HARRIS PREFERRED CAPITAL CORP
Form 10-Q
August 14, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006

COMMISSION FILE NUMBER 1-13805

HARRIS PREFERRED CAPITAL CORPORATION
(Exact name of registrant as specified in its charter)

MARYLAND (State or other jurisdiction of incorporation or organization)	# 36-4183096 (I.R.S. Employer Identification No.)
111 WEST MONROE STREET, CHICAGO, ILLINOIS (Address of principal executive offices)	60603 (Zip Code)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE:
(312) 461-2121

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

TITLE OF EACH CLASS	NAME OF EACH EXCHANGE ON WHICH REGISTERED
7 3/8% Noncumulative Exchangeable Preferred Stock, Series A, par value $1.00 per share	New York Stock Exchange

SECURITIES REGISTERED PURSUANT TO SECTION 12(G) OF THE ACT: NONE

Indicate by check mark 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 [X] No [ ]

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

Large accelerated filer [ ]   Accelerated filer [ ]   Non-accelerated filer [X]

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

The number of shares of Common Stock, $1.00 par value, outstanding on August 14, 2006 was 1,000. No common equity is held by nonaffiliates.

HARRIS PREFERRED CAPITAL CORPORATION

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED BALANCE SHEETS

	JUNE 30, 2006	DECEMBER 31, 2005	JUNE 30 2005
	(UNAUDITED)	(AUDITED)	(UNAUDIT
	(IN THOUSANDS, EXCEPT SHARE DATA)		
ASSETS			
Cash on deposit with Harris N.A..........................	$ 1,192	$ 700	$ 43
Securities purchased from Harris N.A. under agreement to resell..	16,069	20,500	13,00
Notes receivable from Harris N.A.........................	7,219	8,684	10,50
Securities available-for-sale:			

Mortgage-backed	343,947	373,584	431,35
U.S. Treasury	104,888	74,946	29,98
Other assets	1,420	1,461	1,66
TOTAL ASSETS	$474,735	$479,875	$486,94
LIABILITIES AND STOCKHOLDERS' EQUITY			
Accrued expenses	$ 95	$ 129	$ 9
Commitments and contingencies	--	--	-
STOCKHOLDERS' EQUITY			
7 3/8% Noncumulative Exchangeable Preferred Stock, Series A ($1 par value); liquidation value of $250,000,000 and 20,000,000 shares authorized, 10,000,000 shares issued and outstanding	250,000	250,000	250,00
Common stock ($1 par value); 1,000 shares authorized, issued and outstanding	1	1	
Additional paid-in capital	240,733	240,733	240,73
Earnings in excess of (less than) distributions	956	(2)	(37
Accumulated other comprehensive loss -- net unrealized losses on available-for-sale securities	(17,050)	(10,986)	(3,50
TOTAL STOCKHOLDERS' EQUITY	474,640	479,746	486,84
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$474,735	$479,875	$486,94

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

HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED STATEMENTS OF INCOME
AND COMPREHENSIVE INCOME
(UNAUDITED)

	QUARTER ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,	
	2006	2005	2006	2005
	(IN THOUSANDS, EXCEPT PER SHARE DATA)			
INTEREST INCOME:				
Securities purchased from Harris N.A. under agreement to resell	$ 1,256	$ 251	$ 2,270	$ 451
Notes receivable from Harris N.A.	119	171	249	355
Securities available-for-sale:				
Mortgage-backed	3,796	4,423	7,691	8,795
U.S. Treasury	105	17	203	36
Total interest income	5,276	4,862	10,413	9,637
OPERATING EXPENSES:				
Loan servicing fees paid to Harris N.A.	6	8	12	16
Advisory fees	30	41	61	65

General and administrative	78	33	164	135
Total operating expenses	114	82	237	216
Net income	5,162	4,780	10,176	9,421
Preferred dividends	4,609	4,609	9,218	9,218
NET INCOME AVAILABLE TO COMMON STOCKHOLDER	$ 553	$ 171	$ 958	$ 203
Basic and diluted earnings per common share	$553.00	$171.00	$958.00	$203.00
Net income	$ 5,162	$ 4,780	$10,176	$ 9,421
Other comprehensive (loss) income -- net unrealized (losses)/gains on available-for-sale securities	(2,774)	4,200	(6,064)	(2,242)
Comprehensive income	$ 2,388	$ 8,980	$ 4,112	$ 7,179

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

HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(UNAUDITED)

	SIX MONTHS ENDED JUNE 30,	
	2006	2005
	(IN THOUSANDS, EXCEPT PER SHARE DATA)	
Balance at January 1	$479,746	$488,888
Net income	10,176	9,421
Other comprehensive loss	(6,064)	(2,242)
Dividends (preferred stock $0.4609 per share)	(9,218)	(9,218)
Balance at June 30	$474,640	$486,849

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

HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	SIX MONTHS ENDED JUNE 30, 2006	SIX MONTHS ENDED JUNE 30, 2005
	(IN THOUSANDS)	
OPERATING ACTIVITIES:		
Net Income	$ 10,176	$ 9,421
Adjustments to reconcile net income to net cash provided by operating activities:		
Decrease (increase) in other assets	41	(64)
Net decrease in accrued expenses	(34)	(41)
Net cash provided by operating activities	10,183	9,316
INVESTING ACTIVITIES:		
Decrease (increase) in securities purchased from Harris N.A. under agreement to resell	4,431	(2,500)
Repayments of notes receivable from Harris N.A.	1,465	1,625
Decrease in securing mortgage collections due from Harris N.A.	--	78
Purchases of securities available-for-sale	(205,174)	(113,187)
Proceeds from maturities and paydowns of securities available-for-sale	198,805	113,917
Net cash used by investing activities	(473)	(67)
FINANCING ACTIVITIES:		
Cash dividends paid on preferred stock	(9,218)	(9,218)
Net Cash used in financing activities	(9,218)	(9,218)
Net increase in cash on deposit with Harris N.A.	492	31
Cash on deposit with Harris N.A. at beginning of period	700	407
Cash on deposit with Harris N.A. at end of period	$ 1,192	$ 438

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

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HARRIS PREFERRED CAPITAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

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

Company's common stock. The Bank owns all common stock outstanding issued by Harris Capital Holdings, Inc.

The accompanying consolidated financial statements have been prepared by management from the books and records of the Company. These statements reflect all adjustments and disclosures which are, in the opinion of management, necessary for a fair statement of the results for the interim periods presented and should be read in conjunction with the notes to financial statements included in the Company's 2005 Form 10-K. Certain reclassifications were made to conform prior years' financial statements to the current year's presentation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission.

2. COMMITMENTS AND CONTINGENCIES

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

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD-LOOKING INFORMATION

The statements contained in this Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding the Company's expectation, intentions, beliefs or strategies regarding the future. Forward-looking statements include the Company's statements regarding tax treatment as a real estate investment trust, liquidity, provision for loan losses, capital resources and investment activities. In addition, in those and other portions of this document, the words "anticipate," "believe," "estimate," "expect," "intend" and other similar expressions, as they relate to the Company or the Company's management, are intended to identify forward-looking statements. Such statements reflect the current views of the Company with respect to future events and are subject to certain risks, uncertainties and assumptions. It is important to note that the Company's actual results could differ materially from those described herein as anticipated, believed, estimated or expected. Among the factors that could cause the results to differ materially are the risks discussed in Item 1A. "Risk Factors" in the Company's 2005 Form 10-K and in the "Risk Factors" section included in the Company's Registration Statement on Form S-11 (File No. 333-40257), with respect to the Preferred Shares declared effective by the Securities and Exchange Commission on February 5, 1998. The Company assumes no obligation to update any such forward-looking statement.

RESULTS OF OPERATIONS

SECOND QUARTER 2006 COMPARED WITH SECOND QUARTER 2005

The Company's net income for the second quarter of 2006 was $5.2 million, an 8% increase from the second quarter 2005 net income of $4.8 million. Earnings increased primarily because of increased interest income on earning assets.

Interest income on securities purchased under agreement to resell for the second quarter of 2006 was $1.3 million, on an average balance of $87.8 million, with an average rate of 5.7%. During the same period in 2005, the interest income on securities purchased under agreement to resell was $251 thousand on an average balance of $32.4 million, with an average rate of 3.1%. Second quarter 2006 interest income on the Notes totaled $119 thousand and yielded 6.4% on $7.4 million of average principal outstanding for the quarter compared to $171 thousand and a 6.4% yield on $10.7 million average principal outstanding for second quarter 2005. The decrease in income was attributable to a reduction in the Note balance because of principal paydowns by customers on the Securing Mortgage Loans. Interest income on securities available-for-sale for the current quarter was $3.9 million resulting in a yield of 4.4% on an average balance of $359 million, compared to $4.4 million with a yield of 4.1% on an average balance of $433 million for the same period a year ago. The decrease in the interest income is primarily attributable to the decrease in the investment portfolio of mortgage-backed securities.

There were no Company borrowings during second quarter 2006 or 2005.

Second quarter 2006 operating expenses totaled $114 thousand, an increase of $32 thousand or 39% from the second quarter of 2005. Loan servicing expenses totaled $6 thousand, a decrease of $2 thousand from a year ago. This decrease is attributable to the reduction in the principal balance of the Notes, thereby reducing servicing fees payable to the Bank. Advisory fees for the second quarter 2006 were $30 thousand compared to $41 thousand a year earlier. General and administrative expenses totaled $78 thousand, an increase of $45 thousand over the same period in 2005 primarily as a result of credits for printing and processing costs received in 2005 for prior periods.

At June 30, 2006 and 2005, there were no Securing Mortgage Loans on nonaccrual status.

The company classifies all securities as available-for-sale, even if the Company has no current plans to divest. 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, 2006, net unrealized losses on available-for-sale securities were $17.1 million compared to $3.5 million of unrealized losses on June 30, 2005 and $11.0 million of unrealized losses at December 31, 2005. The unrealized loss positions at June 30, 2006 and 2005 and December 31, 2005 were attributed to changes in interest rates and not to lowered credit quality of individual securities; therefore management believes these unrealized losses are temporary.

SIX MONTHS ENDED JUNE 30, 2006 COMPARED WITH JUNE 30, 2005

The Company's net income for the six months ended June 30, 2005 was $10.2 million. This represented a $755 thousand increase or 8% from 2005 earnings. Earnings increased primarily because of an increase in balances of securities purchased under agreement to resell.

Interest income on securities purchased under agreement to resell for the six months ended June 30, 2006 was $2.3 million, on an average balance of $82.6 million, with an average rate of 5.5%. During the same period in 2005, the interest income on securities purchased under agreement to resell was $451 thousand on an average balance of $32.4 million, with an average rate of 2.8%. Interest income on the Notes for the six months ended June 30,2006 totaled $249 thousand, yielding 6.4% on $7.8 million of average principal outstanding compared to $355 thousand of income yielding 6.4% on $11 million of average principal outstanding for the same period in 2005. The decrease in income was attributable to a reduction in the Note balance because of customer payoffs on the Securing Mortgage Loans. The average outstanding balance of the Securing Mortgage Loans was $10 million for the six months ended June 30, 2006 and $14 million for the same period in 2005. There were no Company borrowings during either period. Interest income on securities available-for-sale for the six months ended June 30, 2006 was $7.9 million resulting in a yield of 4.3% on an average balance of $365 million, compared to $8.8 million resulting in a yield of 4.1% on an average balance of $435 million a year ago. The decrease in interest income from available-for-sale securities is primarily attributable to the decrease in the portfolio of mortgage-backed securities.

Operating expense for the six months ended June 30, 2006 totaled $237 thousand, an increase of $21 thousand from a year ago. Loan servicing expenses for the six months ended June 30, 2006 totaled $12 thousand, a decrease of $4 thousand or 25% from 2005. This decrease is attributable to the reduction in the principal balance of the Notes because servicing costs vary directly with these balances. Advisory fees for the six months ended June 30, 2006 were $61 thousand compared to $65 thousand a year ago. General and administrative expenses totaled $164 thousand, an increase of $29 thousand or 21% over the same period in 2005 as a result of increased costs for regulatory filings and prior year credits for printing and processing costs received in 2005.

On June 30, 2006, the Company paid a cash dividend of $0.46094 per share on outstanding Preferred Shares to the stockholders of record on June 15, 2006 as declared on May 31, 2006. On June 30, 2005, the Company paid a cash dividend of $0.46094 per share on outstanding Preferred Shares to the stockholders of record on June 15, 2005, as declared on June 2, 2005.

LIQUIDITY RISK MANAGEMENT

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

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

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

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

As presented in the accompanying Consolidated Statements of Cash Flows, the primary sources of funds in addition to $10.2 million provided from operations during the six months ended June 30, 2006 were $1.5 million provided by principal repayments on the Notes and $198.8 million from the maturities of securities available-for-sale. In the prior period ended June 30, 2005, the primary sources of funds other than $9.3 million from operations were $1.6 million provided by principal repayments on the Notes and $113.9 million from the maturities of securities available-for-sale. The primary uses of funds for the six months ended June 30, 2006 were $205.2 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, 2005, the primary uses of funds were $113.2 million for purchases of securities available-for-sale and $9.2 million in preferred stock dividends paid.

MARKET RISK MANAGEMENT

The Company's market risk is composed primarily of interest rate risk. There have been no material changes in market risk or the manner in which the Company manages market risk since December 31, 2005.

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HARRIS PREFERRED CAPITAL CORPORATION

OTHER MATTERS

As of June 30, 2006, the Company believes that it is in full compliance with the REIT tax rules, and expects to qualify as a non-taxable REIT under the provisions of the Internal Revenue Code. The Company expects to meet all REIT requirements regarding the ownership of its stock and anticipates meeting the annual distribution requirements.

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.

FINANCIAL STATEMENTS OF HARRIS N.A.

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

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HARRIS N.A. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CONDITION
(UNAUDITED)

	JUNE 30, 2006	DECEMBER 31, 2005	JUNE 30, 2005
	(UNAUDITED)	(AUDITED)	(UNAUDITED)
	(IN THOUSANDS EXCEPT SHARE DATA)		
ASSETS			
Cash and demand balances due from banks..............	$ 988,329	$ 1,321,202	$ 925,768
Money market assets:			
Interest-bearing deposits at banks.................	1,201,761	1,007,411	667,915
Federal funds sold................................	595,010	303,130	180,666

Securities available-for-sale (including $4.20 billion, $3.79 billion, and $4.40 billion of securities pledged as collateral for repurchase agreements at June 30, 2006, December 31, 2005 and June 30, 2005, respectively)	7,138,656	6,513,873	7,648,285
Trading account assets	256,747	181,121	127,493
Loans held for sale	34,044	32,364	51,237
Loans	25,014,563	23,783,547	22,351,489
Allowance for loan losses	(319,438)	(324,080)	(314,798)
Net loans	24,695,125	23,459,467	22,036,691
Premises and equipment	449,453	436,609	429,730
Bank-owned insurance	1,136,601	1,115,172	1,092,776
Goodwill and other intangible assets	343,560	353,439	318,626
Other assets	709,841	805,575	697,462
TOTAL ASSETS	$37,549,127	$35,529,363	$34,176,649
LIABILITIES			
Deposits in domestic offices -- noninterest-bearing	$ 6,522,870	$ 6,278,823	$ 5,536,027
-- interest-bearing	18,401,581	17,471,141	17,055,148
Deposits in foreign offices -- interest-bearing	1,531,854	1,270,741	1,207,928
Total deposits	26,456,305	25,020,705	23,799,103
Federal funds purchased and securities sold under agreement to repurchase	3,365,226	3,413,640	3,923,999
Short-term borrowings	1,898,805	2,041,715	1,897,701
Short-term senior notes	500,000	800,000	400,000
Accrued interest, taxes and other expenses	279,991	253,141	218,410
Other liabilities	374,656	261,065	296,447
Long-term notes -- senior	996,500	250,000	250,000
Long-term notes -- subordinated	292,750	292,750	292,750
Minority interest -- preferred stock of subsidiary	250,000	250,000	250,000
TOTAL LIABILITIES	34,414,233	32,583,016	31,328,410
STOCKHOLDER'S EQUITY			
Common stock ($10 par value); authorized 40,000,000 shares; issued and outstanding 13,905,513, 13,618,513 and 13,557,257 shares at June 30, 2006, December 31, 2005 and June 30, 2005, respectively	139,055	136,185	135,573
Surplus	1,358,808	1,204,450	1,155,158
Retained earnings	1,716,724	1,675,571	1,595,965
Accumulated other comprehensive loss	(79,693)	(69,859)	(38,457)
TOTAL STOCKHOLDER'S EQUITY	3,134,894	2,946,347	2,848,239
TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY	$37,549,127	$35,529,363	$34,176,649

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

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HARRIS N.A. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

	QUARTER ENDED JUNE 30, 2006	QUARTER ENDED JUNE 30, 2005	SIX MONTHS ENDED JUNE 30, 2006	SIX MONTHS ENDED JUNE 30, 2005
	(IN THOUSANDS)			
INTEREST INCOME				
Loans	$380,346	$297,340	$739,850	$573,6
Money market assets:				
Deposits at banks	3,361	2,363	6,637	4,5
Federal funds sold	7,078	1,622	10,060	3,1
Trading accounts	2,335	1,448	3,999	2,5
Securities available for sale:				
U.S. Treasury and federal agency	60,359	41,227	111,804	75,0
State and municipal	5,724	4,889	11,004	9,4
Other	5,668	4,592	10,728	8,6
Total interest income	464,871	353,481	894,082	677,0
INTEREST EXPENSE				
Deposits	168,407	105,049	318,189	195,2
Short-term borrowings	73,655	36,248	129,545	63,5
Short-term senior notes	3,983	4,146	11,754	5,8
Long-term notes -- senior	5,073	--	8,543	
Long-term notes -- subordinated	3,904	2,390	7,450	4,5
Minority interest -- dividends on preferred stock of subsidiary	4,610	4,610	9,219	9,2
Total interest expense	259,632	152,443	484,700	278,4
NET INTEREST INCOME	205,239	201,038	409,382	398,5
Provision for loan losses	5,661	2,118	11,307	5,0
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	199,578	198,920	398,075	393,5
NONINTEREST INCOME				
Trust and investment management fees	22,366	23,711	37,690	47,1
Money market and bond trading	4,177	2,542	5,728	5,1
Foreign exchange	1,200	1,425	2,400	2,6
Service charges and fees	33,878	33,533	66,308	63,6
Net securities gains (losses)	2,455	157	2,352	(
Bank-owned insurance	10,856	9,880	21,440	20,1
Letter of credit fees	4,601	5,003	9,538	10,5
Syndication fees	4,168	3,436	5,865	6,1
Other	17,675	26,080	34,014	53,7
Total noninterest income	101,376	105,767	185,335	209,1
NONINTEREST EXPENSES				
Salaries and other compensation	85,176	92,482	169,706	184,2
Pension, profit sharing and other employee benefits	26,583	27,623	56,916	54,6
Net occupancy	19,050	18,591	37,709	35,5
Equipment	16,004	13,554	31,199	27,3
Marketing	9,236	10,327	19,694	18,9
Communication and delivery	6,005	4,785	12,019	10,9
Expert services	7,782	5,770	17,255	11,9
Contract programming	6,484	6,613	14,074	14,0
Intercompany services	13,891	6,180	28,868	16,9
Other	28,668	26,760	53,481	50,8

	218,879	212,685	440,921	425,6
Amortization of intangibles	5,018	4,883	10,042	9,9
Total noninterest expenses	223,897	217,568	450,963	435,5
Income before income taxes	77,057	87,119	132,447	167,0
Applicable income taxes	25,284	26,786	39,294	52,0
NET INCOME	$ 51,773	$ 60,333	$ 93,153	$114,9

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

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HARRIS N.A. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)

	QUARTER ENDED JUNE 30		SIX MONTHS ENDED JUNE 30	
	2006	2005	2006	2005
	(IN THOUSANDS)			
Net income	$51,773	$60,333	$93,153	$114,975
Other comprehensive (loss) income:				
Cash flow hedges:				
Net unrealized gain (loss) on derivative instruments, net of tax expense for the quarter of $45 in 2006 and $5,779 in 2005 and net of tax (benefit) expense year-to-date period of ($658) in 2006 and $350 in 2005	76	9,839	(1,122)	595
Less reclassification adjustment for realized loss (gain) included in income statement, net of tax (benefit) expense for the quarter of ($1,202) in 2006 and $986 in 2005 and net of tax (benefit) expense year-to-date period of ($2,274) in 2006 and $889 in 2005	2,048	(1,678)	3,872	(1,514)
Unrealized (loss) gain on available-for-sale securities:				
Unrealized holding (loss) gain arising during the period, net of tax (benefit) expense for the quarter of ($2,910) in 2006 and $4,574 in 2005 and net of tax (benefit) expense for the year-to-date period of ($5,837) in 2006 and $3,580 in 2005	(5,696)	10,169	(11,149)	6,844
Less reclassification adjustment for realized (gain) loss included in income statement, net of tax expense for the quarter of $957 in 2006 and $61 in 2005 and net of tax expense (benefit) for the year-to-date period of $917 in 2006 and ($31) in 2005	(1,498)	(95)	(1,435)	50

Other comprehensive (loss) income	(5,070)	18,235	(9,834)	5,975
Comprehensive income	$46,703	$78,568	$83,319	$120,950

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

HARRIS N.A. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDER'S EQUITY
(UNAUDITED)

	2006	2005
	(IN THOUSANDS)	
BALANCE AT JANUARY 1	$2,946,347	$2,774,752
Net income	93,153	114,975
Contributions to capital surplus	148,001	--
Issuance of common stock	2,870	--
Stock option exercise	6,357	3,599
Dividends -- preferred stock	--	(62)
Dividends -- common stock	(51,000)	(51,000)
Other comprehensive (loss) income	(9,834)	5,975
BALANCE AT JUNE 30	$3,134,894	$2,848,239

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

HARRIS N.A. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	SIX MONTHS ENDED JUNE 30	
	2006	2005
	(IN THOUSANDS)	
OPERATING ACTIVITIES:		
Net Income	$ 93,153	$ 114,975
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	11,307	5,092
Depreciation and amortization, including intangibles	38,256	38,110
Deferred tax benefit (expense)	36,152	(34,347)

Net (gain) loss on sales of securities	(2,352)	80
Increase in bank-owned insurance	(21,429)	(20,116)
Trading account net cash purchases	(53,285)	(17,954)
Net increase in interest receivable	(11,472)	(8,838)
Net increase (decrease) in interest payable	8,015	(15,418)
Origination of loans held for sale	(122,344)	(202,946)
Proceeds from sale of loans held for sale	121,555	195,652
Net gain on loans held for sale	(891)	(520)
Other, net	113,708	40,389
Net cash provided by operating activities	210,373	94,159
INVESTING ACTIVITIES:		
Net increase in interest-bearing deposits at banks	(225,347)	(5,349)
Net increase in Federal funds sold	(291,880)	(85,716)
Proceeds from sales of securities available-for-sale	257	86,564
Proceeds from maturities of securities available-for-sale	3,547,479	2,477,218
Purchases of securities available-for-sale	(4,188,162)	(2,875,727)
Net increase in loans	(1,261,476)	(1,426,623)
Net (purchases) sales of premises and equipment	(41,058)	74,656
Net cash used by investing activities	(2,460,187)	(1,754,977)
FINANCING ACTIVITIES:		
Net increase in deposits	1,563,765	114,448
Net decrease in Federal funds purchased and securities sold under agreement to repurchase	(48,414)	(567,697)
Net (decrease) increase in other short-term borrowings	(142,910)	1,683,556
Proceeds from issuance of short-term senior notes	1,345,000	1,400,000
Repayment of short-term senior notes	(1,645,000)	(950,000)
Proceeds from issuance of long-term senior notes	746,500	--
Proceeds from issuance of common stock	150,000	--
Cash dividends paid on common stock	(52,000)	(51,000)
Retirement of preferred stock	--	(5,000)
Net cash provided by financing activities	1,916,941	1,624,307
NET DECREASE IN CASH AND DEMAND BALANCES DUE FROM BANKS	(332,873)	(36,511)
CASH AND DEMAND BALANCES DUE FROM BANKS AT JANUARY 1	1,321,202	962,279
CASH AND DEMAND BALANCES DUE FROM BANKS AT JUNE 30	$ 988,329	$ 925,768

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

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HARRIS N.A. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

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

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

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

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

2. LEGAL PROCEEDINGS

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

3. CASH FLOWS

For purposes of the Bank's Consolidated Statements of Cash Flows, cash and cash equivalents is defined to include cash and demand balances due from banks. Cash interest payments for the six months ended June 30 totaled $476.7 million and $263.1 million in 2006 and 2005, respectively. Cash income tax payments over the same periods totaled $65.8 million and $40.2 million, respectively.

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HARRIS N.A. AND SUBSIDIARIES

FINANCIAL REVIEW

SECOND QUARTER 2006 COMPARED WITH SECOND QUARTER 2005

SUMMARY

The Bank had second quarter 2006 net income of $51.8 million, a decrease of $8.6 million or 14 percent from second quarter 2005. Return on equity was 6.90 percent in the current quarter, compared to 8.62 percent from last year's second quarter. Return on assets was 0.56 percent compared to 0.71 percent a year ago.

Second quarter net interest income on a fully taxable equivalent basis was $212.7 million, up $6.2 million or 3 percent from $206.5 million in 2005's second quarter. Average earning assets increased 10 percent to $33.57 billion from $30.61 billion in 2005, due primarily to an increase of $2.6 billion in average loans. Net interest margin decreased to 2.54 percent in the current quarter from 2.70 percent in the year-ago quarter, primarily reflecting a flat yield curve that depressed spreads on earnings assets and the impact of greater reliance on higher-cost wholesale funding sources. This was somewhat offset by strong loan growth, particularly in the retail loan portfolio, which are generally higher yielding earnings assets.

The second quarter 2006 provision for loan losses was $5.7 million compared to $2.1 million in the second quarter of 2005. Net charge-offs increased to $8.2 million from $2.3 million in the prior year. The credit profile of the loan portfolio is expected to remain solid with moderate increases in default and loss experiences in late 2006. The increase in the provision in the second quarter of 2006 reflected charge-off activity and management's assessment of non-performing loans.

Noninterest income was $101.4 million, a decrease of $4.4 million or 4 percent from the same quarter last year. This was primarily attributable to a $5.9 million decline in intercompany service income, a $2.5 million decrease in referral fees and a $1.3 million decrease in trust and investment management fees. The decreases were partially offset by a $2.3 million increase in net securities gains, a $1.6 million increase in money market and bond trading income and $1.0 million higher in bank-owned insurance income.

Second quarter 2006 noninterest expenses of $223.9 million increased $6.3 million or 3 percent from the year ago quarter. The increase was primarily attributable to intercompany service costs rising by $7.7 million and a $2.5 million increase in equipment expenditures. The increases were partially offset by reduced salaries and other compensation expenses. Income tax expense decreased $1.5 million, reflecting lower pretax income from prior year's results. The effective tax rate was higher in this year's quarter as a result of current second quarter settlements for prior years' tax returns.

Nonperforming assets at June 30, 2006 were $125 million or 0.50 percent of total loans, down from $169 million or 0.69 percent at March 31, 2006, and $146 million or 0.65 percent a year ago. At June 30, 2006, the allowance for loan losses was $319 million, equal to 1.28 percent of loans outstanding, compared to $315 million or 1.41 percent of loans outstanding at the end of second quarter 2005. As a result, the ratio of the allowance for loan losses to nonperforming assets increased from 215 percent at June 30, 2005 to 255 percent at June 30, 2006.

At June 30, 2006, Tier 1 capital of the Bank amounted to $3.12 billion, up from $2.83 billion one year earlier. The regulatory leverage capital ratio was 8.48 percent for the second quarter of 2006 compared to 8.43 percent in the same quarter of 2005. The Bank's capital ratio exceeds the prescribed regulatory minimum for banks. The Bank's June 30, 2006 Tier 1 and total risk-based capital ratios were 9.84 percent and 11.77 percent compared to respective ratios of 9.92 percent and 12.05 percent at June 30, 2005.

SIX MONTHS ENDED JUNE 30, 2006 COMPARED WITH JUNE 30, 2005

SUMMARY

The Bank had net income for the six months ended June 30, 2006 of $93.2 million, a decrease of $21.8 million or 19 percent from the same period a year ago. Return on equity was 6.31 percent in the current

year, compared to 8.28 percent from last year. Return on assets was 0.52 percent compared to 0.70 percent a year ago.

Net interest income on a fully taxable equivalent basis was $423.1 million, up $14.4 million or 4 percent from $408.7 million in 2005's year-to-date period. Average earning assets increased 10 percent to $32.98 billion from $30.07 billion in 2005. Loan growth of 4.77% fueled the increase in earnings assets. Net interest margin decreased to 2.58 percent from 2.73 percent in 2005, reflecting the impact of higher rates on deposits and the issuance of higher-cost wholesale supporting funds. This was somewhat offset by higher yields in the loan portfolio and strong retail loan growth.

The year-to-date 2006 provision for loan losses was $11.3 million compared to $5.1 million in 2005, an increase of $6.2 million. Net charge-offs were $15.9 million, an increase of $4.7 million from last year, resulting primarily from higher retail loan write-offs. The increase in provision resulted from increased net charge-offs and management's assessment of non-performing loans.

Noninterest income of $185.3 million decreased $23.8 million or 11 percent from the same period last year. This was primarily attributable to a $9.5 million decline in trust and investment management fees a $9.3 million decrease in intercompany service income, a $3.2 million prior year gain on a loan sale and lower indirect loan and referral fees. The decreases were partially offset by a $2.6 million increase in service charges and fees and a $2.4 million increase in net securities gains.

Noninterest expenses of $451.0 million increased $15.4 million or 4 percent from the year-ago period. The increase was attributable to intercompany service costs rising by $11.9 million and a $5.3 increase in expert service fees, as well as increases in most expense categories. These increases were primarily offset by reduced salaries and other compensation expenses. Income tax expense decreased $12.8 million, reflecting lower pretax income from year ago results.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

ITEM 4. CONTROLS AND PROCEDURES

As of June 30, 2006, Paul R. Skubic, the Chairman of the Board, Chief Executive Officer and President of the Company, and Pamela C. Piarowski, the Chief Financial Officer of the Company, evaluated the effectiveness of the disclosure controls and procedures of the Company and concluded that these disclosure controls and procedures are effective to ensure that material information required to be included in this Report has been recorded, processed, summarized and made known to them in a timely fashion, as appropriate to allow timely decisions regarding disclosures. There was no change in the Company's internal control over financial reporting identified in connection with such evaluations that occurred during the quarter ended June 30, 2006 that has materially affected or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

ITEMS 1, 1A, 2, 3, 4 AND 5 ARE BEING OMITTED FROM THIS REPORT BECAUSE SUCH ITEMS ARE NOT APPLICABLE TO THE REPORTING PERIOD.

ITEM 6. EXHIBITS

31.1 CERTIFICATION OF PAMELA C. PIAROWSKI PURSUANT TO RULE 13A-14(A)

31.2 CERTIFICATION OF PAUL R. SKUBIC PURSUANT TO RULE 13A-14(A)

32.1 CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, Harris Preferred Capital Corporation has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized on the 14th day of August 2006.

/s/ PAUL R. SKUBIC

Paul R. Skubic
Chairman of the Board and President

/s/ PAMELA C. PIAROWSKI

Pamela C. Piarowski
Chief Financial Officer