

HARRIS PREFERRED CAPITAL CORP

Form 10-Q

November 14, 2006

**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 September 30, 2006

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:

| Title of each class | Name of each exchange on which registered |
|---|--|
| 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

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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

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 November 14, 2006 was 1,000. No common equity is held by nonaffiliates.

HARRIS PREFERRED CAPITAL CORPORATION

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

| | September 30, 2006 (unaudited) | December 31, 2005 (audited) | September 30, 2005 (unaudited) |
|--|---|--|---|
| | (in thousands, except share data) | | |
| Assets | | | |
| Cash on deposit with Harris N.A. | \$ 1,026 | \$ 700 | \$ 735 |
| Securities purchased from Harris N.A. under agreement to resell | 12,083 | 20,500 | 12,000 |
| Notes receivable from Harris N.A. | 6,722 | 8,684 | 9,344 |
| Securities available-for-sale: | | | |
| Mortgage-backed | 396,917 | 373,584 | 398,720 |
| U.S. Treasury | 64,926 | 74,946 | 59,970 |
| Other assets | 1,646 | 1,461 | 1,556 |
| Total assets | \$ 483,320 | \$ 479,875 | \$ 482,325 |
| Liabilities and Stockholders Equity | | | |
| Accrued expenses | \$ 51 | \$ 129 | \$ 58 |
| Commitments and contingencies | | | |
| Stockholders Equity | | | |
| 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 | 1,673 | (2) | (185) |
| Accumulated other comprehensive loss net unrealized losses on available-for-sale securities | (9,138) | (10,986) | (8,282) |
| Total stockholders equity | 483,269 | 479,746 | 482,267 |
| Total liabilities and stockholders equity | \$ 483,320 | \$ 479,875 | \$ 482,325 |

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

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

| | Quarter Ended | | Nine Months Ended | |
|--|--|---------------|--------------------------|---------------|
| | September 30, | | September 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| | (in thousands, except per share data) | | | |
| Interest income: | | | | |
| Securities purchased from Harris N.A. under agreement to resell | \$ 1,090 | \$ 432 | \$ 3,360 | \$ 883 |
| Notes receivable from Harris N.A. | 111 | 158 | 360 | 514 |
| Securities available-for-sale: | | | | |
| Mortgage-backed | 4,118 | 4,273 | 11,809 | 13,068 |
| U.S. Treasury | 104 | 28 | 307 | 64 |
| Total interest income | 5,423 | 4,891 | 15,836 | 14,529 |
| Operating expenses: | | | | |
| Loan servicing fees paid to Harris N.A. | 5 | 8 | 17 | 24 |
| Advisory fees | 32 | 34 | 93 | 99 |
| General and administrative | 59 | 46 | 223 | 181 |
| Total operating expenses | 96 | 88 | 333 | 304 |
| Net income | 5,327 | 4,803 | 15,503 | 14,225 |
| Preferred dividends | 4,609 | 4,609 | 13,828 | 13,828 |
| Net income available to common stockholder | \$ 718 | \$ 194 | \$ 1,675 | \$ 397 |
| Basic and diluted earnings per common share | \$ 718.00 | \$ 194.00 | \$ 1,675.00 | \$ 397.00 |
| Net income | \$ 5,327 | \$ 4,803 | \$ 15,503 | \$ 14,225 |
| Other comprehensive income (loss) net unrealized gains/(losses) on available-for-sale securities | 7,912 | (4,776) | 1,848 | (7,018) |
| Comprehensive income | \$ 13,239 | \$ 27 | \$ 17,351 | \$ 7,207 |

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

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

| | Nine Months Ended | |
|--|-------------------------------|-------------|
| | September 30, | |
| | 2006 | 2005 |
| | (in thousands, | |
| | except per share data) | |
| Balance at January 1 | \$ 479,746 | \$ 488,888 |
| Net income | 15,503 | 14,225 |
| Other comprehensive income (loss) | 1,848 | (7,018) |
| Dividends (preferred stock \$0.4609 per share) | (13,828) | (13,828) |
| Balance at September 30 | \$ 483,269 | \$ 486,849 |

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

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

| | Nine Months Ended | |
|--|--------------------------|-------------|
| | September 30, | |
| | 2006 | 2005 |
| | (in thousands) | |
| Operating Activities: | | |
| Net Income | \$ 15,503 | \$ 14,225 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| (Increase) decrease in other assets | (185) | 122 |
| Net decrease in accrued expenses | (79) | (76) |
| Net cash provided by operating activities | 15,239 | 14,271 |
| Investing Activities: | | |
| Decrease (increase) in securities purchased from Harris N.A. under agreement to resell | 8,417 | (1,500) |
| Repayments of notes receivable from Harris N.A. | 1,962 | 2,785 |
| Purchases of securities available-for-sale | (333,447) | (173,520) |
| Proceeds from maturities of securities available-for-sale | 321,983 | 172,120 |
| Net cash used by investing activities | (1,085) | (115) |
| Financing Activities: | | |
| Cash dividends paid on preferred stock | (13,828) | (13,828) |
| Net cash used in financing activities | (13,828) | (13,828) |
| Net increase in cash on deposit with Harris N.A. | 326 | 328 |
| Cash on deposit with Harris N.A. at beginning of period | 700 | 407 |
| Cash on deposit with Harris N.A. at end of period | \$ 1,026 | \$ 735 |

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

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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 financial statements included in the Company's 2005 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 2005 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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Results of Operations

Third Quarter 2006 Compared with Third Quarter 2005

The Company's net income for the third quarter of 2006 was \$5.3 million, an 11% increase from the third quarter 2005 net income of \$4.8 million. Earnings increased primarily because of increased interest income on earning assets.

Interest income on securities purchased under agreement to resell for the third quarter of 2006 was \$1.1 million, on an average balance of \$72.2 million, with an average rate of 6.0%. During the same period in 2005, the interest income on securities purchased under agreement to resell was \$432 thousand on an average balance of \$43 million, with an average rate of 4.1%. Third quarter 2006 interest income on the Notes totaled \$111 thousand and yielded 6.4% on \$6.9 million of average principal outstanding for the quarter compared to \$158 thousand and a 6.4% yield on \$9.9 million average principal outstanding for third quarter 2005. The decrease in income was attributable to a reduction in the Note balance because of principal paydowns by customers in the Securing Mortgage Loans. Interest income on securities available-for-sale for the third quarter was \$4.2 million resulting in a yield of 4.4% on an average balance of \$382 million, compared to \$4.3 million with a yield of 4.1% on an average balance of \$415 million for the same period a year ago. The decrease in the interest income is primarily attributable to the lower balances in the portfolio of mortgage-backed securities during the first two months of the quarter, partially offset by the increase in rates for the recent purchases in the third quarter of 2006. There were no Company borrowings during third quarter 2006 or 2005.

Third quarter 2006 operating expenses totaled \$96 thousand, an increase of \$8 thousand or 9% from the third quarter of 2005. Loan servicing expenses totaled \$5 thousand, a decrease of \$3 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 third quarter 2006 were \$32 thousand compared to \$34 thousand a year earlier. General and administrative expenses totaled \$59 thousand, an increase of \$13 thousand over the same period in 2005 primarily as a result of an increase in expert service fees.

At September 30, 2006 and 2005, 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, although 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 September 30, 2006, net unrealized losses on available-for-sale securities were \$9.1 million compared to \$8.3 million of unrealized losses on September 30, 2005 and \$11.0 million of unrealized losses at December 31, 2005. The unrealized loss positions at September 30, 2006 and 2005 and December 31, 2005 were attributed to changes in interest rates and not to lowered credit quality of individual securities; therefore management believes these unrealized losses are temporary.

Nine Months Ended September 30, 2006 compared with September 30, 2005

The Company's net income for the nine months ended September 30, 2006 was \$15.5 million. This represented a \$1.3 million increase or 9% from 2005 earnings. Earnings increased primarily because of higher returns from positions in securities purchased under agreement to resell.

Interest income on securities purchased under agreement to resell for the nine months ended September 30, 2006 was \$3.4 million, on an average balance of \$79.1 million, with an average rate of 5.7%. During the same period in 2005,

the interest income on securities purchased under agreement to resell was \$883 thousand on an average balance of \$36 million, with an average rate of 3.3%. Interest income on the Notes for the nine months ended September 30, 2006 totaled \$360 thousand, yielding 6.4% on \$7.5 million of average principal outstanding compared to \$514 thousand of income yielding 6.4% on \$11 million of average principal outstanding for the same period in 2005. 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 \$9 million for the nine months ended September 30, 2006 and \$13 million for the same period in 2005. Interest

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income on securities available-for-sale for the nine months ended September 30, 2006 was \$12.1 million resulting in a yield of 4.4% on an average balance of \$371 million, compared to \$13.1 million resulting in a yield of 4.1% on an average balance of \$428 million a year ago. The decrease in interest income from available-for-sale securities is primarily attributable to the decrease in the portfolio of mortgage-backed securities during the first two quarters of 2006, partially offset by the recent acquisitions of \$63 million in mortgage-backed securities. There were no Company borrowings during either period.

Operating expense for the nine months ended September 30, 2006 totaled \$333 thousand, an increase of \$29 thousand or 9.5% from a year ago. Loan servicing expenses for the nine months ended September 30, 2006 totaled \$17 thousand, a decrease of \$7 thousand or 29% from 2005. 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 nine months ended September 30, 2006 were \$93 thousand compared to \$99 thousand a year ago. General and administrative expenses totaled \$223 thousand, an increase of \$42 thousand or 23% over the same period in 2005 as a result of increased costs for regulatory filings and prior year credits for printing and processing costs received in 2005.

On September 30, 2006, the Company paid a cash dividend of \$0.46094 per share on outstanding Preferred Shares to the stockholders of record on September 15, 2006 as declared on August 30, 2006. On September 30, 2005, the Company paid a cash dividend of \$0.46094 per share on outstanding Preferred Shares to the stockholders of record on September 15, 2005, as declared on August 30, 2005.

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.

The Company anticipates that cash and cash equivalents on hand and the cash flow from the Notes and mortgage-backed and U.S 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 sources of funds in addition to \$15.2 million provided from operations during the nine months ended September 30, 2006 were \$8.4 million decrease in securities purchased from Harris N.A. under agreement to resell, \$2.0 million provided by principal repayments on

the Notes and \$322 million from the maturities of securities available-for-sale. In the prior period ended September 30, 2005, the primary sources of funds other than \$14.3 million from operations were \$2.8 million provided by principal repayments on the Notes and \$172.1 million from the maturities of securities available-for-sale. The primary uses of funds for the nine months ended September 30, 2006 were \$333.4 million for purchases of securities available-for-sale and \$13.8 million in preferred stock dividends paid. For the prior year s

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period ended September 30, 2005, the primary uses of funds were \$173.5 million for purchases of securities available-for-sale and \$13.8 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, 2005.

Other Matters

As of September 30, 2006, 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.

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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| | | | |
|---|----------------------|----------------------|----------------------|
| Minority interest preferred stock of subsidiary | 250,000 | 250,000 | 250,000 |
| Total Liabilities | 37,295,391 | 33,199,032 | 32,672,276 |
| Stockholder s Equity | | | |
| Common stock (\$10 par value); authorized 40,000,000 shares; issued and outstanding 14,303,361, 14,016,361 and 13,955,105 shares at September 30, 2006, December 31, 2005 and September 30, 2005, respectively | 143,034 | 140,164 | 139,551 |
| Surplus | 1,487,188 | 1,327,828 | 1,280,446 |
| Retained earnings | 1,759,656 | 1,675,548 | 1,616,558 |
| Accumulated other comprehensive loss | (54,528) | (69,987) | (60,783) |
| Total Stockholder s Equity | 3,335,350 | 3,073,553 | 2,975,772 |
| Total Liabilities and Stockholder s Equity | \$ 40,630,741 | \$ 36,272,585 | \$ 35,648,048 |

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

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

| | Quarter Ended | | Nine Months Ended | |
|---|-----------------------|----------------|--------------------------|------------------|
| | September 30, | | September 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| | (in thousands) | | | |
| Interest Income | | | | |
| Loans | \$ 406,725 | \$ 324,839 | \$ 1,165,732 | \$ 914,368 |
| Money market assets: | | | | |
| Deposits at banks | 3,531 | 2,997 | 10,200 | 8,128 |
| Federal funds sold and securities purchased under agreement to resell | 16,432 | 2,533 | 26,492 | 5,758 |
| Trading accounts | 1,731 | 1,268 | 5,730 | 3,845 |
| Securities available-for-sale: | | | | |
| U.S. Treasury and federal agency | 79,275 | 48,058 | 191,732 | 123,890 |
| State and municipal | 5,959 | 5,236 | 17,051 | 14,845 |
| Other | 5,154 | 4,116 | 16,112 | 12,879 |
| Total interest income | 518,807 | 389,047 | 1,433,049 | 1,083,713 |
| Interest Expense | | | | |
| Deposits | 192,398 | 121,734 | 517,205 | 321,109 |
| Short-term borrowings | 89,785 | 48,216 | 218,898 | 111,838 |
| Short-term notes senior | 4,710 | 1,786 | 16,465 | 7,673 |
| Long-term notes senior | 4,609 | 4,609 | 13,828 | 13,828 |
| Long-term notes subordinated | 13,797 | 2,835 | 22,340 | 2,835 |
| Minority interest dividends on preferred stock of subsidiary | 4,277 | 2,910 | 11,727 | 7,490 |
| Total interest expense | 309,576 | 182,090 | 800,463 | 464,773 |
| Net Interest Income | 209,231 | 206,957 | 632,586 | 618,940 |
| Provision for loan losses | 6,891 | 3,390 | 18,198 | 9,182 |
| Net Interest Income after Provision for Loan Losses | 202,340 | 203,567 | 614,388 | 609,758 |
| Noninterest Income | | | | |
| Trust and investment management fees | 20,405 | 23,390 | 59,385 | 72,175 |
| Money market and bond trading | 5,408 | 1,920 | 11,135 | 7,052 |
| Foreign exchange | 1,000 | 1,720 | 3,400 | 4,360 |
| Service charges and fees | 34,494 | 33,485 | 102,541 | 99,118 |
| Net securities gains (losses) | 25,892 | (178) | 28,244 | (257) |
| Bank-owned insurance | 12,392 | 12,064 | 33,832 | 32,190 |

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| | | | | |
|---|------------------|------------------|-------------------|-------------------|
| Letter of credit fees | 4,509 | 4,806 | 14,251 | 15,584 |
| Syndication fees | 8,456 | 1,149 | 14,321 | 7,277 |
| Other | 15,245 | 23,143 | 51,790 | 78,615 |
| Total noninterest income | 127,801 | 101,499 | 318,899 | 316,114 |
| Noninterest Expenses | | | | |
| Salaries and other compensation | 94,320 | 90,583 | 270,368 | 281,581 |
| Pension, profit sharing and other employee benefits | 25,904 | 27,786 | 84,358 | 84,101 |
| Net occupancy | 21,489 | 19,975 | 60,272 | 56,609 |
| Equipment | 15,915 | 14,472 | 48,032 | 42,997 |
| Marketing | 11,515 | 9,351 | 31,761 | 28,782 |
| Communication and delivery | 6,455 | 6,565 | 19,079 | 18,060 |
| Expert services | 8,930 | 7,525 | 26,135 | 20,598 |
| Contract programming | 9,434 | 10,833 | 23,508 | 24,914 |
| Intercompany services | 13,677 | 14,710 | 43,094 | 31,703 |
| Other | 30,709 | 31,160 | 88,228 | 85,187 |
| | 238,348 | 232,960 | 694,835 | 674,532 |
| Amortization of intangibles | 5,385 | 5,324 | 16,147 | 16,141 |
| Total noninterest expenses | 243,733 | 238,284 | 710,982 | 690,673 |
| Income before income taxes | 86,408 | 66,782 | 222,305 | 235,199 |
| Applicable income taxes | 25,807 | 18,439 | 66,198 | 75,632 |
| Net Income | \$ 60,601 | \$ 48,343 | \$ 156,107 | \$ 159,567 |

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

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

| | Quarter Ended | | Nine Months Ended | |
|--|-----------------------|------------------|--------------------------|-------------------|
| | September 30, | | September 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| | (in thousands) | | | |
| Net income | \$ 60,601 | \$ 48,343 | \$ 156,107 | \$ 159,567 |
| Other comprehensive income (loss): | | | | |
| Cash flow hedges: | | | | |
| Net unrealized loss on derivative instruments, net of tax benefit for the quarter of \$1,990 in 2006 and \$8,819 in 2005 and net of tax benefit year-to-date period of \$2,648 in 2006 and \$8,469 in 2005 | (3,386) | (15,015) | (4,508) | (14,420) |
| Less reclassification adjustment for realized loss included in income statement, net of tax benefit for the quarter of \$1,025 in 2006 and \$2,615 in 2005 and net of tax benefit year-to-date period of \$3,299 in 2006 and \$1,726 in 2005 | 1,744 | 4,452 | 5,616 | 2,938 |
| Unrealized gain (loss) on available-for-sale securities: Unrealized holding gain (loss) arising during the period, net of tax expense (benefit) for the quarter of \$25,845 in 2006 and (\$5,962) in 2005 and net of tax expense (benefit) for the year-to-date period of \$19,399 in 2006 and (\$2,818) in 2005 | 43,860 | (11,061) | 31,580 | (5,026) |
| Less reclassification adjustment for realized (gain) loss included in income statement, net of tax expense (benefit) for the quarter of \$10,098 in 2006 and (\$69) in 2005 and net of tax expense (benefit) for the year-to-date period of \$11,015 in 2006 and (\$100) in 2005 | (15,794) | 108 | (17,229) | 157 |
| Other comprehensive income (loss) | 26,424 | (21,516) | 15,459 | (16,351) |
| Comprehensive Income | \$ 87,025 | \$ 26,827 | \$ 171,566 | \$ 143,216 |

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

HARRIS N.A. AND SUBSIDIARIES

**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDER S EQUITY
(Unaudited)**

| | 2006 | 2005 |
|-----------------------------------|-----------------------|---------------------|
| | (in thousands) | |
| Balance at January 1 | \$ 3,073,553 | \$ 2,902,109 |
| Net income | 156,107 | 159,567 |
| Contributions to capital surplus | 148,001 | |
| Issuance of common stock | 2,870 | |
| Stock option exercise | 11,360 | 5,509 |
| Dividends preferred stock | | (62) |
| Dividends common stock | (72,000) | (75,000) |
| Other comprehensive income (loss) | 15,459 | (16,351) |
| Balance at September 30 | \$ 3,335,350 | \$ 2,975,772 |

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

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

| | Nine Months Ended September 30, | |
|--|--|-------------|
| | 2006 | 2005 |
| | (in thousands) | |
| Operating Activities: | | |
| Net Income | \$ 156,107 | \$ 159,567 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 18,198 | 9,182 |
| Depreciation and amortization, including intangibles | 57,890 | 78,474 |
| Deferred tax expense (benefit) | 66,198 | (34,347) |
| Net (gain) loss on sales of securities | (28,244) | 257 |
| Increase in bank-owned insurance | (29,816) | (32,180) |
| Trading account net cash sales | 316,391 | 177,975 |
| Net increase in interest receivable | (26,024) | (20,451) |
| Net increase (decrease) in interest payable | 19,795 | (17,479) |
| Origination of loans held for sale | (196,595) | (311,547) |
| Proceeds from sale of loans held for sale | 203,236 | 303,117 |
| Net gain on loans held for sale | (1,243) | (1,583) |
| Other, net | 21,005 | (17,811) |
| Net cash provided by operating activities | 576,898 | 293,174 |
| Investing Activities: | | |
| Net decrease (increase) in interest-bearing deposits at banks | 59,622 | (229,126) |
| Net increase in Federal funds sold | (1,119,579) | (378,502) |
| Proceeds from sales of securities available-for-sale | 2,875,170 | 136,560 |
| Proceeds from maturities of securities available-for-sale | 5,535,986 | 4,414,140 |
| Purchases of securities available-for-sale | (10,172,950) | (4,164,725) |
| Net increase in loans | (1,094,677) | (2,207,805) |
| Net (purchases) sales of premises and equipment | (69,514) | 67,185 |
| Net cash used by investing activities | (3,985,942) | (2,362,273) |
| Financing Activities: | | |
| Net increase in deposits | 2,172,142 | 1,080,861 |
| Net increase (decrease) in Federal funds purchased and securities sold under agreement to repurchase | 961,339 | (1,296,790) |
| Net (decrease) increase in other short-term borrowings | (78,200) | 2,105,333 |
| Proceeds from issuance of short-term senior notes | 1,700,000 | 1,400,000 |
| Repayment of short-term senior notes | (2,400,000) | (1,150,000) |
| Proceeds from issuance of long-term senior notes | 746,500 | |
| Proceeds from issuance of common stock | 150,000 | |

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| | | |
|--|---------------------|-------------------|
| Cash dividends paid on common stock | (72,000) | (75,000) |
| Retirement of preferred stock | | (5,000) |
| Net cash provided by financing activities | 3,179,781 | 2,059,404 |
| Net Decrease in Cash and Demand Balances due from Banks | (229,263) | (9,695) |
| Cash and Demand Balances due from Banks at January 1 | 1,399,415 | 984,874 |
| Cash and Demand Balances due from Banks at September 30 | \$ 1,170,152 | \$ 975,179 |

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

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.

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

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 nine months ended September 30 totaled \$780.7 million and \$554.4 million in 2006 and 2005, respectively. Cash income tax payments over the same periods totaled \$88.6 million and \$56.6 million, respectively.

**HARRIS N.A. AND SUBSIDIARIES
FINANCIAL REVIEW**

Third Quarter 2006 Compared with Third Quarter 2005

Summary

The Bank had third quarter 2006 net income of \$60.6 million, an increase of \$12.3 million or 25 percent from third quarter 2005. Return on equity was 7.30 percent in the current quarter, compared to 6.42 percent from last year's third quarter. Return on assets was 0.62 percent compared to 0.55 percent a year ago.

Third quarter net interest income on a fully taxable equivalent basis was \$217.8 million, up \$4.9 million or 2 percent from \$212.9 million in 2005's third quarter. Average earning assets increased 11 percent to \$35.03 billion from \$31.63 billion in 2005, due primarily to an increase of \$2.4 billion in average loans. Net interest margin decreased to 2.47 percent in the current quarter from 2.67 percent in the year-ago quarter, primarily reflecting a flat yield curve that depressed spreads on earnings assets and the impact of greater reliance on higher-cost wholesale funding sources. This was somewhat offset by strong loan growth, particularly in the retail loan portfolio, which are generally higher yielding earning assets.

The third quarter 2006 provision for loan losses was \$6.9 million compared to \$3.4 million in the third quarter of 2005. Net charge-offs increased to \$9.1 million from \$4.9 million in the prior year. The credit profile of the loan portfolio is expected to remain solid with moderate increases in default and loss experiences in late 2006. The increase in the provision in the third quarter of 2006 reflected quarterly charge-off activity and management's assessment of non-performing loans.

Noninterest income was \$127.8 million, an increase of \$26.3 million or 26 percent from the same quarter last year. This favorable performance was primarily attributable to a \$26.1 million increase in net securities gains, a \$7.3 million increase in syndication fees and \$3.5 million higher money market and bond trading profits. The increases were partially offset by reductions in trust and investment management fees and affiliate referral fees.

Third quarter 2006 noninterest expenses of \$243.7 million increased \$5.4 million or 2 percent from the year ago quarter. The increase was primarily attributable to salaries and other compensation costs rising by \$3.7 million and a \$2.2 million increase in marketing costs. The increases were partially offset by reduced pension, profit sharing and other employee benefit expenses. Income tax expense increased \$7.4 million, reflecting higher pretax income. The effective tax rate was higher in this year's quarter as a result of current settlements for prior years' tax returns.

Nonperforming assets at September 30, 2006 were \$131 million or 0.51 percent of total loans, up slightly from \$125 million or 0.50 percent at June 30, 2006, and down from \$150 million or 0.67 percent a year ago. At September 30, 2006, the allowance for loan losses was \$324 million, equal to 1.27 percent of loans outstanding, compared to \$321 million or 1.36 percent of loans outstanding at the end of third quarter 2005. As a result, the ratio of the allowance for loan losses to nonperforming assets increased from 214 percent at September 30, 2005 to 248 percent at September 30, 2006.

At September 30, 2006, Tier 1 capital of the Bank amounted to \$3.24 billion, up from \$2.91 billion one year earlier. The regulatory leverage capital ratio was 8.26 percent for the third quarter of 2006 compared to 8.48 percent in the same quarter of 2005. The Bank's capital ratio exceeds the prescribed regulatory minimum for banks. The Bank's September 30, 2006 Tier 1 and total risk-based capital ratios were 9.73 percent and 11.58 percent compared to respective ratios of 9.72 percent and 11.77 percent at September 30, 2005.

Nine Months Ended September 30, 2006 Compared with Nine Months Ended September 30, 2005

Summary

The Bank had net income for the nine months ended September 30, 2006 of \$156.1 million, a decrease of \$3.5 million or 2 percent from the same period a year ago. Return on equity was 6.58 percent in the current year, compared to 7.24 percent from last year. Return on assets was 0.56 percent compared to 0.62 percent a year ago.

HARRIS N.A. AND SUBSIDIARIES

Net interest income on a fully taxable equivalent basis was \$655.0 million, up \$19.9 million or 3 percent from \$635.1 million in 2005's year-to-date period. Average earning assets increased 10 percent to \$34.08 billion from \$31.02 billion in 2005. Average loan growth of \$2.7 billion fueled the increase in earning assets. Net interest margin decreased to 2.57 percent from 2.74 percent in 2005, reflecting the impact of higher rates on deposits and the issuance of higher-cost wholesale supporting funds. This was somewhat offset by higher yields in the loan portfolio and strong retail loan growth.

The year-to-date 2006 provision for loan losses was \$18.2 million compared to \$9.2 million in 2005, an increase of \$9.0 million. Net charge-offs were \$25.9 million, an increase of \$10.6 million from last year, resulting primarily from higher retail loan write-offs. The increase in provision resulted from higher net charge-offs and management's assessment of non-performing loans.

Noninterest income of \$318.9 million increased \$2.8 million or 1 percent from the same period last year. This was primarily attributable to a \$28.5 million increase in net securities gains, a \$7.0 million increase in syndication fees and \$4.1 million higher money market and bond trading profits. The increases were partially offset by reductions in affiliate referral fees and loan sale fees.

Noninterest expenses of \$711.0 million increased \$20.3 million or 3 percent from the year-ago period. The increase was attributable to intercompany service costs rising by \$11.4 million, an \$8.2 million increase in noncredit losses, as well as increases in most expense categories from recent acquisitions. These increases were primarily offset by reduced salaries and other compensation expenses. Income tax expense decreased \$9.4 million, reflecting lower pretax income from year ago results. The effective tax rate was lower in this year as a result of current year settlements for prior years' tax returns.

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 September 30, 2006, 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 September 30, 2006 that has materially affected or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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

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 November 2006.

Harris Preferred Capital Corporation

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

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