HARRIS PREFERRED CAPITAL CORP
Form 10-K
March 15, 2013
Table of Contents

United States Securities and Exchange Commission

Washington, D.C. 20549

Form 10-K

Annual Report under Section 13 or 15 (d)

of the Securities Exchange Act of 1934

For the fiscal year ended December 31, 2012

Commission file number 1-13805

Harris Preferred Capital Corporation

(Exact name of registrant as specified in its charter)

Maryland	**# 36-4183096**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
111 West Monroe Street, Chicago, Illinois	**60603**
(Address of principal executive offices)	*(Zip Code)*

Registrant s telephone number, including area code:

(312) 461-2121

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

Title of each class	Name of each exchange on which registered
7 3/8% Noncumulative Exchangeable Preferred Stock, Series A, par value $1.00 per share	New York Stock Exchange

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

None

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No þ

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 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 þ No ¨

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 þ No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (229.405 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. þ

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

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer þ Smaller reporting company ¨

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

The number of shares of Common Stock, $1.00 par value, outstanding on March 15, 2013 was 1,180. No common equity is held by nonaffiliates.

Harris Preferred Capital Corporation

TABLE OF CONTENTS

Table of Contents

PART I

Forward-Looking Information

This Annual Report on Form 10-K (Report) of Harris Preferred Capital Corporation (the Company) includes certain forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including (without limitation) statements with respect to the Company s expectations, intentions, beliefs or strategies regarding the future. Forward-looking statements include the Company s statements regarding tax treatment as a real estate investment trust, the regulatory environment in which the Company operates and future regulatory requirements, liquidity, capital resources and investment activities. In addition, in those and other portions of this document, the words anticipate, believe, estimate, expect, intend and other similar expressions, a they relate to the Company or the Company s management, are intended to identify forward-looking statements. Such statements reflect the current views of the Company with respect to future events and are subject to certain risks, uncertainties and assumptions. It is important to note that the Company s actual results could differ materially from those described herein as anticipated, believed, estimated or expected. Among the factors that could cause the results to differ materially are the risks discussed in Risk Factors below (Item 1A of this Report). The Company assumes no obligation to update any such forward-looking statements.

ITEM 1. ***BUSINESS***
General

Harris Preferred Capital Corporation is a Maryland corporation incorporated on September 24, 1997 pursuant to the Maryland General Corporation Law. The Company s principal business objective is to acquire, hold, finance and manage qualifying real estate investment trust (REIT) assets (the Mortgage Assets), consisting of mortgage-backed securities, notes issued by BMO Harris Bank N.A,. formerly Harris N.A. (the Bank) secured by Securing Mortgage Loans (defined below) and other obligations secured by real property, as well as certain other qualifying REIT assets. The Company s assets are held in a Maryland real estate investment trust subsidiary, Harris Preferred Capital Trust. The Company has elected to be treated as a REIT under the Internal Revenue Code of 1986 (the Code), and will generally not be subject to federal income tax if it distributes 90% of its adjusted REIT ordinary taxable income and meets all of the qualifications necessary to be a REIT. All of the shares of the Company s common stock, par value $1.00 per share (the Common Stock), are owned by Harris Capital Holdings, Inc. (HCH), a wholly owned subsidiary of the Bank. The Company was formed by the Bank to provide investors with the opportunity to invest in residential mortgages and other real estate assets and to provide the Bank with a cost-effective means of raising capital for federal regulatory purposes. Beginning January 1, 2009, Illinois requires a captive REIT to increase its state taxable income by the amount of dividends paid. Under this law, a captive REIT includes a REIT of which 50% of the voting power or value of the beneficial interest or shares is owned by a single owner. Management believes that the Company is classified as a captive REIT under Illinois law, in light of the fact that (1) all of the Common Stock is held by HCH, a wholly owned subsidiary of the Bank, (2) the Common Stock represents more than 50% of the voting power of the Company s equity securities and (3) the Common Stock is not listed for trading on an exchange. The Illinois statutory tax rate for 2010 was 7.3% and for 2011 and 2012 the Illinois statutory tax rate was 9.5% and the tax rate for 2013 is expected to remain at 9.5%. Management believes that the state tax expense to be incurred by the Company has not had, and in future years should not have a material adverse effect upon the Company s ability to declare and pay future dividends on the Preferred Shares (as defined below). This belief is based upon the ownership interest of the Company, whereby any tax expense incurred is expected to primarily reduce the net earnings available to the holder of the Company s Common Stock.

On February 11, 1998, the Company, through a public offering (the Offering), issued 10,000,000 shares of its 7 3/8% Noncumulative Exchangeable Preferred Stock, Series A (the Preferred Shares), $1.00 par value. The Offering raised $250 million less $7.9 million of underwriting fees. The Preferred Shares are traded on the New York Stock Exchange under the symbol HBC Pr A . Holders of Preferred Shares are entitled to receive, if declared by the Company s Board of Directors, noncumulative dividends at a rate of 7 3/8% per annum of the $25 per share liquidation preference (an amount equivalent to $1.8438 per share per annum). Dividends on the Preferred Shares, if authorized and declared, are payable quarterly in arrears on March 30, June 30, September 30 and December 30 of each year, provided that, if any interest payment date on the Preferred Shares (Interest Payment Date) would otherwise fall on a day that is not a Business Day, the Interest Payment Date will be on the following Business Day. The Preferred Shares may be redeemed for cash at the option of the Company, in whole or in part, at any time and from time to time, at the liquidation preference thereof, plus the quarterly accrued and unpaid dividends, if any, thereon. The Company may not redeem the Preferred Shares without prior approval from the Office of the Comptroller of the Currency (the OCC) or the appropriate successor or other federal regulatory agency.

Each Preferred Share will be automatically exchanged (the Automatic Exchange) for one newly issued preferred share of the Bank (Bank Preferred Share) in the event (i) the Bank becomes less than adequately capitalized under regulations established pursuant to the Federal Deposit Insurance Corporation Improvement Act of 1991, as amended, (ii) the Bank is placed into conservatorship or receivership, (iii) the OCC directs such exchange in writing because, in its sole discretion and even if the Bank is not less than adequately capitalized, the OCC anticipates that the Bank may become less than adequately capitalized in the near term, or (iv) the OCC in its sole discretion directs in writing an exchange in the event that the Bank has a Tier 1 risk-based capital ratio of less than 5% (each an Exchange Event). As a result of an Exchange Event, the Bank Preferred Shares would constitute a new series of preferred shares of the Bank, would have the same dividend rights, liquidation preference, redemption options and other attributes as the Preferred Shares, except that the Bank Preferred Shares would not be listed on the New York Stock Exchange and would rank *pari passu* in terms of cash dividend payments and liquidation preference with any outstanding shares of preferred stock of the Bank.

Concurrent with the issuance of the Preferred Shares, the Bank contributed additional capital of $241 million, net of acquisition costs, to the Company. The Company and the Bank undertook the Offering for two principal reasons: (i) the qualification of the Preferred Shares as Tier 1 capital of the Bank for U.S. banking regulatory purposes under relevant regulatory capital guidelines, as a result of the treatment of the Preferred Shares as a minority interest in a consolidated subsidiary of the Bank, and (ii) lack of federal income tax on the Company s earnings used to pay the dividends on the Preferred Shares, as a result of the Company s qualification as a REIT. On December 30, 1998, the Bank contributed the Common Stock of the Company to HCH, a newly-formed and wholly-owned subsidiary of the Bank. The Bank is an indirect wholly-owned U.S. subsidiary of Bank of Montreal (BMO). The Bank is required to maintain direct or indirect ownership of at least 80% of the outstanding Common Stock of the Company for as long as any Preferred Shares are outstanding.

The Company used the Offering proceeds and the additional capital contributed by the Bank to purchase $356 million of notes (the Notes) from the Bank and $135 million of mortgage-backed securities at their estimated fair value. The Notes are obligations issued by the Bank that are recourse only to the underlying mortgage loans (the Securing Mortgage Loans) and were acquired pursuant to the terms of a loan agreement with the Bank. The principal amount of the Notes equals approximately 80% of the principal amounts of the Securing Mortgage Loans.

On March 4, 2009, the Company amended its Articles of Incorporation to increase the number of authorized shares of Common Stock from 1,000 shares to 5,000 shares. On March 5, 2009, the Company entered into a contribution agreement with HCH pursuant to which the Company agreed to issue and sell 180 shares of Common Stock to HCH for a purchase price of $444,444.44 per share, or $80,000,000 in cash. HCH acquired the shares on March 5, 2009 and continues to own 100% of the shares of the Common Stock. The Company utilized proceeds from the Common Stock issuance to acquire assets in a manner consistent with Company investment guidelines.

Business

The Company was formed for the purpose of raising capital for the Bank. One of the Company s principal business objectives is to acquire, hold, finance and manage Mortgage Assets. These Mortgage Assets generate interest income for distribution to stockholders. A portion of the Mortgage Assets of the Company consists of Notes issued by the Bank that are recourse only to Securing Mortgage Loans that are secured by real property. The Notes mature on October 1, 2027 and pay interest at 6.4% per annum. Payments of interest are made to the Company from payments made on the Securing Mortgage Loans. Pursuant to an agreement between the Company and the Bank, the Company, through the Bank as agent, receives all scheduled payments made on the

Securing Mortgage Loans, retains a portion of any such payments equal to the amount due on the Notes and remits the balance, if any, to the Bank. The Company also retains approximately 80% of any prepayments of principal in respect of the Securing Mortgage Loans and applies such amounts as a prepayment on the Notes. The Company has a security interest in the real property securing the Securing Mortgage Loans and will be entitled to enforce payment on the loans in its own name if a mortgagor should default. In the event of such default, the Company would have the same rights as the original mortgagee to foreclose the mortgaged property and satisfy the obligations of the Bank out of the proceeds.

The Company may from time to time acquire fixed-rate or variable-rate mortgage-backed securities representing interests in pools of mortgage loans. The Bank may have originated a portion of any such mortgage-backed securities by exchanging pools of mortgage loans for the mortgage-backed securities. The mortgage loans underlying the mortgage-backed securities will be secured by single-family residential properties located throughout the United States. The Company intends to acquire only investment grade mortgage-backed securities issued by agencies of the federal government or government sponsored agencies, such as the Federal Home Loan Mortgage Corporation (FHLMC), the Federal National Mortgage Association (Fannie Mae) and the Government National Mortgage Association (GNMA). The Company does not intend to acquire any interest-only, principal-only or similar mortgage-backed securities. All mortgage-backed securities at December 31, 2012 and 2011 were government secured securities.

The Bank may from time to time acquire or originate both conforming and nonconforming residential mortgage loans. Conventional conforming residential mortgage loans comply with the requirements for inclusion in a loan guarantee program sponsored by either FHLMC or Fannie Mae. Nonconforming residential mortgage loans are residential mortgage loans that do not qualify in one or more respects for purchase by Fannie Mae or FHLMC under their standard programs. The nonconforming residential mortgage loans that the Company purchases will be nonconforming because they have original principal balances which exceed the limits for FHLMC or Fannie Mae under their standard programs. The Company believes that all residential mortgage loans will meet the requirements for sale to national private mortgage conduit programs or other investors in the secondary mortgage market. As of December 31, 2012 and 2011 and for each of the years then ended, the Company did not directly hold any residential mortgage loans.

The Company may from time to time acquire commercial mortgage loans secured by industrial and warehouse properties, recreational facilities, office buildings, retail space and shopping malls, hotels and motels, hospitals, nursing homes or senior living centers. The Company s current policy is not to acquire any interest in a commercial mortgage loan if commercial mortgage loans would constitute more than 5% of the Company s Mortgage Assets at the time of its acquisition. Unlike residential mortgage loans, commercial mortgage loans generally lack standardized terms. Commercial real estate properties themselves tend to be unique and are more difficult to value than residential real estate properties. Commercial mortgage loans may also not be fully amortizing, meaning that they may have a significant principal balance or balloon payment due on maturity. Moreover, commercial properties, particularly industrial and warehouse properties, are generally subject to relatively greater environmental risks than non-commercial properties, generally giving rise to increased costs of compliance with environmental laws and regulations. There is no requirement regarding the percentage of any commercial real estate property that must be leased at the time the Bank acquires a commercial mortgage loan secured by such commercial real estate property, and there is no requirement that commercial mortgage loans have third party guarantees. The credit quality of a commercial mortgage loan may depend on, among other factors, the existence and structure of underlying leases, the physical condition of the property (including whether any maintenance has been deferred), the creditworthiness of tenants, the historical and anticipated level of vacancies and rents on the property and on other comparable properties located in the same region, potential or existing environmental risks, the availability of credit to refinance the commercial mortgage loan at or prior to maturity and the local and regional economic climate in general. Foreclosures of defaulted commercial mortgage loans are generally subject to a number of complicated factors, including environmental considerations, which are generally not present in foreclosures of residential mortgage loans. As of December 31, 2012 and 2011 and for the years then ended, the Company did not hold any commercial mortgage loans.

The Company may invest in assets eligible to be held by REITs other than those described above. In addition to commercial mortgage loans and mortgage loans secured by multi-family properties, such assets could include cash, cash equivalents and securities, including shares or interests in other REITs and partnership interests. At December 31, 2012, the Company held $13 million of short-term money market assets and $375 million of U.S. Treasury securities. At December 31, 2011, the Company held $22 million of short-term money market assets and $100 million of U.S. Treasury Securities.

The Company may continue to acquire Mortgage Assets from the Bank and/or affiliates of the Bank on terms that are comparable to those that could be obtained by the Company if such Mortgage Assets were purchased from unrelated third parties. The Company may also from time to time acquire Mortgage Assets from unrelated third parties.

The Company may, invest in other assets eligible to be held by a REIT. The Company s current policy and the Servicing Agreement (defined below) prohibit the acquisition of any Mortgage Asset constituting an interest in a mortgage loan (other than an interest resulting from the acquisition of mortgage-backed securities), which mortgage loan (i) is delinquent (more than 30 days past due) in the payment of principal or interest at the time of proposed acquisition; (ii) is or was at any time during the preceding 12 months (a) on nonaccrual status or (b) renegotiated due to financial deterioration of the borrower; or (iii) has been, more than once during the preceding 12 months, more than 30 days past due in payment of principal or interest. Loans that are on nonaccrual status are generally loans that are past due 90 days or more in principal or interest. The Company maintains a policy of disposing of any mortgage loan which (i) falls into nonaccrual status, (ii) has to be renegotiated due to the financial deterioration of the borrower, or (iii) is more than 30 days past due in the payment of principal or interest more than once in any 12 month period. The Company may choose, at any time subsequent to its acquisition of any Mortgage Assets, to require the Bank (as part of the Servicing Agreement) to dispose of the mortgage loans for any of these reasons or for any other reason.

The Bank services the Securing Mortgage Loans and the other mortgage loans purchased by the Company on behalf of, and as agent for, the Company and is entitled to receive fees in connection with the servicing thereof pursuant to a servicing agreement (the Servicing Agreement). The Bank receives a fee equal to 0.25% per annum on the principal balances of the loans serviced. Payment of such fees is subordinate to payments of dividends on the Preferred Shares. The Servicing Agreement requires the Bank to service the loans in a manner generally consistent with accepted secondary market practices, with any servicing guidelines promulgated by the Company and, in the case of residential mortgage loans, with Fannie Mae and FHLMC guidelines and procedures. The Servicing Agreement requires the Bank to service the loans solely with a view toward the interest of the Company and without regard to the interest of the Bank or any of its affiliates. The Bank will collect and remit principal and interest payments, administer mortgage escrow accounts, submit and pursue insurance claims and initiate and supervise foreclosure proceedings on the loans it services. The Bank may, with the approval of a majority of the Company s Board of Directors, as well as a majority of the Company s Independent Directors (as defined in Item 13 (c) below), subcontract all or a portion of its obligations under the Servicing Agreement to unrelated third parties. The Bank will not, in connection with the subcontracting of any of its obligations under the Servicing Agreement, be discharged or relieved in any respect from its obligations under the Servicing Agreement. The Company may terminate the Servicing Agreement upon the occurrence of such events as they relate to the Bank s proper and timely performance of its duties and obligations under the Servicing Agreement. As long as any Preferred Shares remain outstanding, the Company may not terminate, or elect to renew, the Servicing Agreement without the approval of a majority of the Company s Independent Directors (as defined in Item 13 (c) below).

The Bank administers the day-to-day operations of the Company, pursuant to an advisory agreement (the Advisory Agreement). The Bank is responsible for (i) monitoring the credit quality of Mortgage Assets held by the Company, (ii) advising the Company with respect to the reinvestment of income from and payments on, and with respect to the acquisition, management, financing and disposition of the Mortgage Assets held by the Company, and (iii) monitoring the Company s compliance with the requirements necessary to qualify as a REIT, and other financial and tax-related matters. The Bank may from time to time subcontract all or a portion of its obligations under the Advisory Agreement to one or more of its affiliates. The Bank may, with the approval of a majority of the Company s Board of Directors, as well as a majority of the Company s Independent Directors, subcontract all or a portion of its obligations under the Advisory Agreement to unrelated third parties. The Bank will not, in connection with the subcontracting of any of its obligations under the Advisory Agreement, be discharged or relieved in any respect from its obligations under the Advisory Agreement. The Advisory Agreement is renewed annually. The Company may terminate the Advisory Agreement at any time upon 60 days prior written notice. As long as any Preferred Shares remain outstanding, any decision by the Company either to renew the Advisory Agreement or to terminate the Advisory Agreement must be approved by a majority of the Board of Directors, as well as by a majority of the Company s Independent Directors (as defined in Item 13 (c) below).

The Advisory Agreements in effect in 2012 and 2011 entitled the Bank to receive advisory fees of $167 thousand and $144 thousand, respectively. It is expected that the annual 2013 advisory fees will be approximately $170 thousand.

The Company may from time to time purchase additional Mortgage Assets out of proceeds received in connection with the repayment or disposition of Mortgage Assets, the issuance of additional shares of preferred stock or additional capital contributions with respect to the Common Stock. The Company may also issue additional series of preferred stock. However, pursuant to the Company s Articles of Incorporation, as amended (the Charter), the Company may not issue additional shares of preferred stock senior to the Series A preferred shares either in the payment of dividends or in the distribution of assets on liquidation without the consent of holders of at least 67% of the outstanding shares of preferred stock at that time or without approval of a majority of the Company s Independent Directors. The Company does not currently intend to issue any additional shares of preferred stock unless it simultaneously receives additional capital contributions from HCH or other affiliates sufficient to support the issuance of such additional shares of preferred stock.

Employees

As of December 31, 2012, the Company had no paid employees. All officers of the Company were employed by the Bank.

Environmental Matters

In the event that the Company is forced to foreclose on a defaulted Securing Mortgage Loan to recover its investment in such loan, the Company may be subject to environmental liabilities in connection with the underlying real property, which could exceed the value of the real property. Although the Company intends to exercise due diligence to discover potential environmental liabilities prior to the acquisition of any property through foreclosure, hazardous substances or wastes, contaminants, pollutants or sources thereof (as defined by state and federal laws and regulations) may be discovered on properties during the Company s ownership or after a sale thereof to a third party. If such hazardous substances are discovered on a property which the Company has acquired through foreclosure or otherwise, the Company may be required to remove those substances and clean up the property. There can be no assurance that in such a case the Company would not incur full recourse liability for the entire costs of any removal and clean-up, that the cost of such removal and clean-up would not exceed the value of the property or that the Company could recoup any of such costs from any third party. The Company may also be liable to tenants and other users of neighboring properties. In addition, the Company may find it difficult or impossible to sell the property prior to or following any such clean-up. The Company has not foreclosed on any Securing Mortgage Loans during 2012 and 2011 and currently holds no foreclosed assets in its portfolio.

Qualification as a REIT

The Company elected to be taxed as a REIT commencing with its taxable year ended December 31, 1998 and intends to comply with the provisions of the Code with respect thereto. The Company will not be subject to Federal income tax to the extent it distributes 90% of its adjusted REIT ordinary taxable income to stockholders and as long as certain assets, income and stock ownership tests are met. For 2012 as well as 2011, the Company met all Code requirements for a REIT, including the asset, income, stock ownership and distribution tests. Beginning January 1, 2009, the state of Illinois requires a captive REIT to increase its state taxable income by the amount of dividends paid. Under this law, a captive REIT includes a REIT of which 50% of the voting power or value of the beneficial interest or shares is owned by a single owner. Management believes that the Company would be classified as a captive REIT under Illinois law, in light of the fact that (1) all of the outstanding

Table of Contents

Common Stock is held by HCH, a wholly owned subsidiary of the Bank, (2) the Company s Common Stock represents more than 50% of the voting power of the Company s equity securities and (3) the Common Stock is not listed for trading on an exchange. Management believes that the state tax expense incurred by the Company has not had, and in future years should not have, a material adverse effect upon the Company s ability to declare and pay future dividends on the preferred shares. This belief is based upon the ownership interest of the Company, whereby any tax expense incurred is expected to primarily reduce the net earnings available to the holder of the Company s Common Stock. The Illinois statutory tax rate for 2012 and 2011 was 9.5%, 7.3% for 2010 and it is expected to be 9.5% for 2013.

The following tables sets forth selected dividend information:

	Year Ended December 31, 2012					
	Dividends per share	# of Shares	Declared Date	Record Date	Paid Date	Amount in Thousands
Preferred Dividends	$ .46094	10,000,000	3/1/2012	3/15/2012	3/30/2012	$ 4,609
	.46094	10,000,000	6/5/2012	6/15/2012	6/30/2012	4,609
	.46094	10,000,000	9/5/2012	9/15/2012	10/1/2012	4,610
	.46094	10,000,000	12/5/2012	12/17/2012	12/31/2012	4,610
						$ 18,438
Common Stock Dividends	$ 150	1,180	9/5/2012	8/31/2012	9/14/2012	**$ 177**

	Year Ended December 31, 2011					
	Dividends per share	# of Shares	Declared Date	Record Date	Paid Date	Amount in Thousands
Preferred Dividends	$ .46094	10,000,000	3/2/2011	3/15/2011	3/30/2011	$ 4,609
	.46094	10,000,000	5/25/2011	6/15/2011	6/30/2011	4,609
	.46094	10,000,000	8/31/2011	9/15/2011	9/30/2011	4,610
	.46094	10,000,000	11/30/2011	12/15/2011	12/30/2011	4,610
						$ 18,438
Common Stock Dividends	$ 294	1,180	5/25/2011	6/1/2011	8/31/2011	$ 347
	424	1,180	11/30/2011	12/15/2011	12/16/2011	500
						$ 847

ITEM 1A. ***RISK FACTORS***

Set forth below and elsewhere in this Report and in other documents filed with the SEC (including the February 5, 1998 Prospectus (the 1998 Prospectus) for the Offering (SEC File No. 333-40257)), are risks and uncertainties with respect to the Company, the Preferred Shares and the Bank. This Report contains forward-looking statements that involve risks and uncertainties. The Company s actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include those discussed below.

Declining interest rates will reduce earnings of the Company

The Company s income will consist primarily of interest payments on the earning assets held by it. If there is a decline in interest rates during a period of time when the Company must reinvest payments of interest and principal in respect of its earning assets, the Company may find it difficult to purchase additional earning assets that generate sufficient income to support payment of dividends on the Preferred Shares.

Table of Contents

Because the rate at which dividends, if, when and as authorized and declared, are payable on the Preferred Shares is fixed, there can be no assurance that an interest rate environment in which there is a decline in interest rates would not adversely affect the Company s ability to pay dividends on the Preferred Shares.

Dividends may not be authorized quarterly by our Board of Directors and dividends not authorized will not be paid

Dividends on the Preferred Shares are not cumulative. Consequently, if the Board of Directors does not authorize a dividend on the Preferred Shares for any quarterly period, the holders of the Preferred Shares would not be entitled to recover such dividend whether or not funds are or subsequently become available. Quarterly dividends may not always be paid on the Preferred Shares. The Board of Directors may determine, in its business judgment, that it would be in the best interests of the Company to pay less than the full amount of the stated dividend on the Preferred Shares or no dividend for any quarter, notwithstanding that funds are available. Factors that may be considered by the Board of Directors in making this determination are the Company s financial condition and capital needs, the impact of legislation and regulations as then in effect or as may be proposed, economic conditions, and such other factors as the Board of Directors may deem relevant. To remain qualified as a REIT, the Company must distribute annually at least 90% of its REIT taxable income (not including capital gains) to stockholders. See Tax Risks.

Dividends, redemptions and other operations of the Company restricted by regulation

Because the Company is a subsidiary of the Bank, bank regulatory authorities will have the right to examine the Company and its activities. Under certain circumstances, including any determination that the Bank s relationship to the Company results in an unsafe and unsound banking practice, such regulatory authorities will have the authority to restrict the ability of the Company to transfer assets, to make distributions to its stockholders (including dividends to the holders of Preferred Shares, as described below), or to redeem Preferred Shares, or even to require the Bank to sever its relationship with, or divest its ownership of, the Company. Such actions could potentially result in the Company s failure to qualify as a REIT.

Payment of dividends on the Preferred Shares could also be subject to regulatory limitations if the Bank became less than adequately capitalized for purposes of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Less than adequately capitalized is currently defined as having (i) a total risk-based capital ratio of less than 8.0%, (ii) a Tier 1 risk-based capital ratio of less than 4.0%, or (iii) a Tier 1 leverage ratio of less than 4.0% (or 3.0% under certain circumstances not currently applicable to the Bank). At December 31, 2012, the Bank s Total risk-based capital ratio was 16.79%, Tier 1 risk-based capital ratio was 14.94% and the Tier 1 leverage ratio was 11.06%. Consequently, the Bank was categorized as well-capitalized by its regulator at December 31, 2012.

In addition, the National Bank Act requires all national banks, including the Bank, to obtain prior approval from the OCC if dividends declared by the national bank (including subsidiaries of the national bank (except for dividends paid by such subsidiary to the national bank)) in any calendar year, will exceed its net income for that year, combined with its retained income (as defined in the applicable regulations) for the preceding two years. These provisions apply to a national bank and its subsidiaries on a consolidated basis, notwithstanding the earnings of any subsidiary on a stand-alone basis. Beginning in 2009, the Bank no longer had sufficient capacity to declare and pay dividends without prior regulatory approval of the OCC. As a result, the Company, as an indirect subsidiary of the Bank, became subject to the provisions relating to dividend approval, and the Bank had to receive prior approval from the OCC before the Company declared dividends on the Preferred Shares. Prior approval from the OCC was received for dividend declarations in March 2011, May 2011 and August 2011. Because the Bank s third quarter 2011 earnings were sufficient to eliminate the need for OCC approval of dividends on the Preferred Shares that were declared by the Company s Board of Directors in the fourth quarter ending December 31, 2011, the Company was not required to obtain approval from the OCC for such a declaration. Further, the Company was not required to obtain approval from the OCC for dividends on the Preferred Shares declared by the Company s Board of Directors in March 2012, June 2012, September 2012 or December 2012, nor will such approval be required for dividends on the Preferred Shares that the Company s Board of Directors may declare in the first quarter of 2013. The need to request similar approvals from the OCC for subsequent quarters will be determined by the Bank s earnings for those future periods. There is no assurance that the Bank and the Company will not be subject to the requirement to receive prior regulatory approvals for Preferred Shares dividend payments in the future or that, if required, such approvals will be obtained. At this time the Company has no reason to expect that such approvals, if required, will not be received.

On July 5, 2011 Bank of Montreal (BMO) completed the acquisition of Milwaukee based Marshall & Ilsley Corporation (M&I). M&I merged with and into BMO Financial Corporation (BFC) and M&I Marshall and Ilsley Bank and M&I bank N.A. merged with and into the Bank. The acquisition was subject to an OCC Commitment Letter requiring the Bank to develop and submit a comprehensive capital plan to the OCC. BFC s and the Bank s 2013 Capital Plan was submitted to the Federal Reserve Board and the Office of the Comptroller of the Currency on January 7th, 2013. This was the second annual Capital Plan submitted.

Automatic exchange for Bank Preferred Shares could occur when value of Bank Preferred Shares is impaired

An investment in the Preferred Shares involves risk with respect to the performance and capital levels of the Bank. A decline in the performance and capital levels of the Bank or the placement of the Bank into conservatorship or receivership could result in the automatic exchange of the Preferred Shares for Bank Preferred Shares, which would be an investment in the Bank and not in the Company. As a result, holders of Preferred Shares would become preferred stockholders of the Bank at a time when the Bank s financial condition was deteriorating or when the Bank had been placed into conservatorship or receivership. If an Exchange Event occurs, the Bank would likely be unable to pay dividends on the Bank Preferred Shares.

An investment in the Bank is also subject to certain risks that are distinct from the risks associated with an investment in the Company. For example, an investment in the Bank would involve risks relating to the capital levels of, and other federal regulatory requirements applicable to, the Bank, and the performance of the Bank s loan portfolio. An investment in the Bank is also subject to the general risks inherent in equity investments in depository institutions. In the event of a liquidation of the Bank, the claims of depositors and secured, senior, general and subordinated creditors of the Bank would be entitled to a priority of payment over the claims of holders of equity interests such as the Bank Preferred Shares. As a result, if the Bank were to be placed into receivership, the holders of the Bank Preferred Shares likely would receive, if anything, substantially less than they would have received had the Preferred Shares not been exchanged for Bank Preferred Shares.

Bank Preferred Shares will not be listed on any exchange and markets may not be liquid

Although the Preferred Shares are listed on the New York Stock Exchange, the Bank does not intend to apply for listing of the Bank Preferred Shares on any national securities exchange. Consequently, there can be no assurance as to the liquidity of the trading markets for the Bank Preferred Shares, if issued, or that an active public market for the Bank Preferred Shares would develop or be maintained.

Adverse consequences of failure to qualify as a REIT

The Company intends to operate so as to qualify as a REIT under the Code. No assurance can be given that the Company will be able to continue to operate in a manner so as to qualify as a REIT. Qualification as a REIT involves the application of highly technical and complex Code provisions for which there are only limited judicial or administrative interpretations. The determination of various factual matters and circumstances, not entirely within the Company s control, may affect the Company s ability to continue to qualify as a REIT. Although the Company is not aware of any proposal in Congress to amend the tax laws in a manner that would materially and adversely affect the Company s ability to operate as a REIT, no assurance can be given that new legislation or new regulations, administrative interpretations or court decisions will not significantly change the tax laws in the future with respect to qualification as a REIT or the federal income tax consequences of such qualification.

If, in any taxable year the Company fails to qualify as a REIT, the Company would not be allowed a deduction for distributions to stockholders in computing its taxable income and would be subject to federal income tax (including any applicable alternative minimum tax) on its taxable income at regular corporate rates.

As a result, the amount available for distribution to the Company s stockholders including the holders of the Preferred Shares, would be reduced for the year or years involved. In addition, unless entitled to relief under certain statutory provisions, the Company would be disqualified from treatment as a REIT for the four taxable years following the year during which qualification was lost. A failure of the Company to qualify as a REIT would not necessarily give the Company the right to redeem the Preferred Shares, nor would it give the holders of the Preferred Shares the right to have their shares redeemed.

Notwithstanding that the Company currently intends to operate in a manner designed to enable it to qualify as a REIT, future economic, market, legal, tax or other considerations may cause the Company to determine that it is in the best interest of the Company and the holders of its Common Stock and Preferred Shares to no longer comply with the provisions of the Code with respect to a REIT and be subject to federal income tax including any applicable alternative minimum tax on its taxable income at regular corporate rates. As long as any Preferred Shares are outstanding, any such determination by the Company may not be made without the approval of a majority of the Independent Directors.

REIT requirements with respect to stockholder distributions

To qualify as a REIT under the Code, the Company generally will be required each year to distribute as dividends to its stockholders at least 90% of its REIT taxable income (excluding capital gains). Failure to comply with this requirement would result in the Company s income being subject to tax at regular corporate rates. In addition, the Company will be subject to a 4% nondeductible excise tax on the amount, if any, by which certain distributions considered as paid by it with respect to any calendar year are less than the sum of 85% of its ordinary income for the calendar year, 95% of its capital gains net income for the calendar year and any undistributed taxable income from prior periods. Under certain circumstances, banking regulatory authorities may restrict the ability of the Company, as a subsidiary of the Bank, to make distributions to its stockholders. Such a restriction could subject the Company to federal income and excise tax and result in the Company s failure to meet REIT requirements with respect to stockholder distributions.

Redemption upon occurrence of a Tax Event

At any time following the occurrence of a Tax Event (as defined under Description of Series A Preferred Shares Redemption in the 1998 Prospectus), the Company will have the right to redeem the Preferred Shares in whole but not in part. The occurrence of a Tax Event will not, however, give the holders of the Preferred Shares any right to have such shares redeemed.

Illinois Tax Law Change

Beginning January 1, 2009, Illinois required a captive REIT to increase its state taxable income by the amount of dividends paid. Under this law, a captive REIT includes a REIT of which 50% of the voting power or value of the beneficial interest or shares is owned by a single owner. Management believes that the Company is classified as a captive REIT under Illinois law, in light of the fact that (1) all of the outstanding Common Stock is held by HCH, a wholly owned subsidiary of the Bank, (2) the Common Stock represents more than 50% of the voting power of the Company s equity securities and (3) the Common Stock is not listed for trading on an exchange. The Illinois statutory rate for 2010 was 7.3% and for 2011 and 2012 the Illinois statutory rate was 9.5%. For 2013 it will remain at 9.5%. Management believes that the Illinois state tax expense to be incurred by the Company has not and in future years should not have a material adverse effect upon the Company s ability to declare and pay future dividends on the Preferred Shares. This belief is based upon the ownership interest of the Company, whereby any tax expense incurred is expected to primarily reduce the net earnings available to the holder of the Company s Common Stock.

Automatic exchange upon occurrence of the Exchange Event

Upon the occurrence of the Exchange Event, the outstanding Preferred Shares will be automatically exchanged on a one-for-one basis into Bank Preferred Shares. Assuming, as is anticipated to be the case, that the Bank Preferred Shares are nonvoting, the Automatic Exchange will be taxable, and each holder of Preferred

Shares will have a gain or loss, as the case may be, measured by the difference between the basis of such holder in the Preferred Shares and the fair market value of the Bank Preferred Shares received in the Automatic Exchange. Assuming that such holder s Preferred Shares were held as capital assets prior to the Automatic Exchange, any gain or loss will be capital gain or loss.

Relationship with the Bank and its affiliates; conflicts of interest

The Bank and its affiliates are involved in virtually every aspect of the Company s existence. The Bank is the sole holder of the Common Stock of the Company and will administer the day-to-day activities of the Company in its role as Advisor under the Advisory Agreement. The Bank will also act as servicer of the Mortgage Loans on behalf of the Company under the Servicing Agreement. In addition, other than the Independent Directors and Non Bank Directors (as defined in Item 10), all of the officers and directors of the Company are also officers and/or directors of the Bank and/or affiliates of the Bank. Their compensation is paid by the Bank, and they have substantial responsibilities in connection with their work as officers of the Bank. As the holder of all of the outstanding voting stock of the Company, the Bank will have the right to elect all directors of the Company, including the Independent Directors.

The Bank and its affiliates may have interests which are not identical to those of the Company. Consequently, conflicts of interest may arise with respect to transactions, including without limitation, future acquisitions of Mortgage Assets from the Bank and/or affiliates of the Bank; servicing of Mortgage Loans; future dispositions of Mortgage Assets to the Bank; and the renewal, termination or modification of the Advisory Agreement or the Servicing Agreement. It is the intention of the Company and the Bank that any agreements and transactions between the Company, on the one hand, and the Bank and/or its affiliates, on the other hand, are fair to all parties and consistent with market terms, including prices paid and received for the Initial Mortgage Assets, on the acquisition or disposition of Mortgage Assets by the Company or in connection with the servicing of Mortgage Loans. The requirement in the terms of the Preferred Shares that certain actions of the Company be approved by a majority of the Independent Directors is also intended to ensure fair dealings between the Company and the Bank and its affiliates. However, there can be no assurance that such agreements or transactions will be on terms as favorable to the Company as those that could have been obtained from unaffiliated third parties.

Risk of future revisions in policies and strategies by Board of Directors

The Board of Directors has established the investment policies and operating policies and strategies of the Company, all material aspects of which are described in this report. These policies may be amended or revised from time to time at the discretion of the Board of Directors (in certain circumstances subject to the approval of a majority of the Independent Directors) without a vote of the Company s stockholders, including holders of the Preferred Shares. The ultimate effect of any change in the policies and strategies of the Company on a holder of Preferred Shares may be positive or negative.

Possible leverage

Although the Company does not currently intend to incur any indebtedness in connection with the acquisition and holding of Mortgage Assets, the Company may do so at any time (although indebtedness in excess of 25% of the Company s total stockholders equity may not be incurred without the approval of a majority of the Independent Directors of the Company). To the extent the Company were to change its policy with respect to the incurrence of indebtedness, the Company would be subject to risks associated with leverage, including, without limitation, changes in interest rates and prepayment risk.