from the common stock investments in financial institutions was $21,100 and it recognized $19,500 of losses on the low income housing partnerships. During 2001 HMN anticipates receiving low income housing credits totaling $84,000, of which $63,000 were credited to current income tax benefits in the nine month period ended September 30, 2001. During the nine month period ended September 30, 2000 HMN's proportionate revenue from a mortgage servicing partnership (which included the reduction of previously established impairment reserves of $264,500) was $174,700, its proportionate share of losses from the common stock investments in financial institutions was $76,600 and it recognized $19,500 of losses on the low income housing partnerships. During 2000 HMN received low income housing credits totaling $84,000, of which $63,000 were credited to current income tax benefits in the nine month period ended September 30, 2000.

(9) Earnings per Share

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

	Three months ended September 30,		Nine months ended September 30,	
	2001	2000	2001	2000
Weighted average number of common shares outstanding				
Used in basic earnings per common share calculation	3,785,130	3,747,683	3,751,198	3,875,107
Net dilutive effect of:				
Options	226,322	153,543	220,716	127,589
Restricted stock awards	284	1,035	509	2,064
Weighted average number of shares outstanding				
Adjusted for effect of dilutive securities	4,011,736	3,902,261	3,972,423	4,004,760

Income available to common shareholders	$	2,023,080	1,703,442	4,886,107	5,113,295
Basic earnings per common share	$	0.53	0.45	1.30	1.32
Diluted earnings per common share	$	0.50	0.44	1.23	1.28

(10) Regulatory Capital

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

Quantitative measures established by regulations to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of Tier I or Core capital and Risk-based capital (as defined in the regulations) to total assets (as defined). Management believes, as of September 30, 2001, that the Bank meets all capital adequacy requirements to which it is subject.

Management believes that based upon the Bank's capital calculations at September 30, 2001 and other conditions consistent with the Prompt Corrective Actions Provisions of the OTS regulations, the Bank would be categorized as well capitalized.

On September 30, 2001 the Bank's tangible assets and adjusted total assets were $710 million and its risk-weighted assets were $466.3 million. The following table presents the Bank's capital amounts and ratios at September 30, 2001 for actual capital, required capital and excess capital including ratios in order to qualify as being well capitalized under the Prompt Corrective Actions regulations.

	Actual		Required to be Adequately Capitalized		Excess Capital		To Be Well Capitalized Under Prompt Corrective Actions Provision	
(in thousands)	Amount	Percent of Assets (1)	Amount	Percent of Assets (1)	Amount	Percent of Assets (1)	Amount	Percent of Assets (1)

Bank stockholder's equity	$ 58,725							
Plus:								
Net unrealized loss on certain								
Securities available for sale	301							
Less:								
Goodwill and other intangibles	4,555							
Excess mortgage servicing rights	177							
Tier I or core capital	54,294							
Tier I capital to adjusted total assets		7.65%	$ 28,398	4.00%	$ 25,896	3.65%	$ 35,497	5.00%
Tier I capital to risk-weighted assets		11.64%	$ 18,652	4.00%	$ 35,642	7.64%	$ 27,979	6.00%
Plus:								
Allowable allowance for loan losses	3,119							
Risk-based capital	57,413		$ 37,305		$ 20,108	4.31%	$ 46,631	10.00%
Risk-based capital to								
risk-weighted assets		12.31%		8.00%				

(1)

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

The tangible capital of the Bank was in excess of the minimum 2% required at September 30, 2001 but is not reflected in the table above.

11) Business Segments

HMN's wholly owned subsidiaries, Home Federal Savings Bank and MSI (through January 31, 2001), have been identified as reportable operating segments in accordance with the provisions of SFAS 131. MSI and its successor through merger, Home Federal Mortgage Services, LLC, were deemed to be a segment because its operations were conducted independently from the Bank. MSI and HFMS, jointly called Mortgage Services, have been segmented further into Mortgage Servicing Rights and Mortgage Banking activities. The mortgage servicing segment owns

servicing rights on loans which have either been sold to FNMA or securitized into mortgage backed instruments which were issued by FNMA. HFMS receives a servicing fee which is based upon the outstanding balance of the loan being serviced and pays a subservicer a monthly fee to service the loan. HFMS's mortgage banking activity includes an origination function and it also purchases loans from other loan originators. All loans acquired either by origination or by purchase are intended to be resold in the secondary loan market.

Security Finance Corporation and HMN, the holding company, did not meet the quantitative thresholds for determining reportable segments and therefore are included in the "Other" category.

HMN evaluates performance and allocates resources based on the segment's net income or loss, return on average assets and return on average equity. Each corporation is managed separately with its own president, who reports directly to HMN's chief operating decision maker, and board of directors.

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

		Home Federal Mortgage Services, LLC					
(Dollars in thousands)	Home Federal Savings Bank	Mortgage Servicing Rights	Mortgage Banking	Total Reportable Segments	Other	Eliminations	Consolidated Total
At or for the three-months ended September 30, 2001							
Interest income							

- external customers	$ 11,596	0	892	12,488	89	0	12,577
Non-interest income							
- external customers	979	6	106	1,091	253	0	1,344
Earnings (loss) on limited partnerships	120	0	0	120	(15)	0	105
Intersegment interest income	766	0	0	766	49	(815)	0
Intersegment non-interest income (expense)	(87)	0	0	(87)	1,763	(1,676)	0
Interest expense	7,520	0	783	8,303	0	(815)	7,488
Amortization of mortgage servicing							
rights and net valuation adjustments	146	12	0	158	0	0	158
Other non-interest expense	2,986	0	543	3,529	263	(141)	3,651
Income tax expense (benefit)	692	0	0	692	(121)	0	571
Minority interest	(163)	0	0	(163)	0	0	(163)
Net income (loss)	1,894	(6)	(328)	1,560	1,998	(1,535)	2,023
Total assets	712,716	114	65,381	778,211	72,435	(129,219)	721,427
Net interest margin	2.83 %	NM	NM	NM	NM	NM	2.93 %
Return on average assets	1.05 %	(2.06) %	(2.11) %	NM	NM	NM	1.12 %
Return on average realized							
common equity	13.17 %	(106.35) %	(110.11) %	NM	NM	NM	11.06 %

At or for the three-months ended							
September 30, 2000							
Interest income							
- external customers	$ 13,282	0	106	13,388	137	0	13,525
Non-interest income							
- external customers	720	16	159	895	11	0	906
Earnings (loss) on							
Limited partnerships	(4)	0	0	(4)	(38)	0	(42)
Intersegment interest income	21	0	0	21	81	(102)	0
Intersegment non-interest income	101	0	0	101	1,671	(1,772)	0
Interest expense	8,564	0	84	8,648	22	(102)	8,568
Amortization of mortgage servicing							
rights and net valuation adjustments	68	10	0	78	0	0	78
Other non-interest expense	2,672	7	216	2,895	125	(101)	2,919
Income tax expense (benefit)	1,087	0	(14)	1,073	3	0	1,076
Net income (loss)	1,684	(1)	(21)	1,662	1,712	(1,671)	1,703
Total assets	709,260	200	5,647	715,107	65,526	(58,476)	722,157
Net interest margin	2.76 %	NM	NM	NM	NM	NM	2.83 %
Return on average assets	0.95 %	(1.38) %	(1.62) %	NM	NM	NM	0.94 %

Return on average realized common equity	12.40 %	(6.94) %	(6.74) %	NM	NM	NM	9.91 %

NM - Not meaningful

(Dollars in thousands)	Home Federal Savings Bank	Home Federal Mortgage Services, LLC Mortgage Servicing Rights	Home Federal Mortgage Services, LLC Mortgage Banking	Total Reportable Segments	Other	Eliminations	Consolidated Total
At or for the nine-months ended September 30, 2001							
Interest income - external customers	$ 36,691	0	2,265	38,956	305	0	39,261
Non-interest income - external customers	2,464	34	1,289	3,787	595	0	4,382
Earnings (loss) on limited partnerships	(503)	0	0	(503)	(21)	0	(524)
Intersegment interest income	2,018	0	0	2,018	222	(2,240)	0

Intersegment non-interest income (expense)	294	0	0	294	4,528	(4,822)	0
Interest expense	23,905	0	2,128	26,033	15	(2,240)	23,808
Amortization of mortgage servicing rights and net valuation adjustments	430	64	0	494	0	0	494
Other non-interest expense	8,978	0	1,528	10,506	760	(411)	10,855
Income tax expense (benefit)	2,391	0	(28)	2,363	(7)	0	2,356
Minority interest	(30)	0	0	(30)	0	0	(30)
Net income (loss)	4,540	(30)	(74)	4,436	4,861	(4,411)	4,886
Total assets	712,716	114	65,381	778,211	72,435	(129,219)	721,427
Net interest margin	2.89 %	NM	NM	NM	NM	NM	2.97 %
Return on average assets	0.84 %	(21.74) %	(0.22) %	NM	NM	NM	0.90 %
Return on average realized common equity	10.78 %	(507.40) %	(9.09) %	NM	NM	NM	9.13 %
At or for the nine- months ended September 30, 2000							
Interest income - external customers	$ 38,520	0	222	38,742	483	0	39,225
Non-interest income							
	1,929	45	422	2,396	15	0	2,411

- external customers							
Earnings (loss) on							
Limited partnerships	154	0	0	154	(77)	0	77
Intersegment interest income	21	0	0	21	208	(229)	0
Intersegment non-interest income	292	0	0	292	4,986	(5,278)	0
Interest expense	24,264	0	169	24,433	64	(229)	24,268
Amortization of mortgage servicing							
rights and net valuation adjustments	184	22	0	206	0	0	206
Other non-interest expense	7,956	24	699	8,679	378	(292)	8,765
Income tax expense (benefit)	3,285	0	(90)	3,195	31	0	3,226
Net income (loss)	5,092	(1)	(134)	4,957	5,142	(4,986)	5,113
Total assets	709,260	200	5,647	715,107	65,526	(58,476)	722,157
Net interest margin	2.83 %	NM	NM	NM	NM	NM	2.90 %
Return on average assets	0.95 %	(0.60) %	(4.58) %	NM	NM	NM	0.96 %
Return on average realized							
common equity	12.40 %	(1.93) %	(14.73) %	NM	NM	NM	9.99 %

NM - Not meaningful

HMN FINANCIAL, INC.

Item 2:

MANAGEMENT'S DISCUSSION AND ANALYSIS

OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

HMN's net income is dependent primarily on its net interest income, which is the difference between interest earned on its loans and investments and the interest paid on interest-bearing liabilities. Net interest income is determined by (i) the difference between the yield earned on interest-earning assets and interest rates paid on interest-bearing liabilities (interest rate spread) and (ii) the relative amounts of interest-earning assets and interest-bearing liabilities. HMN's interest rate spread is affected by regulatory, economic and competitive factors that influence interest rates, loan demand and deposit flows. Net interest margin is calculated by dividing net interest income by the average interest-earning assets and is normally expressed as a percentage. Net interest income and net interest margin are affected by changes in interest rates, the volume and the mix of interest-earning assets and interest-bearing liabilities, and the level of non-performing assets. HMN's net income is also affected by the generation of non-interest income, which primarily consists of gains from the sale of securities, gains from sale of loans, service charges, fees and other income. In addition, net income is affected by the level of operating expenses, provisions made for loan losses and impairment reserve adjustments required on mortgage servicing assets.

The operations of financial institutions, including the Bank, are significantly affected by prevailing economic conditions, competition and the monetary and fiscal policies of governmental agencies. Lending activities are influenced by the demand for and supply of housing, competition among lenders, the level of interest rates and the availability of funds. Deposit flows and costs of funds are influenced by prevailing market rates of interest primarily on competing investments, account maturities and the levels of personal income and savings in the market area of the Bank.

Net Income

HMN's net income for the third quarter of 2001 was $2.0 million, an increase of $320,000 or 18.8%, compared to net income of $1.7 million for the third quarter of 2000. Basic earnings per share were $0.53 for the quarter ended September 30, 2001, an increase of $0.08 per share or 17.8%, from $.45 basic earnings per share for the same quarter of 2000. Diluted earnings per share were $0.50 for the third quarter of 2001, an increase of $0.06 or 13.6%, from $0.44 diluted earnings per share for the third quarter of 2000. Income tax expense was $571,000 for the third quarter of 2001, a decrease of $505,000 compared to the $1.1 million for the third quarter of 2000. The decrease in income tax expense is due to tax benefits derived from amending prior year's tax returns and current year state tax allocations.

HMN's net income for the nine months ended September 30, 2001 was $4.9 million, a decrease of $227,000 or 4.4%, compared to net income of $5.1 million for the same nine month period of 2000. Basic earnings per share were $1.30 for the nine months ended September 30, 2001, a decrease of $0.02 per share or 1.5%, from $1.32 basic earnings per share for the same nine month period of 2000. Diluted earnings per share were $1.23 for the nine months ended September 30, 2001, a decrease of $0.05 or 3.9%, from $1.28 diluted earnings per share for the same nine month period of 2000. During the past nine months, the Bank recognized a pretax impairment loss on its securities portfolio of $610,000, which reduced diluted earning per share by $0.10. Income tax expense was $2.4 million for the nine months ended September 30, 2001, a decrease of $870,000 compared to the $3.2 million for the same nine month period of 2000. The decrease in income tax expense is due to tax benefits derived from amending prior year's tax returns and current year state tax allocations.

Net Interest Income

Net interest income for the third quarter of 2001 was $5.1 million, an increase of $131,000, or 2.6%, compared to $5.0 million for the third quarter of 2000. Interest income for the third quarter of 2001 was $12.6 million, a decrease of $949,000, or 7.0%, compared to $13.5 million for the third quarter of 2000. Interest income decreased by $802,000 due to lower interest rates on assets being added to the portfolio and also due to a general decrease in interest rates from the third quarter of 2000 through the third quarter of 2001. The decrease in rates on average interest-earning assets is the result of the Federal Reserve lowering interest rates during 2001. The yield earned on interest-earning assets decreased from 7.72% at September 30, 2000, to 7.24% at September 30, 2001.

Interest expense was $7.5 million for the third quarter of 2001, a decrease of $1.1 million, or 12.6%, compared to $8.6 million for the same quarter of 2000. Interest expense on deposits was $4.6 million for the third quarter of 2001, a decrease of $363,000, or 7.3%, from $5.0 million for the third quarter of 2000. Interest expense on deposits decreased primarily due to a decrease in the average interest rates that were paid on deposits. Interest expense on Federal Home Loan Bank (FHLB) advances and other borrowed money was $2.9 million for the third quarter of 2001, a decrease of $718,000, or 20.1%, from $3.6 million for the third quarter of 2000. Interest expense decreased due to a decrease in the cost of borrowing from the FHLB including a $478,000 decrease due to declining interest rates between the two periods. The average interest rate paid on the average interest-bearing liabilities was 4.68% during the third quarter of 2001, compared to 5.28% for the third quarter of 2000.

Interest expense decreased by $235,000 due to a $16.4 million decrease in the average outstanding advances from the FHLB. The advances were paid off with excess cash made available from prepayments on mortgage loans.

Net interest margin (net interest income divided by average interest earning assets) for the third quarter of 2001 was 2.93%, an increase of 10 basis points, compared to 2.83% for the third quarter of 2000.

Net interest income for the nine month period ended September 30, 2001 was $15.5 million, an increase of $496,000, or 3.3%, compared to $15.0 million for the same period of 2000. Interest income for the nine month period of 2001 was $39.3 million, an increase of $35,000, or .1%, compared to $39.2 million for the same period of 2000. Interest income increased by $201,000 due to a $8.4 million net increase in average interest-earning assets from the nine month period of 2000 to the same period of 2001. This increase was partially offset by a decrease of $171,000 due to decreasing interest rates on interest bearing assets between the two periods. The increase in average interest-earning assets is the result of HMN's emphasis on originating and/or purchasing commercial real estate loans, commercial business loans and consumer loans which generally have higher interest rates and shorter terms to maturity than single family fixed-rate residential loans. Interest income increased by $918,000 due to higher interest rates being earned on the types of loans being added to the portfolio from the nine month period ended September 30, 2000 to the same period of 2001. The yield earned on interest-earning assets decreased from 7.61% at September 30, 2000, to 7.53% at September 30, 2001.

Interest expense was $23.8 million for the nine months ended September 30, 2001, a decrease of $460,000, or 1.90%, compared to $24.3 million for the same nine month period of 2000. Interest expense on deposits was $14.6 million for the nine months ended September 30, 2001, an increase of $751,000, or 5.4%, from $13.9 million for the same nine month period in 2000. Interest expense on deposits increased by $615,000 due to an increase in the average balance of outstanding deposits from the nine month period ended in September of 2000 to the same nine month period in 2001. Interest expense increased by $124,000 related to higher rates being paid on certificates of deposit. Interest expense on FHLB advances was $9.2 million for the nine month period of 2001, a decrease of $1.2 million, or 11.6%, from $10.4 million for the same period of 2000. Interest expense decreased by $457,000 due to a $10.5 million decrease in the average outstanding advances from the FHLB. The advances were paid off with excess cash made available from prepayments of single family mortgage loans. Interest expense decreased by $749,000 due to a decrease in the cost of borrowing from the FHLB due to lowering interest rates between the two periods. The average interest rate paid on the average interest-bearing liabilities was 4.96% during the nine months ended September 30, 2001, compared to 5.09% for the same period of 2000.

Net interest margin (net interest income divided by average interest earning assets) for the nine months ended September 30, 2001, was 2.97%, an increase of 7 basis points, compared to 2.90% for the same period of 2000.

Provision for Loan Losses

*The provision for loan losses for the third quarter ended September 30, 2001 was $300,000, an increase of $255,000, or 567.0%, compared to $45,000 for the third quarter of 2000. The provision for loan losses for the nine months ended September 30, 2001 was $750,000, an increase of $615,000, or 455.6% compared to $135,000 for the same nine month period ended in 2000. The provision is the result of management's evaluation of the composition of the loan portfolio, the historical level of non-performing loans, increases in loan charge-off experience, and its assessment of the general economic conditions in the geographic area where properties securing the loan portfolio are located such as national and regional unemployment data, local single family construction permits and local economic growth rates. Management's evaluation of probable losses inherent in the loan portfolio revealed conditions that resulted in increasing the 2001 loan loss provision compared to the provision for 2000. This increase was due primarily to the growth that was experienced in the commercial and consumer loan portfolios. Commercial and consumer loans generally require a larger provision due to the greater inherent credit risk of these loans. During the first nine months of 2001 HMN charged off the commercial loans related to two commercial relationships. HMN will continue to monitor its allowance for losses as conditions dictate. Future economic conditions and other unknown factors will impact the need for future provisions for loan losses. As a result, no assurances can be given that increases in the allowance for loan losses will not be required during future periods.

A reconciliation of HMN's allowance for loan losses is summarized as follows:

	2001	2000
Balance at January 1,	$ 3,143,746	$ 3,273,311
Provision	750,000	135,000
Commercial loan charge offs	(347,308)	0
Consumer loan charge offs	(111,788)	(22,017)
Recoveries	1,540	2,890
Balance at September 30,	$ 3,436,190	$ 3,389,184

Non-Interest Income

Non-interest income was $1.4 million for the third quarter of 2001, an increase of $555,000, or 64.2%, from $864,000 for the third quarter of 2000.

Non-interest income increased by $136,000 due to gains recognized on the sale of single family residential loans, increases in the earnings of limited partnerships of $146,000, gains on sales of securities of $77,000, and unrealized gains on derivatives of $118,000. The unrealized gains resulted from interest rates lowering during the quarter, which in turn increased the value of the loans that were in the pipeline at above market rates. Interest rates on fixed rate single family residential loans were favorable during the third quarter of 2001, which caused an increase in the loan volume of new home purchases and existing home refinances. Since HMN sells the majority of its fixed rate single family loans, gain on the sale of loans improved from the third quarter of 2000 to the third quarter of 2001.

Non-interest income was $3.9 million for the nine months ended September 30, 2001, an increase of $1.4 million, or 55.1%, from $2.5 million for the same nine month period of 2000. The increase in non-interest income was primarily due to a $1.9 million increase in gains recognized on the sale of loans which increase was partially offset by a decrease of $222,000 on security gains and a $602,000 decrease in earnings on limited partnership investments.

* This paragraph contains a forward-looking statement(s). Refer to information regarding Forward-looking Information on page 25 of this discussion.

Due to a general decrease in interest rates which started in 2000 and continued through the third quarter 2001, single family conforming loan production increased from 2000, compared to 2001. The higher conforming loan production equated to a higher gain on the sale of loans being recorded between the two nine month periods. Gain on sale of securities declined primarily due to a $610,000 impairment loss recognized in the securities portfolio during the first nine months of 2001. The earnings from limited partnerships also declined due to decreases in the value of mortgage servicing rights held by one of the limited partnerships. Many of the loans for which the limited partnership held the servicing rights were refinanced due to the lowering interest rate environment in 2001 and the value of the servicing portfolio decreased. The decrease in non-interest income was partially offset by an increase of $171,000 in fees and service charges on deposit related accounts and loans.

Non-Interest Expense

Non-interest expense was $3.8 million for the third quarter of 2001, an increase of $780,000 or 26.0%, from $3.0 million for the third quarter of 2000. Compensation and benefits expense increased by $442,000, or 29.8%, due primarily to more commissions paid on higher loan production and annual pay increases and the number of employees in the work force. Occupancy costs increased by $38,000 primarily due to additional depreciation and other costs related to equipment and additional facilities. Data processing expense increase by $36,000 due to the increased costs of services offered to customers including Internet banking services. Other Expenses increased by $190,000 primarily due to increases in legal expenses related to a trademark litigation settlement and other miscellaneous expenses. Amortization of mortgage servicing rights, net of valuation adjustments and servicing costs increased by $74,000 due to the lowering interest rates in 2001, which caused many of the serviced loans to be refinanced.

Non-interest expense was $11.3 million for the nine months ended September 30, 2001, an increase of $2.4 million or 26.5%, from $8.9 for the same nine month period of 2000. Compensation and benefits expense increased by $1.2 million, or 26.0%, due primarily to more commissions paid on higher loan production and annual pay increases and the number of employees in the work force. Occupancy costs increased by $227,000 primarily due to additional depreciation and other costs related to equipment and additional facilities. Amortization of mortgage servicing rights, net of valuation adjustments and servicing costs increased by $264,000 due to the lowering rate environment in 2001, which caused many of the serviced loans to be refinanced. Data processing expense increased by $131,000 due to the increased costs of services offered to customers including Internet banking services. Other expenses increased by $476,000 primarily due to increases in legal expenses related to a trademark litigation settlement and other miscellaneous expenses.

Income Tax Expense

Income tax expense was $571,000 for the third quarter of 2001, a decrease of $505,000 compared to $1.1 million for the third quarter of 2000. Income tax expense was $2.4 million for the nine months ended September 30, 2001, a decrease of $870,000 compared to $3.2 million for the same nine month period of 2000. The decrease in income tax expense is due to tax benefits derived from amending prior years' tax returns and current year state tax allocation.

Non-Performing Assets

The following table sets forth the amounts and categories of non-performing assets in the Bank's portfolio at

September 30, 2001 and December 31, 2000.

(Dollars in Thousands)		Sept.30, 2001		Dec.31, 2000
Non-Accruing Loans				
One-to-four family real estate	$	184		775
Consumer		449		142
Commercial business		280		95
Total		913		1,012
Accruing loans delinquent 90 days or more		0		405
Other assets		1,390		0
Foreclosed Assets				
Real estate:				
One-to-four family		0		195
Total non-performing assets	$	2,303	$	1,612
Total as a percentage of total assets		0.32 %		0.23 %
Total non-performing loans	$	913	$	1,417
Total as a percentage of total loans receivable, net		0.18 %		0.27 %

Total non-performing assets at September 30, 2001 were $2,303,000, an increase of $691,000, from $1,612,000 at December 31, 2000. The net increase of $691,000 was the result of a $99,000 decrease in non-accruing loans, a $1,390,000 increase in non-accruing investments due to bankruptcy filed by the underlying debtors, which were offset by a $405,000 decrease in accruing loans delinquent 90 days or more and a decrease of $195,000 in real estate owned.

Dividends

On October 23, 2001 HMN declared a cash dividend of $.14 per share, payable on December 12, 2001 to shareholders of record on November 23, 2001.

During 2001, HMN has declared and paid dividends as follows:

Record date	Payable date	Dividend per share	Dividend Payout Ratio
February 22, 2001	March 8, 2001	$0.12	29.27%
April 24, 2001	June 11, 2001	$0.12	30.0 %
July 24, 2001	September 11, 2001	$0.14	43.75%

The annualized dividend payout ratio for the past four quarters, ending with the December 12, 2001 payment will be 31.90%.

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

Liquidity

For the nine months ended September 30, 2001, the net cash used by operating activities was $49.9 million. HMN collected $19.1 million from the sale of securities, $26.4 million from principal repayments and the maturity of securities and $317,000 in proceeds from the sale of real estate. It purchased premises and equipment of $1.7 million and net loans receivable decreased by $17.6 million due to loan prepayments and payoffs. HMN had a net increase in deposit balances of $7.6 million for the nine month period. It repaid maturing FHLB advances of $271.8 million and borrowed additional FHLB advances of $259.7 million for a net decrease in advances of $12.1 million. HMN received $512,000 from increased advance payments from borrowers for taxes and insurance. HMN received $125,000 from the sale of a minority interest in HFMS and it also received $476,000 related to the exercise of HMN stock options. HMN purchased $74,000 of its own stock and paid $1,348,000 in dividends to its shareholders.

*HMN has certificates of deposits with outstanding balances of $225.0 million that come due over the next 12 months. Based upon past experience management anticipates that the majority of the deposits will renew for another term. HMN believes that deposits that do not renew will be replaced with deposits from other customers, or funded with advances from the FHLB, or will be funded through the sale of securities. Management does not anticipate that it will have a liquidity problem due to maturing deposits.

*HMN has $25.0 million of FHLB advances which mature after 2003 but have call features that can be exercised by the FHLB during the next 12 months. If the call features are exercised HMN has the option of requesting any advance otherwise available to it pursuant to the Credit Policy of the FHLB. HMN also has $8.5 million of FHLB advances which will mature during the next 12 months. Since HMN has the ability to request another advance to replace the advance that is being called or is maturing, management does not anticipate that it will have a liquidity problem due to advances being called by the FHLB during the next 12 month period.

Market Risk

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

*Since the beginning of 2001, the Federal Reserve has decreased short-term interest rates to levels that have not been experienced since the early 1960's. From September 30, 2001 to November 13, 2001 the Federal Reserve lowered short-term by 100 basis points. The decrease in interest rates has been in response to a worsening economic outlook. The United States economy appears to be in a recession, and current economic growth is very low. Uncertainty created by the terrorist attack on September 11, 2001 appears to have compounded the slow recovery of the economy. In this environment HMN, along with the entire financial services industry, may experience a decrease in demand for the primary products, loans and deposits, and more than likely will experience an increase in past due loans and loan charge-offs. Declines in interest rates may have a negative effect on the value of mortgage servicing rights and HMN's investment in a limited partnership that invests in mortgage servicing rights. Typically an economic recession results in lower earnings for financial institutions. However, the impact of the recession may be offset by the effects of proposed economic stimuli and further short-term rate adjustments by the Federal Reserve.

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

*This paragraph contains a forward-looking statement(s). Refer to information regarding Forward-looking Information on page 25 of this discussion.

*HMN utilizes a model which uses the discounted cash flows from its interest-earning assets and its interest-bearing liabilities to calculate the current market value of those assets and liabilities. The model also calculates the changes in market value of the interest-earning assets and interest-bearing liabilities due to different interest rate changes. HMN believes that over the next twelve months interest rates could conceivably fluctuate in a range of 200 basis points up or down from where the interest rates were at September 30, 2001. HMN does not have a trading portfolio. The following table discloses the projected changes in market value to HMN's interest-earning assets and interest-bearing liabilities based upon incremental 100 basis point changes in interest rates from interest rates in effect on September 30, 2001.

	Market Value
Other than trading portfolio (Dollars in thousands)	

Basis point change in interest rates		-200	-100	0	+100	+200
Cash equivalents	$	21,312	21,297	21,324	21,265	21,251
Securities available for sale:						
Fixed-rate CMOs		9,401	9,381	9,418	9,715	9,573
Variable-rate CMOs		54,409	54,405	54,891	56,871	56,973
Fixed-rate available for sale mortgage-backed and related securities		2,638	2,630	2,700	2,591	2,504
Variable-rate available for sale mortgage-backed and related securities		1,582	1,580	1,576	1,571	1,567
Fixed-rate available for sale other marketable securities		28,726	27,997	27,209	26,436	25,707
Variable-rate available for sale other marketable securities		119	115	115	114	114
Federal Home Loan Bank stock		12,232	12,222	12,245	12,202	12,192
Fixed-rate loans held for sale		70,188	69,039	66,650	64,142	62,895
Loans receivable, net:						
Fixed-rate real estate loans		242,607	240,259	234,661	227,366	219,980
Variable-rate real estate loans		144,315	141,347	138,455	135,762	133,207
Fixed-rate other loans		86,465	85,800	84,819	82,969	81,345
Variable-rate other loans		70,525	69,315	68,335	67,692	67,184
Mortgage servicing rights, net		623	936	1,632	2,007	2,163
Investment in limited partnerships		1,388	1,549	2,314	3,052	3,315
Total market risk sensitive assets		746,530	737,872	726,344	713,755	699,970
NOW deposits		55,805	55,805	55,805	55,805	55,805

Passbook deposits		33,169		33,169		33,169		33,169		33,169	
Money market deposits		43,273		43,273		43,273		43,273		43,273	
Certificate deposits		309,319		306,034		302,852		299,766		296,774	
Fixed-rate Federal Home Loan Bank advances		196,424		187,611		179,327		173,468		172,285	
Variable-rate Federal Home Loan Bank advances		37,799		37,538		37,513		37,489		37,464	
Total market risk sensitive liabilities		675,789		663,430		651,939		642,970		638,770	
Off-balance sheet financial instruments:											
Commitments to extend credit		4,641		3,339		0		(2,011)		(3,369)	
Commitments to sell or deliver loans	$	(8,029)		(5,726)		0		3,824		6,280	
Net market risk		74,129		76,829		74,405		68,972		58,289	
Percentage change from current market value		(0.37)	%	3.26	%	0.00	%	(7.30)	%	(21.66)	%

*This paragraph contains a forward-looking statement(s). Refer to information regarding Forward-looking Information on page 25 of this discussion.

The preceding table was prepared utilizing the following assumptions (the "Model Assumptions") regarding prepayment and decay ratios which were determined by management based upon their review of historical prepayment speeds and future prepayment projections. Fixed rate loans were assumed to prepay at annual rates of between 7% to 44%, depending on the note rate and the period to maturity. Adjustable rate mortgages ("ARMs") were assumed to prepay at annual rates of between 11% and 31%, depending on the note rate and the period to maturity. Growing Equity Mortgage (GEM) loans were assumed to prepay at annual rates of between 18% and 54% depending on the note rate and the period to maturity. Mortgage-backed securities and Collateralized Mortgage Obligations (CMOs) were projected to have prepayments based upon the underlying collateral securing the instrument and the related cash flow priority of the CMO tranche owned. Certificate accounts were assumed not to be withdrawn until maturity. Passbook and money market accounts were assumed to decay at an annual rate of 20%. FHLB advances were projected to be called at the first call date where the projected interest rate on similar remaining term advances exceeded the interest rate on HMN's callable advance.

*Certain shortcomings are inherent in the method of analysis presented in the foregoing table. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types of assets and liabilities may lag behind changes in market interest rates. The model assumes that the difference between the current interest rate being earned or paid compared to a treasury instrument or other interest index with a similar term to maturity (the "Interest Spread") will remain constant over the interest changes disclosed in the table. Changes in Interest Spread could impact projected market value changes. Certain assets, such as ARMs, have features which restrict changes in interest rates on a short-term basis and over the life of the assets. The market value of the interest-bearing assets which are approaching their lifetime interest rate caps could be different from the values disclosed in the table. In the event of a change in interest rates, prepayment and early withdrawal levels may deviate significantly from those assumed in calculating the foregoing table. The ability of many borrowers to service their debt may decrease in the event of an interest rate increase.

Asset/Liability Management

*HMN's management reviews the impact that changing interest rates will have on its net interest income projected for the twelve months following September 30, 2001 to determine if its current level of interest rate risk is acceptable. The following table projects the estimated annual impact on net interest income of immediate interest rate changes called rate shocks.

Rate Shock in Basis Points	Net Interest Income	Percentage Change
+200	23,332,000	12.69 %
+100	22,608,000	9.19 %
0	20,705,000	0.00 %
-100	18,252,000	-11.85 %
-200	16,902,000	-18.37 %

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

Certain shortcomings are inherent in the method of analysis presented in the foregoing table. In the event of a change in interest rates, prepayment and early withdrawal levels would likely deviate significantly from those assumed in calculating the foregoing table. The ability of many borrowers to service their debt may decrease in the event of a substantial increase in interest rates and could impact net interest income.

* This paragraph contains a forward-looking statement(s). Refer to information regarding Forward-looking

Information on page 25 of this discussion.

In an attempt to manage its exposure to changes in interest rates, management closely monitors interest rate risk. The Bank has an Asset/Liability Committee consisting of executive officers which meets at least quarterly to review the interest rate risk position and projected profitability. The committee makes recommendations for adjustments to the asset/liability position of the Bank to the Board of Directors of the Bank. This committee also reviews the Bank's portfolio, formulates investment strategies and oversees the timing and implementation of transactions to assure attainment of the Board's objectives in the most effective manner. In addition, the Board reviews on a quarterly basis the Bank's asset/liability position, including simulations of the effect on the Bank's capital of various interest rate scenarios.

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

To the extent consistent with its interest rate spread objectives, the Bank attempts to reduce its interest rate risk and has taken a number of steps to restructure its assets and liabilities. The Bank has primarily focused its fixed rate one-to-four family residential lending program on loans with contractual terms of 20 years or less. The Bank generally follows the practice of selling all of its fixed rate single family loans which conform to the secondary market guidelines. HMN has focused its portfolio lending since 1999 on the origination of commercial loan products and consumer loans which generally have shorter weighted average terms to maturity and/or interest rates which adjust at least every three years. At times, depending on its interest rate sensitivity, the Bank may sell fixed rate single family loans with shorter contractual maturities than thirty years in order to reduce interest rate risk and record a gain on the sale of loans.

Forward-looking Information

The following paragraphs within Management's Discussion and Analysis of Financial Condition and Results of Operations contain forward-looking statements and actual results may differ materially from the expectations disclosed within this Discussion and Analysis. These forward-looking statements are subject to risks and uncertainties, including those discussed below. HMN assumes no obligations to publicly release results of any revision or updates to these forward-looking statements to reflect future events or unanticipated occurrences.

Provision for Loan Losses

The provision for loan losses for the third quarter ended September 30, 2001 was $300,000, an increase of $255,000, or 567.0%, compared to $45,000 for the third quarter of 2000. The provision for loan losses for the nine months ended September 30, 2001 was $750,000, an increase of $615,000, or 455.6% compared to $135,000 for the same nine month period ended in 2000. The provision is the result of management's evaluation of the composition of the loan portfolio, the historical level of non-performing loans, increases in loan charge-off experience, and its assessment of the general economic conditions in the geographic area where properties securing the loan portfolio are located such as national and regional unemployment data, local single family construction permits and local economic growth rates. Management's evaluation of probable losses inherent in the loan portfolio revealed conditions that resulted in increasing the 2001 loan loss provision compared to the provision for 2000. This increase was due primarily to the growth that was experienced in the commercial and consumer loan portfolios. Commercial and consumer loans generally require a larger provision due to the greater inherent credit risk of these loans. During the first nine months of 2001 HMN charged off the commercial loans related to two commercial relationships. HMN will continue to monitor its allowance for losses as conditions dictate. Future economic conditions and other unknown factors will impact the need for future provisions for loan losses. As a result, no assurances can be given that increases in the allowance for loan losses will not be required during future periods.

Liquidity

HMN has certificates of deposits with outstanding balances of $225.0 million that come due over the next 12 months. Based upon past experience management anticipates that the majority of the deposits will renew for another term. HMN believes that deposits that do not renew will be replaced with deposits from other customers, or funded with advances from the FHLB, or will be funded through the sale of securities. Management does not anticipate that it will have a liquidity problem due to maturing deposits.

HMN has $25.0 million of FHLB advances which mature after 2003 but have call features that can be exercised by the FHLB during the next 12 months. If the call features are exercised HMN has the option of requesting any advance otherwise available to it pursuant to the Credit Policy of the FHLB. HMN also has $8.5 million of FHLB advances which will mature during the next 12 months. Since HMN has the ability to request another advance to replace the advance that is being called or is maturing, management does not anticipate that it will have a liquidity problem due to advances being called by the FHLB during the next 12 month period.

Market Risk

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Since the beginning of 2001, the Federal Reserve has decreased short-term interest rates to levels that have not been experienced since the early 1960's. From September 30, 2001 to November 13, 2001 the Federal Reserve lowered short term interest rates by 100 basis points.The decrease in interest rates has been in response to a worsening economic outlook. The United States economy appears to be in a recession, and current economic growth is very low. Uncertainty created by the terrorist attack on September 11, 2001 appears to have compounded the slow recovery of the economy. In this environment HMN, along with the entire financial services industry, may experience a decrease in demand for the primary products, loans and deposits, and more than likely will experience an increase in past due loans and loan charge-offs. Declines in interest rates may have a negative effect on the value of mortgage servicing rights and HMN's investment in a limited partnership that invests in mortgage servicing rights. Typically an economic recession results in lower earnings for financial institutions. However, the impact of the recession may be offset by the effects of proposed economic stimuli and further short-term rate adjustments by the Federal Reserve. The lower interest rates may increase demand for single family mortgage loans and therefore increase the gain on sale of loans. Future increases in interest rates may result in lower demand for single family loans and increases in the value of servicing rights and investments in limited partnerships that invest in mortgage servicing rights.

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HMN utilizes a model which uses the discounted cash flows from its interest-earning assets and its interest-bearing liabilities to calculate the current market value of those assets and liabilities. The model also calculates the changes in market value of the interest-earning assets and interest-bearing liabilities due to different interest rate changes. HMN believes that over the next twelve months interest rates could conceivably fluctuate in a range of 200 basis points up or down from where the interest rates were at September 30, 2001. HMN does not have a trading portfolio. The table in the Market Risk section discloses the projected changes in market value to HMN's interest-earning assets and interest-bearing liabilities based upon incremental 100 basis point changes in interest rates from interest rates in effect on September 30, 2001.

Certain shortcomings are inherent in the method of analysis in the table presented in the Market Risk section. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types of assets and liabilities may lag behind changes in market interest rates. The model assumes that the difference between the current interest rate being earned or paid compared to a treasury instrument or other interest rate index with a similar term to maturity (the Interest Spread) will remain constant over the interest changes disclosed in the table. Changes in Interest Spread could impact projected market value changes. Certain assets, such as ARMs, have features which restrict changes in interest rates on a short-term basis and over the life of the assets. The market value of the interest-bearing assets which are approaching their lifetime interest rate caps could be different from

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the values disclosed in the table. In the event of a change in interest rates, prepayment and early withdrawal levels may deviate significantly from those assumed in calculating the foregoing table. The ability of many borrowers to service their debt may decrease in the event of an interest rate increase.

Asset/Liability Management

HMN's management reviews the impact that changing interest rates will have on its net interest income projected for the twelve months following September 30, 2001 to determine if its current level of interest rate risk is acceptable. HMN's actual net interest income caused by interest rate changes may differ from the amounts reflected in the table in the Asset/Liability section which projects the estimated impact on net interest income of immediate interest rate changes called rate shocks.

Certain shortcomings are inherent in the method of analysis presented in each of the tables. In the event of a change in interest rates, prepayment and early withdrawal levels would likely deviate significantly from those assumed in calculating the foregoing table. The ability of many borrowers to service their debt may decrease in the event of a substantial increase in interest rates and could impact net interest income.

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HMN FINANCIAL, INC.

PART II - OTHER INFORMATION

ITEM 1. Legal Proceedings.

None.

ITEM 2. Changes in Securities.

Not applicable.

ITEM 3. Defaults Upon Senior Securities.

Not applicable.

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

None.

ITEM 5. Other Information.

None.

ITEM 6. Exhibits and Reports on Form 8-K.

a. Exhibits. See Index to Exhibits on page 30 of this report.
b. Reports filed on Form 8-K.

None.

SIGNATURES

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

HMN FINANCIAL, INC.
Registrant

Date: November 13, 2001 /s/ Michael McNeil

Michael McNeil,
President
(Principal Executive Officer)

Date: November 13, 2001 /s/ Timothy P. Johnson

Timothy P. Johnson,
Chief Financial Officer
(Principal Financial Officer)

HMN FINANCIAL, INC.

INDEX TO EXHIBITS

FOR FORM 10-Q

Regulation S-K Exhibit Number	Document Attached Hereto	Reference to Prior Filing or Exhibit Number	Sequential Page Numbering Where Attached Exhibits Are Located in This Form 10-Q Report
3.1	Amended and Restated Articles of Incorporation	*1	N/A
3.2	Amended and Restated By-laws	*2	N/A
4	Form of Common Stock Including indentures	*3	N/A

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

*2 Incorporated by reference to the same numbered exhibit to the Company's Quarterly Report on Form 10-Q for the period ended September 30, 1997 (File 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).