HARRIS PREFERRED CAPITAL CORP
Form 10-Q
November 12, 2004

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

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2004

COMMISSION FILE NUMBER 1-13805

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

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

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

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

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

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

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

Indicate by check mark whether the registrant is an accelerated filer (as

defined in Rule 12b-2 of the Act)
Yes [ ] No [X]

The number of shares of Common Stock, $1.00 par value, outstanding on November 12, 2004 was 1,000.

HARRIS PREFERRED CAPITAL CORPORATION

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED BALANCE SHEETS

	SEPTEMBER 30 2004	DECEMBER 31 2003	SEPTEMBER 2003
	(UNAUDITED)	(AUDITED)	(UNAUDITED
	(IN THOUSANDS, EXCEPT SHARE DATA)		
ASSETS			
Cash on deposit with Harris Trust and Savings Bank......	$ 30,228	$ 926	$ 141
Securities purchased from Harris Trust and Savings Bank under agreement to resell...........................	16,000	11,500	13,000
Notes receivable from Harris Trust and Savings Bank.....	12,958	16,547	18,753
Securities available-for-sale:			

Mortgage-backed	429,915	233,857	289,566
U.S. Treasury	29,993	229,995	175,000
Securing mortgage collections due from Harris Trust and Savings Bank	121	414	1,135
Other assets	1,653	1,079	1,143
TOTAL ASSETS	$520,868	$494,318	$498,738
LIABILITIES AND STOCKHOLDERS' EQUITY			
Broker payable -- due to securities purchase	$ 29,991	$ --	$ --
Accrued expenses	42	84	20
TOTAL LIABILITIES	30,033	84	20
Commitments and contingencies	--	--	--
STOCKHOLDERS' EQUITY			
7 3/8% Noncumulative Exchangeable Preferred Stock, Series A ($1 par value); liquidation value of $250,000,000 and 20,000,000 shares authorized, 10,000,000 shares issued and outstanding	250,000	250,000	250,000
Common stock ($1 par value); 1,000 shares authorized, issued and outstanding	1	1	1
Additional paid-in capital	240,733	240,733	240,733
Earnings (less than) in excess of distributions	(971)	1,230	3,261
Accumulated other comprehensive income -- net unrealized gains on available-for-sale securities	1,072	2,270	4,723
TOTAL STOCKHOLDERS' EQUITY	490,835	494,234	498,718
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$520,868	$494,318	$498,738

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

HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME
(UNAUDITED)

	QUARTER ENDED SEPTEMBER 30		NINE MONTHS ENDED SEPTEMBER 30	
	2004	2003	2004	2003
	(IN THOUSANDS, EXCEPT PER SHARE DATA)			
INTEREST INCOME:				
Securities purchased from Harris Trust and Savings Bank under agreement to resell	$ 152	$ 307	$ 935	$ 850
Notes receivable from Harris Trust and Savings Bank	214	341	708	1,226
Securities available-for-sale:				
Mortgage-backed	4,438	3,178	10,367	11,754
U.S. Treasury	1	30	27	99

Total interest income	4,805	3,856	12,037	13,929
NON-INTEREST INCOME:				
Gain on sale of securities	464	687	862	3,149
OPERATING EXPENSES:				
Loan servicing fees paid to Harris Trust and Savings Bank	10	16	34	57
Advisory fees paid to Harris Trust and Savings Bank	29	10	86	30
General and administrative	55	54	248	222
Total operating expenses	94	80	368	309
Net income	5,175	4,463	12,531	16,769
Preferred dividends	4,609	4,609	13,828	13,828
NET INCOME (DEFICIT) AVAILABLE TO COMMON STOCKHOLDER	$ 566	$ (146)	$ (1,297)	$ 2,941
Basic and diluted earnings (losses) per common share	$566.00	$(146.00)	$(1,297.00)	$2,941.00
Net income	$ 5,175	$ 4,463	$ 12,531	$ 16,769
Other comprehensive income (loss) -- net unrealized gains/ (losses) on available-for-sale securities	8,139	(3,529)	(1,198)	(5,639)
Comprehensive income	$13,314	$ 934	$ 11,333	$ 11,130

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

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HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(UNAUDITED)

	NINE MONTHS ENDED SEPTEMBER 30	
	2004	2003
	(IN THOUSANDS, EXCEPT PER SHARE DATA)	
Balance at January 1	$494,234	$501,946
Net income	12,531	16,769
Other comprehensive loss	(1,198)	(5,639)
Dividends -- common stock	(904)	(530)
Dividends (preferred stock $0.4109 per share per quarter)	(13,828)	(13,828)
Balance at September 30	$490,835	$498,718

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

HARRIS PREFERRED CAPITAL CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	NINE MONTHS ENDED SEPTEMBER 30	
	2004	2003
	(IN THOUSANDS)	
OPERATING ACTIVITIES:		
Net Income	$ 12,531	$ 16,769
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sale of securities	(862)	(3,149)
(Increase) decrease in other assets	(574)	804
Net decrease in accrued expenses	(42)	(76)
Net cash provided by operating activities	11,053	14,348
INVESTING ACTIVITIES:		
(Decrease) increase in securities purchased from Harris Trust and Savings Bank under agreement to resell	(4,500)	7,000
Repayments of notes receivable from Harris Trust and Savings Bank	3,589	12,325
Net decrease in securing mortgage collections due from Harris Trust and Savings Bank	293	1,795
Purchases of securities available-for-sale	(573,977)	(535,416)
Proceeds from maturities and sales of securities available-for-sale	607,576	513,719
Net cash provided by (used) in investing activities	32,981	(577)
FINANCING ACTIVITIES:		
Cash dividends paid on preferred stock	(13,828)	(13,828)
Cash dividends paid on common stock	(904)	(530)
Net cash used by financing activities	(14,732)	(14,358)
Increase (decrease) in cash on deposit with Harris Trust and Savings Bank	29,302	(587)
Cash on deposit with Harris Trust and Savings Bank at beginning of period	926	728
Cash on deposit with Harris Trust and Savings Bank at end of period	$ 30,228	$ 141
NON CASH TRANSACTION		
Unsettled security purchase	$ 29,991	$ --

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, primarily U.S. treasury securities and securities collateralized with real estate mortgages. The Company holds its assets through a Maryland real estate investment trust subsidiary, Harris Preferred Capital Trust. Harris Capital Holdings, Inc., a wholly-owned subsidiary of the Bank, owns 100% of the Company's common stock.

The accompanying consolidated financial statements have been prepared by management from the books and records of the Company. These statements reflect all adjustments and disclosures which are, in the opinion of management, necessary for a fair statement of the results for the interim periods presented and should be read in conjunction with the notes to financial statements included in the Company's 2003 Form 10-K. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission.

2. COMMITMENTS AND CONTINGENCIES

Legal proceedings in which the Company is a defendant may arise in the normal course of business. There is no outstanding 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, 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 2004 COMPARED WITH THIRD QUARTER 2003

The Company's net income for the third quarter of 2004 was $5.2 million. This represented a $700 thousand or 16% increase from third quarter 2003 earnings of $4.5 million. Earnings increased primarily because of higher yields on earning assets.

Third quarter 2004 interest income on the Notes totaled $214 thousand and yielded 6.4% on $13.5 million of average principal outstanding for the quarter compared to $341 thousand and a 6.4% yield on $21 million average principal outstanding for third quarter 2003. The decrease in income was attributable to a reduction in the Notes balance because of principal paydowns by customers on the Securing Mortgage Loans. The average outstanding balance of the Securing Mortgage Loans for third quarter 2004 and 2003 was $17 million and $26 million, respectively. Interest income on securities available-for-sale for the current quarter was $4.4 million resulting in a yield of 4.3% on an average balance of $415 million, compared to $3.2 million with a yield of 4.1% on an average balance of $316 million for the same period a year ago. The increase in interest income is primarily attributable to the increase in the mortgage-backed investment portfolio.

There were no Company borrowings during third quarter 2004 or 2003.

Third quarter 2004 operating expenses totaled $94 thousand, an increase of $14 thousand or 18% from the third quarter of 2003. Loan servicing expenses totaled $10 thousand, a decrease of $6 thousand from a year ago. This decrease is attributable to the reduction in the principal balance of the Notes, thereby reducing servicing fees payable to the Bank. Advisory fees for the third quarter 2004 were $29 thousand compared to $10 thousand a year earlier, due to increased costs for processing, recordkeeping and administration. General and administrative expenses totaled $55 thousand, an increase of $1 thousand over the same period in 2003.

At September 30, 2004 and 2003, there were no Securing Mortgage Loans on nonaccrual status.

NINE MONTHS ENDED SEPTEMBER 30, 2004 COMPARED WITH SEPTEMBER 30, 2003

The Company's net income for the nine months ended September 30, 2004 was $12.5 million. This represented a $4.2 million decrease or 25% from 2003 earnings. Earnings declined primarily because of a substantial decrease in gains from security sales compared to last year and lower interest income on earning assets. The Company had a $1.3 million loss after dividends on its preferred stock. The Company anticipates that it has sufficient liquidity and earnings capacity to continue preferred dividend payments on an uninterrupted basis. For the current 2004 quarter, net income exceeded preferred dividends by $566 thousand.

Interest income on securities purchased under agreement to resell for the nine months ended September 30, 2004 was $935 thousand, an increase of $85 thousand from the same period in 2003. Interest income on the Notes for the nine months ended September 30, 2004 totaled $708 thousand and yielded 6.4% on $15 million of average principal outstanding compared to $1.2 million of income yielding 6.4% on $26 million of average principal outstanding for the same period in 2003. The decrease in income was attributable to a reduction in the Note balance because of customer payoffs on the Securing Mortgage Loans. The average outstanding balance of the Securing Mortgage Loans was $18 million for the nine months ended September 30, 2004 and $31 million for the same period in 2003. There were no Company borrowings during either period. Interest income on securities available-for-sale for the nine months ended September 30, 2004 was $10.4 million resulting in a yield of 4.3% on an average balance of $323 million, compared to $11.9 million of interest income resulting in a yield of 4.6% on an average balance of $346 million a year ago. The decrease in interest income from available-for-sale securities is primarily attributable to the decrease in the mortgage-backed investment portfolio and an increase in the U.S. Treasury portfolio. Yields on mortgage-backed securities generally exceed that of U.S. Treasuries. Recently, additional mortgage-backed securities were purchased bringing the September 30, 2004 balance to $430 million compared to $234 million at December 31, 2003. The U.S. Treasury portfolio has substantially declined at September 30, 2004 to $30 million. Gains from investment securities sales for the nine months ended September 30, 2004 were $862 thousand compared to $3.1 million a year ago.

Operating expenses for the nine months ended September 30, 2004 totaled $368 thousand, an increase of $59 thousand from a year ago. Loan servicing expenses for the nine months ended September 30, 2004 totaled $34 thousand, a decrease of $23 thousand or 40% from 2003. 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, 2004 were $86 thousand compared to $30 thousand a year ago; primarily attributable to increased costs for processing, recordkeeping and administration. General and administrative

expenses totaled $248 thousand, an increase of $26 thousand or 12% over the same period in 2003 as a result of additional insurance, compliance, printing and processing costs.

On September 30, 2004, the Company paid a cash dividend of $0.46094 per share on outstanding preferred shares to the stockholders of record on September 15, 2004, as declared on September 2, 2004. On September 13, 2004, the Company paid a cash dividend of $904 thousand on the outstanding common shares to the stockholder of record on September 6, 2004, as declared on September 2, 2004. This latter dividend completed the 2003 REIT tax compliance requirements. On September 30, 2003, the Company paid a cash dividend of $0.46094 per share on outstanding preferred shares to the stockholders of record on September 15, 2003, as declared on September 3, 2003. On September 12, 2003, the Company paid a cash dividend of $530 thousand on the outstanding common shares to the stockholder of record on September 3, 2003, as declared on September 3, 2003. This latter dividend completed the 2002 REIT tax compliance requirements. On a year-to-date basis, the Company declared and paid $13.8 million of dividends to holders of preferred shares for each of the nine-month periods ended September 30, 2004 and 2003.

LIQUIDITY RISK MANAGEMENT

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

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

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

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

As presented in the accompanying Consolidated Statements of Cash Flows, the primary sources of funds in addition to $11.1 million provided from operations during the nine months ended September 30, 2004 were $3.6 million provided by principal repayments on the Notes and $607.6 million from the maturities and sales of securities available-for-sale. In the prior period ended September 30, 2003, the primary sources of funds other than $14.3 million from operations were $12.3 million provided by principal repayments on the Notes and $513.7 million from the maturities and sales of securities available-for-sale. The primary uses of funds for the nine months ended September 30, 2004 were $574.0 million for purchases of securities available-for-sale and $13.8 million in preferred stock dividends paid. For the nine-months ended September 30, 2003, the primary uses of funds were $535.4 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, 2003.

OTHER MATTERS

As of September 30, 2004, the Company believes that it is in full compliance with the REIT tax rules, and expects to qualify as a non-taxable REIT under the provisions of the Internal Revenue Code. The Company expects to meet all REIT requirements regarding the ownership of its stock and anticipates meeting the annual distribution requirements.

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

	SEPTEMBER 30 2004	DECEMBER 31 2003	SEPTEM 20
	(UNAUDITED)	(AUDITED)	(UNAUD
	(IN THOUSANDS EXCEPT SHARE DATA		
ASSETS			
Cash and demand balances due from banks....................	$ 730,716	$ 823,615	$ 93
Money market assets:			
Interest-bearing deposits at banks.....................	508,984	424,459	39
Federal funds sold....................................	501,900	409,425	72
Securities available-for-sale (including $3.41 billion, $4.07 billion, and $4.17 billion of securities pledged as collateral for repurchase agreements at September 30, 2004, December 31, 2003 and September 30, 2003, respectively)..	5,782,203	6,624,280	6,67
Trading account assets....................................	71,325	59,467	2
Loans...	10,884,158	9,573,452	9,39
Allowance for possible loan losses........................	(204,211)	(234,798)	(22
Net loans...	10,679,947	9,338,654	9,17
Premises and equipment....................................	309,815	302,975	30
Customers' liability on acceptances.......................	6,156	44,234	3
Bank-owned insurance......................................	1,062,728	1,035,239	1,02
Loans held for sale.......................................	46,437	168,904	17
Goodwill and other valuation intangibles..................	158,192	165,978	16
Other assets..	560,391	522,260	54
TOTAL ASSETS..	$20,418,794	$19,919,490	$20,17
LIABILITIES			
Deposits in domestic offices -- noninterest-bearing.........	$ 4,398,381	$4,231,540	$ 4,31
-- interest-bearing..............	7,999,115	7,844,596	7,49
Deposits in foreign offices -- noninterest-bearing..........	--	49,016	2
-- interest-bearing................	1,304,948	616,889	1,06
Total deposits......................................	13,702,444	12,742,041	12,89
Federal funds purchased and securities sold under agreement to repurchase...	3,549,343	4,643,406	4,71
Short-term borrowings.....................................	80,118	10,841	
Short-term senior notes...................................	400,000	--	
Acceptances outstanding...................................	6,156	44,234	3
Accrued interest, taxes and other expenses................	179,301	171,422	14
Other liabilities...	415,096	230,917	31
Minority interest-preferred stock of subsidiary............	250,000	250,000	25
Preferred stock issued to Harris Bankcorp, Inc.	5,000	5,000	
Long-term notes -- subordinated...........................	200,000	225,000	22
TOTAL LIABILITIES...................................	18,787,458	18,322,861	18,57
STOCKHOLDER'S EQUITY			
Common stock ($10 par value); 10,000,000 shares authorized, issued and outstanding..................................	100,000	100,000	10
Surplus...	646,561	634,944	63
Retained earnings...	931,253	860,674	83
Accumulated other comprehensive (loss) income..............	(46,478)	1,011	2

TOTAL STOCKHOLDER'S EQUITY...........................	1,631,336	1,596,629	1,59
TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY............	$20,418,794	$19,919,490	$20,17

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 SEPTEMBER	
	2004	2003	2004	
	(IN THOUSANDS EXCEPT SHARE DATA			
INTEREST INCOME				
Loans, including fees......................................	$135,377	$114,101	$387,207	$3
Money market assets:				
Deposits at banks..	1,663	583	3,421	
Federal funds sold and securities purchased under agreement to resell..................................	2,284	891	5,646	
Trading account..	632	443	1,626	
Securities available-for-sale:				
U.S. Treasury and Federal agency..........................	22,797	40,732	84,754	1
State and municipal.......................................	221	27	805	
Other...	3,261	347	6,453	
Total interest income....................................	166,235	157,124	489,912	4
INTEREST EXPENSE				
Deposits...	39,140	31,138	109,287	
Short-term borrowings......................................	12,589	10,746	32,614	
Senior notes...	1,202	971	2,601	
Minority interest-dividends on preferred stock of subsidiary..	4,609	4,609	13,828	
Long-term notes..	827	2,585	5,337	
Total interest expense...................................	58,367	50,049	163,667	1
NET INTEREST INCOME..	107,868	107,075	326,245	3
Provision for loan losses (reduction in allowance)..........	(25,000)	28,732	(7,676)	
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES.........	132,868	78,343	333,921	2
NONINTEREST INCOME				
Trust and investment management fees.......................	22,323	21,729	68,583	
Money market and bond trading..............................	4,382	957	10,069	
Foreign exchange...	1,440	1,350	4,600	
Service fees and charges...................................	25,317	27,576	76,448	
Securities gains...	420	1,224	26,028	

Bank-owned insurance investments	9,919	11,659	30,423	
Gains from loan restructuring	--	--	7,131	
Letter of credit fees	5,725	6,528	17,607	
Other	32,184	56,319	118,245	1
Total noninterest income	101,710	127,342	359,134	3
NONINTEREST EXPENSES				
Salaries and other compensation	77,575	88,764	225,831	2
Pension, profit sharing and other employee benefits	20,590	21,199	62,687	
Net occupancy	10,670	11,279	33,955	
Equipment	13,127	13,948	39,779	
Marketing	10,018	8,196	26,987	
Communication and delivery	5,653	6,262	16,458	
Expert services	6,748	6,961	18,494	
Contract programming	9,454	8,761	23,012	
Other	23,403	13,150	67,351	
	177,238	178,520	514,554	5
Amortization of valuation intangibles	2,596	4,682	7,787	
Total noninterest expenses	179,834	183,202	522,341	5
Income before income taxes	54,745	22,483	170,714	1
Applicable income taxes	17,288	2,853	52,174	
NET INCOME	$ 37,457	$ 19,630	$118,540	$
EARNINGS PER COMMON SHARE (based on 10,000,000 average shares outstanding)				
Net Income	$ 3.75	$ 1.96	$ 11.85	$

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 ENDED SEPTEMBER 30	
	2004	2003	2004	2003
	(IN THOUSANDS)			
Net income	$37,457	$ 19,630	$118,540	$ 83,570
Other comprehensive income (loss):				
Minimum pension liability adjustment net of tax expense for the quarter of zero in 2004 and zero in 2003 and net of tax (benefit) for the year-to-date period of ($1,750) in 2004 and zero in 2003	--	--	(3,411)	--
Unrealized gains (losses) on available-for-sale				

securities:				
Unrealized holding gains (losses) arising during the period, net of tax expense (benefit) for the quarter of $10,399 in 2004 and ($19,976) in 2003 and net of tax (benefit) for the year-to-date period of ($16,772) in 2004 and ($11,831) in 2003......	13,358	(29,722)	(28,844)	(17,132)
Less reclassification adjustment for realized gains included in income statement, net of tax expense for the quarter of $164 in 2004 and $476 in 2003 and net of tax expense for the year-to-date period of $10,126 in 2004 and $3,712 in 2003..........................	(256)	(749)	(15,902)	(5,831)
Other comprehensive income (loss)................	13,102	(30,471)	(48,157)	(22,963)
Comprehensive income (loss)........................	$50,559	$(10,841)	$ 70,383	$ 60,607

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 CHANGES IN STOCKHOLDER'S EQUITY
(UNAUDITED)

	2004	2003
	(IN THOUSANDS)	
Balance at January 1......................................	$1,596,629	$1,577,654
Net income..	118,540	83,570
Contributions to capital................................	7,016	6,715
Contribution of parent's banking assets..................	14,984	--
Dividend of non-bank subsidiary..........................	(5,357)	--
Adjustment of prior quarters' preferred dividends.........	767	--
Dividends -- preferred stock.............................	(86)	(338)
Dividends -- common stock................................	(53,000)	(50,000)
Other comprehensive loss.................................	(48,157)	(22,963)
Balance at September 30..................................	$1,631,336	$1,594,638

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 CASH FLOWS
(UNAUDITED)

	NINE MONTHS ENDED SEPTEMBER 30	
	2004	2003
	(IN THOUSANDS)	
OPERATING ACTIVITIES:		
Net Income	$ 118,540	$ 83,570
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses (reduction in allowance)	(7,676)	76,632
Depreciation and amortization, including intangibles	51,134	50,123
Deferred tax expense (benefit)	4,544	(2,940)
Gain on sales of securities	(26,028)	(9,543)
Increase in bank-owned insurance	(29,628)	(32,598)
Trading account net cash sales	127,835	43,801
Net decrease (increase) in interest receivable	5,097	(757)
Net (decrease) increase in interest payable	(5,938)	3,462
Net decrease (increase) in loans held for sale	122,467	(26,851)
Other, net	45,369	40,079
Net cash provided by operating activities	405,716	224,978
INVESTING ACTIVITIES:		
Net (increase) decrease in interest-bearing deposits at banks	(84,525)	22,778
Net increase in Federal funds sold and securities purchased under agreement to resell	(86,353)	(486,395)
Proceeds from sales of securities available-for-sale	2,340,842	827,198
Proceeds from maturities of securities available-for-sale	2,801,244	3,756,918
Purchases of securities available-for-sale	(4,332,117)	(5,526,178)
Net increase (decrease) in loans	(1,222,905)	136,148
Purchases of premises and equipment	(44,244)	(41,578)
Other, net	2,139	(744)
Net cash used by investing activities	(625,919)	(1,311,853)
FINANCING ACTIVITIES:		
Cash received in contribution of parent's banking assets	3,379	--
Net increase in deposits	840,787	1,857,455
Net decrease in Federal funds purchased and securities sold under agreement to repurchase	(1,103,063)	(347,706)
Net increase (decrease) in other short-term borrowings	69,277	(298,768)
Proceeds from issuance of senior notes	1,780,000	2,425,000
Repayment of senior notes	(1,380,000)	(2,625,000)
Proceeds from issuance of long-term notes	200,000	--
Repayment of long-term notes	(225,000)	--
Cash dividends paid on common stock	(53,000)	(50,000)
Cash portion of dividend of non-bank subsidiary	(5,076)	--
Net cash provided by financing activities	127,304	960,981
NET DECREASE IN CASH AND DEMAND BALANCES DUE FROM BANKS	(92,899)	(125,894)
CASH AND DEMAND BALANCES DUE FROM BANKS AT JANUARY 1	823,615	1,057,254
CASH AND DEMAND BALANCES DUE FROM BANKS AT SEPTEMBER 30	$ 730,716	$ 931,360

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

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 Harris Financial Corp. (formerly known as 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 for the nine months ended September 30 totaled $169.6 million and $152.1 million in 2004 and 2003, respectively. Cash income tax payments over the same periods totaled $41.1 million and $7.7 million, respectively.

4. GOODWILL AND OTHER INTANGIBLE ASSETS

The Bank records goodwill and other intangible assets in connection with the acquisition of assets from unrelated parties or the acquisition of new subsidiaries. Goodwill and other intangible assets that have indefinite useful lives are not subject to amortization while intangible assets with finite lives are amortized. Goodwill is periodically assessed for impairment, at least annually. Intangible assets with finite lives are amortized on either an accelerated or straight-line basis depending on the character of the acquired asset. Intangible assets with finite lives are reviewed for impairment when events or future assessments of profitability indicate that the carrying value may not be recoverable.

The carrying value of the Bank's goodwill as of September 30, 2004 was $89.3 million. No impairment was recorded during the quarter ended September 30, 2004.

Other than goodwill, the Bank did not have any intangible assets not subject to amortization as of September 30, 2004.

HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

NOTES TO THE FINANCIAL STATEMENTS -- (CONTINUED)

As of September 30, 2004, the gross carrying amount and accumulated amortization of the Bank's amortizable intangible assets are included in the following table.

	GROSS CARRYING AMOUNT	ACCUMULATED AMORTIZATION	NET CARRYING VALUE
		(IN THOUSANDS)	
Branch network	$145,000	$(79,750)	$65,250
Other	5,724	(2,106)	3,618
Total finite life intangibles	$150,724	$(81,856)	$68,868

Total amortization expense for the Bank's intangible assets was $2.6 million for the quarter ended September 30, 2004.

Estimated intangible asset amortization expense for the years ending December 31, 2004, 2005, 2006, 2007 and 2008 is $10.4 million per year.

HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES
FINANCIAL REVIEW

THIRD QUARTER 2004 COMPARED WITH THIRD QUARTER 2003

SUMMARY

The Bank had third quarter 2004 net income of $37.5 million, an increase of $17.8 million or 91 percent from third quarter 2003.

Cash ROE was 10.66 percent in the current quarter and 6.26 percent in the third quarter 2003. Excluding the impact of unrealized gains and losses in the securities portfolio recorded directly to equity, cash ROE was 10.52 percent in the current quarter, compared to 6.46 percent a year ago.

Third quarter net interest income on a fully taxable equivalent basis was $109.4 million, down $0.3 million from $109.7 million in 2003's third quarter. Average earning assets increased 4 percent to $17.45 billion from $16.79 billion in 2003. Average loans increased by $1.08 billion while average securities available for sale decreased $775 million. Net interest margin decreased to 2.50 percent in the current quarter from 2.60 percent in the year-ago quarter, reflecting the impact of declining yields in the securities portfolio and higher rates on interest-bearing liabilities. This was somewhat offset by a greater retail loan base with yields generally higher than other earning asset portfolios and increased levels of noninterest-bearing funds in the mix of supporting funds.

In the third quarter 2004 the Bank recorded a reduction in the allowance for loan losses (negative provision) of $25.0 million, a decrease of $53.7 million from the third quarter of 2003. Net charge-offs decreased to $4.9 million from $17.6 million in the prior year. The decrease in provision resulted from a reduction in net charge-offs and management's assessment that declining non-performing loan levels are consistent with lower loan losses.

Third quarter noninterest income of $101.7 million decreased $25.6 million from the same quarter last year. Income from service charges decreased $13.8 million, syndication income decreased $5.7 million and income from mortgage sales decreased $7.3 million.

Third quarter 2004 noninterest expenses of $179.8 million decreased $3.4 million from the year ago quarter. A decrease in salary expense was partially offset by increased contract services expense in the quarter.

Nonperforming assets at September 30, 2004 were $135 million or 1.24 percent of total loans, down from $146 million or 1.37 percent at June 30, 2004, and $182 million or 1.94 percent a year ago. At September 30, 2004, the allowance for possible loan losses was $204 million, equal to 1.88 percent of loans outstanding, compared to $227 million or 2.41 percent at the end of third quarter 2003. The ratio of the allowance for possible loan losses to nonperforming assets remained unchanged at 124 percent from September 30, 2003 to September 30, 2004.

At September 30, 2004, Tier 1 capital of the Bank amounted to $1.74 billion, up from $1.62 billion one year earlier. The regulatory leverage capital ratio was 8.71 percent for the third quarter of 2004 compared to 8.42 percent in the same quarter of 2003. The Bank's capital ratio exceeds the prescribed regulatory minimum for banks. The Bank's September 30, 2004 Tier 1 and total risk-based capital ratios were 9.57 percent and 11.80 percent compared to respective ratios of 10.09 percent and 12.28 percent at September 30, 2003.

NINE MONTHS ENDED SEPTEMBER 30, 2004 COMPARED WITH SEPTEMBER 30, 2003

SUMMARY

The Bank had net income for the nine months ended September 30, 2004 of $118.5 million, an increase of $35.0 million or 42 percent from the same period a year ago.

Excluding the impact of unrealized gains and losses in the securities portfolio, cash ROE was 11.37 percent, up from 9.07 percent last year.

Net interest income on a fully taxable equivalent basis was $332.3 million, down $8.4 million or 2 percent from $340.7 million in 2003's year-to-date period. Average earning assets increased 7 percent to $17.58 billion from $16.51 billion in 2003. Most of the increase was attributable to average loans, up $650 million from last year. Net interest margin decreased to 2.52 percent from 2.76 percent in 2003, reflecting the impact of declining yields in the securities portfolio somewhat offset by increased levels of noninterest-bearing funds in the mix of supporting funds.

The year-to-date 2004 reduction in the allowance for loan losses of $7.7 million was down $84.3 million from the $76.6 million provision for loan losses in 2003. Net charge-offs were $24.1 million, a decrease of $32.6 million from last year, resulting from lower commercial loan write-offs.

Noninterest income of $359.1 million decreased $15.6 million from the same period last year. Net gains from securities sales increased $16.5 million compared to a year ago. Trust revenue increased and the Bank realized a $7.1 million gain on the sale of assets received in an earlier troubled debt restructuring and a gain on the termination of a swap. These were offset by decreases in mortgage sale income, syndication fees and income from service charges.

Noninterest expenses of $522.3 million increased $2.0 million from the year ago period. Income tax expense increased $25.9 million, reflecting higher pretax income from year ago results.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

See "Liquidity Risk Management" and "Market Risk Management" under Management's Discussion and Analysis of Financial Condition on page 8 and Results of Operations on page 6.

ITEM 4. CONTROLS AND PROCEDURES

As of September 30, 2004, Paul R. Skubic, the Chairman of the Board, Chief Executive Officer and President of the Company, and Janine Mulhall, the Chief Financial Officer of the Company, evaluated the effectiveness of the disclosure controls and procedures of the Company and concluded that these disclosure controls and procedures are effective to ensure that material information required to be included in this Report has been made known to them in a timely fashion. There was no change in the Company's internal control over financial reporting identified in connection with such evaluations that occurred during the quarter ended September 30, 2004 that has materially affected or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

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

ITEM 6. (A) EXHIBITS

31.1 CERTIFICATION OF JANINE MULHALL PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

31.2 CERTIFICATION OF PAUL R. SKUBIC PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

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

(b) 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 12th day of November 2004.

/s/ PAUL R. SKUBIC

Paul R. Skubic
Chairman of the Board and President

/s/ JANINE MULHALL

Janine Mulhall
Chief Financial Officer

EXHIBIT INDEX

EXHIBIT	DESCRIPTION
31.1	Certification of Janine Mulhall pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Paul R. Skubic pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002