

HARRIS PREFERRED CAPITAL CORP

Form 10-K

March 29, 2007

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

Form 10-K

**ANNUAL REPORT UNDER SECTION 13 or 15 (d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2006**

**Commission file number 1-13805
Harris Preferred Capital Corporation
(Exact name of registrant as specified in its charter)**

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

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

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

60603
(Zip Code)

**Registrant's telephone number, including area code:
(312) 461-2121
Securities registered pursuant to Section 12(b) of the Act:**

Title of Each Class	Name of Each Exchange on Which Registered
73/8% Noncumulative Exchangeable Preferred Stock, Series A, par value \$1.00 per share	New York Stock Exchange

**Securities registered pursuant to Section 12(g) of the Act:
None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

Note checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Exchange Act from their obligations under those Sections.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (229.405 of this chapter) is not contained herein, and will not be contained to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

The number of shares of Common Stock, \$1.00 par value, outstanding on March 29, 2007 was 1,000. No common equity is held by nonaffiliates.

Harris Preferred Capital Corporation

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PART I

Forward-Looking Information

Forward-looking statements contained in this Annual Report on Form 10-K (*Report*) of Harris Preferred Capital Corporation (the *Company*) may include certain forward-looking information, within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including (without limitation) statements with respect to the *Company*'s expectations, 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 *Risk Factors* below (Item 1A of this Report). The *Company* assumes no obligation to update any such forward-looking statements.

ITEM 1. BUSINESS

General

Harris Preferred Capital Corporation is a Maryland corporation incorporated on September 24, 1997, pursuant to the Maryland General Corporation Law. The *Company*'s principal business objective is to acquire, hold, finance and manage qualifying real estate investment trust (*REIT*) assets (the *Mortgage Assets*), consisting of mortgage-backed securities, notes issued by Harris N.A. (the *Bank*) secured by Securing Mortgage Loans (defined below) and other obligations secured by real property, as well as certain other qualifying *REIT* assets. The *Company*'s assets are held in a Maryland real estate investment trust subsidiary, Harris Preferred Capital Trust. The *Company* has elected to be treated as a *REIT* under the Internal Revenue Code of 1986 (the *Code*), and will generally not be subject to federal income tax if it distributes 90% of its adjusted *REIT* ordinary taxable income and meets all of the qualifications necessary to be a *REIT*. All of the shares of the *Company*'s common stock, par value \$1.00 per share (the *Common Stock*), are owned by Harris Capital Holdings, Inc. (*HCH*), a wholly-owned subsidiary of the *Bank*. The *Company* was formed by the *Bank* to provide investors with the opportunity to invest in residential mortgages and other real estate assets and to provide the *Bank* with a cost-effective means of raising capital for federal regulatory purposes.

On February 11, 1998, the *Company*, through a public offering (the *Offering*), issued 10,000,000 shares of its 73/8% Noncumulative Exchangeable Preferred Stock, Series A (the *Preferred Shares*), \$1.00 par value. The *Offering* raised \$250 million less \$7.9 million of underwriting fees. The *Preferred Shares* are traded on the New York Stock Exchange under the symbol *HBC Pr A* . Holders of *Preferred Shares* are entitled to receive, if declared by the *Company*'s Board of Directors, noncumulative dividends at a rate of 73/8% per annum of the \$25 per share liquidation preference (an amount equivalent to \$1.8438 per share per annum). Dividends on the *Preferred Shares*, if authorized and declared, are payable quarterly in arrears on March 30, June 30, September 30 and December 30 of each year, provided that, if any Interest Payment Date would otherwise fall on a day that is not a Business Day the Interest Payment Date will be on the following Business Day. The *Preferred Shares* may be redeemed for cash at the option of the *Company*, in whole or in part, at any time and from time to time, at the principal amount thereof, plus the quarterly accrued and unpaid dividends, if any, thereon. The *Company* may not redeem the *Preferred Shares* without prior approval from the Office of the Comptroller of the Currency (the *OCC*) or the appropriate successor or other federal regulatory agency.

Each Preferred Share will be automatically exchanged (the Automatic Exchange) for one newly issued preferred share of the Bank (Bank Preferred Share) in the event (i) the Bank becomes less than adequately capitalized under regulations established pursuant to the Federal Deposit Insurance Corporation Improvement Act of 1991, as amended, (ii) the Bank is placed into conservatorship or receivership, (iii) the OCC directs such

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exchange in writing because, in its sole discretion and even if the Bank is not less than adequately capitalized, the OCC anticipates that the Bank may become less than adequately capitalized in the near term, or (iv) the OCC in its sole discretion directs in writing an exchange in the event that the Bank has a Tier 1 risk-based capital ratio of less than 5% (each an Exchange Event). In the event of an exchange, the Bank Preferred Shares would constitute a new series of preferred shares of the Bank, would have the same dividend rights, liquidation preference, redemption options and other attributes as the Preferred Shares, except that the Bank Preferred Shares would not be listed on the New York Stock Exchange and would rank *pari passu* in terms of cash dividend payments and liquidation preference with any outstanding shares of preferred stock of the Bank.

Effective May 27, 2005, Harris Bankcorp, Inc., the Bank's parent company, consolidated 26 of its Illinois bank charters (including Harris Trust and Savings Bank) into one national bank charter, Harris N.A. Prior to that time and under the same conditions as described in the prior paragraph, each Preferred Share was automatically exchangeable for one newly issued preferred share of Harris Trust and Savings Bank, which was subject to regulation by the Board of Governors of the Federal Reserve System. References herein to the Bank for those times prior to the charter consolidation are intended to refer to its predecessor, Harris Trust and Savings Bank.

Concurrent with the issuance of the Preferred Shares, the Bank contributed additional capital of \$241 million, net of acquisition costs, to the Company. The Company and the Bank undertook the Offering for two principal reasons: (i) the qualification of the Preferred Shares as Tier 1 capital of the Bank for U.S. banking regulatory purposes under relevant regulatory capital guidelines, as a result of the treatment of the Preferred Shares as a minority interest in a consolidated subsidiary of the Bank, and (ii) lack of federal income tax on the Company's earnings used to pay the dividends on the Preferred Shares, as a result of the Company's qualification as a REIT. On December 30, 1998, the Bank contributed the common stock of the Company to HCH, a newly-formed and wholly-owned subsidiary of the Bank. The Bank is an indirect wholly-owned U.S. subsidiary of Bank of Montreal. The Bank is required to maintain direct or indirect ownership of at least 80% of the outstanding Common Stock of the Company for as long as any Preferred Shares are outstanding.

The Company used the Offering proceeds and the additional capital contributed by the Bank to purchase \$356 million of notes (the Notes) from the Bank and \$135 million of mortgage-backed securities at their estimated fair value. The Notes are obligations issued by the Bank that are recourse only to the underlying mortgage loans (the Securing Mortgage Loans) and were acquired pursuant to the terms of a loan agreement with the Bank. The principal amount of the Notes equals approximately 80% of the principal amounts of the Securing Mortgage Loans.

Business

The Company was formed for the purpose of raising capital for the Bank. One of the Company's principal business objectives is to acquire, hold, finance and manage Mortgage Assets. These Mortgage Assets generate interest income for distribution to stockholders. A portion of the Mortgage Assets of the Company consists of Notes issued by the Bank that are recourse only to Securing Mortgage Loans that are secured by real property. The Notes mature on October 1, 2027 and pay interest at 6.4% per annum. Payments of interest are made to the Company from payments made on the Securing Mortgage Loans. Pursuant to an agreement between the Company and the Bank, the Company, through the Bank as agent, receives all scheduled payments made on the Securing Mortgage Loans, retains a portion of any such payments equal to the amount due on the Notes and remits the balance, if any, to the Bank. The Company also retains approximately 80% of any prepayments of principal in respect of the Securing Mortgage Loans and applies such amounts as a prepayment on the Notes. The Company has a security interest in the real property securing the Securing Mortgage Loans and will be entitled to enforce payment on the loans in its own name if a mortgagor should default. In the event of such default, the Company would have the same rights as the original mortgagee to foreclose the mortgaged property and satisfy the obligations of the Bank out of the proceeds.

The Company may from time to time acquire fixed-rate or variable-rate mortgage-backed securities representing interests in pools of mortgage loans. The Bank may have originated a portion of any such mortgage-backed securities by exchanging pools of mortgage loans for the mortgage-backed securities. The mortgage loans underlying the mortgage-backed securities will be secured by single-family residential properties located throughout the United States. The Company intends to acquire only investment grade mortgage-backed securities issued by

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agencies of the federal government or government sponsored agencies, such as the Federal Home Loan Mortgage Corporation (FHLMC), the Federal National Mortgage Association (Fannie Mae) and the Government National Mortgage Association (GNMA). The Company does not intend to acquire any interest-only, principal-only or similar speculative mortgage-backed securities.

The Bank may from time to time acquire or originate both conforming and nonconforming residential mortgage loans. Conventional conforming residential mortgage loans comply with the requirements for inclusion in a loan guarantee program sponsored by either FHLMC or Fannie Mae. Nonconforming residential mortgage loans are residential mortgage loans that do not qualify in one or more respects for purchase by Fannie Mae or FHLMC under their standard programs. The nonconforming residential mortgage loans that the Company purchases will be nonconforming because they have original principal balances which exceed the limits for FHLMC or Fannie Mae under their standard programs. The Company believes that all residential mortgage loans will meet the requirements for sale to national private mortgage conduit programs or other investors in the secondary mortgage market. As of December 31, 2006 and 2005 and for each of the years then ended, the Company did not directly hold any residential mortgage loans.

The Company may from time to time acquire commercial mortgage loans secured by industrial and warehouse properties, recreational facilities, office buildings, retail space and shopping malls, hotels and motels, hospitals, nursing homes or senior living centers. The Company's current policy is not to acquire any interest in a commercial mortgage loan if commercial mortgage loans would constitute more than 5% of the Company's Mortgage Assets at the time of its acquisition. Unlike residential mortgage loans, commercial mortgage loans generally lack standardized terms. Commercial real estate properties themselves tend to be unique and are more difficult to value than residential real estate properties. Commercial mortgage loans may also not be fully amortizing, meaning that they may have a significant principal balance or balloon payment due on maturity. Moreover, commercial properties, particularly industrial and warehouse properties, are generally subject to relatively greater environmental risks than non-commercial properties, generally giving rise to increased costs of compliance with environmental laws and regulations. There is no requirement regarding the percentage of any commercial real estate property that must be leased at the time the Bank acquires a commercial mortgage loan secured by such commercial real estate property, and there is no requirement that commercial mortgage loans have third party guarantees. The credit quality of a commercial mortgage loan may depend on, among other factors, the existence and structure of underlying leases, the physical condition of the property (including whether any maintenance has been deferred), the creditworthiness of tenants, the historical and anticipated level of vacancies and rents on the property and on other comparable properties located in the same region, potential or existing environmental risks, the availability of credit to refinance the commercial mortgage loan at or prior to maturity and the local and regional economic climate in general. Foreclosures of defaulted commercial mortgage loans are generally subject to a number of complicated factors, including environmental considerations, which are generally not present in foreclosures of residential mortgage loans. As of December 31, 2006 and 2005 and for each of the years then ended, the Company did not hold any commercial mortgage loans.

The Company may invest in assets eligible to be held by REITs other than those described above. In addition to commercial mortgage loans and mortgage loans secured by multi-family properties, such assets could include cash, cash equivalents and securities, including shares or interests in other REITs and partnership interests. At December 31, 2006, the Company held \$9.9 million of short-term money market assets and \$60 million of U.S. Treasury securities. At December 31, 2005, the Company held \$20.5 million of short-term money market assets and \$75 million of U.S. Treasury securities.

The Company intends to continue to acquire Mortgage Assets from the Bank and/or affiliates of the Bank on terms that are comparable to those that could be obtained by the Company if such Mortgage Assets were purchased from unrelated third parties. The Company may also from time to time acquire Mortgage Assets from unrelated third

parties.

The Company intends to maintain a substantial portion of its portfolio in Bank-secured obligations and mortgage-backed securities. The Company may, however, invest in other assets eligible to be held by a REIT. The Company's current policy and the Servicing Agreement (defined below) prohibit the acquisition of any Mortgage Asset constituting an interest in a mortgage loan (other than an interest resulting from the acquisition of mortgage-

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backed securities), which mortgage loan (i) is delinquent (more than 30 days past due) in the payment of principal or interest at the time of proposed acquisition; (ii) is or was at any time during the preceding 12 months (a) on nonaccrual status or (b) renegotiated due to financial deterioration of the borrower; or (iii) has been, more than once during the preceding 12 months, more than 30 days past due in payment of principal or interest. Loans that are on nonaccrual status are generally loans that are past due 90 days or more in principal or interest. The Company maintains a policy of disposing of any mortgage loan which (i) falls into nonaccrual status, (ii) has to be renegotiated due to the financial deterioration of the borrower, or (iii) is more than 30 days past due in the payment of principal or interest more than once in any 12 month period. The Company may choose, at any time subsequent to its acquisition of any Mortgage Assets, to require the Bank (as part of the Servicing Agreement) to dispose of the mortgage loans for any of these reasons or for any other reason.

The Bank services the Securing Mortgage Loans and the other mortgage loans purchased by the Company on behalf of, and as agent for, the Company and is entitled to receive fees in connection with the servicing thereof pursuant to a servicing agreement (the Servicing Agreement). The Bank receives a fee equal to 0.25% per annum on the principal balances of the loans serviced. Payment of such fees is subordinate to payments of dividends on the Preferred Shares. The Servicing Agreement requires the Bank to service the loans in a manner generally consistent with accepted secondary market practices, with any servicing guidelines promulgated by the Company and, in the case of residential mortgage loans, with Fannie Mae and FHLMC guidelines and procedures. The Servicing Agreement requires the Bank to service the loans solely with a view toward the interest of the Company and without regard to the interest of the Bank or any of its affiliates. The Bank will collect and remit principal and interest payments, administer mortgage escrow accounts, submit and pursue insurance claims and initiate and supervise foreclosure proceedings on the loans it services. The Bank may, with the approval of a majority of the Company's Board of Directors, as well as a majority of the Company's Independent Directors (as defined in Item 13 (c) below), subcontract all or a portion of its obligations under the Servicing Agreement to unrelated third parties. The Bank will not, in connection with the subcontracting of any of its obligations under the Servicing Agreement, be discharged or relieved in any respect from its obligations under the Servicing Agreement. The Company may terminate the Servicing Agreement upon the occurrence of such events as they relate to the Bank's proper and timely performance of its duties and obligations under the Servicing Agreement. As long as any Preferred Shares remain outstanding, the Company may not terminate, or elect to renew, the Servicing Agreement without the approval of a majority of the Company's Independent Directors (as defined in Item 13 (c) below).

The Bank administers the day-to-day operations of the Company, pursuant to an advisory agreement (the Advisory Agreement). The Bank is responsible for (i) monitoring the credit quality of Mortgage Assets held by the Company, (ii) advising the Company with respect to the reinvestment of income from and payments on, and with respect to the acquisition, management, financing and disposition of the Mortgage Assets held by the Company, and (iii) monitoring the Company's compliance with the requirements necessary to qualify as a REIT, and other financial and tax-related matters. The Bank may from time to time subcontract all or a portion of its obligations under the Advisory Agreement to one or more of its affiliates. The Bank may, with the approval of a majority of the Company's Board of Directors, as well as a majority of the Company's Independent Directors, subcontract all or a portion of its obligations under the Advisory Agreement to unrelated third parties. The Bank will not, in connection with the subcontracting of any of its obligations under the Advisory Agreement, be discharged or relieved in any respect from its obligations under the Advisory Agreement. The Advisory Agreement is renewed annually. The Company may terminate the Advisory Agreement at any time upon 60 days' prior written notice. As long as any Preferred Shares remain outstanding, any decision by the Company either to renew the Advisory Agreement or to terminate the Advisory Agreement must be approved by a majority of the Board of Directors, as well as by a majority of the Company's Independent Directors (as defined in Item 13 (c) below).

The Advisory Agreements in effect in 2006 and 2005 entitled the Bank to receive advisory fees of \$127 thousand and \$122 thousand, respectively.

The Company may from time to time purchase additional Mortgage Assets out of proceeds received in connection with the repayment or disposition of Mortgage Assets, the issuance of additional shares of Preferred Stock or additional capital contributions with respect to the Common Stock. The Company may also issue additional series of Preferred Stock. However, pursuant to the Articles of Amendment and Restatement of the Company (the Charter), the Company may not issue additional shares of Preferred Stock senior to the Series A

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Preferred Shares either in the payment of dividends or in the distribution of assets on liquidation without the consent of holders of at least 67% of the outstanding shares of Preferred Stock at that time or without approval of a majority of the Company's Independent Directors. The Company does not currently intend to issue any additional shares of Preferred Stock unless it simultaneously receives additional capital contributions from HCH or other affiliates sufficient to support the issuance of such additional shares of Preferred Stock.

Employees

As of December 31, 2006, the Company had no paid employees. All officers of the Company were employed by the Bank.

Environmental Matters

In the event that the Company is forced to foreclose on a defaulted Securing Mortgage Loan to recover its investment in such loan, the Company may be subject to environmental liabilities in connection with the underlying real property, which could exceed the value of the real property. Although the Company intends to exercise due diligence to discover potential environmental liabilities prior to the acquisition of any property through foreclosure, hazardous substances or wastes, contaminants, pollutants or sources thereof (as defined by state and federal laws and regulations) may be discovered on properties during the Company's ownership or after a sale thereof to a third party. If such hazardous substances are discovered on a property which the Company has acquired through foreclosure or otherwise, the Company may be required to remove those substances and clean up the property. There can be no assurance that in such a case the Company would not incur full recourse liability for the entire costs of any removal and clean-up, that the cost of such removal and clean-up would not exceed the value of the property or that the Company could recoup any of such costs from any third party. The Company may also be liable to tenants and other users of neighboring properties. In addition, the Company may find it difficult or impossible to sell the property prior to or following any such clean-up. The Company has not foreclosed on any Securing Mortgage Loans during 2006 and 2005.

Qualification as a REIT

The Company elected to be taxed as a REIT commencing with its taxable year ended December 31, 1998 and intends to comply with the provisions of the Code with respect thereto. The Company will not be subject to Federal income tax to the extent it distributes 90% of its adjusted REIT ordinary taxable income to stockholders and as long as certain assets, income and stock ownership tests are met. For 2006 as well as 2005, the Company met all Code requirements for a REIT, including the asset, income, stock ownership and distribution tests. Cash distributions in the amount of \$1.8438 per Preferred Share were declared in 2006 and 2005. Cash distributions in the amount of \$581 per share of Common Stock were declared on August 30, 2006 to the stockholder of record on September 1, 2006 and paid on November 14, 2006. The company made the election under Internal Revenue Code section 858 (a) to treat this distribution as having been made during 2005. Cash distributions in the amount of \$2,000 per share of Common Stock were declared to the stockholder of record on December 15, 2006 and paid on December 29, 2006. No cash dividends on common stock were paid in 2005.

ITEM 1A. RISK FACTORS

Set forth below and elsewhere in this Report and in other documents filed with the SEC (including the February 5, 1998 Prospectus (the "1998 Prospectus") for the Offering (SEC File No. 333-40257)), are risks and uncertainties with respect to the Company, the Preferred Shares and the Bank. This Report contains forward-looking statements that involve risks and uncertainties. The Company's actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include those discussed below.

Declining interest rates will reduce earnings of the Company

The Company's income will consist primarily of interest payments on the earning assets held by it. If there is a decline in interest rates during a period of time when the Company must reinvest payments of interest and principal

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in respect of its earning assets, the Company may find it difficult to purchase additional earning assets that generate sufficient income to support payment of dividends on the Preferred Shares.

Because the rate at which dividends, if, when and as authorized and declared, are payable on the Preferred Shares is fixed, there can be no assurance that an interest rate environment in which there is a decline in interest rates would not adversely affect the Company's ability to pay dividends on the Preferred Shares.

Dividends may not be authorized quarterly and dividends not authorized will not be paid

Dividends on the Preferred Shares are not cumulative. Consequently, if the Board of Directors does not authorize a dividend on the Preferred Shares for any quarterly period, the holders of the Preferred Shares would not be entitled to recover such dividend whether or not funds are or subsequently become available. Quarterly dividends may not always be paid on the Preferred Shares. The Board of Directors may determine, in its business judgment, that it would be in the best interests of the Company to pay less than the full amount of the stated dividend on the Preferred Shares or no dividend for any quarter, notwithstanding that funds are available. Factors that may be considered by the Board of Directors in making this determination are the Company's financial condition and capital needs, the impact of legislation and regulations as then in effect or as may be proposed, economic conditions, and such other factors as the Board of Directors may deem relevant. To remain qualified as a REIT, the Company must distribute annually at least 90% of its REIT taxable income (not including capital gains) to stockholders. See Tax Risks.

Automatic exchange for Bank Preferred Shares could occur when value of Bank Preferred Shares is impaired

An investment in the Preferred Shares involves risk with respect to the performance and capital levels of the Bank. A decline in the performance and capital levels of the Bank or the placement of the Bank into conservatorship or receivership could result in the automatic exchange of the Preferred Shares for Bank Preferred Shares, which would be an investment in the Bank and not in the Company. As a result, holders of Preferred Shares would become preferred stockholders of the Bank at a time when the Bank's financial condition was deteriorating or when the Bank had been placed into conservatorship or receivership. If an Exchange Event occurs, the Bank would likely be unable to pay dividends on the Bank Preferred Shares.

An investment in the Bank is also subject to certain risks that are distinct from the risks associated with an investment in the Company. For example, an investment in the Bank would involve risks relating to the capital levels of, and other federal regulatory requirements applicable to, the Bank, and the performance of the Bank's loan portfolio. An investment in the Bank is also subject to the general risks inherent in equity investments in depository institutions. In the event of a liquidation of the Bank, the claims of depositors and secured, senior, general and subordinated creditors of the Bank would be entitled to a priority of payment over the claims of holders of equity interests such as the Bank Preferred Shares. As a result, if the Bank were to be placed into receivership, the holders of the Bank Preferred Shares likely would receive, if anything, substantially less than they would have received had the Preferred Shares not been exchanged for Bank Preferred Shares.

Bank Preferred Shares will not be listed on any exchange and markets may not be liquid

Although the Preferred Shares are listed on the New York Stock Exchange, the Bank does not intend to apply for listing of the Bank Preferred Shares on any national securities exchange. Consequently, there can be no assurance as to the liquidity of the trading markets for the Bank Preferred Shares, if issued, or that an active public market for the Bank Preferred Shares would develop or be maintained.

Dividends and operations of the Company restricted by regulation

Because the Company is a subsidiary of the Bank, banking regulatory authorities will have the right to examine the Company and its activities. Under certain circumstances, including any determination that the Bank's relationship to the Company results in an unsafe and unsound banking practice, such regulatory authorities will have the authority to restrict the ability of the Company to transfer assets, to make distributions to its stockholders (including dividends to the holders of Preferred Shares, as described below), or to redeem shares of Preferred Stock,

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or even to require the Bank to sever its relationship with, or divest its ownership of, the Company. Such actions could potentially result in the Company's failure to qualify as a REIT.

Payment of dividends on the Preferred Shares could also be subject to regulatory limitations if the Bank became less than adequately capitalized for purposes of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Less than adequately capitalized is currently defined as having (i) a total risk-based capital ratio of less than 8.0%, (ii) a Tier 1 risk-based capital ratio of less than 4.0%, or (iii) a Tier 1 leverage ratio of less than 4.0% (or 3.0% under certain circumstances not currently applicable to the Bank). At December 31, 2006, the Bank's Total risk-based capital ratio was 11.49%, Tier 1 risk-based capital ratio was 9.69% and the Tier 1 leverage ratio was 8.06%.

If the Automatic Exchange occurs, the Bank would likely be unable to pay dividends on the Bank Preferred Shares. In all circumstances following the Automatic Exchange, the Bank's ability to pay dividends would be subject to various restrictions under applicable regulations. Furthermore, in the event the Bank is placed into conservatorship or receivership (whether before or after the Automatic Exchange), the Bank would be unable to pay dividends on the Bank Preferred Shares. In addition, in the event of a liquidation of the Bank, the claims of the Bank's depositors and of its secured, senior, general and subordinated creditors would be entitled to a priority of payment over the dividend and other claims of holders of equity interests such as the Bank Preferred Shares.

TAX RISKS

Adverse consequences of failure to qualify as a REIT

The Company intends to operate so as to qualify as a REIT under the Code. No assurance can be given that the Company will be able to continue to operate in a manner so as to qualify as a REIT. Qualification as a REIT involves the application of highly technical and complex Code provisions for which there are only limited judicial or administrative interpretations. The determination of various factual matters and circumstances, not entirely within the Company's control, may affect the Company's ability to continue to qualify as a REIT. Although the Company is not aware of any proposal in Congress to amend the tax laws in a manner that would materially and adversely affect the Company's ability to operate as a REIT, no assurance can be given that new legislation or new regulations, administrative interpretations or court decisions will not significantly change the tax laws in the future with respect to qualification as a REIT or the federal income tax consequences of such qualification.

If in any taxable year the Company fails to qualify as a REIT, the Company would not be allowed a deduction for distributions to stockholders in computing its taxable income and would be subject to federal income tax (including any applicable alternative minimum tax) on its taxable income at regular corporate rates. As a result, the amount available for distribution to the Company's stockholders including the holders of the Preferred Shares, would be reduced for the year or years involved. In addition, unless entitled to relief under certain statutory provisions, the Company would be disqualified from treatment as a REIT for the four taxable years following the year during which qualification was lost. A failure of the Company to qualify as a REIT would not necessarily give the Company the right to redeem the Preferred Shares, nor would it give the holders of the Preferred Shares the right to have their shares redeemed. Notwithstanding that the Company currently intends to operate in a manner designed to enable it to qualify as a REIT, future economic, market, legal, tax or other considerations may cause the Company to determine that it is in the best interest of the Company and the holders of its Common Stock and Preferred Stock to revoke the REIT election. As long as any Preferred Shares are outstanding, any such determination by the Company may not be made without the approval of a majority of the Independent Directors. The tax law prohibits the Company from electing treatment as a REIT for the four taxable years following the year of such revocation.

REIT requirements with respect to stockholder distributions

To qualify as a REIT under the Code, the Company generally will be required each year to distribute as dividends to its stockholders at least 90% of its REIT taxable income (excluding capital gains). Failure to comply with this requirement would result in the Company's income being subject to tax at regular corporate rates. In addition, the Company will be subject to a 4% nondeductible excise tax on the amount, if any, by which certain distributions considered as paid by it with respect to any calendar year are less than the sum of 85% of its ordinary income for the calendar year, 95% of its capital gains net income for the calendar year and any undistributed taxable

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income from prior periods. Under certain circumstances, banking regulatory authorities may restrict the ability of the Company, as a subsidiary of the Bank, to make distributions to its stockholders. Such a restriction could subject the Company to federal income and excise tax and result in the Company's failure to meet REIT requirements with respect to stockholder distributions.

Redemption upon occurrence of a Tax Event

At any time following the occurrence of a Tax Event (as defined under "Description of Series A Preferred Shares Redemption" in the 1998 Prospectus), the Company will have the right to redeem the Preferred Shares in whole but not in part. The occurrence of a Tax Event will not, however, give the holders of the Preferred Shares any right to have such shares redeemed.

Automatic exchange upon occurrence of the Exchange Event

Upon the occurrence of the Exchange Event, the outstanding Preferred Shares will be automatically exchanged on a one-for-one basis into Bank Preferred Shares. Assuming, as is anticipated to be the case, that the Bank Preferred Shares are nonvoting, the Automatic Exchange will be taxable, and each holder of Preferred Shares will have a gain or loss, as the case may be, measured by the difference between the basis of such holder in the Preferred Shares and the fair market value of the Bank Preferred Shares received in the Automatic Exchange. Assuming that such holder's Preferred Shares were held as capital assets prior to the Automatic Exchange, any gain or loss will be capital gain or loss.

Relationship with the Bank and its affiliates; conflicts of interest

The Bank and its affiliates are involved in virtually every aspect of the Company's existence. The Bank is the sole holder of the Common Stock of the Company and will administer the day-to-day activities of the Company in its role as Advisor under the Advisory Agreement. The Bank will also act as Servicer of the Mortgage Loans on behalf of the Company under the Servicing Agreement. In addition, other than the Independent Directors, all of the officers and directors of the Company are also officers and/or directors of the Bank and/or affiliates of the Bank. Their compensation is paid by the Bank, and they have substantial responsibilities in connection with their work as officers of the Bank. As the holder of all of the outstanding voting stock of the Company, the Bank will have the right to elect all directors of the Company, including the Independent Directors.

The Bank and its affiliates may have interests which are not identical to those of the Company. Consequently, conflicts of interest may arise with respect to transactions, including without limitation, future acquisitions of Mortgage Assets from the Bank and/or affiliates of the Bank; servicing of Mortgage Loans; future dispositions of Mortgage Assets to the Bank; and the renewal, termination or modification of the Advisory Agreement or the Servicing Agreement. It is the intention of the Company and the Bank that any agreements and transactions between the Company, on the one hand, and the Bank and/or its affiliates, on the other hand, are fair to all parties and consistent with market terms, including prices paid and received for the Initial Mortgage Assets, on the acquisition or disposition of Mortgage Assets by the Company or in connection with the servicing of Mortgage Loans. The requirement in the terms of the Preferred Shares that certain actions of the Company be approved by a majority of the Independent Directors is also intended to ensure fair dealings between the Company and the Bank and its affiliates. However, there can be no assurance that such agreements or transactions will be on terms as favorable to the Company as those that could have been obtained from unaffiliated third parties.

Risk of future revisions in policies and strategies by Board of Directors

The Board of Directors has established the investment policies and operating policies and strategies of the Company, all material aspects of which are described in this report. These policies may be amended or revised from time to time at the discretion of the Board of Directors (in certain circumstances subject to the approval of a majority of the Independent Directors) without a vote of the Company's stockholders, including holders of the Preferred Shares. The ultimate effect of any change in the policies and strategies of the Company on a holder of Preferred Shares may be positive or negative.

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Possible leverage

Although the Company does not currently intend to incur any indebtedness in connection with the acquisition and holding of Mortgage Assets, the Company may do so at any time (although indebtedness in excess of 25% of the Company's total stockholders' equity may not be incurred without the approval of a majority of the Independent Directors of the Company). To the extent the Company were to change its policy with respect to the incurrence of indebtedness, the Company would be subject to risks associated with leverage, including, without limitation, changes in interest rates and prepayment risk.

Additional issuances of preferred stock could have dilutive effect

The Charter of the Company authorizes 20,000,000 shares of Preferred Stock, 10,000,000 shares of which have been issued. The Company could issue additional preferred shares that rank equal to the Preferred Shares in the payment of dividends or in the distribution of assets on liquidation without the approval of the holders of the Preferred Shares. Such future issuances could have the effect of diluting the holders of the Preferred Shares.

RISK FACTORS RELATING TO THE BANK

Because of the possibility of the Automatic Exchange, an investment in Preferred Shares involves a high degree of risk with respect to the performance and capital levels of the Bank. Investors in the Preferred Shares should carefully consider the following risk factors and other considerations relating to the Bank before deciding whether to invest in such shares.

Possible adverse effects of economic conditions

Economic conditions beyond the Bank's control may have a significant impact on the Bank's operations, including changes in net interest income. Examples of such conditions include: (i) the strength of credit demand by customers; (ii) the introduction and growth of new investment instruments and transaction accounts by nonbank financial competitors; and (iii) changes in the general level of interest rates, including changes resulting from the monetary activities of the Board of Governors of the Federal Reserve System. Economic growth in the Bank's market areas is dependent upon the local economy. Adverse changes in the economy of the Chicago metropolitan area and other market areas would likely reduce the Bank's growth rate and could otherwise have a negative effect on its business, including the demand for new loans, the ability of customers to repay loans and the value of the collateral pledged as security therefor.

Increase in interest rates may adversely affect operating results

The Bank's operating results depend to a large extent on its net interest income, which is the difference between the interest the Bank receives from its loans, securities and other assets and the interest the Bank pays on its deposits and other liabilities. Interest rates are highly sensitive to many factors, including governmental monetary policies and domestic and international economic and political conditions. Conditions such as inflation, recession, unemployment, money supply, international disorders and other factors beyond the control of the Bank may affect interest rates. If generally prevailing interest rates increase, the net interest spread of the Bank, which is the difference between the rates of interest earned and the rates of interest paid by the Bank, is likely to contract, resulting in less net interest income. The Bank's liabilities have shorter terms and are more interest-sensitive than its assets. There can be no assurance that the Bank will be able to adjust its asset and liability positions sufficiently to offset any negative effect of changing market interest rates.

Competition

The Bank faces strong direct competition for deposits, loans and other financial services from other commercial banks, thrifts, credit unions, stockbrokers and finance divisions of auto and farm equipment companies. Some of the competitors are local, while others are statewide or nationwide. Several major multibank holding companies currently operate in the Chicago metropolitan area. Many of these financial institutions are larger than the Bank and have greater access to capital and other resources. Some of the financial institutions and financial services organizations with which the Bank competes are not subject to the same degree of regulation as that

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imposed on bank holding companies, and federally insured, state-chartered banks and national banks. As a result, such nonbank competitors have advantages over the Bank in providing certain services. The banking industry is undergoing rapid technological changes with frequent introductions of new technology-driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and enables financial institutions to reduce costs. The Bank's future success will depend in part on its ability to address the needs of its customers by using technology to provide products and services that will satisfy customer demands for convenience as well as to create additional efficiencies in the Bank's operations. Many of the Bank's competitors have greater resources to invest in technological improvements. There can be no assurance that the Bank will be able to effectively implement such products and services or be successful in marketing such products and services to its customers.

Government regulation

The Bank is subject to extensive federal and state legislation, regulation and supervision. Recently enacted, proposed and future legislation and regulations have had, will continue to have or may have significant impact on the financial services industry. Some of the legislative and regulatory changes may benefit the Bank; others, however, may increase its costs of doing business and assist competitors of the Bank. There can be no assurance that state or federal regulators will not, in the future, impose further restriction or limits on the Bank's activities.

ITEM 1B. *UNRESOLVED STAFF COMMENTS*

None.

ITEM 2. *PROPERTIES*

None as of December 31, 2006.

ITEM 3. *LEGAL PROCEEDINGS*

The Company is not currently involved in any material litigation nor, to the Company's knowledge is any material litigation currently threatened against the Company or the Bank other than routine litigation arising in the ordinary course of business. See Note 8 to Financial Statements.

ITEM 4. *SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS*

No matters were submitted to a vote of security holders during the fourth quarter of 2006.

PART II

ITEM 5. *MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES*

HCH presently owns all 1,000 shares of the common stock of the Company, which are not listed or traded on any securities exchange. On November 14, 2006 the Company paid a cash dividend of \$581 thousand (declared August 30, 2006), on the outstanding common shares to the stockholder of record on September 1, 2006. These dividends completed the 2005 REIT tax compliance requirements regarding income distributions. On December 29, 2006 the Company paid a cash dividend of \$2.0 million declared on November 30, 2006 on the outstanding common shares to the stockholder of record on December 15, 2006.

The Preferred Shares are traded on the New York Stock Exchange under the symbol HBC Pr A . During 2006, the Company declared \$18.4 million in preferred dividends and paid \$13.8 million to preferred stockholders. The remaining balance of \$4.6 million was paid on January 2, 2007. During 2005, the Company declared and paid cash dividends to preferred stockholders of approximately \$18.4 million. Although the Company declared cash dividends on the Preferred Shares for 2006 and 2005, no assurances can be made as to the declaration of, or if declared, the amount of, future distributions since such distributions are subject to the Company's financial condition and capital needs; the impact of legislation and regulations as then in effect or as may be proposed;

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economic conditions; and such other factors as the Board of Directors may deem relevant. Notwithstanding the foregoing, to remain qualified as a REIT, the Company must distribute annually at least 90% of its ordinary taxable income to preferred and /or common stockholders.

The Company did not purchase or redeem any common or preferred shares during 2006 or 2005.

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth selected financial data for the Company and should be read in conjunction with the Consolidated Financial Statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in this Report.

	For the Years Ended December 31				
	2006	2005	2004	2003	2002
	(In thousands, except per share data)				
Statement of Operations Data:					
Interest income	\$ 21,442	\$ 19,458	\$ 16,998	\$ 17,678	\$ 19,934
Non-interest income			1,062	4,158	2,677
Operating expenses:					
Loan servicing fees	23	31	44	70	131
Advisory fees	127	122	124	56	43
General and administrative	342	287	362	362	314
Total operating expenses	492	440	530	488	488
Net income	20,950	19,018	17,530	21,348	22,123
Preferred stock dividends	18,438	18,438	18,438	18,438	18,438
Net income available (loss allocated) to common stockholder	\$ 2,512	\$ 580	\$ (908)	\$ 2,910	\$ 3,685
Basic and diluted earnings (loss) per common share	\$ 2,512	\$ 580	\$ (908)	\$ 2,910	\$ 3,685
Distributions per preferred share	\$ 1.8438	\$ 1.8438	\$ 1.8438	\$ 1.8438	\$ 1.8438
Balance Sheet Data (end of period):					
Total assets	\$ 487,340	\$ 479,875	\$ 489,022	\$ 494,318	\$ 502,042
Total liabilities	\$ 4,731	\$ 129	\$ 134	\$ 84	\$ 96
Total stockholders' equity	\$ 482,609	\$ 479,746	\$ 488,888	\$ 494,234	\$ 501,946
Cash Flows Data:					
Operating activities	\$ 20,760	\$ 19,152	\$ 15,997	\$ 18,046	\$ 19,440
Investing activities	\$ 232	\$ (421)	\$ 2,826	\$ 3,120	\$ 2,440

Financing activities	\$ (16,408)	\$ (18,438)	\$ (19,342)	\$ (20,968)	\$ (21,658)
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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the Consolidated Financial Statements and notes thereto appearing later in this Report.

Summary

Year Ended December 31, 2006 Compared to December 31, 2005

The Company's net income for 2006 was \$20.9 million. This represented a 10% increase from 2005 net income of \$19.0 million. Earnings increased primarily because of higher interest income on earning assets.

Interest income on securities purchased under agreement to resell for the year ended December 31, 2006 was \$4.1 million on an average balance of \$71 million with an average yield of 4.7% compared to interest income of \$1.6 million on an average balance of \$65 million with an average yield of 3.0% for 2005. Interest income on the Notes for 2006 totaled \$466 thousand and yielded 6.4% on \$7.3 million of average principal outstanding compared to \$655 thousand and a 6.4% yield on \$10.2 million average principal outstanding for 2005. The decrease in interest income from the Notes was attributable to a reduction in the Note balance because of customer payoffs in the Securing Mortgage Loans. The average outstanding balance of the Securing Mortgage Loans was \$9 million for 2006 and \$13 million for 2005. Interest income on securities available-for-sale for 2006 was \$16.8 million, resulting in a yield of 4.4% on an average balance of \$382 million compared to interest income of \$17.2 million with a yield of 4.1% on an average balance of \$418 million for 2005. There were no Company borrowings during either year.

Operating expenses for the year ended December 31, 2006 totaled \$492 thousand compared to \$440 thousand a year ago. Loan servicing expenses for 2006 totaled \$23 thousand, a decrease of \$8 thousand or 26% from 2005. This decrease was attributable to the reduction in the principal balance of the Notes. Advisory fees for the year ended December 31, 2006 were \$127 thousand compared to \$122 thousand for the same period a year ago. General and administrative expenses totaled \$342 thousand for 2006 and \$287 thousand for 2005. The increase is partially due to higher costs for regulatory filings and prior year credits for printing and processing costs received in 2005.

On January 2, 2007, the Company paid a cash dividend of \$0.46094 per share on the outstanding Preferred Shares to the stockholders of record on December 15, 2006 as declared on November 30, 2006. On December 30, 2005, the Company paid a cash dividend of \$0.46094 per share on the outstanding Preferred Shares to the stockholders of record on December 15, 2005 as declared on December 2, 2005. For each of the full years, the Company declared \$18.4 million of dividends to holders of Preferred Shares for 2006 and 2005, respectively. On December 29, 2006, the Company paid a cash dividend of \$2 million declared on November 30, 2006 on the outstanding common shares to the stockholder of record on December 15, 2006. On November 14, 2006, the Company paid a cash dividend of \$581 thousand on the outstanding common shares to the stockholder of record on September 1, 2006. The Company made the election under Internal Revenue Code Section 858 (a) to treat this distribution as having been made during 2005.

At December 31, 2006 and 2005, there were no Securing Mortgage Loans on nonaccrual status and there was no allowance for loan losses.

Year Ended December 31, 2005 Compared to December 31, 2004

The Company's net income for 2005 was \$19 million. This represented an 8.5% increase from 2004 net income of \$17.5 million. Earnings increased primarily because of higher interest income on earning assets.

Interest income on securities purchased under agreement to resell for the year ended December 31, 2005 was \$1.6 million compared to \$1.1 million in 2004. Interest income on the Notes for 2005 totaled \$655 thousand and yielded 6.4% on \$10 million of average principal outstanding compared to \$907 thousand and a 6.4% yield on \$14 million average principal outstanding for 2004. The decrease in interest income from the Notes was attributable to a reduction in the Note balance because of customer payoffs in the Securing Mortgage Loans. The average outstanding balance of the Securing Mortgage Loans was \$13 million for 2005 and \$18 million for 2004. Interest income on securities available-for-sale for 2005 was \$17.2 million, resulting in a yield of 4.1% on an average

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balance of \$418 million compared to interest income of \$15.0 million with a yield of 4.3% on an average balance of \$353 million for 2004. The increase in interest income on securities available-for-sale was primarily attributable to an increase in the average mortgage-backed securities portfolio. There was \$1 million of gains recognized in 2004. There were no Company borrowings during either year.

Operating expenses for the year ended December 31, 2005 totaled \$440 thousand compared to \$530 thousand in 2004. Loan servicing expenses for 2005 totaled \$31 thousand, a decrease of \$13 thousand or 30% from 2004. This decrease was attributable to the reduction in the principal balance of the Notes. Advisory fees for the year ended December 31, 2005 were \$122 thousand compared to \$124 thousand for 2004. General and administrative expenses totaled \$287 thousand for 2005 and \$362 thousand for 2004. The decrease is partially due to reduced 10-K processing costs and legal costs.

On December 30, 2005, the Company paid a cash dividend of \$0.46094 per share on the outstanding Preferred Shares to the stockholders of record on December 15, 2005 as declared on December 2, 2005. On December 30, 2004, the Company paid a cash dividend of \$0.46094 per share on the outstanding Preferred Shares to the stockholders of record on December 15, 2004 as declared on December 2, 2004. For each of the full years, the Company declared and paid \$18.4 million of dividends to holders of Preferred Shares for 2005 and 2004, respectively. The company made the election under Internal Revenue Code section 858 (a) to treat these distributions as having been made during 2005 and 2004. No cash dividends on common stock were paid during 2005. For the year ended December 31, 2004 there were no common stock dividends declared for the 2004 tax year as there were no earnings available after payment of the preferred dividends. On September 13, 2004 the Company paid a cash dividend of \$904 thousand on the outstanding common shares to the stockholder of record on September 6, 2004. These common share dividends completed the Company's 2003 REIT tax compliance requirements.

At December 31, 2005 and 2004, there were no Securing Mortgage Loans on nonaccrual status and there was no allowance for loan losses.

Quarter Ended December 31, 2006 Compared to Quarter Ended December 31, 2005

The Company's net income for the fourth quarter of 2006 was \$5.4 million compared to \$4.8 million for the same period in 2005.

Interest income on securities available-for-sale for the current quarter was \$4.7 million resulting in a yield of 4.6% on an average balance of \$414 million, compared to interest income of \$4.1 million with a yield of 4.2% on an average balance of \$388 million for the same period a year ago. Interest income on securities purchased under agreement to resell for the current quarter was \$772 thousand on an average balance of \$46 million resulting in an average yield of 5.0% compared to interest income of \$734 thousand on an average balance of \$65 million with an average yield of 4.0% for the same period in the year-ago quarter.

There were no Company borrowings during the fourth quarter of 2006 or 2005.

Fourth quarter 2006 operating expenses totaled \$159 thousand, an increase of \$23 thousand from the fourth quarter of 2005. Advisory fees for the fourth quarter of 2006 were \$34 thousand compared to \$23 thousand in the prior year's fourth quarter due to increased costs for processing, recordkeeping and administration. General and administrative expenses totaled \$120 thousand in the current quarter compared to \$106 thousand for the same period in 2005, primarily due to increased costs for regulatory filings and processing charges.

Allowance for Loan Losses

The Company does not currently maintain an allowance for loan losses due to the over-collateralization of the Securing Mortgage Loans and the prior and expected credit performance of the collateral pool.

Concentrations of Credit Risk

A majority of the collateral underlying the Securing Mortgage Loans is located in Illinois. The financial viability of customers in this state is, in part, dependent on the state's economy. The collateral may be subject to a

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greater risk of default than other comparable loans in the event of adverse economic, political or business developments or natural hazards that may affect such region and the ability of property owners in such region to make payments of principal and interest on the underlying mortgages. The Company's maximum risk of accounting loss, should all customers in Illinois fail to perform according to contract terms and all collateral prove to be worthless, was approximately \$5 million at December 31, 2006 and \$7 million at December 31, 2005.

Interest Rate Risk

The Company's income consists primarily of interest payments on the Mortgage Assets and the securities it holds. If there is a decline in interest rates during a period of time when the Company must reinvest payments of interest and principal with respect to its Mortgage Assets and other interest earning assets, the Company may find it difficult to purchase additional earning assets that generate sufficient income to support payment of dividends on the Preferred Shares. Because the rate at which dividends, if, when and as authorized and declared, are payable on the Preferred Shares is fixed, there can be no assurance that an interest rate environment in which there is a decline in interest rates would not adversely affect the Company's ability to pay dividends on the Preferred Shares.

Competition

The Company does not engage in the business of originating mortgage loans. While the Company will acquire additional Mortgage Assets, it anticipates that such assets will be acquired from the Bank, affiliates of the Bank or unaffiliated parties. Accordingly, the Company does not expect to compete with mortgage conduit programs, investment banking firms, savings and loan associations, banks, thrift and loan associations, finance companies, mortgage bankers or insurance companies in acquiring its assets.

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 liquidity needs are to maintain the current portfolio size through the acquisition of additional qualifying assets and to pay dividends to its stockholders after satisfying obligations to creditors. The acquisition of additional qualifying assets is funded with the proceeds obtained from repayment of principal balances by individual mortgages or maturities of securities held for sale on a reinvested basis. The payment of dividends on the Preferred Shares will be made from legally available funds, principally arising from operating activities of the Company. The Company's cash flows from operating activities principally consist of the collection of interest on short term qualifying investments, the Notes and mortgage-backed securities. 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 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, short-term investments and mortgage-backed 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 Statement of Cash Flows, the primary sources of funds in addition to \$20.8 million provided from operations during 2006 were \$405.7 million from the maturities and sales of securities available-for-sale and \$10.6 million of sales proceeds from securities purchased from Harris N.A. under agreement to resell. In 2005, the primary sources of funds other than \$19.2 million provided from operations were \$254.5 million from the maturities and sales of securities available-for-sale. The primary uses of funds for 2006 were \$418.3 million in purchases of securities available-for-sale and \$13.8 and \$2.6 million in preferred stock dividends and common stock dividends paid, respectively. In 2005, the primary uses of funds were \$248.4 million in

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purchases of securities available-for-sale, \$18.4 in preferred stock dividends paid and \$10.0 million in purchases of securities from Harris N.A. under agreement to resell.

Accounting Pronouncements

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

The FASB issued SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans An Amendment of FASB Statements No. 87, 88, 106 and 132(R)*, in September 2006. The Statement requires recognition in the statement of condition of an asset for a plan s overfunded status or a liability for a plan s underfunded status and measurement of a plan s assets and obligations that determine its funded status as of fiscal year-end. The requirement to recognize the funded status of a benefit plan was effective for the Company as of December 31, 2006. The requirement to measure plan assets and obligations is effective for fiscal years ending after December 15, 2008. This should have no impact on the Company s financial position.

The FASB issued SFAS No. 157, *Fair Value Measurements*, in September 2006. The Statement provides guidance for using fair value to measure assets and liabilities. It clarifies the methods for measuring fair value, establishes a fair value hierarchy and requires expanded disclosure. SFAS 157 applies when other standards require or permit assets or liabilities to be measured at fair value and is effective for fiscal years beginning after November 15, 2007. The Company is in the process of assessing the impact of adopting this Statement on its financial position and results of operations, however the impact is not expected to be material.

The FASB issued FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109*, in July 2006. The Interpretation clarifies accounting for uncertainty in income taxes, prescribes a recognition threshold and measurement attribute for the tax position taken or expected to be taken in a tax return and provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is in the process of assessing the impact of adoption on its financial position and results of operations, however the impact is not expected to be material.

In September 2006, the SEC released Staff Accounting Bulletin, or SAB, No. 108, *Considering the Effects of Prior Year Misstatements When Quantifying Current Year Misstatements*, or SAB No. 108, to address diversity in practice regarding consideration of the effects of prior year errors when quantifying misstatements in current year financial statements. The SEC staff concluded that registrants should quantify financial statement errors using both a balance sheet approach and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB No. 108 states that if correcting an error in the current year materially affects the current year s income statement, the prior period financial statements must be restated. SAB No. 108 is effective for fiscal years ending after November 15, 2006. The adoption of SAB No. 108 in the fourth quarter of 2006 did not have an impact on our consolidated financial statements.

Other Matters

As of December 31, 2006, the Company believes that it is in full compliance with the REIT tax rules, and expects to qualify as a REIT under the provisions of the Code. The Company expects to meet all REIT requirements regarding the ownership of its stock and anticipates meeting the annual distribution requirements.

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ITEM 7A. *QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK*

As of December 31, 2006, the Company had \$6.5 million invested in Notes, a decrease of \$2.2 million from December 31, 2005. The decline was attributable to customer payoffs in the Securing Mortgage Loans. At December 31, 2006, the Company held \$404 million in mortgage-backed securities compared to \$374 million at December 31, 2005. At December 31, 2006, the Company held \$60 million in U.S. Treasuries compared to \$75 million at December 31, 2005. At December 31, 2006, the Company held an investment of \$9.9 million in securities purchased from the Bank under agreement to resell compared to \$20.5 million at December 31, 2005. The Company is subject to exposure for fluctuations in interest rates. Adverse changes in interest rates could impact negatively the value of mortgage-backed securities, as well as the levels of interest income to be derived from these assets.

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 prepayments, repurchases, defaults and liquidations), the pass-through rate and interest rate fluctuations. Changes in interest rates could impact 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.

The Company currently has no outstanding borrowings.

ITEM 8. *FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA*

Refer to the Index to Consolidated Financial Statements for the required information.

ITEM 9. *CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE*

There have been no disagreements with accountants on any matter of accounting principles, practices or financial statement disclosure.

ITEM 9A. *CONTROLS AND PROCEDURES*

As of December 31, 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 for the Company required to be included in this Report has been made known to them in a timely fashion. There were no changes in the Company's internal controls over financial reporting identified in connection with such evaluations that occurred during the quarter ended December 31, 2006 that have materially affected or are reasonably likely to materially affect, the Company's internal control over financial reporting.

ITEM 9B. *OTHER INFORMATION*

Not applicable.

PART III

ITEM 10. *DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE*

The Company's Board of Directors consists of five members. The Company does not anticipate that it will require any additional employees because it has retained the Bank to perform certain functions pursuant to the Advisory Agreement described above. Each officer of the Company currently is also an officer of the Bank and/or affiliates of the Bank. The Company maintains corporate records and audited financial statements that are separate from those of the Bank or any of the Bank's affiliates. None of the officers, directors or employees of the Company will have a direct or indirect pecuniary interest in any Mortgage Asset to be acquired or disposed of by the Company or in any transaction in which the Company has an interest or will engage in acquiring, holding and managing Mortgage Assets.

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Pursuant to terms of the Preferred Shares, the Company's Independent Directors will consider the interests of the holders of both the Preferred Shares and the Common Stock in determining whether any proposed action requiring their approval is in the best interests of the Company.

The persons who are directors and executive officers of the Company are as follows:

Name	Age	Position and Offices Held
Paul R. Skubic	58	Chairman of the Board, President
Pamela C. Piarowski	47	Chief Financial Officer
Frank M. Novosel	60	Treasurer, Director
Teresa L. Patton	59	Vice President of Operations
Margaret M. Sulkin	48	Assistant Treasurer
Delbert J. Wacker	75	Director
David J. Blockowicz	64	Director
Forrest M. Schneider	59	Director

The following is a summary of the business experience of the executive officers and directors of the Company:

Mr. Skubic has been Vice President and Controller of the Bank and Chief Accounting Officer for Harris Bankcorp, Inc. and the Bank since 1990. Prior to joining Harris Bankcorp, Inc., Mr. Skubic was employed by Arthur Andersen & Co. He is a certified public accountant.

Ms. Piarowski, has been Chief Financial Officer of the Company since May 31, 2006, although she previously served as Chief Financial Officer of the Company and Senior Vice-President and Chief Financial Officer of Harris Bankcorp, Inc. from June 2001 through July 2003. In 2003, she was appointed Vice-President, Financial Performance Management Bank of Montreal. In April, 2006 she was appointed Vice-President and Chief Financial Officer, BMO US.

Mr. Novosel has been a Vice President in the Treasury Group of the Bank since 1995. Previously, he served as Treasurer of Harris Bankcorp, Inc., managing financial planning. Mr. Novosel is a Chartered Financial Analyst and a member of the CFA Society of Chicago.

Ms. Patton has been a Vice President in Residential Mortgages at the Bank for 16 years and is currently the Director of Secondary Marketing. Prior to this position she was the Manager of Sales and Delivery for the Residential Mortgage Division. She has been employed by the Bank for over 29 years holding positions in Consumer and Commercial Banking.

Ms. Sulkin has been a Vice President in the Taxation Department of the Bank since 1992. Ms. Sulkin has been employed by the Bank since 1984. Prior to joining the Bank, she was employed by KPMG LLP. She is a certified public accountant.

Mr. Wacker retired as a partner from Arthur Andersen & Co. in 1987 after 34 years. From July 1988 to November 1990, he was Vice President -Treasurer, Parkside Medical Services, a subsidiary of Lutheran General Health System. From November 1990 to September 1993, he completed various financial consulting projects for Lutheran General.

Mr. Blockowicz is a certified public accountant and is a partner with Blockowicz & Tognocchi LLC. Prior to forming his firm, Mr. Blockowicz was a partner with Arthur Andersen & Co. through 1990.

Mr. Schneider is President and Chief Executive Officer of Lane Industries, Inc. Mr. Schneider is a director of Lane Industries. He has been employed by Lane Industries since 1976. He is a graduate of the University of Illinois where he received his B.S. and masters degree in finance.

Independent Directors

The terms of the Preferred Shares require that, as long as any Preferred Shares are outstanding, certain actions by the Company be approved by a majority of the Company's Independent Directors (as defined in Item 13

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(c) below). Delbert J. Wacker, David J. Blockowicz and Forrest M. Schneider are the Company's Independent Directors.

If at any time the Company fails to declare and pay a quarterly dividend payment on the Preferred Shares, the number of directors then constituting the Board of Directors of the Company will be increased by two at the Company's next annual meeting and the holders of Preferred Shares, voting together with the holders of any other outstanding series of Preferred Stock as a single class, will be entitled to elect two additional directors to serve on the Company's Board of Directors. Any member of the Board of Directors elected by holders of the Company's Preferred Shares will be deemed to be an Independent Director for purposes of the actions requiring the approval of a majority of the Independent Directors.

Audit Committee

The Board of Directors of the Company has established an audit committee, with an approved Audit Committee Charter, which will review the engagement of independent accountants and review their independence. The audit committee will also review the adequacy of the Company's internal accounting controls. The audit committee is comprised of Delbert J. Wacker, David J. Blockowicz and Forrest M. Schneider. The Company's Board of Directors has determined that each member of the audit committee is an audit committee financial expert as defined in rules of the Securities and Exchange Commission. Each audit committee member is independent as defined in rules of the New York Stock Exchange.

Compensation of Directors and Officers

The Company pays the Independent Directors (as defined in Item 13 (c) below) fees for their services as directors. The Independent Directors receive annual compensation of \$12,000 plus a fee of \$1,000 for each attendance (in person or by telephone) at each meeting of the Board of Directors or the audit committee.

The Company has adopted a code of ethics for its senior officers which is filed as an Exhibit hereto.

Section 16(a) Beneficial Ownership Reporting Compliance

Based on a review of reports filed with respect to the year ended December 31, 2006, the Company believes that all ownership reports were filed on a timely basis.

ITEM 11. EXECUTIVE COMPENSATION

The Company has not paid and does not currently intend to pay any compensation to its officers or employees or to directors who are not Independent Directors.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

(a) Security ownership of certain beneficial owners

No person owns of record or is known by the Company to own beneficially more than 5% of the outstanding 73/8% Noncumulative Exchangeable Preferred Stock, Series A.

(b) Security Ownership of Management

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The following table shows the ownership as of March 1, 2007 of 73/8% Noncumulative Exchangeable Preferred Stock, Series A, by the officers or directors who own any such shares.

Title of Class	Name of Beneficial Owner	Amount of Beneficial Ownership	Percent of Class
Preferred Stock	Paul R. Skubic	1,300 Shares	.013 %
Preferred Stock	Forrest Schneider	2,200 Shares	.022 %
Preferred Stock	David J. Blockowicz	1,000 Shares	.01 %

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ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

(a) Transactions with Related Persons

The Bank, through its wholly-owned subsidiary, HCH, indirectly owns 100% of the common stock of the Company. Paul R. Skubic, Chairman of the Board of the Company, and all of its executive officers, Pamela C. Piarowski, Frank M. Novosel, Teresa L. Patton and Margaret M. Sulkin, are also officers of the Bank

A substantial portion of the assets of the Company initially consisted of Notes issued by the Bank. The Notes mature on October 1, 2027 and pay interest at 6.4% per annum. During 2006, the Company received repayments on the Notes of \$2 million compared to 2005 repayments of \$3 million. In years ended December 31, 2006, 2005 and 2004, the Bank paid interest on the Notes in the amount of \$466 thousand, \$655 thousand and \$907 thousand, respectively, to the Company.

The Company purchases U.S. Treasury and Federal agency securities from the Bank under agreements to resell identical securities. At December 31, 2006, the Company held \$9.9 million of such assets and had earned \$4.1 million of interest from the Bank during 2006. At December 31, 2005, the Company held \$20.5 million of such assets and earned \$1.6 million of interest for 2005. The Company receives rates on these assets comparable to the rates that the Bank offers to unrelated counterparties under similar circumstances.

The Bank and the Company have entered into a Servicing Agreement and an Advisory Agreement, the terms of which are described in further detail on page 5 of this Report. In 2006, the Bank received payments of \$23 thousand and \$127 thousand, respectively, compared to \$31 thousand and \$122 thousand for 2005, under the terms of these agreements.

(b) Review, Approval or Ratification of Transactions with Related Persons

The terms of the Preferred Shares require that, as long as any Preferred Shares are outstanding, certain actions by the Company, including transactions with the Bank and other related persons, be approved by a majority of the Independent Directors (as defined in the following paragraph).

(c) Director Independence

The Charter of the Company defines an Independent Director as one who is not a current officer or employee of the company or a current director, officer or employee of the Bank or of its affiliates.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

Audit Fees

For the year ended December 31, 2006, the Company's principal accountant billed \$57 thousand for the audit of the Company's annual financial statements and review of financial statements included in Form 10-Q filings. For the year ended December 31, 2005, the Company's principal accountant billed \$58 thousand for the audit of the Company's annual financial statements and review of financial statements included in Form 10-Q filings.

Audit-Related Fees

There were no fees billed for services reasonably related to the performance of the audit or review of the Company's financial statements outside of those fees disclosed above under "Audit Fees" for the years ended December 31, 2006 and 2005.

Tax Fees

There were no fees billed for tax-related services for the years ended December 31, 2006 and 2005.

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All Other Fees

There were no other fees billed to the Company by the Company's principal accountants other than those disclosed above for the years ended December 31, 2006 and 2005.

Pre-Approval Policies and Procedures

Prior to engaging accountants to perform a particular service, the Board of Directors obtains an estimate for the service to be performed. All of the services described above were approved by the audit committee and Board of Directors in accordance with its procedures.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) Documents filed with Report:

- (1) Consolidated Financial Statements (See page 22 for a listing of all financial statements included in Item 8)
- (2) Financial Statement Schedules

All schedules normally required by Form 10-K are omitted since they are either not applicable or because the required information is shown in the financial statements or notes thereto.

(3) Exhibits:

- *3(a)(I) Articles of Incorporation of the Company
- *3(a)(ii) Form of Articles of Amendment and Restatement of the Company establishing the Series A Preferred Shares
- *3(b) Bylaws of the Company
- *4 Specimen of certificate representing Series A Preferred Shares
- *10(a) Form of Servicing Agreement between the Company and the Bank
- *10(b) Form of Advisory Agreement between the Company and the Bank
- *10(c) Form of Bank Loan Agreement between the Company and the Bank
- *10(d) Form of Mortgage Loan Assignment Agreement between the Company and the Bank
- 14 Code of Ethics for Senior Officers (Incorporated by reference to Exhibit 14 to the Company's Annual Report on Form 10-K for the year ended December 31, 2003)
- 24 Power of attorney
- 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

* Incorporated by reference to the exhibit of the same number filed with the Company's Registration Statement on Form S-11 (Securities and Exchange Commission file number 333-40257)

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Index to Consolidated Financial Statements

The following consolidated financial statements are included in Item 8 of this Annual Report on Form 10-K:

Harris Preferred Capital Corporation

Consolidated Financial Statements

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets

Consolidated Statements of Income and Comprehensive Income

Consolidated Statements of Changes in Stockholders' Equity

Consolidated Statements of Cash Flows

Notes to Consolidated Financial Statements

Harris N.A.

Financial Review

Consolidated Financial Statements

Report of Independent Registered Public Accounting Firm

Consolidated Statements of Condition

Consolidated Statements of Income

Consolidated Statements of Comprehensive Income

Consolidated Statements of Changes in Stockholders' Equity

Consolidated Statements of Cash Flows

Notes to Consolidated Financial Statements

All schedules are omitted since the required information is not present or is not present in amounts sufficient to require submission of the schedule or because the information required is included in the consolidated financial statements and notes hereof.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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 29th day of March 2007.

/s/ PAUL R. SKUBIC

Paul R. Skubic

Chairman of the Board and President

/s/ PAMELA C. PIAROWSKI

Pamela C. Piarowski

Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by Paul R. Skubic, Chairman of the Board and President of the Company, as attorney-in-fact for the following Directors on behalf of Harris Preferred Capital Corporation of the 29th day of March 2007.

David J. Blockowicz

Frank M. Novosel

Forrest M. Schneider

Delbert J. Wacker

Paul R. Skubic

Attorney-In-Fact

Supplemental Information

No proxy statement will be sent to security holders in 2007.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and Board of Directors
of Harris Preferred Capital Corporation

We have audited the accompanying consolidated balance sheets of Harris Preferred Capital Corporation and subsidiary (the Company) as of December 31, 2006 and 2005, and the related consolidated statements of operations and comprehensive income, changes in stockholders' equity, and cash flows for each of the years in the three year period ended December 31, 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the years in the three year period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

Chicago, Illinois
March 15, 2007

Table of Contents**Harris Preferred Capital Corporation****Consolidated Balance Sheets**

	December 31	
	2006	2005
	(In thousands, except share data)	
ASSETS		
Cash on deposit with Harris N.A.	\$ 5,284	\$ 700
Securities purchased from Harris N.A. under agreement to resell	9,854	20,500
Notes receivable from Harris N.A.	6,512	8,684
Securities available-for-sale:		
Mortgage-backed	404,075	373,584
U.S. Treasury	59,948	74,921
Other assets	1,667	1,486
Total assets	\$ 487,340	\$ 479,875
LIABILITIES AND STOCKHOLDERS EQUITY		
Accrued expenses	\$ 120	\$ 129
Preferred dividends payable	4,611	
Total liabilities	\$ 4,731	\$ 129
Commitments and contingencies		
Stockholders Equity		
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
Common stock (\$1 par value); 1,000 shares authorized, issued and outstanding	1	1
Additional paid-in capital	240,733	240,733
Distributions in excess of earnings	(71)	(2)
Accumulated other comprehensive loss net unrealized losses on available-for-sale securities	(8,054)	(10,986)
Total stockholders equity	482,609	479,746
Total liabilities and stockholders equity	\$ 487,340	\$ 479,875

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**

	For the Years Ended December 31		
	2006	2005	2004
	(In thousands, except share data)		
Interest income:			
Securities purchased from Harris N.A. under agreement to resell	\$ 4,132	\$ 1,618	\$ 1,060
Notes receivable from Harris N.A.	466	655	907
Securities available-for-sale:			
Mortgage-backed	16,475	17,097	14,973
U.S. Treasury	369	88	58
Total interest income	21,442	19,458	16,998
Non-interest income:			
Gain on sale of securities			1,062
			1,062
Operating expenses:			
Loan servicing fees paid to Harris N.A.	23	31	44
Advisory fees paid to Harris N.A.	127	122	124
General and administrative	342	287	362
Total operating expenses	492	440	530
Net income	20,950	19,018	17,530
Preferred stock dividends	18,438	18,438	18,438
Net income available (loss allocated) to common stockholder	\$ 2,512	\$ 580	\$ (908)
Basic and diluted earnings (loss) per common share	\$ 2,512	\$ 580	\$ (908)
Net income	\$ 20,950	\$ 19,018	\$ 17,530
Other comprehensive income (loss) net unrealized gains (losses) on available-for-sale securities	2,932	(9,722)	(3,534)
Comprehensive income	\$ 23,882	\$ 9,296	\$ 13,990

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
For the Years Ended December 31, 2006, 2005 and 2004**

	Preferred Stock	Common Stock	Additional Paid-in Capital (In thousands except per share data)	(Distributions in Excess of Earnings) in Excess of Distributions	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balance at December 31, 2003	\$ 250,000	\$ 1	\$ 240,733	\$ 1,230	\$ 2,270	\$ 494,234
Net income				17,530		17,530
Other comprehensive loss					(3,534)	(3,534)
Dividends declared on common stock (\$904 per share)				(904)		(904)
Dividends declared on preferred stock (\$1.8438 per share)				(18,438)		(18,438)
Balance at December 31, 2004	\$ 250,000	\$ 1	\$ 240,733	\$ (582)	\$ (1,264)	\$ 488,888
Net income				19,018		19,018
Other comprehensive loss					(9,722)	(9,722)
Dividends declared on preferred stock (\$1.8438 per share)				(18,438)		(18,438)
Balance at December 31, 2005	\$ 250,000	\$ 1	\$ 240,733	\$ (2)	\$ (10,986)	\$ 479,746
Net income				20,950		20,950
Other comprehensive income					2,932	2,932
Dividends declared on common stock (\$2,581.00 per share)				(2,581)		(2,581)
Dividends declared on preferred stock (\$1.8438 per share)				(18,438)		(18,438)

Balance at December 31, 2006	\$ 250,000	\$ 1	\$ 240,733	\$	(71)	\$	(8,054)	\$	482,609
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The accompanying notes are an integral part of these financial statements.

Table of Contents**Harris Preferred Capital Corporation****Consolidated Statements of Cash Flows**

	For the Years Ended December 31		
	2006	2005	2004
	(In thousands)		
Operating Activities:			
Net income	\$ 20,950	\$ 19,018	\$ 17,530
Adjustments to reconcile net income to net cash provided by operating activities:			
Gain on sale of securities			(1,062)
Net (increase) decrease in other assets	(181)	139	(521)
Net (decrease) increase in accrued expenses	(9)	(5)	50
Net cash provided by operating activities	20,760	19,152	15,997
Investing Activities:			
Net decrease (increase) in securities purchased from Harris N.A. under agreement to resell	10,646	(10,000)	1,000
Repayments of notes receivable from Harris N.A.	2,172	3,445	4,418
Decrease in securing mortgage collections due from Harris N.A.		53	336
Purchases of securities available-for-sale	(418,311)	(248,441)	(676,706)
Proceeds from sales of securities available-for-sale			51,458
Proceeds from maturities/redemptions of securities available-for-sale	405,725	254,522	622,320
Net cash provided by (used in) investing activities	232	(421)	2,826
Financing Activities:			
Cash dividends paid on preferred stock	(13,827)	(18,438)	(18,438)
Cash dividends paid on common stock	(2,581)		(904)
Net cash used in financing activities	(16,408)	(18,438)	(19,342)
Net increase (decrease) in cash on deposit with Harris N.A.	4,584	293	(519)
Cash on deposit with Harris N.A. at beginning of year	700	407	926
Cash on deposit with Harris N.A. at end of year	\$ 5,284	\$ 700	\$ 407

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

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Harris Preferred Capital Corporation

Notes to Consolidated Financial Statements

1. Organization and 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. The Company holds its assets through a Maryland real estate investment trust subsidiary, Harris Preferred Capital Trust. The Company has elected to be a REIT under sections 856 through 860 of the Internal Revenue Code of 1986, as amended (the Code), and will generally not be subject to Federal income tax to the extent that it meets all of the REIT requirements in the Code Sections 856-860. All of the 1,000 shares of the Company's common stock, par value \$1.00 per share (the Common Stock), are owned by Harris Capital Holdings, Inc. (HCH), a wholly-owned subsidiary of the Bank. On December 30, 1998, the Bank transferred its ownership of the common stock of the Company to HCH. The Bank is required to maintain direct or indirect ownership of at least 80% of the outstanding Common Stock of the Company for as long as any 73/8% Noncumulative Exchangeable Preferred Stock, Series A (the Preferred Shares), \$1.00 par value, is outstanding. The Company was formed to provide the opportunity to invest in residential mortgages and other real estate assets and to provide the Bank with a cost-effective means of raising capital for federal regulatory purposes.

On February 11, 1998, the Company completed an initial public offering (the Offering) of 10,000,000 shares of the Company's Preferred Shares, receiving proceeds of \$242,125,000, net of underwriting fees. The Preferred Shares are traded on the New York Stock Exchange. Concurrent with the issuance of the Preferred Shares, the Bank contributed additional capital of \$250 million to the Company.

2. Summary of Significant Accounting Policies

Cash and Cash Equivalents

Cash and cash equivalents include cash on deposit with the Bank.

Allowance for Probable Loan Losses

The allowance for probable loan losses is maintained at a level considered adequate to provide for probable loan losses. The allowance is increased by provisions charged to operating expense and reduced by net charge-offs. Known losses of principal on impaired loans are charged off. The provision for loan losses is based on past loss experience, management's evaluation of the loan portfolio securing the Mortgage Assets under current economic conditions and management's estimate of anticipated, but as yet not specifically identified, loan losses. Such estimates are reviewed periodically and adjustments, if necessary, are recorded during the periods in which they become known. At December 31, 2006 and 2005, no allowance for probable loan losses was recorded under this policy.

Income Taxes

The Company has elected to be taxed as a REIT commencing with its taxable year ended December 31, 1998 and intends to comply with the provisions of the Code with respect thereto. The Company does not expect to be subject to Federal income tax because assets, income distribution and stock ownership tests in Code Sections 856-860 are met. Accordingly, no provision for income taxes is included in the accompanying financial statements.

The REIT Modernization Act, which took effect on January 1, 2001, modified certain provisions of the Code with respect to the taxation of REITs. A key provision of this tax law change reduced the required level of distributions by a REIT from 95% to 90% of ordinary taxable income.

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Harris Preferred Capital Corporation

Notes to Consolidated Financial Statements (Continued)

Securities

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.

Interest income on securities, including amortization of discount or premium on an effective yield basis, is included in earnings. Realized gains and losses, as a result of securities sales, are included in gain on sale of securities in the consolidated statement of income, with the cost of securities sold determined on the specific identification basis.

The Company purchases U.S. Treasury and Federal agency securities from the Bank under agreements to resell identical securities. The amounts advanced under these agreements represent short-term assets and are reflected as securities purchased under agreement to resell in the consolidated balance sheet. Securities purchased under agreement to resell totaled \$9.9 million at December 31, 2006 compared to \$20.5 million at December 31, 2005. The securities underlying the agreements are book-entry securities. Securities are transferred by appropriate entry into the Company's account with the Bank under a written custodial agreement with the Bank that explicitly recognizes the Company's interest in these securities.

The Company's investment securities are exposed to various risks such as interest rate, market and credit. Due to the level of risk associated with certain investment securities and the level of uncertainty related to changes in the value of investment securities, it is at least reasonably possible that changes in risks in the near term would materially affect the carrying value of investments in securities available-for-sale currently reported in the consolidated balance sheet.

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.

New Accounting Pronouncements

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

The FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - An Amendment of FASB Statements No. 87, 88, 106 and 132(R)*, in September 2006. The Statement requires recognition in the statement of condition of an asset for a plan's overfunded status or a liability for a plan's underfunded status and measurement of a plan's assets and obligations that determine its funded status as of fiscal year-end. The requirement to recognize the funded status of a benefit plan was effective for the Bank as of December 31, 2006. The requirement to measure plan assets and obligations is effective for fiscal years ending after December 15, 2008. This should have no impact on the Company's financial position.

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Harris Preferred Capital Corporation

Notes to Consolidated Financial Statements (Continued)

The FASB issued SFAS No. 157, Fair Value Measurements, in September 2006. The Statement provides guidance for using fair value to measure assets and liabilities. It clarifies the methods for measuring fair value, establishes a fair value hierarchy and requires expanded disclosure. SFAS 157 applies when other standards require or permit assets or liabilities to be measured at fair value and is effective for fiscal years beginning after November 15, 2007. The Company is in the process of assessing the impact of adopting this Statement on its financial position and results of operations, however the impact is not expected to be material.

The FASB issued FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes—An Interpretation of FASB Statement No. 109, in July 2006. The Interpretation clarifies accounting for uncertainty in income taxes, prescribes a recognition threshold and measurement attribute for the tax position taken or expected to be taken in a tax return and provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is in the process of assessing the impact of adoption on its financial position and results of operations, however the impact is not expected to be material.

In September 2006, the SEC released Staff Accounting Bulletin, or SAB, No. 108, *Considering the Effects of Prior Year Misstatements When Quantifying Current Year Misstatements*, or SAB No. 108, to address diversity in practice regarding consideration of the effects of prior year errors when quantifying misstatements in current year financial statements. The SEC staff concluded that registrants should quantify financial statement errors using both a balance sheet approach and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material.

SAB No. 108 states that if correcting an error in the current year materially affects the current year's income statement, the prior period financial statements must be restated. SAB No. 108 is effective for fiscal years ending after November 15, 2006. The adoption of SAB No. 108 in the fourth quarter of 2006 did not have an impact on our consolidated financial statements.

Management's Estimates

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.

3. Notes Receivable from the Bank

On February 11, 1998, proceeds received from the Offering were used in part to purchase \$356 million of Notes at a rate of 6.4%. The Notes are secured by mortgage loans originated by the Bank. The principal amount of the Notes equals approximately 80% of the aggregate outstanding principal amount of the Securing Mortgage Loans. During 2006, the Company received repayments on the Notes of \$2.2 million compared to 2005 repayments of \$3.4 million. For years ended December 31, 2006, 2005 and 2004, the Bank paid interest on the Notes in the amount of \$466 thousand, \$655 thousand and \$907 thousand, respectively, to the Company.

The Notes are recourse only to the Securing Mortgage Loans that are secured by real property. The Notes mature on October 1, 2027. Payments of principal and interest on the Notes are recorded monthly from payments received on the Securing Mortgage Loans. The Company has a security interest in the real property securing the underlying mortgage loans and is entitled to enforce payment on the Securing Mortgage Loans in its own name if a mortgagor should default. In the event of default, the Company has the same rights as the original mortgagee to foreclose the mortgaged property and satisfy the obligations of the Bank out of the proceeds. The Securing Mortgage Loans are serviced by the Bank, as agent of the Company.

Table of Contents**Harris Preferred Capital Corporation****Notes to Consolidated Financial Statements (Continued)**

The Company intends that each mortgage loan securing the Notes will represent a first lien position and will be originated in the ordinary course of the Bank's real estate lending activities based on the underwriting standards generally applied (at the time of origination) for the Bank's own account. The Company also intends that all Mortgage Assets held by the Company will meet market standards, and servicing guidelines promulgated by the Company, and Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (FHLMC) guidelines and procedures.

The balance of Securing Mortgage Loans at December 31, 2006 and 2005 was \$8 million and \$11 million, respectively. The weighted average interest rate on those loans at December 31, 2006 and 2005 was 7.478% and 6.725%, respectively.

None of the Securing Mortgage Loans collateralizing the Notes were on nonaccrual status at December 31, 2006 or 2005.

A majority of the collateral securing the underlying mortgage loans is located in Illinois. The financial viability of customers in Illinois is, in part, dependent on that state's economy. The Company's maximum risk of accounting loss, should all customers in Illinois fail to perform according to contract terms and all collateral prove to be worthless, was approximately \$5 million at December 31, 2006 and \$7 million at December 31, 2005.

4. Securities

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

	December 31, 2006			Fair Value	December 31, 2005			Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses		Amortized Cost	Unrealized Gains	Unrealized Losses	
Available-for-Sale Securities								
Mortgage-backed	\$ 412,128	643	\$ 8,696	\$ 404,075	\$ 384,570		\$ 10,986	\$ 373,584
U.S. Treasury Bills	59,949		1	59,948	74,921			74,921
Total Securities	\$ 472,077	\$ 643	\$ 8,697	\$ 464,023	\$ 459,491	\$	\$ 10,986	\$ 448,505

The following table summarizes mortgage-backed securities with unrealized losses as of December 31, 2006 and 2005, the amount of the unrealized loss and the related fair value of the securities with unrealized losses. The unrealized losses have been further segregated by mortgage-backed securities that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 or more months. As of December 31, 2006 and 2005 there were 29 and 20 securities, respectively that were in a loss position for 12 or more months. Management believes that all of the unrealized losses are temporary, due to the

unrealized losses on investments in mortgage-backed securities and U.S. Treasuries being caused by interest rate increases. The contractual cash flows of these securities are guaranteed by a U.S. government-sponsored enterprise. It is expected that the securities would not be settled at a price less than the amortized cost of the investment. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the

Table of Contents**Harris Preferred Capital Corporation****Notes to Consolidated Financial Statements (Continued)**

Company has the ability and intent to hold these investments until a market price recovery or maturity, these investments are not considered other-than-temporarily impaired.

December 31, 2006

	Length of Continuous Unrealized Loss Position					
	Less Than 12 Months Unrealized		12 Months or Longer Unrealized		Total Unrealized	
	Fair Value	Loss	Fair Value	Losses	Fair Value	Losses
	(In thousands)					
U.S. Treasury bills	\$ 59,948	\$ 1	\$	\$	\$ 59,948	\$ 1
Mortgage-backed			309,534	8,696	309,534	8,696
Total	\$ 59,948	\$ 1	\$ 309,534	\$ 8,696	\$ 369,482	\$ 8,697

December 31, 2005

	Length of Continuous Unrealized Loss Position					
	Less Than 12 Months Unrealized		12 Months or Longer Unrealized		Total Unrealized	
	Fair Value	Losses	Fair Value	Losses	Fair Value	Losses
	(In thousands)					
Mortgage-backed	\$ 89,256	\$ 1,791	\$ 284,328	\$ 9,195	\$ 373,584	\$ 10,986

The amortized cost and estimated fair value of total available-for-sale securities at December 31, 2006, by contractual maturity, are shown below. Expected maturities can differ from contractual maturities since borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	December 31, 2006	
	Amortized Cost	Fair Value
Maturities:		
Within 1 year	\$ 59,949	\$ 59,948
1 to 5 years	89,677	88,087

5 to 10 years	47,669	46,468
Over 10 years	274,782	269,520
Total Securities	\$ 472,077	\$ 464,023

5. Common and Preferred Stock

On February 11, 1998, the Company issued 10,000,000 Preferred Shares, Series A, at a price of \$25 per share pursuant to its Registration Statement on Form S-11. Proceeds from this issuance, net of underwriting fees, totaled \$242,125,000. The liquidation value of each Preferred Share is \$25 plus any authorized, declared and unpaid dividends. The Preferred Shares are redeemable at the option of the Company, in whole or in part, at the liquidation preference thereof, plus the quarterly accrued and unpaid dividends, if any, to the date of redemption. The Company may not redeem the Preferred Shares without prior approval from the Office of the Comptroller of the Currency or the appropriate successor or other federal regulatory agency. Except under certain limited circumstances, as defined, the holders of the Preferred Shares have no voting rights. The Preferred Shares are automatically exchangeable for a new series of preferred stock of the Bank upon the occurrence of certain events.

Holders of Preferred Shares are entitled to receive, if declared by the Board of Directors of the Company, noncumulative dividends at a rate of 73/8% per annum of the \$25 per share liquidation preference (an amount equivalent to \$1.84375 per share per annum). Dividends on the Preferred Shares, if authorized and declared, are

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Harris Preferred Capital Corporation

Notes to Consolidated Financial Statements (Continued)

payable quarterly in arrears on March 30, June 30, September 30, and December 30 each year. Dividends declared to the holders of the Preferred Shares for the years ended December 31, 2006 and 2005 were \$18,438,000 in both years. The allocations of the distributions declared and paid for income tax purposes for the year ended December 31, 2006 and 2005 were 100% of ordinary income. The allocations of the distributions declared and paid for income tax purposes for the year ended December 31, 2004 were 87.7% of ordinary income, 7.4% of capital gain and 4.9% return of capital.

On December 30, 1998, the Bank contributed the Common Stock of the Company to HCH. The Bank is required to maintain direct or indirect ownership of at least 80% of the outstanding Common Stock of the Company for as long as any Preferred Shares are outstanding. Dividends on Common Stock are paid if and when authorized and declared by the Board of Directors out of funds legally available after all preferred dividends have been paid. On December 29, 2006, the Company paid a cash dividend of \$2 million declared on November 30, 2006 on the outstanding common shares to the stockholder of record on December 15, 2006. On November 14, 2006 the Company paid a cash dividend of \$581 thousand on the outstanding common shares to the stockholder of record on September 1, 2006. These common share dividends completed the Company's 2005 REIT tax compliance requirements.

6. Transactions with Affiliates

The Company entered into an advisory agreement (the Advisory Agreement) with the Bank pursuant to which the Bank administers the day-to-day operations of the Company. The Bank is responsible for (i) monitoring the credit quality of Mortgage Assets held by the Company; (ii) advising the Company with respect to the reinvestment of income from and payments on, and with respect to, the acquisition, management, financing, and disposition of the Mortgage Assets held by the Company; and (iii) monitoring the Company's compliance with the requirements necessary to qualify as a REIT.

The Advisory Agreement in effect for 2006, 2005 and 2004 entitled the Bank to receive advisory fees of \$127 thousand, \$122 thousand, and \$124 thousand, respectively for processing, recordkeeping, legal, management and other services.

The Securing Mortgage Loans are serviced by the Bank pursuant to the terms of a servicing agreement (the Servicing Agreement). The Bank receives a fee equal to 0.25% per annum on the principal balances of the loans serviced. The Servicing Agreement requires the Bank to service the mortgage loans in a manner generally consistent with accepted secondary market practices, and servicing guidelines promulgated by the Company and with Fannie Mae and FHLMC guidelines and procedures. In 2006, 2005, and 2004 the Bank received payments of \$23 thousand, \$31 thousand and \$44 thousand, respectively.

The Company purchases U.S. Treasury and Federal agency securities from the Bank under agreements to resell identical securities. At December 31, 2006, the Company held \$9.9 million of such assets and had earned \$4.1 million of interest from the Bank during 2006. At December 31, 2005, the Company held \$20.5 million of such assets and earned \$1.6 million of interest for 2005. The Company receives rates on these assets comparable to the rates that the Bank offers to unrelated counterparties under similar circumstances.

7. Operating Segment

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

8. Commitments and Contingencies

Legal proceedings in which the Company is a defendant may arise in the normal course of business. At December 31, 2006 and 2005, there was no pending litigation against the Company.

Table of Contents**Harris Preferred Capital Corporation****Notes to Consolidated Financial Statements (Continued)****9. Quarterly Financial Information (unaudited)**

The following table sets forth selected quarterly financial data for the Company:

	Year Ended December 31, 2006				Year Ended December 31, 2005			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(In thousands except per share data)							
Total interest income	\$ 5,137	\$ 5,276	\$ 5,423	\$ 5,606	\$ 4,775	\$ 4,862	\$ 4,891	\$ 4,930
Total operating expenses	123	114	96	159	134	82	88	136
Net income	5,014	5,162	5,327	5,447	4,641	4,780	4,803	4,794
P preferred dividends	4,609	4,609	4,609	4,611	4,609	4,609	4,609	4,611
Net income available to common stockholder	\$ 405	\$ 553	\$ 718	\$ 836	\$ 32	\$ 171	\$ 194	\$ 183
Basic and diluted earnings per common share	\$ 405.00	\$ 553.00	\$ 718.00	\$ 836.00	\$ 32.00	\$ 171.00	\$ 194.00	\$ 183.00

Financial Statements of Harris N.A.

The following unaudited financial information and audited financial statements for Harris N.A. are included because the Preferred Shares are automatically exchangeable for a new series of preferred stock of the Bank upon the occurrence of certain events.

On May 27, 2005, Harris Bankcorp, Inc., the Bank's parent company, consolidated 26 of its separate bank subsidiaries in Illinois (including Harris Trust and Savings Bank, the parent company of Harris Capital Holdings, Inc. at that date) into one national bank, Harris N.A. Each outstanding share of the Company's Series A Preferred Stock became automatically exchangeable for one newly issued preferred share of Harris N.A. under the same exchange conditions previously in existence for preferred shares of Harris Trust and Savings Bank, except that the primary regulator for purposes of the exchange conditions will be the Office of the Comptroller of the Currency, not the Board of Governors of the Federal Reserve Bank. References herein to the Bank for those times prior to the charter

consolidation are intended to refer to Harris Trust and Savings Bank.

Financial statements are presented for the Bank using the historical cost basis for all combining entities, similar to pooling-of-interests accounting. Results for prior periods have been restated assuming the combination had taken place before the earliest period presented.

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HARRIS N.A.

Certain Information Regarding Harris N.A.

Harris N.A. (the Bank) is an Illinois banking operation located at 111 West Monroe Street, Chicago, Illinois 60603. The Bank is a wholly-owned subsidiary of Harris Bankcorp, Inc. (Bankcorp), a multibank holding company incorporated under the laws of the State of Delaware, headquartered in Chicago and registered under the Bank Holding Company Act of 1956, as amended. Bankcorp is a wholly-owned subsidiary of Harris Financial Corp. (HFC). Bankcorp also owns three other banks, one with locations in Arizona, Florida and Washington, one with locations in Indiana and one wholesale bank located in Illinois. HFC is a wholly-owned subsidiary of Bank of Montreal (BMO). At December 31, 2006, Bankcorp assets amounted to \$42.5 billion, with the Bank representing approximately 98 percent of that total.

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

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

On December 1, 2005 Bankcorp acquired Edville Bankcorp, Inc. and its subsidiary Villa Park Trust and Savings Bank (Villa Park Bank). On December 3, 2005 Bankcorp consolidated Villa Park Bank with and into the Bank.

On May 27, 2005 Bankcorp consolidated 26 of its individually chartered bank subsidiaries (including Harris Trust and Savings Bank) into one national bank, Harris N.A. The combination was recorded at historical carrying value and prior year financial statements have been restated.

The Bank, a federally-chartered bank, has its principal office, 201 domestic branch offices and 551 automated teller machines located in the Chicago area. The Bank also has offices in Atlanta, Los Angeles, Boston and San Francisco and a foreign branch office in Nassau. At December 31, 2006, the Bank had total assets of \$41.8 billion, total deposits of \$30.1 billion, total loans of \$25.4 billion and equity capital of \$3.3 billion.

The Bank provides a broad range of banking and financial services to individuals and corporations domestically and abroad, including corporate banking, personal and commercial financial services, personal trust services and investment services. The Bank also offers (i) demand and time deposit accounts; (ii) various types of loans (including term, real estate, revolving credit facilities and lines of credit); (iii) sales and purchases of foreign currencies; (iv) interest rate management products (including swaps, forward rate agreements and interest rate guarantees); (v) cash management services; (vi) underwriting of municipal bonds; (vii) financial consulting; and (viii) a wide variety of personal trust and trust-related services.

Competitors of the Bank include commercial banks, savings and loan associations, consumer and commercial finance companies, credit unions and other financial services companies. Based on legislation passed in 1986 that allows Illinois banks to be acquired by banks or holding companies in states with a reciprocal law in effect, together with the Federal Interstate Banking Efficiency Act of 1994 that allows for both interstate banking and interstate branching in certain circumstances, the Bank believes that the level of competition will increase in the future.

The Bank is subject to regulation by the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation. As a federally-chartered bank, it is also regulated by the Office of the Comptroller of the Currency. These regulatory bodies examine the Bank and supervise numerous aspects of its business. The Federal

Reserve System regulates money and credit conditions and interest rates in order to influence general economic conditions, primarily through open market operations in U.S. Government securities, varying the discount rate on bank borrowings, setting reserve requirements against financial institution deposits and prescribing minimum capital requirements for member banks. These policies have a significant influence on overall growth and distribution of bank loans, investments and deposits, and affect interest rates charged on loans and earned on investments or paid for time, savings and other deposits. Board of Governors monetary policies have had a significant effect on the operating results of commercial banks in the past and this is expected to continue.

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**MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

2006 Compared to 2005

Summary

The Bank had 2006 net income of \$207.9 million, a decrease of \$6.9 million or 3 percent from 2005. Return on equity (ROE) was 6.47 percent in the current year compared to 7.26 percent in the prior year. Return on assets (ROA) was 0.53 percent compared to 0.62 percent a year ago.

Net interest income was \$838.0 million, down \$0.4 million from \$838.4 million in 2005. Average interest earning assets grew 13.6 percent from \$31.28 billion to \$35.54 billion in the current year primarily attributable to an increase of \$2.4 billion in average loans and an increase of \$1.2 billion in average money market assets. Net interest margin decreased from 2.75 percent to 2.45 percent in 2006. This decline primarily reflects a flat yield curve thereby reducing spreads on earning assets and related funding and a greater reliance on deposits and wholesale funding. This was partially offset by growth in interest earning assets, primarily the loan and money market portfolios.

The provision for loan losses was \$21.7 million in 2006 compared to \$19.5 million in 2005. Net loan charge-offs during the current year were \$30.8 million compared to \$16.5 million in the same period last year, reflecting higher write-offs primarily in the residential and installment loan portfolios. The provision for loan losses takes into account portfolio quality and management's estimate of probable loan loss.

Noninterest income was \$417.6 million, an increase from the 2005 amount of \$412.3 million. This increase was primarily attributable to a \$31.2 million increase in net securities gains, a \$6.2 million increase in money market and bond trading profits, a \$6.1 million increase in service charges and fees, a \$5.7 million increase in syndication fees and increases in mutual fund fees, commissions and bank owned life insurance income. These increases were largely offset by a \$16.6 million decrease in intercompany service charge revenue, a \$16.2 million decrease in trust and investment management fees, a \$4.8 million decrease in loan service fees, a \$4.3 million decrease in referral fees and decreases in letter of credit fees, foreign exchange income and fixed asset disposal gains.

Noninterest expense of \$940.8 million in 2006 increased \$21.3 million or 2 percent from last year. The increase was primarily attributable to a \$14.9 million increase in intercompany service charge expenses, a \$5.8 million increase in equipment expenses, a \$4.6 million increase in net occupancy costs related to the sale of a major building in 2005, and additional marketing and expert services costs. These increases were largely offset by \$7.8 million of reduced salaries and other compensation expenses. Income taxes decreased \$11.7 million, reflecting lower pretax income in 2006.

Nonperforming assets at December 31, 2006 totaled \$164 million or 0.64 percent of total loans, compared to \$139 million or 0.57 percent a year earlier. At December 31, 2006, the allowance for loan losses was \$323 million, equal to 1.27 percent of loans outstanding compared to \$332 million at the end of 2005, equal to 1.36 percent of loans outstanding. The ratio of the allowance for loan losses to nonperforming assets was 197 percent at December 31, 2006 compared to 239 percent at December 31, 2005.

At December 31, 2006 consolidated stockholder's equity of the Bank amounted to \$3.35 billion, up from \$3.07 billion at December 31, 2005. In 2006 the Bank issued 287,000 shares of common stock to Bankcorp in consideration for a \$150 million cash capital infusion to support certain business initiatives. The Bank paid \$72 million in dividends on common stock in 2006 compared to \$90 million in the prior year.

The Bank's regulatory capital leverage ratio was 8.06 percent at December 31, 2006 compared to 8.66 percent at December 31, 2005. Regulators require most banking institutions to maintain capital leverage ratios of not less than 4.0 percent. At December 31, 2006, the Bank's Tier 1 and total risk based capital ratios were 9.69 percent and 11.49 percent, respectively, compared to respective ratios of 9.57 percent and 11.57 percent at December 31, 2005.

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2005 Compared to 2004

Summary

The Bank had 2005 net income of \$214.9 million, a decrease of \$39.0 million or 15 percent from 2004. Return on equity (ROE) was 7.26 percent in 2005 compared to 9.57 percent in 2004. Return on assets (ROA) was 0.62 percent compared to 0.82 percent in 2004.

Net interest income was \$838.4 million, up \$36.0 million or 5 percent from \$802.4 million in 2004. Average interest earning assets grew 12 percent from \$27.96 billion to \$31.28 billion in 2005 primarily attributable to an increase of \$3.2 billion in average loans. Net interest margin decreased from 2.94 percent to 2.75 percent in 2005. This decline primarily reflects a flat yield curve thereby reducing spreads on interest earning assets and related funding and a greater reliance on wholesale funding. This was partially offset by growth in the loan portfolio, which accounted for virtually the entire increase in interest earning assets.

The provision for loan losses was \$19.5 million in 2005 compared to \$23.8 million in 2004. Net loan charge-offs during 2005 were \$16.5 million compared to \$30.4 million in 2004, reflecting lower write-offs in the corporate loan portfolio. The provision for loan losses takes into account portfolio quality and management's estimate of probable loan loss.

Noninterest income was \$412.3 million, a decrease from the 2004 amount of \$464.6 million. This decrease was primarily attributable to a \$26.4 million decrease in net securities gains, a \$7.7 million gain recognized in 2004 on the termination of a swap, a \$7.1 million gain recognized in 2004 on a loan restructuring, a \$7.1 million decrease in mortgage servicing fees, a \$4.0 million decrease in money market and bond trading profits and a \$3.1 million decrease in letter of credit fees. These decreases were partially offset by increased bank-owned insurance income and trust and investment management fees.

Noninterest expense of \$919.4 million in 2005 increased \$52.3 million or 6 percent from last year. The increase primarily attributable to \$39.5 million of additional expenses incurred during 2005 related to the 2004 acquisitions of Mercantile Bancorp, Inc. (December 30, 2004), New Lenox Holding Company and New Lenox State Bank (June 1, 2004), additional occupancy costs related to the sale of a major building in 2005 and higher intercompany services. These increases were partially offset by reduced communication and delivery costs. Income taxes decreased \$25.3 million, reflecting lower pretax income in 2005.

Nonperforming assets at December 31, 2005 totaled \$139 million or 0.57 percent of total loans, compared to \$147 million or 0.73 percent a year earlier. At December 31, 2005, the allowance for loan losses was \$332 million, equal to 1.36 percent of loans outstanding compared to \$327 million at the end of 2004, equal to 1.52 percent of loans outstanding. The ratio of the allowance for loan losses to nonperforming assets was 239 percent at December 31, 2005 compared to 222 percent at December 31, 2004.

At December 31, 2005 consolidated stockholder's equity of the Bank amounted to \$3.07 billion, up from \$2.90 billion at December 31, 2004. In 2005 Villa Park Trust and Savings Bank (Villa Park), a wholly owned subsidiary of Harris Bankcorp, Inc., was merged with and into the Bank. At the time, Villa Park total assets were \$329 million and total deposits were \$260 million. The impact on the Bank's stockholder's equity was an increase of \$62 million. The combination was recorded using historical carrying values for Villa Park as recognized by Bankcorp. In consideration of this contribution to its capital, the Bank issued 61,256 shares of common stock to Bankcorp. The Bank paid \$90 million in dividends on common stock in 2005.

The Bank's regulatory capital leverage ratio was 8.66 percent at December 31, 2005 compared to 8.72 percent at December 31, 2004. Regulators require most banking institutions to maintain capital leverage ratios of not less than 4.0 percent. At December 31, 2005, the Bank's Tier 1 and total risk based capital ratios were 9.57 percent and 11.57 percent, respectively, compared to respective ratios of 10.55 percent and 12.89 percent at December 31, 2004. The 2005 year-end risk-based capital ratios marginally dropped from the previous year due to a proportionately higher increase in risk-weighted assets over Tier 1 capital; however, year-end ratios substantially exceeded minimum required regulatory ratios of 4.0 percent and 8.0 percent, respectively.

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INDEPENDENT AUDITORS REPORT

To the Stockholder and Board
of Directors of Harris N.A.

We have audited the accompanying consolidated statements of condition of Harris N.A. (an indirect wholly-owned subsidiary of Bank of Montreal) and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income, comprehensive income, changes in stockholder's equity and cash flows for each of the years in the three year period ended December 31, 2006. These consolidated financial statements are the responsibility of Harris N.A.'s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Harris N.A. and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the years in the three year period ended December 31, 2006 in conformity with U.S. generally accepted accounting principles.

Chicago, Illinois
March 28, 2007

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Harris N.A. and Subsidiaries
Consolidated Statements of Condition

	December 31	
	2006	2005
	(In thousands except share data)	
ASSETS		
Cash and demand balances due from banks	\$ 1,084,959	\$ 1,399,415
Money market assets:		
Interest-bearing deposits at banks	944,116	1,007,667
Federal funds sold	672,760	258,915
Securities available-for-sale (including \$5.15 billion and \$3.80 billion of securities pledged as collateral for repurchase agreements at December 31, 2006 and December 31, 2005, respectively)	10,713,910	6,573,222
Trading account assets	220,716	181,121
Loans	25,402,554	24,347,528
Allowance for loan losses	(322,742)	(331,838)
Net loans	25,079,812	24,015,690
Loans held for sale	34,451	32,364
Premises and equipment	474,073	448,144
Bank-owned insurance	1,155,925	1,115,172
Goodwill and other intangible assets	395,140	416,498
Other assets	989,965	810,818
Total assets	\$ 41,765,827	\$ 36,259,026
LIABILITIES		
Deposits in domestic offices noninterest-bearing	\$ 6,232,744	\$ 6,480,021
interest-bearing	22,855,715	17,882,772
Deposits in foreign offices interest-bearing	1,030,838	1,270,741
Total deposits	30,119,297	25,633,534
Federal funds purchased	476,000	927,990
Securities sold under agreement to repurchase	3,475,839	2,488,493
Sh		