

HARRIS PREFERRED CAPITAL CORP

Form 10-Q

May 14, 2001

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SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
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FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 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 (I.R.S. Employer Identification  
incorporation or organization) No.)

111 WEST MONROE STREET, 60603  
CHICAGO, ILLINOIS (Zip Code)  
(Address of principal executive  
offices)

Registrant's telephone number, including area code: (312) 461-2121  
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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 [ ]

The number of shares of Common Stock, \$1.00 par value, outstanding on May 11,  
2001 was 1,000.

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HARRIS PREFERRED CAPITAL CORPORATION

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### HARRIS PREFERRED CAPITAL CORPORATION

#### BALANCE SHEETS (UNAUDITED)

	MARCH 31, 2001	DECEMBER 31, 2000	MARCH 31, 2000
	-----	-----	-----
	(IN THOUSANDS, EXCEPT SHARE DATA)		
<b>ASSETS</b>			
Cash on deposit with Harris Trust and Savings			
Bank.....	\$ 1,063	\$ 819	\$
Securities purchased from Harris Trust and Savings			
Bank under agreement to resell.....	14,002	3,000	
Notes receivable from Harris Trust and Savings			
Bank.....	91,611	102,960	
Securities available-for-sale:			
Mortgage-backed.....	342,163	352,965	
U.S. Treasury.....	39,903	24,850	
Securing mortgage collections due from Harris Trust and Savings Bank.....	4,042	2,786	
Other assets.....	2,810	2,559	
	-----	-----	-----
Total assets.....	\$495,594	\$489,939	\$
	=====	=====	=====
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>			
Accrued expenses.....	\$ 84	\$ 115	\$
	-----	-----	-----
Commitments and contingencies.....	--	--	
<b>STOCKHOLDERS' EQUITY</b>			
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.....	5,833	536	
Accumulated other comprehensive income -- unrealized losses on available-for-sale securities.....	(1,057)	(1,446)	
	-----	-----	-----

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Total stockholders' equity.....	495,510	489,824
	-----	-----
Total liabilities and stockholders' equity.....	\$495,594	\$489,939
	=====	=====

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

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HARRIS PREFERRED CAPITAL CORPORATION

STATEMENTS OF OPERATIONS  
AND OTHER COMPREHENSIVE INCOME  
(UNAUDITED)

	QUARTER ENDED MARCH 31	
	2001	2000
	----	----
	(IN THOUSANDS, EXCEPT PER SHARE DATA)	
INTEREST INCOME:		
Securities purchased from Harris Trust and Savings Bank under agreement to resell.....	\$ 543	\$ 313
Notes receivable from Harris Trust and Savings Bank.....	1,584	2,150
Securities available-for-sale:		
Mortgage-backed.....	5,569	5,462
U.S. Treasury.....	167	4
	-----	-----
Total interest income.....	7,863	7,929
NON-INTEREST INCOME:		
Gain on sale of securities.....	2,203	--
	-----	-----
OPERATING EXPENSES:		
Loan servicing fees paid to Harris Trust and Savings Bank.....	75	103
Advisory fees paid to Harris Trust and Savings Bank.....	12	15
General and administrative.....	73	31
	-----	-----
Total operating expenses.....	160	149
	-----	-----
Net income.....	9,906	7,780
Preferred dividends.....	4,609	4,609
	-----	-----
NET INCOME AVAILABLE TO COMMON STOCKHOLDER.....	\$ 5,297	\$ 3,171
	=====	=====
Basic and diluted earnings per common share.....	\$5,297.00	\$3,171.00
	=====	=====
Net income.....	\$ 9,906	\$ 7,780
Other comprehensive income -- unrealized gains/(losses) on available-for-sale securities.....	389	(610)
	-----	-----
Comprehensive income.....	\$ 10,295	\$ 7,170
	=====	=====

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HARRIS PREFERRED CAPITAL CORPORATION  
 STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
 (UNAUDITED)

	QUARTER ENDED MARCH 31	
	2001	2000
	----	----
	(IN THOUSANDS, EXCEPT PER SHARE DATA)	
Balance at January 1.....	\$489,824	\$473,891
Net income.....	9,906	7,780
Other comprehensive income/(loss).....	389	(610)
Dividends (preferred stock \$0.4609 per share).....	(4,609)	(4,609)
	-----	-----
Balance at March 31.....	\$495,510	\$476,452
	=====	=====

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

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HARRIS PREFERRED CAPITAL CORPORATION  
 STATEMENTS OF CASH FLOWS  
 (UNAUDITED)

	QUARTER ENDED MARCH 31	
	2001	2000
	----	----
	(IN THOUSANDS)	
OPERATING ACTIVITIES:		
Net Income.....	\$ 9,906	\$ 7,780
Adjustments to reconcile net income to net cash provided by operating activities:		
Gain on sale of securities.....	(2,203)	--
Net (increase) decrease in other assets.....	(251)	71
Net decrease in accrued expenses.....	(31)	(31)
Other, net.....	10,571	5,126
	-----	-----
Net cash provided in operating activities.....	17,992	12,946
	-----	-----
INVESTING ACTIVITIES:		
Net (increase) decrease in securities purchased from Harris Trust and Savings Bank under agreement to resell.....	(11,002)	8,499

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Repayments of notes receivable from Harris Trust and Savings Bank.....	11,349	7,172
(Increase) decrease in securing mortgage collections due from Harris Trust and Savings Bank.....	(1,256)	23
Purchases of securities available-for-sale.....	(138,975)	(24,883)
Proceeds from maturities and sales of securities available-for-sale.....	126,745	--
	-----	-----
Net cash used by investing activities.....	(13,139)	(9,189)
	-----	-----
<b>FINANCING ACTIVITIES:</b>		
Cash dividends paid on preferred stock.....	(4,609)	(4,609)
	-----	-----
Net cash used by financing activities.....	(4,609)	(4,609)
	-----	-----
Net increase (decrease) in cash on deposit with Harris Trust and Savings Bank.....	244	(852)
Cash on deposit with Harris Trust and Savings Bank at beginning of period.....	819	1,262
	-----	-----
Cash on deposit with Harris Trust and Savings Bank at end of period.....	\$ 1,063	\$ 410
	=====	=====

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

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### 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.

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### 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

##### QUARTER ENDED MARCH 31, 2001 COMPARED TO QUARTER ENDED MARCH 31, 2000

The Company's net income for the first quarter of 2001 was \$9.9 million. This represented a \$2.1 million or 26.9% increase from 2000 earnings of \$7.8 million.

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#### HARRIS PREFERRED CAPITAL CORPORATION

##### NOTES TO FINANCIAL STATEMENTS -- (CONTINUED)

First quarter 2001 interest income on the Notes totaled \$1.6 million and yielded 6.4% on \$98.7 million of average principal outstanding for the quarter compared to \$2.2 million and a 6.4% yield on \$135 million average principal outstanding for first quarter 2000. The decrease in income was attributable to a reduction in the Notes balance because of customer payoffs in the Securing Mortgage Loans. The average outstanding balance of the Securing Mortgage Loans for first quarter 2001 and 2000 was \$122 million and \$167 million, respectively. Interest income on securities available-for-sale for the current quarter was \$5.7 million resulting in a yield of 6.6% on an average balance of \$348 million, compared to \$5.5 million with a yield of 7.1% on an average balance of \$309 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. Gains from investment securities sales increased \$2.2 million from the same period in 2000. There were no Company borrowings during the quarter.

First quarter 2001 operating expenses totaled \$160 thousand, an increase of \$11 thousand or 7% from the first quarter of 2000. Loan servicing expenses totaled \$75 thousand, a decrease of \$28 thousand or 27% from a year ago. This

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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 first quarter 2001 were \$12 thousand compared to \$15 thousand a year earlier. General and administrative expenses totaled \$73 thousand, an increase of \$42 thousand over first quarter 2000, primarily due to the timing of rating agency fees and insurance costs paid in the current quarter.

At March 31, 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.

On March 30, 2001, the Company paid a cash dividend of \$0.46094 per share on outstanding preferred shares to the stockholders of record on March 15, 2001, as declared on March 2, 2001. On March 30, 2000, the Company paid a cash dividend of \$0.46094 per share on outstanding preferred shares to the stockholders of record on March 15, 2000, as declared on March 6, 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 from repayment of principal balances by individual mortgages or maturities of securities held for sale on a reinvested basis. The payment of dividends on the preferred shares will be made from legally available funds, principally arising from operating activities of the Company. The Company's cash flows from operating activities principally consist of the collection of interest on 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 currently 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.

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### HARRIS PREFERRED CAPITAL CORPORATION

#### NOTES TO FINANCIAL STATEMENTS -- (CONTINUED)

As presented in the accompanying Statements of Cash Flows, the primary sources of funds in addition to \$7.8 million provided from operations during the three months ended March 31, 2001 were \$11 million provided by principal payments on the Notes and \$137 million from the maturities and sales of securities available-for-sale. In the prior period ended March 31, 2000, the primary sources of funds other than from operations of \$7.8 million were \$7

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million provided by principal payments on the Notes and \$5 million from the maturities of securities available-for-sale. The primary use of funds for the three months ended March 31, 2001 was \$139 million in purchases of securities available-for-sale. For the prior year's quarter ended March 31, 2000 the primary uses of funds were \$25 million in purchases of securities available-for-sale, and \$5 million in 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 June 1998, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities." The Statement is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. The Company adopted this Statement at January 1, 2001. The adoption did not have an effect on the Company because the Company has not invested in derivatives or participated in hedging activities.

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 pertaining to accounting for securitizations and other transfers of financial assets and collateral and requires certain disclosures. It carries over most of the provisions of SFAS No. 125 without change. The Statement is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001. The Statement is effective for recognition and reclassification of collateral and for disclosures relating to securitization transactions and collateral for fiscal years ending after December 15, 2000. The Company does not expect the implementation of this Statement to have a material effect on the Company's financial position or results of operations.

### OTHER MATTERS

As of March 31, 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.

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

MARCH 31	DECEMBER 31	MARCH 31
2001	2000	2000
-----	-----	-----



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(IN THOUSANDS EXCEPT SHARE DATA)

<b>ASSETS</b>			
Cash and demand balances due from banks.....	\$ 1,081,252	\$ 1,292,694	\$ 1,204,4
Money market assets:			
Interest-bearing deposits at banks.....	174,005	141,348	251,4
Federal funds sold and securities purchased under agreement to resell.....	394,925	491,075	228,4
Trading account assets.....	39,910	65,211	24,1
Securities available-for-sale.....	6,593,537	6,500,164	6,423,3
Loans.....	10,689,492	10,768,712	10,661,0
Allowance for possible loan losses.....	(115,761)	(118,951)	(114,5
Net loans.....	10,573,731	10,649,761	10,546,4
Premises and equipment.....	284,303	284,142	279,4
Customers' liability on acceptances.....	36,334	34,100	50,2
Bank-owned insurance investments.....	916,601	906,103	871,8
Assets held for sale.....	125,908	242,271	
Goodwill and other valuation intangibles.....	217,314	221,326	230,9
Other assets.....	515,706	461,420	625,6
<b>TOTAL ASSETS.....</b>	<b>\$20,953,526</b>	<b>\$21,289,615</b>	<b>\$20,736,1</b>
<b>LIABILITIES</b>			
Deposits in domestic offices -- noninterest bearing...	\$ 2,376,021	\$ 3,067,296	\$ 3,138,0
-- interest-bearing.....	7,090,977	7,065,300	6,644,8
Deposits in foreign offices -- noninterest bearing.....	36,853	34,780	35,5
-- interest-bearing.....	2,375,965	2,326,001	1,976,3
<b>Total deposits.....</b>	<b>11,879,816</b>	<b>12,493,377</b>	<b>11,794,7</b>
Federal funds purchased and securities sold under agreement to repurchase.....	5,191,832	4,608,879	4,510,0
Other short-term borrowings.....	884,041	1,489,730	1,539,4
Senior notes.....	608,500	389,500	853,0
Acceptances outstanding.....	36,334	34,100	50,2
Accrued interest, taxes and other expenses.....	257,354	213,794	160,2
Other liabilities.....	74,554	60,812	50,4
Minority interest-preferred stock of subsidiary.....	250,000	250,000	250,0
Long-term notes.....	225,000	225,000	225,0
<b>TOTAL LIABILITIES.....</b>	<b>19,407,431</b>	<b>19,765,192</b>	<b>19,433,1</b>
<b>STOCKHOLDER'S EQUITY</b>			
Common stock (\$10 par value); authorized 10,000,000 shares; issued and outstanding 10,000,000 shares....	100,000	100,000	100,0
Surplus.....	616,340	613,365	611,2
Retained earnings.....	820,786	821,719	730,3
Accumulated other comprehensive income (loss).....	8,969	(10,661)	(138,5
<b>TOTAL STOCKHOLDER'S EQUITY.....</b>	<b>1,546,095</b>	<b>1,524,423</b>	<b>1,303,0</b>
<b>TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY.....</b>	<b>\$20,953,526</b>	<b>\$21,289,615</b>	<b>\$20,736,1</b>

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

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## CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	QUARTER ENDED MARCH 31	
	2001	2000
	-----	-----
	(IN THOUSANDS EXCEPT SHARE DATA)	
<b>INTEREST INCOME</b>		
Loans, including fees.....	\$217,646	\$205,972
Money market assets:		
Deposits at banks.....	841	571
Federal funds sold and securities purchased under agreement to resell.....	4,380	3,190
Trading account.....	749	665
Securities available-for-sale:		
U.S. Treasury and Federal agency.....	98,173	98,081
State and municipal.....	66	338
Other.....	433	356
	-----	-----
Total interest income.....	322,288	309,173
	-----	-----
<b>INTEREST EXPENSE</b>		
Deposits.....	111,573	97,643
Short-term borrowings.....	81,552	81,749
Senior notes.....	8,430	16,087
Minority interest-dividends on preferred stock of subsidiary.....	4,609	4,609
Long-term notes.....	3,959	3,756
	-----	-----
Total interest expense.....	210,123	203,844
	-----	-----
NET INTEREST INCOME.....	112,165	105,329
Provision for loan losses.....	14,458	5,145
	-----	-----
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES.....	97,707	100,184
	-----	-----
<b>NONINTEREST INCOME</b>		
Trust and investment management fees.....	22,390	29,814
Money market and bond trading.....	5,661	265
Foreign exchange.....	1,675	1,800
Merchant and charge card fees.....	42	5,329
Service fees and charges.....	22,128	24,661
Securities gains.....	12,963	--
Gain on sale of corporate trust businesses.....	--	47,193
Bank-owned insurance investments.....	11,599	9,859
Foreign fees.....	5,089	4,981
Other.....	13,806	8,059
	-----	-----
Total noninterest income.....	95,353	131,961
	-----	-----
<b>NONINTEREST EXPENSES</b>		
Salaries and other compensation.....	68,131	70,683
Pension, profit sharing and other employee benefits.....	13,612	13,688
Net occupancy.....	8,656	10,671
Equipment.....	12,561	13,370

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Marketing.....	6,627	5,229
Communication and delivery.....	4,668	4,546
Expert services.....	4,962	5,423
Contract programming.....	6,698	3,488
Other.....	(1,902)	507
	-----	-----
	124,013	127,605
Goodwill and other valuation intangibles.....	5,773	5,686
	-----	-----
Total noninterest expenses.....	129,786	133,291
	-----	-----
Income before income taxes.....	63,274	98,854
Applicable income taxes.....	16,207	31,751
	-----	-----
NET INCOME.....	\$ 47,067	\$ 67,103
	=====	=====
EARNINGS PER COMMON SHARE (based on 10,000,000 average shares outstanding)		
Net Income.....	\$ 4.71	\$ 6.71
	=====	=====

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 MARCH 31	
	2001	2000
	----	----
	(IN THOUSANDS)	
Net income.....	\$47,067	\$67,103
Other comprehensive income:		
Cash flow hedges:		
Cumulative effect of accounting change.....	(7,976)	--
Net unrealized gain on derivative instruments, net of tax expense of \$1,189.....	2,024	--
Unrealized gains (losses) on available-for-sale securities:		
Unrealized holding gains (losses) arising during the period, net of tax expense (benefit) of \$22,016 in 2001 and (\$589) in 2000.....	33,502	(893)
Less reclassification adjustment for realized gains included in income statement, net of tax expense of \$5,043 in 2001 and \$0 in 2000.....	(7,920)	--
	-----	-----
Other comprehensive income (loss).....	19,630	(893)
	-----	-----
Comprehensive income.....	\$66,697	\$66,210
	=====	=====

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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)

	2001 ----	2000 ----
(IN THOUSANDS)		
BALANCE AT JANUARY 1.....	\$1,524,423	\$1,251,094
Net income.....	47,067	67,103
Contributions to capital.....	2,975	742
Dividends -- common stock.....	(48,000)	(15,000)
Other comprehensive income (loss).....	19,630	(893)
	-----	-----
BALANCE AT MARCH 31.....	\$1,546,095	\$1,303,046
	=====	=====

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)

	QUARTER ENDED MARCH 31	
	2001 ----	2000 ----
(IN THOUSANDS)		
OPERATING ACTIVITIES		
Net income.....	\$ 47,067	\$ 67,103
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses.....	14,458	5,145
Depreciation and amortization, including intangibles.....	16,845	17,460
Deferred tax expense (benefit).....	1,668	(91)
Gain on sales of securities.....	(12,963)	--
Gain on sale of corporate trust businesses.....	--	(47,193)
Trading account net sales.....	25,301	42,878
Net decrease in interest receivable.....	42,093	11,582
Net decrease in interest payable.....	(12,328)	(26,153)
Net decrease in assets held for sale.....	116,363	45,224
Other, net.....	(13,825)	(8,810)
	-----	-----
Net cash provided by operating activities.....	224,679	107,145

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INVESTING ACTIVITIES:		
Net increase in interest-bearing deposits at banks.....	(32,657)	(11,581)
Net decrease in Federal funds sold and securities purchased under agreement to resell.....	96,150	69,600
Proceeds from sales of securities available-for-sale.....	696,111	0
Proceeds from maturities of securities available-for-sale.....	2,060,377	726,589
Purchases of securities available-for-sale.....	(2,794,344)	(886,414)
Net decrease (increase) in loans.....	61,572	(646,760)
Purchases of premises and equipment.....	(11,233)	(8,702)
Net increase in bank-owned insurance investments.....	(10,498)	(99,278)
Other, net.....	(36,302)	(189,821)
Net cash provided (used) by investing activities.....	29,176	(1,046,367)
FINANCING ACTIVITIES:		
Net (decrease) increase in deposits.....	(613,561)	665,104
Net increase (decrease) in Federal funds purchased and securities sold under agreement to repurchase.....	582,953	(229,530)
Net (decrease) increase in short-term borrowings.....	(605,689)	858,306
Proceeds from issuance of senior notes.....	838,500	75,000
Repayment of senior notes.....	(619,500)	(722,000)
Net cash proceeds from the sale of the corporate trust businesses.....	--	88,704
Cash dividends paid on common stock.....	(48,000)	(15,000)
Net cash (used) provided by financing activities.....	(465,297)	720,584
NET DECREASE IN CASH AND DEMAND BALANCES DUE FROM BANKS.....	(211,442)	(218,638)
CASH AND DEMAND BALANCES DUE FROM BANKS AT JANUARY 1...	1,292,694	1,423,043
CASH AND DEMAND BALANCES DUE FROM BANKS AT MARCH 31....	\$ 1,081,252	\$ 1,204,405

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 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.

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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 three months ended March 31 totaled \$222.5 million and \$230.0 million in 2001 and 2000, respectively. Cash income tax payments over the same periods totaled \$16.1 million and \$6.1 million, respectively.

### 4. ACCOUNTING CHANGES

In September 2000, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("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. It carries over most of the provisions of SFAS No. 125 without change. The Statement is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001. The Statement is effective for recognition and reclassification of collateral and for disclosures relating to securitization transactions and collateral for fiscal years ending after December 15, 2000. The Bank does not expect the implementation of this Statement to have a material effect on the Bank's financial position or results of operations.

### 5. 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.

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HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS -- (CONTINUED)

#### ACCOUNTING FOR DERIVATIVES AND HEDGING ACTIVITIES

All derivative instruments are recognized at fair value in the Consolidated Statement 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

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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.

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HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS -- (CONTINUED)

## 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.



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### 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

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### HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

#### NOTES TO FINANCIAL STATEMENTS -- (CONTINUED)

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 March 31, 2001 the Bank recorded the fair value of derivative instrument liabilities of \$5.4 million in other liabilities. A net loss of \$0.2 million was recorded for the quarter ended March 31, 2001 representing the ineffective portion of all of the Bank's fair value hedges. 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 March 31, 2001 the Bank recorded the fair value of derivative instrument liabilities of \$9.4 million in other liabilities. No hedge ineffectiveness was recorded to earnings for the quarter ended March 31, 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 nineteen 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. The commitments are derivatives, 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.

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.

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As of March 31, 2001 the Bank recorded the fair value of trading derivative instrument assets of \$216.0 million in other assets and trading derivative instrument liabilities of \$217.8 million in other liabilities. These amounts reflect the netting of certain derivative instrument assets and liabilities when the conditions in FIN No. 39, "Offsetting of Amounts Related to Certain Contracts," have been met.

### 6. CORPORATE TRUST SALE

In March 2000, Bankcorp 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. Additional revenue of approximately \$2.0 million was recognized in first quarter.

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## HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

### FINANCIAL REVIEW

#### FIRST QUARTER 2001 COMPARED WITH FIRST QUARTER 2000

##### SUMMARY

The Bank had first quarter 2001 net income of \$47.1 million, a decrease of \$20.0 million or 30 percent from first quarter 2000. First quarter 2000 earnings included a pretax gain of \$47.2 million resulting from the sale of the corporate trust business. Excluding this gain, earnings in the first quarter increased from \$39.2 million last year to \$47.1 million, an increase of 20 percent.

Cash ROE was 15.67 percent in the current quarter. Excluding the gain on the sale of the corporate trust business, cash ROE was 17.10 percent in first quarter 2000. Excluding unrealized gains and losses on the securities portfolio recorded directly to equity and the corporate trust gain, cash ROE rose 96 basis points from last year's first quarter. These favorable operating results were attributable to continued strong earnings growth in the core businesses and a more favorable interest rate environment that contributed to increased earnings from treasury and trading activities. This was partially offset by an increased loan loss provision with a slowing economy.

First quarter net interest income on a fully taxable equivalent basis was \$117.1 million, up \$6.6 million or 6 percent from \$110.5 million in 2000's first quarter. Average earning assets rose 3 percent to \$17.92 billion from \$17.42 billion in 2000, primarily attributable to an increase of \$383 million in average loans and \$101 million in money market assets, somewhat offset by a decline in investment securities of \$69 million. Consumer loans and residential mortgages were the most significant contributors to the growth in loans. Net interest margin increased to 2.69 percent from 2.55 percent in the same quarter last year.

The first quarter 2001 provision for loan losses of \$14.5 million was up \$9.3 million from \$5.1 million in the first quarter of 2000. Net charge-offs were \$17.6 million compared to \$4.3 million in the prior year's quarter. Most of the increase resulted from higher commercial loan write offs.

First quarter 2001 noninterest income of \$95.4 million decreased \$36.6 million from the same quarter last year. Excluding the \$47.2 million gain on the sale of the corporate trust business in 2000, noninterest income increased 13

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percent. Further, last year's results also included operating revenue for both the corporate trust business and the merchant card business which was also sold in 2000. Excluding both the gain on trust sale and operating revenue from these businesses, noninterest revenue increased 32 percent. Most of the increase resulted from additional net gains from securities sales of \$13.0 million and higher bond trading profits of \$5.7 million.

First quarter 2001 noninterest expenses of \$129.8 million decreased \$3.5 million or 3 percent from the year-ago quarter. Excluding the operating expenses for the corporate trust and merchant card businesses sold in 2000, noninterest expenses increased five percent.

Nonperforming assets at March 31, 2001 were \$109 million or 1.02 percent of total loans, compared to \$101 million or 0.94 percent at December 31, 2000, and \$34 million or 0.32 percent a year ago. At March 31, 2001, the allowance for possible loan losses was \$116 million, equal to 1.08 percent of loans outstanding, compared to \$115 million or 1.07 percent at the end of first quarter 2000. As a result, the ratio of the allowance for possible loan losses to nonperforming assets was 300 percent at March 31, 2000 compared to 106 percent at March 31, 2001.

At March 31, 2001, Tier 1 capital of the Bank amounted to \$1.58 billion, up from \$1.46 billion one year earlier. The regulatory leverage capital ratio was 7.65 percent for the first quarter of 2001 compared to 7.24 percent in the same quarter of 2000. The Bank's capital ratio exceeds the prescribed regulatory minimum for banks. The Bank's March 31, 2001 Tier 1 and total risk-based capital ratios were 9.31 percent and 11.23 percent compared to respective ratios of 8.66 percent and 10.61 percent at March 31, 2000.

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### 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 11th day of May, 2001.

/s/ PAUL R. SKUBIC

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Paul R. Skubic  
Chairman of the Board and President

/s/ PIERRE O. GREFFE

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Pierre O. Greffe  
Chief Financial Officer

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