HARRIS PREFERRED CAPITAL CORP
Form 10-Q
August 13, 2001

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 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 August 13, 2001 was 1,000.

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HARRIS PREFERRED CAPITAL CORPORATION

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HARRIS PREFERRED CAPITAL CORPORATION

BALANCE SHEETS
(UNAUDITED)

	JUNE 30, 2001	DECEMBER 31, 2000	JUN
		(IN THOUSANDS)	
ASSETS			
Cash on deposit with Harris Trust and Savings Bank	$ 540	$ 819	$
Securities purchased from Harris Trust and Savings Bank under agreement to resell	10,001	3,000	
Notes receivable from Harris Trust and Savings Bank	78,922	102,960	
Securities available-for-sale:			
Mortgage-backed	376,831	352,965	
U.S. Treasury	24,973	24,850	
Securing mortgage collections due from Harris Trust and Savings Bank	2,765	2,786	
Other assets	2,500	2,559	
Total assets	$496,532	$489,939	$
LIABILITIES AND STOCKHOLDERS' EQUITY			
Accrued expenses	$ 44	$ 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	
Common stock ($1 par value); 1,000 shares authorized, issued and outstanding	1	1	
Additional paid-in capital	240,733	240,733	
Earnings in excess of distributions	8,842	536	
Accumulated other comprehensive income -- net unrealized losses on available-for-sale securities	(3,088)	(1,446)	
Total stockholders' equity	496,488	489,824	

Total liabilities and stockholders' equity...	$496,532	$489,939	$

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 JUNE 30		SIX MONTHS ENDED J	
	2001	2000	2001	2
		(IN THOUSANDS)		
INTEREST INCOME:				
Securities purchased from Harris Trust and Savings Bank under agreement to resell......	$ 372	$ 461	$ 915	$
Notes receivable from Harris Trust and Savings Bank.....................................	1,382	2,027	2,966	
Securities available-for-sale:				
Mortgage-backed...........................	5,850	5,354	11,419	
U.S. Treasury.............................	120	170	287	
Total interest income....................	7,724	8,012	15,587	
NON-INTEREST INCOME:				
Gain on sale of securities....................	--	--	2,203	
OPERATING EXPENSES:				
Loan servicing fees paid to Harris Trust and Savings Bank..............................	64	97	139	
Advisory fees paid to Harris Trust and Savings Bank.....................................	8	15	20	
General and administrative....................	34	108	107	
Total operating expenses.................	106	220	266	
Net income....................................	7,618	7,792	17,524	
Preferred dividends...........................	4,609	4,609	9,218	
NET INCOME AVAILABLE TO COMMON STOCKHOLDER.......	$ 3,009	$ 3,183	$ 8,306	$
Basic and diluted earnings per common share......	$3,009.00	$3,183.00	$8,306.00	$6,
Net income....................................	$ 7,618	$ 7,792	$ 17,524	$
Other comprehensive income -- net unrealized gains (losses) on available-for-sale securities..................................	(2,031)	3,230	(1,642)	
Comprehensive income..........................	$ 5,587	$ 11,022	$ 15,882	$

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

HARRIS PREFERRED CAPITAL CORPORATION

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(UNAUDITED)

	SIX MONTHS ENDED JUNE 30	
	2001	2000
	(IN THOUSANDS)	
Balance at January 1	$489,824	$473,891
Net income	17,524	15,572
Other comprehensive income (loss)	(1,642)	2,620
Dividends -- Series A preferred stock	(9,218)	(9,218)
Balance at June 30	$496,488	$482,865

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

HARRIS PREFERRED CAPITAL CORPORATION

STATEMENTS OF CASH FLOWS
(UNAUDITED)

	SIX MONTHS ENDED JUNE 30	
	2001	2000
	(IN THOUSANDS)	
OPERATING ACTIVITIES:		
Net Income	$ 17,524	$15,572
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sale of securities	(2,203)	--
Net decrease in other assets	59	161
Net decrease in accrued expenses	(71)	(40)
Net cash provided by operating activities	15,309	15,693
INVESTING ACTIVITIES:		
Net (increase) decrease in securities purchased from Harris Trust and Savings Bank under agreement to resell	(7,001)	9,199
Repayments of notes receivable from Harris Trust and Savings Bank	24,038	15,890
Decrease in securing mortgage collections due from Harris		

Trust and Savings Bank	21	218
Purchases of securities available-for-sale	(213,589)	(44,874)
Proceeds from maturities and sales of securities available-for-sale	190,161	12,695
Net cash used in investing activities	(6,370)	(6,872)
FINANCING ACTIVITIES:		
Cash dividends paid on preferred stock	(9,218)	(9,218)
Net cash used by financing activities	(9,218)	(9,218)
Net decrease in cash on deposit with Harris Trust and Savings Bank	(279)	(397)
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	$ 540	$ 865

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

SECOND QUARTER 2001 COMPARED WITH SECOND QUARTER 2000

The Company's net income for the second quarter of 2001 was $7.6 million. This represented a $.2 million or 2.56% decrease from 2000 earnings of $7.8 million. The decrease is attributable to lower yields on the investment portfolio.

HARRIS PREFERRED CAPITAL CORPORATION

NOTES TO FINANCIAL STATEMENTS -- (CONTINUED)

Second quarter 2001 interest income on the Notes totaled $1.4 million and yielded 6.4% on $86.3 million of average principal outstanding for the quarter compared to $2.0 million and a 6.4% yield on $127 million average principal outstanding for second 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 second quarter 2001 and 2000 was $106 million and $157 million, respectively. Interest income on securities available-for-sale for the current quarter was $6.0 million resulting in a yield of 6.6% on an average balance of $365 million, compared to $5.5 million with a yield of 6.87% on an average balance of $322 million for the same period a year ago. The increase in interest income is primarily attributable to an increase in the investment securities portfolio partially offset by a reduction in yield. As securities mature or are sold, proceeds are invested in lower yielding securities as market interest rates have been declining in recent months. There were no Company borrowings during the quarter.

Second quarter 2001 operating expenses totaled $106 thousand, a decrease of $114 thousand or 52% from the second quarter of 2000. Loan servicing expenses totaled $64 thousand, a decrease of $33 thousand or 34% from a year ago. This decrease is attributable to the reduction in the principal balance of the Notes, thereby reducing servicing fees payable to the Bank. Advisory fees for the second quarter 2001 were $8 thousand compared to $15 thousand a year earlier.

General and administrative expenses totaled $34 thousand, a decrease of $74 thousand over second quarter 2000. The decrease is primarily attributable to insurance costs and proxy service fees recorded in 2000, which have declined in 2001.

At June 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.

SIX MONTHS ENDED JUNE 30, 2001 COMPARED WITH JUNE 30, 2000

The Company's net income for the six months ended June 30, 2001 was $17.5 million. This represented a $1.9 million or 12% increase from 2000 earnings of $15.6 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 six months ended June 30, 2001 was $915 thousand, an increase of $141 thousand from the same period in 2000. Interest income on the Notes for the six months ended June 30, 2001 totaled $3.0 million and yielded 6.40% on $93 million of average principal outstanding compared to $4.2 million of income yielding 6.40% on $131 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 six months ended June 30, 2001 was $11.7 million resulting in a yield of 6.57% on an average balance of $356 million, compared to $11.0 million of income with a yield of 6.97% on an average balance of $316 million a year ago. The increase in interest income is primarily attributable to an increase in the investment securities portfolio partially offset by a reduction in yield. As securities mature or are sold, proceeds are invested in lower yielding securities as a result of market interest rates declining in recent months. Gains from investment securities sales were $2.2 million currently. No gains were realized in 2000. The average outstanding balance of the Securing Mortgage Loans was $114 million for the six months ended June 30, 2001 and $162 million for the same period in 2000. There were no Company borrowings during either period.

Operating expenses for the six months ended June 30, 2001 totaled $266 thousand, a decrease of $103 thousand from a year ago. Loan servicing expenses for the six months ended June 30, 2001 totaled $139 thousand, a decrease of $61 thousand or 30% from 2000. This decrease is attributable to the reduction in the principal balance of the Notes. Advisory fees for the six months ended June 30, 2001 were $20 thousand compared to $30 thousand a year ago. General and administrative expenses totaled $107 thousand, a decrease

of $32 thousand or 23% over the same period in 2000, primarily attributable to higher legal costs, insurance and proxy charges in 2000 compared to 2001.

On June 30, 2001, the Company paid a cash dividend of $0.46094 per share on outstanding preferred shares to the stockholders of record on June 15, 2001, as declared on June 1, 2001. On June 30, 2000, the Company paid a cash dividend of $0.46094 per share on outstanding preferred shares to the stockholders of record on June 15, 2000, as declared on June 1, 2000. On a year-to-date basis, the

Company has declared and paid $9.2 million of dividends to holders of preferred shares for each of the six-month periods ended June 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 $15.3 million provided from operations during the six months ended June 30, 2001 were $24.0 million provided by principal payments on the Notes and $190.2 million from the maturities and sales of securities available-for-sale. In the prior period ended June 30, 2000, the primary sources of funds other than from operations of $15.7 million were $15.9 million provided by principal payments on the Notes and $12.7 million from the maturities of securities available-for-sale. The primary uses of funds for the six months ended June 30, 2001 were $213.6 million for purchases of securities available-for-sale and $9.2 million of preferred stock dividends. For the prior year's quarter ended June 30, 2000 the primary uses of funds were $44.9 million for purchases of securities available-for-sale and $9.2 million of preferred stock dividends.

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

NOTES TO FINANCIAL STATEMENTS -- (CONTINUED)

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 has determined that this statement will hot have a material impact 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 has determined that this statement will hot have a material impact on its financial position and results of operations.

In September 2000, the FASB issued SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a replacement of SFAS No. 125." The Statement revises the standards for accounting for securitizations and other transfers of financial assets and collateral and requires certain disclosures relating to securitization transactions and collateral. It carries over most of the provisions of SFAS No. 125 without change. The collateral and disclosure provisions of the Statement were effective for year-end 2000 financial statements. The other provisions of the Statement relating to transfers and servicing of financial assets and extinguishments of liabilities were adopted as of April 1, 2001, with the exception of certain provisions which are effective for transfers of financial assets occurring after December 31, 2001. The adoption of the Standard did not have a material impact on the Company's financial statements.

OTHER MATTERS

As of June 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)

	JUNE 30 2001	DECEMBER 31 2000	JUNE 30 2000
	(IN THOUSANDS EXCEPT SHARE DATA)		
ASSETS			
Cash and demand balances due from banks	$ 1,040,209	$ 1,292,694	$ 1,188,4
Money market assets:			
Interest-bearing deposits at banks	182,473	141,348	148,2
Federal funds sold and securities purchased under agreement to resell	332,825	491,075	353,0
Trading account assets	62,978	65,211	79,3
Securities available-for-sale (including $3.61 billion and $3.30 billion of securities pledged as collateral for repurchase agreements at June 30, 2001 and December 31, 2000, respectively)	6,486,531	6,500,164	6,663,9
Loans	10,485,823	10,768,712	10,804,0
Allowance for possible loan losses	(113,376)	(118,951)	(116,1
Net loans	10,372,447	10,649,761	10,687,8
Premises and equipment	285,622	284,142	277,9
Customers' liability on acceptances	31,482	34,100	32,7
Bank-owned insurance investments	928,323	906,103	883,0
Loans held for sale	119,835	242,271	
Goodwill and other valuation intangibles	213,640	221,326	226,7
Other assets	484,727	461,420	585,1
TOTAL ASSETS	$20,541,092	$21,289,615	$21,126,4
LIABILITIES			
Deposits in domestic offices -- noninterest bearing	$ 2,287,866	$ 3,067,296	$ 3,060,3
-- interest-bearing	6,969,163	7,065,300	6,551,7
Deposits in foreign offices -- noninterest bearing	49,017	34,780	27,0
-- interest-bearing	2,628,087	2,326,001	1,805,6
Total deposits	11,934,133	12,493,377	11,444,7
Federal funds purchased and securities sold under agreement to repurchase	5,098,410	4,608,879	5,713,7
Other short-term borrowings	152,705	1,489,730	862,6
Senior notes	985,000	389,500	1,089,5
Acceptances outstanding	31,482	34,100	32,7
Accrued interest, taxes and other expenses	253,241	213,794	138,5
Other liabilities	58,272	60,812	48,3
Minority interest- preferred stock of subsidiary	250,000	250,000	250,0
Long-term notes	225,000	225,000	225,0
TOTAL LIABILITIES	18,988,243	19,765,192	19,805,3
STOCKHOLDER'S EQUITY			
Common stock ($10 par value); authorized 10,000,000 shares; issued and outstanding 10,000,000 shares	100,000	100,000	100,0
Surplus	618,120	613,365	612,1
Retained earnings	842,576	821,719	728,0
Accumulated other comprehensive income (loss)	(7,847)	(10,661)	(119,0
TOTAL STOCKHOLDER'S EQUITY	1,552,849	1,524,423	1,321,1
TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY	$20,541,092	$21,289,615	$21,126,4

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 JUNE 30		SIX MON JUN
	2001	2000	2001
	(IN THOUSANDS EXCEPT SHARE		
INTEREST INCOME			
Loans, including fees..	$195,189	$220,915	$412,834
Money market assets:			
Deposits at banks..	638	1,891	1,479
Federal funds sold and securities purchased under agreement to resell..................................	3,466	4,651	7,846
Trading account..	687	822	1,436
Securities available-for-sale:			
U.S. Treasury and Federal agency.........................	92,264	102,488	190,437
State and municipal..	24	269	91
Other..	547	357	980
Total interest income......................................	292,815	331,393	615,103
INTEREST EXPENSE			
Deposits...	94,071	123,926	205,644
Short-term borrowings......................................	62,198	86,837	143,749
Senior notes...	9,234	8,693	17,663
Minority interest-dividends on preferred stock of subsidiary..	4,609	4,609	9,219
Long-term notes..	3,595	3,909	7,555
Total interest expense.....................................	173,707	227,974	383,830
NET INTEREST INCOME..	119,108	103,419	231,273
Provision for loan losses..................................	23,741	6,351	38,199
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES.........	95,367	97,068	193,074
NONINTEREST INCOME			
Trust and investment management fees.......................	22,809	23,559	45,200
Money market and bond trading..............................	4,060	2,975	9,720
Foreign exchange...	1,720	2,100	3,395
Merchant and charge card fees..............................	24	6,691	65
Service fees and charges...................................	23,570	24,538	45,698
Securities gains...	4,955	2,986	17,918
Gain on sale of corporate trust business...................	--	--	--
Bank-owned insurance investments...........................	11,725	11,238	23,324
Foreign fees...	5,259	7,463	10,348
Other..	9,927	9,026	23,734

Total noninterest income	84,049	90,576	179,402
NONINTEREST EXPENSES			
Salaries and other compensation	75,000	70,062	143,131
Pension, profit sharing and other employee benefits	13,189	13,840	26,801
Net occupancy	9,793	10,752	18,449
Equipment	12,823	11,912	25,384
Marketing	8,571	6,412	15,198
Other	1,938	13,393	16,365
	121,314	126,371	245,328
Goodwill and other valuation intangibles	5,860	5,629	11,633
Total noninterest expenses	127,174	132,000	256,961
Income before income taxes	52,242	55,644	115,515
Applicable income taxes	12,452	14,951	28,658
NET INCOME	$ 39,790	$ 40,693	$ 86,857
EARNINGS PER COMMON SHARE (based on 10,000,000 average shares outstanding)			
Net Income	$ 3.98	$ 4.07	$ 8.69

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
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)

	QUARTER ENDED JUNE 30		SIX MONTHS ENDE
	2001	2000	2001
		(IN THOUSANDS)	
Net income	$ 39,790	$40,693	$ 86,857
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 $3,432 in 2001 and net of tax expense for the year-to-date period of $4,621 in 2001	5,844	--	7,868
Unrealized (losses) gains on available-for-sale securities:			
Unrealized holding (losses) gains arising during the period, net of tax (benefit) expense for the quarter of ($12,584) in 2001 and $14,055 in 2000 and net of tax (benefit) expense for the year-to-date period of $9,432 in 2001 and $13,443 in 2000	(19,632)	21,321	13,870
Less reclassification adjustment for realized gains included in income statement, net of			

tax expense for the quarter of $1,927 in 2001 and $1,162 in 2000 and net of tax expense for the year-to-date period of $6,970 in 2001 and $1,162 in 2000	(3,028)	(1,824)	(10,948)
Other comprehensive (loss) income	(16,816)	19,497	2,814
Comprehensive (loss) income	$ 22,974	$60,190	$ 89,671

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	86,857	107,796
Contributions to capital	4,755	1,621
Dividends -- common stock	(66,000)	(58,000)
Other comprehensive income (loss)	2,814	18,604
BALANCE AT JUNE 30	$1,552,849	$1,321,115

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)

	SIX MONTHS ENDED JUNE 30	
	2001	2000
	(IN THOUSANDS)	
OPERATING ACTIVITIES:		
Net income	$ 86,857	$ 107,796
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	38,199	11,496
Depreciation and amortization, including intangibles	33,816	34,883

Deferred tax (benefit) expense	(99)	1,898
Gain on sales of securities	(17,918)	(2,986)
Gain on sale of corporate trust business	--	(47,193)
Trading account net sales (purchases)	2,233	(12,309)
Net decrease (increase) in interest receivable	44,117	(4,341)
Net decrease in interest payable	(12,817)	(34,928)
Net decrease in loans held for sale	122,436	49,458
Other, net	(22,496)	(32,521)
Net cash provided by operating activities	274,328	71,253
INVESTING ACTIVITIES:		
Net (increase) decrease in interest-bearing deposits at banks	(41,125)	91,623
Net decrease (increase) in Federal funds sold and securities purchased under agreement to resell	158,250	(55,025)
Proceeds from sales of securities available-for-sale	961,230	104,887
Proceeds from maturities of securities available-for-sale	3,916,785	3,637,281
Purchases of securities available-for-sale	(4,841,081)	(4,107,217)
Net decrease (increase) in loans	239,115	(798,719)
Purchases of premises and equipment	(23,663)	(19,026)
Net increase in bank-owned insurance	(22,220)	(110,500)
Other, net	3,134	(140,148)
Net cash provided (used) by investing activities	350,425	(1,396,844)
FINANCING ACTIVITIES:		
Net (decrease) increase in deposits	(559,244)	315,097
Net increase in Federal funds purchased and securities sold under agreement to repurchase	489,531	974,189
Net (decrease) increase in short-term borrowings	(1,337,025)	181,553
Proceeds from issuance of senior notes	2,008,500	1,050,000
Repayment of senior notes	(1,413,000)	(1,460,500)
Proceeds from the sale of corporate trust business	--	88,704
Cash dividends paid on common stock	(66,000)	(58,000)
Net cash (used) provided by financing activities	(877,238)	1,091,043
NET DECREASE IN CASH AND DEMAND BALANCES DUE FROM BANKS	(252,485)	(234,548)
CASH AND DEMAND BALANCES DUE FROM BANKS AT JANUARY 1	1,292,694	1,423,043
CASH AND DEMAND BALANCES DUE FROM BANKS AT JUNE 30	$ 1,040,209	$ 1,188,495

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 six months ended June 30 totaled $396.6 million and $369.4 million in 2001 and 2000, respectively. Cash income tax payments over the same periods totaled $41.8 million and $34.3 million, respectively.

4. 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. The Bank is in the process of assessing the 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 Bank is in the process of assessing the impact of adopting the Statement on its financial position and results of operations. Upon adoption of SFAS No. 142, the Bank will discontinue the amortization of goodwill with an expected net carrying value of $89.3 million at the date of adoption and annual amortization of $9.4 million that resulted from business combinations prior to the adoption of SFAS No. 141.

HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS -- (CONTINUED)

5. NEW ACCOUNTING STANDARDS

In September 2000, the FASB issued SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a replacement of SFAS No. 125." The Statement revises the standards for accounting for securitizations and other transfers of financial assets and collateral and requires certain disclosures relating to securitization transactions and collateral. It carries over most of the provisions of SFAS No. 125 without change. The collateral and disclosure provisions of the Statement were effective for year-end 2000 financial statements. The other provisions of the Statement relating to transfers and servicing of financial assets and extinguishments of liabilities were adopted as of April 1, 2001, with the exception of certain provisions relating to isolation in bankruptcy for banks subject to FDIC receivership which are effective for transfers of financial assets occurring after December 31, 2001. The adoption of this Standard did not have a material impact on the Bank's financial statements.

6. DERIVATIVES

The Bank adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities," on January 1, 2001. The transition adjustment arising from the adoption of the Statement on January 1, 2001 was not material to the consolidated financial statements of the Bank.

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 June 30, 2001 the Bank recorded the fair value of derivative instrument liabilities of $4.2 million in other liabilities. Net losses recorded for the quarter-to-date and year-to-date periods ended June 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 uses a total return swap to reduce the variability associated with the cash flows from an equity security. A total return swap converts the cash flows received on an available-for-sale equity security from variable to fixed. Changes in the fair value of the swap are recorded in other comprehensive income. The unrealized holding gain (loss) on the available-for-sale equity security is also recorded in other comprehensive income. For cash flow hedges, as of June 30, 2001 the Bank recorded the fair value of derivative instrument liabilities of $0.2 million in other liabilities. No hedge ineffectiveness was recorded to earnings for the quarter ended June 30, 2001. The unrealized gain (loss) in accumulated other comprehensive income related to the total return swap will be reclassified to earnings if and when the unrealized holding gain (loss) on the available-for-sale equity security affects earnings. The amount expected to be reclassified into earnings over the next twelve months is expected to be immaterial. The Bank is hedging its exposure to the variability of future cash flows over a maximum term of sixteen months.

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 June 30, 2001 the Bank recorded the fair value of trading derivative instrument assets of $204.6 million in other assets and trading derivative instrument liabilities of $205.2 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.

7. 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

SECOND QUARTER 2001 COMPARED WITH SECOND QUARTER 2000

SUMMARY

The Bank had second quarter 2001 net income of $39.8 million, a decrease of $0.9 million or 2 percent from second quarter 2000. Cash ROE was 13.15 percent in the current quarter compared to 16.90 percent one year earlier, with the decrease primarily due to unrealized gains and losses on the securities portfolio which are recorded directly to equity. Excluding this factor, cash ROE declined 155 basis points from last year's second quarter.

Second quarter net interest income on a fully taxable equivalent basis was $123.5 million, up $14.8 million or 14 percent from $108.8 million in 2000's second quarter. Average earning assets essentially remained unchanged. Net interest margin rose from 2.44 percent in the year-ago quarter to 2.78 percent currently, reflecting the impact of the declining interest rate environment during 2001.

The second quarter provision for loan losses of $23.7 million was up $17.4 million from $6.3 million in the second quarter of 2000. Net charge-offs increased to $26.1 million compared to $4.8 million in the prior year. Most of the increase resulted from higher commercial loan write-offs.

Second quarter noninterest income of $84.0 million decreased $6.5 million from the same quarter last year. Last year's second 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 remained essentially unchanged from a quarter year ago.

Second quarter 2001 noninterest expenses of $127.2 million decreased $4.8 million or 4 percent from the year ago quarter. Excluding the operating expenses of the corporate trust and merchant card businesses sold in 2000, noninterest expenses increased two percent.

Nonperforming assets at June 30, 2001 were $139 million or 1.32 percent of total loans, compared to $109 million or 1.02 percent at March 31, 2001, and $34 million or 0.32 percent a year ago. The increase in nonperforming assets from June 30, 2000 is attributable to ten corporate loans, averaging approximately $10 million, in nine different industry sectors. At June 30, 2001, the allowance for possible loan losses was $113 million, equal to 1.08 percent of loans outstanding, compared to $116 million or 1.07 percent at the end of second quarter 2000. As a result, the ratio of the allowance for possible loan losses to nonperforming assets decreased from 339 percent at June 30, 2000 to 82 percent at June 30, 2001.

At June 30, 2001, Tier 1 capital of the Bank amounted to $1.60 billion, up from $1.47 billion one year earlier. The regulatory leverage capital ratio was 7.77 percent for the second quarter of 2001 compared to 7.06 percent in the same quarter of 2000. The Bank's capital ratio exceeds the prescribed regulatory minimum for banks. The Bank's June 30, 2001 Tier 1 and total risk-based capital ratios were 9.76 percent and 11.70 percent compared to respective ratios of 8.50

percent and 10.41 percent at June 30, 2000.

HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES
FINANCIAL REVIEW

SIX MONTHS ENDED JUNE 30, 2001 COMPARED WITH 2000

SUMMARY

The Bank had net income for the six months ended June 30, 2001 of $86.9 million, an increase of $7.0 million or 9 percent 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. Excluding the impact of both of these divestitures, earnings grew 11 percent for the first six months of 2001.

Cash ROE was 14.40 percent in the current year. Excluding unrealized gains and losses on the securities portfolio recorded directly to equity and the corporate trust gain, cash ROE was 14.70 percent last year.

Net interest income on a fully taxable equivalent basis was $240.6 million, up $21.4 million or 10 percent from $219.2 million in 2000's year-to-date period. Average earning assets rose 1 percent to $17.90 billion from $17.68 billion in 2000, primarily attributable to an increase of $270 million in average loans offset by a decrease of $112 million in the investment securities portfolio. Residential mortgages and consumer lending were the most significant contributors to the growth in loans. Net interest margin rose from 2.51 percent in 2000 to 2.75 percent currently, primarily reflecting the impact of the declining interest rate environment in 2001.

The year-to-date 2001 provision for loan losses of $38.2 million was up $26.7 million from $11.5 million in 2000. Net charge-offs were $43.8 million, an increase of $34.7 million from last year, primarily reflecting an increase in commercial loan write-offs.

Noninterest income of $179.4 million decreased $43.1 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 17 percent. Most of this increase resulted from additional net gains from securities sales of $14.9 million and higher bond trading profits of $6.5 million.

Noninterest expenses of $257.0 million decreased $8.3 million or 3 percent from the year ago period. Excluding the operating expenses for the corporate trust and merchant card businesses sold in 2000, noninterest expenses increased 4 percent. Income tax expense decreased $16.9 million, reflecting lower pretax income.

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 August, 2001.

/s/ PAUL R. SKUBIC

Paul R. Skubic
Chairman of the Board and President

/s/ PAMELA PIAROWSKI

Pamela Piarowski
Chief Financial Officer