

HARRIS PREFERRED CAPITAL CORP

Form 10-Q

August 14, 2007

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**United States  
Securities And Exchange Commission  
Washington, D.C. 20549**

**Form 10-Q**

**QUARTERLY REPORT UNDER SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended June 30, 2007**

**Commission file number 1-13805**

**Harris Preferred Capital Corporation**  
(Exact name of registrant as specified in its charter)

**Maryland**  
(State or other jurisdiction  
of incorporation or organization)

**# 36-4183096**  
(I.R.S. Employer  
Identification No.)

**111 West Monroe Street, Chicago, Illinois**  
(Address of principal executive offices)

**60603**  
(Zip Code)

**Registrant's telephone number, including area code:**  
(312) 461-2121

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

<b>Title of each class</b>	<b>Name of each exchange on which registered</b>
73/8% 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 whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Yes  No

The number of shares of Common Stock, \$1.00 par value, outstanding on August 14, 2007 was 1,000. No common equity is held by nonaffiliates.

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**HARRIS PREFERRED CAPITAL CORPORATION**

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**Table of Contents****Part I. FINANCIAL INFORMATION****Item 1. Financial Statements****HARRIS PREFERRED CAPITAL CORPORATION****CONSOLIDATED BALANCE SHEETS**

	<b>June 30, 2007</b>	<b>December 31, 2006</b>	<b>June 30, 2006</b>
	<b>(unaudited)</b>	<b>(audited)</b>	<b>(unaudited)</b>
	<b>(in thousands, except share data)</b>		
<b>Assets</b>			
Cash on deposit with Harris N.A.	\$ 5,199	\$ 5,284	\$ 1,192
Securities purchased from Harris N.A. under agreement to resell	9,665	9,854	16,069
Notes receivable from Harris N.A.	5,651	6,512	7,219
Securities available-for-sale:			
Mortgage-backed	394,404	404,075	343,947
U.S. Treasury	69,934	59,948	104,888
Other assets	1,666	1,667	1,420
<b>Total assets</b>	<b>\$ 486,519</b>	<b>\$ 487,340</b>	<b>\$ 474,735</b>
<b>Liabilities and Stockholders Equity</b>			
Accrued expenses	\$ 61	\$ 120	\$ 95
Preferred dividends payable	4,609	4,611	
<b>Total liabilities</b>	<b>\$ 4,670</b>	<b>\$ 4,731</b>	<b>\$ 95</b>
Commitments and contingencies			
<b>Stockholders Equity</b>			
73/8% Noncumulative Exchangeable Preferred Stock, Series A (\$1 par value); liquidation value of \$250,000,000 and 20,000,000 shares authorized, 10,000,000 shares issued and outstanding	\$ 250,000	\$ 250,000	\$ 250,000
Common stock (\$1 par value); 1,000 shares authorized, issued and outstanding	1	1	1
Additional paid-in capital	240,733	240,733	240,733
Earnings in excess of (less than) distributions	1,825	(71)	956
Accumulated other comprehensive loss net unrealized losses on available-for-sale securities	(10,710)	(8,054)	(17,050)
<b>Total stockholders equity</b>	<b>481,849</b>	<b>482,609</b>	<b>474,640</b>
<b>Total liabilities and stockholders equity</b>	<b>\$ 486,519</b>	<b>\$ 487,340</b>	<b>\$ 474,735</b>

*The accompanying notes are an integral part of these consolidated financial statements.*

Table of Contents**HARRIS PREFERRED CAPITAL CORPORATION****CONSOLIDATED STATEMENTS OF INCOME  
AND COMPREHENSIVE INCOME  
(Unaudited)**

	<b>Quarter Ended</b>		<b>Six Months Ended</b>	
	<b>June 30</b>		<b>June 30</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
	<b>(in thousands, except per share data)</b>			
<b>Interest income:</b>				
Securities purchased from Harris N.A. under agreement to resell	\$ 998	\$ 1,256	\$ 1,858	\$ 2,270
Notes receivable from Harris N.A.	92	119	189	249
Securities available-for-sale:				
Mortgage-backed	4,531	3,796	9,122	7,691
U.S. Treasury	78	105	148	203
Total interest income	5,699	5,276	11,317	10,413
<b>Operating expenses:</b>				
Loan servicing fees paid to Harris N.A.	5	6	9	12
Advisory fees	36	30	67	61
General and administrative	46	78	127	164
Total operating expenses	87	114	203	237
Net income	5,612	5,162	11,114	10,176
Preferred dividends	4,609	4,609	9,218	9,218
<b>Net income available to common stockholder</b>	<b>\$ 1,003</b>	<b>\$ 553</b>	<b>\$ 1,896</b>	<b>\$ 958</b>
Basic and diluted earnings per common share	\$ 1,003.00	\$ 553.00	\$ 1,896.00	\$ 958.00
Net income	\$ 5,612	\$ 5,162	\$ 11,114	\$ 10,176
Other comprehensive loss net unrealized losses on available-for-sale securities	(4,356)	(2,774)	(2,656)	(6,064)
Comprehensive income	\$ 1,256	\$ 2,388	\$ 8,458	\$ 4,112

*The accompanying notes are an integral part of these consolidated financial statements.*

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**HARRIS PREFERRED CAPITAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY**  
**(Unaudited)**

	<b>Six Months Ended June 30</b>	
	<b>2007</b>	<b>2006</b>
	<b>(in thousands, except per share data)</b>	
Balance at January 1	\$ 482,609	\$ 479,746
Net income	11,114	10,176
Other comprehensive loss	(2,656)	(6,064)
Dividends (preferred stock \$0.4609 per share)	(9,218)	(9,218)
 Balance at June 30	 \$ 481,849	 \$ 474,640

*The accompanying notes are an integral part of these consolidated financial statements.*



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**HARRIS PREFERRED CAPITAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**

	<b>Six Months Ended June 30</b>	
	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>	
<b>Operating Activities:</b>		
Net Income	\$ 11,114	\$ 10,176
Adjustments to reconcile net income to net cash provided by operating activities:		
Decrease in other assets	1	41
Net decrease in accrued expenses and other liabilities	(61)	(34)
Net cash provided by operating activities	11,054	10,183
<b>Investing Activities:</b>		
Decrease in securities purchased from Harris N.A. under agreement to resell	189	4,431
Repayments of notes receivable from Harris N.A.	861	1,465
Purchases of securities available-for-sale	(168,861)	(205,174)
Proceeds from maturities of securities available-for-sale	165,890	198,805
Net cash used in investing activities	(1,921)	(473)
<b>Financing Activities:</b>		
Cash dividends paid on preferred stock	(9,218)	(9,218)
Net cash used in financing activities	(9,218)	(9,218)
Net (decrease) increase in cash on deposit with Harris N.A.	(85)	492
Cash on deposit with Harris N.A. at beginning of period	5,284	700
Cash on deposit with Harris N.A. at end of period	\$ 5,199	\$ 1,192

*The accompanying notes are an integral part of these consolidated financial statements.*

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**HARRIS PREFERRED CAPITAL CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Basis of Presentation**

Harris Preferred Capital Corporation (the Company) is a Maryland corporation whose principal business objective is to acquire, hold, finance and manage qualifying real estate investment trust (REIT) assets (the Mortgage Assets), consisting of a limited recourse note or notes (the Notes) issued by Harris N.A. (the Bank) secured by real estate mortgage assets (the Securing Mortgage Loans) and other obligations secured by real property, as well as certain other qualifying REIT assets, primarily U.S. treasury securities and securities collateralized with real estate mortgages. The Company holds its assets through a Maryland real estate investment trust subsidiary, Harris Preferred Capital Trust. Harris Capital Holdings, Inc., owns 100% of the Company's common stock. The Bank owns all common stock outstanding issued by Harris Capital Holdings, Inc.

The accompanying consolidated financial statements have been prepared by management from the books and records of the Company. These statements reflect all adjustments and disclosures which are, in the opinion of management, necessary for a fair statement of the results for the interim periods presented and should be read in conjunction with the notes to consolidated financial statements included in the Company's 2006 Form 10-K. Certain reclassifications were made to conform prior years' financial statements to the current year's presentation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission.

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**2. Commitments and Contingencies**

Legal proceedings in which the Company is a defendant may arise in the normal course of business. There is no pending litigation against the Company.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

**Forward-Looking Information**

The statements contained in this Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding the Company's expectation, intentions, beliefs or strategies regarding the future. Forward-looking statements include the Company's statements regarding tax treatment as a real estate investment trust, liquidity, provision for loan losses, 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, as 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 Item 1A. Risk Factors in the Company's 2006 Form 10-K and in the Risk Factors section included in the Company's Registration Statement on Form S-11 (File No. 333-40257), with respect to the Preferred Shares declared effective by the Securities and Exchange Commission on February 5, 1998. The Company assumes no obligation to update any such forward-looking statement.

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**HARRIS PREFERRED CAPITAL CORPORATION**

**Results of Operations**

**Second Quarter 2007 Compared with Second Quarter 2006**

The Company's net income for the first quarter of 2007 was \$5.6 million, a 9% increase from the second quarter 2006 net income of \$5.2 million. Earnings increased primarily because of increased interest income on earning assets.

Interest income on securities purchased under agreement to resell for the second quarter of 2007 was \$998 thousand, on an average balance of \$83.7 million, with an annualized yield of 4.8%. During the same period in 2006, the interest income on securities purchased under agreement to resell was \$1.26 million, on an average balance of \$107.6 million, with an annualized yield of 4.7%. The decrease in income was attributable to lower balances, partially offset by higher yields. Second quarter 2007 interest income on the Notes totaled \$92 thousand and yielded 6.4% on \$5.8 million of average principal outstanding for the quarter compared to \$119 thousand and a 6.4% yield on \$7.4 million average principal outstanding for the second quarter 2006. The decrease in income was attributable to a reduction in the Notes balance because of principal paydowns by customers in the Securing Mortgage Loans. Interest income on securities available-for-sale for the current quarter was \$4.6 million resulting in a yield of 4.6% on an average balance of \$399 million, compared to \$3.9 million with a yield of 4.4% on an average balance of \$359 million for the same period a year ago. The increase in interest income is primarily attributable to growth in the portfolio of mortgage-backed securities generating higher interest yields.

There were no Company borrowings during second quarter 2007 or 2006.

Second quarter 2007 operating expenses totaled \$87 thousand, a decrease of \$27 thousand or 24% from the second quarter of 2006. Loan servicing expenses totaled \$5 thousand, a decrease of \$1 thousand from a year ago. This decrease is attributable to the reduction in the principal balance of the Notes, thereby reducing servicing fees payable to the Bank. Advisory fees for the second quarter 2007 were \$36 thousand compared to \$30 thousand a year earlier. General and administrative expenses totaled \$46 thousand, a decrease of \$32 thousand from the same period in 2006 due to a decrease in printing, processing and insurance costs.

At June 30, 2007 and 2006, there were no Securing Mortgage Loans on nonaccrual status.

The Company classifies all securities as available-for-sale. The Company has no intent to sell specific securities, and the Company has the ability to hold all securities to maturity. Available-for-sale securities are reported at fair value with unrealized gains and losses included as a separate component of stockholders' equity. At June 30, 2007, net unrealized losses on available-for-sale securities were \$10.7 million compared to \$17.1 million of unrealized losses on June 30, 2006 and \$8.1 million of unrealized losses at December 31, 2006. The unrealized loss positions at June 30, 2007 and 2006 and December 31, 2006 were attributable to changes in interest rates and not to lowered credit quality of individual securities; therefore management believes these unrealized losses are temporary.

In making a determination of temporary vs. other-than-temporary impairment of an investment, a major consideration of management is whether the Company will be able to collect all amounts due according to the contractual terms of the investment. Such a determination involves estimation of the outcome of future events as well as knowledge and experience about past and current events. Factors considered include the following: whether the fair value is significantly below cost and the decline is attributable to specific adverse conditions in an industry or geographic area; the period of time the decline in fair value has existed; if an outside rating agency has downgraded the investment; if dividends have been reduced or eliminated; if scheduled interest payments have not been made and finally, whether the financial condition of the issuer has deteriorated. In addition, it may be necessary for the Company to demonstrate

its ability and intent to hold a debt security to maturity.

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**HARRIS PREFERRED CAPITAL CORPORATION**

**Six Months Ended June 30, 2007 compared with June 30, 2006**

The Company's net income for the six months ended June 30, 2007 was \$11.1 million. This represented a \$0.9 million increase or 9% from 2006 earnings. Earnings increased primarily because of an increase in interest income on earning assets.

Interest income on securities purchased under agreement to resell for the six months ended June 30, 2007 was \$1.9 million, on an average balance of \$76 million, with an average rate of 4.9%. During the same period in 2006, the interest income on securities purchased under agreement to resell was \$2.3 million on an average balance of \$99 million, with an average rate of 4.6%. Interest income on the Notes for the six months ended June 30, 2007 totaled \$189 thousand, yielding 6.4% on \$5.9 million of average principal outstanding compared to \$249 thousand of income yielding 6.4% on \$7.8 million of average principal outstanding for the same period in 2006. The decrease in income was attributable to a reduction in the Note balance because of customer payoffs on the Securing Mortgage Loans. The average outstanding balance of the Securing Mortgage Loans was \$7.5 million for the six months ended June 30, 2007 and \$9.8 million for the same period in 2006. There were no Company borrowings during either period. Interest income on securities available-for-sale for the six months ended June 30, 2007 was \$9.3 million resulting in a yield of 4.6% on an average balance of \$403 million, compared to \$7.9 million resulting in a yield of 4.3% on an average balance of \$365 million a year ago. The increase in interest income from available-for-sale securities is primarily attributable to growth in the portfolio of mortgage-backed securities.

Operating expense for the six months ended June 30, 2007 totaled \$203 thousand, a decrease of \$34 thousand from a year ago. Loan servicing expenses for the six months ended June 30, 2007 totaled \$9 thousand, a decrease of \$3 thousand or 25% from 2006. This decrease is attributable to the reduction in the principal balance of the Notes because servicing costs vary directly with these balances. Advisory fees for the six months ended June 30, 2007 were \$67 thousand compared to \$61 thousand a year ago. General and administrative expenses totaled \$127 thousand, a decrease of \$37 thousand or 23% from the same period in 2006 as a result of reduced costs for printing, insurance and processing costs.

On July 2, 2007, the Company paid a cash dividend of \$0.46094 per share on outstanding Preferred Shares to the stockholders of record on June 15, 2007 as declared on May 31, 2007. On June 30, 2006, the Company paid a cash dividend of \$0.46094 per share on outstanding Preferred Shares to the stockholders of record on June 15, 2006, as declared on May 31, 2006.

**Liquidity Risk Management**

The objective of liquidity management is to ensure the availability of sufficient cash flows to meet all of the Company's financial commitments. In managing liquidity, the Company takes into account various legal limitations placed on a REIT.

The Company's principal asset management requirements are to maintain the current earning asset portfolio size through the acquisition of additional Notes or other qualifying assets in order to pay dividends to its stockholders after satisfying obligations to creditors. The acquisition of additional Notes or other qualifying assets is funded with the proceeds obtained as a result of repayment of principal balances of individual Securing Mortgage Loans or maturities or sales of securities. The payment of dividends on the Preferred Shares is made from legally available funds, arising from operating activities of the Company. The Company's cash flows from operating activities principally consist of the collection of interest on the Notes, mortgage-backed securities and other earning assets. The Company does not have and does not anticipate having any material capital expenditures.

In order to remain qualified as a REIT, the Company must distribute annually at least 90% of its adjusted REIT ordinary taxable income, as provided for under the Internal Revenue Code, to its common and preferred stockholders. The Company currently expects to distribute dividends annually equal to 90% or more of its adjusted REIT ordinary taxable income.

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**HARRIS PREFERRED CAPITAL CORPORATION**

The Company anticipates that cash and cash equivalents on hand and the cash flow from the Notes and mortgage-backed treasury securities will provide adequate liquidity for its operating, investing and financing needs including the capacity to continue preferred dividend payments on an uninterrupted basis.

As presented in the accompanying Consolidated Statements of Cash Flows, the primary source of funds in addition to \$11.1 million provided from operations during the six months ended June 30, 2007, were \$166 million provided from the maturities of securities available-for-sale. In the prior period ended June 30, 2006, the primary sources of funds other than \$10.2 million from operations were \$199 million provided from the maturities of securities available-for-sale and \$4.4 million resulting from a decrease in securities purchased under agreement to resell. The primary uses of funds for the six months ended June 30, 2007 were \$169 million for purchases of securities available-for-sale and \$9.2 million in preferred stock dividends paid. In the prior period ended June 30, 2006, the primary uses of funds were \$205 million for purchases of securities available-for-sale and \$9.2 million in preferred stock dividends paid.

**Market Risk Management**

The Company's market risk is composed primarily of interest rate risk. There have been no material changes in market risk or the manner in which the Company manages market risk since December 31, 2006.

**Accounting Pronouncements**

The Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 157, Fair Value Measurements, in September 2006. The Statement provides guidance for using fair value to measure assets and liabilities. It clarifies the methods for measuring fair value, establishes a fair value hierarchy and requires expanded disclosure. SFAS 157 applies when other standards require or permit assets or liabilities to be measured at fair value and is effective for fiscal years beginning after November 15, 2007. The Company is in the process of assessing the impact of adopting this Statement on its financial position and results of operations.

The FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115, in February 2007. The Statement permits entities to choose to measure certain eligible items at fair value at specified election dates. Although most of the provisions are elective, the amendment to SFAS 115 applies to all entities with available-for-sale and trading securities. SFAS 159 is effective as of the beginning of the fiscal year that begins after November 15, 2007. The Company is in the process of assessing the impact of adopting this Statement on its financial position and results of operations.

**Other Matters**

As of June 30, 2007, the Company believes that it is in full compliance with the REIT tax rules, and expects to qualify as a non-taxable REIT under the provisions of the Internal Revenue Code. The Company expects to meet all REIT requirements regarding the ownership of its stock and anticipates meeting the annual distribution requirements.

On June 8, 2007, Standard & Poor's Ratings Services lowered its short and long-term counterparty ratings on Bank of Montreal (the Company's ultimate parent). At the same time, Standard & Poor's removed the ratings from Creditwatch with negative implications, where they were placed May 17, 2007. The outlook is stable. As part of this action, the Standard & Poor's rating for the preferred stock of the Company was lowered from A- to A- .

**Financial Statements of Harris N.A.**



The following unaudited financial information for the Bank is included because the Company's Preferred Shares are automatically exchangeable for a new series of preferred stock of the Bank upon the occurrence of certain events.



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Long-term notes	subordinated	292,750	292,750	292,750
<b>Total liabilities</b>		\$ 39,557,483	\$ 38,426,908	\$ 35,061,640
<b>STOCKHOLDER S EQUITY</b>				
Common stock (\$10 par value); authorized 40,000,000 shares; issued and outstanding 15,514,761, 14,303,361 and 14,303,361 shares at June 30, 2007, December 31, 2006 and June 30, 2006, respectively				
		\$ 155,148	\$ 143,034	\$ 143,034
Surplus		1,786,229	1,489,521	1,482,190
Retained earnings		1,848,660	1,811,497	1,719,055
Accumulated other comprehensive loss		(125,999)	(97,639)	(80,951)
<b>Total stockholder s equity</b>		\$ 3,664,038	\$ 3,346,413	\$ 3,263,328
<b>Total liabilities and stockholder s equity</b>		\$ 43,221,521	\$ 41,773,321	\$ 38,324,968

*The accompanying notes to consolidated financial statements are an integral part of these statements.*

Table of Contents**HARRIS N.A. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME**  
**(Unaudited)**

	<b>Quarter Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>		<b>(in thousands)</b>	
<b>Interest Income</b>				
Loans	\$ 411,202	\$ 390,250	\$ 819,613	\$ 759,007
Money market assets:				
Deposits at banks	4,990	3,364	10,091	6,669
Federal funds sold and securities purchased under agreement to resell	5,695	7,078	9,927	10,060
Trading accounts	2,716	2,335	4,498	3,999
Securities available-for-sale:				
U.S. Treasury and federal agency	115,516	60,682	228,567	112,457
State and municipal	8,724	5,769	16,491	11,091
Other	6,544	5,784	12,613	10,958
Total interest income	\$ 555,387	\$ 475,262	\$ 1,101,800	\$ 914,241
<b>Interest Expense</b>				
Deposits	241,336	172,000	475,266	324,807
Short-term borrowings	68,920	73,433	146,318	129,113
Short-term notes senior	10,990	3,983	12,320	11,754
Long-term notes senior	14,300	5,074	28,028	8,543
Long-term notes subordinated	4,266	3,904	8,491	7,450
Minority interest-dividends on preferred stock of subsidiary	4,609	4,609	9,219	9,219
Total interest expense	\$ 344,421	\$ 263,003	\$ 679,642	\$ 490,886
<b>Net Interest Income</b>	210,966	212,259	422,158	423,355
Provision for loan losses	10,800	5,661	13,800	11,307
<b>Net Interest Income after Provision for Loan Losses</b>	\$ 200,166	\$ 206,598	\$ 408,358	\$ 412,048
<b>Noninterest Income</b>				
Trust and investment management fees	23,194	22,992	45,986	38,980
Money market and bond trading	4,230	4,176	7,086	5,727
Foreign exchange	925	1,200	2,075	2,400
Service charges and fees	36,370	34,774	70,342	68,047
Net securities (losses) gains	(5,297)	2,456	(5,825)	2,352
Bank-owned insurance	12,098	10,856	24,786	21,440
Letter of credit fees	4,549	4,731	9,782	9,742
Syndication fees	350	4,168	1,076	5,866

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Other	26,114	18,642	49,258	36,337
Total noninterest income	\$ 102,533	\$ 103,995	\$ 204,566	\$ 190,891
<b>Noninterest Expenses</b>				
Salaries and other compensation	88,628	88,617	180,413	176,049
Pension, profit sharing and other employee benefits	26,319	27,250	60,123	58,455
Net occupancy	21,416	19,547	43,236	38,783
Equipment	16,532	16,452	32,305	32,117
Marketing	7,958	9,567	18,025	20,245
Communication and delivery	6,653	6,275	13,848	12,558
Expert services	6,498	7,821	14,386	17,205
Contract programming	7,826	6,484	15,747	14,074
Intercompany services	16,772	14,075	33,802	29,416
Restructuring (recovery) charge (note 4)	(303)		13,376	
Other	28,870	30,821	57,963	57,377
Amortization of intangibles	6,378	5,300	12,784	10,763
Total noninterest expenses	\$ 233,547	\$ 232,209	\$ 496,008	\$ 467,042
Income before income taxes	69,152	78,384	116,916	135,897
Applicable income taxes	16,244	25,661	24,355	40,391
<b>Net Income</b>	\$ 52,908	\$ 52,723	\$ 92,561	\$ 95,506

*The accompanying notes to consolidated financial statements are an integral part of these statements.*

**Table of Contents****HARRIS N.A. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(Unaudited)**

	Quarter Ended		Six Months Ended	
	June 30, 2007	2006	June 30, 2007	2006
	(in thousands)			
Net income	\$ 52,908	\$ 52,723	\$ 92,561	\$ 95,506
Other comprehensive income (loss):				
Cash flow hedges:				
Net unrealized gain (loss) on derivative instruments, net of tax expense for the quarter of \$1,959 in 2007 and \$1,123 in 2006 and net of tax (benefit) expense for the year-to-date period of (\$146) in 2007 and \$2,754 in 2006	3,321	1,894	(271)	4,863
Less reclassification adjustment for realized loss (gain) included in income statement, net of tax benefit for the quarter of (\$1,018) in 2007 and (\$124) in 2006 and net of tax (benefit) expense for the year-to-date period of (\$2,184) in 2007 and \$1,138 in 2006	1,890	230	4,055	(2,112)
Pension and Other Postretirement Benefit Adjustments:				
Net unrealized gain on pension and other postretirement benefits, net of tax expense for the quarter of \$1,432 in 2007 and \$0 in 2006 and net of tax expense for the year-to-date period of \$1,432 in 2007 and \$0 in 2006	2,660		2,660	
Unrealized loss on available-for-sale securities:				
Unrealized holding loss arising during the period, net of tax benefit for the quarter of (\$24,298) in 2007 and (\$3,580) in 2006 and net of tax benefit for the year-to-date period of (\$20,700) in 2007 and (\$6,540) in 2006	(45,337)	(6,661)	(38,590)	(12,186)
Less reclassification adjustment for realized loss (gain) included in income statement, net of tax (benefit) expense for the quarter of (\$1,854) in 2007 and \$860 in 2006 and net of tax (benefit) expense for the year-to-date period of (\$2,039) in 2007 and \$823 in 2006	3,443	(1,596)	3,786	(1,529)
Other comprehensive loss	(34,023)	(6,133)	(28,360)	(10,964)
<b>Comprehensive income</b>	<b>\$ 18,885</b>	<b>\$ 46,590</b>	<b>\$ 64,201</b>	<b>\$ 84,542</b>

*The accompanying notes to consolidated financial statements are an integral part of these statements.*

Table of Contents**HARRIS N.A. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDER S EQUITY  
(Unaudited)**

	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>	
<b>Balance at January 1</b>	\$ 3,346,413	\$ 3,073,553
Net income	92,561	95,506
Contributions to capital surplus	280,520	148,001
Issuance of common stock	12,114	2,870
Stock option exercise	609	866
Tax benefit from stock option exercise	3,181	5,496
Dividends - common stock	(43,000)	(52,000)
Other comprehensive loss	(28,360)	(10,964)
<b>Balance at June 30</b>	<b>\$ 3,664,038</b>	<b>\$ 3,263,328</b>

*The accompanying notes to consolidated financial statements are an integral part of these statements.*

**Table of Contents****HARRIS N.A. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)**

	<b>Six Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>	
<b>Operating Activities:</b>		
Net Income	\$ 92,561	\$ 95,506
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	13,800	11,307
Depreciation and amortization, including intangibles	17,611	39,526
Deferred tax expense (benefit)	5,118	(5,523)
Tax benefit from stock options exercise	3,181	5,496
Net securities losses (gains)	5,825	(2,352)
Increase in bank-owned insurance	(21,087)	(21,774)
Trading account net cash purchases	(620,153)	(18,298)
Decrease (increase) in accrued interest receivable	6,965	(11,546)
Increase in accrued interest payable	20,007	8,253
Increase in other accrued expenses	1,966	16,367
Origination of loans held for sale	(168,937)	(122,344)
Proceeds from sale of loans held for sale	152,314	121,555
Net gain on loans held for sale	(1,864)	(891)
Net (decrease) increase in pension and post retirement benefits	(5,386)	500
Net (decrease) increase in undistributed loan principle	(8,250)	33,720
Recoveries on charged-off loans	13,496	14,512
Net (decrease) increase in marked to market hedging derivatives	(24,892)	5,441
Other, net	40,915	42,610
Net cash (used in) provided by operating activities	\$ (476,810)	\$ 212,065
<b>Investing Activities:</b>		
Net decrease (increase) in interest-bearing deposits at banks	91,439	(225,343)
Net increase in Federal funds sold and securities purchased under agreement to resell	(929,856)	(336,095)
Proceeds from sales of securities available-for-sale	5,625,624	257
Proceeds from maturities of securities available-for-sale	11,911,041	3,554,053
Purchases of securities available-for-sale	(17,198,084)	(4,189,951)
Net increase in loans	(609,199)	(1,272,578)
Purchases of premises and equipment	(47,591)	(41,327)
Net cash used in investing activities	\$ (1,156,626)	\$ (2,510,984)
<b>Financing Activities:</b>		
Net increase in deposits	1,378,059	1,572,366
	(646,756)	(66,815)



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Net increase in Federal funds purchased and securities sold under agreement to repurchase		
Net decrease in short-term borrowings	(403,021)	(135,314)
Net decrease in short-term senior notes	(1,000,000)	(300,000)
Proceeds from issuance of long-term senior notes	2,430,000	746,500
Proceeds from issuance of common stock		150,000
Cash dividends paid on common stock	(43,000)	(52,000)
Net proceeds from stock options exercise	608	866
Excess tax (expense) benefit from stock options exercise	(25)	78
Net cash provided by financing activities	\$ 1,715,865	\$ 1,915,681
<b>Net increase (decrease) in cash and demand balances due from banks</b>	<b>82,429</b>	<b>(383,238)</b>
<b>Cash and demand balances due from banks at January 1</b>	<b>1,084,959</b>	<b>1,399,415</b>
<b>Cash and demand balances due from banks at June 30</b>	<b>\$ 1,167,388</b>	<b>\$ 1,016,177</b>

*The accompanying notes to consolidated financial statements are an integral part of these statements.*

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**HARRIS N.A. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Basis of Presentation**

Harris N.A. (the Bank) is a wholly-owned subsidiary of Harris Bankcorp, Inc. (Bankcorp), a wholly-owned subsidiary of Harris Financial Corp., a wholly-owned U.S. subsidiary of Bank of Montreal. The consolidated financial statements of the Bank include the accounts of the Bank and its wholly-owned subsidiaries. Significant intercompany accounts and transactions have been eliminated. Certain reclassifications were made to conform prior year's financial statements to the current year's presentation.

On February 17, 2006 Bankcorp merged one of its bank subsidiaries, New Lenox State Bank, with and into Harris N.A. This transaction was recorded at its carrying value and prior year financial statements have been restated to include operations from the time New Lenox State Bank was initially acquired by Bankcorp.

On August 26, 2006 Bankcorp consolidated one of its bank subsidiaries, Mercantile National Bank of Indiana, with and into the Bank. This transaction was recorded at its carrying value and prior year financial statements have been restated.

On May 12, 2007 Bankcorp consolidated one of its bank subsidiaries, First National Bank and Trust (FNBT), with and into the Bank. This transaction was recorded at its carrying value.

The consolidated financial statements have been prepared by management from the books and records of the Bank, without audit by independent certified public accountants. However, these statements reflect all adjustments and disclosures which are, in the opinion of management, necessary for a fair presentation of the results for the interim periods presented.

Because the results of operations are so closely related to and responsive to changes in economic conditions, the results for any interim period are not necessarily indicative of the results that can be expected for the entire year.

**2. Legal Proceedings**

The Bank and certain of its subsidiaries are defendants in various legal proceedings arising in the normal course of business. In the opinion of management, based on the advice of legal counsel, the ultimate resolution of these matters will not have a material adverse effect on the Bank's consolidated financial position.

**3. Cash Flows**

For purposes of the Bank's Consolidated Statements of Cash Flows, cash and cash equivalents is defined to include cash and demand balances due from banks. Cash interest payments for the six months ended June 30 totaled \$659.6 million and \$482.6 million in 2007 and 2006, respectively. Cash income tax payments over the same periods totaled \$35.5 million and \$65.8 million, respectively.

**4. Restructuring Charge**

During the quarter, the Bank recorded a restructuring recovery \$0.3 million for the three months ended June 30, 2007 and expense of \$13.4 million for the six months ended June 30, 2007, which is part of a \$15.1 million restructuring

charge for Harris Bankcorp, Inc., in the Consolidated Statement of Income. The objectives of the restructuring are to enhance customer service by directing spending and resources on front-line sales and service improvements, creating more effective processes and systems across the Bank and continuing accelerating the pace of the Bank's growth.

The charge relates to the elimination of approximately 200 positions in primarily non-customer-facing areas of the Bank across all support functions and business groups. Of the charge, \$10.7 million relates to severance related costs and \$2.7 million is associated with premises related charges.

Premises related charges include lease cancellation payments for those locations where we have legally extinguished our lease obligations as well as the carrying value of abandoned assets in excess of their fair market value.

At June 30, 2007, \$5.8 million remained in other liabilities on the Consolidated Statement of Condition related to amounts to be paid in future periods.

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**HARRIS N.A. AND SUBSIDIARIES**

**FINANCIAL REVIEW**

**Second Quarter 2007 Compared with Second Quarter 2006**

**Summary**

The Bank's second quarter 2007 net income was \$52.9 million, an increase of \$185,000 or 0.4 percent from the second quarter 2006. Return on equity was 5.90 percent in the current quarter, compared to 7.97 percent from last year's second quarter. Return on assets was 0.51 percent compared to 0.68 percent a year ago.

Second quarter 2007 net interest income was \$211.0 million, down \$1.3 million or 0.6 percent from \$212.3 million in the second quarter of 2006. Average earning assets increased 11.4 percent to \$38.1 billion from \$34.2 billion in 2006, due in part to an increase of \$3.6 billion in securities available for sale. Net interest margin decreased to 2.34 percent in the second quarter of 2007 from 2.58 percent in the second quarter of 2006, primarily reflecting a flat yield curve depressing spreads and the impact of greater reliance on higher-cost wholesale funding sources. This was somewhat offset by the growth in securities available for sale, particularly US government agencies.

Second quarter 2007 provision for loan losses was \$10.8 million compared to \$5.7 million in the second quarter of 2006. This is due to loan growth and some modest credit impairment of the portfolio. Net charge-offs increased to \$23.5 million from \$7.9 million in the prior year, reflecting higher write-offs primarily in the commercial loan portfolio. The provision for loan losses takes into account portfolio quality and management's estimate of probable loan losses.

Second quarter 2007 noninterest income was \$102.5 million, a decrease of \$1.5 million or 1.4 percent from the second quarter of 2006. This was primarily attributable to a \$7.8 million decrease in net securities gains and a decrease in syndication fees of \$3.8 million. The decreases were offset by increases of \$1.6 million in service charges and fees, a \$1.2 million increase in bank-owned insurance (\$0.3 million FNBT) and \$7.5 million increase in other income which includes an increase of \$6.7 million in intercompany service income.

Second quarter 2007 noninterest expenses were \$233.5 million, an increase of \$1.3 million or 0.6 percent from the second quarter of 2006. The increase reflects normal growth to support increased business activities. The increases were attributable to inter-company service costs rising \$2.7 million, higher net occupancy costs of \$1.9 million, contract programming increasing by \$1.3 million due to volume increases and amortization of intangibles of \$1.1 million due to FNBT. The increases were partially offset by decreases in marketing of \$1.6 million, \$1.3 million in expert service expenses and \$0.9 million in pension, profit sharing and other employee benefits. Income tax expense decreased \$9.4 million, reflecting lower pretax income from the second quarter of 2006.

Nonperforming assets at June 30, 2007 were \$199.5 million or 0.77 percent of total loans, up from \$163.8 million or 0.64 percent at December 31, 2006 and \$134.0 million or 0.52 percent from the second quarter of 2006. At June 30, 2007, the allowance for loan losses was \$313.5 million, equal to 1.22 percent of loans outstanding, compared to \$326.4 million or 1.28 percent of loans outstanding at the end of second quarter 2006. As a result, the ratio of the allowance for loan losses to nonperforming assets decreased from 251.1 percent at June 30, 2006 to 157.1 percent at June 30, 2007.

At June 30, 2007 consolidated stockholder's equity of the Bank amounted to \$3.66 billion, up from \$3.35 billion at December 31, 2006. Common stock of \$12.1 million was issued during the second quarter 2007 in conjunction with

the FNBT transaction (note 1). The Bank declared and paid \$15.0 million in dividends on common stock in the second quarter of 2007 compared to \$22.0 million declared and paid in the second quarter of 2006.

At June 30, 2007, Tier 1 capital of the Bank amounted to \$3.49 billion, up from \$3.23 billion one year earlier. The regulatory leverage capital ratio was 8.39 percent for the second quarter of 2007 compared to 8.80 percent in the same quarter of 2006. The Bank's capital ratio exceeds the prescribed regulatory minimum for banks. The Bank's

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June 30, 2007 Tier 1 and total risk-based capital ratios were 10.04 percent and 11.79 percent compared to respective ratios of 9.99 percent and 11.90 percent at June 30, 2006.

### **Six Months ended June 30, 2007 Compared with June 30, 2006**

#### **Summary**

The Bank's net income for the six months ended June 30, 2007 was \$92.6 million, a decrease of \$2.9 million or 3.1 percent from the same period last year. Return on equity was 5.19 percent in the current year, compared to 7.26 percent from last year. Return on assets was 0.45 percent compared to 0.62 percent a year ago.

Six months ended June 30, 2007 net interest income was \$422.2 million, down \$1.2 million or 0.3 percent from \$423.4 million from last year. Average earning assets increased 13.0 percent to \$38.0 billion from \$33.6 billion in 2006, due in part to an increase of \$6.8 billion in securities available for sale. Net interest margin decreased to 2.35 percent in 2007 from 2.62 percent in the same period in 2006, primarily reflecting a flat yield curve depressing spreads and the impact of greater reliance on higher-cost wholesale funding sources. This was somewhat offset by the growth in securities available for sale, particularly US government agencies.

Year to date 2007 provision for loan losses was \$13.8 million compared to \$11.3 million in 2006. This is due to loan growth and some modest credit impairment of the portfolio. Net charge-offs increased to \$32.1 million from \$16.8 million in the prior year, reflecting higher write-offs primarily in the commercial loan portfolio. The provision for loan losses takes into account portfolio quality and management's estimate of probable loan losses.

Six months ended June 30, 2007 noninterest income was \$204.6 million, an increase of \$13.7 million or 7.2 percent from last year. This was primarily attributable to a \$7.0 million increase in trust and investment management fees, a \$3.3 million increase in bank-owned insurance (\$0.6 million FNBT), a \$2.3 million increase in service charges and fees and \$12.9 million increase in other noninterest income which is primarily \$10.6 million of intercompany service income and \$2.0 million in mutual fund fees. The increases were partially offset by decreases in net securities gains of \$8.2 million and \$4.8 million decrease in syndication fees.

Six months ended June 30, 2007 noninterest expenses were \$496.0 million, an increase of \$29.0 million or 6.2 percent from last year. The increase was attributable in part to a restructuring charge of \$13.4 million (note 4). Excluding the restructuring charge, expenses rose \$15.6 million or 3.3 percent from the same period in 2006. The increase reflects normal growth to support increased business activities. The increases were attributable to higher net occupancy costs of \$4.5 million due to increased building depreciation and maintenance, rent expense and higher real estate tax expense, inter-company service costs rising \$4.4 million, an increase in salaries and other compensation of \$4.4 million, an increase in amortization of intangibles of \$2.0 million due to FNBT, increase in contract programming of \$1.7 million due to contract renegotiation of cost and volume increases and pension, profit sharing and other employee benefits increasing by \$1.7 million. The increases were partially offset by a \$2.8 million decrease in expert service expenses and \$2.2 million in marketing expenses. Income tax expense decreased \$16.0 million, reflecting lower pretax income for the six months ended June 30, 2006.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

See Liquidity Risk Management and Market Risk Management under Management's Discussion and Analysis of Financial Condition and Results of Operations on page 6.

### **Item 4. Controls and Procedures**

As of June 30, 2007, Paul R. Skubic, the Chairman of the Board, Chief Executive Officer and President of the Company, and Pamela C. Piarowski, the Chief Financial Officer of the Company, evaluated the effectiveness of the disclosure controls and procedures of the Company and concluded that these disclosure controls and procedures are effective to ensure that material information required to be included in this Report has been recorded, processed, summarized and made known to them in a timely fashion, as appropriate to allow timely decisions regarding disclosures. There was no change in the Company's internal control over financial reporting identified in connection with such evaluations that occurred during the quarter ended June 30, 2007 that has materially affected or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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**Part II. OTHER INFORMATION**

Items 1, 1A, 2, 3, 4 and 5 are being omitted from this Report because such items are not applicable to the reporting period.

**Item 6. Exhibits**

**31.1 Certification of Pamela C. Piarowski pursuant to rule 13a-14(a)**

**31.2 Certification of Paul R. Skubic pursuant to rule 13a-14(a)**

**32.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**



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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, Harris Preferred Capital Corporation has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized on the 14th day of August 2007.

/s/ Paul R. Skubic  
Paul R. Skubic  
Chairman of the Board and President

/s/ Pamela C. Piarowski  
Pamela C. Piarowski  
Chief Financial Officer