

HARRIS PREFERRED CAPITAL CORP

Form 10-Q

May 15, 2009

**Table of Contents**

**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 March 31, 2009**

**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 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 May 15, 2009 was 1,180. No common equity is held by nonaffiliates.

---

**HARRIS PREFERRED CAPITAL CORPORATION**

**TABLE OF CONTENTS**

Part I	FINANCIAL INFORMATION	
Item 1.	Financial Statements:	
	<u>Consolidated Balance Sheets</u>	2
	<u>Consolidated Statements of Income and Comprehensive Income</u>	3
	<u>Consolidated Statements of Changes in Stockholders' Equity</u>	4
	<u>Consolidated Statements of Cash Flows</u>	5
	<u>Notes to Consolidated Financial Statements</u>	6
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	8
	Consolidated Financial Statements:	
	<u>Consolidated Statements of Condition</u>	11
	<u>Consolidated Statements of Income</u>	12
	<u>Consolidated Statements of Comprehensive Income</u>	13
	<u>Consolidated Statements of Changes In Stockholders' Equity</u>	14
	<u>Consolidated Statements of Cash Flows</u>	15
	<u>Notes to Consolidated Financial Statements</u>	16
	<u>Financial Review</u>	19
Item 3.	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	20
Item 4T.	<u>Controls and Procedures</u>	20
<b>PART II</b>	<b>OTHER INFORMATION</b>	
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	21
Item 6.	<u>Exhibits</u>	21
Signatures		22
<u>EX-31.1</u>		
<u>EX-31.2</u>		
<u>EX-32.1</u>		

---

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

	<b>March 31, 2009 (unaudited)</b>	<b>December 31, 2008 (audited)</b>	<b>March 31, 2008 (unaudited)</b>
	<b>(in thousands, except share data)</b>		
<b>Assets</b>			
Cash on deposit with Harris N.A.	\$ 50,909	\$ 816	\$ 1,134
Securities purchased from Harris N.A. under agreement to resell	6,367	5,863	13,191
Total cash and cash equivalents	\$ 57,276	\$ 6,679	\$ 14,325
Notes receivable from Harris N.A.	3,948	4,284	4,992
Securities available-for-sale, at fair value			
Mortgage-backed	492,633	488,282	438,698
U.S. Treasury Bills	79,999		34,997
Other assets	1,868	1,885	1,906
<b>Total assets</b>	<b>\$ 635,724</b>	<b>\$ 501,130</b>	<b>\$ 494,918</b>
<b>Liabilities and Stockholders Equity</b>			
Accrued expenses	\$ 503	\$ 112	\$ 95
Deferred state tax liabilities	1,060	774	
Payable for security purchased	49,999		
<b>Total liabilities</b>	<b>\$ 51,562</b>	<b>\$ 886</b>	<b>\$ 95</b>
Commitments and contingencies			
<b>Stockholders Equity</b>			
73/8% Noncumulative Exchangeable Preferred Stock, Series A (\$1 par value); liquidation value of \$250,000; 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 at March 31, 2009; and 1,000 shares authorized, issued and outstanding at December 31, 2008 and March 31, 2008.	1	1	1
Additional paid-in capital	320,733	240,733	240,733
Earnings (less than) in excess of distributions	(39)	(322)	723
Accumulated other comprehensive income net unrealized gains on available-for-sale securities	13,467	9,832	3,366
<b>Total stockholders equity</b>	<b>\$ 584,162</b>	<b>\$ 500,244</b>	<b>\$ 494,823</b>
<b>Total liabilities and stockholders equity</b>	<b>\$ 635,724</b>	<b>\$ 501,130</b>	<b>\$ 494,918</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 March 31, 2009          2008 (in thousands)</b>	
<b>Interest income:</b>		
Securities purchased from Harris N.A. under agreement to resell	\$ 9	\$ 634
Notes receivable from Harris N.A.	64	82
Securities available-for-sale:		
Mortgage-backed	5,382	4,674
U.S. Treasury Bills	1	16
Total interest income	\$ 5,456	\$ 5,406
<b>Operating expenses:</b>		
Loan servicing fees paid to Harris N.A.	\$ 3	\$ 4
Advisory fees paid to Harris N.A.	56	39
General and administrative	120	98
Total operating expenses	\$ 179	\$ 141
Income before income taxes	\$ 5,277	\$ 5,265
Applicable state income taxes	385	
Net Income	\$ 4,892	\$ 5,265
Preferred stock dividends	4,609	4,609
<b>Net income available to common stockholder</b>	<b>\$ 283</b>	<b>\$ 656</b>
Basic and diluted earnings per common share	\$ 283	\$ 656
Net income	\$ 4,892	\$ 5,265
Other comprehensive income:		
Available-for-sale securities:		
Unrealized holding gains arising during the period, net of deferred state taxes	\$ 3,635	\$ 4,373
Less reclassification adjustment for realized (gains) losses included in net income		
Comprehensive income	\$ 8,527	\$ 9,638

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





**Table of Contents**

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

	<b>Quarter Ended                      March 31,                      2009                  2008                      (in thousands)</b>	
Balance at January 1	\$ 500,244	\$ 489,794
Net income	4,892	5,265
Other comprehensive income	3,635	4,373
Capital contribution and issuance of common stock	80,000	
Dividends (preferred stock \$0.4609 per share)	(4,609)	(4,609)
 Balance at March 31	 \$ 584,162	 \$ 494,823

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

**Table of Contents**

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

	<b>Quarter Ended March 31,</b>	
	<b>2009</b>	<b>2008</b>
	<b>(in thousands)</b>	
<b>Operating Activities:</b>		
Net income	\$ 4,892	\$ 5,265
Adjustments to reconcile net income to net cash provided by operating activities:		
Net decrease (increase) in other assets	17	(377)
Net increase (decrease) in accrued expenses	391	(34)
Net increase in payable for security purchased	49,999	
Net cash provided by operating activities	\$ 55,299	\$ 4,854
<b>Investing Activities:</b>		
Repayments of notes receivable from Harris N.A.	\$ 336	\$ 343
Purchases of securities available-for-sale	(128,575)	(121,331)
Proceeds from maturities/redemptions of securities available-for-sale	48,146	121,203
Net cash (used in) provided by investing activities	\$ (80,093)	\$ 215
<b>Financing Activities:</b>		
Cash dividends paid on preferred stock	\$ (4,609)	\$ (4,609)
Cash dividends paid on common stock		(3,000)
Capital contribution and issuance of common stock	80,000	
Net cash provided by (used in) financing activities	\$ 75,391	\$ (7,609)
Net increase (decrease) in cash on deposit with Harris N.A.	\$ 50,597	\$ (2,540)
Cash and cash equivalents with Harris N.A. at beginning of period	6,679	16,865
Cash and cash equivalents with Harris N.A. at end of period	\$ 57,276	\$ 14,325

*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 2008 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 March 31, 2009.

**3. Securities**

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

	<b>Amortized Cost</b>	<b>March 31, 2009</b>		<b>Fair Value</b>
		<b>Unrealized Gains</b>	<b>Unrealized Losses</b>	
		<b>(in thousands)</b>		
<b>Available-for-Sale Securities</b>				
Mortgage-backed	\$ 478,108	\$ 14,525	\$	\$ 492,633
U.S. Treasury Bills	79,998	1		79,999

Total Securities	\$ 558,106	\$ 14,526	\$	\$ 572,632
------------------	------------	-----------	----	------------

**Table of Contents****HARRIS PREFERRED CAPITAL CORPORATION**

	Amortized Cost	December 31, 2008		Fair Value
		Unrealized Gains	Unrealized Losses	
		(in thousands)		
<b>Available-for-Sale Securities</b>				
Mortgage-backed	\$ 477,678	\$ 10,720	\$ 116	\$ 488,282
U.S. Treasury Bills				
Total Securities	\$ 477,678	\$ 10,720	\$ 116	\$ 488,282

	Amortized Cost	March 31, 2008		Fair Value
		Unrealized Gains	Unrealized Losses	
		(in thousands)		
<b>Available-for-Sale Securities</b>				
Mortgage-backed	\$ 435,332	\$ 3,961	\$ 595	\$ 438,698
U.S. Treasury Bills	34,997			34,997
Total Securities	\$ 470,329	\$ 3,961	\$ 595	\$ 473,695

The Company classifies all securities as available-for-sale. Available-for-sale securities are reported at fair value with unrealized gains and losses included as a separate component of stockholders' equity. At March 31, 2009, net unrealized gains on available-for-sale securities were \$14.5 million compared to \$10.6 million of net unrealized gains on December 31, 2008.

**4. Fair Value Measurements**

The Company uses a fair value hierarchy to categorize the inputs used in valuation techniques to measure fair value. The extent of the use of quoted market prices (Level 1), internal models using observable market information as inputs (Level 2) and internal models without observable market information (Level 3) in the valuation of available-for-sale securities at March 31, 2009, December 31, 2008 and March 31, 2008 are presented in the following table:

	Fair Value March 31, 2009	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
		(in thousands)		
Available-for-sale securities	\$ 572,632	\$ 79,999	\$ 492,633	\$

	<b>Fair Value December 31, 2008</b>	<b>Fair Value Measurements Using</b>		
		<b>Level 1</b>	<b>Level 2 (in thousands)</b>	<b>Level 3</b>
Available-for-sale securities	\$ 488,282	\$	\$ 488,282	\$

	<b>Fair Value March 31, 2008</b>	<b>Fair Value Measurements Using</b>		
		<b>Level 1</b>	<b>Level 2 (in thousands)</b>	<b>Level 3</b>
Available-for-sale securities	\$ 473,695	\$ 34,997	\$ 438,698	\$

7

---

**Table of Contents**

**HARRIS PREFERRED CAPITAL CORPORATION**

**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 2008 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**

**First Quarter 2009 Compared with First Quarter 2008**

The Company's net income for the first quarter of 2009 was \$4.9 million, compared to \$5.3 million from the first quarter 2008. Earnings decreased primarily because of the initial recognition of Illinois state income taxes during the current quarter.

Interest income on securities purchased under agreement to resell for the first quarter of 2009 was \$9 thousand, on an average balance of \$34 million, with an annualized yield of 0.11%. During the same period in 2008, the interest income on securities purchased under agreement to resell was \$634 thousand, on an average balance of \$69 million, with an annualized yield of 3.69%. The decrease in income was attributable to lower yields in the short-term money market. The Federal Fund rates at March 31, 2009 was 0.18% compared to the Federal Fund rates at March 31, 2008 of 2.61%. First quarter 2009 interest income on the Notes receivable (Notes) totaled \$64 thousand and yielded 6.4% on \$4 million of average principal outstanding for the quarter compared to \$82 thousand and a 6.4% yield on \$5.1 million average principal outstanding for first quarter 2008. The decrease in income was attributable to a reduction in the Notes balance because of customer payoffs in the Securing Mortgage Loans. At March 31, 2009 and 2008, there were no Securing Mortgage Loans on nonaccrual status. Interest income on securities available-for-sale for the current quarter was \$5.4 million resulting in a yield of 4.52% on an average balance of \$476 million, compared to \$4.7 million with a yield of 4.5% on an average balance of \$413 million for the same period a year ago. Virtually all income in the current quarter was attributable to the mortgage-backed security portfolio.

There were no Company borrowings during first quarter 2009 or 2008.

First quarter 2009 operating expenses totaled \$179 thousand, an increase of \$38 thousand or 27% from the first quarter of 2008. General and administrative expenses totaled \$120 thousand, an increase of \$22 thousand over the same period in 2008, primarily due to increases in insurance costs and regulatory filings and processing costs, and

director fees. Advisory fees for the first quarter 2009 were \$56 thousand compared to \$39 thousand a year earlier, primarily due to increase in production costs.

On March 30, 2009, the Company paid a cash dividend of \$0.46094 per share on outstanding Preferred Shares to the stockholders of record on March 15, 2009 as declared on March 4, 2009. On March 30, 2008, the Company paid a cash dividend of \$0.46094 per share on outstanding Preferred Shares to the stockholders of record on March 15, 2008 as declared on March 5, 2008.



**Table of Contents**

**HARRIS PREFERRED CAPITAL CORPORATION**

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 March 31, 2009, net unrealized gains on available-for-sale securities were \$14.5 million compared to \$3.4 million of unrealized gains on March 31, 2008.

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.

**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. In addition, the Company believes that the \$80 million capital contribution from the Company's parent in March 2009 should provide additional opportunity to invest in earning assets.

As presented in the accompanying Consolidated Statements of Cash Flows, the primary sources of funds in addition to \$55.3 million provided from operations during the three months ended March 31, 2009, were \$48.1 million from the maturities of securities available-for-sale and the \$80 million from the issuance of the common stock. In the prior period ended March 31, 2008, the primary sources of funds other than \$4.9 million from operations were

\$121.2 million from the maturities of securities available-for-sale. The primary uses of funds for the three months ended March 31, 2009 were \$128.6 million for purchases of securities available-for-sale and \$4.6 million in preferred stock dividends paid. Net cash provided by financing activities were \$75.4 million compared to \$7.6 million used in the prior period ended March 31, 2008. The primary reason was the issuance of stock and capital contribution from the Company's parent totaling \$80 million. For the prior year's quarter ended March 31, 2008, the primary uses of funds were \$121.3 million for purchases of securities available-for-sale and \$4.6 million in preferred stock dividends and \$3.0 million in common stock dividends paid.

**Table of Contents**

**HARRIS PREFERRED CAPITAL CORPORATION**

**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, 2008.

**Accounting Pronouncements**

In April 2009, the Financial Accounting Standards Board ( FASB ) issued three related Staff Positions ( FSP ) to provide additional application guidance and disclosure requirements regarding fair value measurements and impairments of securities. FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, provides guidance on determining fair value when there is no active market and requires additional disaggregated disclosures. FSP FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments, relate to fair value disclosures under FAS 107 for financial instruments that are not currently reflected on the balance sheet at fair value and require disclosures on a quarterly basis rather than the current annual basis. FSP FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments, relate to the evaluation of other-than-temporary impairment ( OTTI ) for debt securities classified as available-for-sale or held-to-maturity, the identification of credit and noncredit components of impairment, the recognition of impairment in earnings or OCI and require significant expanded disclosures on a quarterly basis. The three Staff Positions are effective for periods ending after June 15, 2009. The Company is in the process of assessing the impact of adopting the Staff Positions on its financial position and results of operations.

The Company adopted Statement of Financial Accounting Standards ( SFAS ) No. 160, Noncontrolling Interests in Consolidated Financial Statements An Amendment of ARB 51, as of January 1, 2009. The Statement requires those entities that have an outstanding noncontrolling (minority) interest in a subsidiary to report that noncontrolling interest as equity in the consolidated financial statements. The adoption of the Statement did not have a material effect on the Company's financial position or results of operations.

**Tax Matters**

As of March 31, 2009, 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 represents more than 50% of the voting power of the Company's equity securities and (3) the Common Stock is not listed for trading on an exchange. Management believes that the future state tax expense to be incurred by the Company beginning January 1, 2009 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 Common Stock. For the first quarter of 2009, \$385,000 Illinois income tax was recorded.

**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>March 31, 2009 (unaudited)</b>	<b>December 31, 2008 (audited)</b>	<b>March 31, 2008 (unaudited)</b>
	<b>(in thousands except share data)</b>		
<b>ASSETS</b>			
Cash and demand balances due from banks	\$ 1,098,403	\$ 1,072,255	\$ 1,359,417
Money market assets:			
Interest-bearing deposits at banks (\$10.1 billion, \$24.7 billion, and \$0 held at Federal Reserve Bank at March 31, 2009, December 31, 2008, and March 31, 2008 respectively)	11,134,016	26,031,291	1,046,522
Federal funds sold and securities purchased under agreement to resell	326,313	182,063	582,712
Total cash and cash equivalents	\$ 12,558,732	\$ 27,285,609	\$ 2,988,651
Securities available-for-sale at fair value (amortized cost of \$7.2 billion at March 31, 2009 and \$9.2 billion at December 31, 2008 and March 31, 2008)	7,265,687	9,283,283	9,254,701
Trading account assets and derivative instruments	1,302,193	1,367,833	447,057
Loans, net of unearned income	25,099,589	26,396,381	27,660,618
Allowance for loan losses	(607,561)	(574,224)	(405,603)
Net loans	\$ 24,492,028	\$ 25,822,157	\$ 27,255,015
Loans held for sale	72,587	29,544	88,178
Premises and equipment	521,719	533,516	514,250
Bank-owned insurance	1,315,451	1,304,315	1,263,651
Goodwill and other intangible assets	772,696	779,444	804,202
Other assets	881,225	900,354	987,105
<b>Total assets</b>	<b>\$ 49,182,318</b>	<b>\$ 67,306,055</b>	<b>\$ 43,602,810</b>
<b>LIABILITIES</b>			
Deposits in domestic offices noninterest-bearing	\$ 12,055,125	\$ 28,059,575	\$ 6,294,205
interest-bearing (includes \$156.2 million, \$77.7 million, and \$0 measured at fair value at March 31, 2009, December 31, 2008 and March 31, 2008, respectively)	24,086,415	24,374,034	23,044,496
Deposits in foreign offices interest-bearing	806,129	920,235	971,270
Total deposits	\$ 36,947,669	\$ 53,353,844	\$ 30,309,971
Federal funds purchased	299,678	78,525	404,218
Securities sold under agreement to repurchase	1,541,936	3,501,758	1,010,239
Short-term borrowings	593,229	359,476	561,612
Short-term senior notes		75,000	930,000
Accrued interest, taxes and other expenses	194,142	247,825	231,008

Edgar Filing: HARRIS PREFERRED CAPITAL CORP - Form 10-Q

Accrued pension and post-retirement	113,228	171,933	83,366
Other liabilities	592,350	631,487	786,652
Long-term notes senior	2,096,500	2,096,500	2,096,500
Long-term notes subordinated	292,750	292,750	297,750
Long-term notes secured	2,375,000	2,375,000	2,375,000
<b>Total liabilities</b>	<b>\$ 45,046,482</b>	<b>\$ 63,184,098</b>	<b>\$ 39,086,316</b>

**STOCKHOLDER S EQUITY**

Common stock (\$10 par value); authorized 40,000,000 shares; issued and outstanding 17,149,512 shares at March 31, 2009,

December 31, 2008, and March 31, 2008	\$ 171,495	\$ 171,495	\$ 171,495
Surplus	2,172,217	2,172,029	2,168,784
Retained earnings	1,737,956	1,734,472	1,947,945
Accumulated other comprehensive loss	(195,832)	(206,039)	(21,730)

Stockholder s equity before noncontrolling interest preferred stock of subsidiary	\$ 3,885,836	\$ 3,871,957	\$ 4,266,494
Noncontrolling interest preferred stock of subsidiary	250,000	250,000	250,000
<b>Total stockholder s equity</b>	<b>\$ 4,135,836</b>	<b>\$ 4,121,957</b>	<b>\$ 4,516,494</b>

<b>Total liabilities and stockholder s equity</b>	<b>\$ 49,182,318</b>	<b>\$ 67,306,055</b>	<b>\$ 43,602,810</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 INCOME  
(Unaudited)**

	<b>Three Months Ended March 31,</b>	
	<b>2009</b>	<b>2008</b>
	<b>(in thousands)</b>	
<b>Interest Income</b>		
Loans	\$ 287,978	\$ 380,245
Money market assets:		
Deposits at banks	6,386	5,429
Federal funds sold and securities purchased under agreement to resell	455	7,561
Trading account assets	2,537	2,508
Securities available-for-sale:		
U.S. Treasury and federal agency	34,269	77,608
State and municipal	13,853	12,051
Other	4,110	4,761
Total interest income	\$ 349,588	\$ 490,163
<b>Interest Expense</b>		
Deposits	\$ 111,980	\$ 190,843
Short-term borrowings	1,897	22,766
Short-term senior notes	6	5,152
Long-term notes senior	10,317	20,432
Long-term notes subordinated	1,650	3,565
Long-term notes secured	2,832	20,662
Total interest expense	\$ 128,682	\$ 263,420
<b>Net Interest Income</b>	<b>\$ 220,906</b>	<b>\$ 226,743</b>
Provision for loan losses	93,094	23,202
<b>Net Interest Income after Provision for Loan Losses</b>	<b>\$ 127,812</b>	<b>\$ 203,541</b>
<b>Noninterest Income</b>		
Trust and investment management fees	\$ 18,782	\$ 22,851
Net money market and bond trading income (losses), including derivative activity	4,432	(455)
Foreign exchange	2,625	1,125
Service charges and fees	47,646	47,445
Equity securities gains, net	1,952	39,796
Net securities gains, other than trading	28,486	10,837
Bank-owned insurance	11,103	12,449
Letter of credit fees	5,094	3,829

Edgar Filing: HARRIS PREFERRED CAPITAL CORP - Form 10-Q

Loan sale gains, net	1,732	1,340
Other	9,060	10,323
Total noninterest income	\$ 130,912	\$ 149,540
<b>Noninterest Expenses</b>		
Salaries and other compensation	\$ 92,879	\$ 99,934
Pension, profit sharing and other employee benefits	30,732	33,801
Net occupancy	26,984	25,915
Equipment	17,502	15,843
Marketing	8,825	10,912
Communication and delivery	7,647	7,335
Professional fees	28,219	23,838
Outside information processing, database and network fees	8,979	9,694
FDIC Insurance	15,034	1,265
Intercompany services, net	(184)	5,001
Visa indemnification reversal		(17,000)
Other	18,242	18,394
Amortization of intangibles	7,106	6,700
Total noninterest expenses	\$ 261,965	\$ 241,632
(Loss) income before income tax (benefit) expense	\$ (3,241)	\$ 111,449
Applicable income tax (benefit) expense	(11,335)	30,802
Net income before noncontrolling interest dividends on preferred stock of subsidiary	\$ 8,094	\$ 80,647
Noncontrolling interest dividends on preferred stock of subsidiary	4,609	4,609
<b>Net Income Available for Common Stockholder</b>	\$ 3,485	\$ 76,038

*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)**

	<b>Three Months Ended March 31,</b>	
	<b>2009</b>	<b>2008</b>
	<b>(in thousands)</b>	
<b>Net income available for common stockholder</b>	\$ 3,485	\$ 76,038
Other comprehensive income:		
Cash flow hedges:		
Net unrealized gain (loss) on derivative instruments, net of tax (expense) benefit of (\$9,147) in 2009 and \$14,533 in 2008	16,988	(26,988)
Less reclassification adjustment for losses included in net income, net of tax benefit of \$1,681 in 2009 and \$1,638 in 2008	3,121	3,042
Pension and postretirement medical benefit plans:		
Net gain and net prior service cost, net of tax expense of \$3,531 in 2009 and \$512 in 2008	6,557	949
Less reclassification adjustment for amortization included in net income, net of tax benefit of \$366 in 2009 and \$0 in 2008	681	
Available-for-sale securities:		
Unrealized holding gains arising during the period, net of tax expense of \$799 in 2009 and \$19,121 in 2008	1,495	35,633
Less reclassification adjustment for realized gains included in net income, net of tax expense of \$10,034 in 2009 and \$3,793 in 2008	(18,635)	(7,044)
Other comprehensive income	\$ 10,207	\$ 5,592
<b>Comprehensive income available for common stockholder</b>	<b>\$ 13,692</b>	<b>\$ 81,630</b>

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

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

	<b>2009</b>	<b>2008</b>
	<b>(in thousands)</b>	
<b>Balance at January 1</b>	\$ 4,121,957	\$ 4,038,342
Net income before dividends on preferred stock of subsidiary	8,094	80,647
Contributions to capital surplus		386,935
Issuance of common stock		16,347
Stock options	187	520
Tax benefit from stock option exercise		720
Dividends (\$0.52 in 2008 per common share)		(8,000)
Dividends preferred stock of subsidiary	(4,609)	(4,609)
Other comprehensive income	10,207	5,592
<b>Balance at March 31</b>	\$ 4,135,836	\$ 4,516,494

*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>Three Months Ended March 31,</b>	
	<b>2009</b>	<b>2008</b>
	<b>(in thousands)</b>	
<b>Operating Activities:</b>		
Net Income available for common stockholder	\$ 3,485	\$ 76,038
Adjustments to reconcile net income available for common stockholder to net cash provided by (used in) operating activities:		
Provision for loan losses	93,094	23,202
Depreciation and amortization, including intangibles	25,221	19,236
Deferred tax expense (benefit)	7,874	(8,004)
Tax benefit from stock options exercise		720
Other than temporary impairment on securities	183	
Net gains on securities, other than trading	(28,669)	(10,837)
Net equity investments gains	(1,952)	(39,796)
(Increase) decrease in bank-owned insurance	(11,136)	1,305
Net decrease (increase) in trading securities	142,933	(286,955)
Net decrease in accrued interest receivable	23,027	24,758
Net decrease in prepaid expenses	2,359	
Net decrease in accrued interest payable	(16,454)	(17,667)
Net decrease in other accrued expenses	(6,292)	(25,919)
Origination of loans held for sale	(211,016)	(118,484)
Proceeds from sale of loans held for sale	169,702	94,293
Net gains on loans held for sale	(1,729)	(1,292)
Net losses on sale of premises and equipment	321	17
Recoveries on charged-off loans	16,168	14,670
Net increase in settlement clearing account	(43,367)	(78)
Net change in pension and post retirement benefits	(47,570)	(3,588)
Net (decrease) increase in marked to market hedging derivatives	(29,752)	46,961
Visa indemnification		17,000
Other, net	(53,306)	10,996
Net cash provided by (used in) operating activities	\$ 33,124	\$ (183,424)
<b>Investing Activities:</b>		
Proceeds from sales of securities available-for-sale	\$ 2,830,608	\$ 837,912
Proceeds from maturities of securities available-for-sale	1,054,551	5,073,723
Purchases of securities available-for-sale	(1,866,025)	(5,567,444)
Net (increase) decrease in loans	1,220,867	(573,166)
Purchases of premises and equipment	(19,065)	(19,404)
Sales of premises and equipment	12,999	24,181
Proceeds from Visa redemption		37,800

Edgar Filing: HARRIS PREFERRED CAPITAL CORP - Form 10-Q

Acquisition, net of cash acquired	(3,423)	(285,214)
Net cash provided by (used in) investing activities	\$ 3,230,512	\$ (471,612)
<b>Financing Activities:</b>		
Net decrease in deposits	\$ (16,406,175)	\$ (861,848)
Net increase (decrease) in Federal funds purchase and securities sold under agreement to repurchase	(1,738,669)	(381,697)
Net increase (decrease) in other short-term borrowings	233,753	(382,780)
Net (decrease) increase in short-term notes senior	(75,000)	850,000
Proceeds from issuance long-term notes subordinated		5,000
Proceeds from issuance long-term notes secured		375,000
Net proceeds from stock options	187	520
Excess tax expense from stock options exercise		(299)
Cash dividends paid on common stock		(8,000)
Cash dividends paid on preferred stock	(4,609)	(4,609)
Issuance of common stock		16,347
Contributions to capital surplus		386,935
Net cash used in financing activities	\$ (17,990,513)	\$ (5,431)
Net decrease in cash and cash equivalents	(14,726,877)	(660,467)
Cash and cash equivalents at January 1	27,285,609	3,649,120
Cash and cash equivalents at March 31	\$ 12,558,732	\$ 2,988,653

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

**Table of Contents**

**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 February 29, 2008 Bankcorp completed the acquisition of Merchants and Manufacturers Bancorporation, Inc. (Merchants and Manufacturers), for a purchase price of \$136.7 million. Of this amount, \$111.5 million was recorded as goodwill and \$11.0 million was recorded as a core deposit premium intangible with an expected life of ten years. Bankcorp recorded additional goodwill of \$3.4 million for related acquisition costs. Goodwill and other intangibles related to this acquisition are not deductible for tax purposes. The results of Merchants and Manufacturers' operations have been included in Bankcorp's consolidated financial statements since March 1, 2008. The acquisition of Merchants and Manufacturers provides Bankcorp with the opportunity to expand banking services in the Wisconsin market.

On February 29, 2008 BMO completed the acquisition of Ozaukee Bank (Ozaukee), for a purchase price of \$183.3 million consisting of 3,283,190 BMO common shares with a market value of \$55.84 per share. BMO immediately contributed Ozaukee to HFC in exchange for HFC common shares. HFC immediately contributed Ozaukee to Bankcorp in exchange for Bankcorp common shares. Of the purchase price amount, \$127.7 million was recorded as goodwill and \$11.7 million was recorded as a core deposit premium intangible with an expected life of ten years. Bankcorp recorded additional goodwill of \$1.8 million for related acquisition costs. Goodwill and other intangibles related to this acquisition are not deductible for tax purposes. The results of Ozaukee's operations have been included in Bankcorp's consolidated financial statements since March 1, 2008. The acquisition of Ozaukee provides Bankcorp with the opportunity to expand banking services in the Wisconsin market.

On September 6, 2008, Bankcorp merged Merchants and Manufacturers with and into the Bank and merged Ozaukee with and into the Bank. Each transaction was recorded at its respective carrying value on that date. The interim financial statements for the three month period ended March 31, 2008 of the Bank include the results of the merged entities since March 1, 2008.

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. 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 three months ended March 31 totaled \$145.1 million and \$281.4 million in

**Table of Contents**

**HARRIS N.A. AND SUBSIDIARIES**

2009 and 2008, respectively. Cash income tax payments over the same periods totaled \$294 thousand and \$26.8 million, respectively.

**4. Visa Indemnification Charge**

Harris N.A. 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. Harris N.A. and other Visa U.S.A. member banks were obligated to share in potential losses resulting from certain indemnified litigation involving Visa that has been settled.

A member bank such as Harris N.A. was 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 in accordance with FASB Interpretation No. 45, Guarantors Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. Harris N.A. 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 was highly judgmental, as of December 31, 2007, Harris N.A. 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, Harris N.A. received \$37.8 million in cash in conjunction with the mandatory partial redemption which was recognized as an equity security gain in the Consolidated Statement of Income 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 other non-interest expense.

On October 27, 2008, Visa announced the settlement of the litigation involving Discover Financial Services. As a result, the Bank recorded an additional reserve for this matter of \$7.0 million (pretax) during the third quarter as an increase to non-interest expense.

In December 2008 Harris N.A. recorded a decrease to non-interest expense of \$6.3 million 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 March 31, 2009 and December 31, 2008 the recorded reserve relating to the Visa litigation matter included in the Consolidated Statement of Condition was \$17.8 million.

**5. Fair Value Measurements**

In April 2009, the Financial Accounting Standards Board (FASB) issued three related Staff Positions (FSP) to provide additional application guidance and disclosure requirements regarding fair value measurements and impairments of securities. FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, provides guidance on determining fair value when there is no active market and requires additional disaggregated disclosures. FSP FAS 107-1 and APB

28-1, Interim Disclosures about Fair Value of Financial Instruments, relate to fair value disclosures under FAS 107 for financial instruments that are not currently reflected on the balance sheet at fair value and require disclosures on a quarterly basis rather than the current annual basis. FSP FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments, relate to the evaluation of other-than-temporary impairment ( OTTI ) for debt securities classified as available-for-sale or held-to-maturity, the identification of credit and noncredit components of impairment, the recognition of impairment in earnings or OCI and require significant expanded disclosures on a quarterly basis. The three Staff Positions are



**Table of Contents**

**HARRIS N.A. AND SUBSIDIARIES**

effective for periods ending after June 15, 2009. The Bank is in the process of assessing the impact of adopting the Staff Positions on its financial position and results of operations.

**6. Fair Value Option**

The Bank adopted FAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115, as of January 1, 2008. The Statement permits entities to choose to measure certain eligible items at fair value at specified election dates. In 2008, the Bank elected the fair value option for certain financial liabilities. The carrying value of those liabilities was \$156.2 million at March 31, 2009 and \$77.7 million at December 31, 2008.

**7. Accounting for Endorsement Split-Dollar Life Insurance Arrangements**

The Bank adopted Emerging Issues Task Force ( EITF ) Issue No. 06-04, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements, in the first quarter of 2008. It requires recognition of a liability and related compensation costs for endorsement split-dollar life insurance arrangements that provide employee benefits in postretirement periods. The Bank acquired endorsement split-dollar life insurance arrangements for certain employees through various bank acquisitions. Upon adoption of the EITF, the Bank recognized a \$0.5 million increase in the liability for deferred compensation; recorded a \$0.3 million decrease in retained earnings and a \$0.2 million increase in deferred taxes.

**8. 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 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.

In 2008, the Bank offered to purchase specific holdings of ARS from certain client accounts at par value plus accrued interest. 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. The difference between the estimated fair values and the par values paid by the Bank resulted in a pre-tax charge of \$21.8 million for the year ended December 31, 2008 in addition to the legal costs of \$185 thousand. The purchases of these securities were substantially completed by December 31, 2008 and the ARS purchased are classified as available-for-sale. As of March 31, 2009 the fair value of the ARS held by the Bank was \$61.3 million and the amortized cost was \$68.5 million.

**9. Noncontrolling Interests**

The Bank adopted Statement of Financial Accounting Standards ( SFAS ) No. 160, Noncontrolling Interests in Consolidated Financial Statements An Amendment of ARB 51, as of January 1, 2009. The Statement requires those entities that have an outstanding noncontrolling (minority) interest in a subsidiary to report that noncontrolling interest as equity in the consolidated financial statements. Upon adoption, \$250 million of noncontrolling interest was reclassified from liabilities to the Bank s stockholder s equity.



**Table of Contents**

**HARRIS N.A. AND SUBSIDIARIES**

**FINANCIAL REVIEW**

**First Quarter 2009 Compared with First Quarter 2008**

**Summary**

The Bank's first quarter 2009 net income was \$3.5 million, a decrease of \$72.6 million or 95.4 percent from the first quarter of 2008, primarily the result of a higher provision for credit losses.

Net interest income was \$220.9 million, down \$5.8 million or 2.6 percent from a year ago, largely due to a higher level of non-accrual loans. The decline in the net interest margin to 1.91 percent from 2.53 percent in the first quarter of 2008 also reflects an increase in low return Federal Reserve Bank interest-bearing deposits. Average earning assets increased to \$47.2 billion in 2009 from \$37.6 billion in 2008, due to an increase of \$11.2 billion in Federal Reserve Bank interest-bearing deposits. In turn, these balances are the result of a substantial increase in nonretail demand deposits.

Provision for loan losses of \$93.1 million was up \$69.9 million over last year primarily attributable to higher net charge-offs on commercial and consumer credits and increased levels of estimated loss in both the commercial and consumer credit portfolios. Net loan charge-offs during the quarter were \$58.3 million compared to \$17.2 million in the same period last year. 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.

Non-interest income was \$130.9 million, a decrease of \$18.6 million or 12.5 percent. This was primarily attributable to a \$37.8 million decrease in equity securities gains largely due to participation in the Visa initial public offering in the first quarter of 2008. This impact was partially offset by a \$17.6 million increase in net securities gains during the current quarter.

First quarter 2009 non-interest expenses were \$262.0 million, an increase of \$20.3 million or 8.4 percent. During first quarter 2008, the Bank reversed \$17.0 million of prior expense in conjunction with the Visa litigation escrow account funding (Note 4). In addition, in 2009 there was a \$10.0 million increase in operating and integration costs associated with the Wisconsin acquisitions (Note 1). Excluding these items, expenses declined \$6.6 million largely due to a \$12.8 million reduction in compensation-related costs along with a \$5.2 million decline in inter-company service charges. This was somewhat offset by a \$13.8 million rise in FDIC insurance. Income tax expense decreased \$42.1 million from the first quarter of 2008, reflecting lower pre-tax income.

Nonperforming loans at March 31, 2009 totaled \$579 million or 2.31 percent of total loans, compared to \$427 million or 1.64 percent a year earlier. At March 31, 2009, the allowance for loan losses was \$607.6 million, equal to 2.42 percent of loans outstanding compared to \$373.2 million or 1.43 percent of loans outstanding at the end of the first quarter 2008. Coverage of nonperforming loans by the allowance for loan losses increased from 87 percent at March 31, 2008 to 105 percent at March 31, 2009.

At March 31, 2009 consolidated stockholder's equity of the Bank amounted to \$3.9 billion, unchanged from December 31, 2008. Return on equity was 0.37 percent in the current quarter, compared to 7.79 percent in last year's first quarter. Return on assets was 0.03 percent compared to 0.74 percent a year ago. The Bank did not declare any dividends on common stock in the first quarter of 2009 compared to \$8.0 million declared in the first quarter of 2008.

At March 31, 2009, Tier 1 capital of the Bank amounted to \$3.6 billion, unchanged from one year earlier. The Bank's March 31, 2009 Tier 1 and total risk-based capital ratios were 10.95 percent and 13.09 percent compared to respective ratios of 10.72 percent and 12.69 percent at March 31, 2008. The regulatory leverage capital ratio was 7.05 percent for the first quarter of 2009 compared to 8.95 percent a year ago, the decrease primarily attributable to the aforementioned increase in Federal Reserve Bank deposits. The Bank's capital ratios exceed the prescribed regulatory minimum for well-capitalized banks.

**Table of Contents****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 8.

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

	Apr. 1, 2009 to Dec. 31, 2009	Year Ending December 31,					Total	Fair Value at March 31, 2009
		2010	2011	2012	2013	Thereafter		
<u>Mortgage-Backed</u>								
Amortized cost	\$ 21,720	\$ 39,086	\$ 21,258	\$	\$ 16,822	\$ 379,221	\$ 478,107	\$ 492,633
Average Yield	4.17%	4.59%	4.00%		4.00%	4.85%	4.68%	
<u>U.S. Treasury</u>								
<u>Bills</u>								
Amortized cost	\$ 79,999	\$	\$	\$	\$	\$	\$ 79,999	\$ 79,999
Average Yield	0.002%						0.002%	
	2009	Year Ending December 31,					Total	Fair Value at December 31, 2008
		2010	2011	2012	2013	Thereafter		
<u>Mortgage-Backed</u>								
Amortized cost	\$ 43,936	\$ 41,881	\$ 22,902	\$	\$ 18,237	\$ 350,721	\$ 477,677	\$ 488,282
Average Yield	4.10%	4.57%	4.00%		4.00%	4.85%	4.68%	
	Apr. 1, 2008 to Dec. 31, 2008	Year Ending December 31,					Total	Fair Value at March 31, 2008
		2009	2010	2011	2012	Thereafter		
<u>Mortgage-Backed</u>								
Amortized cost	\$ 4,635	\$ 62,548	\$ 22,345	\$ 26,412	\$	\$ 319,392	\$ 435,332	\$ 438,698
Average Yield	4.00%	4.10%	4.06%	4.00%		4.88%	4.66%	
<u>U.S. Treasury</u>								
<u>Bills</u>								
Amortized cost	\$ 34,997	\$	\$	\$	\$	\$	\$ 34,997	\$ 34,997
Average Yield	0.0468%						0.0468%	

At March 31, 2009, December 31, 2008 and March 31, 2008, 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 Freddie Mac, and none of the underlying loan collateral is represented by sub-prime mortgages.

#### **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 March 31, 2009. 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 March 31, 2009 that has materially affected, or is reasonably likely to materially affect, internal control over financial reporting.

**Table of Contents**

**Part II. OTHER INFORMATION**

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

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

Please refer to the Company's Current Report filed on Form 8-K dated March 4, 2009

**Item 6. Exhibits**

**3.1 Articles of Incorporation, as amended, of Harris Preferred Capital Corporation\***

**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**

\* Incorporated by reference to Exhibit 3.1 with the Company's Form 8-K dated March 4, 2009.

**Table of Contents**

**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, there unto duly authorized on the 15th day of May 2009.

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

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