HARRIS PREFERRED CAPITAL CORP
Form 10-Q
November 14, 2001

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q
QUARTERLY REPORT UNDER SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2001

COMMISSION FILE NUMBER 1-13805
HARRIS PREFERRED CAPITAL CORPORATION
(Exact name of registrant as specified in its charter)

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

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

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

The number of shares of Common Stock, $1.00 par value, outstanding on November 13, 2001 was 1,000.

HARRIS PREFERRED CAPITAL CORPORATION

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HARRIS PREFERRED CAPITAL CORPORATION

BALANCE SHEETS
(UNAUDITED)

	SEPTEMBER 30, 2001	DECEMBER 31, 2000	SEPT
		(IN THOUSANDS)	
ASSETS			
Cash on deposit with Harris Trust and Savings Bank......	$ 1,070	$ 819	$
Securities purchased from Harris Trust and Savings Bank under agreement to resell............................	21,001	3,000	
Notes receivable from Harris Trust and Savings Bank.....	68,659	102,960	1
Securities available-for-sale:			
Mortgage-backed......................................	213,775	352,965	3
U.S. Treasury..	199,724	24,850	
Securing mortgage collections due from Harris Trust and Savings Bank...	2,403	2,786	
Other assets..	1,520	2,559	
TOTAL ASSETS....................................	$508,152	$489,939	$4
LIABILITIES AND STOCKHOLDERS' EQUITY			
Accrued expenses..	$ 21	$ 115	$
Commitments and contingencies...........................	--	--	
STOCKHOLDERS' EQUITY			
7 3/8% 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	2
Common stock ($1 par value); 1,000 shares authorized, issued and outstanding...............................	1	1	
Additional paid-in capital..............................	240,733	240,733	2
Earnings in excess of distributions.....................	13,833	536	
Accumulated other comprehensive income -- net unrealized gains/(losses) on available-for-sale securities.......	3,564	(1,446)	(
TOTAL STOCKHOLDERS' EQUITY......................	508,131	489,824	4
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY.......	$508,152	$489,939	$4

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

HARRIS PREFERRED CAPITAL CORPORATION

STATEMENTS OF OPERATIONS
AND OTHER COMPREHENSIVE INCOME
(UNAUDITED)

	QUARTER ENDED SEPTEMBER 30		NINE MONTHS END SEPTEMBER 30	
	2001	2000	2001	20
	(IN THOUSANDS, EXCEPT PER SHARE DATA)			
INTEREST INCOME:				
Securities purchased from Harris Trust and Savings Bank under agreement to resell......	$ 365	$ 646	$ 1,280	$
Notes receivable from Harris Trust and Savings Bank.......................................	1,198	1,884	4,164	
Securities available-for-sale:				
Mortgage-backed............................	5,832	5,450	17,251	1
U.S. Treasury..............................	73	126	360	
Total interest income....................	7,468	8,106	23,055	2
NON-INTEREST INCOME:				
Gain on sale of securities....................	2,593	257	4,796	
OPERATING EXPENSES:				
Loan servicing fees paid to Harris Trust and Savings Bank...............................	56	90	195	
Advisory fees paid to Harris Trust and Savings Bank.......................................	8	15	28	
General and administrative....................	50	29	157	
Total operating expenses.................	114	134	380	
Net income......................................	9,947	8,229	27,471	2
Preferred dividends............................	4,609	4,609	13,828	1
NET INCOME AVAILABLE TO COMMON STOCKHOLDER.......	$ 5,338	$ 3,620	$ 13,643	$
Basic and diluted earnings per common share......	$5,338.00	$3,620.00	$13,643.00	$9,9
Net income......................................	$ 9,947	$ 8,229	$ 27,471	$ 2
Other comprehensive income -- net unrealized gains on available-for-sale securities.........	6,652	4,410	5,010	
Comprehensive income............................	$ 16,599	$ 12,639	$ 32,481	$ 3

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

HARRIS PREFERRED CAPITAL CORPORATION

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(UNAUDITED)

	NINE MONTHS ENDED SEPTEMBER 30	
	2001	2000
	(IN THOUSANDS)	
Balance at January 1	$489,824	$473,891
Net income	27,471	23,801
Other comprehensive income	5,010	7,030
Dividends -- common stock	(346)	(224)
Dividends- Series A preferred stock	(13,828)	(13,828)
Balance at September 30	$508,131	$490,670

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

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HARRIS PREFERRED CAPITAL CORPORATION

STATEMENTS OF CASH FLOWS
(UNAUDITED)

	NINE MONTHS ENDED SEPTEMBER 30	
	2001	2000
	(IN THOUSANDS)	
OPERATING ACTIVITIES:		
Net Income	$ 27,471	$ 23,801
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sale of securities	(4,796)	(257)
Net decrease (increase) in other assets	1,039	(61)
Net decrease in accrued expenses	(94)	(36)
Net cash provided by operating activities	23,620	23,447
INVESTING ACTIVITIES:		
Net increase in securities purchased from Harris Trust and Savings Bank under agreement to resell	(18,001)	(7,004)
Repayments of notes receivable from Harris Trust and Savings Bank	34,301	24,189
Decrease in securing mortgage collections due from Harris Trust and Savings Bank	383	1,598
Purchases of securities available-for-sale	(413,304)	(144,825)
Proceeds from maturities and sales of securities available-for-sale	387,426	116,197
Net cash used in investing activities	(9,195)	(9,845)

FINANCING ACTIVITIES:		
Cash dividends paid on preferred stock	(13,828)	(13,828)
Cash dividends paid on common stock	(346)	(224)
Net cash used by financing activities	(14,174)	(14,052)
Net increase (decrease) in cash on deposit with Harris Trust and Savings Bank	251	(450)
Cash on deposit with Harris Trust and Savings Bank at beginning of period	819	1,262
Cash on deposit with Harris Trust and Savings Bank at end of period	$ 1,070	$ 812

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

HARRIS PREFERRED CAPITAL CORPORATION

NOTES TO FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

Harris Preferred Capital Corporation (the "Company") is a Maryland corporation whose principal business objective is to acquire, hold, finance and manage qualifying real estate investment trust ("REIT") assets (the "Mortgage Assets"), consisting of a limited recourse note or notes (the "Notes") issued by Harris Trust and Savings Bank (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. Harris Capital Holdings, Inc., a wholly-owned subsidiary of the Bank, owns 100% of the Company's common stock.

The accompanying financial statements have been prepared by management from the books and records of the Company, without audit by independent certified public accountants. These statements reflect all adjustments and disclosures which are, in the opinion of management, necessary for a fair statement of the results for the interim periods presented and should be read in conjunction with the notes to financial statements included in the Company's 2000 Form 10-K. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission.

2. COMMITMENTS AND CONTINGENCIES

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

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

FORWARD-LOOKING INFORMATION

The statements contained in this Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of

1934, including statements regarding the Company's expectation, intentions, beliefs or strategies regarding the future. Forward-looking statements include the Company's statements regarding tax treatment as a real estate investment trust, liquidity, provision for loan losses, capital resources and investment activities. In addition, in those and other portions of this document, the words "anticipate," "believe," "estimate," "expect," "intend" and other similar expressions, as they relate to the Company or the Company's management, are intended to identify forward-looking statements. Such statements reflect the current views of the Company with respect to future events and are subject to certain risks, uncertainties and assumptions. It is important to note that the Company's actual results could differ materially from those described herein as anticipated, believed, estimated or expected. Among the factors that could cause the results to differ materially are the risks discussed in the "Risk Factors" section included in the Company's Registration Statement on Form S-11 (File No. 333-40257), with respect to the Preferred Shares declared effective by the Securities and Exchange Commission on February 5, 1998. The Company assumes no obligation to update any such forward-looking statement.

RESULTS OF OPERATIONS

THIRD QUARTER 2001 COMPARED WITH THIRD QUARTER 2000

The Company's net income for the third quarter of 2001 was $9.9 million. This represented a $1.7 million or 21% increase from 2000 earnings of $8.2 million. Earnings increased primarily because of gains realized from the sale of investment securities.

Third quarter 2001 interest income on the Notes totaled $1.2 million and yielded 6.4% on $75.1 million of average principal outstanding for the quarter compared to $1.9 million and a 6.4% yield on $118 million average principal outstanding for third quarter 2000. The decrease in income was attributable to a reduction in the Notes balance because of customer payoffs on the Securing Mortgage Loans. The average outstanding balance of the Securing Mortgage Loans for third quarter 2001 and 2000 was $91 million and $146 million, respectively. Interest income on securities available-for-sale for the current quarter was $5.9 million resulting in a yield of 6.31% on an average balance of $374 million, compared to $5.6 million with a yield of 6.92% on an average balance of $322 million for the same period a year ago. The increase in interest income is primarily attributable to growth in the investment securities portfolio partially offset by a reduction in yield. As securities mature or are sold, proceeds have been invested in lower yielding securities as market interest rates have been declining in recent months. There were no Company borrowings during the quarter.

Third quarter 2001 operating expenses totaled $114 thousand, a decrease of $20 thousand or 15% from the third quarter of 2000. Loan servicing expenses totaled $56 thousand, a decrease of $34 thousand or 37% from a year ago. This decrease is attributable to the reduction in the principal balance of the Notes, thereby reducing servicing fees payable to the Bank. Advisory fees for the third quarter 2001 were $8 thousand compared to $15 thousand a year earlier. General and administrative expenses totaled $50 thousand, an increase of $21 thousand over third quarter 2000.

At September 30, 2001 and 2000, there were no Securing Mortgage Loans on nonaccrual status.

The Company does not currently maintain an allowance for loan losses due to the over-collateralization of the Notes represented by the Securing Mortgage Loans.

NINE MONTHS ENDED SEPTEMBER 30, 2001 COMPARED WITH SEPTEMBER 30, 2000

The Company's net income for the nine months ended September 30, 2001 was $27.5 million. This represented a $3.7 million or 16% increase from 2000 earnings of $23.8 million. Earnings increased primarily because of gains realized from the sale of investment securities.

Interest income on securities purchased under agreement to resell for the nine months ended September 30, 2001 was $1.3 million, a decrease of $140 thousand from the same period in 2000. Interest income on the Notes for the nine months ended September 30, 2001 totaled $4.2 million and yielded 6.40% on $87 million of average principal outstanding compared to $6.1 million of income yielding 6.40% on $126 million of average principal outstanding for the same period in 2000. The decrease in income was attributable to a reduction in the Note balance because of customer payoffs on the Securing Mortgage Loans. Interest income on securities available-for-sale for the nine months ended September 30, 2001 was $17.6 million resulting in a yield of 6.48% on an average balance of $363 million, compared to $16.6 million of income with a yield of 6.95% on an average balance of $318 million a year ago. The increase in interest income is primarily attributable to growth in the investment securities portfolio partially offset by a reduction in yield. As securities mature or are sold, proceeds have been invested in lower yielding securities as a result of market interest rates declining in recent months. Gains from investment securities sales for the nine months ended September 30, 2001 were $4.8 million compared to $257 thousand a year ago. The average outstanding balance of the Securing Mortgage Loans was $106 million for the nine months ended September 30, 2001 and $156 million for the same period in 2000. There were no Company borrowings during either period.

Operating expenses for the nine months ended September 30, 2001 totaled $380 thousand, a decrease of $123 thousand from a year ago. Loan servicing expenses for the nine months ended September 30, 2001 totaled $195 thousand, a decrease of $95 thousand or 33% from 2000. This decrease is attributable to the reduction in the principal balance of the Notes because servicing costs vary directly with these balances. Advisory fees for the nine months ended September 30, 2001 were $28 thousand compared to $45 thousand a

year ago primarily attributed to lower inter-company charges in the current year. General and administrative expenses totaled $157 thousand, a decrease of $11 thousand or 7% over the same period in 2000.

On September 30, 2001, the Company paid a cash dividend of $0.46094 per share on outstanding preferred shares to the stockholders of record on September 15, 2001, as declared on August 30, 2001. On September 12, 2001, the Company paid a cash dividend of $346 thousand on the outstanding common shares to the stockholder of record on September 4, 2001, as declared on August 30, 2000. This dividend completed the 2000 REIT tax compliance requirements. On September 30, 2000, the Company paid a cash dividend of $0.46094 per share on outstanding preferred shares to the stockholders of record on September 15, 2000, as declared on August 31, 2000. On September 12, 2000, the Company paid a cash dividend of $224 thousand on the outstanding common shares to the stockholder of record on December 30, 1999, as declared on August 31, 2000. This dividend completed the 1999 REIT tax compliance requirements. On a year-to-date basis, the Company has declared and paid $13.8 million of dividends to holders of preferred shares for each of the nine-month periods ended September 30, 2001 and 2000.

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 Notes or other qualifying assets and to pay dividends to its stockholders after satisfying obligations to creditors. The acquisition of additional Notes or other qualifying assets is funded with the proceeds obtained as a result of repayment of principal balances by individual mortgages representing collateral for the Notes, or from maturities or sales of securities. 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 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% (95% for years prior to January 1, 2001) of its adjusted REIT taxable income, as provided for under the Internal Revenue Code, to its common and preferred stockholders. The Company expects to distribute dividends annually equal to 90% or more of its adjusted REIT taxable income.

The Company anticipates that cash and cash equivalents on hand and the cash flow from the Notes and mortgage-backed securities will provide adequate liquidity for its operating, investing and financing needs.

As presented in the accompanying Statements of Cash Flows, the primary sources of funds in addition to $23.6 million provided from operations during the nine months ended September 30, 2001 were $34.3 million provided by principal payments on the Notes and $387.4 million from the maturities and sales of securities available-for-sale. In the prior period ended September 30, 2000, the primary sources of funds other than from operations of $23.4 million were $24.2 million provided by principal payments on the Notes and $116.2 million from the sales and maturities of securities available-for-sale. The primary uses of funds for the nine months ended September 30, 2001 were $413.3 million for purchases of securities available-for-sale and $13.8 million in preferred stock dividends paid. For the prior year's quarter ended September 30, 2000 the primary uses of funds were $144.8 million for purchases of securities available-for-sale and $13.8 million in preferred stock dividends paid.

MARKET RISK MANAGEMENT

The Company's market risk is composed primarily of interest rate risk. There have been no material changes in market risk or the manner in which the Company manages market risk since December 31, 2000.

ACCOUNTING PRONOUNCEMENTS

In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations." The Statement addresses financial accounting and reporting for business combinations and supersedes APB Opinion No. 16, "Business Combinations." It requires all business combinations within the scope of the Statement to be accounted for using one method, the purchase method. It establishes criteria for the initial recognition of intangible assets acquired in a business combination. The provisions of the Statement apply to all business combinations initiated after June 30, 2001 and to all business combinations accounted for by the purchase method for which the date of acquisition is July 1, 2001 or later. The Company does not anticipate that there will be a material impact of adopting the Statement on its financial position and results of operations.

In July 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets." The Statement addresses financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, "Intangible Assets." Under this Standard, goodwill and other intangible assets that have indefinite useful lives will not be subject to amortization while intangible assets with finite lives will be amortized. The Statement is effective for fiscal years beginning after December 15, 2001. However, goodwill and intangible assets acquired after June 30, 2001 will be subject immediately to the nonamortization and amortization provisions of the Statement. The Company does not anticipate that there will be a material impact of adopting the Statement on its financial position and results of operations.

OTHER MATTERS

As of September 30, 2001, 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.

FINANCIAL STATEMENTS OF HARRIS TRUST AND SAVINGS BANK

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

HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CONDITION
(UNAUDITED)

	SEPTEMBER 30 2001	DECEMBER 31 2000	SEPTEMBE 2000
	(IN THOUSANDS EXCEPT SHARE DATA)		
ASSETS			
Cash and demand balances due from banks..............	$ 968,638	$ 1,292,694	$ 1,255,
Money market assets:			
Interest-bearing deposits at banks.................	258,001	141,348	164,
Federal funds sold and securities purchased under agreement to resell............................	165,700	491,075	266,

Trading account assets	60,522	65,211	41,
Securities available-for-sale (including $2.99 billion and $3.30 billion of securities pledged as collateral for repurchase agreements at September 30, 2001 and December 31, 2000, respectively)	6,372,401	6,500,164	6,607,
Loans	10,464,900	10,768,712	11,303,
Allowance for possible loan losses	(231,308)	(118,951)	(120,
Net loans	10,233,592	10,649,761	11,183,
Premises and equipment	295,563	284,142	276,
Customers' liability on acceptances	20,306	34,100	31,
Bank-owned insurance investments	940,182	906,103	894,
Loans held for sale	139,219	242,271	
Goodwill and other valuation intangibles	210,394	221,326	222,
Other assets	552,013	461,420	1,022,
TOTAL ASSETS	$20,216,531	$21,289,615	$21,966,
LIABILITIES			
Deposits in domestic offices -- noninterest bearing	$ 2,864,594	$ 3,067,296	$ 3,460,
-- interest-bearing	6,736,662	7,065,300	7,268,
Deposits in foreign offices -- noninterest bearing	34,782	34,780	38,
-- interest-bearing	1,915,640	2,326,001	2,286,
Total deposits	11,551,678	12,493,377	13,053,
Federal funds purchased and securities sold under agreement to repurchase	4,373,258	4,608,879	4,582,
Other short-term borrowings	453,046	1,489,730	1,361,
Senior notes	910,000	389,500	882,
Acceptances outstanding	20,306	34,100	31,
Accrued interest, taxes and other expenses	314,503	213,794	150,
Other liabilities	558,346	60,812	42,
Minority interest -- preferred stock of subsidiary	250,000	250,000	250,
Long-term notes -- subordinated	225,000	225,000	225,
TOTAL LIABILITIES	18,656,137	19,765,192	20,579,
STOCKHOLDER'S EQUITY			
Common stock ($10 par value); authorized 10,000,000 shares; issued and outstanding 10,000,000 shares	100,000	100,000	100,
Surplus	619,463	613,365	612,
Retained earnings	779,783	821,719	756,
Accumulated other comprehensive income (loss)	61,148	(10,661)	(81,
TOTAL STOCKHOLDER'S EQUITY	1,560,394	1,524,423	1,387,
TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY	$20,216,531	$21,289,615	$21,966,

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

HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

	QUARTER ENDED SEPTEMBER 30		NINE MONTHS SEPTEMBE
	2001	2000	2001
	(IN THOUSANDS EXCEPT SHARE DAT		
INTEREST INCOME			
Loans, including fees	$170,175	$236,628	$583,009
Money market assets:			
Deposits at banks	1,535	2,021	3,014
Federal funds sold and securities purchased under agreement to resell	3,948	4,326	11,794
Trading account	829	775	2,265
Securities available-for-sale:			
U.S. Treasury and Federal agency	81,119	107,302	271,556
State and municipal	4	180	95
Other	587	360	1,567
Total interest income	258,197	351,592	873,300
INTEREST EXPENSE			
Deposits	78,133	126,355	283,777
Short-term borrowings	42,876	94,210	186,625
Senior notes	9,581	16,752	27,244
Minority interest-dividends on preferred stock of subsidiary	4,609	4,609	13,828
Long-term notes	3,357	3,963	10,913
Total interest expense	138,556	245,889	522,387
NET INTEREST INCOME	119,641	105,703	350,913
Provision for loan losses	146,118	6,870	184,316
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	(26,477)	98,833	166,597
NONINTEREST INCOME			
Trust and investment management fees	21,850	22,332	67,049
Money market and bond trading	4,950	2,446	14,671
Foreign exchange	1,885	1,900	5,280
Merchant and charge card fees	1	6,229	66
Service fees and charges	25,442	24,796	71,140
Securities gains	7,557	3,131	25,475
Gain on sale of corporate trust business	--	--	--
Bank-owned insurance investments	11,859	11,262	35,183
Foreign fees	5,168	3,983	15,517
Other	13,266	11,668	36,999
Total noninterest income	91,978	87,747	271,380
NONINTEREST EXPENSES			
Salaries and other compensation	77,632	68,491	220,763
Pension, profit sharing and other employee benefits	12,907	9,567	39,708
Net occupancy	9,336	9,234	27,785
Equipment	12,623	12,270	38,007
Marketing	9,884	8,545	25,082
Other	14,683	14,103	31,047
	137,065	122,210	382,392
Goodwill and other valuation intangibles	5,994	5,666	17,627

Total noninterest expenses	143,059	127,876	400,019
(Loss) Income before income taxes	(77,558)	58,704	37,958
Applicable income taxes	(32,765)	15,611	(4,106)
NET (LOSS) INCOME	$(44,793)	$ 43,093	$ 42,064
EARNINGS PER COMMON SHARE (based on 10,000,000 average shares outstanding)			
Net (Loss) Income	$ (4.48)	$ 4.31	$ 4.21

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

HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)

	QUARTER ENDED SEPTEMBER 30		NINE MONTHS END JUNE 30	
	2001	2000	2001	2
		(IN THOUSANDS)		
Net (loss) income	$(44,793)	$43,093	$ 42,064	$15
Other comprehensive income:				
Cash flow hedges:				
Cumulative effect of accounting change	--	--	(7,976)	
Net unrealized gain on derivative instruments, net of tax expense for the quarter of $63 in 2001 and net of tax expense for the year-to-date period of $4,684 in 2001	108	--	7,976	
Unrealized gains on available-for-sale securities:				
Unrealized holding gains arising during the period, net of tax expense for the quarter of $48,431 in 2001 and $26,165 in 2000 and net of tax expense for the year-to-date period of $57,862 in 2001 and $39,608 in 2000	73,505	39,762	87,374	6
Less reclassification adjustment for realized gains included in income statement, net of tax expense for the quarter of $2,940 in 2001 and $1,218 in 2000 and net of tax expense for the year-to-date period of $9,910 in 2001 and $2,380 in 2000	(4,617)	(1,913)	(15,565)	(
Other comprehensive income	68,996	37,849	71,809	5
Comprehensive income	$ 24,203	$80,942	$113,873	$20

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

HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

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

	2001	2000
	(IN THOUSANDS)	
BALANCE AT JANUARY 1	$1,524,423	$1,251,094
Net income	42,064	150,889
Contributions to capital	6,098	2,046
Dividends -- common stock	(84,000)	(73,000)
Other comprehensive income	71,809	56,453
BALANCE AT SEPTEMBER 30	$1,560,394	$1,387,482

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

HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	NINE MONTHS ENDED SEPTEMBER 30	
	2001	2000
	(IN THOUSANDS)	
OPERATING ACTIVITIES:		
Net income	$ 42,064	$ 150,889
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	184,316	18,365
Depreciation and amortization, including intangibles	51,257	52,393
Deferred tax expense (benefit)	26,582	(2,769)
Gain on sales of securities	(25,475)	(6,117)
Gain on sale of corporate trust business	--	(47,193)
Trading account net sales	4,689	25,649
Net decrease (increase) in interest receivable	58,497	(13,902)
Net decrease in interest payable	(7,651)	(19,135)
Net decrease in loans held for sale	103,052	58,417
Other, net	(96,373)	(42,902)

Net cash provided by operating activities	340,958	173,695
INVESTING ACTIVITIES:		
Net (increase) decrease in interest-bearing deposits at banks	(116,653)	74,903
Net decrease in Federal funds sold and securities purchased under agreement to resell	325,375	31,375
Proceeds from sales of securities available-for-sale	1,417,046	130,221
Proceeds from maturities of securities available-for-sale	6,026,533	4,831,701
Purchases of securities available-for-sale	(7,170,579)	(5,404,189)
Net decrease (increase) in loans	231,853	(1,310,115)
Purchases of premises and equipment	(45,051)	(29,760)
Net increase in bank-owned insurance investments	(34,079)	(121,751)
Other, net	478,045	(389,144)
Net cash provided (used) by investing activities	1,112,490	(2,186,759)
FINANCING ACTIVITIES:		
Net (decrease) increase in deposits	(941,699)	1,924,044
Net decrease in Federal funds purchased and securities sold under agreement to repurchase	(235,621)	(156,748)
Net (decrease) increase in short-term borrowings	(1,036,684)	680,347
Proceeds from issuance of senior notes	2,308,500	2,232,000
Repayment of senior notes	(1,788,000)	(2,850,000)
Proceeds from the sale of corporate trust business	--	88,704
Cash dividends paid on common stock	(84,000)	(73,000)
Net cash (used) provided by financing activities	(1,777,504)	1,845,347
NET DECREASE IN CASH AND DEMAND BALANCES DUE FROM BANKS	(324,056)	(167,717)
CASH AND DEMAND BALANCES DUE FROM BANKS AT JANUARY 1	1,292,694	1,423,043
CASH AND DEMAND BALANCES DUE FROM BANKS AT SEPTEMBER 30	$ 968,638	$ 1,255,326

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

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HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

NOTES TO THE FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

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

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

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

2. LEGAL PROCEEDINGS

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

3. CASH FLOWS

For purposes of the Bank's Consolidated Statements of Cash Flows, cash and cash equivalents is defined to include cash and demand balances due from banks. Cash interest payments (net of amounts capitalized) for the nine months ended September 30 totaled $530.0 million and $599.5 million in 2001 and 2000, respectively. Cash income tax payments over the same periods totaled $62.0 million and $54.5 million, respectively.

4. PENDING ACCOUNTING CHANGES

In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations." The Statement addresses financial accounting and reporting for business combinations and supersedes APB Opinion No. 16, "Business Combinations." It requires all business combinations within the scope of the Statement to be accounted for using one method, the purchase method. It establishes criteria for the initial recognition of intangible assets acquired in a business combination. The provisions of the Statement apply to all business combinations initiated after June 30, 2001 and to all business combinations accounted for by the purchase method for which the date of acquisition is July 1, 2001 or later.

In July 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets." The Statement addresses financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, "Intangible Assets." Under this Standard, goodwill and other intangible assets that have indefinite useful lives will not be subject to amortization while intangible assets with finite lives will be amortized. The Statement is effective for fiscal years beginning after December 15, 2001. However, goodwill and intangible assets acquired after June 30, 2001 will be subject immediately to the nonamortization and amortization provisions of the Statement. Upon adoption of SFAS No. 142, the Bank will discontinue the amortization of goodwill with an expected net carrying value of approximately $89 million at the date of adoption and annual amortization of $9 million that resulted from business combinations prior to the adoption of SFAS No. 141.

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HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

NOTES TO THE FINANCIAL STATEMENTS -- (CONTINUED)

5. DERIVATIVES

ACCOUNTING FOR DERIVATIVES AND HEDGING ACTIVITIES

All derivative instruments are recognized at fair value in the Consolidated Statements of Condition. All derivative instruments are designated either as hedges or as held for trading or non-hedging purposes.

Derivative instruments that are used in the management of the Bank's risk strategy may qualify for hedge accounting if the derivatives are designated as hedges and applicable hedge criteria are met. On the date that the Bank enters into a derivative contract, it designates the derivative as a hedge of the fair value of a recognized asset or liability or an unrecognized firm commitment, a hedge of a forecasted transaction or the variability of cash flows that are to be received or paid in connection with a recognized asset or liability, a foreign currency fair value or cash flow hedge, or a hedge of a net investment in a foreign operation. Changes in the fair value of a derivative that is highly effective (as defined) and qualifies as a fair value hedge, along with changes in the fair value of the underlying hedged item, are recorded in current period earnings. Changes in the fair value of a derivative that is highly effective (as defined) and qualifies as a cash flow hedge, to the extent that the hedge is effective, are recorded in other comprehensive income only until earnings are recognized from the underlying hedged item. Net gains or losses resulting from hedge ineffectiveness are recorded in current period earnings. Changes in the fair value of a derivative that is highly effective (as defined) and qualifies as a foreign currency hedge are recorded in either current period earnings or other comprehensive income depending on whether the hedging relationship meets the criteria for a fair value or cash flow hedge. For a derivative used as a hedge of a net investment in a foreign operation, changes in the derivative's fair value, to the extent that the hedge is effective, are recorded in the cumulative translation adjustment account within other comprehensive income.

The Bank formally documents all hedging relationships at inception of hedge transactions. The process includes documenting the risk management objective and strategy for undertaking the hedge transaction and identifying the specific derivative instrument and the specific underlying asset, liability, firm commitment or forecasted transaction. The Bank formally assesses, both at inception and on an ongoing quarterly basis, whether the derivative hedging instruments have been highly effective in offsetting changes in the fair value or cash flows of the hedged items and whether the derivatives are expected to remain highly effective in future periods.

Hedge accounting is discontinued prospectively when the Bank determines that the hedge is no longer highly effective, the derivative instrument expires or is sold, terminated or exercised, it is no longer probable that the forecasted transaction will occur, the hedged firm commitment no longer meets the definition of a firm commitment, or the designation of the derivative as a hedging instrument is no longer appropriate.

When hedge accounting is discontinued because a fair value hedge is no longer highly effective, the derivative instrument will continue to be recorded on the balance sheet at fair value but the underlying hedged item will no longer be adjusted for changes in fair value. When hedge accounting is discontinued because the hedged item no longer meets the definition of a firm commitment, the derivative instrument will continue to be recorded on the balance sheet at fair value and any asset or liability that was recorded to recognize the firm commitment will be removed from the balance sheet and recognized as a gain or loss in current period earnings. When hedge accounting is discontinued because it is no longer probable that the forecasted transaction will occur, the gain or loss on the derivative that was in accumulated other comprehensive income will be recognized immediately in earnings. When hedge accounting is discontinued and the derivative remains outstanding, the derivative may be redesignated as a hedging instrument as long as the applicable hedge criteria are met under the terms of the new contract.

Derivative instruments that are used as part of the Bank's dealer and trading activities are marked to market and the resulting unrealized gains and losses are recognized in noninterest income in the period of

change. Realized and unrealized gains and losses on interest rate contracts and foreign exchange contracts are recorded in trading account income and foreign exchange income, respectively.

DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

The Bank has an interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that may be caused by interest rate volatility. The Bank manages interest rate sensitivity by modifying the repricing or maturity characteristics of certain fixed rate assets so that net interest margin is not adversely affected, on a material basis, by movements in interest rates. As a result of interest rate fluctuations, fixed rate assets will appreciate or depreciate in market value. The effect of the unrealized appreciation or depreciation will generally be offset by the gains or losses on the derivative instruments.

The Bank has a foreign currency risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that may be caused by foreign currency exchange rate fluctuations. Certain senior notes are denominated in foreign currency, creating exposure to changes in exchange rates. The Bank uses cross currency interest rate swaps and foreign currency forward exchange contracts to hedge this risk.

The Bank uses various interest rate and foreign exchange derivative contracts as part of its dealer and trading activities. As dealer, the Bank serves customers seeking to manage interest rate risk by entering into contracts as a counterparty to their (customer) transactions. In its trading activities, the Bank uses interest rate contracts to profit from expected future market movements. The Bank is also a dealer in foreign exchange contracts.

Interest rate derivative contracts may create exposure to both credit and market risk. Replacement risk, the primary component of credit risk, is the risk of loss should a counterparty default following unfavorable market movements and is measured as the Bank's cost of replacing contracts at current market rates. The Bank manages credit risk by establishing credit limits for customers and products through an independent corporate-wide credit review process and continually monitoring exposure against those limits to ensure they are not exceeded. Credit risk is, in many cases, further mitigated by the existence of netting agreements, which provide for netting of contractual receivables and payables in the event of default or bankruptcy. Netting agreements apply to situations where the Bank is engaged in more than one outstanding derivative transaction with the same counterparty and also has a legally enforceable master netting agreement with that counterparty. Market risk is the potential for loss arising from potential adverse changes in underlying market factors, including interest and foreign exchange rates. The Bank manages market risk through the imposition of integrated value-at-risk limits and an active, independent monitoring process. Value-at-risk methodology is used for measuring the market risk of the Bank's trading positions. This statistical methodology uses recent market volatility to estimate the maximum daily trading loss that the Bank would expect to incur, on average, 99 percent of the time. The model also measures the effect of correlation among the various trading instruments to determine how much risk is eliminated by offsetting positions.

Foreign exchange derivative contracts may create exposure to market and credit risk, including replacement risk and settlement risk. Credit risk is managed by establishing limits for customers through an independent corporate-wide credit approval process and continually monitoring exposure against those limits. In addition, both settlement and replacement risk are reduced through netting by novation, agreements with counterparties to offset certain related obligations. Market risk is managed through establishing exposure limits by currency and monitoring actual exposure against those limits, entering into offsetting positions, and closely monitoring price behavior.

FAIR VALUE HEDGES

The Bank uses interest rate swaps to alter the character of revenue earned on certain long-term, fixed rate loans. Interest rate swaps convert the fixed rate loans into variable rate loans. Interest rate swap contracts generally involve the exchange of fixed and variable rate interest payments between two parties, based on a common notional amount and maturity date.

For fair value hedges, as of September 30, 2001 the Bank recorded the fair value of derivative instrument liabilities of $10.1 million in other liabilities. Net losses recorded for the quarter-to-date and year-to-date periods ended September 30, 2001 representing the ineffective portion of the fair value hedges were not material to the consolidated financial statements of the Bank. Gains or losses resulting from hedge ineffectiveness are recorded in noninterest income.

CASH FLOW HEDGES

The Bank had used a total return swap to reduce the variability associated with the cash flows from an equity security. The total return swap converted the cash flows received on an available-for-sale equity security from variable to fixed. Changes in the fair value of the swap were recorded in other comprehensive income. The unrealized holding gain (loss) on the available-for-sale equity security is recorded in other comprehensive income. Prior to September 30, 2001 the Bank dedesignated the hedge due to the expectation of diminished cash flows from the equity security. The unrealized loss in accumulated other comprehensive income related to the total return swap was not material to the consolidated financial statements of the Bank. As of September 30, 2001 the swap, designated a nonhedging derivative, was marked to market and the resulting unrealized gain was recorded in noninterest income.

DEALER AND TRADING ACTIVITIES

Trading activities include derivative transactions that are entered into for risk management purposes and do not otherwise qualify for hedge accounting.

Foreign exchange contracts are used to stabilize any currency exchange rate fluctuation for certain senior notes. The derivative instruments, primarily cross currency interest rate swaps, do not qualify for hedge accounting.

The Bank has qualifying mortgage loan commitments that are intended to be sold in the secondary market. These loan commitments are derivatives and are accounted for at fair value, but since they are not firm commitments they do not qualify for hedge accounting. The Bank enters into forward sales of mortgage-backed securities to minimize its exposure to interest rate volatility. These forward sales of mortgage-backed securities are also derivatives and are accounted for at fair value.

The Bank utilizes various derivative instruments to meet its customers' financing and risk management needs and produce fee income and trading profits. Interest rate contracts include futures, forward rate agreements, option contracts, guarantees (caps, floors and collars) and swaps. Foreign exchange contracts include spot, futures, forwards, option contracts and swaps.

As of September 30, 2001 the Bank recorded the fair value of trading derivative instrument assets of $340.3 million in other assets and trading derivative instrument liabilities of $344.3 million in other liabilities. These amounts reflect the netting of certain derivative instrument assets and liabilities when the conditions in FASB Interpretation ("FIN") No. 39, "Offsetting of Amounts Related to Certain Contracts," have been met.

6. CORPORATE TRUST SALE

In March 2000, the Bank sold its corporate trust business. In separate and unrelated transactions, the indenture trust business was sold to a subsidiary of The Bank of New York Company, Inc., and the shareholder services business to Computershare Limited. The combined sales resulted in a pre-tax gain to Bankcorp of $50.2 million in first quarter 2000. The Bank recognized $47.2 million of that gain.

HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

FINANCIAL REVIEW

THIRD QUARTER 2001 COMPARED WITH THIRD QUARTER 2000

SUMMARY

The Bank had a third quarter 2001 net loss of $44.8 million, a decrease of $87.9 million from third quarter 2000. The third quarter 2001 results were impacted by a special provision for loan losses of $121 million pre-tax. Cash ROE was -11.89 percent in the current quarter compared to 16.55 percent one year earlier, with the decrease primarily due to unrealized gains and losses on the securities portfolio which are recorded directly to equity and the special provision. Excluding these factors, cash ROE declined 429 basis points from last year's third quarter.

Management's assessment of the adequacy of the allowance for possible loan losses was based on a comprehensive review of the loan portfolio that considered several quantitative and qualitative factors. This intense review, prompted by the rapidly changing environment, weakening economic conditions and management's expectation that economic recovery would be delayed from the end of 2001 until mid-2002, resulted in recognition of a special $121 million provision for loan losses.

Third quarter net interest income on a fully taxable equivalent basis was $123.4 million, up $12.3 million or 11 percent from $111.1 million in 2000's third quarter. Average earning assets decreased 5 percent to $17.30 billion from

$18.12 billion in 2000, primarily attributable to a decrease of $431 million in average loans and $696 million in the investment securities portfolio, somewhat offset by an increase in money market assets of $233 million. Net interest margin rose to 2.84 percent from 2.44 percent in the same quarter last year, primarily reflecting the impact of the declining interest rate environment during 2001.

The third quarter provision for loan losses of $146.1 million, including the $121 million special provision, increased from the $6.9 million in the third quarter of 2000. Net charge-offs increased to $28.2 million compared to $2.7 million in the prior year. Most of this increase resulted from higher commercial loan write-offs.

Third quarter noninterest income of $92.0 million increased $4.2 million from the same quarter last year. Last year's third quarter results included operating revenue for both the corporate trust business and the merchant card business, each sold in 2000. Excluding the operating revenue from these businesses, noninterest revenue increased 12 percent. Net gains from investment securities sales increased $4.4 million, while bond trading profits increased $2.5 million.

Third quarter 2001 noninterest expenses of $143.1 million increased $15.2 million or 12 percent from the year ago quarter. Excluding the operating expenses of the corporate trust and merchant card businesses sold in 2000, noninterest expenses increased 15 percent, reflecting expansion initiatives in our corporate and investment banking and private client and retail banking businesses.

Nonperforming assets at September 30, 2001 were $193 million or 1.84 percent of total loans, compared to $139 million or 1.32 percent at June 30, 2001, and $89 million or 0.79 percent a year ago. This increase is comprised of fifteen loans in the shared national credit portfolio ranging in size from $7 million to $20 million, to borrowers in fourteen different industry sectors. At September 30, 2001, the allowance for possible loan losses was $231 million, equal to 2.21 percent of loans outstanding, compared to $120 million or 1.06 percent at the end of third quarter 2000. As a result, the ratio of the allowance for possible loan losses to nonperforming assets declined from 135 percent at September 30, 2000 to 120 percent at September 30, 2001.

At September 30, 2001, Tier 1 capital of the Bank amounted to $1.55 billion, up from $1.50 billion one year earlier. The regulatory leverage capital ratio was 7.78 percent for the third quarter of 2001 compared to 7.18 percent in the same quarter of 2000. The Bank's capital ratio exceeds the prescribed regulatory minimum for banks. The Bank's September 30, 2001 Tier 1 and total risk-based capital ratios were 9.25 percent and 11.72 percent compared to respective ratios of 8.25 percent and 10.09 percent at September 30, 2000.

NINE MONTHS ENDED SEPTEMBER 30, 2001 COMPARED WITH 2000

SUMMARY

The Bank had net income for the nine months ended September 30, 2001 of $42.1 million, a decrease of $108.8 million from the same period a year ago, excluding the $27.9 million after-tax gain on the sale of the corporate trust business in the first quarter 2000. Year-to-year comparative results were also affected by the sale of the merchant card business sold in the fourth quarter

2000 and the third quarter 2001 special provision for loan losses. Excluding the impact of both of these divestitures and the special provision, earnings grew 6 percent for the first nine months of 2001.

Cash ROE was 5.27 percent in the current year. Excluding unrealized gains and losses on the securities portfolio recorded directly to equity, the corporate trust gain and the special loan loss provision, cash ROE was 14.82 percent last year.

Net interest income on a fully taxable equivalent basis was $364.0 million, up $33.6 million or 10 percent from $330.4 million in 2000's year-to-date period. Average earning assets remained essentially unchanged from a year ago. Net interest margin rose slightly to 2.75 percent from 2.48 percent in 2000, primarily reflecting the impact of the declining interest rate environment in 2001.

The year-to-date 2001 provision for loan losses of $184.3 million increased from $18.4 million in 2000. Net charge-offs were $72.0 million, an increase of $60.2 million from last year, primarily reflecting an increase in commercial loan write-offs.

Noninterest income of $271.4 million decreased $38.9 million from the same period last year. Excluding the $47.2 million gain on the sale of the corporate trust business and the operating revenue from both the merchant card and corporate trust businesses sold in 2000, noninterest income increased 16 percent. Most of this increase resulted from additional net gains from securities sales of $19.4 million and higher bond trading profits of $9.0 million.

Noninterest expenses of $400.0 million increased $6.9 million or 2 percent from the year ago period. Excluding the operating expense for the corporate trust and merchant card businesses sold in 2000, noninterest expense increased 8 percent. Income tax expense decreased $66.4 million, reflecting lower pretax income, including the gain on the sale of the corporate trust business.

PART II. OTHER INFORMATION

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

ITEM 6. (A) REPORTS ON FORM 8-K: NONE

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 13th day of November, 2001.

/s/ PAUL R. SKUBIC

Paul R. Skubic
Chairman of the Board and President

/s/ PAMELA PIAROWSKI

Pamela Piarowski
Chief Financial Officer