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

----

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 August 13, 2004 was 1,000.

HARRIS PREFERRED CAPITAL CORPORATION

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED BALANCE SHEETS

	JUNE 30 2004	DECEMBER 31 2003	JUNE 3 2003
	(UNAUDITED)	(AUDITED)	(UNAUDIT
	(IN THOUSANDS, EXCEPT SHARE DATA)		
ASSETS			
Cash on deposit with Harris Trust and Savings Bank........	$ 6,081	$ 926	$ 31
Securities purchased from Harris Trust and Savings Bank under agreement to resell..............................	16,000	11,500	17,50
Notes receivable from Harris Trust and Savings Bank.......	14,013	16,547	22,93
Securities available-for-sale:			

Mortgage-backed	405,248	233,857	343,90
U.S. Treasury	39,800	229,995	114,99
Securing mortgage collections due from Harris Trust and Savings Bank	281	414	1,53
Other assets	1,643	1,079	1,83
TOTAL ASSETS	$483,066	$494,318	$503,00
LIABILITIES AND STOCKHOLDERS' EQUITY			
Accrued expenses	$ 33	$ 84	$ 8
Commitments and contingencies	--	--	-
STOCKHOLDERS' EQUITY			
7 3/8% Noncumulative Exchangeable Preferred Stock, Series A ($1 par value); liquidation value of $250,000,000 and 20,000,000 shares authorized, 10,000,000 shares issued and outstanding	250,000	250,000	250,00
Common stock ($1 par value); 1,000 shares authorized, issued and outstanding	1	1	
Additional paid-in capital	240,733	240,733	240,73
Earnings in excess (less than) of distributions	(634)	1,230	3,93
Accumulated other comprehensive income -- net unrealized gains/ (losses) on available-for-sale securities	(7,067)	2,270	8,25
TOTAL STOCKHOLDERS' EQUITY	483,033	494,234	502,92
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$483,066	$494,318	$503,00

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 JUNE 30		SIX MONTHS ENDED JUNE 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	$ 312	$ 296	$ 783	$ 543
Notes receivable from Harris Trust and Savings Bank	234	413	492	885
Securities available-for-sale:				
Mortgage-backed	3,299	4,050	5,929	8,576
U.S. Treasury	2	20	26	68
Total interest income	3,847	4,779	7,230	10,072

NON-INTEREST INCOME:				
Gain on sale of securities	--	--	398	2,463
OPERATING EXPENSES:				
Loan servicing fees paid to Harris Trust and Savings Bank	12	19	24	41
Advisory fees paid to Harris Trust and Savings Bank	28	10	57	20
General and administrative	97	70	193	168
Total operating expenses	137	99	274	229
Net income	3,710	4,680	7,354	12,306
Preferred dividends	4,609	4,609	9,218	9,218
NET (DEFICIT) INCOME AVAILABLE TO COMMON STOCKHOLDER	$ (899)	$ 71	$ (1,864)	3,088
Basic and diluted (losses) earnings per common share	$(899.00)	$71.00	$(1,864.00)	$3,088.00
Net income	$ 3,710	$4,680	$ 7,354	$ 12,306
Other comprehensive (loss) income -- net unrealized gains/(losses) on available-for-sale securities	(10,143)	123	(9,337)	(2,110)
Comprehensive (loss) income	$ (6,433)	$4,803	$ (1,983)	$ 10,196

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

3

HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(UNAUDITED)

	SIX MONTHS ENDED JUNE 30	
	2004	2003
	(IN THOUSANDS, EXCEPT PER SHARE DATA)	
Balance at January 1	$494,234	$501,946
Net income	7,354	12,306
Other comprehensive loss	(9,337)	(2,110)
Dividends (preferred stock $0.4109 per share per quarter)	(9,218)	(9,218)
Balance at June 30	$483,033	$502,924

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

HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	SIX MONTHS ENDED JUNE 30	
	2004	2003
	(IN THOUSANDS)	
OPERATING ACTIVITIES:		
Net Income	$ 7,354	$ 12,306
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sale of securities	(398)	(2,463)
(Increase) decrease in other assets	(564)	115
Net decrease in accrued expenses	(51)	(14)
Net cash provided by operating activities	6,341	9,944
INVESTING ACTIVITIES:		
(Decrease) increase in securities purchased from Harris Trust and Savings Bank under agreement to resell	(4,500)	2,500
Repayments of notes receivable from Harris Trust and Savings Bank	2,534	8,145
Net decrease in securing mortgage collections due from Harris Trust and Savings Bank	133	1,396
Purchases of securities available-for-sale	(516,889)	(340,490)
Proceeds from maturities and sales of securities available-for-sale	526,754	327,307
Net cash provided (used) in investing activities	8,032	(1,142)
FINANCING ACTIVITIES:		
Cash dividends paid on preferred stock	(9,218)	(9,218)
Increase (decrease) in cash on deposit with Harris Trust and Savings Bank	5,155	(416)
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	$ 6,081	$ 312

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 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 2004 COMPARED WITH SECOND QUARTER 2003

The Company's net income for the second quarter of 2004 was $3.7 million. This represented a $1 million or 21% decrease from second quarter 2003 earnings of $4.7 million. Earnings declined primarily because of reduced interest income on earning assets.

Second quarter 2004 interest income on the Notes totaled $234 thousand and yielded 6.4% on $14.7 million of average principal outstanding for the quarter compared to $413 thousand and a 6.4% yield on $25.8 million average principal outstanding for second 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 second quarter 2004 and 2003 was $18 million and $32 million, respectively. Interest income on securities available-for-sale for the current quarter was $3.3 million resulting in a yield of 4.3% on an average balance of $310 million, compared to $4.1 million with a yield of 4.6% on an average balance of $354 million for the same period a year ago. The decrease in interest income is primarily attributable to the reduction in the investment portfolio and lower interest rate of mortgage-backed securities. During the current quarter, additional securities were purchased, bringing the June 30, 2004 balance to $435 million with an average yield at that date of approximately 4.40%.

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

Second quarter 2004 operating expenses totaled $137 thousand, an increase of $38 thousand or 38% from the second quarter of 2003. Loan servicing expenses totaled $12 thousand, a decrease of $7 thousand from a year ago. This decrease is attributable to the reduction in the principal balance of the Notes, thereby reducing servicing fees payable to the Bank. Advisory fees for the second quarter 2004 were $28 thousand compared to $10 thousand a year earlier, due to increased costs for processing, recordkeeping and administration. General and administrative expenses totaled $97 thousand, an increase of $27 thousand over the same period in 2003 as a result of additional costs for insurance, compliance, printing and processing.

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

SIX MONTHS ENDED JUNE 30, 2004 COMPARED WITH JUNE 30, 2003

The Company's net income for the six months ended June 30, 2004 was $7.3 million. This represented a $5 million decrease or 40% from 2003 earnings. Earnings declined primarily because of reduced interest income on earning assets and a substantial decrease in gains from security sales.

Interest income on securities purchased under agreement to resell for the six months ended June 30, 2004 was $783 thousand, an increase of $240 thousand from the same period in 2003. Interest income on the Notes for the six months ended June 30, 2004 totaled $492 thousand and yielded 6.4% on $15 million of average principal outstanding compared to $885 thousand of income yielding 6.4% on $28 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 $19 million for the six months ended June 20, 2004 and $34 million for the same period in 2003. There were no Company borrowings during either period. Interest income on securities available-for-sale for the six months ended June 30, 2004 was $6.0 million resulting in a yield of 4.3% on an average balance of $277 million, compared to $8.6 million resulting in a yield of 4.8% on an average balance of $361 million a year ago. The decrease in interest income from available-for-sale securities is primarily attributable to the decrease in the investment portfolio and the reduction in yield for the greater part of the current period. Gains from investment securities sales for the six months ended June 30, 2004 were $398 thousand compared to $2.5 million a year ago.

Operating expenses for the six months ended June 30, 2004 totaled $274 thousand, an increase of $45 thousand from a year ago. Loan servicing expenses for the six months ended June 30, 2004 totaled $24 thousand, a decrease of $17 thousand or 41% 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 six months ended June 30, 2004 were $57 thousand compared to $20 thousand a year ago; primarily attributable to increased costs for processing, recordkeeping and administration. General and administrative expenses totaled $193 thousand, an increase of $25 thousand or 15% over the same period in 2003 as a result of additional insurance, compliance, printing and processing costs.

On June 30, 2004, the Company paid a cash dividend of $0.46094 per share on outstanding preferred shares to the stockholders of record on June 15, 2004, as declared on June 1, 2004. On June 30, 2003, the Company paid a cash dividend of $0.46094 per share on outstanding preferred shares to the stockholders of record on June 15, 2003, as declared on June 3, 2003. On a year-to-date basis, the Company declared and paid $9.2 million of dividends to holders of preferred shares for each of the six-month periods ended June 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 or securities. The payment of dividends on the Preferred Shares is made from legally available funds, arising from operating activities of the Company and sales or maturities of portfolio securities. 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 $6.34 million provided from operations during the six months ended June 30, 2004 were $2.5 million provided by principal repayments on the Notes and $526.8 million from the maturities and sales of securities available-for-sale. In the prior period ended June 30, 2003, the primary sources of funds other than $9.9 million from operations were $8.1 million provided by principal repayments on the Notes and $327.3 million from the maturities and sales of securities available-for-sale. The primary uses of funds for the six months ended June 30, 2004 were $516.9 million for purchases of securities available-for-sale and $9.2 million in preferred stock dividends paid. For the six-months ended June 30, 2003, the primary uses of funds were $340.5 million for purchases of securities available-for-sale and $9.2 million in preferred stock dividends paid.

MARKET RISK MANAGEMENT

The Company's market risk is composed primarily of interest rate risk. There have been no material changes in market risk or the manner in which the Company manages market risk since December 31, 2003.

OTHER MATTERS

As of June 30, 2004, 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 Internal Revenue Code. The Company expects to meet all REIT requirements regarding the ownership of its stock and anticipates meeting the annual distribution requirements.

HARRIS PREFERRED CAPITAL CORPORATION

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

	JUNE 30 2004 (UNAUDITED)	DECEMBER 31 2003 (AUDITED)	JUNE 30 2003 (UNAUDITED)
	(IN THOUSANDS EXCEPT SHARE DATA)		
ASSETS			
Cash and demand balances due from banks..............	$ 1,118,125	$ 823,615	$ 1,096,975
Money market assets:			
Interest-bearing deposits at banks.................	410,111	424,459	355,839
Federal funds sold.................................	768,168	409,425	679,238
Securities available-for-sale (including $2.87 billion, $4.07 billion, and $5.20 billion of securities pledged as collateral for repurchase agreements at June 30, 2004, December 31, 2003 and			

June 30, 2003, respectively)	5,367,110	6,624,280	6,816,419
Trading account assets	94,879	59,467	52,948
Loans	10,648,356	9,573,452	9,802,195
Allowance for possible loan losses	(234,059)	(234,798)	(215,833)
Net loans	10,414,297	9,338,654	9,586,362
Premises and equipment	305,755	302,975	301,098
Customers' liability on acceptances	7,934	44,234	25,326
Bank-owned insurance	1,053,436	1,035,239	1,014,876
Loans held for sale	122,432	168,904	239,818
Goodwill and other valuation intangibles	160,787	165,978	169,321
Other assets	471,866	522,260	553,698
TOTAL ASSETS	$20,294,900	$19,919,490	$20,891,918
LIABILITIES			
Deposits in domestic offices -- noninterest-bearing	$ 3,982,996	$ 4,231,540	$ 4,128,062
-- interest-bearing	8,031,987	7,844,596	6,570,548
Deposits in foreign offices -- noninterest-bearing	--	49,016	27,194
-- interest-bearing	1,016,051	616,889	1,002,636
Total deposits	13,031,034	12,742,041	11,728,440
Federal funds purchased and securities sold under agreement to repurchase	4,431,378	4,643,406	5,505,440
Short-term borrowings	300,397	10,841	301,562
Short-term senior notes	100,000	--	600,000
Acceptances outstanding	7,934	44,234	25,326
Accrued interest, taxes and other expenses	171,035	171,422	147,286
Other liabilities	203,337	230,917	485,361
Minority interest -- preferred stock of subsidiary	250,000	250,000	250,000
Preferred stock issued to Harris Bankcorp, Inc.	5,000	5,000	5,000
Long-term notes -- subordinated	200,000	225,000	225,000
TOTAL LIABILITIES	18,700,115	18,322,861	19,273,415
STOCKHOLDER'S EQUITY			
Common stock ($10 par value); 10,000,000 shares authorized, issued and outstanding	100,000	100,000	100,000
Surplus	644,535	634,944	631,274
Retained earnings	909,830	860,674	831,957
Accumulated other comprehensive (loss) income	(59,580)	1,011	55,272
TOTAL STOCKHOLDER'S EQUITY	1,594,785	1,596,629	1,618,503
TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY	$20,294,900	$19,919,490	$20,891,918

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 MONTHS E JUNE 30	
	2004	2003	2004	
	(IN THOUSANDS EXCEPT SHARE DATA			
INTEREST INCOME				
Loans, including fees	$130,660	$121,747	$251,830	$2
Money market assets:				
Deposits at banks	881	763	1,758	
Federal funds sold and securities purchased under agreement to resell	1,915	1,000	3,362	
Trading account	622	404	994	
Securities available-for-sale:				
U.S. Treasury and Federal agency	28,521	42,966	61,957	
State and municipal	305	7	584	
Other	2,505	348	3,192	
Total interest income	165,409	167,235	323,677	3
INTEREST EXPENSE				
Deposits	35,272	28,527	70,147	
Short-term borrowings	10,097	15,334	20,025	
Senior notes	1,273	1,703	1,399	
Minority interest-dividends on preferred stock of subsidiary	4,610	4,610	9,219	
Long-term notes	1,932	2,610	4,510	
Total interest expense	53,184	52,784	105,300	1
NET INTEREST INCOME	112,225	114,451	218,377	2
Provision for loan losses	0	30,282	17,325	
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	112,225	84,169	201,052	1
NONINTEREST INCOME				
Trust and investment management fees	23,208	20,604	46,260	
Money market and bond trading	3,574	3,635	5,687	
Foreign exchange	1,435	1,250	3,160	
Service fees and charges	26,028	29,182	51,131	
Securities gains	14,113	5,856	25,608	
Bank-owned insurance investments	10,116	10,773	20,504	
Gains from loan restructuring	--	--	7,131	
Foreign fees	5,732	6,220	11,882	
Other	40,828	48,554	86,061	
Total noninterest income	125,034	126,074	257,424	2
NONINTEREST EXPENSES				
Salaries and other compensation	73,957	74,294	148,256	1
Pension, profit sharing and other employee benefits	21,403	18,939	42,097	
Net occupancy	11,357	10,760	23,285	
Equipment	13,527	14,123	26,652	
Marketing	8,677	7,518	16,969	
Communication and delivery	5,190	5,427	10,805	
Expert services	6,144	7,181	11,746	
Contract programming	5,267	6,423	13,558	

Other	22,305	19,900	43,948	
	167,827	164,565	337,316	3
Amortization of valuation intangibles	2,596	4,365	5,191	
Total noninterest expenses	170,423	168,930	342,507	3
Income before income taxes	66,836	41,313	115,969	
Applicable income taxes	20,828	10,795	34,886	
NET INCOME	$ 46,008	$ 30,518	$ 81,083	$
EARNINGS PER COMMON SHARE (based on 10,000,000 average shares outstanding)				
Net Income	$ 4.60	$ 3.05	$ 8.11	$

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 JUNE 30		SIX MONTHS ENDED JUNE 30	
	2004	2003	2004	2003
	(IN THOUSANDS)			
NET INCOME	$ 46,008	$30,518	$ 81,083	$63,940
OTHER COMPREHENSIVE INCOME:				
Minimum pension liability adjustment net of tax benefit for the quarter of $1,591 in 2004 and zero in 2003 and net of tax benefit for the year-to-date period of $1,749 in 2004 and zero in 2003	(3,152)	--	(3,411)	--
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 ($29,589) in 2004 and $13,598 in 2003 and net of tax (benefit) expense for the year-to-date period of ($27,171) in 2004 and $8,145 in 2003	(45,798)	20,806	(42,202)	12,590
Less reclassification adjustment for realized gains included in income statement, net of tax expense for the quarter of $5,574 in 2004 and $2,278 in 2003 and net of tax expense for the year-to-date period of $9,962 in 2004 and $3,236 in 2003	(8,539)	(3,578)	(15,646)	(5,083)
Other comprehensive (loss) income	(57,489)	17,228	(61,259)	7,507

COMPREHENSIVE (LOSS) INCOME	$(11,481)	$47,746	$ 19,824	$71,447

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

12

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	81,083	63,940
Contributions to capital	4,991	4,635
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	(53)	(233)
Dividends -- common stock	(37,000)	(35,000)
Other comprehensive (loss) income	(61,259)	7,507
BALANCE AT JUNE 30	$1,594,785	$1,618,503

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

13

HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	SIX MONTHS ENDED JUNE 30	
	2004	2003
	(IN THOUSANDS)	
OPERATING ACTIVITIES:		
Net Income	$ 81,083	$ 63,940
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	17,325	47,899
Depreciation and amortization, including intangibles	33,590	32,727
Deferred tax expense	775	1,128

Gain on sales of securities	(25,608)	(8,319)
Increase in bank-owned insurance	(19,950)	(21,756)
Trading account net cash purchases	(43,981)	(2,883)
Net decrease (increase) in interest receivable	8,051	(992)
Net (decrease) increase in interest payable	(3,839)	3,642
Net decrease (increase) in loans held for sale	46,472	(90,507)
Other, net	22,066	29,357
Net cash provided by operating activities	115,984	54,236
INVESTING ACTIVITIES:		
Net decrease in interest-bearing deposits at banks	14,348	61,367
Net increase in Federal funds sold and securities purchased under agreement to resell	(352,621)	(441,288)
Proceeds from sales of securities available-for-sale	2,316,660	214,760
Proceeds from maturities of securities available-for-sale	2,418,932	2,409,116
Purchases of securities available-for-sale	(3,526,448)	(3,489,126)
Net increase in loans	(978,272)	(244,193)
Purchases of premises and equipment	(27,471)	(26,896)
Other, net	1,753	1,065
Net cash used by investing activities	(133,119)	(1,515,195)
FINANCING ACTIVITIES:		
Cash received in contribution of parent's banking assets	3,379	--
Net increase in deposits	206,814	690,156
Net (decrease) increase in Federal funds purchased and securities sold under agreement to repurchase	(221,028)	444,656
Net increase in other short-term borrowings	289,556	868
Proceeds from issuance of senior notes	1,130,000	1,625,000
Repayment of senior notes	(1,030,000)	(1,225,000)
Proceeds from issuance of long-term notes	200,000	--
Repayment of long-term notes	(225,000)	--
Cash dividends paid on common stock	(37,000)	(35,000)
Cash portion of dividend of non-bank subsidiary	(5,076)	--
Net cash provided by financing activities	311,645	1,500,680
NET INCREASE IN CASH AND DEMAND BALANCES DUE FROM BANKS	294,510	39,721
CASH AND DEMAND BALANCES DUE FROM BANKS AT JANUARY 1	823,615	1,057,254
CASH AND DEMAND BALANCES DUE FROM BANKS AT JUNE 30	$ 1,118,125	$ 1,096,975

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 six months ended June 30 totaled $109.1 million and $101.9 million in 2004 and 2003, respectively. Cash income tax payments over the same periods totaled $27.6 million and $0.6 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 June 30, 2004 was $89.3 million. No impairment was recorded during the quarter ended June 30, 2004.

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

15

HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

NOTES TO THE FINANCIAL STATEMENTS -- (CONTINUED)

As of June 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 CARR VALUE
		(IN THOUSANDS)	
Branch network..	$145,000	$(77,333)	$67,66
Other...	5,724	(1,927)	3,79
Total finite life intangibles.........................	$150,724	$(79,260)	$71,46

Total amortization expense for the Bank's intangible assets was $2.6 million for the quarter ended June 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.

16

HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

FINANCIAL REVIEW

SECOND QUARTER 2004 COMPARED WITH SECOND QUARTER 2003

SUMMARY

The Bank had second quarter 2004 net income of $46.0 million, an increase of $15.5 million or 51 percent from second quarter 2003.

Cash ROE was 13.21 percent in the current quarter and 8.97 percent in the second quarter 2003. Excluding the impact of unrealized gains and losses in the securities portfolio recorded directly to equity, cash ROE was 13.21 percent in the current quarter, compared to 9.46 percent a year ago.

Second quarter net interest income on a fully taxable equivalent basis was $114.3 million, down $3.1 million or 3 percent from $117.4 million in 2003's second quarter. Average earning assets increased 7 percent to $18.01 billion from $16.86 billion in 2003, due in part to an increase of $563 million in average loans. Net interest margin decreased to 2.55 percent in the current quarter from 2.79 percent in the year-ago quarter, reflecting the impact of declining yields in the securities portfolio and volume increases in higher-cost supporting funds, somewhat offset by greater levels of noninterest-bearing funds.

There was no provision for loan losses in the current quarter, a decrease of $30.3 million from the second quarter of 2003. This decrease in provisions was a result of the reduction in net charge-offs during the first half of 2004 as well as management's assessment that declining non-performing loan levels will result in potentially lower loan losses. Net charge-offs decreased to $10.0 million from $22.7 million in the prior year.

Second quarter noninterest income of $125.0 million decreased $1.0 million from the same quarter last year. Net gains from securities sales increased $8.3 million. This was offset by declines in mortgage sale income and service fees and charges.

Second quarter 2004 noninterest expenses of $170.4 million increased $1.5 million from the year ago quarter.

Nonperforming assets at June 30, 2004 were $146 million or 1.37 percent of total loans, down from $159 million or 1.56 percent at March 31, 2004, and $202 million or 2.06 percent a year ago. At June 30, 2004, the allowance for possible loan losses was $234 million, equal to 2.20 percent of loans outstanding, compared to $216 million or 2.20 percent at the end of second quarter 2003. As a result, the ratio of the allowance for possible loan losses to nonperforming assets increased from 107 percent at June 30, 2003 to 161 percent at June 30, 2004.

At June 30, 2004, Tier 1 capital of the Bank amounted to $1.72 billion, up from $1.61 billion one year earlier. The regulatory leverage capital ratio was 8.34 percent for the second quarter of 2004 compared to 8.35 percent in the same quarter of 2003. The Bank's capital ratio exceeds the prescribed regulatory minimum for banks. The Bank's June 30, 2004 Tier 1 and total risk-based capital ratios were 9.68 percent and 12.06 percent compared to respective ratios of 9.65 percent and 11.80 percent at June 30, 2003.

SIX MONTHS ENDED JUNE 30, 2004 COMPARED WITH JUNE 30, 2003

SUMMARY

The Bank had net income for the six months ended June 30, 2003 of $81.1 million, an increase of $17.1 million or 27 percent from the same period a year ago.

Excluding the impact of unrealized gains and losses in the securities portfolio, cash ROE was 11.81 percent, up from 10.04 percent last year.

Net interest income on a fully taxable equivalent basis was $222.9 million, down $8.1 million or 4 percent from $231.0 million in 2003's year-to-date period. Average earning assets increased 8 percent to $17.65 billion from $16.36 billion in 2003. Average securities available for sale showed the largest increase, up $465 million

17

from last year. Net interest margin decreased to 2.54 percent from 2.84 percent in 2003, reflecting the impact of declining yields in the securities portfolio.

The year-to-date 2004 provision for loan losses of $17.3 million was down $30.6 million from $47.9 million in 2003. Net charge-offs were $19.3 million, a decrease of $19.8 million from last year, resulting from lower commercial loan write-offs.

Noninterest income of $257.4 million increased $10.0 million from the same period last year. Net gains from securities sales increased $17.3 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 and service fees and charges.

Noninterest expenses of $342.5 million increased $5.4 million or 2 percent from the year ago period. Income tax expense increased $11.5 million, reflecting higher pretax income from year ago results.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

ITEM 4. CONTROLS AND PROCEDURES

As of June 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 June 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 13th day of August 2004.

/s/ PAUL R. SKUBIC

Paul R. Skubic
Chairman of the Board and President

/s/ JANINE MULHALL

Janine Mulhall
Chief Financial Officer