HARRIS PREFERRED CAPITAL CORP
Form 10-Q
November 14, 2005

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

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2005

COMMISSION FILE NUMBER 1-13805

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

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

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

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

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

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

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

Indicate by check mark whether this registrant is an accelerated filer (as defined in Rule 12b-2 of the Act)

Yes [ ]     No [X]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes [ ]     No [X]

The number of shares of Common Stock, $1.00 par value, outstanding on November 14, 2005 was 1,000. No common equity is held by nonaffiliates.

HARRIS PREFERRED CAPITAL CORPORATION

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED BALANCE SHEETS

| | SEPTEMBER 30, 2005 | DECEMBER 31, 2004 | SEPTEMBER 2004 |
|---|---|---|---|
| | (UNAUDITED) | (AUDITED) | (UNAUDITE |
| | (IN THOUSANDS, EXCEPT SHARE DATA) | | |
| ASSETS | | | |
| Cash on deposit with Harris N.A. | $ 735 | $ 407 | $ 30,228 |
| Securities purchased from Harris N.A. under agreement to resell | 12,000 | 10,500 | 16,000 |
| Notes receivable from Harris N.A. | 9,344 | 12,129 | 12,958 |
| Securities available-for-sale: | | | |
| Mortgage-backed | 398,720 | 419,315 | 429,915 |
| U.S. Treasury | 59,984 | 44,993 | 29,993 |
| Other assets | 1,542 | 1,678 | 1,774 |

| | | | |
|---|---|---|---|
| TOTAL ASSETS | $482,325 | $489,022 | $520,868 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | | |
| Broker payable -- due to securities purchased | $ -- | $ -- | $ 29,991 |
| Accrued expenses | 58 | 134 | 42 |
| TOTAL LIABILITIES | 58 | 134 | 30,033 |
| Commitments and contingencies | -- | -- | -- |
| STOCKHOLDERS' EQUITY | | | |
| 7 3/8% Noncumulative Exchangeable Preferred Stock, Series A ($1 par value); liquidation value of $250,000,000 and 20,000,000 shares authorized, 10,000,000 shares issued and outstanding | 250,000 | 250,000 | 250,000 |
| Common stock ($1 par value); 1,000 shares authorized, issued and outstanding | 1 | 1 | 1 |
| Additional paid-in capital | 240,733 | 240,733 | 240,733 |
| Distributions in excess of earnings | (185) | (582) | (971 |
| Accumulated other comprehensive (loss) gain -- net unrealized (losses) gain on available-for-sale securities | (8,282) | (1,264) | 1,072 |
| TOTAL STOCKHOLDERS' EQUITY | 482,267 | 488,888 | 490,835 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | $482,325 | $489,022 | $520,868 |

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

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HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED STATEMENTS OF INCOME
AND COMPREHENSIVE INCOME
(UNAUDITED)

| | QUARTER ENDED SEPTEMBER 30, | | NINE MONTHS ENDED SEPTEMBER 30, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| | (IN THOUSANDS, EXCEPT PER SHARE DATA) | | | |
| INTEREST INCOME: | | | | |
| Securities purchased from Harris N.A. under agreement to resell | $ 432 | $ 152 | $ 883 | $ 935 |
| Notes receivable from Harris N.A. | 158 | 214 | 514 | 708 |
| Securities available-for-sale: | | | | |
| Mortgage-backed | 4,449 | 4,438 | 13,616 | 10,367 |
| U.S. Treasury | 28 | 1 | 64 | 27 |
| Total interest income | 5,067 | 4,805 | 15,077 | 12,037 |
| NON-INTEREST INCOME: | | | | |
| (Loss) gain on sale of securities | (176) | 464 | (548) | 862 |

| | | | | |
|---|---|---|---|---|
| OPERATING EXPENSES: | | | | |
| Loan servicing fees paid to Harris N.A. | 8 | 10 | 24 | 34 |
| Advisory fees paid to Harris N.A. | 34 | 29 | 99 | 86 |
| General and administrative | 46 | 55 | 181 | 248 |
| Total operating expenses | 88 | 94 | 304 | 368 |
| Net income | 4,803 | 5,175 | 14,225 | 12,531 |
| Preferred dividends | 4,609 | 4,609 | 13,828 | 13,828 |
| NET INCOME (LOSS) AVAILABLE TO COMMON STOCKHOLDER | $ 194 | $ 566 | $ 397 | $ (1,297) |
| Basic and diluted earnings (loss) per common share | $194.00 | $566.00 | $397.00 | $(1,297.00) |
| Net income | $ 4,803 | $ 5,175 | $14,225 | $ 12,531 |
| Other comprehensive income (loss) -- net unrealized gains/ (losses) on available-for-sale securities | (4,776) | 8,139 | (7,018) | (1,198) |
| Comprehensive income | $ 27 | $13,314 | $ 7,207 | $ 11,333 |

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



HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDER'S EQUITY
(UNAUDITED)

| | NINE MONTHS ENDED SEPTEMBER 30, | |
|---|---|---|
| | 2005 | 2004 |
| | (IN THOUSANDS, EXCEPT PER SHARE DATA) | |
| Balance at January 1 | $488,888 | $494,234 |
| Net income | 14,225 | 12,531 |
| Other comprehensive loss | (7,018) | (1,198) |
| Dividends -- common stock | -- | (904) |
| Dividends (preferred stock $0.4609 per share) | (13,828) | (13,828) |
| Balance at September 30 | $482,267 | $490,835 |

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



HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

| | NINE MONTHS ENDED SEPTEMBER 30, 2005 | 2004 |
|---|---|---|
| | (IN THOUSANDS) | |
| OPERATING ACTIVITIES: | | |
| Net Income | $ 14,225 | $ 12,531 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Loss (gain) on sale of securities | 548 | (862) |
| Decrease (increase) in other assets | 58 | (574) |
| Net decrease in accrued expenses | (76) | (42) |
| Net cash provided by operating activities | 14,755 | 11,053 |
| INVESTING ACTIVITIES: | | |
| Net increase in securities purchased from Harris N.A. under agreement to resell | (1,500) | (4,500) |
| Repayments of notes receivable from Harris N.A. | 2,785 | 3,589 |
| Decrease in securing mortgage collections due from Harris N.A. | 78 | 293 |
| Purchases of securities available-for-sale | (173,541) | (573,977) |
| Proceeds from sales of securities available-for-sale | -- | 35,170 |
| Proceeds from maturities of securities available-for-sale | 171,579 | 572,406 |
| Net cash (used) provided by investing activities | (599) | 32,981 |
| FINANCING ACTIVITIES: | | |
| Cash dividends paid on preferred stock | (13,828) | (13,828) |
| Cash dividends paid on common stock | -- | (904) |
| Net cash used by financing activities | (13,828) | (14,732) |
| Net increase in cash on deposit with Harris N.A. | 328 | 29,302 |
| Cash on deposit with Harris N.A. at beginning of period | 407 | 926 |
| Cash on deposit with Harris N.A. at end of period | $ 735 | $ 30,228 |
| NON CASH TRANSACTION | | |
| Unsettled security purchase | $ -- | $ 29,991 |

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



HARRIS PREFERRED CAPITAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

Harris Preferred Capital Corporation (the "Company") is a Maryland corporation whose principal business objective is to acquire, hold, finance and manage qualifying real estate investment trust ("REIT") assets (the "Mortgage Assets"), consisting of a limited recourse note or notes (the "Notes") issued by Harris N.A. (the "Bank") secured by real estate mortgage assets (the "Securing Mortgage Loans") and other obligations secured by real property, as well as certain other qualifying REIT assets, primarily U.S. treasury securities and securities collateralized with real estate mortgages. The Company holds its assets through a Maryland real estate investment trust subsidiary, Harris Preferred Capital Trust. Harris Capital Holdings, Inc., owns 100% of the Company's common stock. The Bank owns all common stock outstanding issued by Harris Capital Holdings, Inc.

The accompanying consolidated financial statements have been prepared by management from the books and records of the Company. These statements reflect all adjustments and disclosures which are, in the opinion of management, necessary for a fair presentation of the results for the interim periods presented and should be read in conjunction with the notes to financial statements included in the Company's 2004 Form 10-K. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission.

2. COMMITMENTS AND CONTINGENCIES

Legal proceedings in which the Company is a defendant may arise in the normal course of business. There is no pending litigation against the Company.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### FORWARD-LOOKING INFORMATION

The statements contained in this Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding the Company's expectation, intentions, beliefs or strategies regarding the future. Forward-looking statements include the Company's statements regarding tax treatment as a real estate investment trust, liquidity, provision for loan losses, capital resources and investment activities. In addition, in those and other portions of this document, the words "anticipate," "believe," "estimate," "expect," "intend" and other similar expressions, as they relate to the Company or the Company's management, are intended to identify forward-looking statements. Such statements reflect the current views of the Company with respect to future events and are subject to certain risks, uncertainties and assumptions. It is important to note that the Company's actual results could differ materially from those described herein as anticipated, believed, estimated or expected. Among the factors that could cause the results to differ materially are the risks discussed in the "Risk Factors" section included in the Company's Registration Statement on Form S-11 (File No. 333-40257), with respect to the Preferred Shares declared effective by the Securities and Exchange Commission on February 5, 1998. The Company assumes no obligation to update any such forward-looking statement.

### RESULTS OF OPERATIONS

### THIRD QUARTER 2005 COMPARED WITH THIRD QUARTER 2004

The Company's net income for the third quarter of 2005 was $4.8 million. This represented a 7% decrease from third quarter 2004 earnings of $5.2 million.

Interest income on securities purchased under agreement to resell for the third quarter 2005 was $432 thousand and yielded 4.05% on $43 million of average outstanding balance for the quarter compared to $152





thousand and a 1.36% yield on $44 million average outstanding balance for the third quarter 2004. Third quarter 2005 interest income on the Notes totaled $158 thousand and yielded 6.4% on $9.9 million of average principal outstanding for the quarter compared to $214 thousand and a 6.4% yield on $13.5 million average principal outstanding for third quarter 2004. 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 third quarter 2005 and 2004 was $12 million and $17 million, respectively. Interest income on securities available-for-sale, including mortgage-backed and U.S. Treasury securities, for the current quarter was $4.5 million resulting in a yield of 4.31% on an average balance of $415 million, compared to $4.4 million with a yield of 4.28% on an average balance of $415 million for the same period a year ago.

There were no Company borrowings during third quarter 2005 or 2004.

Third quarter 2005 operating expenses totaled $88 thousand, a decrease of $6 thousand or 6% from the third quarter of 2004. Loan servicing expenses totaled $8 thousand, a decrease of $2 thousand from a year ago. This decrease is attributable to the reduction in the principal balance of the Notes, thereby reducing servicing fees payable to the Bank. Advisory fees for the third quarter 2005 were $34 thousand compared to $29 thousand a year earlier. The increase is partially due to increased internal processing costs. General and administrative expenses totaled $46 thousand, a decrease of $9 thousand over the same period in 2004 as a result of lower legal, processing, recordkeeping and administration costs.

At September 30, 2005 and 2004, there were no Securing Mortgage Loans on nonaccrual status.

NINE MONTHS ENDED SEPTEMBER 30, 2005 COMPARED WITH SEPTEMBER 30, 2004

The Company's net income for the nine months ended September 30, 2005 was $14.2 million. This represented a $1.7 million increase or 14% from 2004 earnings. Earnings increased primarily because of the increase in the overall yield on earning assets.

Interest income on securities purchased under agreement to resell for the nine months ended September 30, 2005 was $883 thousand with a yield of 3.28% on an average outstanding balance of $36 million compared to $935 thousand with a yield of 1.21% on an average outstanding balance of $103 million. Interest income on the Notes for the nine months ended September 30, 2005 totaled $514 thousand and yielded 6.4% on $11 million of average principal outstanding compared to $708 thousand of income yielding 6.4% on $15 million of average principal outstanding for the same period in 2004. The decrease in income was attributable to a reduction in the Note balance because of customer payoffs on the Securing Mortgage Loans. The average outstanding balance of the Securing Mortgage Loans was $13 million for the nine months ended September 30, 2005 and $18 million for the same period in 2004. There were no Company borrowings during either period. Interest income on securities available-for-sale for the nine months ended September 30, 2005 was $13.7 million resulting in a yield of 4.3% on an average balance of $428 million, compared to $10.4 million resulting in a yield of 4.3% on an average balance of $323 million a year ago. The increase in interest income from available-for-sale securities is primarily attributable to the growth of the portfolio.

Operating expenses for the nine months ended September 30, 2005 totaled $304 thousand, a decrease of $64 thousand from a year ago. Loan servicing expenses for the nine months ended September 30, 2005 totaled $24 thousand, a decrease of $10 thousand or 29% from 2004. This decrease is attributable to the reduction in the principal balance of the Notes because servicing costs vary directly with these balances. Advisory fees for the nine months ended September 30, 2005 were $99 thousand compared to $86 thousand a year ago; primarily attributable to increased internal costs for processing, recordkeeping and administration. General and administrative expenses totaled $181 thousand, a decrease of $67 thousand or 27% over the same period in 2004 as a result of reduced costs for insurance, compliance, printing and processing.

On September 30, 2005, the Company paid a cash dividend of $0.46094 per share on outstanding preferred shares to the stockholders of record on September 15, 2005, as declared on August 30, 2005. On September 30, 2004, the Company paid a cash dividend of $0.46094 per share on outstanding preferred shares to the





stockholders of record on September 15, 2004, as declared on September 2, 2004. There were no common stock dividends paid in 2005 for the year ended December 31, 2004, as there were no earnings available after payment of the preferred dividends. On September 13, 2004, the Company paid a cash dividend of $904 thousand on the outstanding common shares to the stockholder of record on September 6, 2004, as declared on September 2, 2004. This latter dividend completed the 2003 REIT tax compliance requirements. On a year to date basis, the Company declared and paid $13.8 million of dividends to holders of preferred shares for the nine-months ended September 20, 2005 and 2004, respectively.

At September 30, 2005, net unrealized losses on available-for-sale securities were $8.3 million compared to $1.1 million of net unrealized gains at September 30, 2004 and $1.3 million of net unrealized losses at December 31, 2004. The unrealized loss positions at September 30, 2005 and December 31, 2004 were attributed to changes in interest rates and not to lowered credit quality of individual securities and therefore management believes these losses are temporary.

## LIQUIDITY RISK MANAGEMENT

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

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

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

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

As presented in the accompanying Consolidated Statements of Cash Flows, the primary sources of funds in addition to $14.8 million provided from operations during the nine months ended September 30, 2005 were $2.8 million provided by principal repayments on the Notes and $171.6 million from the maturities of securities available-for-sale. In the prior period ended September 30, 2004, the primary sources of funds other than $11.1 million from operations were $3.6 million provided by principal repayments on the Notes and $607.6 million from the maturities and sales of securities available-for-sale. The primary uses of funds for the nine months ended September 30, 2005 were $173.5 million for purchases of securities available-for-sale and $13.8 million in preferred stock dividends paid. For the prior year's nine-month period ended September 30, 2004, the primary uses of funds were $574.0 million for purchases of securities available-for-sale, $13.8 million in preferred stock dividends paid and $904 thousand in common stock dividends paid.

MARKET RISK MANAGEMENT

The Company's market risk is composed primarily of interest rate risk. There have been no material changes in market risk or the manner in which the Company manages market risk since December 31, 2004.





OTHER MATTERS

As of September 30, 2005, the Company believes that it is in full compliance with the REIT tax rules, and expects to qualify as a non-taxable REIT under the provisions of the Internal Revenue Code. The Company expects to meet all REIT requirements regarding the ownership of its stock and anticipates meeting the annual distribution requirements.

FINANCIAL STATEMENTS OF HARRIS N.A.

The following unaudited financial information for the Bank is included because the Company's preferred shares are automatically exchangeable for a new series of preferred stock of the Bank upon the occurrence of certain events.

On May 27, 2005, Harris Bankcorp, Inc., the Bank's parent company, consolidated twenty-six of its separate bank subsidiaries in Illinois (including Harris Trust and Savings Bank, the parent company of Harris Capital Holdings, Inc. at that date) into one national bank, Harris N.A. Each outstanding share of the Company's Series A Preferred Stock became automatically exchangeable for one newly issued preferred share of Harris N.A. under the same exchange conditions previously in existence for preferred shares of Harris Trust and Savings Bank, except that the primary regulator for purposes of the exchange conditions will be the Office of the Comptroller of the Currency, not the Board of Governors of the Federal Reserve Bank. References herein to the "Bank" for those times prior to the charter consolidation are intended to refer to Harris Trust and Savings Bank.

Financial statements are presented for the Bank using the historical cost basis for all combining entities, similar to pooling-of-interests accounting. Results for prior periods have been restated assuming the combination had taken place before the earliest period presented.

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HARRIS N.A. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CONDITION
(UNAUDITED)

| | SEPTEMBER 30 2005 | DECEMBER 31 2004 | SEPTEM 20 |
|---|---|---|---|
| | (IN THOUSANDS EXCEPT SHARE DATA | | |
| ASSETS | | | |
| Cash and demand balances due from banks | $ 941,387 | $ 947,580 | $ 78 |
| Money market assets: | | | |
| Interest-bearing deposits at banks | 908,992 | 662,366 | 50 |
| Federal funds sold | 480,282 | 94,950 | 12 |
| Securities available-for-sale (including $3.50 billion, $4.27 billion, and $4.19 billion of securities pledged as collateral for repurchase agreements at September 30, 2005, December 31, 2004 and September 30, 2004, respectively) | 6,837,032 | 7,154,743 | 7,20 |
| Trading account assets | 118,133 | 90,130 | 7 |
| Loans | 22,303,452 | 20,218,993 | 19,49 |
| Allowance for loan losses | (306,875) | (316,575) | (29 |
| Net loans | 21,996,577 | 19,902,418 | 19,19 |
| Premises and equipment | 405,274 | 455,211 | 45 |
| Bank-owned insurance | 1,104,840 | 1,072,660 | 1,06 |
| Loans held for sale | 53,436 | 43,423 | 4 |
| Goodwill and other intangible assets | 294,824 | 306,760 | 31 |
| Other assets | 713,466 | 594,225 | 73 |
| TOTAL ASSETS | $33,854,243 | $31,324,466 | $30,50 |
| LIABILITIES | | | |
| Deposits in domestic offices -- noninterest-bearing | $ 5,467,795 | $5,372,605 | $ 5,68 |
| -- interest-bearing | 16,546,030 | 15,646,690 | 15,55 |
| Deposits in foreign offices -- interest-bearing | 1,773,507 | 1,677,428 | 1,30 |
| Total deposits | 23,787,332 | 22,696,723 | 22,54 |
| Federal funds purchased and securities sold under agreement to repurchase | 3,519,496 | 4,613,046 | 3,62 |
| Short-term borrowings | 2,127,898 | 120,795 | 10 |
| Short-term senior notes | 200,000 | 200,000 | 40 |
| Accrued interest, taxes and other expenses | 243,205 | 227,679 | 23 |
| Other liabilities | 487,509 | 289,131 | 43 |
| Minority interest-preferred stock of subsidiary | 250,000 | 250,000 | 25 |
| Preferred stock issued to Harris Bankcorp, Inc. | -- | 5,000 | |
| Long-term notes -- subordinated | 542,750 | 292,750 | 29 |
| TOTAL LIABILITIES | 31,158,190 | 28,695,124 | 27,89 |

| | | | |
|---|---|---|---|
| STOCKHOLDER'S EQUITY | | | |
| Common stock ($10 par value); 40,000,000 shares authorized, 13,487,257 shares issued and outstanding................. | 134,873 | 134,873 | 13 |
| Surplus................................................ | 1,064,540 | 1,061,314 | 1,05 |
| Retained earnings...................................... | 1,556,197 | 1,477,163 | 1,45 |
| Accumulated other comprehensive loss...................... | (59,557) | (44,008) | (3 |
| TOTAL STOCKHOLDER'S EQUITY............................ | 2,696,053 | 2,629,342 | 2,60 |
| TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY............. | $33,854,243 | $31,324,466 | $30,50 |

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

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HARRIS N.A. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

| | QUARTER ENDED SEPTEMBER 30 | | NINE MONTHS ENDED SEPTEMBER 30 | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| | (IN THOUSANDS) | | | |
| INTEREST INCOME | | | | |
| Loans............................................ | $304,518 | $238,767 | $ 858,200 | $692,6 |
| Money market assets: | | | | |
| Deposits at banks................................ | 2,580 | 1,663 | 7,147 | 3,4 |
| Federal funds sold and securities purchased under agreement to resell............................ | 2,535 | 898 | 5,702 | 2,8 |
| Trading accounts................................... | 1,268 | 632 | 3,845 | 1,6 |
| Securities available-for-sale: | | | | |
| U.S. Treasury and federal agency.................. | 46,462 | 28,300 | 118,816 | 102,9 |
| State and municipal............................... | 5,078 | 4,816 | 14,345 | 14,5 |
| Other............................................. | 3,999 | 3,393 | 12,608 | 6,8 |
| Total interest income............................. | 366,440 | 278,469 | 1,020,663 | 824,8 |
| INTEREST EXPENSE | | | | |
| Deposits............................................ | 115,546 | 63,285 | 304,615 | 178,8 |
| Short-term borrowings............................... | 48,337 | 12,937 | 112,100 | 33,6 |
| Senior notes........................................ | 1,786 | 1,202 | 7,673 | 2,6 |
| Minority interest-dividends on preferred stock of subsidiary.......................................... | 4,610 | 4,610 | 13,828 | 13,8 |
| Long-term notes..................................... | 5,744 | 1,302 | 10,325 | 6,5 |
| Total interest expense............................ | 176,023 | 83,336 | 448,541 | 235,5 |
| NET INTEREST INCOME................................. | 190,417 | 195,133 | 572,122 | 589,3 |
| Provision for loan losses (reduction in allowance).... | 3,001 | (22,526) | 6,442 | 4,5 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES... | 187,416 | 217,659 | 565,680 | 584,8 |

| | | | | |
|---|---|---|---|---|
| NONINTEREST INCOME | | | | |
| Trust and investment management fees.................. | 22,562 | 22,355 | 69,655 | 68,6 |
| Money market and bond trading......................... | 1,920 | 4,382 | 7,052 | 10,0 |
| Foreign exchange...................................... | 1,720 | 1,440 | 4,360 | 4,6 |
| Service charges and fees.............................. | 31,769 | 32,949 | 94,096 | 98,6 |
| Net securities gains (losses)......................... | (178) | 494 | (258) | 25,9 |
| Bank-owned insurance.................................. | 12,064 | 9,918 | 32,190 | 30,4 |
| Gains from loan restructuring......................... | -- | -- | -- | 7,1 |
| Foreign fees.......................................... | 4,672 | 5,868 | 15,160 | 17,9 |
| Other................................................. | 21,932 | 24,359 | 81,030 | 87,0 |
| Total noninterest income........................... | 96,461 | 101,765 | 303,285 | 350,4 |
| NONINTEREST EXPENSES | | | | |
| Salaries and other compensation....................... | 85,375 | 94,466 | 265,245 | 277,2 |
| Pension, profit sharing and other employee benefits... | 26,603 | 26,127 | 80,170 | 79,7 |
| Net occupancy......................................... | 19,130 | 14,831 | 53,921 | 46,1 |
| Equipment............................................. | 13,507 | 13,934 | 40,188 | 42,1 |
| Marketing............................................. | 8,930 | 10,655 | 27,726 | 28,7 |
| Communication and delivery............................ | 6,203 | 6,074 | 16,754 | 17,7 |
| Expert services....................................... | 7,535 | 6,958 | 19,508 | 19,2 |
| Contract programming.................................. | 10,833 | 9,454 | 24,914 | 23,0 |
| Intercompany service charge........................... | 14,710 | 13,699 | 31,703 | 21,8 |
| Other................................................. | 28,422 | 20,074 | 77,471 | 71,5 |
| | 221,248 | 216,272 | 637,600 | 627,3 |
| Amortization of intangibles........................... | 4,071 | 4,097 | 12,217 | 12,3 |
| Total noninterest expenses......................... | 225,319 | 220,369 | 649,817 | 639,7 |
| Income before income taxes............................ | 58,558 | 99,055 | 219,148 | 295,5 |
| Applicable income taxes............................... | 15,352 | 33,319 | 65,052 | 96,9 |
| NET INCOME......................................... | $ 43,206 | $ 65,736 | $ 154,096 | $198,5 |

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

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HARRIS N.A. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)

| | QUARTER ENDED SEPTEMBER 30 | | NINE MONTHS ENDED SEPTEMBER 30 | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| | (IN THOUSANDS) | | | |
| Net income........................................ | $ 43,206 | $65,736 | $154,096 | $198,572 |
| Other comprehensive income (loss): | | | | |
| Cash flow hedges: | | | | |
| Net unrealized loss on derivative instruments, | | | | |

| | | | | |
|---|---|---|---|---|
| net of tax (benefit) for the quarter of ($6,203) in 2005 and zero in 2004 and net of tax (benefit) for the year-to-date period of ($6,743) in 2005 and ($540) in 2004......... | (10,563) | 1 | (11,482) | (920) |
| Minimum pension liability adjustment net of tax expense for the quarter of zero in 2005 and 2004 and net of tax expense for the year-to-date period of zero in 2005 and $2,290 in 2004....................................... | -- | -- | -- | (2,490) |
| Unrealized gains (losses) on available-for-sale securities: | | | | |
| Unrealized holding gains (losses) arising during the period, net of tax expense (benefit) for the quarter of ($6,193) in 2005 and $11,657 in 2004 and net of tax expense (benefit) for the year-to-date period of ($2,304) in 2005 and ($22,815) in 2004....... | (11,488) | 17,471 | (4,225) | (35,986) |
| Less reclassification adjustment for realized (gains) losses included in income statement, net of tax (benefit) expense for the quarter of ($69) in 2005 and $150 in 2004 and net of tax (benefit) expense for the year-to-date period of ($100) in 2005 and $10,126 in 2004....................................... | 109 | (303) | 158 | (15,792) |
| Other comprehensive income (loss)................ | (21,942) | 17,169 | (15,549) | (55,188) |
| Comprehensive income.............................. | $ 21,264 | $82,905 | $138,547 | $143,384 |

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



HARRIS N.A. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDER'S EQUITY
(UNAUDITED)

| | 2005 | 2004 |
|---|---|---|
| | (IN THOUSANDS) | |
| BALANCE AT JANUARY 1....................................... | $2,629,342 | $2,521,778 |
| Net income............................................... | 154,096 | 198,572 |
| Contributions to capital................................. | 3,226 | 9,788 |
| Contribution of parent's banking assets.................. | -- | 36,556 |
| Dividend of non-bank subsidiary.......................... | -- | (5,357) |
| Adjustment of prior quarters' preferred dividends......... | -- | 767 |
| Dividends -- preferred stock............................. | (62) | (86) |
| Dividends -- common stock................................ | (75,000) | (98,000) |
| Other comprehensive loss................................. | (15,549) | (55,188) |
| BALANCE AT SEPTEMBER 30.................................... | $2,696,053 | $2,608,830 |

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



HARRIS N.A. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

| | NINE MONTHS ENDED SEPTEMBER 30 | |
|---|---|---|
| | 2005 | 2004 |
| | (IN THOUSANDS) | |
| OPERATING ACTIVITIES: | | |
| Net Income | $ 154,096 | $ 198,572 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 6,442 | 4,509 |
| Depreciation and amortization, including intangibles | 54,270 | 59,883 |
| Deferred tax benefit | (5,621) | (2,167) |
| Net loss (gain) on sales of securities | 258 | (25,918) |
| Increase in bank-owned insurance | (32,180) | (29,628) |
| Trading account net cash sales | 134,334 | 127,835 |
| Net (increase) decrease in interest receivable | (21,025) | 5,751 |
| Net increase (decrease) in interest payable | 17,683 | (6,554) |
| Net (increase) decrease in loans held for sale | (10,013) | 122,466 |
| Other, net | (20,503) | 88,104 |
| Net cash provided by operating activities | 277,741 | 542,853 |
| INVESTING ACTIVITIES: | | |
| Net decrease in interest-bearing deposits at banks | (246,626) | (84,419) |
| Net increase in Federal funds sold and securities purchased under agreement to resell | (385,332) | (35,828) |
| Proceeds from sales of securities available-for-sale | 136,560 | 2,586,808 |
| Proceeds from maturities of securities available-for-sale | 4,302,643 | 4,430,077 |
| Purchases of securities available-for-sale | (4,165,081) | (5,977,497) |
| Net increase in loans | (2,117,373) | (1,530,968) |
| Purchases of premises and equipment | (44,273) | (65,834) |
| Other, net | 107,580 | 2,139 |
| Net cash used by investing activities | (2,411,902) | (675,522) |
| FINANCING ACTIVITIES: | | |
| Cash received in contribution of parent's banking assets | -- | 3,380 |
| Net increase in deposits | 1,044,415 | 795,026 |
| Net decrease in Federal funds purchased and securities sold under agreement to repurchase | (1,093,550) | (1,021,308) |
| Net increase (decrease) in other short-term borrowings | 2,007,103 | (35,729) |
| Proceeds from issuance of senior notes | 1,400,000 | 1,780,000 |
| Repayment of senior notes | (1,150,000) | (1,380,000) |
| Proceeds from issuance of long-term notes | -- | 206,250 |
| Repayment of long-term notes | -- | (225,000) |

| | | |
|---|---|---|
| Cash dividends paid on common stock | (75,000) | (98,000) |
| Cash portion of dividend of non-bank subsidiary | -- | (5,076) |
| Retirement of preferred stock | (5,000) | -- |
| Net cash provided by financing activities | 2,127,968 | 19,543 |
| NET DECREASE IN CASH AND DEMAND BALANCES DUE FROM BANKS | (6,193) | (113,126) |
| CASH AND DEMAND BALANCES DUE FROM BANKS AT JANUARY 1 | 947,580 | 902,404 |
| CASH AND DEMAND BALANCES DUE FROM BANKS AT SEPTEMBER 30 | $ 941,387 | $ 789,278 |

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

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HARRIS N.A. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

Harris N.A. (the "Bank") is a wholly-owned subsidiary of Harris Bankcorp, Inc. ("Bankcorp"), a wholly-owned subsidiary of Harris Financial Corp., a wholly-owned subsidiary of Bank of Montreal. The consolidated financial statements of the Bank include the accounts of the Bank and its wholly-owned subsidiaries. Significant intercompany accounts and transactions have been eliminated. Certain reclassifications were made to conform prior year's financial statements to the current year's presentation.

On May 27, 2005 Bankcorp consolidated 26 of its individually chartered bank subsidiaries (including Harris Trust and Savings Bank) into one national bank, Harris N.A. The combination was recorded at historical carrying value and prior year financial statements have been restated. Harris N.A. is subject to regulation by the Office of the Comptroller of the Currency.

The consolidated financial statements have been prepared by management from the books and records of the Bank, without audit by independent certified public accountants. However, these statements reflect all adjustments and disclosures which are, in the opinion of management, necessary for a fair presentation of the results for the interim periods presented.

Because the results of operations are so closely related to and responsive to changes in economic conditions, the results for any interim period are not necessarily indicative of the results that can be expected for the entire year.

2. LEGAL PROCEEDINGS

The Bank and certain of its subsidiaries are defendants in various legal proceedings arising in the normal course of business. In the opinion of management, based on the advice of legal counsel, the ultimate resolution of these matters will not have a material adverse effect on the Bank's consolidated financial position.

3. CASH FLOWS

For purposes of the Bank's Consolidated Statements of Cash Flows, cash and cash equivalents is defined to include cash and demand balances due from banks. Cash interest payments for the nine months ended September 30 totaled $430.8 million and $241.5 million in 2005 and 2004, respectively. Cash income tax payments over the same periods totaled $56.6 million and $41.1 million, respectively.

4. GOODWILL AND OTHER INTANGIBLE ASSETS

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

The carrying value of the Bank's goodwill was $214 million at both September 30, 2005 and 2004, respectively. No impairment was recorded during the quarter ended September 30, 2005.

Other than goodwill, the Bank's intangible assets were all subject to amortization as of September 30, 2005 and 2004.





As of September 30, 2005, the gross carrying amount and accumulated amortization of the Bank's amortizable intangible assets are included in the following table.

| | SEPTEMBER 30, 2005 | | SEPTEMBER 30, | |
|---|---|---|---|---|
| | | | 2005 | 20 |
| | GROSS CARRYING AMOUNT | ACCUMULATED AMORTIZATION | NET CARRYING VALUE | NE CARR VAL |
| | (IN THOUSANDS) | | | |
| Branch network........................... | $145,000 | $ (89,417) | $55,583 | $65, |
| Core deposits............................ | 53,161 | (27,825) | 25,336 | 31, |
| Total finite life intangibles........... | $198,161 | $(117,242) | $80,919 | $97, |

Total amortization expense for the Bank's intangible assets was $4.1 million for each of the quarters ended September 30, 2005 and September 30, 2004.

Estimated intangible asset amortization expense (assuming the current level of intangible assets) for the years ending December 31, 2005, 2006, 2007, 2008 and 2009 is $16.3 million, $16.3 million, $16.2 million, $16.2 million and $13.3

million, respectively.

5. SALE OF BUILDING

On March 1, 2005, the Bank sold to a third party the land and building located at 111 W. Monroe Street in Chicago. Upon sale, the Bank entered into a leaseback agreement for approximately 50 percent of the building space with an average lease term of 16 years. The leaseback agreement meets the criteria to be recorded as an operating lease. The sale resulted in a gain of $55.8 million, all of which was deferred and will be amortized over the term of the leaseback.

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HARRIS N.A. AND SUBSIDIARIES

FINANCIAL REVIEW

THIRD QUARTER 2005 COMPARED WITH THIRD QUARTER 2004

SUMMARY

The Bank had third quarter 2005 net income of $43.2 million, a decrease of $22.5 million or 34 percent from third quarter 2004. ROE was 6.33 percent in the current quarter, compared to 10.14 percent from last year's third quarter. ROA was 0.52 percent compared to 0.87 percent a year ago.

Third quarter net interest income on a fully taxable equivalent basis was $196.2 million, down $3.2 million or 2 percent from $199.4 million in 2004's third quarter. Average earning assets increased 10 percent to $32.00 billion from $29.11 billion in 2004, due in part to an increase of $2.1 billion in average loans. Net interest margin decreased to 2.39 percent in the current quarter from 2.64 percent in the year-ago quarter, primarily reflecting a flat yield curve depressing spreads and the impact of greater reliance on higher-cost wholesale funding sources. This was somewhat offset by strong loan growth, particularly in the retail loan portfolio.

The third quarter 2005 provision for loan losses was $3.0 million, an increase of $25.5 million compared to the negative provision of $22.5 million in the third quarter of 2004. Net charge-offs decreased to $5.1 million from $7.5 million in the prior year. The increase in provision was primarily attributable to the reduction in the allowance for loan losses recognized a year ago to reflect a very healthy credit environment that has somewhat diminished currently.

Third quarter noninterest income of $96.5 million decreased $5.3 million or 5 percent from the same quarter last year. Money market and bond trading income decreased by $2.5 million, letter of credit fees declined by $1.2 million and service charges and fees decreased $1.2 million.

Third quarter 2005 noninterest expenses of $225.3 million increased $5.0 million from the year ago quarter. The increase was attributable to occupancy costs rising by $4.3 million, higher contract programming costs of $1.4 million and additional expenses for outsourced administrative and technology activities of $1.0 million. The increases were partially offset by lower salary and marketing expenses. Income tax expense decreased $18.0 million, reflecting lower pretax income from year ago results.

Nonperforming assets at September 30, 2005 were $145 million or 0.65 percent of total loans, down from $146 million or 0.68 percent at June 30, 2005, and $152 million or 0.78 percent a year ago. At September 30, 2005, the allowance for possible loan losses was $307 million, equal to 1.38 percent of loans outstanding, compared to $300 million or 1.54 percent of loans outstanding at the end of third quarter 2004. As a result, the ratio of the allowance for possible loan losses to nonperforming assets increased from 197 percent at September 30, 2004 to 212 percent at September 30, 2005.

At September 30, 2005, Tier 1 capital of the Bank amounted to $2.68 billion, up from $2.56 billion one year earlier. The regulatory leverage capital ratio was 8.12 percent for the third quarter of 2005 compared to 8.57 percent in the same quarter of 2004. The Bank's capital ratio exceeds the prescribed regulatory minimum for banks. The Bank's September 30, 2005 Tier 1 and total risk-based capital ratios were 9.26 percent and 11.34 percent compared to respective ratios of 9.89 percent and 12.18 percent at September 30, 2004.

NINE MONTHS ENDED SEPTEMBER 30, 2005 COMPARED WITH NINE MONTHS ENDED SEPTEMBER 30, 2004

SUMMARY

The Bank had net income for the nine months ended September 30, 2005 of $154.1 million, a decrease of $44.5 million or 22 percent from the same period a year ago. ROE was 7.72 percent, down from 10.34 percent last year. ROA was 0.63 percent currently compared to 0.88 percent in the first nine months of 2004.

Net interest income on a fully taxable equivalent basis was $587.9 million, down $15.8 million or 3 percent from $603.7 million in 2004's year-to-date period. Average earning assets increased 7 percent to $31.62 billion from $29.48 billion in 2004. Net interest margin decreased to 2.42 percent from 2.66 percent in 2004, reflecting a





flat yield curve reducing spreads and the impact of substantially higher rates on wholesale funds. This was somewhat offset by strong growth in the retail loan base.

The year-to-date 2005 provision for loan losses of $6.4 million was up $1.9 million from $4.5 million in 2004. Net charge-offs were $16.1 million, a decrease of $13.5 million from last year, resulting from lower commercial loan write-offs. The increase in provision was primarily attributable to the reduction in the allowance for loan losses recorded in 2004.

Noninterest income of $303.3 million decreased $47.1 million or 13 percent from the same period last year. This was largely due to a reduction in gains from sales of securities amounting to $26.2 million, a $7.1 million gain realized in 2004 by the Bank on the sale of assets received in an earlier troubled debt restructuring and a $7.7 million gain realized in 2004 by the Bank on the termination of a swap. Service fees and charges also decreased by $4.5 million, mortgage origination fees decreased $4.9 million and money market and bond trading income decreased $3.0 million. This was somewhat offset by higher ATM and debit card fees of $3.0 million and commissions of $3.0 million.

Noninterest expenses of $649.8 million increased $10.1 million or 2 percent from the year-ago period. The increase was attributable to expenses for outsourced administrative and technology activities of $9.9 million, occupancy costs related to the sale of a major building in 2005 rising by $7.8 million and higher contract programming costs of $1.9 million, partially offset by lower salary expense of $12.1 million. Income tax expense decreased $31.9 million, reflecting lower pretax income from year-ago results.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

ITEM 4. CONTROLS AND PROCEDURES

As of September 30, 2005, 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 recorded, processed, summarized and made known to them in a timely fashion, as appropriate to allow timely discussion regarding disclosures. There was no change in the Company's internal control over financial reporting identified in connection with such evaluations that occurred during the quarter ended September 30, 2005 that has materially affected or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

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

ITEM 6. EXHIBITS

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

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

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



SIGNATURES

Pursuant to the requirements 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 14th day of November 2005.

/s/ PAUL R. SKUBIC

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Paul R. Skubic
Chief Executive Officer

/s/ JANINE MULHALL

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Janine Mulhall
Chief Financial Officer