

HARRIS PREFERRED CAPITAL CORP

Form 10-Q

August 12, 2010

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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, 2010**

**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 the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T(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  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a 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

The number of shares of Common Stock, \$1.00 par value, outstanding on August 12, 2010 was 1,180. No common equity is held by nonaffiliates.

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**HARRIS PREFERRED CAPITAL CORPORATION**

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Table of Contents**HARRIS PREFERRED CAPITAL CORPORATION****CONSOLIDATED BALANCE SHEETS**

	<b>June 30 2010 (unaudited)</b>	<b>December 31 2009 (audited)</b>	<b>June 30 2009 (unaudited)</b>
	<b>(in thousands, except share data)</b>		
<b>Assets</b>			
Cash on deposit with Harris N.A.	\$ 829	\$ 916	\$ 729
Securities purchased from Harris N.A. under agreement to resell	12,500	22,000	10,672
Total cash and cash equivalents	\$ 13,329	\$ 22,916	\$ 11,401
Notes receivable from Harris N.A.	3,459	3,584	3,896
Securities available for sale, at fair value			
Mortgage-backed	515,492	515,190	566,047
U.S. Treasury Bills	59,998	39,999	
Other assets	1,808	1,885	2,094
<b>Total assets</b>	<b>\$ 594,086</b>	<b>\$ 583,574</b>	<b>\$ 583,438</b>
<b>Liabilities and Stockholders Equity</b>			
Accrued expenses	\$ 111	\$ 111	\$ 869
Deferred state tax liabilities	1,720	973	846
<b>Total liabilities</b>	<b>\$ 1,831</b>	<b>\$ 1,084</b>	<b>\$ 1,715</b>
<b>Stockholders Equity</b>			
73/8% Noncumulative Exchangeable Preferred Stock, Series A (\$1 par value); liquidation value of \$250,000; 20,000,000 shares authorized; 10,000,000 shares issued and outstanding	\$ 250,000	\$ 250,000	\$ 250,000
Common stock (\$1 par value); 5,000 shares authorized; 1,180 issued and outstanding	1	1	1
Additional paid-in capital	320,733	320,733	320,733
Earnings in excess of (less than) distributions	(320)	(601)	250
Accumulated other comprehensive income net unrealized gains on available-for-sale securities, net of tax	21,841	12,357	10,739
<b>Total stockholders equity</b>	<b>\$ 592,255</b>	<b>\$ 582,490</b>	<b>\$ 581,723</b>
<b>Total liabilities and stockholders equity</b>	<b>\$ 594,086</b>	<b>\$ 583,574</b>	<b>\$ 583,438</b>

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

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

	<b>Quarter Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
	<b>(in thousands, except share date)</b>			
<b>Interest income:</b>				
Securities purchased from Harris N.A. under agreement to resell	\$ 27	\$ 8	\$ 38	\$ 17
Notes receivable from Harris N.A.	56	62	113	127
Securities available for sale:				
Mortgage-backed	5,126	5,612	10,407	10,994
U.S. Treasury Bills	2	1	3	1
Total interest income	\$ 5,211	\$ 5,683	\$ 10,561	\$ 11,139
<b>Operating expenses:</b>				
Loan servicing fees paid to Harris N.A.	\$ 3	\$ 3	\$ 6	\$ 6
Advisory fees paid to Harris N.A.	39	41	102	97
General and administrative	77	74	207	194
Total operating expenses	\$ 119	\$ 118	\$ 315	\$ 297
Income before income taxes	\$ 5,092	\$ 5,565	\$ 10,246	\$ 10,842
Applicable state income taxes	371	406	747	791
Net Income	\$ 4,721	\$ 5,159	\$ 9,499	\$ 10,051
Preferred stock dividends	4,609	4,609	9,218	9,218
<b>Net income available to common stockholder</b>	<b>\$ 112</b>	<b>\$ 550</b>	<b>\$ 281</b>	<b>\$ 833</b>
Basic and diluted earnings per common share	\$ 94	\$ 466	\$ 237	\$ 746
Net income	\$ 4,721	\$ 5,159	\$ 9,499	\$ 10,051
Other comprehensive income:				
Available-for-sale securities:				
Unrealized holding gains (losses) arising during the period, net of deferred state taxes	6,289	(2,728)	9,484	907
Less reclassification adjustment for realized (gains) losses included in net income				
Comprehensive income	\$ 11,010	\$ 2,431	\$ 18,983	\$ 10,958

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

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

	<b>Six Months Ended</b>	
	<b>June 30</b>	
	<b>2010</b>	<b>2009</b>
	<b>(in thousands)</b>	
Balance at January 1	\$ 582,490	\$ 500,244
Net income	9,499	10,051
Other comprehensive income	9,484	907
Capital contribution and issuance of common stock		80,000
Dividends on common stock		(261)
Dividends on preferred stock (\$0.4609 per share)	(9,218)	(9,218)
Balance at June 30	\$ 592,255	\$ 581,723

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



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**HARRIS PREFERRED CAPITAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>Six Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>
	<b>(in thousands)</b>	
<b>Operating Activities:</b>		
Net income	\$ 9,499	\$ 10,051
Adjustments to reconcile net income to net cash provided by operating activities:		
Net decrease (increase) in other assets	75	(209)
Net increase in accrued expenses		756
Net cash provided by operating activities	\$ 9,574	\$ 10,598
<b>Investing Activities:</b>		
Repayments of notes receivable from Harris N.A.	\$ 125	\$ 388
Purchases of securities available for sale	(189,499)	(261,617)
Proceeds from maturities/redemptions of securities available-for-sale	179,431	184,832
Net cash used in investing activities	\$ (9,943)	\$ (76,397)
<b>Financing Activities:</b>		
Cash dividends paid on preferred stock	\$ (9,218)	\$ (9,218)
Cash dividends paid on common stock		(261)
Capital contribution and issuance of common stock		80,000
Net cash (used in) provided by financing activities	\$ (9,218)	\$ 70,521
Net (decrease) increase in cash and cash equivalents with Harris N.A.	\$ (9,587)	\$ 4,722
Cash and cash equivalents with Harris N.A. at beginning of period	22,916	6,679
Cash and cash equivalents with Harris N.A. at end of period	\$ 13,329	\$ 11,401

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

Table of Contents**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 financial statements included in the Company's 2009 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 at June 30, 2010.

**3. Securities**

The amortized cost and estimated fair value of securities available for sale were as follows:

	Amortized Cost	June 30, 2010 Unrealized Gains    Unrealized Losses (in thousands)		Fair Value
<b>Available-for-Sale Securities</b>				
Residential mortgage-backed	\$ 491,931	\$ 23,561	\$	\$ 515,492
U.S. Treasury Bills	59,998			59,998

Total Securities	\$ 551,929	\$ 23,561	\$	\$ 575,490
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	<b>December 31, 2009</b>			
	<b>Amortized Cost</b>	<b>Unrealized Gains</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>
	<b>(in thousands)</b>			
<b>Available-for-Sale Securities</b>				
Residential mortgage-backed	\$ 501,861	\$ 14,214	\$ 885	\$ 515,190
U.S. Treasury Bills	40,000		1	39,999
Total Securities	\$ 541,861	\$ 14,214	\$ 886	\$ 555,189

	<b>June 30, 2009</b>			
	<b>Amortized Cost</b>	<b>Unrealized Gains</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>
	<b>(in thousands)</b>			
<b>Available-for-Sale Securities</b>				
Residential mortgage-backed	\$ 554,463	\$ 13,207	\$ 1,623	\$ 566,047

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, 2010, net unrealized gains on available-for-sale securities were \$23.6 million compared to \$13.3 million of net unrealized gains on December 31, 2009 and \$11.6 million of net unrealized gains at June 30, 2009.

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.

The following tables summarize residential mortgage-backed and U.S. Treasuries securities with unrealized losses, the amount of the unrealized loss and the related fair value of the securities with unrealized losses. The unrealized losses have been further segregated by mortgage-backed and U.S. Treasury securities that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position. As of June 30, 2010 and 2009, there were no securities that were in a loss position for 12 or more months. Management believes that all of the unrealized losses, caused by interest rate increases on investments in mortgage-backed securities and U.S. Treasuries, are temporary. The contractual cash flows of these securities are guaranteed directly by a U.S. government-sponsored enterprise. It is expected that the securities would not be settled at a price less than the amortized cost of the investment. Because the decline in fair value is attributable to changes in interest rates and not

credit quality, and because the Company has the ability and intent to hold these investments and does not anticipate being required to sell these investments until a market price recovery or maturity, these investments are not considered other-than-temporarily impaired. There were no reclassification adjustments for security sales



#### **4. Fair Value Measurements**

The Company uses a fair value hierarchy to categorize the inputs used in valuation techniques to measure fair value. Level 1 relies on the use of quoted market prices. Level 2 relies on valuation models using observable market information as inputs and Level 3 relies on internal models without observable market information. The Company has investments in U.S. Treasuries that are classified in Level 1 of the fair value hierarchy. The Company has investments in U.S. government sponsored mortgage-backed securities that are classified in Level 2 of the fair value hierarchy. External vendors typically use pricing models to determine fair values for the securities. Standard market inputs include benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets and additional market reference data.

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Assets that are measured at fair value on a recurring basis at June 30, 2010, December 31, 2009 and June 30, 2009 are presented in the following table:

	Fair Value June 30, 2010	Fair Value Measurements Using		
		Level 1	Level 2 (in thousands)	Level 3
Available-for-sale securities				
Residential mortgage-backed	\$ 515,492	\$	\$ 515,492	\$
U.S. Treasury	59,998	59,998		
	\$ 575,490	\$ 59,998	\$ 515,492	\$

	Fair Value December 31, 2009	Fair Value Measurements Using		
		Level 1	Level 2 (in thousands)	Level 3
Available-for-sale securities				
Residential mortgage-backed	\$ 515,190	\$	\$ 515,190	\$
U.S. Treasury	39,999	39,999		
	\$ 555,189	\$ 39,999	\$ 515,190	\$

	Fair Value June 30, 2009	Fair Value Measurements Using		
		Level 1	Level 2 (in thousands)	Level 3
Available-for-sale securities				
Residential mortgage-backed	\$ 566,047	\$	\$ 566,047	\$

**5. Fair Value of Financial Instruments**

Generally accepted accounting principles require the disclosure of estimated fair values for both on and off-balance-sheet financial instruments. The Company's fair values are based on quoted market prices when available. For financial instruments not actively traded, fair values have been estimated using various valuation methods and assumptions. Although management used its best judgment in estimating these values, there are inherent limitations in any estimation methodology. In addition, accounting pronouncements require that fair values be estimated on an item-by-item basis, thereby ignoring the impact a large sale would have on a thin market and intangible values



imbedded in established lines of business. Therefore, the fair value estimates presented herein are not necessarily indicative of the amounts the Company could realize in an actual transaction. The fair value estimation methodologies employed by the Company were as follows:

The carrying amounts for cash and demand balances due from banks along with short-term money market assets (including securities purchased under agreement to resell) and accrued interest receivable reported on the Company's Consolidated Balance Sheets were considered to be the best estimates of fair value for these financial instruments due to their short term nature.

The fair value of notes receivable from Harris N.A. was estimated using a discounted cash flow calculation utilizing current market rates offered by Harris N.A. as the discount rates.

The fair value of securities available for sale and the methods used to determine fair value are provided in Notes 3 and 4 to the Consolidated Financial Statements.

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The estimated fair values of the Company's financial instruments at June 30, 2010 are presented in the following table.

	<b>June 30, 2010</b>	
	<b>Carrying Value</b>	<b>Fair Value</b>
	<b>(in thousands)</b>	
<b>Assets</b>		
Cash on deposit with Harris N.A.	\$ 829	\$ 829
Securities purchased from Harris N.A. under agreement to resell	12,500	12,500
Notes receivable from Harris N.A.	3,459	5,317
Securities available for sale	575,490	575,490
Accrued interest receivable	1,808	1,808
Total on-balance-sheet financial assets	\$ 594,086	\$ 595,944

**6. Operating Segment**

The Company's operations consist of monitoring and evaluating the investments in mortgage assets. Accordingly, the Company operates in only one segment. The Company has no external customers and transacts most of its business with the Bank.

**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, as amended, 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 2009 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.

**Results of Operations****Second Quarter 2010 Compared with Second Quarter 2009**

The Company's net income for the second quarter of 2010 was \$4.7 million, compared to \$5.2 million from the second quarter 2009.

Interest income on securities purchased under agreement to resell for the second quarter of 2010 was \$27 thousand, on an average balance of \$72 million, with an annualized yield of 0.15%. During the same period in 2009, the interest income on securities purchased under agreement to resell was \$8 thousand, on an average balance of \$31 million, with an annualized yield of 0.10%. The Federal Funds rate at June 30, 2010 was 0.18%. Second quarter 2010 interest income on the Notes totaled \$56 thousand and yielded 6.4% on \$3.5 million of average principal

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outstanding for the quarter compared to \$62 thousand and a 6.4% yield on \$3.9 million average principal outstanding for second quarter 2009. The decrease in interest income was attributable to a reduction in the Notes balance resulting from customer payoffs in the Securing Mortgage Loans. At June 30, 2010 and 2009, there were no Securing Mortgage Loans on nonaccrual status. Interest income on securities available for sale for the current quarter was \$5.1 million resulting in a yield of 4.17% on an average balance of \$492 million, compared to \$5.6 million with a yield of 4.16% on an average balance of \$539 million for the same period a year ago. Virtually all income in the current quarter was attributable to the residential mortgage-backed security portfolio.

There were no Company borrowings during second quarter 2010 or 2009.

Second quarter 2010 operating expenses totaled \$119 thousand, an increase of 1% from the second quarter of 2009. General and administrative expenses totaled \$77 thousand, an increase of \$3 thousand over the same period in 2009, primarily due to increases in processing costs. Advisory fees for the second quarter 2010 were \$39 thousand compared to \$41 thousand a year earlier.

On June 30, 2010, the Company paid a cash dividend of \$0.46094 per share on outstanding Preferred Shares to the stockholders of record on June 15, 2010 as declared on May 26, 2010. On June 30, 2009, the Company paid a cash dividend of \$0.46094 per share on outstanding Preferred Shares to the stockholders of record on June 15, 2009 as declared on May 28, 2009. On June 22, 2009 the Company paid a cash dividend in the amount of \$261,477 to the common stockholder of record on June 15, 2009.

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 must receive prior approval from the OCC before the Company declares dividends on the Preferred Shares. Prior approval from the OCC was received for the most recent dividend declaration in June 2010. With respect to any dividends on the Preferred Shares that may be declared by the Company's Board of Directors in the third quarter ended September 30, 2010, the Company has sought and received permission from the OCC for such a declaration, subject to the Company's determination that such dividends are appropriate. The Company anticipates the need to request similar approvals from the OCC for subsequent quarters of 2010. At this time, the Company has no reason to expect that such approvals will not be received. 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.

**Six Months Ended June 30, 2010 compared with June 30, 2009**

The Company's net income for the six months ended June 30, 2010 was \$9.5 million. This represented a \$553 thousand or 5.5% decrease from earnings for the six months ended June 30, 2009. Earnings decreased primarily because of lower interest yields on lower average balances of earning assets in 2010 compared to 2009.

Interest income on securities purchased under agreement to resell for the six months ended June 30, 2010 was \$38 thousand, on an average balance of \$66 million, with a yield of 0.12%. During the same period in 2009, the interest income on securities purchased under agreement to resell was \$17 thousand on an average balance of \$32 million,

with a yield of 0.10%. Interest income on the Notes for the six months ended June 30, 2010 totaled \$113 thousand, yielding 6.4% on \$3.6 million of average principal outstanding compared to \$127 thousand of income yielding 6.4% on \$4.0 million of average principal outstanding for the same period in 2009. The decrease in income was attributable to a reduction in the Notes balance resulting from customer payoffs on the Securing Mortgage Loans. Interest income on securities available-for-sale for the six months ended June 30, 2010 was \$10.4 million resulting in a yield of 4.2% on an average balance of \$495 million, compared to \$11.0 million

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resulting in a yield of 4.3% on an average balance of \$508 million for the same period a year ago. The decrease in interest income from available-for-sale securities is primarily attributable to maturities in the portfolio of mortgage-backed securities with reinvestment in similar securities at a lower yield. There were no Company borrowings during either period.

Operating expense for the six months ended June 30, 2010 totaled \$315 thousand, an increase of \$18 thousand from the same period a year ago. Advisory fees for the six months ended June 30, 2010 were \$102 thousand compared to \$97 thousand for the same period a year ago. General and administrative expenses totaled \$207 thousand, an increase of \$13 thousand or 7% from the same period in 2009 as a result of increased costs for director fees and also due to a change in assessing certain affiliate services. Loan servicing expenses for the six months ended June 30, 2010 and 2009 totaled \$6 thousand.

**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 \$9.6 million provided from operations during the six months ended June 30, 2010, were \$179.4 million from the maturities of securities available-for-sale. In the prior period ended June 30, 2009, the primary sources of funds other than \$10.6 million from operations were \$184.8 million from the maturities of securities available-for-sale and the \$80 million capital contribution received by the Company from the sale of its common stock. The primary uses of funds for the six months ended June 30, 2010 were \$189.5 million for purchases of securities available-for-sale and \$9.2 million in preferred stock dividends paid. For the prior year's period ended June 30, 2009, the primary uses of funds were \$261.6 million for purchases of securities available-for-sale and \$9.2 million in preferred stock dividends paid. Net cash used in financing activities were \$9.2 million of cash compared to \$70.5 million of cash provided in the prior period ended June 30, 2009. The primary reason was the issuance of stock and capital contribution from the Company's parent totaling \$80 million in 2009.

**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, 2009.

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**HARRIS PREFERRED CAPITAL CORPORATION**

**Tax Matters**

As of June 30, 2010, the Company believes that it is in full compliance with the REIT federal tax rules, and expects to qualify as a 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. 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 person. 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 Company's outstanding common shares are held by Harris Capital Holdings, Inc. a wholly owned subsidiary of Harris N.A. and (2) the Company's Common Stock represent 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 to be incurred by the Company 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. The current Illinois statutory tax rate is 7.3%. 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. For the second quarter and first six months of 2010, \$371,000 and \$747,000 of Illinois income tax expense was recorded compared to \$406,000 in the second quarter 2009 and \$791,000 in the first six months of 2009.

**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.



**Table of Contents****HARRIS N.A. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CONDITION**

	<b>June 30 2010 (unaudited)</b>	<b>December 31 2009 (audited)</b>	<b>June 30 2009 (unaudited)</b>
	<b>(in thousands except share data)</b>		
<b>ASSETS</b>			
Cash and demand balances due from banks	\$ 686,350	\$ 904,865	\$ 1,102,486
Money market assets:			
Interest-bearing deposits at banks (\$10.2 billion, \$8.4 billion, and \$3.0 billion held at Federal Reserve Bank at June 30, 2010, December 31, 2009, and June 30, 2009 respectively)	10,788,872	9,231,581	4,311,466
Federal funds sold and securities purchased under agreement to resell	141,050	174,979	78,538
Total cash and cash equivalents	\$ 11,616,272	\$ 10,311,425	\$ 5,492,490
Securities available-for-sale at fair value	5,496,483	5,898,831	7,616,642
Trading account assets and derivative instruments	1,207,521	1,353,509	1,336,124
Loans, net of unearned income	22,735,050	23,175,717	24,250,612
Allowance for loan losses	(701,490)	(680,782)	(646,184)
Net loans	\$ 22,033,560	\$ 22,494,935	\$ 23,604,428
Loans held for sale	21,755	29,974	92,775
Premises and equipment	524,664	526,623	527,451
Bank-owned insurance	1,358,149	1,339,657	1,320,877
Goodwill and other intangible assets	908,379	817,507	766,582
Other assets	1,775,740	1,199,166	815,350
<b>Total assets</b>	<b>\$ 44,942,523</b>	<b>\$ 43,971,627</b>	<b>\$ 41,572,719</b>
<b>LIABILITIES</b>			
Deposits in domestic offices noninterest-bearing interest-bearing (includes \$1.1 billion, \$707.4 million and \$187.4 million measured at fair value at June 30, 2010, December 31, 2009 and June 30, 2009, respectively)	\$ 8,274,901	\$ 9,704,773	\$ 7,494,673
Deposits in foreign offices interest-bearing	21,724,858	18,968,058	19,130,311
	1,511,593	1,622,410	2,351,579
Total deposits	\$ 31,511,352	\$ 30,295,241	\$ 28,976,563
Federal funds purchased	247,270	236,099	328,963
Securities sold under agreement to repurchase	1,347,299	2,512,490	661,927
Short-term borrowings	642,454	717,050	992,516
Short-term senior notes			400,000
Accrued interest, taxes and other expenses	180,803	172,618	194,813
Accrued pension and post-retirement	22,898	58,393	109,725

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Other liabilities	757,754	643,289	450,415
Long-term notes senior/unsecured	2,396,500	2,396,500	2,646,500
Long-term notes senior/secured	2,375,000	2,375,000	2,375,000
Long-term notes subordinated	200,000	292,750	292,750
<b>Total liabilities</b>	<b>\$ 39,681,330</b>	<b>\$ 39,699,430</b>	<b>\$ 37,429,172</b>
<b>STOCKHOLDER S EQUITY</b>			
Common stock (\$10 par value); authorized 40,000,000 shares; issued and outstanding 19,989,512 shares at June 30, 2010, 17,534,512 shares at December 31, 2009, and 17,149,512 shares at June 30, 2009			
	\$ 199,895	\$ 175,345	\$ 171,495
Surplus	3,291,667	2,322,917	2,173,757
Retained earnings	1,637,817	1,621,719	1,693,581
Accumulated other comprehensive loss	(118,241)	(97,784)	(145,286)
Stockholder s equity before noncontrolling interest preferred stock of subsidiary	\$ 5,011,138	\$ 4,022,197	\$ 3,893,547
Noncontrolling interest preferred stock of subsidiary	250,055	250,000	250,000
<b>Total stockholder s equity</b>	<b>\$ 5,261,193</b>	<b>\$ 4,272,197</b>	<b>\$ 4,143,547</b>
<b>Total liabilities and stockholder s equity</b>	<b>\$ 44,942,523</b>	<b>\$ 43,971,627</b>	<b>\$ 41,572,719</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 OPERATIONS  
(Unaudited)**

	<b>Quarter Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
	<b>(in thousands)</b>			
<b>Interest Income</b>				
Loans	\$ 277,188	\$ 273,201	\$ 532,246	\$ 561,179
Money market assets:				
Deposits at banks	6,629	3,693	12,412	10,079
Federal funds sold and securities purchased under agreements to resell	21	(310)	84	145
Trading account assets	2,797	2,559	5,747	5,097
Securities available-for-sale:				
U.S. Treasury and federal agency	12,187	25,233	28,184	59,502
State and municipal	12,067	13,552	24,488	27,405
Other	4,399	5,607	5,868	9,716
<b>Total interest income</b>	<b>\$ 315,288</b>	<b>\$ 323,535</b>	<b>\$ 609,029</b>	<b>\$ 673,123</b>
<b>Interest Expense</b>				
Deposits	\$ 45,891	\$ 80,850	\$ 88,659	\$ 192,830
Short-term borrowings	1,910	2,413	3,663	4,310
Short-term senior notes		1,313		1,319
Long-term notes senior/unsecured	22,782	8,162	45,261	18,479
Long-term notes senior/secured	8,371	2,495	20,611	5,328
Long-term notes subordinated	365	1,081	832	2,731
<b>Total interest expense</b>	<b>\$ 79,319</b>	<b>\$ 96,314</b>	<b>\$ 159,026</b>	<b>\$ 224,997</b>
<b>Net Interest Income</b>	<b>\$ 235,969</b>	<b>\$ 227,221</b>	<b>\$ 450,003</b>	<b>\$ 448,126</b>
Provision for loan losses	92,019	147,142	183,746	240,236
<b>Net Interest Income after Provision for Loan Losses</b>	<b>\$ 143,950</b>	<b>\$ 80,079</b>	<b>\$ 266,257</b>	<b>\$ 207,890</b>
<b>Noninterest Income</b>				
Trust and investment management fees	\$ 23,433	\$ 19,856	\$ 43,995	\$ 38,638
Net money market and bond trading income, including derivative activity	11,283	4,776	25,140	9,209
Foreign exchange trading gains, net	1,303	2,775	4,216	5,400
Service charges and fees	53,331	51,815	100,241	99,462
Charge card income	29,454	277	58,748	333
Equity securities gains, net	1,913	2,835	4,088	3,937
Net securities gains, other than trading	642	500	2,316	30,019

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Other-than-temporary impairment on securities	(110)	(850)	(131)	(1,033)
Bank-owned insurance	11,238	11,423	23,138	22,526
Letter of credit fees	6,207	5,268	11,593	10,362
Net gains on loans held for sale	3,573	9,400	7,668	11,618
Other	9,494	9,902	20,194	18,418
<b>Total noninterest income</b>	<b>\$ 151,761</b>	<b>\$ 117,977</b>	<b>\$ 301,206</b>	<b>\$ 248,889</b>
<b>Noninterest Expenses</b>				
Salaries and other compensation	\$ 111,750	\$ 105,238	\$ 205,761	\$ 198,117
Pension, profit sharing and other employee benefits	24,666	23,575	54,405	54,306
Net occupancy	24,051	24,035	49,020	51,019
Equipment	18,484	17,079	38,532	34,581
Marketing	14,752	9,792	26,643	18,617
Communication and delivery	8,131	7,249	15,503	14,896
Professional fees	27,673	21,160	48,799	49,378
Outside information processing, database and network fees	7,351	8,702	15,856	17,681
FDIC Insurance	12,137	28,670	23,371	43,704
Intercompany services, net	(2,314)	(198)	(5,262)	(382)
Visa indemnification reversal	(2,800)		(2,800)	
Charge card expense	6,997		14,302	
Amortization of intangibles	6,554	7,080	12,242	14,186
Other	34,839	22,789	58,592	41,032
<b>Total noninterest expenses</b>	<b>\$ 292,271</b>	<b>\$ 275,171</b>	<b>\$ 554,964</b>	<b>\$ 537,135</b>
Income (loss) before income tax benefit	\$ 3,440	\$ (77,115)	\$ 12,499	\$ (80,356)
Applicable income tax benefit	(8,658)	(37,349)	(12,818)	(48,684)
Net income (loss)	\$ 12,098	\$ (39,766)	\$ 25,317	\$ (31,672)
Less: noncontrolling interest dividends on preferred stock of subsidiary	4,610	4,609	9,219	9,219
<b>Net Income (Loss) Available for Common Stockholder</b>	<b>\$ 7,488</b>	<b>\$ (44,375)</b>	<b>\$ 16,098</b>	<b>\$ (40,891)</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 COMPREHENSIVE INCOME  
(Unaudited)**

	Quarter Ended		Six Months Ended	
	June 30, 2010	2009	June 30, 2010	2009
	(in thousands)			
<b>Net income (loss) available for common stockholder</b>	\$ 12,098	\$ (39,766)	\$ 25,317	\$ (31,672)
Other comprehensive (loss) income:				
Cash flow hedges:				
Net unrealized (loss) gain on derivative instruments, net of tax (benefit) expense for the quarter of (\$6,966) in 2010 and \$20,770 in 2009 and net of tax (benefit) expense for the year-to-date period of (\$17,179) in 2010 and \$29,918 in 2009	(12,939)	38,573	(31,905)	55,560
Reclassification adjustment for realized loss included in net income (loss), net of tax benefit for the quarter of \$548 in 2010 and \$401 in 2009 and net of tax benefit for the year-to-date period of \$938 in 2010 and \$2,081 in 2009	1,020	744	1,743	3,866
Pension and postretirement medical benefit plans: Net (loss) gain and net prior service cost included in net income (loss), net of tax benefit for the quarter of \$0 in 2010 and 2009 and net of tax expense for the year-to-date period of \$1,318 in 2010 and \$3,531 in 2009	(319)		4,574	6,556
Reclassification adjustment for amortization included in net income (loss), net of tax benefit for the quarter of \$663 in 2010 and \$367 in 2009 and net of tax benefit for the year-to-date period of \$1,326 in 2010 and \$733 in 2009	1,231	681	2,462	1,362
Available-for-sale securities: Unrealized holding gain arising during the period, net of tax expense for the quarter of \$2,749 in 2010 and \$6,148 in 2009 and net of tax (benefit) expense for the year-to-date period of (\$2,155) in 2010 and \$6,947 in 2009	10,536	11,426	4,174	12,921
Reclassification adjustment for realized gain included in net income (loss), net of tax expense for the quarter of \$225 in 2010 and \$473 in 2009 and net of tax expense for the year-to-date period of \$811 in 2010 and \$10,507 in 2009	(417)	(877)	(1,505)	(19,512)
Other comprehensive (loss) income	\$ (888)	\$ 50,547	\$ (20,457)	\$ 60,753
Comprehensive income	\$ 11,210	\$ 10,781	\$ 4,860	\$ 29,081
Comprehensive income related to noncontrolling interest	4,610	4,609	9,219	9,219
	\$ 6,600	\$ 6,172	\$ (4,359)	\$ 19,862

**Comprehensive income (loss) available for common  
stockholder**

*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)**

	Common		Retained	Accumulated Other Comprehensive	Noncontrolling Interest Preferred Stock of Subsidiary	Total Stockholder s Equity
	Stock	Surplus	Earnings	Loss		
	(in thousands except per share data)					
<b>Balance at December 31, 2009</b>	\$ 175,345	\$ 2,322,917	\$ 1,621,719	\$ (97,784)	\$ 250,000	\$ 4,272,197
Stock option exercise		300				300
Net income			16,098		9,219	25,317
Dividends preferred stock of subsidiary					(9,219)	(9,219)
Change in noncontrolling interest ownership					55	55
Other comprehensive loss				(20,457)		(20,457)
Issuance of common stock and contribution to capital surplus	24,550	968,450				993,000
<b>Balance at June 30, 2010</b>	\$ 199,895	\$ 3,291,667	\$ 1,637,817	\$ (118,241)	\$ 250,055	\$ 5,261,193
<b>Balance at December 31, 2008</b>	\$ 171,495	\$ 2,172,030	\$ 1,734,471	\$ (206,039)	\$ 250,000	\$ 4,121,957
Stock option exercise		494				494
Tax benefit from stock option exercise		1,234				1,234
Net income			(40,891)		9,219	(31,672)
Dividends preferred stock of subsidiary					(9,219)	(9,219)
Other comprehensive income				60,753		60,753
<b>Balance at June 30, 2009</b>	\$ 171,495	\$ 2,173,758	\$ 1,693,580	\$ (145,286)	\$ 250,000	\$ 4,143,547

*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>2010</b>	<b>2009</b>
<b>Cash Flows from Operating Activities:</b>		
Net income (loss)	\$ 25,317	\$ (31,672)
Less: noncontrolling interest dividends on preferred stock of subsidiary	9,219	9,219
Net income (loss) available for common stockholder	\$ 16,098	\$ (40,891)
Adjustments to determine net cash flows provided by operating activities:		
Provision for loan losses	183,746	240,236
Depreciation and amortization, including intangibles	53,063	56,316
Deferred tax expense (benefit)	62,536	(20,758)
Excess tax expense from stock options exercise	119	1,234
Other-than-temporary impairment on securities	131	1,033
Net gains on securities, other than trading	(2,316)	(30,019)
Net equity investment gains	(4,088)	(3,937)
Increase in bank-owned insurance	(18,492)	(16,562)
Net decrease in trading securities	237,391	31,672
Decrease in accrued interest receivable	16,058	33,547
(Increase) decrease in prepaid expenses	(85,788)	5,507
Decrease in accrued interest payable	(706)	(49,683)
Net (increase) decrease in accrued tax payable	(65,930)	15,362
Net (decrease) increase in other accrued expenses	(42,285)	72,734
Net increase in pension and post retirement benefits	(25,815)	(51,492)
Origination of loans held for sale	(372,086)	(688,859)
Proceeds from sale of loans held for sale	387,973	637,246
Net gains on loans held for sale	(7,668)	(11,618)
Net gains on sale of premises and equipment	(803)	(1,477)
Recoveries on charged-off loans	38,369	33,124
Net increase in settlement clearing account	(1)	(13,875)
Net increase (decrease) in trading hedging derivatives	27,635	(88,238)
Visa indemnification reversal	(2,800)	
Other, net	17,266	(49,037)
Net cash provided by operating activities	\$ 411,607	\$ 61,565
<b>Cash Flows from Investing Activities:</b>		
Proceeds from sales of securities available-for-sale	\$ 463,525	\$ 2,830,608
Proceeds from maturities of securities available-for-sale	2,330,121	2,245,203
Purchases of securities available-for-sale	(2,393,605)	(3,372,114)
Net decrease in loans	1,493,028	1,944,369
Proceeds from loans sold to affiliates	273,522	
Purchases of premises and equipment	(51,815)	(49,662)

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Sales of premises and equipment	18,045	17,867
Acquisitions, net of cash received	191,663	(3,423)
Net cash provided by investing activities	\$ 2,324,484	\$ 3,612,848
<b>Cash flows from Financing Activities:</b>		
Net decrease in deposits	\$ (1,326,658)	\$ (24,487,001)
Net increase in deposits measured at fair value	370,227	109,720
Net decrease in Federal funds purchased and securities sold under agreement to repurchase	(1,154,020)	(2,589,393)
Net (decrease) increase in other short-term borrowings	(74,596)	633,040
Net increase in short-term senior notes		325,000
Proceeds from issuance long-term notes senior		550,000
Repayment of long-term notes senior/secured	(137,409)	
Repayment of long-term notes subordinated	(92,750)	
Net proceeds from stock options exercise	300	494
Excess tax expense from stock options exercise	(119)	(173)
Capital contributions	993,000	
Cash dividends paid on preferred stock	(9,219)	(9,219)
Net cash used in financing activities	\$ (1,431,244)	\$ (25,467,532)
Net increase (decrease) in cash and cash equivalents	\$ 1,304,847	\$ (21,793,119)
Cash and cash equivalents at January 1	10,311,425	27,285,609
Cash and cash equivalents at June 30	\$ 11,616,272	\$ 5,492,490

*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. (HFC), 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 inter-company accounts and transactions have been eliminated. Certain reclassifications were made to conform prior year's financial statements to the current year's presentation.

On April 23, 2010, the Bank acquired certain assets and liabilities of Rockford, Illinois-based, AMCORE Bank N.A. (AMCORE) from the FDIC for \$221.5 million. The Bank assumed approximately \$2.5 billion in assets, including approximately \$2.1 billion in loans, and \$2.2 billion in deposits. The Bank recorded a core deposit intangible of \$22.1 million to be amortized over 10 years on an accelerated basis and a customer relationship intangible of \$1.3 million to be amortized over 13 years on an accelerated basis. The acquisition includes a loss share agreement with the FDIC and the related indemnification asset was estimated at \$427.5 million. The Bank recorded goodwill of \$84.3 million which is expected to be deductible for tax purposes. Acquisition costs of \$4.4 million were recorded to noninterest expense during the quarter ended June 30, 2010. The acquisition provides the Bank the opportunity to expand its branch network into communities in northern Illinois and southern Wisconsin. The results of AMCORE's operations have been included in the Bank's consolidated financial statements since April 23, 2010.

On December 31, 2009, BMO and the Bank acquired the net cardholder receivables and other assets and obligations of the Diners Club North American franchise from Citigroup for initial cash consideration of \$678 million, subject to a post-closing adjustment based on all parties' final agreement of the net asset value transferred. The acquisition of the net cardholder receivables of Diners Club gives the Bank the right to issue Diners Club cards to corporate and professional clients in the United States and will accelerate the Bank's initiative to expand in the travel-and-entertainment card sector. As part of this acquisition, the Bank recorded a purchased credit card relationship intangible asset estimated at \$44.3 million which will be amortized on an accelerated basis over 15 years. The Bank recorded goodwill of \$17.8 million which is expected to be deductible for tax purposes. The gross contractual amount of receivables was \$743.2 million and the fair value was \$704.6 million. Acquisition-related costs of \$0.6 million for the year ended December 31, 2009 were recorded to noninterest expense. The results of the operations have been included in the Bank's consolidated financial statements since January 1, 2010. As of March 31, 2010 a preliminary contractual true up of \$48.4 million was received from Citigroup mainly due to the overestimation of initial credit card loan balances of \$56.7 million. As a result, goodwill was decreased by \$6.3 million and the credit card relationship intangible asset was increased by \$3.4 million. During the quarter ended June 30, 2010 a \$15.2 million fair value adjustment to credit card receivables was recorded as an increase to interest income.

On February 13, 2009, the Bank completed the acquisition of selected assets of Pierce, Givens & Associates, LLC (Pierce Givens) for cash consideration of \$3.4 million. The Bank acquired a customer relationship intangible asset estimated at \$3.0 million with an expected life of 5 years. No goodwill was recorded in the transaction. Acquisition-related costs of \$0.4 million for the year-ended December 31, 2009 were recorded to noninterest expense. The acquisition provides the Bank with the opportunity to expand its tax planning and compliance capabilities in the ultra high-net-worth market. The results of Pierce Givens' operations have been included in the Bank's consolidated financial statements since February 14, 2009.

The interim 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. Events occurring subsequent to the date of the balance sheet have been evaluated for potential recognition or disclosure in the consolidated financial statements.

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**HARRIS N.A. AND SUBSIDIARIES**

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. Contingent Liabilities and Litigation**

Harris N.A. and certain of its subsidiaries are party to legal proceedings in the ordinary course of their businesses. While there is inherent difficulty in predicting the outcome of these proceedings, management does not expect the outcome of any of these proceedings, individually or in the aggregate, to have a material adverse effect on the Bank's consolidated financial position or results of operations.

**3. Cash Flows**

In the Consolidated Statements of Cash Flows, cash and cash equivalents include cash and demand balances due from banks, interest-bearing deposits at banks and federal funds sold and securities purchased under agreement to resell. Cash interest payments for the six months ended June 30 totaled \$156.8 million and \$274.7 million in 2010 and 2009, respectively. Cash income tax refunds received for the six months ended June 30, 2010 and 2009 totaled \$12.7 million and \$59.7 million, respectively.

**4. Visa Indemnification Charge**

HNA was a member of Visa U.S.A. Inc. ( "Visa U.S.A." ) and in 2007 received shares of restricted stock in Visa, Inc. ( "Visa" ) as a result of its participation in the global restructuring of Visa U.S.A., Visa Canada Association, and Visa International Service Association in preparation for an initial public offering by Visa. HNA and other Visa U.S.A. member banks are obligated to share in potential losses resulting from certain indemnified litigation involving Visa that has been settled.

A member bank such as HNA is also required to recognize the contingent obligation to indemnify Visa under Visa's bylaws (as those bylaws were modified at the time of the Visa restructuring on October 3, 2007) for potential losses arising from the other indemnified litigation that has not yet settled at its estimated fair value. HNA is not a direct party to this litigation and does not have access to any specific, non-public information concerning the matters that are the subject of the indemnification obligations. While the estimation of any potential losses is highly judgmental, as of December 31, 2007, HNA recorded a liability and corresponding charge of \$34 million (pretax) for the remaining litigation.

The initial public offering (IPO) occurred on March 25, 2008 followed by a mandatory partial redemption of Harris restricted stock in Visa that took place in two parts: exchange for cash and funding of the covered litigation escrow account. During the first quarter of 2008, HNA received \$37.8 million in cash in conjunction with the mandatory partial redemption which was recognized as an equity security gain in the Consolidated Statements of Operations since there was no basis in the stock. In addition, Visa funded the U.S. litigation escrow account with IPO proceeds. Harris' share of the U.S. litigation escrow account funding was \$17 million which was recognized as a reversal to the litigation reserve and as a decrease to non-interest expense.

In June 2010, July 2009 and December 2008, HNA recorded decreases to non-interest expense of \$2.8 million, \$3.0 million and \$6.3 million, respectively, as a reduction in the Visa litigation reserve to reflect Visa's use of a portion of the Bank's restricted Visa stock to fund the escrow account available to settle certain litigation matters. Visa's funding of amounts required beyond the current escrow, if any, will be obtained via additional mandatory redemptions of restricted shares. As of June 30, 2010, December 31, 2009 and June 30, 2009, the recorded reserve relating to the

Visa litigation matter included in the Consolidated Statements of Condition was \$12.0 million, \$14.8 million and \$17.8 million, respectively.

**5. Auction Rate Securities Purchase Program**

Auction-rate securities (ARS) are typically short-term notes issued in the United States to fund long-term, fixed rate debt instruments (corporate or municipal bonds primarily issued by municipalities, student loan

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**HARRIS N.A. AND SUBSIDIARIES**

authorities and other sponsors). The interest rate on ARS is regularly reset every 7 to 35 days through auctions managed by financial institutions. A disruption in the market for ARS occurred in the early part of 2008. Certain customer-managed portfolios held these securities, which were no longer liquid. Certain of the Bank's affiliates voluntarily offered to purchase such securities from customers, at par value.

In addition, in 2008 a settlement with the Financial Industry Regulatory Authority (FINRA) required Harris Investor Services, Inc. (HIS), an affiliate of the Bank, to purchase specific holdings of ARS from certain client accounts at par value plus accrued interest. In addition to the required terms of the FINRA settlement, management of certain other legal entities within HFC offered to purchase certain other customer ARS holdings under similar terms. For the ARS holdings purchased by the Bank, the gross par value of ARS holdings purchased was \$93.1 million plus accrued interest. A discounted cash flow valuation methodology was applied to estimate the fair value of the securities. The methodology included management assumptions about future cash flows, discount rates, market liquidity and credit spreads.

Remaining ARS were purchased during 2009 and had a gross par value of \$8.6 million. A minimal pre-tax charge was recorded for the year ended December 31, 2009 for the difference between the estimated fair values and the par values paid by the Bank. The charge was recorded in noninterest expense in the Consolidated Statements of Operations. During the six months ended June 30, 2010 ARS with a gross par value of \$16.5 million were called and a gain of \$3.6 million was recorded to net securities gains, other than trading in the Consolidated Statements of Operations. The fair value of ARS was \$51.8 million as of June 30, 2010, \$73.6 million as of December 31, 2009 and \$76.8 million as of June 30, 2009. The ARS purchased are classified as available-for-sale.

**6. Health Care Legislation**

In March 2010, new health care legislation (The Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act) was enacted that changed the tax treatment of the subsidy associated with postretirement medical benefits. The legislation reduced the tax deductions for the cost of providing postretirement prescription drug coverage by the amount of subsidies received. With enactment of the legislation, the Bank was required to write off any deferred tax asset as a tax expense through the income statement, even if a portion of such asset had initially been established through OCI. As a result of this legislation, the Bank recorded tax expense of \$5.5 million during the quarter ended March 31, 2010. Nothing material was recorded during the quarter ended June 30, 2010.

**7. Noncontrolling Interests**

The Bank adopted Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 160, Noncontrolling Interests in Consolidated Financial Statements-An Amendment of ARB 51, (subsequently codified in Accounting Standards Codification (ASC) Topic 810-10-65) on January 1, 2009. The standard requires noncontrolling interests held by parties other than the parent to be reported as equity in the consolidated financial statements. The Bank has two subsidiaries that are less than wholly-owned and the noncontrolling interest in the preferred stock of the subsidiaries is held by third parties. The noncontrolling interest in the preferred stock of the subsidiaries is presented as a component of stockholder's equity in the Consolidated Statements of Condition. Net income attributable to the noncontrolling interest is separately presented in the Consolidated Statements of Operations, outside of net income (loss).

**8. FDIC Special Assessment**

On December 30, 2009 the FDIC required insured depository institutions to prepay their estimated quarterly risk-based assessments for all of 2010, 2011, and 2012. The Bank made a payment of \$114 million which was recorded as prepaid expense within other assets. As the Bank is charged monthly for FDIC insurance, the Bank will decrease the prepaid expense and charge FDIC insurance expense until the prepaid amount is exhausted. Any prepaid amounts unused at June 30, 2013 will be returned to the Bank. Starting in 2010, fees increased from 10 basis points on an annual basis, to 15 basis points.



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**HARRIS N.A. AND SUBSIDIARIES**

**9. Recent accounting standards**

The FASB issued Statement of Financial Accounting Standards ( SFAS ) No. 166, Accounting for Transfers of Financial Assets an amendment of FASB Statement No. 140, (subsequently codified in FASB ASC 860) in June 2009. The standard removes the concept of a qualifying special-purpose entity ( QSPE ). It also creates more stringent conditions for reporting a transfer of a portion of a financial asset as a sale. The standard is effective January 1, 2010. The adoption of the standard did not impact the Bank s financial position or results of operations.

The FASB issued SFAS No. 167, Amendments to FASB Interpretation No. 46(R), (subsequently codified in FASB ASC 810) in June 2009. The standard changes the criteria by which an enterprise determines whether it must consolidate a variable interest entity ( VIE ). It amends the existing guidance to require an enterprise to consolidate a VIE if it has both the power to direct the activities that most significantly impact the VIE s economic performance and the obligation to absorb losses or the right to receive benefits from the VIE. Existing guidance requires an enterprise to consolidate a VIE if it absorbs a majority of the expected losses or residual returns, or both. A continuous assessment of which party must consolidate a VIE will be required, rather than an assessment only when certain trigger events occur. In addition, the new standard requires an enterprise to assess if VIEs that were previously QSPEs must be consolidated by the enterprise. The standard is effective January 1, 2010. The adoption of this standard did not impact the Bank s financial position or results of operations.

The FASB issued Accounting Standards Update ( ASU ) 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, in July 2010. The standard requires companies to significantly increase disclosures about the credit quality of financing receivables and the credit reserves held against them. The additional disclosures include aging of past due receivables, credit quality information such as credit risk scores or external credit agency ratings and the modification of financing receivables. Further disaggregation of information by certain classification of the total portfolio will be required. The FASB also amended ASC 310-10-50, *Receivables Overall Disclosure*, in order to expand the requirements for separate reporting and disclosure of allowances for credit losses and the policies for managing credit exposures. The disclosures will be effective for the Bank for the annual reporting period ending December 31, 2011. The Bank does not expect the adoption of this standard to impact it s financial position or results of operations.

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**HARRIS N.A. AND SUBSIDIARIES**

**FINANCIAL REVIEW**

**Second Quarter 2010 Compared with Second Quarter 2009**

**Summary**

For the second quarter 2010, Harris N.A. and subsidiaries ( Bank ) reported net income of \$7.5 million, an increase of \$51.9 million from the second quarter of 2009, reflecting a significant reduction in the provision for loan losses as well as earnings associated with the Diners Club North American franchise purchased from Citigroup, which closed at the end of December 2009. The results also include the acquisition of certain assets and liabilities of Rockford, IL based AMCORE Bank, N.A. (AMCORE) from the Federal Deposit Insurance Corporation (FDIC) in April, 2010 (Note 1).

Net interest income was \$236.0 million, up \$8.7 million or 3.8 percent from a year ago, largely due to lower cost of deposits and the additional net interest income associated with the acquisition of AMCORE. Average earning assets increased to \$40.1 billion in the second quarter of 2010 from \$39.2 billion in 2009. This primarily reflects an increase in interest bearing deposits placed at the Federal Reserve Bank (\$5.3 billion) largely offset by decreases in loan balances (\$1.7 billion) and the available-for-sale securities portfolio (\$2.1 billion). The higher average earning asset level was partially offset by a 2 basis point decrease in the net interest margin to 2.42 percent from 2.44 percent in the second quarter of 2009. The lower margin reflects a lower rate of return on securities available-for-sale plus an increase in the level of low-yield interest bearing deposits placed at the Federal Reserve Bank largely offset by reduced interest costs on deposits and improved loan yields.

Provision for loan losses for the second quarter 2010 was \$92.0 million, a decrease of \$55.1 million or 37.5 percent from second quarter 2009 mainly attributable to a decrease in reserves for specific commercial credits partially offset by \$21.3 million of provision associated with the Diners Club portfolio. Net loan charge-offs during the quarter were \$83.6 million compared to \$108.5 million in the same period last year primarily due to decreases in both commercial and consumer loan charge-offs. The provision for loan losses is based on past loss experience, management's evaluation of the loan portfolio under current economic conditions and management's estimate of losses inherent in the portfolio.

Noninterest income for the second quarter 2010 was \$151.8 million, an increase of \$33.8 million or 28.6 percent. This increase largely reflects \$29.2 million of additional charge card income due to the Diners Club acquisition. Additionally, higher trading revenues (\$6.5 million) and trust fees (\$3.6 million) were partially offset by a year over year decrease in net gains on loans held for sale (\$5.8 million).

Second quarter 2010 noninterest expenses were \$292.3 million, up \$17.1 million or 6.2 percent from second quarter 2009. Higher costs associated with the Diners Club credit card portfolio (\$11.0 million) and the acquisition of AMCORE (\$22.8 million) were partially offset by a \$16.8 million reduction in FDIC insurance expense, which reflects a \$19.0 million FDIC special assessment in 2009 (Note 8). Additionally, a \$5.4 million increase in mortgage servicing rights impairment was partially offset by the Bank's reversal of \$2.8 million of reserves in conjunction with the Visa litigation escrow account funding and lower intangible amortization expense (\$1.9 million). The income tax benefit decreased \$28.7 million from the second quarter of 2009 primarily due to the increase in pre-tax income between periods. A tax benefit was recorded this quarter despite positive pre-tax earnings due to the benefit of certain tax exempt loans and investments as well as bank owned life insurance.

Nonperforming loans at June 30, 2010 totaled \$686.1 million or 3.02 percent of total loans, up from \$486.0 million or 2.10 percent of total loans at December 31, 2009 and \$549.5 million or 2.27 percent a year earlier, primarily attributable to higher commercial non-performing loans. At June 30, 2010, the allowance for loan losses was \$701.5 million, equal to 3.09 percent of loans outstanding compared to \$680.8 million or 2.94 percent of loans outstanding and \$646.2 million or 2.66 percent of loans outstanding at December 31, 2009 and June 30, 2009, respectively. Coverage of nonperforming loans by the allowance for loan losses decreased from 118 percent at June 30, 2009 to 101 percent at June 30, 2010, largely due to higher non-performing loan levels. At December 31, 2009, the ratio was 140 percent. Ratios reflect the sale of loans to psp Holdings, LLC, a subsidiary of Harris

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Financial Corp., in the amount of \$502.7 million during the full year 2009 and \$273.5 million in the second quarter 2010.

At June 30, 2010 consolidated stockholder's equity of the Bank amounted to \$5.3 billion, up \$1.0 billion from December 31, 2009, mainly due to a capital contribution from Harris Bankcorp, Inc. during the year. Return (loss) on equity was 0.72 percent in the current quarter, compared to (4.57) percent in last year's second quarter. Return (loss) on assets was 0.07 percent compared to (0.41) percent a year ago. The Bank did not declare any dividends on common stock in either the current quarter or in the year-ago quarter.

At June 30, 2010 Tier 1 capital of the Bank amounted to \$4.5 billion, up \$1.1 billion from a year ago, while risk-weighted assets declined by \$3.0 billion to \$28.5 billion. The Bank's June 30, 2010 Tier 1 and total risk-based capital ratios were 15.73 percent and 17.60 percent compared to respective ratios of 11.46 percent and 13.55 percent at December 31, 2009 and 10.68 percent and 12.73 percent at June 30, 2009. The regulatory leverage capital ratio was 10.35 percent for the second quarter of 2010 compared to 8.82 percent at year-end 2009 and 7.95 percent a year ago. The Bank's capital ratios significantly exceed the prescribed regulatory minimum for well-capitalized banks.

## **Six Months Ended June 30, 2010 Compared with Six Months Ended June 30, 2009**

### **Summary**

For the six months ended June 30, 2010, the Bank reported net income of \$16.1 million, an increase of \$57.0 million from the net loss of \$40.9 million for the same period last year, mainly due to higher charge card fees resulting from the purchase of the Diners Club North American franchise from Citigroup, which closed at the end of December 2009, as well as a reduction in the provision for loan losses. The results also include the acquisition of certain assets and liabilities of Rockford, IL based AMCORE Bank, N.A. (AMCORE) from the Federal Deposit Insurance Corporation (FDIC) in April (Note 1). Return (loss) on equity was 0.80 percent in the current year, compared to (2.14) percent for first six months of last year. Return (loss) on assets was 0.08 percent compared to (0.17) percent a year ago.

Net interest income was \$450.0 million, up slightly from the \$448.1 million reported a year ago as reduced loan income and interest on securities available for sale were offset by reduced interest costs on deposits. Net interest margin increased to 2.37 percent in 2010 from 2.15 percent in the same period in 2009, reflecting lower costs of deposits and improved yield on loans. Average earning assets of \$39.3 billion decreased \$3.9 billion with a \$2.4 billion decline in loans and a decrease of \$2.2 billion in available-for-sale securities due to maturities partially offset by a \$1.1 billion increase in Federal Reserve Bank deposits.

Year-to-date 2010 provision for loan losses was \$183.7 million compared to \$240.2 million in 2009. This is primarily attributable to a decrease in reserves for specific commercial credits partially offset by \$29.7 million provision associated with the Diners Club portfolio acquired in December of 2009. Net charge-offs decreased to \$163.2 million from \$166.8 million in the prior year, reflecting a lower level of commercial charge-offs.

Noninterest income was \$301.2 million, up \$52.7 million or 21.0 percent from a year ago. This reflects \$58.4 million of charge card income due to the Diners Club acquisition plus higher trading revenues (\$15.9 million) and trust fees (\$5.4 million) partially offset by a decrease in net gains on loans held for sale (\$27.7 million).

Noninterest expenses were \$555.0 million, an increase of \$17.8 million or 3.3 percent. Several items affect the year over year comparison including higher costs associated with the Diners Club credit card portfolio (\$22.6 million) and the acquisition of AMCORE (\$23.0 million, including integration expense of \$6.5 million). These additional costs were partially offset by a \$20.3 million reduction in FDIC Insurance expense, which reflects a \$19.0 million FDIC special assessment in 2009 (Note 8). Excluding the impact of these items, expenses were down \$7.4 million or

1.5 percent with lower professional fees (\$6.3 million), inter-company service charges (\$5.9 million), employee costs (\$5.6 million), amortization of intangibles (\$3.7 million) and the Bank's reversal of \$2.8 million of reserves in conjunction with the Visa litigation escrow account funding being partially offset by higher marketing expense (\$7.5 million), mortgage servicing rights impairment (\$5.4 million) and other credit related costs (\$5.5 million). The income tax benefit decreased \$35.9 million from the first six months of 2009 primarily due to the increase in pre-tax income between periods. Results reflect a tax benefit despite positive pre-tax earnings due to the benefit of certain tax exempt loans and investments as well as bank owned life insurance.

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See Liquidity Risk Management and Market Risk Management under Management's Discussion and Analysis of Financial Condition and Results of Operations on page 10.

The following table stratifies the Company's available-for-sale securities by maturity date (dollars in thousands):

	July 1, 2010 to Dec. 31, 2010	Year Ending December 31,					Total	Fair Value at June 30, 2010
		2011	2012	2013	2014	Thereafter		
Residential mortgage-backed								
Amortized cost	\$ 4,242	\$ 11,587	\$ 9,720	\$ 5,738	\$ 460,644	\$ 491,931	\$ 515,492	
Average Yield	4.00%	4.00%	4.00%	4.00%	4.42%	4.40%		
U.S. Treasury Bills								
Amortized cost	\$ 59,998	\$	\$	\$	\$	\$ 59,998	\$ 59,998	
Average Yield	0.070%					0.070%		

At June 30, 2010, December 31, 2009 and June 30, 2009, the Company's investments held in mortgage-backed securities are secured by adjustable and fixed interest rate residential mortgage loans. The yield to maturity on each security depends on, among other things, the price at which each such security is purchased, the rate and timing of principal payments (including prepayment rates as well as default rates, which in turn would impact the value and yield to maturity of the Company's mortgage-backed securities. These investments are guaranteed by the Federal National Mortgage Association, ( FNMA ) or Federal Home Loan Mortgage Corporation ( Freddie Mac ) and none of the underlying loan collateral is represented by sub-prime mortgages.

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**Item 4T. Controls and Procedures**

**(a) Evaluation of Disclosure Controls and Procedures**

Harris Preferred Capital Corporation's management, with the participation of the Chief Executive Officer and Chief Financial Officer, has evaluated the Company's disclosure controls and procedures as of June 30, 2010. Based on this evaluation, management has concluded that the disclosure controls and procedures are effective to provide reasonable assurance that the information required to be disclosed by the Company in the reports filed under the Securities Exchange Act of 1934, as amended is (i) recorded, processed, summarized and reported within the time period specified in the Securities and Exchange Commission's rules and forms, and (ii) accumulated and communicated to management, including the Chief Executive Officer and the Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

**(b) Changes in Internal Control over Financial Reporting**

There were no changes in our internal control over financial reporting that occurred during the quarter ended June 30, 2010 that has materially affected, or is reasonably likely to materially affect, 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.**

**None**

**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 12th day of August 2010.

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

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