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HARRIS PREFERRED CAPITAL CORP
Form 10-K
March 29, 2005

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

2004
FORM 10-K

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

FOR THE FISCAL YEAR ENDED DECEMBER 31, 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 REGIS

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 checkmark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (229.405 of this chapter) is not contained herein, and will not be contained to the best of registrant's knowledge, in definitive proxy

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or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

Indicate by check mark whether this 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 March 28, 2005 was 1,000. No common equity is held by nonaffiliates.

HARRIS PREFERRED CAPITAL CORPORATION

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Forward-Looking Information

Forward-looking statements contained in this Annual Report on Form 10-K ("Report") of Harris Preferred Capital Corporation (the "Company") may include certain forward-looking information, within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including (without limitation) statements with respect to the Company's expectations, 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 statements.

ITEM 1. BUSINESS

General

Harris Preferred Capital Corporation is a Maryland corporation incorporated on September 24, 1997, pursuant to the Maryland General Corporation Law. The Company's 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's assets are held in a Maryland real estate investment trust subsidiary, Harris Preferred Capital Trust. The Company has elected to be treated as a REIT under the Internal Revenue Code of 1986 (the "Code"), and will generally not be subject to federal income tax if it distributes 90% of its adjusted REIT ordinary taxable income and meets all of the qualifications necessary to be a REIT. All of the shares of the Company's common stock, par value \$1.00 per share (the "Common Stock"), are owned by Harris Capital Holdings, Inc. ("HCH"), a wholly-owned subsidiary of the Bank. The Company was formed by the Bank to provide investors with the opportunity to invest in residential mortgages and other real estate assets and to provide the Bank with a cost-effective means of raising capital for federal regulatory purposes.

On February 11, 1998, the Company, through a public offering (the "Offering"), issued 10,000,000 shares of its 7 3/8% Noncumulative Exchangeable Preferred Stock, Series A (the "Preferred Shares"), \$1.00 par value. The Offering raised \$250 million less \$7.9 million of underwriting fees. The Preferred Shares are traded on the New York Stock Exchange under the symbol "HBC Pr A". Holders of Preferred Shares are entitled to receive, if declared by the Company's Board of Directors, noncumulative dividends at a rate of 7 3/8% per annum of the \$25 per share liquidation preference (an amount equivalent to \$1.8438 per share per annum). Dividends on the Preferred Shares, if authorized and declared, are payable quarterly in arrears on March 30, June 30, September 30 and December 30 of each year. The Preferred Shares may be redeemed for cash at the option of the Company, in whole or in part, at any time and from time to

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time, at the principal amount thereof, plus the quarterly accrued and unpaid dividends, if any, thereon. The Company may not redeem the Preferred Shares without prior approval from the Board of Governors of the Federal Reserve System or the appropriate successor federal regulatory agency.

Each Preferred Share will be automatically exchanged for one newly issued preferred share of the Bank ("Bank Preferred Share") in the event (i) the Bank becomes less than "adequately capitalized" under

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regulations established pursuant to the Federal Deposit Insurance Corporation Improvement Act of 1991, as amended, (ii) the Bank is placed into conservatorship or receivership, (iii) the Board of Governors directs such exchange in writing because, in its sole discretion and even if the Bank is not less than "adequately capitalized," the Board of Governors anticipates that the Bank may become less than adequately capitalized in the near term, or (iv) the Board of Governors in its sole discretion directs in writing an exchange in the event that the Bank has a Tier 1 risk-based capital ratio of less than 5%. In the event of an exchange, the Bank Preferred Shares would constitute a new series of preferred shares of the Bank, would have the same dividend rights, liquidation preference, redemption options and other attributes as the Preferred Shares, except that the Bank Preferred Shares would not be listed on the New York Stock Exchange and would rank pari passu in terms of cash dividend payments and liquidation preference with any outstanding shares of preferred stock of the Bank.

On June 4, 2004, Harris Bankcorp, Inc., the Bank's parent company, announced its plan to consolidate twenty-five of its Illinois bank charters (including the Bank) into one national bank charter, Harris N.A. This transaction is expected to be completed in May 2005. After that time and under the same conditions as described in the prior paragraph, each Preferred Share will be automatically exchangeable for one newly issued preferred share of Harris N.A. except that Harris N.A. will be subject to regulation by the Office of the Comptroller of the Currency. References herein to the Bank for those times subsequent to the charter consolidation are intended to refer to Harris Bank N.A.

Concurrent with the issuance of the Preferred Shares, the Bank contributed additional capital of \$241 million, net of acquisition costs, to the Company. The Company and the Bank undertook the Offering for two principal reasons: (i) the qualification of the Preferred Shares as Tier 1 capital of the Bank for U.S. banking regulatory purposes under relevant regulatory capital guidelines, as a result of the treatment of the Preferred Shares as a minority interest in a consolidated subsidiary of the Bank, and (ii) lack of federal income tax on the Company's earnings used to pay the dividends on the Preferred Shares, as a result of the Company's qualification as a REIT. On December 30, 1998, the Bank contributed the common stock of the Company to HCH, a newly-formed and wholly-owned subsidiary of the Bank. The Bank is an indirect wholly-owned U.S. subsidiary of Bank of Montreal. The Bank is required to maintain direct or indirect ownership of at least 80% of the outstanding Common Stock of the Company for as long as any Preferred Shares are outstanding.

The Company used the Offering proceeds and the additional capital contributed by the Bank to purchase \$356 million of notes (the "Notes") from the Bank and \$135 million of mortgage-backed securities at their estimated fair value. The Notes are obligations issued by the Bank that are recourse only to the underlying mortgage loans (the "Securing Mortgage Loans") and were acquired pursuant to the terms of a loan agreement with the Bank. The principal amount of the Notes equals approximately 80% of the principal amounts of the Securing Mortgage Loans.

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Business

The Company was formed for the purpose of raising capital for the Bank. One of the Company's principal business objectives is to acquire, hold, finance and manage Mortgage Assets. These Mortgage Assets generate interest income for distribution to stockholders. A portion of the Mortgage Assets of the Company consists of Notes issued by the Bank that are recourse only to Securing Mortgage Loans that are secured by real property. The Notes mature on October 1, 2027 and pay interest at 6.4% per annum. Payments of interest are made to the Company from payments made on the Securing Mortgage Loans. Pursuant to an agreement between the Company and the Bank, the Company, through the Bank as agent, receives all scheduled payments made on the Securing Mortgage Loans, retains a portion of any such payments equal to the amount due on the Notes and remits the balance, if any, to the Bank. The Company also retains approximately 80% of any prepayments of principal in respect of the Securing Mortgage Loans and applies such amounts as a prepayment on the Notes. The Company has a security interest in the real property securing the Securing Mortgage Loans and will be entitled to enforce payment on the loans in its own name if a mortgagor should default. In the event of such default, the Company would have the same rights as the original mortgagee to foreclose the mortgaged property and satisfy the obligations of the Bank out of the proceeds.

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The Company may from time to time acquire fixed-rate or variable-rate mortgage-backed securities representing interests in pools of mortgage loans. The Bank may have originated a portion of any such mortgage-backed securities by exchanging pools of mortgage loans for the mortgage-backed securities. The mortgage loans underlying the mortgage-backed securities will be secured by single-family residential properties located throughout the United States. The Company intends to acquire only investment grade mortgage-backed securities issued by agencies of the federal government or government sponsored agencies, such as the Federal Home Loan Mortgage Corporation ("FHLMC"), the Federal National Mortgage Association ("Fannie Mae") and the Government National Mortgage Association ("GNMA"). The Company does not intend to acquire any interest-only, principal-only or similar speculative mortgage-backed securities.

The Bank may from time to time acquire or originate both conforming and nonconforming residential mortgage loans. Conventional conforming residential mortgage loans comply with the requirements for inclusion in a loan guarantee program sponsored by either FHLMC or Fannie Mae. Nonconforming residential mortgage loans are residential mortgage loans that do not qualify in one or more respects for purchase by Fannie Mae or FHLMC under their standard programs. The nonconforming residential mortgage loans that the Company purchases will be nonconforming because they have original principal balances which exceed the limits for FHLMC or Fannie Mae under their standard programs. The Company believes that all residential mortgage loans will meet the requirements for sale to national private mortgage conduit programs or other investors in the secondary mortgage market. As of December 31, 2004 and 2003 and for each of the years then ended, the Company did not directly hold any residential mortgage loans.

The Company may from time to time acquire commercial mortgage loans secured by industrial and warehouse properties, recreational facilities, office buildings, retail space and shopping malls, hotels and motels, hospitals, nursing homes or senior living centers. The Company's current policy is not to acquire any interest in a commercial mortgage loan if commercial mortgage loans would constitute more than 5% of the Company's Mortgage Assets at the time of its acquisition. Unlike residential mortgage loans, commercial mortgage loans generally lack standardized terms. Commercial real estate properties themselves tend to be unique and are more difficult to value than residential real estate

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properties. Commercial mortgage loans may also not be fully amortizing, meaning that they may have a significant principal balance or "balloon" payment due on maturity. Moreover, commercial properties, particularly industrial and warehouse properties, are generally subject to relatively greater environmental risks than non-commercial properties, generally giving rise to increased costs of compliance with environmental laws and regulations. There is no requirement regarding the percentage of any commercial real estate property that must be leased at the time the Bank acquires a commercial mortgage loan secured by such commercial real estate property, and there is no requirement that commercial mortgage loans have third party guarantees. The credit quality of a commercial mortgage loan may depend on, among other factors, the existence and structure of underlying leases, the physical condition of the property (including whether any maintenance has been deferred), the creditworthiness of tenants, the historical and anticipated level of vacancies and rents on the property and on other comparable properties located in the same region, potential or existing environmental risks, the availability of credit to refinance the commercial mortgage loan at or prior to maturity and the local and regional economic climate in general. Foreclosures of defaulted commercial mortgage loans are generally subject to a number of complicated factors, including environmental considerations, which are generally not present in foreclosures of residential mortgage loans. As of December 31, 2004 and 2003 and for each of the years then ended, the Company did not hold any commercial mortgage loans.

The Company may invest in assets eligible to be held by REITs other than those described above. In addition to commercial mortgage loans and mortgage loans secured by multi-family properties, such assets could include cash, cash equivalents and securities, including shares or interests in other REITs and partnership interests. At December 31, 2004, the Company held \$10.5 million of short-term money market assets and \$45 million of U.S. Treasury securities. At December 31, 2003, the Company held \$11.5 million of short-term money market assets and \$230 million of U.S. Treasury securities.

The Company intends to continue to acquire Mortgage Assets from the Bank and/or affiliates of the Bank on terms that are comparable to those that could be obtained by the Company if such Mortgage Assets

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were purchased from unrelated third parties. The Company may also from time to time acquire Mortgage Assets from unrelated third parties.

The Company intends to maintain a substantial portion of its portfolio in Bank-secured obligations and mortgage-backed securities. The Company may, however, invest in other assets eligible to be held by a REIT. The Company's current policy and the Servicing Agreement (defined below) prohibit the acquisition of any Mortgage Asset constituting an interest in a mortgage loan (other than an interest resulting from the acquisition of mortgage-backed securities), which mortgage loan (i) is delinquent (more than 30 days past due) in the payment of principal or interest at the time of proposed acquisition; (ii) is or was at any time during the preceding 12 months (a) on nonaccrual status or (b) renegotiated due to financial deterioration of the borrower; or (iii) has been, more than once during the preceding 12 months, more than 30 days past due in payment of principal or interest. Loans that are on "nonaccrual status" are generally loans that are past due 90 days or more in principal or interest. The Company maintains a policy of disposing of any mortgage loan which (i) falls into nonaccrual status, (ii) has to be renegotiated due to the financial deterioration of the borrower, or (iii) is more than 30 days past due in the payment of principal or interest more than once in any 12 month period. The Company may choose, at any time subsequent to its acquisition of any Mortgage Assets, to require the Bank (as part of the Servicing Agreement) to dispose of the mortgage loans for any of these reasons or for any other reason.

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The Bank services the Securing Mortgage Loans and the other mortgage loans purchased by the Company on behalf of, and as agent for, the Company and is entitled to receive fees in connection with the servicing thereof pursuant to the servicing agreement (the "Servicing Agreement"). The Bank receives a fee equal to 0.25% per annum on the principal balances of the loans serviced. Payment of such fees is subordinate to payments of dividends on the Preferred Shares. The Servicing Agreement requires the Bank to service the loans in a manner generally consistent with accepted secondary market practices, with any servicing guidelines promulgated by the Company and, in the case of residential mortgage loans, with Fannie Mae and FHLMC guidelines and procedures. The Servicing Agreement requires the Bank to service the loans solely with a view toward the interest of the Company and without regard to the interest of the Bank or any of its affiliates. The Bank will collect and remit principal and interest payments, administer mortgage escrow accounts, submit and pursue insurance claims and initiate and supervise foreclosure proceedings on the loans it services. The Bank may, with the approval of a majority of the Company's Board of Directors, as well as a majority of the Company's Independent Directors, subcontract all or a portion of its obligations under the Servicing Agreement to unrelated third parties. An "Independent Director" is a director who is not a current officer or employee of the Company or a current director, officer or employee of the Bank or of its affiliates. The Bank will not, in connection with the subcontracting of any of its obligations under the Servicing Agreement, be discharged or relieved in any respect from its obligations under the Servicing Agreement. The Company may terminate the Servicing Agreement upon the occurrence of such events as they relate to the Bank's proper and timely performance of its duties and obligations under the Servicing Agreement. As long as any Preferred Shares remain outstanding, the Company may not terminate, or elect to renew, the Servicing Agreement without the approval of a majority of the Company's Independent Directors.

The Company entered into an advisory agreement with the Bank (the "Advisory Agreement") pursuant to which the Bank administers the day-to-day operations of the Company. The Bank is responsible for (i) monitoring the credit quality of Mortgage Assets held by the Company, (ii) advising the Company with respect to the reinvestment of income from and payments on, and with respect to the acquisition, management, financing and disposition of the Mortgage Assets held by the Company, and (iii) monitoring the Company's compliance with the requirements necessary to qualify as a REIT, and other financial and tax-related matters. The Bank may from time to time subcontract all or a portion of its obligations under the Advisory Agreement to one or more of its affiliates. The Bank may, with the approval of a majority of the Company's Board of Directors, as well as a majority of the Company's Independent Directors, subcontract all or a portion of its obligations under the Advisory Agreement to unrelated third parties. The Bank will not, in connection with the subcontracting of any of its obligations under the Advisory Agreement, be discharged or relieved in any respect from its obligations under the Advisory Agreement. The Advisory Agreement is renewed annually. The Company may terminate the Advisory Agreement at any time upon 60 days' prior

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written notice. As long as any Preferred Shares remain outstanding, any decision by the Company either to renew the Advisory Agreement or to terminate the Advisory Agreement must be approved by a majority of the Board of Directors, as well as by a majority of the Company's Independent Directors.

The Advisory Agreement in effect in 2004 and 2003 entitled the Bank to receive advisory fees of \$124,000 and \$56,000, respectively. The increase in costs is primarily attributable to increased costs for processing, recordkeeping and administration. In 2005, advisory fees of \$148,000 have been approved.

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The Company may from time to time purchase additional Mortgage Assets out of proceeds received in connection with the repayment or disposition of Mortgage Assets, the issuance of additional shares of Preferred Stock or additional capital contributions with respect to the Common Stock. The Company may also issue additional series of Preferred Stock. However, the Company may not issue additional shares of Preferred Stock senior to the Series A Preferred Shares either in the payment of dividends or in the distribution of assets on liquidation without the consent of holders of at least 67% of the outstanding shares of Preferred Stock at that time or without approval of a majority of the Company's Independent Directors. The Company does not currently intend to issue any additional shares of Preferred Stock unless it simultaneously receives additional capital contributions from HCH or other affiliates sufficient to support the issuance of such additional shares of Preferred Stock.

Although the Company does not currently intend to incur any indebtedness in connection with the acquisition and holding of Mortgage Assets, the Company may do so at any time (although indebtedness in excess of 25% of the Company's total stockholders' equity may not be incurred without the approval of a majority of the Company's Independent Directors). To the extent the Company were to change its policy with respect to the incurrence of indebtedness, the Company would be subject to risks associated with leverage, including, without limitation, changes in interest rates and prepayment risk.

Employees

As of December 31, 2004, the Company had no paid employees. All officers of the Company were employed by the Bank.

Environmental Matters

In the event that the Company is forced to foreclose on a defaulted Securing Mortgage Loan to recover its investment in such loan, the Company may be subject to environmental liabilities in connection with the underlying real property, which could exceed the value of the real property. Although the Company intends to exercise due diligence to discover potential environmental liabilities prior to the acquisition of any property through foreclosure, hazardous substances or wastes, contaminants, pollutants or sources thereof (as defined by state and federal laws and regulations) may be discovered on properties during the Company's ownership or after a sale thereof to a third party. If such hazardous substances are discovered on a property which the Company has acquired through foreclosure or otherwise, the Company may be required to remove those substances and clean up the property. There can be no assurance that in such a case the Company would not incur full recourse liability for the entire costs of any removal and clean-up, that the cost of such removal and clean-up would not exceed the value of the property or that the Company could recoup any of such costs from any third party. The Company may also be liable to tenants and other users of neighboring properties. In addition, the Company may find it difficult or impossible to sell the property prior to or following any such clean-up. The Company has not foreclosed on any Securing Mortgage Loans.

Qualification as a REIT

The Company elected to be taxed as a REIT commencing with its taxable year ended December 31, 1998 and intends to comply with the provisions of the Code with respect thereto. The Company will not be subject to Federal income tax to the extent it distributes 90% (95% for years prior to January 1, 2001) of its adjusted REIT ordinary taxable income to stockholders and as long as certain assets, income and stock ownership tests are met. For 2004 as well as 2003, the Company met all Code requirements for a REIT, including the asset, income, stock ownership and distribution tests. Cash distributions in the amount of \$1.8438 per Preferred

Share were paid in 2004 and 2003. For the year ended December 31, 2004 there were no common stock dividends declared as there were no earnings available after payment of the preferred dividends. A cash dividend on common stock of \$2 million was declared on December 2, 2003 to the stockholder of record on December 15, 2003 and paid on December 31, 2003. In addition, on September 13, 2004 and September 12, 2003, the Company paid a cash dividend of \$904 thousand (declared December 2, 2003) and \$530 thousand (declared December 4, 2002), on the outstanding common shares to the stockholder of record on September 6, 2004 and September 3, 2003, respectively. These dividends completed the 2003 and 2002 REIT tax compliance requirements.

ITEM 2. PROPERTIES

None as of December 31, 2004.

ITEM 3. LEGAL PROCEEDINGS

The Company is not currently involved in any material litigation nor, to the Company's knowledge is any material litigation currently threatened against the Company or the Bank other than routine litigation arising in the ordinary course of business. See Note 8 to Financial Statements on page 30.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of 2004.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

HCH presently owns all 1,000 shares of the common stock of the Company, which are not listed or traded on any securities exchange. For the year ended December 31, 2004 there were no common stock dividends declared, as there were no earnings available after payment of the preferred dividends. On December 2, 2003, the Company declared \$2 million in cash dividends on common stock, which were paid in December 2003. In addition, on September 13, 2004 and September 12, 2003, respectively the Company paid a cash dividend of \$904 thousand (declared December 2, 2003) and \$530 thousand (declared December 4, 2002), on the outstanding common shares to the stockholder of record on September 6, 2004, and September 3, 2003, respectively. These dividends completed the 2003 and 2002 REIT tax compliance requirements regarding income distributions.

The Preferred Shares are traded on the New York Stock Exchange under the symbol "HBC Pr A". During 2004 and 2003, the Company declared and paid cash dividends to preferred stockholders of approximately \$18.4 million in each year. Although the Company declared cash dividends on the Preferred Shares for 2004 and 2003, no assurances can be made as to the declaration of, or if declared, the amount of, future distributions since such distributions are subject to the Company's financial condition and capital needs; the impact of legislation and regulations as then in effect or as may be proposed; economic conditions; and such other factors as the Board of Directors may deem relevant. Notwithstanding the foregoing, to remain qualified as a REIT, the Company must distribute annually at least 90% of its ordinary taxable income to preferred and/or common stockholders.

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ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth selected financial data for the Company and should be read in conjunction with the Consolidated Financial Statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in this Report.

| | FOR THE YEARS ENDED DECEMBER 31 | | | | |
|---|---------------------------------------|-------------|-------------|-------------|-------------|
| | 2004 | 2003 | 2002 | 2001 | 2000 |
| | (IN THOUSANDS, EXCEPT PER SHARE DATA) | | | | |
| Statement of Operations Data: | | | | | |
| Interest income..... | \$ 16,998 | \$ 17,678 | \$ 19,934 | \$ 28,715 | \$ 32,311 |
| Noninterest income..... | 1,062 | 4,158 | 2,677 | 4,796 | 25 |
| Operating expenses: | | | | | |
| Loan servicing fees..... | 44 | 70 | 131 | 243 | 37 |
| Advisory fees..... | 124 | 56 | 43 | 35 | 5 |
| General and administrative..... | 362 | 362 | 314 | 300 | 29 |
| Total operating expenses..... | 530 | 488 | 488 | 578 | 72 |
| Net income..... | 17,530 | 21,348 | 22,123 | 32,933 | 31,843 |
| Preferred stock dividends..... | 18,438 | 18,438 | 18,438 | 18,438 | 18,438 |
| Net income available (loss allocated) to common stockholder..... | \$ (908) | \$ 2,910 | \$ 3,685 | \$ 14,495 | \$ 13,411 |
| Basic and diluted net income (loss) per common share..... | \$ (908) | \$ 2,910 | \$ 3,685 | \$ 14,495 | \$ 13,411 |
| Distributions per preferred share..... | \$ 1.8438 | \$ 1.8438 | \$ 1.8438 | \$ 1.8438 | \$ 1.8438 |
| Balance Sheet Data (end of period): | | | | | |
| Total assets..... | \$489,022 | \$494,318 | \$502,042 | \$489,342 | \$489,931 |
| Total liabilities..... | \$ 134 | \$ 84 | \$ 96 | \$ 100 | \$ 111 |
| Total stockholders' equity..... | \$488,888 | \$494,234 | \$501,946 | \$489,242 | \$489,820 |
| Cash Flows Data: | | | | | |
| Operating activities..... | \$ 15,998 | \$ 18,046 | \$ 19,440 | \$ 28,736 | \$ 31,631 |
| Investing activities..... | \$ 2,825 | \$ 3,120 | \$ 2,440 | \$ 4,035 | \$ (41) |
| Financing activities..... | \$ (19,342) | \$ (20,968) | \$ (21,658) | \$ (33,084) | \$ (31,661) |

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the Consolidated Financial Statements and notes thereto appearing later in this Report.

SUMMARY

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YEAR ENDED DECEMBER 31, 2004 COMPARED TO DECEMBER 31, 2003

The Company's net income for 2004 was \$17.5 million. This represented an 18% decrease from 2003 net income of \$21.3 million. Earnings declined primarily because of a substantial decrease in gains from security sales compared to last year and lower interest income on earning assets.

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Interest income on securities purchased under agreement to resell for the year ended December 31, 2004 was \$1.1 million compared to \$1.3 million a year ago. Interest income on the Notes for 2004 totaled \$907 thousand and yielded 6.4% on \$14 million of average principal outstanding compared to \$1.5 million and a 6.4% yield on \$24 million average principal outstanding for 2003. The decrease in income was attributable to a reduction in the Note balance because of customer payoffs in the Securing Mortgage Loans. The average outstanding balance of the Securing Mortgage Loans was \$18 million for 2004 and \$29 million for 2003. Interest income on securities available-for-sale for 2004 was \$15.0 million, resulting in a yield of 4.3% on an average balance of \$353 million compared to interest income of \$14.9 million with a yield of 4.6% on an average balance of \$326 million for 2003. The increase in interest income on securities available-for-sale was primarily attributable to an increase in the average mortgage-backed securities portfolio partially offset by lower yields than the prior year. Gains from investment securities sales were \$1.1 million in 2004 and \$4.2 million in 2003. There were no Company borrowings during either year.

Operating expenses for the year ended December 31, 2004 totaled \$530 thousand compared to \$488 thousand a year ago. Loan servicing expenses for 2004 totaled \$44 thousand, a decrease of \$26 thousand or 37% from 2003. This decrease was attributable to the reduction in the principal balance of the Notes. Advisory fees for the year ended December 31, 2004 were \$124 thousand compared to \$56 thousand for the same period a year ago, due to higher internal processing, record-keeping and overhead costs. General and administrative expenses totaled \$362 thousand for both 2004 and 2003.

On December 30, 2004, the Company paid a cash dividend of \$0.46094 per share on the outstanding Preferred Shares to the stockholders of record on December 15, 2004 as declared on December 2, 2004. On December 30, 2003, the Company paid a cash dividend of \$0.46094 per share on the outstanding Preferred Shares to the stockholders of record on December 15, 2003 as declared on December 2, 2003. On a year-to-date basis, the Company declared and paid \$18.4 million of dividends to holders of Preferred Shares for 2004 and 2003, respectively. For the year ended December 31, 2004 there were no common stock dividends declared, as there were no earnings available after payment of the preferred dividends. A cash dividend on common stock of \$2.0 million was declared on December 2, 2003 to the stockholder of record on December 15, 2003 and paid on December 31, 2003. In addition, on September 13, 2004 and September 12, 2003, the Company paid a cash dividend of \$904 thousand (declared December 2, 2003) and \$530 thousand (declared December 4, 2002), on the outstanding common shares to the stockholder of record on September 6, 2004 and September 3, 2003, respectively. These common share dividends completed the Company's 2003 and 2002 REIT tax compliance requirements.

At December 31, 2004 and 2003, there were no Securing Mortgage Loans on nonaccrual status and there was no allowance for loan losses.

YEAR ENDED DECEMBER 31, 2003 COMPARED TO DECEMBER 31, 2002

The Company's net income for 2003 was \$21.3 million. This represented a 4% decrease from 2002 net income of \$22.1 million. Earnings decreased primarily because of reduced interest income on earning assets, partially offset by

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increased gains on securities sales from \$2.7 million in 2002 to \$4.2 million in 2003.

Interest income on the Notes for 2003 totaled \$1.5 million and yielded 6.4% on \$24 million of average principal outstanding compared to \$2.8 million and a 6.4% yield on \$43 million average principal outstanding for 2002. The decrease in income was attributable to a reduction in the Note balance because of customer payoffs in the Securing Mortgage Loans. The average outstanding balance of the Securing Mortgage Loans was \$29 million for 2003 and \$53 million for 2002. Interest income on securities available-for-sale for 2003 was \$14.9 million, resulting in a yield of 4.6% on an average balance of \$326 million compared to interest income of \$15.1 million with a yield of 4.9% on an average balance of \$309 million for 2002. The decrease in interest income on securities available-for-sale was primarily attributable to a reduction in yield, partially offset by growth in the investment portfolio. As securities matured or were sold, proceeds were invested in lower yielding securities as market interest rates declined. Gains from investment securities sales were \$4.2 million in 2003 and \$2.7 million in 2002. There were no Company borrowings during either year.

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Operating expenses for both of the years ended December 31, 2003 and 2002 totaled \$488 thousand. Loan servicing expenses for 2003 totaled \$70 thousand, a decrease of \$61 thousand or 47% from 2002. This decrease was attributed to the reduction in the principal balance of the Notes. Advisory fees for the year ended December 31, 2003 were \$56 thousand compared to \$43 thousand for the same period a year ago, due to higher internal processing, record-keeping and overhead costs. General and administrative expenses for the same period totaled \$362 thousand, an increase of \$48 thousand or 15% from 2002, due to increased reporting and compliance governance costs.

On December 30, 2003, the Company paid a cash dividend of \$0.46094 per share on the outstanding Preferred Shares to the stockholders of record on December 15, 2003 as declared on December 2, 2003. On December 30, 2002, the Company paid a cash dividend of \$0.46094 per share on the outstanding Preferred Shares to the stockholders of record on December 15, 2002 as declared on December 4, 2002. On a year-to-date basis, the Company declared and paid \$18.4 million of dividends to holders of Preferred Shares for 2003 and 2002, respectively. A cash dividend on common stock of \$2.0 million was declared on December 2, 2003 to the stockholder of record on December 15, 2003 and paid on December 31, 2003. A cash dividend on common stock of \$3.090 million was declared on December 4, 2002 to the stockholder of record on December 15, 2002 and paid on December 27, 2002. In addition, on September 12, 2003 and September 12, 2002, the Company paid a cash dividend of \$530 thousand and \$130 thousand, respectively, on the outstanding common shares to the stockholder of record on September 3, 2003 and September 4, 2002, respectively. These common share dividends completed the Company's 2002 and 2001 REIT tax compliance requirements.

At December 31, 2003 and 2002, there were no Securing Mortgage Loans on nonaccrual status and there was no allowance for loan losses.

QUARTER ENDED DECEMBER 31, 2004 COMPARED TO QUARTER ENDED DECEMBER 31, 2003

The Company's net income for the fourth quarter of 2004 was \$5.0 million compared to \$4.6 million in the fourth quarter of 2003. Earnings increased primarily because of increased interest income on earning assets, partially offset by a decline in security gains of \$808 thousand from the fourth quarter 2003.

Fourth quarter 2004 interest income on the Notes totaled \$199 thousand and

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yielded 6.4% on \$12 million of average principal outstanding compared to interest income of \$282 thousand and a 6.4% yield on \$18 million average principal outstanding for the fourth quarter of 2003. The decrease in income was attributable to a reduction in the Note balance because of principal paydowns by customers in the Securing Mortgage Loans. The average outstanding balance of the Securing Mortgage Loans for the fourth quarter of 2004 and 2003 was \$16 million and \$22 million, respectively. Interest income on securities available-for-sale for the current quarter was \$4.6 million resulting in a yield of 4.2% on an average balance of \$441 million, compared to interest income of \$3.1 million with a yield of 4.6% on an average balance of \$265 million for the same period a year ago. The increase in interest income is primarily attributable to the increase in higher-yielding mortgage-backed securities with an offsetting decline in lower-yielding money market assets and short-term U.S. Treasury securities.

There were no Company borrowings during the fourth quarter of 2004 or 2003.

Fourth quarter 2004 operating expenses totaled \$162 thousand, a decrease of \$17 thousand from the fourth quarter of 2003. Loan servicing expenses totaled \$10 thousand, a decrease of \$3 thousand or 23% from the prior year's fourth quarter, attributable to the reduction in the principal balance of the Notes. Advisory fees for the fourth quarter of 2004 were \$38 thousand compared to \$26 thousand in the prior year's fourth quarter, due to increased costs for processing, recordkeeping and administration. General and administrative expenses totaled \$114 thousand in the current quarter compared to \$140 thousand for the same period in 2003, partially attributable to lower legal fees and external auditing costs.

ALLOWANCE FOR LOAN LOSSES

The Company does not currently maintain an allowance for loan losses due to the over-collateralization of the Securing Mortgage Loans and the prior and expected credit performance of the collateral pool.

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CONCENTRATIONS OF CREDIT RISK

A majority of the collateral underlying the Securing Mortgage Loans is located in Illinois. The financial viability of customers in this state is, in part, dependent on the state's economy. The collateral may be subject to a greater risk of default than other comparable loans in the event of adverse economic, political or business developments or natural hazards that may affect such region and the ability of property owners in such region to make payments of principal and interest on the underlying mortgages. The Company's maximum risk of accounting loss, should all customers in Illinois fail to perform according to contract terms and all collateral prove to be worthless, was approximately \$11 million at December 31, 2004 and \$12 million at December 31, 2003.

INTEREST RATE RISK

The Company's income consists primarily of interest payments on the Mortgage Assets and other securities it holds. If there is a decline in interest rates during a period of time when the Company must reinvest payments of interest and principal with respect to its Mortgage Assets and other interest earning assets, the Company may find it difficult to purchase additional earning assets that generate sufficient income to support payment of dividends on the Preferred Shares. Because the rate at which dividends, if, when and as authorized and declared, are payable on the Preferred Shares is fixed, there can be no assurance that an interest rate environment in which there is a decline in

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interest rates would not adversely affect the Company's ability to pay dividends on the Preferred Shares.

COMPETITION

The Company does not engage in the business of originating mortgage loans. While the Company will acquire additional Mortgage Assets, it anticipates that such Mortgage Assets will be acquired from the Bank and affiliates of the Bank. Accordingly, the Company does not expect to compete with mortgage conduit programs, investment banking firms, savings and loan associations, banks, thrift and loan associations, finance companies, mortgage bankers or insurance companies in acquiring its Mortgage Assets.

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% of its adjusted REIT ordinary taxable income, as provided for under the 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 Statement of Cash Flows, the primary sources of funds in addition to \$16.0 million provided from operations during 2004 were \$4.4 million provided by principal payments received

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on the Notes and \$673.8 million from the maturities and sales of securities available-for-sale. In 2003, the primary sources of funds other than \$18.0 million provided from operations were \$14.5 million provided by principal payments received on the Notes and \$743.0 million from the maturities and sales of securities available-for-sale. The primary uses of funds for 2004 were \$676.7 million in purchases of securities available-for-sale and \$18.4 and \$904 thousand in preferred stock dividends and common stock dividends paid, respectively. In 2003, the primary uses of funds were \$765.4 million in purchases of securities available-for-sale and \$18.4 and \$2.5 million in preferred stock dividends and common stock dividends paid, respectively.

ACCOUNTING PRONOUNCEMENTS

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The Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "Share-Based Payments" in 2004. The Statement replaces SFAS No. 123, "Accounting for Stock-Based Compensation," and supersedes Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS 123(R) applies primarily to accounting for transactions where an entity obtains employee services in share-based payment transactions using the fair value based method of accounting. The Statement is effective as of the beginning of the first interim or annual reporting period that begins after June 15, 2005. The Company does not expect the implementation of this Statement to have a material effect on its financial position or results of operations.

OTHER MATTERS

As of December 31, 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 Code. The Company expects to meet all REIT requirements regarding the ownership of its stock and anticipates meeting the annual distribution requirements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

As of December 31, 2004, the Company had \$12 million invested in Notes, a decrease of \$5 million from December 31, 2003. The decline was attributable to customer payoffs in the Securing Mortgage Loans. At December 31, 2004, the Company held \$419 million in mortgage-backed securities compared to \$234 million at December 31, 2003. At December 31, 2004, the Company held \$45 million in U.S. Treasuries compared to \$230 million at December 31, 2003. At December 31, 2004, the Company held an investment of \$10.5 million in securities purchased from the Bank under agreement to resell compared to \$11.5 million at December 31, 2003. The Company is subject to exposure for fluctuations in interest rates. Adverse changes in interest rates could impact negatively the value of mortgage-backed securities, as well as the levels of interest income to be derived from these assets.

The Company's investments held in mortgage-backed securities are secured by adjustable and fixed interest rate residential mortgage loans. The yield to maturity on each security depends on, among other things, the price at which each such security is purchased, the rate and timing of principal payments (including prepayments, repurchases, defaults and liquidations), the pass-through rate and interest rate fluctuations. Changes in interest rates could impact prepayment rates as well as default rates, which in turn would impact the value and yield to maturity of the Company's mortgage-backed securities.

The Company currently has no outstanding borrowings.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Refer to the Index to Consolidated Financial Statements on page 18 for the required information.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

There have been no disagreements with accountants on any matter of accounting principles, practices or financial statement disclosure.

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On January 27, 2004, the audit committee of the Company dismissed PricewaterhouseCoopers, LLP as its independent accountants effective upon completion of audit services related to the Company's December 31, 2003 financial statements and appointed KPMG LLP as the audit firm for the 2004 year.

ITEM 9A. CONTROLS AND PROCEDURES

As of December 31, 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 controls over financial reporting identified in connection with such evaluations that occurred during the quarter ended December 31, 2004 that have materially affected or are reasonably likely to materially affect, the Company's internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

Not Applicable.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT AND RELATED STOCKHOLDER MATTERS

The Company's Board of Directors consists of five members. The Company does not anticipate that it will require any additional employees because it has retained the Bank to perform certain functions pursuant to the Advisory Agreement described above. Each officer of the Company currently is also an officer of the Bank and/or affiliates of the Bank. The Company maintains corporate records and audited financial statements that are separate from those of the Bank or any of the Bank's affiliates. None of the officers, directors or employees of the Company will have a direct or indirect pecuniary interest in any Mortgage Asset to be acquired or disposed of by the Company or in any transaction in which the Company has an interest or will engage in acquiring, holding and managing Mortgage Assets.

Pursuant to terms of the Preferred Shares, the Company's Independent Directors will consider the interests of the holders of both the Preferred Shares and the Common Stock in determining whether any proposed action requiring their approval is in the best interests of the Company.

The persons who are directors and executive officers of the Company are as follows:

| NAME | AGE | POSITION AND OFFICES HELD |
|---------------------------|-----|----------------------------------|
| ---- | --- | ----- |
| Paul R. Skubic..... | 56 | Chairman of the Board, President |
| Janine Mulhall..... | 43 | Chief Financial Officer |
| Frank M. Novosel..... | 58 | Treasurer, Director |
| Teresa L. Patton..... | 57 | Vice President of Operations |
| Margaret M. Sulkin..... | 46 | Assistant Treasurer |
| Delbert J. Wacker..... | 73 | Director |
| David J. Blockowicz..... | 62 | Director |
| Forrest M. Schneider..... | 57 | Director |

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The following is a summary of the experience of the executive officers and directors of the Company:

Mr. Skubic has been Vice President and Controller of the Bank and Chief Accounting Officer for Harris Bankcorp, Inc., and the Bank since 1990. Prior to joining Harris Bankcorp, Inc., Mr. Skubic was employed by Arthur Andersen & Co. He is a certified public accountant.

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Ms. Mulhall, has been Senior Vice President and Chief Financial Officer of Harris Bankcorp, Inc. since July 2003. From November 1995 to that time she held several positions in the Finance area of Harris Bankcorp's parent company, Bank of Montreal, including most recently Vice President and Chief Accountant. From 1984 to 1995, Ms. Mulhall was with KPMG LLP in Toronto. She is a Canadian Chartered Accountant.

Mr. Novosel has been a Vice President in the Treasury Group of the Bank since 1995. Previously, he served as Treasurer of Harris Bankcorp, Inc., managing financial planning. Mr. Novosel is a Chartered Financial Analyst and a member of the Investment Analysts' Society of Chicago.

Ms. Patton has been a Vice President in Residential Mortgages at the Bank for 16 years and is currently the Director of Secondary Marketing. Prior to this position she was the Manager of Sales and Delivery for the Residential Mortgage Division. She currently serves on the Bank's Asset/Liability Committee, and has been employed by the Bank for over 27 years holding positions in Consumer and Commercial Banking.

Ms. Sulkin has been a Vice President in the Taxation Department of the Bank since 1992. Ms. Sulkin has been employed by the Bank since 1984. Prior to joining the Bank, she was employed by KPMG, LLP. She is a certified public accountant.

Mr. Wacker retired as a partner from Arthur Andersen & Co. in 1987 after 34 years. From July 1988 to November 1990, he was Vice President -- Treasurer, Parkside Medical Services, a subsidiary of Lutheran General Health System. From November 1990 to September 1993, he completed various financial consulting projects for Lutheran General.

Mr. Blockowicz is a certified public accountant and is a partner with Blockowicz & Del Guidicic LLC. Prior to forming his firm, Mr. Blockowicz was a partner with Arthur Andersen & Co. through 1990.

Mr. Schneider is President and Chief Executive Officer of Lane Industries, Inc. Mr. Schneider is a director of Lane Industries and director of General Binding Corporation. He has been employed by Lane Industries since 1976. He is a graduate of the University of Illinois where he received his B.S. and masters degree in finance.

INDEPENDENT DIRECTORS

The terms of the Preferred Shares require that, as long as any Preferred Shares are outstanding, certain actions by the Company be approved by a majority of the Company's Independent Directors. Delbert J. Wacker, David J. Blockowicz and Forrest M. Schneider are the Company's Independent Directors.

If at any time the Company fails to declare and pay a quarterly dividend payment on the Preferred Shares, the number of directors then constituting the Board of Directors of the Company will be increased by two at the Company's next

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annual meeting and the holders of Preferred Shares, voting together with the holders of any other outstanding series of Preferred Stock as a single class, will be entitled to elect two additional directors to serve on the Company's Board of Directors. Any member of the Board of Directors elected by holders of the Company's Preferred Shares will be deemed to be an Independent Director for purposes of the actions requiring the approval of a majority of the Independent Directors.

AUDIT COMMITTEE

The Board of Directors of the Company has established an audit committee, with an approved Audit Committee Charter, which will review the engagement of independent accountants and review their independence. The audit committee will also review the adequacy of the Company's internal accounting controls. The audit committee is comprised of Delbert J. Wacker, David J. Blockowicz and Forrest M. Schneider. The Company's Board of Directors has determined that each member of the audit committee is an audit committee financial expert as defined in rules of the Securities and Exchange Commission. Each audit committee member is independent as defined in rules of the New York Stock Exchange.

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COMPENSATION OF DIRECTORS AND OFFICERS

The Company pays the Independent Directors of the Company fees for their services as directors. The Independent Directors receive annual compensation of \$10,000 plus a fee of \$750 for each attendance (in person or by telephone) at each meeting of the Board of Directors or the audit committee.

The Company has adopted a code of ethics for its senior officers and which is filed as an Exhibit hereto.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Based on a review of reports filed with respect to the year ended December 31, 2004, the Company believes that all ownership reports were filed on a timely basis.

ITEM 11. EXECUTIVE COMPENSATION

The Company will not pay any compensation to its officers or employees or to directors who are not Independent Directors.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

(a) SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS

No person owns of record or is known by the Company to own beneficially more than 5% of the outstanding 7 3/8% Noncumulative Exchangeable Preferred Stock, Series A.

(b) SECURITY OWNERSHIP OF MANAGEMENT

The following table shows the ownership of 7 3/8% Noncumulative Exchangeable Preferred Stock, Series A, by the only officer or director who owns any such shares.

NAME OF

AMOUNT OF

PE

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| TITLE OF CLASS ----- | BENEFICIAL OWNER ----- | BENEFICIAL OWNERSHIP ----- | OF ----- |
|-------------------------|---------------------------|-------------------------------|-------------|
| Preferred Stock..... | Paul R. Skubic | 300 Shares | . |
| Preferred Stock..... | Forrest Schneider | 2,200 Shares | . |
| Preferred Stock..... | David J. Blockowicz | 1,000 Shares | . |

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

(a) TRANSACTIONS WITH MANAGEMENT AND OTHERS

The Bank, through its wholly-owned subsidiary, HCH, indirectly owns 100% of the common stock of the Company.

A substantial portion of the assets of the Company initially consisted of Notes issued by the Bank. The Notes mature on October 1, 2027 and pay interest at 6.4% per annum. During 2004, the Company received repayments on the Notes of \$4 million compared to 2003 repayments of \$15 million. In years ended December 31, 2004, 2003 and 2002, the Bank paid interest on the Notes in the amount of \$907 thousand, \$1.5 million and \$2.8 million, respectively, to the Company.

The Company purchases U.S. Treasury and Federal agency securities from the Bank under agreements to resell identical securities. At December 31, 2004, the Company held \$10.5 million of such assets and had earned \$1.0 million of interest from the Bank during 2004. At December 31, 2003, the Company held \$11.5 million of such assets and earned \$1.3 million of interest for 2003. The Company receives rates on these assets comparable to the rates that the Bank offers to unrelated counterparties under similar circumstances.

The Bank and the Company have entered into a Servicing Agreement and an Advisory Agreement, the terms of which are described in further detail on page 5 of this Report. In 2004, the Bank received payments of

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\$44 thousand and \$124 thousand, respectively, compared to \$70 thousand and \$56 thousand for 2003, under the terms of these agreements.

(b) CERTAIN BUSINESS RELATIONSHIPS

Paul R. Skubic, Chairman of the Board of the Company, and all of its executive officers, Janine Mulhall, Frank M. Novosel, Teresa L. Patton and Margaret M. Sulkin, are also officers of the Bank.

(c) INDEBTEDNESS OF MANAGEMENT

None.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

AUDIT FEES

For year ended December 31, 2004, the Company's principal accountant billed \$42 thousand, for the audit of the Company's annual financial statements and review of financial statements included in Form 10-Q filings. For year ended December 31, 2003 the Company's principal accountant billed \$72 thousand, for the audit of the Company's annual financial statements and review of financial statements included in Form 10-Q filings.

AUDIT-RELATED FEES

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There were no fees billed for services reasonably related to the performance of the audit or review of our financial statements outside of those fees disclosed above under "Audit Fees" for years ended December 31, 2004 and 2003.

ALL OTHER FEES

There were no other fees billed by the Company's principal accountants other than those disclosed above for years ended December 31, 2004 and 2003.

PRE-APPROVAL POLICIES AND PROCEDURES

Prior to engaging accountants to perform a particular service, this Board of Directors obtains an estimate for the service to be performed. All of the services described above were approved by the audit committee and Board of Directors in accordance with its procedures.

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) Documents filed with Report:

(1) Consolidated Financial Statements (See page 18 for a listing of all financial statements included in Item 8)

(2) Financial Statement Schedules

All schedules normally required by Form 10-K are omitted since they are either not applicable or because the required information is shown in the financial statements or notes thereto.

(3) Exhibits:

| | |
|------------|---|
| *3(a) (I) | Articles of Incorporation of the Company |
| *3(a) (ii) | Form of Articles of Amendment and Restatement of the Company establishing the Series A Preferred Shares |
| *3(b) | Bylaws of the Company |
| *4 | Specimen of certificate representing Series A Preferred Shares |
| *10(a) | Form of Servicing Agreement between the Company and the Bank |
| *10(b) | Form of Advisory Agreement between the Company and the Bank |
| *10(c) | Form of Bank Loan Agreement between the Company and the Bank |
| *10(d) | Form of Mortgage Loan Assignment Agreement between the Company and the Bank |
| 14 | Code of Ethics for Senior Officers (incorporated by reference to Exhibit 14 to the Company's Annual Report on Form 10-K for the year ended December 31, 2003) |
| 21 | Subsidiaries |
| 24 | Power of attorney |
| 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 |

* Incorporated by reference to the exhibit of the same number filed with the Company's Registration Statement on Form S-11 (Securities and Exchange Commission file number 333-40257)

(b) No reports on Form 8-K were filed.

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INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

The following consolidated financial statements are included in Item 8 of this Annual Report on Form 10-K:

HARRIS PREFERRED CAPITAL CORPORATION

Consolidated Financial Statements

Reports of Independent Registered Public Accounting Firm

Consolidated Balance Sheets

Consolidated Statements of Operations and Comprehensive Income

Consolidated Statements of Changes in Stockholders' Equity

Consolidated Statements of Cash Flows

Notes to Consolidated Financial Statements

HARRIS TRUST AND SAVINGS BANK

Financial Review

Consolidated Financial Statements

Independent Auditors' Report

Consolidated Statements of Condition

Consolidated Statements of Income

Consolidated Statements of Comprehensive Income

Consolidated Statements of Changes in Stockholders' Equity

Consolidated Statements of Cash Flows

Notes to Consolidated Financial Statements

All schedules are omitted since the required information is not present or is not present in amounts sufficient to require submission of the schedule or because the information required is included in the consolidated financial statements and notes hereof.

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SIGNATURES

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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 28th day of March 2005.

/s/ PAUL R. SKUBIC

Paul R. Skubic
Chairman of the Board and President

/s/ JANINE MULHALL

Janine Mulhall
Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by Paul R. Skubic, Chairman of the Board and President of the Company, as attorney-in-fact for the following Directors on behalf of Harris Preferred Capital Corporation of the 28th day of March 2005.

David J. Blockowicz
Frank M. Novosel

Forrest M. Schneider
Delbert J. Wacker

Paul R. Skubic
Attorney-In-Fact
Supplemental Information

No proxy statement will be sent to security holders in 2005.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and Board of Directors
of Harris Preferred Capital Corporation

We have audited the accompanying consolidated balance sheet of Harris Preferred Capital Corporation and subsidiary (the Company) as of December 31, 2004, and the related consolidated statements of operations and comprehensive income, changes in stockholders' equity, and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2004, and the results of its operations and its cash flows for the

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year then ended, in conformity with U.S. generally accepted accounting principles.

/S/ KPMG LLP

March 2, 2005
Chicago, Illinois

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and Board of Directors
of Harris Preferred Capital Corporation

In our opinion, the accompanying consolidated balance sheet and the related consolidated statements of operations and comprehensive income, of changes in stockholders' equity and of cash flows present fairly, in all material respects, the financial position of Harris Preferred Capital Corporation (the "Company") and its subsidiary at December 31, 2003, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP

February 23, 2004
Chicago, Illinois

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HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED BALANCE SHEETS

| | DECEMBER 31 | |
|---|-----------------------------------|--------|
| | 2004 | 2003 |
| | (IN THOUSANDS, EXCEPT SHARE DATA) | |
| ASSETS | | |
| Cash on deposit with Harris Trust and Savings Bank..... | \$ 407 | \$ 926 |
| Securities purchased from Harris Trust and Savings Bank under agreement to resell..... | 10,500 | 11,500 |
| Notes receivable from Harris Trust and Savings Bank..... | 12,129 | 16,547 |
| Securities available-for-sale: | | |

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| | | |
|--|-----------|-----------|
| Mortgage-backed..... | 419,315 | 233,857 |
| U.S. Treasury..... | 44,993 | 229,995 |
| Securing mortgage collections due from Harris Trust and Savings Bank..... | 78 | 414 |
| Other assets..... | 1,600 | 1,079 |
| | ----- | ----- |
| TOTAL ASSETS..... | \$489,022 | \$494,318 |
| | ===== | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Accrued expenses..... | \$ 134 | \$ 84 |
| | ----- | ----- |
| Commitments and contingencies..... | -- | -- |
| STOCKHOLDERS' EQUITY | | |
| 7 3/8% Noncumulative Exchangeable Preferred Stock, Series A (\$1 par value); liquidation value of \$250,000; 20,000,000 shares authorized, 10,000,000 shares issued and outstanding..... | 250,000 | 250,000 |
| Common stock (\$1 par value); 1,000 shares authorized, issued and outstanding..... | 1 | 1 |
| Additional paid-in capital..... | 240,733 | 240,733 |
| (Distributions in excess of earnings) earnings in excess of distributions..... | (582) | 1,230 |
| Accumulated other comprehensive income -- net unrealized gains/(losses) on available-for-sale securities..... | (1,264) | 2,270 |
| | ----- | ----- |
| TOTAL STOCKHOLDERS' EQUITY..... | 488,888 | 494,234 |
| | ----- | ----- |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY..... | \$489,022 | \$494,318 |
| | ===== | ===== |

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

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HARRIS PREFERRED CAPITAL CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME

| | FOR THE YEARS ENDED DECEMBER 31 | | |
|--|-----------------------------------|----------|----------|
| | 2004 | 2003 | 2002 |
| | ----- | ----- | ----- |
| | (IN THOUSANDS, EXCEPT SHARE DATA) | | |
| INTEREST INCOME: | | | |
| Securities purchased from Harris Trust and Savings Bank under agreement to resell..... | \$ 1,060 | \$ 1,266 | \$ 2,063 |
| Notes receivable from Harris Trust and Savings Bank..... | 907 | 1,508 | 2,776 |
| Securities available-for-sale: | | | |
| Mortgage-backed..... | 14,973 | 14,791 | 14,693 |
| U.S. Treasury..... | 58 | 113 | 402 |
| | ----- | ----- | ----- |
| Total interest income..... | 16,998 | 17,678 | 19,934 |
| NON-INTEREST INCOME: | | | |
| Gain on sale of securities..... | 1,062 | 4,158 | 2,677 |
| | ----- | ----- | ----- |

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| | | | |
|--|----------|----------|----------|
| | 1,062 | 4,158 | 2,677 |
| OPERATING EXPENSES: | | | |
| Loan servicing fees paid to Harris Trust and Savings | | | |
| Bank..... | 44 | 70 | 131 |
| Advisory fees paid to Harris Trust and Savings Bank..... | 124 | 56 | 43 |
| General and administrative..... | 362 | 362 | 314 |
| | ----- | ----- | ----- |
| Total operating expenses..... | 530 | 488 | 488 |
| | ----- | ----- | ----- |
| Net income..... | 17,530 | 21,348 | 22,123 |
| Preferred stock dividends..... | 18,438 | 18,438 | 18,438 |
| | ----- | ----- | ----- |
| NET INCOME AVAILABLE (LOSS ALLOCATED) TO COMMON | | | |
| STOCKHOLDER..... | \$ (908) | \$ 2,910 | \$ 3,685 |
| | ===== | ===== | ===== |
| Basic and diluted earnings (loss) per common share..... | \$ (908) | \$ 2,910 | \$ 3,685 |
| | ===== | ===== | ===== |
| Net income..... | \$17,530 | \$21,348 | \$22,123 |
| Other comprehensive income/(loss) -- net unrealized | | | |
| gains/(losses) on available-for-sale securities..... | (3,534) | (8,092) | 12,239 |
| | ----- | ----- | ----- |
| Comprehensive income..... | \$13,996 | \$13,256 | \$34,362 |
| | ===== | ===== | ===== |

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
FOR THE YEARS ENDED DECEMBER 31, 2004, 2003 AND 2002

| | PREFERRED STOCK | COMMON STOCK | ADDITIONAL PAID-IN CAPITAL | (DISTRIBUTIONS IN EXCESS OF EARNINGS) EARNINGS IN EXCESS OF DISTRIBUTIONS | ACCUMULA OTHER COMPREHEN INCOME (LOSS) |
|---------------------------------|--------------------------------------|-----------------|----------------------------------|---|--|
| | ----- | ----- | ----- | ----- | ----- |
| | (IN THOUSANDS EXCEPT PER SHARE DATA) | | | | |
| BALANCE AT DECEMBER 31, 2001... | \$250,000 | \$ 1 | \$240,733 | \$ 385 | \$ (1,87 |
| Net income..... | -- | -- | -- | 22,123 | -- |
| Other comprehensive income... | -- | -- | -- | -- | 12,23 |
| Dividends declared on common | | | | | |
| stock (\$3,220.00 per | | | | | |
| share)..... | -- | -- | -- | (3,220) | -- |
| Dividends declared on | | | | | |
| preferred stock (\$1.8438 | | | | | |
| per share)..... | -- | -- | -- | (18,438) | -- |
| | ----- | ----- | ----- | ----- | ----- |
| BALANCE AT DECEMBER 31, 2002... | \$250,000 | \$ 1 | \$240,733 | \$ 850 | \$10,36 |
| | ===== | ===== | ===== | ===== | ===== |
| Net income..... | -- | -- | -- | 21,348 | -- |
| Other comprehensive loss..... | -- | -- | -- | -- | (8,09 |
| Dividends declared on common | | | | | |
| stock (\$2,530.00 per | | | | | |
| share)..... | -- | -- | -- | (2,530) | -- |

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| | | | | | |
|---|-----------|------|-----------|----------|----------|
| Dividends declared on preferred stock (\$1.8438 per share)..... | -- | -- | -- | (18,438) | -- |
| BALANCE AT DECEMBER 31, 2003... | \$250,000 | \$ 1 | \$240,733 | \$ 1,230 | \$ 2,27 |
| Net income..... | -- | -- | -- | 17,530 | -- |
| Other comprehensive loss..... | -- | -- | -- | -- | (3,53) |
| Dividends declared on common stock (\$904 per share)..... | -- | -- | -- | (904) | -- |
| Dividends declared on preferred stock (\$1.8438 per share)..... | -- | -- | -- | (18,438) | -- |
| BALANCE AT DECEMBER 31, 2004... | \$250,000 | \$ 1 | \$240,733 | \$ (582) | \$ (1,26 |

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

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HARRIS PREFERRED CAPITAL CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | FOR THE YEARS ENDED DECEMBER 31 | | |
|--|---------------------------------|-----------|-----------|
| | 2004 | 2003 | 2002 |
| | (IN THOUSANDS) | | |
| OPERATING ACTIVITIES: | | | |
| Net income..... | \$ 17,530 | \$ 21,348 | \$ 22,123 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Gain on sale of securities..... | (1,062) | (4,158) | (2,677) |
| Net (increase) decrease in other assets..... | (521) | 868 | (2) |
| Net increase (decrease) in accrued expenses..... | 50 | (12) | (4) |
| Net cash provided by operating activities..... | 15,997 | 18,046 | 19,440 |
| INVESTING ACTIVITIES: | | | |
| Net decrease in securities purchased from Harris Trust and Savings Bank under agreement to resell..... | 1,000 | 8,500 | 1,000 |
| Repayments of notes receivable from Harris Trust and Savings Bank..... | 4,418 | 14,531 | 24,884 |
| Decrease in securing mortgage collections due from Harris Trust and Savings Bank..... | 336 | 2,516 | 2,423 |
| Purchases of securities available-for-sale..... | (676,706) | (765,405) | (848,215) |
| Proceeds from sales of securities available-for-sale.... | 51,458 | 99,756 | 181,510 |
| Proceeds from maturities of securities available-for-sale..... | 622,320 | 643,222 | 640,838 |
| Net cash provided by investing activities..... | 2,826 | 3,120 | 2,440 |
| FINANCING ACTIVITIES: | | | |
| Cash dividends paid on preferred stock..... | (18,438) | (18,438) | (18,438) |
| Cash dividends paid on common stock..... | (904) | (2,530) | (3,220) |

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| | | | |
|--|----------|----------|----------|
| Net cash used by financing activities..... | (19,342) | (20,968) | (21,658) |
| Net (decrease) increase in cash on deposit with Harris Trust and Savings Bank..... | (519) | 198 | 222 |
| Cash on deposit with Harris Trust and Savings Bank at beginning of period..... | 926 | 728 | 506 |
| Cash on deposit with Harris Trust and Savings Bank at end of period..... | \$ 407 | \$ 926 | \$ 728 |
| | ===== | ===== | ===== |

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

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HARRIS PREFERRED CAPITAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION AND 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. The Company has elected to be a REIT under sections 856 through 860 of the Internal Revenue Code of 1986, as amended (the "Code"), and will generally not be subject to Federal income tax to the extent that it meets all of the REIT requirements in the Code Sections 856-860. All of the 1,000 shares of the Company's common stock, par value \$1.00 per share (the "Common Stock"), are owned by Harris Capital Holdings, Inc. ("HCH"), a wholly-owned subsidiary of the Bank. On December 30, 1998, the Bank transferred its ownership of the common stock of the Company to HCH. The Bank is required to maintain direct or indirect ownership of at least 80% of the outstanding Common Stock of the Company for as long as any 7 3/8% Noncumulative Exchangeable Preferred Stock, Series A (the "Preferred Shares"), \$1.00 par value, is outstanding. The Company was formed by the Bank to provide the opportunity to invest in residential mortgages and other real estate assets and to provide the Bank with a cost-effective means of raising capital for federal regulatory purposes.

On February 11, 1998, the Company completed an initial public offering (the "Offering") of 10,000,000 shares of the Company's Preferred Shares, receiving proceeds of \$242,125,000, net of underwriting fees. The Preferred Shares are traded on the New York Stock Exchange. Concurrent with the issuance of the Preferred Shares, the Bank contributed additional capital of \$250 million to the Company.

The Company used the proceeds raised from the initial public offering of the Preferred Shares and the additional capital contributed by the Bank to purchase \$356 million of Notes from the Bank and \$135 million of mortgage-backed securities at their estimated fair value.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

CASH AND CASH EQUIVALENTS

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Cash and cash equivalents include cash on deposit with the Bank.

ALLOWANCE FOR POSSIBLE LOAN LOSSES

The allowance for possible loan losses is maintained at a level considered adequate to provide for potential loan losses. The allowance is increased by provisions charged to operating expense and reduced by net charge-offs. Known losses of principal on impaired loans are charged off. The provision for loan losses is based on past loss experience, management's evaluation of the loan portfolio securing the Mortgage Assets under current economic conditions and management's estimate of anticipated, but as yet not specifically identified, loan losses. Such estimates are reviewed periodically and adjustments, if necessary, are recorded during the periods in which they become known. At December 31, 2004 and 2003, no allowance for possible loan losses was recorded under this policy.

INCOME TAXES

The Company has elected to be taxed as a REIT commencing with its taxable year ended December 31, 1998 and intends to comply with the provisions of the Code with respect thereto. The Company does not expect to be subject to Federal income tax because assets, income distribution and stock ownership tests in Code Sections 856-860 are met. Accordingly, no provision for income taxes is included in the accompanying financial statements.

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The REIT Modernization Act, which took effect on January 1, 2001, modified certain provisions of the Code with respect to the taxation of REITs. A key provision of this tax law change reduced the required level of distributions by a REIT from 95% to 90% of ordinary taxable income.

SECURITIES

The Company classifies all securities as available-for-sale, even if the Company has no current plans to divest. Available-for-sale securities are reported at fair value with unrealized gains and losses included as a separate component of stockholders' equity.

Interest income on securities, including amortization of discount or premium, is included in earnings. Realized gains and losses, as a result of securities sales, are included in gain on sale of securities in the consolidated statement of operations, with the cost of securities sold determined on the specific identification basis.

The Company purchases U.S. Treasury and Federal agency securities from the Bank under agreements to resell identical securities. The amounts advanced under these agreements represent short-term loans and are reflected as securities purchased under agreement to resell in the balance sheet. Securities purchased under agreement to resell totaled \$10.5 million at December 31, 2004 compared to \$11.5 million at December 31, 2003. The securities underlying the agreements are book-entry securities. Securities are transferred by appropriate entry into the Company's account with the Bank under a written custodial agreement with the Bank that explicitly recognizes the Company's interest in these securities.

The Company's investment securities are exposed to various risks such as interest rate, market and credit. Due to the level of risk associated with certain investment securities and the level of uncertainty related to changes in the value of investment securities, it is at least reasonably possible that changes in risks in the near term would materially affect the carrying value of investments in securities available-for-sale currently reported in the balance

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sheet.

In making a determination of temporary vs. other-than-temporary impairment of an investment, a major consideration of management is whether the Company will be able to collect all amounts due according to the contractual terms of the investment. Such a determination involves estimation of the outcome of future events as well as knowledge and experience about past and current events. Factors considered include the following: whether the fair value is significantly below cost and the decline is attributable to specific adverse conditions in an industry or geographic area; the period of time the decline in fair value has existed; if an outside rating agency has downgraded the investment; if dividends have been reduced or eliminated; if scheduled interest payments have not been made and finally, whether the financial condition of the issuer has deteriorated

NEW ACCOUNTING PRONOUNCEMENTS

The Financial Accounting Standards Board issued Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "Share-Based Payments" in 2004. The Statement replaces SFAS No. 123, "Accounting for Stock-Based Compensation," and supersedes Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS 123(R) applies primarily to accounting for transactions where an entity obtains employee services in share-based payment transactions using the fair value based method of accounting. The Statement is effective as of the beginning of the first interim or annual reporting period that begins after June 15, 2005. The Company does not expect the implementation of this Statement to have a material effect on its financial position or results of operations.

MANAGEMENT'S ESTIMATES

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

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3. NOTES RECEIVABLE FROM THE BANK

On February 11, 1998, proceeds received from the Offering were used in part to purchase \$356 million of Notes at a rate of 6.4%. The Notes are secured by mortgage loans originated by the Bank. The principal amount of the Notes equals approximately 80% of the aggregate outstanding principal amount of the Mortgage Loans. During 2004, the Company received repayments on the Notes of \$4.4 million compared to 2003 repayments of \$14.5 million. For years ended December 31, 2004, 2003 and 2002, the Bank paid interest on the Notes in the amount of \$907 thousand, \$1.5 million and \$2.8 million, respectively, to the Company.

The Notes are recourse only to the Securing Mortgage Loans that are secured by real property. The Notes mature on October 1, 2027. Payments of principal and interest on the Notes are recorded monthly from payments received on the Securing Mortgage Loans. The Company has a security interest in the real property securing the underlying mortgage loans and is entitled to enforce payment on the Securing Mortgage Loans in its own name if a mortgagor should default. In the event of default, the Company has the same rights as the original mortgagee to foreclose the mortgaged property and satisfy the obligations of the Bank out of the proceeds. The Securing Mortgage Loans are

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serviced by the Bank, as agent of the Company.

The Company intends that each mortgage loan securing the Notes will represent a first lien position and will be originated in the ordinary course of the Bank's real estate lending activities based on the underwriting standards generally applied (at the time of origination) for the Bank's own account. The Company also intends that all Mortgage Assets held by the Company will meet market standards, and servicing guidelines promulgated by the Company, and Federal National Mortgage Association ("Fannie Mae") and Federal Home Loan Mortgage Corporation ("FHLMC") guidelines and procedures.

The balance of Securing Mortgage Loans at December 31, 2004 and 2003 was \$15 million and \$21 million, respectively. The weighted average interest rate on those loans at December 31, 2004 and 2003 was 5.862% and 5.996%, respectively.

None of the Securing Mortgage Loans collateralizing the Notes were on nonaccrual status at December 31, 2004 or 2003.

A majority of the collateral securing the underlying mortgage loans is located in Illinois. The financial viability of customers in this state is, in part, dependent on the state's economy. The Company's maximum risk of accounting loss, should all customers in Illinois fail to perform according to contract terms and all collateral prove to be worthless, was approximately \$11 million at December 31, 2004 and \$12 million as of December 31, 2003.

4. SECURITIES

The amortized cost and estimated fair value of securities available-for-sale were as follows:

| | DECEMBER 31, 2004 | | | | DECEMBER 31, 2003 | |
|----------------------------------|-------------------|---------------------|----------------------|---------------|-------------------|---------------------|
| | AMORTIZED COST | UNREALIZED GAINS | UNREALIZED LOSSES | FAIR VALUE | AMORTIZED COST | UNREALIZED GAINS |
| | (IN THOUSANDS) | | | | | |
| AVAILABLE-FOR-SALE SECURITIES | | | | | | |
| Mortgage-backed..... | \$420,583 | \$971 | \$2,239 | \$419,315 | \$231,587 | \$2,666 |
| U.S. Treasury..... | 44,989 | 4 | -- | 44,993 | 229,995 | -- |
| Total Securities..... | \$465,572 | \$975 | \$2,239 | \$464,308 | \$461,582 | \$2,666 |

The following table summarizes mortgage-backed securities with unrealized losses as of December 31, 2004, the amount of the unrealized loss and the related fair value of the securities with unrealized losses. The unrealized losses have been further segregated by mortgage-backed securities that have been in a continuous unrealized loss position for less than 12 months and those that have been and those that been in a continuous unrealized loss position for 12 or more months. Management believes that all of the unrealized losses are temporary.

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LENGTH OF CONTINUOUS UNREALIZED LOSS POSITION

| | LESS THAN 12 MONTHS | | 12 MONTHS OR LONGER | | TOTAL | |
|----------------------|---------------------|----------------------|---------------------|----------------------|---------------|----------------------|
| | FAIR VALUE | UNREALIZED LOSSES | FAIR VALUE | UNREALIZED LOSSES | FAIR VALUE | UNREALIZED LOSSES |
| | (IN THOUSAND) | | | | | |
| Mortgage-backed..... | \$236,138 | \$1,866 | \$37,692 | \$373 | \$273,830 | \$2,239 |
| | ===== | ===== | ===== | ===== | ===== | ===== |

The amortized cost and estimated fair value of total available-for-sale securities at December 31, 2004, by contractual maturity, are shown below. Expected maturities can differ from contractual maturities since borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The U.S. Treasury Bills held at December 31, 2004 mature within the next month.

| | DECEMBER 31, 2004 | |
|-----------------------|-------------------|---------------|
| | AMORTIZED COST | FAIR VALUE |
| Maturities: | | |
| Within 1 year..... | \$ 44,993 | \$ 44,997 |
| 1 to 5 years..... | 131,776 | 132,011 |
| 5 to 10 years..... | 98,626 | 97,327 |
| Over 10 years..... | 190,177 | 189,973 |
| | ----- | ----- |
| Total Securities..... | \$465,572 | \$464,308 |
| | ===== | ===== |

5. COMMON AND PREFERRED STOCK

On February 11, 1998, the Company issued 10,000,000 Preferred Shares, Series A, at a price of \$25 per share pursuant to its Registration Statement on Form S-11. Proceeds from this issuance, net of underwriting fees, totaled \$242,125,000. The liquidation value of each Preferred Share is \$25 plus any authorized, declared and unpaid dividends. The Preferred Shares are redeemable at the option of the Company, in whole or in part, at the liquidation preference thereof, plus the quarterly accrued and unpaid dividends, if any, to the date of redemption. The Company may not redeem the Preferred Shares without prior approval from the Board of Governors of the Federal Reserve System or the appropriate successor federal regulatory agency. Except under certain limited circumstances, as defined, the holders of the Preferred Shares have no voting rights. The Preferred Shares are automatically exchangeable for a new series of preferred stock of the Bank upon the occurrence of certain events.

Holders of Preferred Shares are entitled to receive, if declared by the Board of Directors of the Company, noncumulative dividends at a rate of 7 3/8% per annum of the \$25 per share liquidation preference (an amount equivalent to \$1.84375 per share per annum). Dividends on the Preferred Shares, if authorized and declared, are payable quarterly in arrears on March 30, June 30, September 30, and December 30 each year. Dividends paid to the holders of the Preferred Shares for the years ended December 31, 2004 and 2003 were \$18,438,000 in both years. The allocations of the distributions declared and paid for income tax

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purposes for the years ended December 31, 2004 and 2003 were 87.7% of ordinary income, 7.4% of capital gain and 4.9% of return of capital and 92% of ordinary income and 8% of capital gain, respectively.

On December 30, 1998, the Bank contributed the Common Stock of the Company to HCH. The Bank is required to maintain direct or indirect ownership of at least 80% of the outstanding Common Stock of the Company for as long as any Preferred Shares are outstanding. Dividends on Common Stock are paid if and when authorized and declared by the Board of Directors out of funds legally available after all preferred

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dividends have been paid. A Common Stock dividend of \$2,000 per common share was declared on December 2, 2003, to the stockholder of record on December 15, 2003 and paid on December 31, 2003. In addition, on September 13, 2004 and September 12, 2003, the Company paid a cash dividend of \$904 thousand and \$530 thousand, respectively, on the outstanding common shares. These dividends completed the 2003 and 2002 REIT tax compliance requirements.

6. TRANSACTIONS WITH AFFILIATES

The Company entered into an advisory agreement (the "Advisory Agreement") with the Bank pursuant to which the Bank administers the day-to-day operations of the Company. The Bank is responsible for (i) monitoring the credit quality of Mortgage Assets held by the Company; (ii) advising the Company with respect to the reinvestment of income from and payments on, and with respect to, the acquisition, management, financing, and disposition of the Mortgage Assets held by the Company; and (iii) monitoring the Company's compliance with the requirements necessary to qualify as a REIT.

The Advisory Agreement in effect for 2004, 2003 and 2002 entitled the Bank to receive advisory fees of \$124,000, \$56,000, and \$43,000, respectively for processing, recordkeeping, legal, management and other services.

The Securing Mortgage Loans are serviced by the Bank pursuant to the terms of a servicing agreement (the "Servicing Agreement"). The Bank receives a fee equal to 0.25% per annum on the principal balances of the loans serviced. The Servicing Agreement requires the Bank to service the mortgage loans in a manner generally consistent with accepted secondary market practices, and servicing guidelines promulgated by the Company and with Fannie Mae and FHLMC guidelines and procedures. In 2004, 2003, and 2002 the Bank received payments of \$44 thousand, \$70 thousand and \$131 thousand, respectively.

The Company purchases U.S. Treasury and Federal agency securities from the Bank under agreements to resell identical securities. At December 31, 2004, the Company held \$10.5 million of such assets and had earned \$1.0 million of interest from the Bank during 2004. At December 31, 2003 the Company held \$11.5 million of such assets and earned \$1.3 million of interest for 2003. At December 31, 2002 the Company held \$20 million of such assets and earned \$2.1 million of interest for 2002. The Company receives rates on these assets comparable to the rates that the Bank offers to unrelated counterparties under similar circumstances.

7. OPERATING SEGMENT

The Company's operations consist of monitoring and evaluating the investments in Mortgage Assets. Accordingly, the Company operates in only one segment. The Company has no external customers and transacts most of its business with the Bank.

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8. COMMITMENTS AND CONTINGENCIES

Legal proceedings in which the Company is a defendant may arise in the normal course of business. At December 31, 2004 and 2003, there was no pending litigation against the Company.

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9. QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

The following table sets forth selected quarterly financial data for the Company:

| | YEAR ENDED DECEMBER 31, 2004 | | | | YEAR ENDED DECEMBER 31, | | |
|-------------------------|--------------------------------------|-------------------|------------------|-------------------|-------------------------|-------------------|------------------|
| | FIRST QUARTER | SECOND QUARTER | THIRD QUARTER | FOURTH QUARTER | FIRST QUARTER | SECOND QUARTER | THIRD QUARTER |
| | (IN THOUSANDS EXCEPT PER SHARE DATA) | | | | | | |
| Total interest | | | | | | | |
| income..... | \$ 3,383 | \$ 3,847 | \$ 4,805 | \$ 4,963 | \$ 5,293 | \$4,779 | \$ 3,856 |
| Total noninterest | | | | | | | |
| income..... | 398 | -- | 464 | 200 | 2,463 | -- | 687 |
| Total operating | | | | | | | |
| expenses..... | 137 | 137 | 94 | 162 | 130 | 99 | 80 |
| Net income..... | 3,644 | 3,710 | 5,175 | 5,001 | 7,626 | 4,680 | 4,463 |
| Preferred dividends.... | 4,609 | 4,609 | 4,609 | 4,611 | 4,609 | 4,609 | 4,609 |
| Net income available | | | | | | | |
| (loss allocated) to | | | | | | | |
| common stockholder... | (965) | (899) | 566 | 390 | 3,017 | 71 | (146) |
| Basic and diluted | | | | | | | |
| (loss) income per | | | | | | | |
| common share..... | \$(965.00) | \$(899.00) | \$566.00 | \$390.00 | \$3,017.00 | \$71.00 | \$(146.00) |

FINANCIAL STATEMENTS OF HARRIS TRUST AND SAVINGS BANK

The following unaudited financial information and audited financial statements for Harris Trust and Savings Bank are included because the 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

CERTAIN INFORMATION REGARDING HARRIS TRUST AND SAVINGS BANK

Harris Trust and Savings Bank ("the Bank") is an Illinois banking operation located at 111 West Monroe Street, Chicago, Illinois 60603. The Bank is a wholly-owned subsidiary of Harris Bankcorp, Inc., a multibank holding company incorporated under the laws of the State of Delaware and headquartered in Chicago and registered under the Bank Holding Company Act of 1956, as amended.

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Harris Bankcorp, Inc. is a wholly-owned subsidiary of Harris Financial Corp. ("HFC") (formerly known as Bankmont Financial Corp.). Harris Bankcorp, Inc. also owns 29 other banks, 27 in the counties surrounding Chicago, one with locations in Arizona, Florida and Washington and one with locations in northwest Indiana. HFC is a wholly-owned subsidiary of Bank of Montreal. At December 31, 2004, Harris Bankcorp's assets amounted to \$34.12 billion, with the Bank representing approximately 62 percent of that total.

The Bank, an Illinois state-chartered bank, has its principal office, 56 domestic branch offices and 128 automated teller machines located in the Chicago area. The Bank also has offices in Atlanta, Los Angeles and San Francisco and a foreign branch office in Nassau. At December 31, 2004, the Bank had total assets of \$21.22 billion, total deposits of \$13.85 billion, total loans of \$11.48 billion and equity capital of \$1.64 billion.

The Bank provides a broad range of banking and financial services to individuals and corporations domestically and abroad, including corporate banking, personal financial services, personal trust services and investment services. The Bank also offers (i) demand and time deposit accounts; (ii) various types of loans (including term, real estate, revolving credit facilities and lines of credit); (iii) sales and purchases of foreign currencies; (iv) interest rate management products (including swaps, forward rate agreements and interest rate guarantees); (v) cash management services; (vi) underwriting of municipal bonds; (vii) financial consulting; and (viii) a wide variety of personal trust and trust-related services.

Competitors of the Bank include commercial banks, savings and loan associations, consumer and commercial finance companies, credit unions and other financial services companies. Based on legislation passed in 1986 that allows Illinois banks to be acquired by banks or holding companies in states with a reciprocal law in effect, together with the Federal Interstate Banking Efficiency Act of 1994 that allows for both interstate banking and interstate branching in certain circumstances, the Bank believes that the level of competition will increase in the future.

The Bank is subject to regulation by the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation. As a state-chartered bank, it is also regulated by the Illinois Office of Banks and Real Estate. These regulatory bodies examine the Bank and supervise numerous aspects of its business. The Federal Reserve System regulates money and credit conditions and interest rates in order to influence general economic conditions, primarily through open market operations in U.S. Government securities, varying the discount rate on bank borrowings, setting reserve requirements against financial institution deposits and prescribing minimum capital requirements for member banks. These policies have a significant influence on overall growth and distribution of bank loans, investments and deposits, and affect interest rates charged on loans and earned on investments or paid for time, savings and other deposits. Board of Governors monetary policies have had a significant effect on the operating results of commercial banks in the past and this is expected to continue.

On June 4, 2004, Harris Bankcorp, Inc. announced its plan to consolidate twenty-six of its existing bank charters, including the Bank, into one national bank charter, Harris N.A. This transaction is expected to be completed in May 2005. The combination will be recorded at historical carrying value and, where applicable, prior years' financial statements will be restated.

Although primarily focusing on U.S. domestic customers, identifiable foreign assets accounted for 4 percent of the Bank's total consolidated assets at December 31, 2004 and foreign net loss was \$31.8 million in 2004. Foreign activities result from three primary sources: (i) lending to foreign banks and other financial institutions; (ii) time deposits held or issued to foreign

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banks; and (iii) foreign exchange trading profits of approximately \$5.9 million.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

2004 COMPARED TO 2003

SUMMARY

The Bank's 2004 net income was \$141.1 million, up \$23.2 million from 2003. A significantly lower provision for loan losses was the primary reason for this improvement. This was partially offset by lower noninterest income. Return on average common equity ("ROE") for 2004 was 8.71 percent and 7.43 percent in 2003. Return on average assets ("ROA") was 0.69 percent in 2004 and 0.61 percent in 2003.

Earnings before amortization of valuation intangibles ("cash earnings") were \$147.3 million in 2004, a 19 percent increase compared to 2003. Cash return on average common stockholder's equity ("cash ROE") represents net income applicable to common stock plus after-tax amortization expense of intangibles, divided by average common stockholder's equity less average intangible assets. Cash ROE, excluding the impact of unrealized securities gains and losses on equity, was 10.08 percent in 2004 compared to 9.06 percent in 2003.

For 2004, net interest income on a fully taxable equivalent basis of \$442.2 million was down 1 percent from 2003. Net interest margin declined from 2.70 percent to 2.49 percent in 2004, reflecting the impact of lower yields in the investment securities portfolio and higher funding costs for certain borrowings. Average earning assets increased \$1.20 billion or 7 percent to \$17.79 billion in the current year, largely due to an increase of \$884 million in average loans.

Noninterest income decreased \$58.4 million to \$456.3 million for 2004. Gains on sales of mortgage loans decreased \$9.2 million, net fees from providing service to related corporate entities decreased \$28.9 million, syndication fee income decreased \$10.1 million and service fees and charges decreased \$12.4 million. Trust and investment management fees increased \$8.5 million and the Bank realized a \$7.1 million gain on the sale of assets received in an earlier troubled debt restructuring. A gain of \$7.7 million was realized on the termination of a swap.

Total noninterest expenses were \$683.6 million, down \$7.1 million or 1 percent from 2003. Total direct compensation costs declined by 8 percent in 2004 although this was somewhat offset by charges for outsourced services. Income taxes were \$58.7 million, up \$19.4 million from 2003, reflecting higher pretax income in 2004.

The provision for loan losses was \$7.2 million in 2004 compared to \$103.6 million in 2003. Net loan charge-offs during the current year were \$23.5 million compared to \$75.8 million in 2003 reflecting lower write-offs in the commercial loan portfolio. The decrease in provision was based on management's estimate of potentially lower loan losses due to continued declines in non-performing loan levels as well as reduced charge-offs.

Nonperforming assets totaled \$125 million or 1.09 percent of total loans compared to \$172 million or 1.79 percent a year earlier. At December 31, 2004, the allowance for loan losses was \$220 million or 1.91 percent of total loans outstanding compared to \$235 million or 2.45 percent of loans at the end of 2003. As a result, the ratio of the allowance for loan losses to nonperforming assets increased from a multiple of 1.4 at December 31, 2003 to 1.8 at December

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31, 2004.

At December 31, 2004, the Bank's equity capital amounted to \$1.64 billion, up from \$1.60 billion at December 31, 2003. The Bank paid cash and non-cash dividends totaling \$70.5 million in 2004. Unrealized securities losses, net of tax benefit, were \$21.3 million at December 31, 2004 compared to net of tax unrealized securities gains of \$31.0 million at December 31, 2003. In February 1998, Harris Preferred Capital Corporation, a subsidiary of the Bank, issued \$250 million of noncumulative preferred stock in a public offering (see Note 18 to Financial Statements). The preferred stock qualifies as Tier 1 capital for U.S. banking regulatory purposes.

The Bank's regulatory capital leverage ratio was 8.33 percent compared to 8.52 percent one year earlier. Regulators require most banking institutions to maintain capital leverage ratios of not less than 4.0 percent. At

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December 31, 2004, the Bank's Tier 1 and total risk-based capital ratios were 9.49 percent and 11.75 percent, respectively, compared to respective ratios of 10.20 percent and 12.25 percent at December 31, 2003. The 2004 year-end risk-based capital ratios substantially exceeded minimum required regulatory ratios of 4.0 percent and 8.0 percent, respectively.

2003 COMPARED TO 2002

SUMMARY

The Bank's 2003 net income was \$117.9 million, down \$54.0 million from 2002. Declines in gains from sales of portfolio securities, a higher provision for loan losses and increased pension costs more than offset increased noninterest revenue excluding security sales. Return on average common equity ("ROE") for 2003 was 7.43 percent and 11.02 percent in 2002. Return on average assets ("ROA") was 0.61 percent in 2003 and 0.95 percent in 2002.

Earnings before amortization of goodwill and other valuation intangibles ("cash earnings") were \$124.0 million in 2003, a 30 percent decrease compared to 2002. Cash return on average common stockholder's equity ("cash ROE") represents net income applicable to common stock plus after-tax amortization expense of goodwill and other valuation intangibles, divided by average common stockholder's equity less average intangible assets. Cash ROE was 8.76 percent in 2003 compared to 12.85 percent in 2002.

For 2003, net interest income on a fully taxable equivalent basis of \$447.9 million was down 4 percent from 2002. Net interest margin declined from 2.99 percent to 2.70 percent in 2003, reflecting the impact of lower yields in the investment securities portfolio. Average earning assets increased \$1.01 billion or 6 percent to \$16.59 billion in the current year, attributable to an increase of \$990 million in investment securities.

Noninterest income increased \$2.2 million to \$514.7 million for 2003. Gains on sales of mortgage loans increased \$8.9 million and fees from providing service to related corporate entities rose \$28.5 million. Net gains from sales of investment securities decreased \$35.3 million.

Total noninterest expenses were \$690.7 million, up \$34.4 million or 5 percent from 2002. Income taxes were \$39.3 million, down \$28.0 million from 2002, reflecting lower pretax income in 2003.

The provision for loan losses was \$103.6 million in 2003 compared to \$71.2 million in 2002. Net loan charge-offs during the current year were \$75.8 million compared to \$91.6 million in 2002 reflecting lower write-offs in the commercial

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loan portfolio.

Nonperforming assets totaled \$172 million or 1.79 percent of total loans at both December 31, 2003 and December 31, 2002. At December 31, 2003, the allowance for possible loan losses was \$235 million or 2.45 percent of total loans outstanding compared to \$207 million or 2.15 percent of loans at the end of 2002. As a result, the ratio of the allowance for possible loan losses to nonperforming assets increased from a multiple of 1.2 at December 31, 2002 to 1.4 at December 31, 2003.

At December 31, 2003, the Bank's equity capital amounted to \$1.60 billion, up slightly from \$1.58 billion at December 31, 2002. Unrealized securities gains, net of tax, were \$31.0 million at December 31, 2003 compared to \$73.0 million at December 31, 2002. In February 1998, Harris Preferred Capital Corporation, a subsidiary of the Bank, issued \$250 million of noncumulative preferred stock in a public offering (see Note 18 to Financial Statements). The preferred stock qualifies as Tier 1 capital for U.S. banking regulatory purposes.

The Bank's regulatory capital leverage ratio was 8.52 percent compared to 8.64 percent one year earlier. Regulators require most banking institutions to maintain capital leverage ratios of not less than 4.0 percent. At December 31, 2003, the Bank's Tier 1 and total risk-based capital ratios were 10.20 percent and 12.25 percent, respectively, compared to respective ratios of 10.19 percent and 12.50 percent at December 31, 2002. The 2003 year-end risk-based capital ratios substantially exceeded minimum required regulatory ratios of 4.0 percent and 8.0 percent, respectively.

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INDEPENDENT AUDITORS' REPORT

To the Stockholder and Board
of Directors of Harris Trust and Savings Bank

We have audited the accompanying consolidated statements of condition of Harris Trust and Savings Bank (an indirect wholly-owned subsidiary of Bank of Montreal) and subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of income, comprehensive income, changes in stockholder's equity and cash flows for each of the years in the three year period ended December 31, 2004. These consolidated financial statements are the responsibility of Harris Trust and Savings Bank's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Harris Trust and Savings Bank and subsidiaries as of December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the years in the three year period ended December 31, 2004 in conformity with United States of America generally accepted accounting principles.

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/S/ KPMG LLP

Chicago, Illinois
March 16, 2005

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HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CONDITION

| | DECEMBER 31 | |
|---|----------------------------------|---------------------|
| | 2004 | 2003 |
| | (IN THOUSANDS EXCEPT SHARE DATA) | |
| ASSETS | | |
| Cash and demand balances due from banks..... | \$ 887,827 | \$ 823,615 |
| Money market assets: | | |
| Interest-bearing deposits at banks..... | 662,366 | 424,459 |
| Federal funds sold..... | 541,300 | 409,425 |
| Securities available-for-sale (including \$3.36 billion and \$4.07 billion of securities pledged as collateral for repurchase agreements at December 31, 2004 and December 31, 2003, respectively)..... | 5,784,417 | 6,624,280 |
| Trading account assets..... | 90,130 | 59,467 |
| Loans..... | 11,484,948 | 9,573,452 |
| Allowance for loan losses..... | (219,740) | (234,798) |
| | ----- | ----- |
| Net loans..... | 11,265,208 | 9,338,654 |
| Premises and equipment..... | 309,415 | 302,975 |
| Bank-owned insurance..... | 1,072,660 | 1,035,239 |
| Loans held for sale..... | 43,423 | 168,904 |
| Goodwill and other intangible assets..... | 155,596 | 165,978 |
| Other assets..... | 412,305 | 566,494 |
| | ----- | ----- |
| TOTAL ASSETS..... | \$21,224,647 | \$19,919,490 |
| | ===== | ===== |
| LIABILITIES | | |
| Deposits in domestic offices -- noninterest-bearing..... | \$ 4,019,416 | \$ 4,231,540 |
| -- interest-bearing..... | 8,149,640 | 7,844,596 |
| Deposits in foreign offices -- noninterest-bearing..... | -- | 49,016 |
| -- interest-bearing..... | 1,677,428 | 616,889 |
| | ----- | ----- |
| Total deposits..... | 13,846,484 | 12,742,041 |
| Federal funds purchased..... | 1,267,850 | 1,190,839 |
| Securities sold under agreement to repurchase..... | 3,299,029 | 3,452,567 |
| Short-term borrowings..... | 88,070 | 10,841 |
| Short-term senior notes..... | 200,000 | -- |
| Accrued interest, taxes and other expenses..... | 165,618 | 171,422 |
| Other liabilities..... | 264,134 | 275,151 |
| Minority interest -- preferred stock of subsidiary..... | 250,000 | 250,000 |
| Preferred stock issued to Harris Bankcorp, Inc. | 5,000 | 5,000 |
| Long-term notes -- subordinated..... | 200,000 | 225,000 |
| | ----- | ----- |
| TOTAL LIABILITIES..... | 19,586,185 | 18,322,861 |

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| | ----- | ----- |
|--|--------------|--------------|
| STOCKHOLDER'S EQUITY | | |
| Common stock (\$10 par value); 10,100,000 and 10,000,000 shares authorized, issued and outstanding at December 31, 2004 and December 31, 2003, respectively..... | 101,000 | 100,000 |
| Surplus..... | 647,365 | 634,944 |
| Retained earnings..... | 941,767 | 860,674 |
| Accumulated other comprehensive (loss) income..... | (51,670) | 1,011 |
| | ----- | ----- |
| TOTAL STOCKHOLDER'S EQUITY..... | 1,638,462 | 1,596,629 |
| | ----- | ----- |
| TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY..... | \$21,224,647 | \$19,919,490 |
| | ===== | ===== |

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

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HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

| | FOR THE YEARS ENDED DECEMBER 31 | | |
|---|----------------------------------|-----------|-----------|
| | ----- | ----- | ----- |
| | 2004 | 2003 | 2002 |
| | ----- | ----- | ----- |
| | (IN THOUSANDS EXCEPT SHARE DATA) | | |
| INTEREST INCOME | | | |
| Loans..... | \$535,018 | \$470,500 | \$512,946 |
| Money market assets: | | | |
| Deposits at banks..... | 5,417 | 3,061 | 2,066 |
| Federal funds sold and securities purchased under agreement to resell..... | 8,638 | 3,655 | 7,938 |
| Trading accounts..... | 2,396 | 1,672 | 2,031 |
| Securities available-for-sale: | | | |
| U.S. Treasury and federal agency..... | 110,007 | 163,593 | 195,336 |
| State and municipal..... | 1,140 | 302 | 24 |
| Other..... | 10,431 | 2,178 | 2,243 |
| | ----- | ----- | ----- |
| Total interest income..... | 673,047 | 644,961 | 722,584 |
| | ----- | ----- | ----- |
| INTEREST EXPENSE | | | |
| Deposits..... | 155,868 | 125,102 | 162,267 |
| Short-term borrowings..... | 54,573 | 50,458 | 64,262 |
| Senior notes..... | 3,238 | 3,722 | 12,144 |
| Minority interest -- dividends on preferred stock of subsidiary..... | 18,438 | 18,438 | 18,438 |
| Long-term notes..... | 6,601 | 10,452 | 11,257 |
| | ----- | ----- | ----- |
| Total interest expense..... | 238,718 | 208,172 | 268,368 |
| | ----- | ----- | ----- |
| NET INTEREST INCOME..... | 434,329 | 436,789 | 454,216 |
| Provision for loan losses..... | 7,177 | 103,604 | 71,220 |
| | ----- | ----- | ----- |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES..... | 427,152 | 333,185 | 382,996 |
| | ----- | ----- | ----- |

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| | | | |
|--|-----------|-----------|-----------|
| NONINTEREST INCOME | | | |
| Trust and investment management fees..... | 93,043 | 84,586 | 82,829 |
| Money market and bond trading..... | 11,994 | 9,343 | 9,347 |
| Foreign exchange..... | 5,850 | 5,076 | 7,155 |
| Service charges and fees..... | 100,310 | 112,683 | 118,635 |
| Net securities gains..... | 26,180 | 25,953 | 61,272 |
| Bank-owned insurance..... | 40,355 | 43,712 | 50,713 |
| Gains from loan restructuring..... | 7,131 | -- | -- |
| Letter of credit fees..... | 22,922 | 26,349 | 24,399 |
| Syndication fees..... | 4,063 | 14,168 | 6,289 |
| Other..... | 144,450 | 192,856 | 151,869 |
| | ----- | ----- | ----- |
| Total noninterest income..... | 456,298 | 514,726 | 512,508 |
| | ----- | ----- | ----- |
| NONINTEREST EXPENSES | | | |
| Salaries and other compensation..... | 293,896 | 321,170 | 310,116 |
| Pension, profit sharing and other employee benefits..... | 83,552 | 76,572 | 61,279 |
| Net occupancy..... | 43,905 | 41,964 | 41,727 |
| Equipment..... | 52,236 | 54,586 | 53,531 |
| Marketing..... | 34,772 | 31,217 | 29,165 |
| Communication and delivery..... | 22,230 | 22,963 | 22,593 |
| Expert services..... | 22,650 | 26,733 | 28,328 |
| Contract programming..... | 31,137 | 28,930 | 29,105 |
| Other..... | 88,873 | 76,337 | 70,369 |
| | ----- | ----- | ----- |
| Amortization of intangibles..... | 673,251 | 680,472 | 646,213 |
| | 10,382 | 10,267 | 10,151 |
| | ----- | ----- | ----- |
| Total noninterest expenses..... | 683,633 | 690,739 | 656,364 |
| | ----- | ----- | ----- |
| Income before income taxes..... | 199,817 | 157,172 | 239,140 |
| Applicable income taxes..... | 58,726 | 39,301 | 67,306 |
| | ----- | ----- | ----- |
| NET INCOME..... | \$141,091 | \$117,871 | \$171,834 |
| | ===== | ===== | ===== |

The accompanying notes to consolidated 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

| | FOR THE YEARS ENDED DECEMBER 31 | | |
|---|---------------------------------|-----------|-----------|
| | 2004 | 2003 | 2002 |
| | ----- | ----- | ----- |
| | (IN THOUSANDS) | | |
| NET INCOME..... | \$141,091 | \$117,871 | \$171,834 |
| Other comprehensive (loss) income: | | | |
| Cash flow hedges: | | | |
| Net unrealized (loss) gain on derivative instruments, net of tax (benefit) expense of (\$3,077) in 2004, \$21 in 2003 and zero in 2002..... | (5,309) | 35 | -- |
| Minimum pension liability adjustment net of tax expense (benefit) of \$6,210 in 2004, (\$3,161) in 2003 and | | | |

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| | | | |
|---|-----------|-----------|-----------|
| (\$16,618) in 2002..... | 4,864 | (4,792) | (25,194) |
| Unrealized (losses) gains on available-for-sale securities: | | | |
| Unrealized holding (losses) gains arising during period, net of tax (benefit) expense of (\$21,105) in 2004, (\$18,194) in 2003 and \$58,702 in 2002..... | (36,909) | (26,140) | 90,296 |
| Less reclassification adjustment for gains included in net income, net of tax expense of \$10,185 in 2004, \$10,096 in 2003 and \$23,835 in 2002..... | (15,995) | (15,857) | (37,437) |
| | ----- | ----- | ----- |
| Other comprehensive (loss) income..... | (53,349) | (46,754) | 27,665 |
| | ----- | ----- | ----- |
| Comprehensive income..... | \$ 87,742 | \$ 71,117 | \$199,499 |
| | ===== | ===== | ===== |

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

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HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

STATEMENTS OF CHANGES IN STOCKHOLDER'S EQUITY

| | COMMON STOCK | SURPLUS | RETAINED EARNINGS | ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) | TOTAL STOCKHOLDER EQUITY |
|---|--------------------------------------|-----------|-------------------|---|--------------------------|
| | ----- | ----- | ----- | ----- | ----- |
| | (IN THOUSANDS EXCEPT PER SHARE DATA) | | | | |
| BALANCE AT DECEMBER 31, 2001..... | \$100,000 | \$620,586 | \$ 819,991 | \$ 20,100 | \$1,560,677 |
| Contribution to capital surplus..... | -- | 5,591 | -- | -- | 5,591 |
| Tax benefit from stock option exercise..... | -- | 463 | -- | -- | 463 |
| Net income..... | -- | -- | 171,834 | -- | 171,834 |
| Dividends -- (\$18.80 per common share)..... | -- | -- | (188,000) | -- | (188,000) |
| Dividends -- (\$0.115 per preferred share)..... | -- | -- | (576) | -- | (576) |
| Other comprehensive income..... | -- | -- | -- | 27,665 | 27,665 |
| | ----- | ----- | ----- | ----- | ----- |
| BALANCE AT DECEMBER 31, 2002..... | 100,000 | 626,640 | 803,249 | 47,765 | 1,577,654 |
| Contribution to capital surplus..... | -- | 6,086 | -- | -- | 6,086 |
| Tax benefit from stock option exercise..... | -- | 2,218 | -- | -- | 2,218 |
| Net income..... | -- | -- | 117,871 | -- | 117,871 |
| Dividends -- (\$6.00 per common share)..... | -- | -- | (60,000) | -- | (60,000) |
| Dividends -- (\$0.089 per preferred share)..... | -- | -- | (446) | -- | (446) |
| Other comprehensive loss..... | -- | -- | -- | (46,754) | (46,754) |
| | ----- | ----- | ----- | ----- | ----- |
| BALANCE AT DECEMBER 31, 2003..... | 100,000 | 634,944 | 860,674 | 1,011 | 1,596,629 |
| Contribution to capital | | | | | |

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| | | | | | |
|--|-----------|-----------|------------|------------|-------------|
| surplus..... | -- | 4,423 | -- | -- | 4,423 |
| Tax benefit from stock option exercise..... | -- | 4,398 | -- | -- | 4,398 |
| Contribution of parent's banking assets..... | 1,000 | 3,600 | 9,716 | 668 | 14,984 |
| Net income..... | -- | -- | 141,091 | -- | 141,091 |
| Dividends -- (\$6.50 per common share)..... | -- | -- | (65,000) | -- | (65,000) |
| Dividends -- (\$0.025 per preferred share)..... | -- | -- | (124) | -- | (124) |
| Adjustment of prior quarters' preferred dividends..... | -- | -- | 767 | -- | 767 |
| Non-cash dividend of subsidiary..... | -- | -- | (5,357) | -- | (5,357) |
| Other comprehensive loss..... | -- | -- | -- | (53,349) | (53,349) |
| BALANCE AT DECEMBER 31, 2004..... | \$101,000 | \$647,365 | \$ 941,767 | \$(51,670) | \$1,638,463 |

The accompanying notes to consolidated 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

| | FOR THE YEARS ENDED DECEMBER 31 | | |
|---|---------------------------------|------------|------------|
| | 2004 | 2003 | 2002 |
| | (IN THOUSANDS) | | |
| OPERATING ACTIVITIES: | | | |
| Net Income..... | \$ 141,091 | \$ 117,871 | \$ 171,834 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Provision for loan losses..... | 7,177 | 103,604 | 71,220 |
| Depreciation and amortization, including intangibles..... | 68,413 | 67,207 | 61,892 |
| Deferred tax expense..... | 1,264 | 9,487 | 6,035 |
| Net gain on sales of securities..... | (26,180) | (25,953) | (61,272) |
| Increase in bank-owned insurance..... | (39,560) | (43,054) | (47,105) |
| Trading account net cash purchases..... | (27,550) | (14,712) | (21,486) |
| (Increase) decrease in interest receivable..... | (9) | 4,839 | 19,811 |
| Increase (decrease) in interest payable..... | (107) | 7,331 | (22,155) |
| Decrease (increase) in loans held for sale..... | 125,481 | (19,593) | (27,723) |
| Other, net..... | 113,044 | 74,257 | 14,234 |
| Net cash provided by operating activities..... | 363,064 | 281,284 | 165,285 |
| INVESTING ACTIVITIES: | | | |
| Net increase in interest-bearing deposits at banks..... | (237,907) | (7,253) | (221,483) |
| Net (increase) decrease in Federal funds sold and securities purchased under agreement to resell..... | (125,753) | (171,475) | 341,800 |

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| | | | |
|---|-------------|-------------|--------------|
| Proceeds from sales of securities available-for-sale..... | 2,610,520 | 1,539,979 | 2,678,763 |
| Proceeds from maturities of securities available-for-sale..... | 3,099,331 | 4,526,559 | 7,453,346 |
| Purchases of securities available-for-sale..... | (4,920,853) | (7,031,858) | (9,992,242) |
| Net (increase) decrease in loans..... | (1,826,595) | (53,809) | 246,595 |
| Net purchases of premises and equipment..... | (56,211) | (53,744) | (56,753) |
| Other, net..... | 2,139 | 152 | 5,145 |
| | ----- | ----- | ----- |
| Net cash (used) provided by investing activities..... | (1,455,329) | (1,251,449) | 455,171 |
| | ----- | ----- | ----- |
| FINANCING ACTIVITIES: | | | |
| Cash received in contribution of parent's banking assets..... | 3,379 | -- | -- |
| Net increase (decrease) in deposits..... | 1,056,472 | 1,703,757 | (152,576) |
| Net (decrease) increase in Federal funds purchased and securities sold under agreement to repurchase..... | (85,527) | (417,378) | 637,433 |
| Net increase (decrease) in other short-term borrowings..... | 77,229 | (289,853) | (404,005) |
| Proceeds from issuance of senior notes..... | 2,380,000 | 2,590,000 | 750,000 |
| Repayment of senior notes..... | (2,180,000) | (2,790,000) | (1,410,000) |
| Proceeds from issuance of long-term notes..... | 200,000 | -- | -- |
| Repayment of long-term notes..... | (225,000) | -- | -- |
| Cash dividends paid on common stock..... | (65,000) | (60,000) | (188,000) |
| Cash portion of dividend of non-bank subsidiary..... | (5,076) | -- | -- |
| | ----- | ----- | ----- |
| Net cash provided (used) by financing activities..... | 1,156,477 | 736,526 | (767,148) |
| | ----- | ----- | ----- |
| Net increase (decrease) in cash and demand balances due from banks..... | 64,212 | (233,639) | (146,692) |
| Cash and demand balances due from banks at January 1..... | 823,615 | 1,057,254 | 1,203,946 |
| | ----- | ----- | ----- |
| Cash and demand balances due from banks at December 31..... | \$ 887,827 | \$ 823,615 | \$ 1,057,254 |
| | ===== | ===== | ===== |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | | |
| Cash paid during the year for: | | | |
| Interest..... | \$ 238,826 | \$ 200,841 | \$ 290,524 |
| Income taxes..... | \$ 43,651 | \$ 21,263 | \$ 67,056 |

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

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HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION AND NATURE OF OPERATIONS

Harris Trust and Savings Bank is a wholly-owned subsidiary of Harris Bankcorp, Inc. ("Bankcorp"), a Delaware corporation which is a wholly-owned

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subsidiary of Harris Financial Corp. ("HFC"), a Delaware corporation which is a wholly-owned subsidiary of Bank of Montreal ("BMO"). Throughout these Notes to Consolidated Financial Statements, the term "Bank" refers to Harris Trust and Savings Bank and subsidiaries.

The consolidated financial statements 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 years' financial statements to the current year's presentation. See Note 23 to the Consolidated Financial Statements for additional information on business combinations and Note 24 for additional information on related party transactions.

The Bank provides banking, trust and other services domestically and internationally through the main banking facility and 5 active nonbank subsidiaries. The Bank provides a variety of financial services to commercial and industrial companies, financial institutions, governmental units, not-for-profit organizations and individuals throughout the U.S., primarily the Midwest, and abroad. Services rendered and products sold to customers include demand and time deposit accounts and certificates; various types of loans; sales and purchases of foreign currencies; interest rate management products; cash management services; underwriting of municipal bonds; and financial consulting.

BASIS OF ACCOUNTING

The accompanying consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America and conform to practices within the banking industry.

FOREIGN CURRENCY AND FOREIGN EXCHANGE CONTRACTS

Assets and liabilities denominated in foreign currencies have been translated into United States dollars at respective year-end rates of exchange. Monthly translation gains or losses are computed at rates prevailing at month-end. There were no material translation gains or losses during any of the years presented. Foreign exchange trading positions including spot, forwards, option contracts and swaps are revalued monthly using prevailing market rates. Exchange adjustments are included with noninterest income in the Consolidated Statements of Income.

DERIVATIVE FINANCIAL INSTRUMENTS

The Bank uses various interest rate, foreign exchange, equity and commodity derivative contracts in the management of its risk strategy or as part of its dealer and trading activities. Interest rate contracts may include futures, forwards, forward rate agreements, option contracts, caps, floors, collars and swaps. Foreign exchange contracts may include spot, forwards, futures, option contracts and swaps. Equity contracts and commodity contracts may include option contracts and swaps.

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

Derivative instruments that are used in the management of the Bank's risk strategy may qualify for hedge accounting if the derivatives are designated as hedges and applicable hedge criteria are met. On the date that the Bank enters into a derivative contract, it designates the derivative as a hedge of the fair value of a recognized asset or liability or an unrecognized firm commitment, a hedge of a forecasted transaction or the

variability of cash flows that are to be received or paid in connection with a recognized asset or liability, a foreign currency fair value or cash flow hedge. 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 until earnings are impacted by 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.

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 hedged item will no longer be adjusted for changes in fair value that are attributable to the hedged risk. When hedge accounting is discontinued because the hedged item in a fair value hedge 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 a cash flow hedge is no longer highly effective, the gain or loss on the derivative that is in accumulated other comprehensive income ("AOCI") will remain there until earnings are impacted by the hedged item and the derivative instrument will be marked to market through earnings. When hedge accounting is discontinued because it is no longer probable that the forecasted transaction in a cash flow hedge will occur, the gain or loss on the derivative that was in AOCI will be recognized immediately in earnings and the derivative instrument will be marked to market through 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 entered into for risk management purposes and do not otherwise qualify for hedge accounting are marked to market and the resulting unrealized gains and losses are recognized in noninterest income in the period of change.

Derivative instruments that are used as part of the Bank's dealer and

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trading activities are marked to market and the resulting unrealized gains and losses are recognized in noninterest income in the period of change.

IMPACT OF NEW ACCOUNTING STANDARDS

The Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "Share-Based Payment," in 2004. The Statement replaces SFAS No. 123, "Accounting for Stock-Based Compensation," and supersedes Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS 123(R) applies primarily to accounting for transactions where an entity obtains employee services in share-based payment transactions using the fair value based method of accounting. The Statement is effective as of the beginning of the first

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annual reporting period that begins after December 15, 2005. The Bank uses the fair value based method of accounting for its stock-based compensation plans and does not expect the implementation of this Statement to have a material effect on its financial position or results of operations.

The American Institute of Certified Public Accountants ("AICPA") issued Statement of Position ("SOP") 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer," in December 2003. The SOP applies to the purchase of a loan, a group of loans, and loans acquired in a purchase business combination. It does not apply to loans originated by the Bank. The SOP addresses accounting for differences, attributable to credit quality, between contractual and expected cash flows from the initial investment in loans acquired in a transfer. It prohibits the acquirer from carrying over or establishing an allowance for loan losses in the initial accounting for loans acquired in a transfer. This SOP is effective for loans acquired in fiscal years beginning after December 15, 2004.

SECURITIES

The Bank classifies securities as either trading account assets or available-for-sale. Trading account assets include securities acquired as part of trading activities and are typically purchased with the expectation of near-term profit. These assets consist primarily of municipal bonds and U.S. government securities. All other securities are classified as available-for-sale, even if the Bank has no current plans to divest.

Trading account assets are reported at fair value with unrealized gains and losses included in trading account income, which also includes realized gains and losses from closing such positions. Available-for-sale securities are reported at fair value with unrealized gains and losses included, on an after-tax basis, in a separate component of stockholder's equity. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Realized gains and losses, as a result of securities sales, are included in securities gains, with the cost of securities sold determined on the specific identification basis.

In making a determination of temporary vs. other-than-temporary impairment of an investment, a major consideration of management is whether the Bank will be able to collect all amounts due according to the contractual terms of the investment. Such a determination involves estimation of the outcome of future events as well as knowledge and experience about past and current events. Factors considered include the following: whether the fair value is significantly below cost and the decline is attributable to specific adverse conditions in an industry or geographic area; the period of time the decline in fair value has existed; if an outside rating agency has downgraded the investment; if dividends have been reduced or eliminated; if scheduled interest

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payments have not been made and finally, whether the financial condition of the issuer has deteriorated.

LOANS, LOAN FEES AND COMMITMENT FEES

Loans not held for sale are recorded at the principal amount outstanding, net of unearned income, deferred fees and origination costs. For fair value hedges that are highly effective, loans designated as the underlying hedged items are recorded net of changes in fair value attributable to the hedged risks. Origination fees collected and origination costs incurred on commercial loans, loan commitments, mortgage loans and standby letters of credit (except loans held for sale) are generally deferred and amortized over the life of the related facility. Other loan-related fees that are not the equivalent of yield adjustments are recognized as income when received or earned. At December 31, 2004 and 2003, the Bank's Consolidated Statements of Condition included approximately \$8 million and \$12 million, respectively, of deferred loan-related fees net of deferred origination costs.

In conjunction with its mortgage and commercial banking activities, the Bank will originate loans with the intention of selling them in the secondary market. These loans are classified as held for sale and are included in "Loans held for sale" on the Bank's Consolidated Statements of Condition. The loans are carried at the lower of allocated cost or current market value, on a portfolio basis. Deferred origination fees and costs associated with these loans are not amortized and are included as part of the basis of the loan at time of sale. Realized gains and unrealized losses are included with other noninterest income.

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The Bank engages in the servicing of mortgage loans and acquires mortgage servicing rights by purchasing or originating mortgage loans and then selling those loans with servicing rights retained. The rights to service mortgage loans for others are recognized as separate assets by allocating the total cost of the mortgage loans to the mortgage servicing rights and the loans (without the mortgage servicing rights) based on their relative fair values. The capitalized mortgage servicing rights are amortized in proportion to and over the period of estimated net servicing income. The capitalized mortgage servicing rights are periodically evaluated for impairment based on the fair value of those rights. Fair values are estimated using discounted cash flow analyses. The risk characteristics of the underlying loans used to stratify capitalized mortgage servicing rights for purposes of measuring impairment are market interest rates, loan type and repricing interval.

Commercial and real estate loans are placed on nonaccrual status when the collection of interest is doubtful or when principal or interest is 90 days past due, unless the credit is adequately collateralized and the loan is in process of collection. When a loan is placed on nonaccrual status, all interest accrued but not yet collected which is deemed uncollectible is charged against interest income in the current year. Interest on nonaccrual loans is recognized as income only when cash is received and the Bank expects to collect the entire principal balance of the loan. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. Interest income on restructured loans is accrued according to the most recently agreed upon contractual terms.

Commercial and real estate loans are charged off when, in management's opinion, the loan is deemed uncollectible. Consumer installment loans are charged off when 120 days past due. Consumer revolving loans are charged off when 180 days past due. Accrued interest on these loans is recorded to interest income. Such loans are not normally placed on nonaccrual status.

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Commercial loan commitments and letters of credit are executory contracts and the notional balances are not reflected on the Bank's Consolidated Statements of Condition. Fees collected are generally deferred and recognized over the life of the facility.

Impaired loans (primarily commercial credits) are measured based on the present value of expected future cash flows (discounted at the loan's effective interest rate) or, alternatively, at the loan's observable market price or the fair value of supporting collateral. Impaired loans are defined as those where it is probable that amounts due for principal or interest according to contractual terms will not be collected. Nonaccrual and certain restructured loans meet this definition. Large groups of smaller-balance, homogeneous loans, primarily residential real estate and consumer installment loans, are excluded from this definition of impairment. The Bank determines loan impairment when assessing the adequacy of the allowance for loan losses.

ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses is maintained at a level considered adequate to provide for probable loan losses. The allowance is increased by provisions charged to operating expense and reduced by net charge-offs. Known losses of principal on impaired loans are charged off. The provision for loan losses is based on past loss experience, management's evaluation of the loan portfolio under current economic conditions and management's estimate of losses inherent in the portfolio. Such estimates are reviewed periodically and adjustments, if necessary, are recorded during the periods in which they become known.

PREMISES AND EQUIPMENT

Premises and equipment are stated at cost less accumulated depreciation and amortization. Interest costs associated with long-term construction projects are capitalized and then amortized over the life of the related asset after the project is completed. For financial reporting purposes, the provision for depreciation and amortization is computed on the straight-line basis over the estimated useful lives of the assets. Estimated useful lives range from 3 years to 39 years.

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BANK-OWNED INSURANCE

The Bank has purchased life insurance coverage for certain officers. The one-time premiums paid for the policies, which coincide with the initial cash surrender value, are recorded as assets on the Consolidated Statements of Condition. Increases or decreases in cash surrender value (other than proceeds from death benefits) are recorded as other income or other expense. Proceeds from death benefits first reduce the cash surrender value attributable to the individual policy and any additional proceeds are recorded as other income.

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 that originated prior to July 1, 2001 was amortized on a straight-line basis through 2001 year-end but discontinued effective January 1, 2002 in connection with the adoption of SFAS No. 142. Goodwill arising subsequent to July 1, 2001 is not amortized. Goodwill is periodically assessed for impairment, at least annually. The excess of carrying value over fair value, if any, is recorded as an impairment loss. Intangible assets with finite lives are amortized on either an accelerated or straight-line basis depending on the character of the acquired asset. Original lives range from 3 to 15 years.

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Intangible assets subject to amortization are reviewed for impairment when events or future assessments of profitability indicate that the carrying value may not be recoverable. If the carrying value is not expected to be recovered and the carrying value exceeds fair value, an impairment loss is recognized. Intangible assets with indefinite useful lives are not amortized and are reviewed for impairment annually or more frequently if events indicate impairment. The excess of carrying value over fair value, if any, is recorded as an impairment loss.

OTHER ASSETS

Property or other assets received in satisfaction of debt are included in "Other Assets" on the Bank's Consolidated Statements of Condition and are recorded at the lower of remaining cost or fair value. Fair values for other real estate owned generally are reduced by estimated costs to sell. Losses arising from subsequent write-downs to fair value are charged directly to noninterest expense.

RETIREMENT AND OTHER POSTEMPLOYMENT BENEFITS

The Bank has noncontributory defined benefit pension plans covering virtually all its employees. For its primary plan, the policy of the Bank is to, at a minimum, fund annually an amount necessary to satisfy the requirements under the Employee Retirement Income Security Act ("ERISA"), without regard to prior years' contributions in excess of the minimum. The Bank generally contributes the maximum allowable under the U.S. Internal Revenue Code.

The Bank provides medical care benefits for retirees meeting certain age and service requirements. The Bank contributes to the cost of coverage based on employees' length of service.

Postemployment benefits provided to former or inactive employees after employment but before retirement are accrued if they meet the conditions for accrual of compensated absences. Otherwise, postemployment benefits are recorded when expenses are incurred.

INCOME TAXES

Deferred tax assets and liabilities, as determined by the temporary differences between financial reporting and tax bases of assets and liabilities, are computed using enacted tax rates and laws. The effect on deferred tax assets and liabilities of a change in tax rates or law is recognized as income or expense in the period including the enactment date.

The Bank is included in the consolidated Federal income tax return of HFC. Income tax return liabilities or benefits for all the consolidated entities are not materially different than they would have been if computed on a separate return basis.

MANAGEMENT'S ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The areas requiring significant management judgment include provision and allowance for loan losses, income taxes, pension cost, postemployment

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benefits, valuation of intangible assets, fair values and temporary vs. other-than-temporary impairment.

RECLASSIFICATIONS

Certain reclassifications were made to conform prior years' financial statements to the current year's presentation.

2. SECURITIES

The amortized cost and estimated fair value of securities available-for-sale were as follows:

| | DECEMBER 31, 2004 | | | DECEMBER 31, 2003 | | |
|---|-------------------|---------------------|----------------------|-------------------|-------------------|---------------------|
| | AMORTIZED COST | UNREALIZED GAINS | UNREALIZED LOSSES | FAIR VALUE | AMORTIZED COST | UNREALIZED GAINS |
| | (IN THOUSANDS) | | | | | |
| U.S. Treasury..... | \$1,108,221 | \$ 4 | \$ 5,746 | \$1,102,479 | \$2,820,111 | \$35,934 |
| Federal agency..... | 3,892,537 | 1,044 | 21,022 | 3,872,559 | 3,663,043 | 5,886 |
| Mortgage-backed..... | 37,004 | 1,161 | 126 | 38,039 | 43,385 | 1,073 |
| State and municipal... Non-mortgage asset backed..... | 42,002 706,099 | 634 -- | 74 10,267 | 42,562 695,832 | 28,592 -- | 364 -- |
| Other..... | 31,286 | 1,660 | -- | 32,946 | 31,260 | 125 |
| Total securities..... | \$5,817,149 | \$4,503 | \$37,235 | \$5,784,417 | \$6,586,391 | \$43,382 |

The following table summarizes, for available-for-sale securities with unrealized losses as of December 31, 2004, the amount of the unrealized loss and the related fair value of the securities with unrealized losses. The unrealized losses have been further segregated by investment securities that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 or more months. The majority of unrealized losses are attributable to rising interest rates in 2004. Management believes that all of the unrealized losses are temporary.

| | LENGTH OF CONTINUOUS UNREALIZED LOSS POSITION | | | | |
|--------------------------------|---|----------------------|---------------------|----------------------|-------------|
| | LESS THAN 12 MONTHS | | 12 MONTHS OR LONGER | | TOTAL |
| | FAIR VALUE | UNREALIZED LOSSES | FAIR VALUE | UNREALIZED LOSSES | FAIR VALUE |
| | (IN THOUSANDS) | | | | |
| U.S. Treasury..... | \$ 759,506 | \$ 4,153 | \$ 297,980 | \$1,593 | \$1,057,486 |
| Federal agency..... | 2,616,190 | 16,958 | 1,015,681 | 4,064 | 3,631,871 |
| Mortgage-backed..... | -- | -- | 11,978 | 126 | 11,978 |
| State and municipal..... | 8,705 | 53 | 3,007 | 21 | 11,712 |
| Non-mortgage asset backed..... | 695,832 | 10,267 | -- | -- | 695,832 |
| Other..... | -- | -- | -- | -- | -- |

Temporarily impaired

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| | | | | | |
|------------------------------------|-------------|----------|-------------|---------|-------------|
| securities -- available-for-sale.. | \$4,080,233 | \$31,431 | \$1,328,646 | \$5,804 | \$5,408,879 |
| | ===== | ===== | ===== | ===== | ===== |

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At December 31, 2004 and 2003, available-for-sale and trading account securities having a carrying amount of \$3.36 billion and \$4.07 billion, respectively, were pledged as collateral for certain liabilities, securities sold under agreement to repurchase, public and trust deposits, trading account activities and for other purposes where permitted or required by law. The Bank maintains effective control over the securities sold under agreement to repurchase and accounts for the transactions as secured borrowings.

The amortized cost and estimated fair value of available-for-sale securities at December 31, 2004, by contractual maturity, are shown below. Expected maturities can differ from contractual maturities since borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | DECEMBER 31, 2004 | |
|---|-------------------|---------------|
| | AMORTIZED COST | FAIR VALUE |
| | ----- | ----- |
| | (IN THOUSANDS) | |
| Maturities: | | |
| Within 1 year..... | \$3,759,912 | \$3,740,561 |
| 1 to 5 years..... | 1,669,097 | 1,654,113 |
| 5 to 10 years..... | 122,252 | 121,220 |
| Over 10 years..... | 197,598 | 197,538 |
| Mortgage-backed..... | 37,004 | 38,039 |
| Other securities without stated maturity..... | 31,286 | 32,946 |
| | ----- | ----- |
| Total securities..... | \$5,817,149 | \$5,784,417 |
| | ===== | ===== |

In 2004, 2003 and 2002, proceeds from the sale of securities available-for-sale amounted to \$2.61 billion, \$1.54 billion and \$2.68 billion, respectively. Gross gains of \$26.5 million and gross losses of \$0.3 million were realized on these sales in 2004, gross gains of \$26.5 million and gross losses of \$0.5 million were realized on these sales in 2003 and gross gains of \$63.0 million and gross losses of \$1.7 million were realized on these sales in 2002. Net unrealized holding gains on trading securities decreased during 2004 from an unrealized gain of \$1.1 million at December 31, 2003 to an unrealized gain of \$0.7 million at December 31, 2004. The decrease of \$0.4 million has been included in 2004 earnings.

3. LOANS

The following table summarizes loan balances by category:

| | DECEMBER 31 | |
|--|-------------|-------|
| | ----- | ----- |
| | 2004 | 2003 |

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| | ----- (IN THOUSANDS) ----- | |
|--|----------------------------------|-------------|
| Domestic loans: | | |
| Commercial, financial, agricultural, brokers and dealers..... | \$ 5,677,305 | \$5,043,936 |
| Real estate construction..... | 220,430 | 289,364 |
| Real estate mortgages..... | 3,629,480 | 3,260,731 |
| Installment..... | 1,868,108 | 930,644 |
| Foreign loans: | | |
| Banks and other financial institutions..... | -- | 29,223 |
| Other, primarily commercial and industrial..... | 89,625 | 19,554 |
| | ----- | ----- |
| Total loans..... | 11,484,948 | 9,573,452 |
| Less allowance for loan losses..... | 219,740 | 234,798 |
| | ----- | ----- |
| Loans, net of allowance for loan losses..... | \$11,265,208 | \$9,338,654 |
| | ===== | ===== |

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Nonaccrual loans, restructured loans and other nonperforming assets are summarized below:

| | YEARS ENDED DECEMBER 31 | | |
|---|----------------------------------|-----------|-----------|
| | 2004 | 2003 | 2002 |
| | ----- (IN THOUSANDS) ----- | | |
| Nonaccrual loans..... | \$125,214 | \$171,226 | \$169,588 |
| Restructured loans..... | -- | -- | -- |
| | ----- | ----- | ----- |
| Total nonperforming loans..... | 125,214 | 171,226 | 169,588 |
| Other assets received in satisfaction of debt..... | 220 | 450 | 1,975 |
| | ----- | ----- | ----- |
| Total nonperforming assets..... | \$125,434 | \$171,676 | \$171,563 |
| | ===== | ===== | ===== |
| Gross amount of interest income that would have been recorded if year-end nonperforming loans had been accruing interest at their original terms..... | \$ 7,976 | \$ 12,380 | \$ 8,496 |
| Interest income actually recognized..... | -- | -- | -- |
| | ----- | ----- | ----- |
| Interest shortfall..... | \$ 7,976 | \$ 12,380 | \$ 8,496 |
| | ===== | ===== | ===== |
| 90-day past due loans, still accruing interest (all domestic)..... | \$ 48,236 | \$ 14,865 | \$ 12,478 |
| | ===== | ===== | ===== |

At December 31, 2004 and 2003, the Bank had no aggregate public and private sector outstandings to any single country experiencing a liquidity problem which exceeded one percent of the Bank's consolidated assets. At December 31, 2004 and 2003 commercial loans with a carrying value of \$2.9 billion and \$4.78 billion, respectively, were pledged to secure potential borrowings with the Federal Reserve.

4. ALLOWANCE FOR LOAN LOSSES

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The changes in the allowance for loan losses are as follows:

| | YEARS ENDED DECEMBER 31 | | |
|---------------------------------------|-------------------------|-----------|------------|
| | 2004 | 2003 | 2002 |
| | (IN THOUSANDS) | | |
| Balance, beginning of year..... | \$234,798 | \$206,999 | \$ 227,374 |
| Charge-offs..... | (47,820) | (88,244) | (106,650) |
| Recoveries..... | 24,360 | 12,439 | 15,055 |
| Net charge-offs..... | (23,460) | (75,805) | (91,595) |
| Provisions charged to operations..... | 7,176 | 103,604 | 71,220 |
| Acquired reserve..... | 1,226 | -- | -- |
| Balance, end of year..... | \$219,740 | \$234,798 | \$ 206,999 |

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Details on impaired loans and related allowance are as follows:

| | IMPAIRED LOANS FOR WHICH THERE IS A RELATED ALLOWANCE | IMPAIRED LOANS FOR WHICH THERE IS NO RELATED ALLOWANCE | TOTAL IMPAIRED LOANS |
|--------------------------------|--|---|----------------------------|
| | (IN THOUSANDS) | | |
| | ----- | ----- | ----- |
| December 31, 2004 | | | |
| Balance..... | \$ 79,303 | \$45,911 | \$125,214 |
| Related allowance..... | 34,441 | -- | 34,441 |
| Balance, net of allowance..... | \$ 44,862 | \$45,911 | \$ 90,773 |
| December 31, 2003 | | | |
| Balance..... | \$144,064 | \$27,162 | \$171,226 |
| Related allowance..... | 76,913 | -- | 76,913 |
| Balance, net of allowance..... | \$ 67,151 | \$27,162 | \$ 94,313 |

| | YEARS ENDED DECEMBER 31 | | |
|-----------------------------|-------------------------|-----------|-----------|
| | 2004 | 2003 | 2002 |
| | (IN THOUSANDS) | | |
| Average impaired loans..... | \$142,156 | \$181,900 | \$191,493 |

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Total interest income on impaired loans recorded on a cash basis..... \$ -- \$ -- \$ --
===== ===== =====

5. PREMISES AND EQUIPMENT

Premises and equipment are stated at cost less accumulated depreciation and amortization. A summary of these accounts is set forth below:

| | DECEMBER 31 | |
|--|-------------|-----------|
| | 2004 | 2003 |
| (IN THOUSANDS) | | |
| Land..... | \$ 28,336 | \$ 22,855 |
| Premises..... | 222,334 | 209,877 |
| Equipment..... | 403,707 | 410,674 |
| Leasehold improvements..... | 47,062 | 47,175 |
| | ----- | ----- |
| Total..... | 701,439 | 690,581 |
| Accumulated depreciation and amortization..... | 392,024 | 387,606 |
| | ----- | ----- |
| Premises and equipment..... | \$309,415 | \$302,975 |
| | ===== | ===== |

Depreciation and amortization expense was \$48.7 million in 2004, \$49.4 million in 2003 and \$46.3 million in 2002.

On December 17, 2001, the Bank closed on the sale of its fifteen story operations center containing approximately 415,000 gross square feet located at 311 West Monroe Street, Chicago, Illinois, and leased back approximately 259,000 rentable square feet. The lease ends on December 31, 2011. The Bank has rights of first offering to lease additional space and options to extend to December 31, 2026. The remainder of the building was occupied by third-party tenants. The sale resulted in a realized gain of \$1 million and a deferred gain, which is being amortized in to income over the remaining life of the lease, of \$12.2 million and \$14.0 million as of December 31, 2004 and 2003, respectively.

In addition, the Bank owns or leases premises at other locations to conduct branch banking activities.

6. GOODWILL AND OTHER INTANGIBLE ASSETS

The Bank adopted SFAS No. 142, "Goodwill and Other Intangible Assets," on January 1, 2002. Under this standard, 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. Upon adoption of SFAS No. 142, the Bank had no goodwill.

The Bank adopted SFAS No. 147, "Acquisitions of Certain Financial Institutions -- an amendment of FASB Statements No. 72 and 144 and FASB Interpretation No. 9," on October 1, 2002. Under this standard, most acquisitions of financial institutions are removed from the scope of SFAS No. 72

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and Interpretation 9 and are accounted for in accordance with SFAS No. 141, "Business Combinations," and SFAS No. 142. As such, unidentifiable intangible assets recognized and amortized in accordance with SFAS No. 72, "Accounting for Certain Acquisitions of Banking or Thrift Institutions," represent goodwill that will be accounted for under SFAS No. 142. At adoption date, the Bank had an unidentifiable intangible asset that, in accordance with SFAS No. 72, was excluded from the scope of SFAS No. 142 and continued to be amortized through third quarter 2002. Upon adoption of the Statement, the unidentifiable intangible asset was reclassified to goodwill and no longer amortized starting in fourth quarter 2002. Under the transitional requirements of the Statement, the first three quarters of 2002 were restated to reflect the reversal of previously amortized goodwill in those quarters. The earnings impact for each of these three quarters was \$2.35 million pretax (\$1.4 million after tax).

The Bank's goodwill was subject to the annual impairment test in the fourth quarter of 2004. The fair value of the reporting unit was estimated using a valuation technique based on discounted cash flow analyses. The test did not identify potential impairment and no impairment loss was recognized in 2004.

The carrying value of the Bank's goodwill was \$89.3 million at December 31, 2004 and 2003.

Besides goodwill, the Bank did not have any intangible assets not subject to amortization as of December 31, 2004 and 2003.

As of December 31, 2004, the gross carrying amount and accumulated amortization of the Bank's amortizable intangible assets are included in the following table:

| | DECEMBER 31, 2004 | | DECEMBER 31, | |
|-----------------------------------|--------------------------|-----------------------------|-------------------------------|-------------------------------|
| | GROSS CARRYING AMOUNT | ACCUMULATED AMORTIZATION | 2004 NET CARRYING VALUE | 2003 NET CARRYING VALUE |
| | (IN THOUSANDS) | | | |
| Branch network..... | \$145,000 | \$(82,167) | \$62,833 | \$72,500 |
| Other..... | 5,724 | (2,284) | 3,440 | 4,155 |
| Total finite life intangibles.... | \$150,724 | \$(84,451) | \$66,273 | \$76,655 |

Total amortization expense for the Bank's intangible assets was \$10.4 million in 2004, \$10.3 million in 2003 and \$10.2 million in 2002.

Estimated intangible asset amortization expense is \$10.4 million for each of the years ending December 31, 2005, 2006, 2007 and 2008 and \$9.9 million for the year ending December 31, 2009.

MORTGAGE SERVICING RIGHTS

The carrying amount of mortgage servicing rights ("MSR") was \$17.9 million and \$16.3 million at December 31, 2004 and 2003, respectively. The fair value of those rights equaled the carrying amount at both December 31, 2004 and December 31, 2003. MSR, included in other assets, of \$5.2 million and \$11.2 million were capitalized during 2004 and 2003, respectively. Amortization expense associated with MSR was \$8.7 million and \$7.7 million in 2004 and 2003, respectively. The

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carrying amount of the MSR valuation allowance was \$0.9 million and \$6.0 million at December 31, 2004 and 2003, respectively. There were no direct write-downs in 2004 or 2003.

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The Corporation accounts for MSR at the lower of cost or fair value, in accordance with SFAS No. 140. Fair value of MSR is estimated using discounted cash flow analyses. The analyses consider portfolio characteristics, servicing fees, prepayment assumptions, delinquency rates, late charges, other ancillary revenues, costs to service and other economic factors. The estimated fair value of MSR is sensitive to changes in interest rates, including their effect on prepayment speeds. The Corporation stratifies its portfolio on the basis of market interest rates, loan type and repricing interval. MSR impairment is considered temporary and recognized as an expense through a valuation allowance to the extent that the carrying value exceeds estimated fair value.

7. DEPOSITS

The following table summarizes deposit balances by category:

| | DECEMBER 31 | | INCREASE (DECREASE) 2004 VS. 2003 | |
|---|--------------|--------------|--------------------------------------|------|
| | 2004 | 2003 | AMOUNT | % |
| ----- | | | | |
| (DOLLARS IN THOUSANDS) | | | | |
| Demand deposits..... | \$ 4,019,416 | \$ 4,231,540 | \$ (212,124) | (5) |
| Interest-bearing checking deposits..... | 129,408 | 146,441 | (17,033) | (12) |
| Money market accounts..... | 2,369,938 | 2,094,733 | 275,205 | 13 |
| Statement savings accounts..... | 1,693,152 | 1,799,684 | (106,532) | (6) |
| Savings certificates..... | 1,481,071 | 1,477,743 | 3,328 | -- |
| Other time deposits..... | 2,476,071 | 2,325,995 | 150,076 | 6 |
| Deposits in foreign offices..... | 1,677,428 | 665,905 | 1,011,523 | 152 |
| | ----- | ----- | ----- | |
| Total deposits..... | \$13,846,484 | \$12,742,041 | \$1,104,443 | 9 |
| | ===== | ===== | ===== | |

Certificates of deposit in denominations of \$100,000 or more issued by domestic offices totaled \$2.94 billion and \$2.73 billion at December 31, 2004 and 2003, respectively. All time deposits in foreign offices were in denominations of \$100,000 or more.

8. SECURITIES PURCHASED UNDER AGREEMENT TO RESELL AND SECURITIES SOLD UNDER AGREEMENT TO REPURCHASE

At various times the Bank enters into purchases of U.S. Treasury and Federal agency securities under agreements to resell identical securities. The amounts advanced under these agreements represent short-term loans and are reflected as receivables in the Consolidated Statements of Condition. There were no securities purchased under agreement to resell outstanding at December 31, 2004 and December 31, 2003. The securities underlying the agreements are book-entry securities. Securities are transferred by appropriate entry into the Bank's account with Bank of New York through the Federal Reserve Bank of New York under a written custodial agreement with Bank of New York that explicitly recognizes the Bank's interest in these securities.

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The Bank also enters into sales of U.S. Treasury and Federal agency securities under agreements to repurchase identical securities. The amounts received under these agreements represent short-term borrowings and are reflected as liabilities in the Consolidated Statements of Condition. Securities sold under agreement to repurchase totaled \$3.30 billion and \$3.45 billion at December 31, 2004 and 2003, respectively. Securities sold under agreement to repurchase are transferred via book-entry to the counterparty, if transacted with a financial institution or a broker-dealer, or are delivered to customer safekeeping accounts. The Bank monitors the market value of these securities and adjusts the level of collateral for repurchase agreements, as appropriate. The Bank maintains effective control over the securities sold under agreement to repurchase and accounts for the transactions as secured borrowings.

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SECURITIES PURCHASED UNDER AGREEMENT TO RESELL

| | 2004 | 2003 |
|---|------------------------|-----------|
| | (DOLLARS IN THOUSANDS) | |
| Amount outstanding at end of year..... | \$ -- | \$ -- |
| Highest amount outstanding as of any month-end during the year..... | \$553,250 | \$350,375 |
| Daily average amount outstanding during the year..... | \$107,401 | \$ 65,847 |
| Daily average annualized rate of interest..... | 0.89% | 0.53% |

SECURITIES SOLD UNDER AGREEMENT TO REPURCHASE

| | 2004 | 2003 |
|---|------------------------|-------------|
| | (DOLLARS IN THOUSANDS) | |
| Amount outstanding at end of year..... | \$3,299,028 | \$3,452,567 |
| Highest amount outstanding as of any month-end during the year..... | \$3,802,636 | \$4,821,309 |
| Daily average amount outstanding during the year..... | \$3,215,071 | \$4,164,402 |
| Daily average annualized rate of interest..... | 1.22% | 1.04% |

9. SENIOR NOTES AND LONG-TERM NOTES

The following table summarizes the Bank's long-term notes:

| | DECEMBER 31 | |
|---|----------------|-----------|
| | 2004 | 2003 |
| | (IN THOUSANDS) | |
| Floating rate subordinated note to Bankcorp due March 31, 2005..... | \$ -- | \$ 50,000 |
| Floating rate subordinated note to Bankcorp due December 1, 2006..... | -- | 50,000 |

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| | | |
|--|-----------|-----------|
| Fixed rate 6.5% subordinated note to Bankcorp due December 27, 2007..... | -- | 60,000 |
| Fixed rate 7.63% subordinated note to Bankcorp due June 27, 2008..... | -- | 15,000 |
| Fixed rate 7.13% subordinated note to Bankcorp due June 30, 2009..... | -- | 50,000 |
| Floating rate subordinated note to Bankcorp due May 31, 2014..... | 100,000 | -- |
| Floating rate subordinated note to Bankcorp due May 31, 2016..... | 100,000 | -- |
| | ----- | ----- |
| Total..... | \$200,000 | \$225,000 |
| | ===== | ===== |

All of the Bank notes are unsecured obligations, ranking on a parity with all unsecured and subordinated indebtedness of the Bank and are not subject to redemption prior to maturity at the election of the debtholders. The interest rate on the floating rate note due May 31, 2014 reprices quarterly and floats at 35 basis points above 90 day London Interbank Offering Rate ("LIBOR"). The interest rate on the floating rate note due May 31, 2016 reprices quarterly and floats at 37.5 basis points above 90 day LIBOR. At year-end 2004, 90 day LIBOR was 2.56 percent.

There are no scheduled principal payments on long-term notes during the years 2005 through 2009. In 2010 and beyond, scheduled principal payments on long-term notes are \$200 million.

The Bank offers to institutional investors from time to time, unsecured short-term and medium-term bank notes in an aggregate principal amount of up to \$1.50 billion outstanding at any time. The term of each note could range from 14 days to 15 years. These senior notes are subordinated to deposits and rank pari passu with all other unsecured senior indebtedness of the Bank. As of December 31, 2004, a \$200 million senior short-term note was outstanding with an original maturity of 32 days (remaining maturity of 28 days) and stated interest rate of 2.34 percent. There were no senior short-term notes outstanding as of December 31, 2003.

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10. FAIR VALUE OF FINANCIAL INSTRUMENTS

Generally accepted accounting principles require the disclosure of estimated fair values for both on and off-balance-sheet financial instruments. The Bank's fair values are based on quoted market prices when available. For financial instruments not actively traded, such as certain loans, deposits, off-balance-sheet transactions and long-term borrowings, fair values have been estimated using various valuation methods and assumptions. Although management used its best judgment in estimating these values, there are inherent limitations in any estimation methodology. In addition, accounting pronouncements require that fair values be estimated on an item-by-item basis, thereby ignoring the impact a large sale would have on a thin market and intangible values imbedded in established lines of business. Therefore, the fair value estimates presented herein are not necessarily indicative of the amounts the Bank could realize in an actual transaction. The fair value estimation methodologies employed by the Bank were as follows:

The carrying amounts for cash and demand balances due from banks along with short-term money market assets and liabilities (including Federal funds sold, Federal funds purchased, securities purchased under agreement to resell and securities sold under agreement to repurchase) reported on the Bank's

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Consolidated Statements of Condition were considered to be the best estimates of fair value for these financial instruments. Fair values of trading account assets and available-for-sale securities were based on quoted market prices.

A variety of methods were used to estimate the fair value of loans. Changes in estimated fair value of loans reflect changes in credit risk and general interest rates which have occurred since the loans were originated. Fair values of floating rate loans, including commercial, broker dealer, financial institution, construction, charge card, consumer and home equity, were assumed to be the same as carrying value since the loans' interest rates automatically reprice to market. Fair values of residential mortgages were based on current prices for securities backed by similar loans. For long-term fixed rate loans, including consumer installment and commercial mortgage loans, fair values were estimated based on the present value of future cash flows with current market rates as discount rates. Additionally, management considered appraisal values of collateral when nonperforming loans were secured by real estate.

The fair values of accrued interest receivable and payable approximate carrying values due to the short-term nature of these assets and liabilities.

The fair value of loans held for sale is based on future mortgage-backed security prices corresponding to the mortgage loan pools.

The fair values of bank-owned insurance approximate carrying value, because upon liquidation of these investments the Bank would receive the cash surrender value which equals carrying value.

The fair values of demand deposits, savings accounts, interest-bearing checking deposits and money market accounts were the amounts payable on demand at the reporting date, or the carrying amounts. The fair value of time deposits was estimated using a discounted cash flow calculation with current market rates offered by the Bank as discount rates.

The fair value of short-term borrowings and short-term senior notes approximates carrying value because the average maturity on these notes is less than one year.

The fair value of minority interest -- preferred stock of subsidiary (Harris Preferred Capital Corporation) approximates carrying value as the preferred stock has a liquidation preference that equals book value.

In 2004 the fair value of floating rate long-term notes were assumed to be the same as carrying value since the notes' interest rates automatically reprice to market. In 2003 the fair value of the fixed rate long-term notes was determined using a discounted cash flow calculation with current rates available to the Bank for similar debt as discount rates.

The fair value of credit facilities approximates their carrying value (i.e. deferred income) or estimated cost that would be incurred to induce third parties to assume these commitments.

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The estimated fair values of the Bank's financial instruments at December 31, 2004 and 2003 are presented in the following table. See Note 11 to Consolidated Financial Statements for additional information regarding fair values of off-balance-sheet financial instruments.

DECEMBER 31

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| | 2004 | | 2003 | |
|---|-------------------|---------------|-------------------|---------------|
| | CARRYING VALUE | FAIR VALUE | CARRYING VALUE | FAIR VALUE |
| (IN THOUSANDS) | | | | |
| ASSETS | | | | |
| Cash and demand balances due from banks..... | \$ 887,827 | \$ 887,827 | \$ 823,615 | \$ 823,615 |
| Money market assets: | | | | |
| Interest-bearing deposits at banks..... | 662,366 | 662,366 | 424,459 | 424,459 |
| Federal funds sold and securities purchased under agreement to resell..... | 541,300 | 541,300 | 409,425 | 409,425 |
| Securities available-for-sale..... | 5,784,417 | 5,784,417 | 6,624,280 | 6,624,280 |
| Trading account assets..... | 90,130 | 90,130 | 59,467 | 59,467 |
| Loans, net of unearned income and allowance for loan losses..... | 11,265,208 | 11,260,262 | 9,338,654 | 9,364,083 |
| Accrued interest receivable..... | 72,627 | 72,627 | 71,811 | 71,811 |
| Loans held for sale..... | 43,423 | 43,916 | 168,904 | 168,904 |
| Bank-owned insurance..... | 1,072,660 | 1,072,660 | 1,035,239 | 1,035,239 |
| Total on-balance-sheet financial assets..... | \$20,419,958 | \$20,415,505 | \$18,955,854 | \$18,981,283 |
| LIABILITIES | | | | |
| Deposits: | | | | |
| Demand deposits..... | \$ 8,188,806 | \$ 8,188,806 | \$ 8,301,415 | \$ 8,301,415 |
| Time deposits..... | 5,657,678 | 5,661,138 | 4,440,626 | 4,455,398 |
| Federal funds purchased..... | 1,267,850 | 1,267,850 | 1,190,839 | 1,190,839 |
| Securities sold under agreement to repurchase..... | 3,299,029 | 3,299,029 | 3,452,567 | 3,452,567 |
| Short-term borrowings..... | 88,070 | 88,070 | 10,841 | 10,841 |
| Accrued interest payable..... | 23,306 | 23,306 | 23,251 | 23,251 |
| Short-term notes -- senior..... | 200,000 | 200,000 | -- | -- |
| Minority interest -- preferred stock of subsidiary..... | 250,000 | 250,000 | 250,000 | 250,000 |
| Preferred stock issued to Harris Bankcorp, Inc..... | 5,000 | 5,000 | 5,000 | 5,000 |
| Long-term notes -- subordinated..... | 200,000 | 200,000 | 225,000 | 243,571 |
| Total on-balance-sheet financial liabilities..... | \$19,179,739 | \$19,183,199 | \$17,899,539 | \$17,932,882 |
| OFF-BALANCE-SHEET CREDIT FACILITIES (POSITIVE POSITIONS/(OBLIGATIONS)) | | | | |
| Loan commitments..... | \$ (6,694) | \$ (6,694) | \$ (11,239) | \$ (11,239) |
| Standby letters of credit..... | (1,313) | (1,313) | (1,126) | (1,126) |
| Total off-balance-sheet credit facilities..... | \$ (8,007) | \$ (8,007) | \$ (12,365) | \$ (12,365) |

11. FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK

The Bank utilizes various financial instruments with off-balance-sheet risk in the normal course of business to meet its customers' financing and risk management needs. The Bank's major categories of financial

instruments with off-balance-sheet risk include credit facilities, financial guarantees and various securities-related activities.

CREDIT FACILITIES

Credit facilities with off-balance-sheet risk include commitments to extend credit and commercial letters of credit.

Commitments to extend credit are contractual agreements to lend to a customer as long as contract terms have been met. They generally require payment of a fee and have fixed expiration dates. The Bank's commitments serve both business and individual customer needs, and include commercial loan commitments, home equity lines, commercial real estate loan commitments and mortgage loan commitments. The maximum potential amount of undiscounted future payments the Bank could be required to make is represented by the total contractual amount of commitments, which was \$9.6 billion and \$8.3 billion at December 31, 2004 and 2003, respectively. Since only a portion of commitments will ultimately be drawn down, the Bank does not expect to provide funds for the total contractual amount. Risks associated with certain commitments are reduced by participations to third parties, which at December 31, 2004, totaled \$970 million and at December 31, 2003, totaled \$944 million.

Commercial letters of credit are commitments to make payments on behalf of customers when letter of credit terms have been met. Maximum risk of accounting loss is represented by total commercial letters of credit outstanding of \$30 million at December 31, 2004 and \$46 million at December 31, 2003.

Credit risks associated with all of these facilities are mitigated by reviewing customers' creditworthiness on a case-by-case basis, obtaining collateral, limiting loans to individual borrowers, setting restrictions on long-duration maturities and establishing stringent covenant terms outlining performance expectations which, if not met, may cause the Bank to terminate the contract. Credit risks are further mitigated by monitoring and maintaining portfolios that are well-diversified.

Collateral is required to support certain of these credit facilities when they are drawn down and may include equity and debt securities, commodities, inventories, receivables, certificates of deposit, savings instruments, fixed assets, real estate, life insurance policies and memberships on national or regional stock and commodity exchanges. Requirements are based upon the risk inherent in the credit and are more stringent for firms and individuals with greater default risks. The Bank monitors collateral values and appropriately perfects its security interest. Periodic evaluations of collateral adequacy are performed by Bank personnel.

The fair value of credit facilities (i.e. deferred income) is approximately equal to their carrying value of \$8.0 million at December 31, 2004 and \$12.4 million at December 31, 2003.

FINANCIAL GUARANTEES

Financial guarantees with off-balance-sheet risk include standby letters of credit, loans sold with recourse and written put options.

Standby letters of credit are unconditional commitments that guarantee the obligation of a customer to a third party should that customer default. They are issued to support financial and performance-related obligations including brokers' margin maintenance, industrial revenue bond repayment, debt repayment,

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construction contract performance and trade agreement performance. The Bank's maximum risk of accounting loss for these items is represented by the total commitments outstanding of \$2.89 billion at December 31, 2004 and \$2.76 billion at December 31, 2003. Risks associated with standby letters of credit are reduced by participations to third parties which totaled \$1.06 billion at December 31, 2004 and \$948 million at December 31, 2003. In most cases, these commitments expire within three years without being drawn upon.

The Bank has sold mortgage loans with limited recourse. The recourse provisions require the Bank to reimburse the buyer, based on pre-determined rates, upon the occurrence of certain credit-related events. The maximum amount payable under the recourse provisions is \$7.0 million at December 31, 2004 and 2003. The

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carrying amount of the recourse liability is \$0.5 million at December 31, 2004 and \$1.3 million at December 31, 2003.

Written put options are contracts that provide the buyer the right (but not the obligation) to sell a financial instrument at a specified price, either within a specified period of time or on a certain date. The Bank writes put options, providing the buyer the right to require the Bank to buy the specified assets per the contract terms. The maximum amount payable for the written put options is equal to their notional amount of \$930 million and \$865 million at December 31, 2004 and 2003, respectively. The fair value of the related derivative liability is \$4.7 million at December 31, 2004 and \$4.3 million at December 31, 2003.

SECURITIES ACTIVITIES

The Bank's securities activities that have off-balance-sheet risk include municipal bond underwriting and short selling of securities.

Through its municipal bond underwriting activities, the Bank commits to buy and offer for resale newly issued bonds. The Bank is exposed to market risk because it may be unable to resell its inventory of bonds profitably as a result of unfavorable market conditions. In syndicate arrangements, the Bank is obligated to fulfill syndicate members' commitments should they default. The syndicates of which the Bank was a member had underwriting commitments totaling \$59 million at December 31, 2004 and \$47 million at December 31, 2003.

Security short selling, defined as selling of securities not yet owned, exposes the Bank to off-balance-sheet market risk because the Bank may be required to buy securities at higher prevailing market prices to cover its short positions. The Bank had a short position of \$0.1 million at December 31, 2004 and no position at December 31, 2003.

12. DERIVATIVE FINANCIAL INSTRUMENTS

The Bank utilizes various derivative financial instruments in the normal course of business to a) meet its customers' financing and risk management needs, b) reduce its own risk exposure, and c) produce fee income and trading profits. Fair values of derivative financial instruments are based on market prices of comparable instruments, pricing models using year-end rates and counterparty credit ratings.

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

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The Bank uses various interest rate, foreign exchange, equity, and commodity derivative contracts as part of its dealer and trading activities or in the management of its risk strategy. Interest rate contracts may include futures, forwards, forward rate agreements, option contracts, caps, floors, collars and swaps. Foreign exchange contracts may include spot, futures, forwards, option contracts and swaps. Equity contracts and commodity contracts may include options and swaps. The Bank enters into derivative contracts with BMO to facilitate a more efficient use of combined resources and to better serve customers. See Note 24 for additional information on related party transactions.

At December 31, 2004, the Bank recorded, for dealer and trading activities and for risk management activities that do not otherwise qualify for hedge accounting, the fair value of derivative instrument assets of \$174 million in other assets and derivative instrument liabilities of \$173 million in other liabilities. At December 31, 2003, the Bank recorded the fair value of derivative instrument assets of \$112 million in other assets and derivative instrument liabilities of \$93 million in other liabilities. These amounts reflect the netting of certain derivative instrument assets and liabilities when the conditions in FASB Interpretation ("FIN") No. 39, "Offsetting of Amounts Related to Certain Contracts," have been met.

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DEALER AND TRADING ACTIVITY

Interest Rate Contracts

As dealer, the Bank serves customers seeking to manage interest rate risk by entering into contracts as counterparty to their (customer) transactions. In its trading activities, the Bank uses interest rate contracts to profit from expected future market movements.

These 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 by 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 that 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.

Futures and forward contracts are agreements in which the Bank is obligated to make or take delivery, at a specified future date, of a specified instrument, at a specified price or yield. Futures contracts are exchange traded and,

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because of exchange requirements that gains and losses be settled daily, create negligible exposure to credit risk.

Forward rate agreements are arrangements between two parties to exchange amounts, at a specified future date, based on the difference between an agreed upon interest rate and reference rate applied to a notional principal amount. These agreements enable purchasers and sellers to fix interest costs and returns.

Options are contracts that provide the buyer the right (but not the obligation) to purchase or sell a financial instrument, at a specified price, either within a specified period of time or on a certain date. Interest rate guarantees (caps, floors and collars) are agreements between two parties that, in general, establish for the purchaser a maximum level of interest expense or a minimum level of interest revenue based on a notional principal amount for a specified term. Options and interest rate guarantees written create exposure to market risk. As a writer of interest rate options and guarantees, the Bank receives a premium at the outset of the agreement and bears the risk of an unfavorable change in the price of the financial instrument underlying the option or interest rate guarantee. Options and interest rate guarantees purchased create exposure to credit risk and, to the extent of the premium paid or unrealized gain recognized, market risk.

Interest rate swaps are contracts involving the exchange of interest payments based on a notional amount for a specified period. Most of the Bank's activity in swaps is as intermediary in the exchange of interest payments between customers, although the Bank also uses swaps to manage its own interest rate exposure (see discussion of risk management activity).

Foreign Exchange Contracts

The Bank is a dealer in foreign exchange ("FX") contracts. FX 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

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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.

The Bank and BMO combine their U.S. FX revenues. Under this arrangement, FX net profit is shared by the Bank and BMO in accordance with a specific formula set forth in the agreement. This agreement expires on October 31, 2005, but may be extended at that time. Either party may terminate the arrangement at its option. FX revenues are reported net of expenses. Net gains (losses) from dealer/trading foreign exchange contracts, for the years ended December 31, 2004 and December 31, 2003, totaled \$5.9 million and \$5.1 million, respectively, of net profit under the aforementioned agreement with BMO.

At December 31, 2004, approximately 98 percent of the Bank's gross notional positions in foreign currency contracts are represented by seven currencies: Eurodollar, Canadian dollar, British pound, Australian dollar, Swedish krona, Japanese yen and the Mexican peso.

Foreign exchange contracts include spot, futures, forwards, options and swaps that enable customers to manage their foreign exchange risk. Spot, future and forward contracts are agreements to exchange currencies at a future date, at

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a specified rate of exchange. Foreign exchange option contracts give the buyer the right and the seller an obligation (if the buyer asserts his right) to exchange currencies during a specified period (or on a certain date in the case of "European" options) at a specified exchange rate. Cross currency swap contracts are agreements to exchange principal denominated in two different currencies at the spot rate and to repay the principal at a specified future date and exchange rate.

Equity Contracts

The Bank enters into equity contracts that enable customers to manage the risk associated with equity price fluctuations. Equity contracts include options and swaps.

Commodity Contracts

The Bank enters into commodity contracts that enable customers to manage the risk associated with commodity price fluctuations. Commodity contracts include options and swaps.

RISK MANAGEMENT ACTIVITY

In addition to its dealer and trading activities, the Bank uses interest rate contracts, primarily swaps, and foreign exchange contracts to reduce the level of financial risk inherent in mismatches between the interest rate sensitivities and foreign currency exchange rate fluctuations of certain assets and liabilities. For non-trading risks, market risk is controlled by actively managing the asset and liability mix, either directly through the balance sheet or with off-balance sheet derivative instruments. Measures also focus on interest rate exposure gaps and sensitivity to rate changes.

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 assets and liabilities are denominated in foreign currency, creating exposure to changes in exchange rates. The Bank uses cross currency interest rate swaps and foreign exchange forward contracts to hedge the risk.

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Risk management activities include the following derivative transactions that qualify for hedge accounting.

Fair Value Hedges

The Bank uses interest rate swaps to alter the character of 1) revenue earned on certain long-term, fixed rate loans and available-for-sale securities and 2) interest paid on certain long-term, fixed rate deposits. Interest rate swaps convert the loans, securities and deposits from fixed rate to variable rate. Interest rate swap contracts generally involve the exchange of fixed and variable rate interest payments between two parties, based on a common notional

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amount and maturity date.

For fair value hedges, as of December 31, 2004 the Bank recorded the fair value of derivative instrument liabilities of \$38.0 million in other liabilities. For fair value hedges, as of December 31, 2003 the Bank recorded the fair value of derivative instrument assets and liabilities of \$10.7 million and \$23.9 million, respectively, in other assets and other liabilities. No hedge ineffectiveness was recorded to earnings for the year ended December 31, 2004. Net losses recorded for the year-to-date period ended December 31, 2003 representing the ineffective portion of the fair value hedges were not material to the consolidated financial statements of the Bank. Gains or losses resulting from hedge ineffectiveness are recorded in noninterest income.

Cash Flow Hedges

The Bank uses interest rate swaps to reduce the variability associated with future interest payments on floating-rate, prime-based loans. Interest rate swaps convert the expected cash flows on the loans from variable to fixed. Changes in the fair value of the swaps that are effective hedges are recorded in other comprehensive income.

For cash flow hedges, as of December 31, 2004 the Bank recorded the fair value of derivative instrument liabilities of \$8.6 million in other liabilities. No hedge ineffectiveness was recorded to earnings for the year ended December 31, 2004. The unrealized gains (losses) in accumulated other comprehensive income ("AOCI") related to the interest rate swaps are reclassified to earnings in the same period that the interest on the floating-rate loans affects earnings. Approximately \$2.0 million is expected to be reclassified to earnings over the next twelve months. As of September 30, 2004 certain swaps were redesignated as hedges in order to comply with FAS 133 Implementation Issue No. G25, "Cash Flow Hedges: Using the First-Payments-Received Technique in Hedging the Variable Interest Payments on a Group of Non-Benchmark-Rate-Based Loans." Losses from the hedge redesignation were reclassified from AOCI and recorded in noninterest income for the year ended December 31, 2004 but were not material to the consolidated financial statements of the Bank.

For cash flow hedges, as of December 31, 2003 the fair value of the derivative instrument asset was recorded in other assets and was not material to the consolidated financial statements of the Bank. No hedge ineffectiveness was recorded to earnings for the year ended December 31, 2003.

Risk management activities also include the following derivative transactions that do not otherwise qualify for hedge accounting.

Foreign exchange contracts are used to stabilize any currency exchange rate fluctuation for certain senior notes and certain loans. The derivative instruments, primarily cross currency interest rate swaps and to a lesser extent forward contracts, do not qualify for hedge accounting and are accounted for at fair value.

The Bank has qualifying mortgage loan commitments that are intended to be sold in the secondary market. These loan commitments are derivatives and are recorded as liabilities at fair value. The Bank enters into forward sales of mortgage-backed securities to minimize its exposure to interest rate volatility. These forward sales of mortgage-backed securities are also derivatives and are accounted for at fair value.

Interest rate swaps are used to modify exposure to variability in cash flows for certain syndication arrangements, where the Bank is agent. The

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derivative instruments do not qualify for hedge accounting and are accounted for at fair value.

13. CONCENTRATIONS OF CREDIT RISK IN FINANCIAL INSTRUMENTS

The Bank had one major concentration of credit risk arising from financial instruments at December 31, 2004 and 2003. This concentration was the Midwest geographic area. This concentration exceeded 10 percent of the Bank's total credit exposure, which is the total potential accounting loss should all customers fail to perform according to contract terms and all collateral prove to be worthless.

MIDWESTERN GEOGRAPHIC AREA

A majority of the Bank's customers are located in the Midwestern region of the United States, defined here to include Illinois, Indiana, Iowa, Michigan, Minnesota, Missouri, Ohio and Wisconsin. The Bank provides credit to these customers through a broad array of banking and trade financing products including commercial loans, commercial loan commitments, commercial real estate loans, consumer installment loans, mortgage loans, home equity loans and lines, standby and commercial letters of credit and banker's acceptances. The financial viability of customers in the Midwest is, in part, dependent on the region's economy. The Bank's maximum risk of accounting loss, should all customers making up the Midwestern concentration fail to perform according to contract terms and all collateral prove to be worthless, was approximately \$16.9 billion or 55 percent of the Bank's total credit exposure at December 31, 2004 and \$14.0 billion or 50 percent of the Bank's total credit exposure at December 31, 2003.

The Bank manages this exposure by continually reviewing local market conditions and customers, adjusting individual and industry exposure limits within the region and by obtaining or closely monitoring collateral values. See Note 11 to Financial Statements for information on collateral supporting credit facilities.

14. EMPLOYEE BENEFIT PLANS

The Bank has noncontributory defined benefit pension plans covering virtually all its employees as of December 31, 2004. Most of the employees participating in retirement plans were included in one primary plan ("primary plan") during the three-year period ended December 31, 2004. The plan is a multiple-employer plan covering the Bank's employees as well as persons employed by certain affiliated entities.

Certain employees participating in the primary plan are also covered by a supplemental unfunded retirement plan. The purpose of this plan is to extend full retirement benefits to individuals without regard to statutory limitations for qualified funded plans.

Effective January 1, 2002, the plan's benefit formula for new employees was changed to an account-based formula from a final average pay formula. The account-based benefit formula is based upon eligible pay, age and length of service. Prior to January 1, 2002, the plan's benefit formula was a final average pay formula, based upon length of service and an employee's highest qualifying compensation during five consecutive years of active employment less an estimated Social Security benefit. For employees who were employed as of December 31, 2001 and leave the Corporation on or after January 1, 2002, benefits are initially calculated two ways: under the account-based formula for service beginning January 1, 2002 and under the final average pay formula for all service. This latter group of employees will receive that retirement benefit which yields the highest return.

The policy for this plan is to have the participating entities, at a

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minimum, fund annually an amount necessary to satisfy the requirements under ERISA, without regard to prior years' contributions in excess of the minimum. The Bank generally contributes the maximum allowable under the U.S. Internal Revenue Code. For 2004, 2003 and 2002, cumulative contributions were less than the amounts recorded as primary plan pension expense for financial reporting purposes. For 2005 (plan year 2004), the estimated pension contribution is approximately \$17 million. The total consolidated pension expense of the Bank, including the supplemental unfunded retirement plan (excluding settlement losses and curtailment gains), for 2004, 2003,

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and 2002 was \$30.2 million, \$22.2 million and \$11.7 million, respectively. The qualified pension accumulated benefit obligation as of December 31, 2004, 2003, and 2002 was \$288.8 million, \$263.6 million and \$233.3 million, respectively.

For the supplemental unfunded retirement plan, no settlement losses were recorded in 2004 or 2002 and a \$2.6 million settlement loss was recognized in 2003.

In addition to pension benefits, the Bank provides medical care benefits for retirees (and their dependents) who have attained age 55 and have at least 10 years of service. The Bank also provides medical care benefits for disabled employees and widows of former employees (and their dependents). The Bank provides these medical care benefits through a self-insured plan. Under the terms of the plan, the Bank contributes to the cost of coverage based on employees' length of service. Cost sharing with plan participants is accomplished through deductibles, coinsurance and out-of-pocket limits. Funding for the plan largely comes from the general assets of the Bank supplemented by contributions to a trust fund created under Internal Revenue Code Section 401(h).

Effective July 1, 2004 the Bank adopted FASB Staff Position No. 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003." The Bank elected retroactive application to December 31, 2003. Under the Act, an employer is eligible for a federal subsidy if the prescription drug benefit available under its postretirement medical plan is "actuarially equivalent" to the Medicare Part D benefit. In 2004, the Bank recorded a reduction to postretirement medical expense in the amount of \$0.5 million, as determined by the Bank's actuarial consultants. Based on their analysis, the Bank's postretirement benefit medical plan would pass the test for actuarial equivalence and would qualify for the subsidy.

The following tables set forth the change in benefit obligation and plan assets for the pension and postretirement medical care benefit plans for the Bank:

| | PENSION BENEFITS | | | POSTRETIREMENT MEDICAL BENEFITS | | |
|--|------------------|------------|------------|---------------------------------|-----------|-----------|
| | 2004** | 2003** | 2002** | 2004** | 2003** | 2002** |
| | (IN THOUSANDS) | | | | | |
| CHANGE IN BENEFIT OBLIGATION* | | | | | | |
| Benefit obligation at beginning of year..... | \$ 340,935 | \$ 311,566 | \$ 248,377 | \$ 54,169 | \$ 44,361 | \$ 38,389 |
| Service cost..... | 16,969 | 13,867 | 10,871 | 1,876 | 1,569 | 1,259 |

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| | | | | | | |
|---|------------|------------|------------|----------|-----------|-----------|
| Interest cost..... | 19,400 | 19,239 | 18,451 | 2,944 | 2,917 | 2,799 |
| Plan Amendments..... | -- | -- | 1,585 | -- | -- | -- |
| Acquisitions/transfers..... | 40 | -- | -- | -- | -- | -- |
| Medicare drug legislation... | -- | -- | -- | (9,157) | -- | -- |
| Benefits paid (net of participant contributions)..... | (31,500) | (42,600) | (19,065) | (2,265) | (2,227) | (2,863) |
| Actuarial (gain) or loss.... | 4,551 | 38,863 | 51,347 | (1,700) | 7,549 | 4,777 |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Benefit obligation at end of year..... | \$ 350,395 | \$ 340,935 | \$ 311,566 | \$45,867 | \$ 54,169 | \$ 44,361 |
| | ===== | ===== | ===== | ===== | ===== | ===== |

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| | PENSION BENEFITS | | | POSTRETIREMENT MEDICAL BENEFITS | | |
|---|------------------|--------------|--------------|---------------------------------|-------------|-------------|
| | 2004** | 2003** | 2002** | 2004** | 2003** | 2002** |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| | (IN THOUSANDS) | | | | | |
| CHANGE IN PLAN ASSETS | | | | | | |
| Fair value of plan assets at beginning of year..... | \$ 215,285 | \$ 210,844 | \$ 236,956 | \$31,407 | \$ 24,406 | \$ 25,962 |
| Actual return on plan assets..... | 32,317 | 38,180 | (14,316) | 5,010 | 7,001 | (3,579) |
| Acquisitions/transfers..... | 358 | -- | -- | -- | -- | -- |
| Employer contribution..... | 13,626 | 8,861 | 7,269 | -- | -- | 2,023 |
| Benefits paid..... | (31,500) | (42,600) | (19,065) | -- | -- | -- |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Fair value of plan assets at end of year***..... | \$ 230,086 | \$ 215,285 | \$ 210,844 | \$36,417 | \$ 31,407 | \$ 24,406 |
| | ===== | ===== | ===== | ===== | ===== | ===== |
| Funded Status..... | \$ (120,309) | \$ (125,650) | \$ (100,722) | \$ (9,450) | \$ (22,762) | \$ (19,955) |
| Contributions made between measurement date (September 30) and end of year..... | -- | -- | -- | -- | -- | -- |
| Unrecognized actuarial (gain) or loss..... | 110,839 | 131,102 | 117,006 | (5,842) | 7,506 | 5,079 |
| Unrecognized transition (asset) or obligation..... | -- | -- | -- | 13,890 | 15,641 | 17,392 |
| Unrecognized prior service cost..... | 3,116 | 2,836 | 2,556 | 846 | 1,015 | 1,184 |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Net amount at year-end..... | \$ (6,354) | \$ 8,288 | \$ 18,840 | \$ (556) | \$ 1,400 | \$ 3,700 |
| | ===== | ===== | ===== | ===== | ===== | ===== |
| AMOUNTS RECOGNIZED IN THE STATEMENT OF CONDITION CONSIST OF: | | | | | | |
| Prepaid benefit cost..... | \$ -- | \$ -- | \$ -- | \$ -- | \$ 1,400 | \$ 3,700 |
| Accrued benefit liability... | (48,117) | (44,313) | (25,528) | (556) | -- | -- |
| Intangible asset..... | 3,114 | 2,836 | 2,556 | -- | -- | -- |
| Accumulated other comprehensive income (gross of tax)..... | 38,649 | 49,765 | 41,812 | -- | -- | -- |
| | ----- | ----- | ----- | ----- | ----- | ----- |
| Net amount recognized at | | | | | | |

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| | | | | | | |
|---|-------------|----------|-----------|----------|----------|----------|
| year-end..... | \$ (6,354) | \$ 8,288 | \$ 18,840 | \$ (556) | \$ 1,400 | \$ 3,700 |
| | ===== | ===== | ===== | ===== | ===== | ===== |
| Other comprehensive income attributable to change in additional minimum liability (gross of tax)..... | \$ (11,116) | \$ 7,953 | \$ 41,812 | \$ -- | \$ -- | \$ -- |

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| | PENSION BENEFITS | | | POSTRETIREMENT MEDICAL BENEFITS | | |
|---|------------------|-----------|-----------|---------------------------------|----------|----------|
| | 2004** | 2003** | 2002** | 2004** | 2003** | 2002** |
| | (IN THOUSANDS) | | | | | |
| COMPONENTS OF NET PERIODIC BENEFIT COST | | | | | | |
| Service cost..... | \$ 16,969 | \$ 13,867 | \$ 10,871 | \$ 1,876 | \$ 1,569 | \$ 1,259 |
| Interest cost..... | 19,400 | 19,239 | 18,451 | 2,944 | 2,917 | 2,799 |
| Expected return on plan assets..... | (15,073) | (17,591) | (21,778) | (2,513) | (1,953) | (2,077) |
| Amortization of prior service cost..... | (279) | (279) | (280) | 169 | 169 | 169 |
| Amortization of transition (asset) or obligation..... | -- | -- | (85) | 1,751 | 1,751 | 1,751 |
| Amortization of actuarial (gain) or loss..... | 7,283 | 4,638 | -- | (6) | -- | (233) |
| Net periodic benefit cost... | \$ 28,300 | \$ 19,874 | \$ 7,179 | \$ 4,221 | \$ 4,453 | \$ 3,668 |

* Benefit obligation is projected for Pension Benefits and accumulated for Postretirement Medical Benefits.

** Plan assets and obligation measured as of September 30.

*** The actual allocation of plan assets by category are as follows:

| | 2004 | 2003 | 2002 |
|------------------------------|------|------|------|
| | ---- | ---- | ---- |
| Pension: | | | |
| Equity securities..... | 72% | 73% | 67% |
| Fixed income securities..... | 28% | 27% | 33% |
| Postretirement Medical: | | | |
| Equity securities..... | 72% | 73% | 66% |
| Fixed income securities..... | 28% | 27% | 34% |

At December 31, 2004 over one-half of the plan assets consisted of investments in mutual funds administered by Harris Investment Management, Inc., a subsidiary of Bankcorp.

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Investment objectives include the achievement of a total account return (net of fees) which meets or exceeds over a long time horizon the expected return on plan assets, the inflation rate as measured by the Consumer Price Index, and the median performance in a comparable manager universe. The return on asset assumption is based upon management's review of the current rate environment, historical trend analysis and the mix of asset categories represented in the Plan's portfolio. The performance benchmark includes the asset classes of equities and fixed income securities. Plan asset and liability studies are presented to the Investment Committee periodically. The current portfolio target allocation is as follows:

| | |
|------------------------------|-----|
| Equity securities..... | 70% |
| Fixed income securities..... | 30% |

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| | PENSION BENEFITS | | | POSTRETIREMENT MEDICAL BENEFITS | | |
|---|------------------|-------|-------|---------------------------------|-------|-------|
| | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 |
| WEIGHTED-AVERAGE ASSUMPTIONS USED TO DETERMINE BENEFIT OBLIGATIONS AS OF DECEMBER 31 | | | | | | |
| Discount rate..... | 6.00% | 6.00% | 6.75% | 6.00% | 6.00% | 6.75% |
| Rate of compensation increase..... | 3.80% | 4.20% | 5.50% | N/A | N/A | N/A |
| WEIGHTED-AVERAGE ASSUMPTIONS USED TO DETERMINE NET BENEFIT COST FOR YEARS ENDED DECEMBER 31 | | | | | | |
| Discount rate..... | 6.00% | 6.75% | 7.50% | 6.00% | 6.75% | 7.50% |
| Expected return on plan assets..... | 8.00% | 8.00% | 9.00% | 8.00% | 8.00% | 8.00% |
| Rate of compensation increase..... | 3.80% | 4.20% | 5.50% | N/A | N/A | N/A |

For measurement purposes, a 9 percent annual rate of increase for pre 65 and an 11 percent annual rate of increase for post 65 in the per capita cost of covered health care benefits was assumed for 2004. The rate will be graded down to 5.0 percent for pre 65 and 5.5 percent for post 65 in 2013 and 2012, respectively, and remain level thereafter.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects:

| | 1-PERCENTAGE POINT INCREASE | 1-PERCENTAGE POINT DECREASE |
|--|-----------------------------|-----------------------------|
| | (IN THOUSANDS) | |
| Effect on total of service and interest cost components... | \$ 882 | \$ (694) |
| Effect on postretirement benefit obligation..... | \$6,653 | \$ (5,387) |

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The following table sets forth the status of the supplemental unfunded retirement plan:

| | SUPPLEMENTAL UNFUNDED RETIREMENT BENEFITS | | |
|---|--|-----------|-----------|
| | 2004 | 2003 | 2002 |
| | (IN THOUSANDS) | | |
| CHANGE IN BENEFIT OBLIGATION | | | |
| Benefit obligation at beginning of year..... | \$ 13,951 | \$ 25,544 | \$ 23,750 |
| Service cost..... | 1,234 | 1,132 | 2,273 |
| Interest cost..... | 635 | 1,075 | 1,398 |
| Settlement (gain) or loss..... | -- | 1,546 | -- |
| Plan amendments/merger..... | -- | -- | -- |
| Benefits paid (net of participant contributions)..... | (3,784) | (180) | (239) |
| Settlement payments..... | -- | (10,872) | -- |
| Actuarial (gain) or loss..... | 2,454 | (4,294) | (1,638) |
| | ----- | ----- | ----- |
| Benefit obligation at end of year..... | \$ 14,490 | \$ 13,951 | \$ 25,544 |
| | ===== | ===== | ===== |
| CHANGE IN PLAN ASSETS | | | |
| Fair value of plan assets at beginning of year..... | \$ -- | \$ -- | \$ -- |
| Actual return on plan assets..... | -- | -- | -- |
| Employer contribution..... | 3,784 | 11,052 | 239 |
| Benefits paid..... | (3,784) | (11,052) | (239) |
| | ----- | ----- | ----- |
| Fair value of plan assets at end of year..... | \$ -- | \$ -- | \$ -- |
| | ===== | ===== | ===== |

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| | SUPPLEMENTAL UNFUNDED RETIREMENT BENEFITS | | |
|--|--|-------------|-------------|
| | 2004 | 2003 | 2002 |
| | (IN THOUSANDS) | | |
| Funded Status..... | \$ (14,490) | \$ (13,951) | \$ (25,544) |
| Contributions made between measurement date (September 30) and end of year..... | 28 | 916 | -- |
| Unrecognized actuarial (gain) or loss..... | 5,101 | 3,325 | 8,020 |
| Unrecognized transition (asset) or obligation..... | -- | -- | 12 |
| Unrecognized prior service cost..... | (3,001) | (2,978) | (2,880) |
| | ----- | ----- | ----- |
| Prepaid (accrued) benefit cost..... | \$ (12,362) | \$ (12,688) | \$ (20,392) |
| | ===== | ===== | ===== |
| COMPONENTS OF NET PERIODIC BENEFIT COST | | | |
| Service cost..... | \$ 1,234 | \$ 1,132 | \$ 2,273 |
| Interest cost..... | 635 | 1,075 | 1,398 |
| Expected return on plan assets..... | -- | -- | -- |
| Amortization of prior service cost..... | 23 | 97 | 170 |
| Amortization of transition (asset) or obligation..... | -- | 13 | 10 |

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| | | | |
|--|----------|----------|----------|
| Amortization of actuarial (gain) or loss..... | 15 | 53 | 664 |
| | ----- | ----- | ----- |
| Net periodic benefit cost..... | \$ 1,907 | \$ 2,370 | \$ 4,515 |
| | ===== | ===== | ===== |
| Additional (gain) or loss recognized due to: | | | |
| Settlement..... | \$ -- | \$ 2,597 | \$ -- |
| WEIGHTED-AVERAGE ASSUMPTIONS USED TO DETERMINE | | | |
| BENEFIT OBLIGATIONS AS OF DECEMBER 31 | | | |
| Discount rate..... | 5.25% | 5.25% | 5.50% |
| Rate of compensation increase..... | 3.80% | 4.20% | 5.50% |
| WEIGHTED-AVERAGE ASSUMPTIONS USED TO DETERMINE NET | | | |
| BENEFIT COST FOR YEARS ENDED DECEMBER 31 | | | |
| Discount rate..... | 5.25% | 5.50% | 6.00% |
| Rate of compensation increase..... | 3.80% | 4.20% | 5.50% |

The benefits expected to be paid in each of next five years and the aggregate for the five years thereafter are as follows:

| YEAR | PENSION BENEFITS | POSTRETIREMENT MEDICAL BENEFITS | SUPPLEMENTAL UNFUNDED RETIREMENT BENEFITS |
|----------------|------------------|------------------------------------|--|
| ---- | ----- | ----- | ----- |
| | (IN THOUSANDS) | | |
| 2005..... | \$ 18,758 | \$ 2,929 | \$ 889 |
| 2006..... | 19,799 | 2,875 | 1,129 |
| 2007..... | 21,662 | 2,923 | 1,346 |
| 2008..... | 23,625 | 2,971 | 1,614 |
| 2009..... | 24,643 | 3,016 | 2,090 |
| 2010-2014..... | 146,201 | 15,916 | 15,116 |

The Bank has a defined contribution plan that is available to virtually all employees. Effective January 1, 2002, the Bank amended the plan to enhance the 401(k) matching contribution and discontinue the profit sharing contribution. The matching contribution is based on the amount of eligible employee contributions. The profit sharing contribution was based on the annual financial performance of the Bank relative to predefined targets. The Bank's total expense for this plan was \$9.8 million, \$9.4 million and \$9.3 million in 2004, 2003 and 2002, respectively.

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15. STOCK OPTIONS

The Bank has three stock-based compensation plans: an options program, a performance incentive plan and an employee share purchase plan. The option plans are accounted for under the fair value based method of accounting and are described below.

STOCK OPTION PROGRAM

The Stock Option Program was established under the Bank of Montreal Stock Option Plan for certain designated executives and other employees of the Bank and affiliated companies in order to provide incentive to attain long-term strategic goals and to attract and retain services of key employees.

The Bank has two types of option plans. The Fixed Stock Option Plan consists of standard stock options with a ten-year term which are exercisable

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only during the second five years of their term, assuming cumulative performance goals are met. The Performance Based Option Plan consists of standard and performance conditioned stock options with a ten-year term and a four-year vesting period, which are exercisable twenty-five percent per annum. The standard options may be exercised at any time once vested. The performance-conditioned options may be exercised provided the BMO shares trade at fifty percent over the price of the stock at date of grant for twenty consecutive days, after the vesting date. The stock options are exercisable for BMO common stock equal to the market price on the date of grant. The compensation expense related to this program totaled \$4.0 million, \$5.8 million and \$5.6 million in 2004, 2003 and 2002, respectively.

The following table summarizes the stock option activity for 2004, 2003 and 2002 and provides details of stock options outstanding at December 31, 2004:

| OPTIONS | 2004 | | 2003 | | SHARES |
|---|-----------|--------------------------|-----------|--------------------------|-----------|
| | SHARES | WTD. AVG. EXERCISE PRICE | SHARES | WTD. AVG. EXERCISE PRICE | |
| Outstanding at beginning of year..... | 3,422,184 | \$33.40 | 3,994,491 | \$33.32 | 3,609,059 |
| Granted..... | 379,700 | 44.08 | -- | -- | 425,300 |
| Exercised..... | (520,475) | 36.10 | (470,448) | 34.25 | (76,115) |
| Forfeited, cancelled..... | -- | -- | -- | -- | -- |
| Transferred..... | 8,200 | 37.01 | (101,859) | 26.18 | 36,247 |
| Expired..... | -- | -- | -- | -- | -- |
| Outstanding at end of year..... | 3,289,609 | 34.22 | 3,422,184 | 33.40 | 3,994,491 |
| Options exercisable at year-end..... | 2,526,266 | \$34.66 | 2,432,304 | \$35.70 | 1,552,213 |
| Weighted-average fair value of options granted during the year..... | | \$ 8.57 | | N/A | |

N/A -- There were no stock options granted during fiscal 2003.

| RANGE OF EXERCISE PRICES | OPTIONS OUTSTANDING | | | OPTIONS EXERCISABLE |
|--------------------------|--------------------------------------|--------------------------------------|--------------------------|--------------------------------------|
| | NUMBER OUTSTANDING DECEMBER 31, 2004 | WTD. AVG. REMAINING CONTRACTUAL LIFE | WTD. AVG. EXERCISE PRICE | NUMBER EXERCISABLE DECEMBER 31, 2004 |
| \$22-30..... | 1,508,845 | 6.84 years | \$23.68 | 1,073,302 |
| 34-42..... | 969,998 | 5.39 | 38.11 | 814,298 |
| 46-54..... | 810,766 | 6.47 | 49.17 | 638,666 |
| 22-54..... | 3,289,609 | 6.32 | 34.22 | 2,526,266 |

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The fair value of the stock options granted has been estimated using a trinomial option pricing model. The weighted-average fair value of options granted during the years ended December 31, 2004 and

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December 31, 2002 was \$8.57 and \$5.27, respectively. No stock options were granted during the year ended December 31, 2003. The following weighted-average assumptions were used to determine the fair value of options on the date of grant:

| | 2004 ----- | 2003 ---- | 2002 ----- |
|--------------------------------------|---------------|--------------|---------------|
| Risk-free interest rate..... | 4.51% | N/A | 4.80% |
| Expected life, in years..... | 7.0 | N/A | 7.0 |
| Expected volatility..... | 23.06% | N/A | 23.44% |
| Compound annual dividend growth..... | 9.45% | N/A | 8.39% |

MID-TERM INCENTIVE PLAN

The Bank maintains the Mid-Term Incentive Plan which was established in January 2000. The plan is intended to enhance the Bank's ability to attract and retain high quality employees and to provide a strong incentive to employees to achieve BMO's governing objective of maximizing value for its shareholders.

During 2004 the Bank was party to an agreement made between BMO and a third party to assume the obligation related to the 2004 Mid-Term Incentive Plan. The Bank's share of the payment was \$12.4 million. A similar agreement was entered into in 2003 and 2002 related to the 2003 and 2002 Mid-Term Incentive Plans for a payment of \$14.7 million and \$8.0 million, respectively. These amounts will be recorded as compensation expense over the three year performance cycle of the plan on a straight-line basis. Any future payments required under these plans will be the responsibility of the third party.

Payouts under the plan to participants depend on the achievement of specific performance criteria that are set at the grant date. The right to receive distributions under the plan vest and are paid out after three years based on various factors including the BMO share price. Compensation expense for this plan totaled \$11.4 million, \$20.5 million and \$10.6 million in 2004, 2003 and 2002, respectively.

EMPLOYEE SHARE PURCHASE PLAN

The Bank of Montreal ("BMO") Employee Share Purchase Plan offers employees the opportunity to purchase BMO common shares at a discount of 15 percent from market value. Full-time and part-time employees of the Bank are eligible to participate in the plan. Employees can elect to contribute up to 15 percent of their salary toward the purchase of BMO common shares. The Bank contributes the difference between the employee cost and the market price. The shares in the plan are purchased on the open market and the plan reinvests all cash dividends in additional common shares. The Bank's contribution is recorded as compensation expense over each three-month offering period. Compensation expense for the employee share purchase plan totaled \$0.4 million, \$0.3 million and \$0.1 million in 2004, 2003 and 2002, respectively.

16. LEASE EXPENSE AND OBLIGATIONS

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Rental expense for all operating leases was \$16.5 million in 2004, \$16.6 million in 2003, and \$15.9 million in 2002. These amounts include real estate taxes, maintenance and other rental-related operating costs of \$6.1 million, \$6.2 million, and \$6.6 million for 2004, 2003, and 2002, respectively, paid under net lease arrangements. Lease commitments are primarily for office space.

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Minimum rental commitments as of December 31, 2004 for all noncancelable operating leases are as follows:

| | (IN THOUSANDS) |
|-----------------------------------|----------------|
| 2005..... | \$10,351 |
| 2006..... | 9,904 |
| 2007..... | 8,750 |
| 2008..... | 6,577 |
| 2009..... | 6,431 |
| 2010 and thereafter..... | 15,825 |
| | ----- |
| Total minimum future rentals..... | \$57,838 |
| | ===== |

Occupancy expenses for 2004, 2003, and 2002 have been reduced by \$18 million, \$17 million, and \$17 million, respectively, for rental income from leased premises.

17. INCOME TAXES

The 2004, 2003 and 2002 applicable income tax expense (benefit) were as follows:

| | FEDERAL | STATE | TOTAL |
|--------------------|----------------|-----------|----------|
| | ----- | ----- | ----- |
| | (IN THOUSANDS) | | |
| 2004: Current..... | \$53,328 | \$ 4,134 | \$57,462 |
| Deferred..... | 2,036 | (772) | 1,264 |
| | ----- | ----- | ----- |
| Total..... | \$55,364 | \$ 3,362 | \$58,726 |
| | ===== | ===== | ===== |
| 2003: Current..... | \$31,116 | \$(1,302) | \$29,814 |
| Deferred..... | 8,374 | 1,113 | 9,487 |
| | ----- | ----- | ----- |
| Total..... | \$39,490 | \$ (189) | \$39,301 |
| | ===== | ===== | ===== |
| 2002: Current..... | \$58,791 | \$ 2,480 | \$61,271 |
| Deferred..... | 5,247 | 788 | 6,035 |
| | ----- | ----- | ----- |
| Total..... | \$64,038 | \$ 3,268 | \$67,306 |
| | ===== | ===== | ===== |

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Deferred tax assets (liabilities) are comprised of the following at December 31, 2004, 2003 and 2002:

| | DECEMBER 31 | | |
|---|----------------|-----------|-----------|
| | 2004 | 2003 | 2002 |
| | (IN THOUSANDS) | | |
| Deferred tax assets: | | | |
| Allowance for loan losses..... | \$ 87,384 | \$ 91,977 | \$ 83,194 |
| Deferred expense and prepaid income..... | 13,588 | 13,155 | 13,554 |
| Deferred employee compensation..... | 19,621 | 19,110 | 16,605 |
| Other assets..... | 261 | 882 | 16,697 |
| | ----- | ----- | ----- |
| Gross deferred tax assets..... | 120,854 | 125,124 | 130,050 |
| | ----- | ----- | ----- |
| Deferred tax liabilities: | | | |
| Depreciable assets..... | (37,595) | (40,650) | (43,608) |
| Amortizable intangibles..... | (12,306) | (8,937) | (5,676) |
| Other liabilities..... | (5,282) | (9,747) | (5,489) |
| | ----- | ----- | ----- |
| Gross deferred tax liabilities..... | (55,183) | (59,334) | (54,773) |
| | ----- | ----- | ----- |
| Deferred tax assets..... | 65,671 | 65,790 | 75,277 |
| The tax effect of fair value adjustments on available-for-sale securities, minimum pension liabilities and hedging transactions recorded directly to stockholder's equity..... | 28,080 | (76) | (31,507) |
| | ----- | ----- | ----- |
| Net deferred tax assets..... | \$ 93,751 | \$ 65,714 | \$ 43,770 |
| | ----- | ----- | ----- |

At December 31, 2004 and 2003, the respective deferred tax assets of \$65.6 million and \$65.8 million included \$58.3 million and \$59.3 million for Federal taxes and \$7.3 million and \$6.5 million for state taxes, respectively. Management believes that the realization of the recognized net deferred tax asset is more likely than not based on existing carryback ability and expectations as to future taxable income.

Total income tax expense of \$58.7 million for 2004, \$39.3 million for 2003 and \$67.3 million for 2002 reflects effective tax rates of 29.4 percent, 25.0 percent and 28.2 percent, respectively. The reconciliation between actual tax expense and the amount determined by applying the federal statutory rate of 35 percent to income before income taxes were as follows:

| | YEARS ENDED DECEMBER 31 | | | | | |
|---------------------------|-------------------------|--------------------------------|-----------|--------------------------------|-----------|--------------------------------|
| | 2004 | | 2003 | | 2002 | |
| | AMOUNT | PERCENT OF PRETAX INCOME | AMOUNT | PERCENT OF PRETAX INCOME | AMOUNT | PERCENT OF PRETAX INCOME |
| | (DOLLARS IN THOUSANDS) | | | | | |
| Computed tax expense..... | \$ 69,936 | 35.0% | \$ 55,010 | 35.0% | \$ 83,699 | 35.0% |

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| | | | | | | |
|--|-----------|-------|-----------|-------|-----------|-------|
| Increase (reduction) in income tax expense due to: | | | | | | |
| Tax-exempt income from loans and investments net of municipal interest expense disallowance..... | (1,108) | (0.6) | (563) | (0.4) | (567) | (0) |
| Bank-owned insurance..... | (14,082) | (7.0) | (15,253) | (9.7) | (17,709) | (7) |
| State income taxes..... | 2,185 | 1.1 | (123) | (0.1) | 2,124 | 0 |
| Other, net..... | 1,795 | 0.9 | 230 | 0.2 | (241) | (0) |
| | ----- | ---- | ----- | ---- | ----- | ---- |
| Actual tax expense..... | \$ 58,726 | 29.4% | \$ 39,301 | 25.0% | \$ 67,306 | 28 |
| | ===== | ===== | ===== | ===== | ===== | ===== |

18. REGULATORY CAPITAL

The Bank, as a state-member bank, must adhere to the capital adequacy guidelines of the Federal Reserve Board ("the Board"), which are not significantly different than those published by other U.S. banking regulators. The guidelines specify minimum ratios for Tier 1 capital to risk-weighted assets of 4 percent and total regulatory capital to risk-weighted assets of 8 percent.

Risk-based capital guidelines define total capital to consist primarily of Tier 1 (core) and Tier 2 (supplementary) capital. In general, Tier 1 capital is comprised of stockholder's equity, including certain types of preferred stock, less goodwill and certain other intangibles. Core capital must comprise at least 50 percent of total capital. Tier 2 capital basically includes subordinated debt (less a discount factor during the five years prior to maturity), other types of preferred stock and the allowance for loan losses. The portion of the allowance for loan losses includable in Tier 2 capital is limited to 1.25 percent of risk-weighted assets.

The Board also requires an additional measure of capital adequacy, the Tier 1 leverage ratio, which is evaluated in conjunction with risk-based capital ratios. The Tier 1 leverage ratio is computed by dividing period-end Tier 1 capital by adjusted quarterly average assets. The Board established a minimum ratio of 3 percent applicable only to the strongest banking organizations having, among other things, excellent asset quality, high liquidity, good earnings and no undue interest rate risk exposure. Other institutions are expected to maintain a minimum ratio of 4 percent.

The Federal Deposit Insurance Corporation Improvement Act of 1991 contains prompt corrective action provisions that established five capital categories for all Federal Deposit Insurance Corporation ("FDIC")-insured institutions ranging from "well capitalized" to "critically undercapitalized." Classification within a category is based primarily on the three capital adequacy measures. An institution is considered "well capitalized" if its capital level significantly exceeds the required minimum levels, "adequately capitalized" if it meets the minimum levels, "undercapitalized" if it fails to meet the minimum levels, "significantly undercapitalized" if it is significantly below the minimum levels and "critically undercapitalized" if it has a ratio of tangible equity to total assets of 2 percent or less.

Noncompliance with minimum capital requirements may result in regulatory corrective actions that could have a material effect on the Bank's financial statements. Depending on the level of noncompliance, regulatory corrective actions may include the following: requiring a plan for restoring the institution to an acceptable capital category, restricting or prohibiting certain activities and appointing a receiver or conservator for the institution.

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As of December 31, 2004, the most recent notification from the FDIC categorized the Bank as "well capitalized" under the regulatory framework for prompt corrective action. Management is not aware of any conditions or events since December 31, 2004 that have changed the capital category of the Bank.

At December 31, 2004 the Bank had \$255 million of minority interest in preferred stock of subsidiaries including \$250 million noncumulative, exchangeable Series A preferred stock with dividends payable at the rate of 7 3/8% per annum. The Bank also had a total of \$5 million of preferred stock with cumulative dividends payable at the rate of LIBOR plus 100 basis points adjusted as of the first business day of the calendar quarter that the record date falls. During both 2004 and 2003, \$18 million of dividends were paid on the preferred stock. All issues of preferred stock qualify as Tier 1 capital for the Bank under U.S. banking regulatory guidelines.

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The following table summarizes the Bank's risk-based capital ratios and Tier 1 leverage ratio for the past two years as well as the minimum amounts and ratios as per capital adequacy guidelines and FDIC prompt corrective action provisions.

| | ACTUAL | | FOR CAPITAL ADEQUACY PURPOSES | | TO BE WELL CAPITALIZED UNDER PROMPT CORRECTIVE ACTION PROVISIONS | |
|---------------------------------------|----------------|---------------|-------------------------------|---------------|--|---------------|
| | CAPITAL AMOUNT | CAPITAL RATIO | CAPITAL AMOUNT | CAPITAL RATIO | CAPITAL AMOUNT | CAPITAL RATIO |
| (IN THOUSANDS) | | | | | | |
| As of December 31, 2004: | | | | | | |
| Total Capital to Risk- | | | | | | |
| Weighted Assets..... | \$2,185,086 | 11.75% | \$1,487,718 | 8.00% | \$1,859,648 | \$10.00% |
| Tier 1 Capital to Risk- | | | | | | |
| Weighted Assets..... | \$1,764,599 | 9.49% | \$ 743,772 | 4.00% | \$1,115,658 | \$ 6.00% |
| Tier 1 Capital to Average Assets..... | \$1,764,599 | 8.33% | \$ 847,346 | 4.00% | \$1,059,183 | \$ 5.00% |
| As of December 31, 2003: | | | | | | |
| Total Capital to Risk- | | | | | | |
| Weighted Assets..... | \$1,980,042 | 12.25% | \$1,293,089 | 8.00% | \$1,616,361 | \$10.00% |
| Tier 1 Capital to Risk- | | | | | | |
| Weighted Assets..... | \$1,649,198 | 10.20% | \$ 646,744 | 4.00% | \$ 970,116 | \$ 6.00% |
| Tier 1 Capital to Average Assets..... | \$1,649,198 | 8.52% | \$ 774,271 | 4.00% | \$ 967,839 | \$ 5.00% |

19. INVESTMENTS IN SUBSIDIARIES AND STATUTORY RESTRICTIONS

Harris Trust and Savings Bank's investment in the combined net assets of its wholly-owned subsidiaries was \$777 million and \$792 million at December 31, 2004 and 2003, respectively.

Provisions of both Illinois and Federal banking laws place restrictions upon the amount of dividends that can be paid to Bankcorp by its bank subsidiaries. Illinois law requires that no dividends may be paid in an amount greater than the net profits then on hand, reduced by certain loan losses (as defined). In addition to these restrictions, Federal Reserve member banking

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subsidiaries require prior approval of Federal banking authorities if dividends declared by a subsidiary bank, in any calendar year, will exceed its net profits (as defined in the applicable statute) for that year, combined with its retained net profits, as so defined, for the preceding two years. Based on these and certain other prescribed regulatory limitations, the Bank could have declared, without regulatory approval, \$183 million of dividends at December 31, 2004. Actual dividends paid, however, would be subject to prudent capital maintenance. Cash and non-cash dividends paid to Bankcorp by the Bank amounted to \$70 million and \$60 million in 2004 and 2003, respectively.

The Bank is required by the Federal Reserve Act to maintain reserves against certain of their deposits. Reserves are held either in the form of vault cash or balances maintained with the Federal Reserve Bank. Required reserves are essentially a function of daily average deposit balances and statutory reserve ratios prescribed by type of deposit. During 2004 and 2003, daily average reserve balances of \$263 million and \$279 million, respectively, were required for the Bank. At year-end 2004 and 2003, balances on deposit at the Federal Reserve Bank totaled \$213 million and \$164 million, respectively.

20. CONTINGENT LIABILITIES

Harris Trust and Savings Bank and certain 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 financial position or results of operations.

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21. OTHER COMPREHENSIVE INCOME

The following table summarizes the components of other comprehensive income (loss) shown in stockholder's equity:

| | UNREALIZED GAINS (LOSSES) ON AVAILABLE-FOR-SALE SECURITIES | MINIMUM PENSION LIABILITY ADJUSTMENT | UNREALIZED GAIN ON DERIVATIVE INSTRUMENTS | TOTAL ACCUMULATED OTHER COMPREHENSIVE INCOME |
|-----------------------------------|---|---|--|--|
| | ----- | ----- | ----- | ----- |
| | (IN THOUSANDS) | | | |
| Balance at December 31, 2002..... | \$ 72,959 ===== | \$ (25,194) ===== | \$ -- ===== | \$ 47,765 ===== |
| Balance at December 31, 2003..... | \$ 30,962 ===== | \$ (29,986) ===== | \$ 35 ===== | \$ 1,011 ===== |
| Balance at December 31, 2004..... | \$ (21,274) ===== | \$ (25,122) ===== | \$ (5,274) ===== | \$ (51,670) ===== |

22. FOREIGN ACTIVITIES (BY DOMICILE OF CUSTOMER)

Income and expenses identifiable with foreign and domestic operations are summarized in the table below:

| FOREIGN | DOMESTIC | CONSOLIDATED |
|---------|----------|--------------|
| ----- | ----- | ----- |

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(IN THOUSANDS)

| | | | |
|--------------------------------------|-------------|--------------|--------------|
| 2004 | | | |
| Total operating income..... | \$ 15,772 | \$ 1,113,573 | \$ 1,129,345 |
| Total expenses..... | 68,483 | 861,045 | 929,528 |
| | ----- | ----- | ----- |
| (Loss) income before taxes..... | (52,711) | 252,528 | 199,817 |
| Applicable income taxes..... | (20,950) | 79,676 | 58,726 |
| | ----- | ----- | ----- |
| Net (loss) income..... | \$ (31,761) | \$ 172,852 | \$ 141,091 |
| | ===== | ===== | ===== |
| Identifiable assets at year-end..... | \$756,654 | \$20,467,993 | \$21,224,647 |
| | ===== | ===== | ===== |
| 2003 | | | |
| Total operating income..... | \$ 17,790 | \$ 1,141,897 | \$ 1,159,687 |
| Total expenses..... | 27,425 | 975,090 | 1,002,515 |
| | ----- | ----- | ----- |
| (Loss) income before taxes..... | (9,635) | 166,807 | 157,172 |
| Applicable income taxes..... | (3,829) | 43,130 | 39,301 |
| | ----- | ----- | ----- |
| Net (loss) income..... | \$ (5,806) | \$ 123,677 | \$ 117,871 |
| | ===== | ===== | ===== |
| Identifiable assets at year-end..... | \$523,206 | \$19,396,284 | \$19,919,490 |
| | ===== | ===== | ===== |
| 2002 | | | |
| Total operating income..... | \$ 18,305 | \$ 1,216,787 | \$ 1,235,092 |
| Total expenses..... | 2,978 | 992,974 | 995,952 |
| | ----- | ----- | ----- |
| Income before taxes..... | 15,327 | 223,813 | 239,140 |
| Applicable income taxes..... | 6,092 | 61,214 | 67,306 |
| | ----- | ----- | ----- |
| Net income..... | \$ 9,235 | \$ 162,599 | \$ 171,834 |
| | ===== | ===== | ===== |
| Identifiable assets at year-end..... | \$559,259 | \$18,467,759 | \$19,027,018 |
| | ===== | ===== | ===== |

Determination of rates for foreign funds generated or used are based on the actual external costs of specific interest-bearing sources or uses of funds for the periods. Internal allocations for certain unidentifiable income and expenses were distributed to foreign operations based on the percentage of identifiable foreign

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income to total income. As of December 31, 2004, 2003 and 2002, identifiable foreign assets accounted for 4 percent, 3 percent and 3 percent, respectively, of total consolidated assets.

23. BUSINESS COMBINATIONS

At December 31, 2004 and 2003, intangible assets, including goodwill resulting from business combinations, amounted to \$156 million and \$166 million, respectively. Amortization of these intangibles amounted to \$10.4 million in 2004, \$10.3 million in 2003 and \$10.2 million in 2002.

In June 2004, Harris Bank Round Lake, a wholly-owned subsidiary of Harris Bankcorp Inc., was merged with and into the Bank. At that time, Harris Bank Round Lake total assets were \$167 million and total deposits were \$151 million. The impact to the Bank's stockholder's equity was an increase of \$15.0 million. The combination was recorded using historical carrying values for Harris Bank

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Round Lake. In consideration of this contribution to its capital, the Bank issued 100,000 shares of common stock to Bankcorp.

On June 4, 2004, Harris Bankcorp, Inc. announced its plan to consolidate twenty-six of its existing bank charters, including the Bank, into one national bank charter, Harris N.A. This transaction is expected to be completed in May 2005. The combination will be recorded at historical carrying value and, where applicable, prior years' financial statements will be restated. The following information is presented to illustrate the relative magnitude of the combination.

| | ACTUAL DECEMBER 31, 2004 BALANCES FOR HARRIS TRUST AND SAVINGS BANK | PROFORMA COMBINED BALANCES OF HARRIS N.A. AT DECEMBER 31, 2004 |
|---------------|---|--|
| ----- | | |
| (IN MILLIONS) | | |
| Assets..... | \$23,199 | \$33,267 |
| Deposits..... | 12,172 | 21,022 |
| Equity..... | 1,643 | 2,620 |

24. RELATED PARTY TRANSACTIONS

During 2004, 2003 and 2002, the Bank engaged in various transactions with BMO and its subsidiaries. These transactions included the payment and receipt of service fees and occupancy expenses; purchasing and selling Federal funds; repurchase and reverse repurchase agreements; short-term borrowings; time deposit issuance; interest rate and foreign exchange rate contracts. The purpose of these transactions was to facilitate a more efficient use of combined resources and to better serve customers. Fees for these services were determined in accordance with applicable banking regulations. During 2004, 2003 and 2002, the Bank received from BMO approximately \$14.0 million, \$17.3 million and \$20.8 million, respectively, primarily for trust services, data processing and other operations support provided by the Bank. Excluding interest expense payments disclosed below, the Bank made payments to BMO of approximately \$47.5 million, \$30.4 million and \$24.9 million in 2004, 2003 and 2002, respectively.

At December 31, 2004, derivative contracts with BMO represent \$37.6 million and \$45.5 million of unrealized gains and unrealized losses, respectively. At December 31, 2003, derivative contracts with BMO represented \$49.4 million and \$102.1 million of unrealized gains and unrealized losses, respectively.

The Bank and BMO combine their U.S. foreign exchange activities. Under this arrangement, the Bank and BMO share FX net profit in accordance with a specific formula set forth in the agreement. This agreement expires in October 2005 but may be extended at that time. Either party may terminate the arrangement at its option. FX revenues are reported net of expenses. 2004, 2003 and 2002 foreign exchange revenues included \$5.9 million, \$5.1 million and \$7.2 million of net profit, respectively, under this agreement.

On June 18, 2004, the Bank issued a dividend to Harris Bankcorp, Inc. consisting of a wholly-owned U.S. subsidiary, Harris Bank International Corp. ("HBIC"). At the time of the dividend, HBIC had assets of \$7.1 million and equity of \$5.4 million.

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On July 3, 2003, the Bank issued a \$1.0 billion certificate of deposit ("CD") to a subsidiary of BMO, BMO (Barbados) Limited. The certificate matures June 30, 2008 and bears a 2.84 percent fixed rate of interest, payable quarterly. On August 28, 2003, the Bank issued a \$427.7 million CD to BMO (Barbados) Limited. The certificate matures March 31, 2009 and bears a 4.30 percent fixed rate of interest, payable semi-annually. On September 22, 2003, the Bank issued a \$570 million CD to BMO (Barbados) Limited. The certificate matures September 24, 2007 and bears a 3.28 percent fixed rate of interest, payable quarterly. Interest expense recognized on these CD's in 2004 and 2003 was \$66.6 million and \$25.4 million, respectively.

On June 29, 1999, the Bank borrowed (Canadian) \$109.0 million from BMO (US) Finance, LLC ("FINCO"), a Delaware limited liability company and an indirect subsidiary of BMO. The Bank entered into a currency and interest rate swap agreement to exchange the C\$109.0 million for U.S. \$73.7 million and made monthly interest payments on the swap. This debt was paid off July 29, 2004.

On June 28, 1999, the Bank borrowed (Canadian) \$100.2 million from FINCO. The Bank entered into a currency swap agreement to exchange the C\$100.2 million for U.S. \$74.5 million and made monthly interest payments on the swap. This debt was paid off July 29, 2004.

The Bank has loans outstanding to certain executive officers and directors. These loans totaled \$5.6 million and \$8.8 million at December 31, 2004 and 2003, respectively.