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HARRIS PREFERRED CAPITAL CORP
Form 10-K
March 26, 2003

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

2002
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, 2002

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

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Indicate by check mark whether the registrant is an accelerated filer (as defined in rule 12b-2 of the Act). Yes [] No [X]

The number of shares of Common Stock, \$1.00 par value, outstanding on March 26, 2003 was 1,000.

HARRIS PREFERRED CAPITAL CORPORATION

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PART I

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

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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% (95% for years prior to January 1, 2001) 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. Except upon the occurrence of certain events, the Preferred Shares are not redeemable by the Company prior to March 30, 2003. On or after such date, 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 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.

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

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 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. At December 31, 2002, the Bank indirectly owned 100% of the Common Stock of the Company.

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.

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.

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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.

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,

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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, 2002 and 2001 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 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

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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, 2002 and 2001 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, 2002 the Company held \$20 million of short-term money market assets and \$80 million of U.S. Treasury securities. At December 31, 2001 the Company held \$21 million of short-term money market assets and \$85 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 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

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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.

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

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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 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 Agreements in effect in 2002, 2001 and 2000 entitled the Bank to receive advisory fees of \$43,000, \$35,000, and \$57,000 respectively. In 2003, advisory fees are estimated to be \$45,000.

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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

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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, 2002, the Company had no employees paid directly by the Company. 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 2002 as well as 2001 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 cents per Preferred Share were paid in 2002 and 2001. A cash dividend on common stock of \$3.1 million was declared on December 4, 2002 to the stockholder of record on December 15, 2002 and paid on December 27, 2002. A cash dividend on common stock of \$14.3 million was declared on December 4, 2001 to the stockholder of record on December 15, 2001 and paid on December 31, 2001. In addition, on September 12, 2002 and 2001 the Company paid a cash dividend of \$130 thousand and \$346 thousand, respectively, on the outstanding common shares to the stockholder of record on September 4, 2002 and 2001, respectively. These dividends were paid on the Company's 2001 and 2000 earnings.

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ITEM 2. PROPERTIES

None as of December 31, 2002.

ITEM 3. LEGAL PROCEEDINGS

The Company is not currently involved in any material litigation nor, to

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the Company's knowledge is any material litigation currently threatened against the Company, the Bank or any affiliate of the Bank other than routine litigation arising in the ordinary course of business. See Note 8 to Financial Statements on page 31.

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 2002.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY AND RELATED SECURITY HOLDER MATTERS

HCH presently owns all 1,000 shares of the common stock of the Company, which are not listed or traded on any securities exchange. On December 4, 2002, the Company declared \$3.1 million in cash dividends on common stock, which were paid in December 2002. On December 4, 2001, the Company declared \$14.3 million in cash dividends on common stock, which were paid in December 2001. In addition, on September 12, 2002 and 2001, the Company paid a cash dividend of \$130 thousand and \$346 thousand, respectively, on the outstanding common shares to the stockholder of record on September 4, 2002, and September 4, 2001, respectively. These dividends were paid on the Company's 2001 and 2000 earnings.

The Preferred Shares are traded on the New York Stock Exchange under the symbol "HBC Pr A". During 2002 and 2001, 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 2002 and 2001, 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% (95% for years prior to January 1, 2001) 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 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				JANUARY 2, (INCEPTION THROUGH DECEMBER 31, -----
	2002	2001	2000	1999	
(IN THOUSANDS, EXCEPT PER SHARE DATA)					
Statement of Operations Data:					
Interest income.....	\$ 19,934	\$ 28,715	\$ 32,312	\$ 31,588	\$ 27,46
Noninterest income.....	2,677	4,796	257	--	-
Operating expenses:					
Loan Servicing fee.....	131	243	373	511	75

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Advisory fee.....	43	35	57	50	4
General and administrative.....	314	300	290	300	18
	-----	-----	-----	-----	-----
Total operating expenses.....	488	578	720	861	98
	-----	-----	-----	-----	-----
Net income.....	22,123	32,933	31,849	30,727	26,48
Preferred stock dividends.....	18,438	18,438	18,438	18,438	16,38
	-----	-----	-----	-----	-----
Net income available to common stockholder.....	\$ 3,685	\$ 14,495	\$ 13,411	\$ 12,289	\$ 10,09
	=====	=====	=====	=====	=====
Basic and diluted net income per common share.....	\$ 3,685	\$ 14,495	\$ 13,411	\$ 12,289	\$ 10,09
	=====	=====	=====	=====	=====
Distributions per preferred share.....	\$ 1.8438	\$ 1.8438	\$ 1.8438	\$ 1.8438	\$ 1.638
	=====	=====	=====	=====	=====
Balance Sheet Data (end of period):					
Total assets.....	\$502,042	\$489,342	\$489,939	\$473,988	\$ 503,39
	=====	=====	=====	=====	=====
Total liabilities.....	\$ 96	\$ 100	\$ 115	\$ 97	\$ 9,76
	=====	=====	=====	=====	=====
Total stockholders' equity.....	\$501,946	\$489,242	\$489,824	\$473,891	\$ 493,62
	=====	=====	=====	=====	=====
Cash Flows Data:					
Operating activities.....	\$ 19,440	\$ 28,736	\$ 31,638	\$ 30,821	\$ 23,89
	=====	=====	=====	=====	=====
Investing activities.....	\$ 2,440	\$ 4,035	\$ (419)	\$ 10,290	\$ (497,62
	=====	=====	=====	=====	=====
Financing activities.....	\$ (21,658)	\$ (33,084)	\$ (31,662)	\$ (40,470)	\$ 474,34
	=====	=====	=====	=====	=====

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

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

SUMMARY

YEAR ENDED DECEMBER 31, 2002 COMPARED TO YEAR ENDED DECEMBER 31, 2001

The Company's net income for 2002 was \$22.1 million. This represented a \$10.8 million or 33% decrease from 2001 net income of \$32.9 million. Earnings decreased primarily because of reduced interest income on earning assets. In addition, gains on securities sales declined from \$4.8 million in 2001 to \$2.7 million in 2002.

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Interest income on the Notes for 2002 totaled \$2.8 million and yielded 6.4% on \$43 million of average principal outstanding compared to \$5.2 million and a 6.4% yield on \$81 million average principal outstanding for 2001. 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 was \$53 million for 2002 and \$99 million for 2001. Interest income on securities available-for-sale for 2002 was \$15.1 million, resulting in a yield of 4.9% on an average balance of \$309 million compared to \$21.9 million with a yield of 6.1% on an average balance of \$363 million for 2001. The decrease in interest income on securities available-for-sale was primarily attributable to a reduction in yield. As

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securities matured or were sold, proceeds have been invested in lower yielding securities as a result of declining interest rates. Gains from investment securities sales were \$2.7 million in 2002 and \$4.8 million in 2001.

There were no Company borrowings during either year.

Operating expenses for the year ended December 31, 2002 totaled \$488 thousand; a decrease of \$90 thousand from the year ended December 31, 2001. Loan servicing expenses for 2002 totaled \$131 thousand, a decrease of \$112 thousand or 46% from 2001. This decrease was attributed to the reduction in the principal balance of the Notes because servicing costs vary directly with their balances. Advisory fees for the year ended December 31, 2002 were \$43 thousand compared to \$35 thousand for the same period a year ago. General and administrative expenses for the same period totaled \$314 thousand, an increase of \$14 thousand or 5 % from 2001, as a result of additional reporting and compliance costs.

On December 30, 2002, the Company paid a cash dividend of \$0.46094 cents per share on the outstanding Preferred Shares to the stockholders of record on December 15, 2002 as declared on December 4, 2002. On December 30, 2001, the Company paid a cash dividend of \$0.46094 cents per share on the outstanding Preferred Shares to the stockholders of record on December 15, 2001 as declared on December 4, 2001. Annually the Company declared and paid \$18.4 million of dividends to holders of Preferred Shares for both 2002 and 2001. A cash dividend on common stock of \$3.1 million was declared on December 4, 2002 to the stockholder of record on December 15, 2002 and paid on December 27, 2002. A cash dividend on common stock of \$14.3 million was declared on December 4, 2001 to the stockholder of record on December 15, 2001 and paid on December 31, 2001. In addition, on September 12, 2002 and September 12, 2001 the Company paid a cash dividend of \$130 thousand and \$346 thousand, respectively, on the outstanding common shares to the stockholder of record on September 4, 2002 and December 30, 2000, respectively. These dividends completed the Company's 2001 and 2000 REIT tax compliance requirements.

At December 31, 2002 and 2001, there were no Securing Mortgage Loans on nonaccrual status and there was no allowance for loan losses.

YEAR ENDED DECEMBER 31, 2001 COMPARED TO YEAR ENDED DECEMBER 31, 2000

The Company's net income for 2001 was \$32.9 million. This represented a \$1.1 million or 3% increase from 2000 net income of \$31.8 million.

Interest income on the Notes for 2001 totaled \$5.2 million and yielded 6.4% on \$81 million of average principal outstanding compared to \$7.8 million and a 6.4% yield on \$122 million average principal outstanding for 2000. 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 \$99 million for 2001 and \$151 million for 2000. Interest income on securities available-for-sale for 2001 was \$21.9 million, resulting in a yield of 6.1% on an average balance of \$363 million compared to \$22.6 million with a yield of 6.9% on an average balance of \$328 million for 2000. 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 \$4.8 million in 2001 and \$257 thousand in 2000.

There were no Company borrowings during either year.

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Operating expenses for the year ended December 31, 2001 totaled \$578 thousand; a decrease of \$142 thousand from the year ended December 31, 2000. Loan servicing expenses for 2001 totaled \$243 thousand, a decrease of \$130 thousand or 35% from 2000. This decrease was attributed to the reduction in the principal balance of the Notes. Advisory fees for the year ended December 31, 2001 were \$35 thousand compared to \$57 thousand in 2000. General and administrative expenses for the same period totaled \$300 thousand, an increase of \$10 thousand or 3% from 2000.

QUARTER ENDED DECEMBER 31, 2002 COMPARED TO QUARTER ENDED DECEMBER 31, 2001

The Company's net income for the fourth quarter of 2002 was \$4.7 million compared to \$5.5 million in the fourth quarter of 2001. Earnings decreased primarily because of reduced interest income on earning assets.

Fourth quarter 2002 interest income on the Notes totaled \$550 thousand and yielded 6.4% on \$34 million of average principal outstanding compared to interest income of \$1.0 million and a 6.4% yield on \$65 million average principal outstanding for the fourth quarter of 2001. 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 2002 and 2001 was \$42 million and \$79 million, respectively. Interest income on securities available-for-sale for the current quarter was \$3.9 million resulting in a yield of 4.1% on an average balance of \$379 million, compared to interest income of \$4.3 million with a yield of 4.8% on an average balance of \$363 million for the same period a year ago. The decrease in interest income is primarily attributable to the reduction in yield. As securities mature or are sold, proceeds have been invested in lower yielding securities because market interest rates have been declining.

There were no Company borrowings during the fourth quarter of 2002 or 2001.

Fourth quarter 2002 operating expenses totaled \$175 thousand, a decrease of \$23 thousand from the fourth quarter of 2001. Loan servicing expenses totaled \$26 thousand, a decrease of \$22 thousand or 46% from the prior year's fourth quarter, attributed to the reduction in the principal balance of the Notes, thereby reducing servicing fees payable to the Bank. Advisory fees for both 2002 and 2001 were \$8 thousand. General and administrative expenses totaled \$141 thousand in the current quarter, a decrease of \$1 thousand from fourth quarter 2001.

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.

CONCENTRATIONS OF CREDIT RISK

A majority of the collateral underlying the Securing Mortgage Loans is located in Illinois and Arizona. The financial viability of customers in these states is, in part, dependent on the states' economies. 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 and Arizona fail to perform according to contract terms and all collateral prove to be worthless, was approximately \$26 million and \$7 million, respectively at December 31, 2002 and \$46 million and \$12 million, respectively, at December 31, 2001.

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INTEREST RATE RISK

The Company's income consists primarily of interest payments on the Mortgage Assets it holds. If there is a decline in interest rates during a period of time when the Company must reinvest receipts of interest and principal with respect to its Mortgage Assets, the Company may find it difficult to purchase additional Mortgage Assets that generate sufficient income to support payment of dividends on the Preferred Shares.

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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 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% (95% for years prior to January 1, 2001) of its adjusted REIT ordinary taxable income through 2002, 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

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sources of funds in addition to \$19.4 million provided from operations during 2002 were \$24.9 million provided by principal payments on the Notes and \$822.3 million from the maturities and sales of securities available-for-sale. In 2001, the primary sources of funds other than from operations of \$28.7 million were \$47.0 million provided by principal payments on the Notes and \$874.9 million from the maturities of securities available-for-sale. The primary uses of funds for 2002 were \$848.2 million in purchases of securities available-for-sale and \$18.4 and \$3.2 million in preferred stock dividends and common stock dividends paid, respectively. In 2001 the primary uses of funds were \$897.2 million in purchases of securities available-for-sale and \$18.4 and \$14.6 million in preferred stock dividends and common stock dividends paid, respectively.

ACCOUNTING PRONOUNCEMENTS

The Company 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. The Company does not expect the implementation of this Statement to have a material effect on its financial position or results of operations.

The Company 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

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standard, most acquisitions of financial institutions are removed from the scope of SFAS No. 72 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 is accounted for under SFAS No. 142. The Company does not expect the implementation of this Statement to have a material effect on its financial position or results of operations.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." The Statement addresses financial accounting and reporting for costs associated with exit or disposal activities and requires that liabilities for those costs be recognized when the liability is incurred, as defined in Concepts Statement 6. It nullifies Emerging Issues Task Force (EITF) Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." The Statement is effective for exit or disposal activities initiated after December 31, 2002. The Company does not expect the implementation of this Statement to have a material effect on its financial position or results of operations.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation -- Transition and Disclosure -- an amendment of FASB Statement No. 123." The Statement provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based compensation and requires additional disclosures in annual and interim financial statements. The disclosure requirements are effective for financial statements for fiscal years ending after December 15, 2002. During the first quarter of 1996, the Company adopted SFAS No. 123 and elected the fair value based method of accounting for stock-based compensation plans. 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

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As of December 31, 2002, 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, 2002, the Company had \$31 million invested in Notes, a decrease of \$25 million from December 31, 2001, attributable to principal paydowns by customers in the Securing Mortgage Loans. At December 31, 2002, the Company holds \$365 million in mortgage-backed securities compared to \$320 million at December 31, 2001. At December 31, 2002 the Company holds \$80 million in U.S. Treasuries compared to \$85 million at December 31, 2001. At December 31, 2002, the Company holds an investment of \$20 million in securities purchased from the Bank under agreement to resell compared to \$21 million at December 31, 2001. 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.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Refer to the Index to Financial Statements on page 21 for the required information.

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

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

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE COMPANY

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,

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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.....	54	Chairman of the Board, President
Pamela C. Piarowski.....	43	Chief Financial Officer
Frank M. Novosel.....	56	Treasurer, Director
Teresa L. Patton.....	55	Vice President of Operations
Margaret M. Sulkin.....	44	Assistant Treasurer
Delbert J. Wacker.....	71	Director
David J. Blockowicz.....	60	Director
Forrest M. Schneider.....	55	Director

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.

Ms. Piarowski has been Senior Vice President and Chief Financial Officer of Harris Bankcorp, Inc. since June 2001. From June 1995 to that time she held several positions in the Bank's finance group, including Vice President and Corporate Controller. From 1989 to 1995, Ms. Piarowski was with the Chicago Branch of Bank of Montreal. Before joining Bank of Montreal, Ms. Piarowski was employed by Coopers & Lybrand. She is a certified public 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.

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Ms. Patton has been a Vice President in Residential Mortgages at the Bank for 15 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 25 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 Peat Marwick 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,

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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 Guidicie 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 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 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.

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 attendance (in person or by telephone) at each meeting of the Board of Directors.

ITEM 11. EXECUTIVE COMPENSATION

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

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ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

(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.

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(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.

TITLE OF CLASS -----	NAME OF BENEFICIAL OWNER -----	AMOUNT OF BENEFICIAL OWNERSHIP -----
Preferred Stock.....	Paul R. Skubic	300 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.

As described on page 3 of this Report, 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 2002, the Company received repayments on the Notes of \$25 million compared to 2001 repayments of \$47 million. In years ended December 31, 2002, 2001 and 2000, the Bank paid interest on the Notes in the amount of \$2.8 million, \$5.2 million and \$7.8 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, 2002, the Company held \$20 million of such assets and had earned \$2.1 million of interest from the Bank during 2002. At December 31, 2001, the Company held \$21 million of such assets and earned \$1.6 million of interest for 2001. At December 31, 2002, the Company held \$3 thousand of such assets and earned \$1.9 million of interest for 2000. The Company receives rates on these assets comparable to the rates that the Bank offers to unrelated counterparties under similar circumstances.

During 2002 and 2001, the Company acquired \$253 million and \$273 million, respectively, of GNMA securities at fair value from the Bank. During 2002 and 2001, the Company acquired \$595 million and \$624 million of U.S. Treasury securities at fair value from the Bank.

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 2002, the Bank received payments of \$131 thousand and \$43 thousand, respectively, compared to \$243 thousand and \$35 thousand for 2001, in 2000 the Bank received payments of \$373 thousand and \$57 thousand, 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, Pamela C. Piarowski, Frank M. Novosel, Teresa L. Patton and Margaret M. Sulkin, are also officers of the Bank.

(C) INDEBTEDNESS OF MANAGEMENT

None.

ITEM 14. CONTROL AND PROCEDURES

Within 90 days prior to the filing of this report, Paul R. Skubic, the Chairman of the Board, Chief Executive Officer and President of the Company, and Pamela C. Piarowski, 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 were no significant changes in the Company's internal controls or in other factors that could significantly affect these internal controls subsequent to the date of their evaluation, including any corrective action with regard to significant deficiencies and material weaknesses.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(a) Documents filed with Report:

(1) Financial Statements (See page 21 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
24	Power of attorney
99.1	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.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, Harris Preferred Capital Corporation has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized on the 26th day of March 2003.

/s/ PAUL R. SKUBIC

Paul R. Skubic
Chairman of the Board and President

/s/ PAMELA C. PIAROWSKI

Pamela C. Piarowski
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 21st day of March 2003.

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 2003.

CERTIFICATIONS

HARRIS PREFERRED CAPITAL CORPORATION

I, Paul R. Skubic, certify that:

1. I have reviewed this annual report on Form 10-K of Harris Preferred Capital Corporation;

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of Harris Preferred Capital Corporation as of, and for, the periods presented in this annual report;

4. Harris Preferred Capital Corporation's other certifying officer and

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I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for Harris Preferred Capital Corporation and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to Harris Preferred Capital Corporation, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of Harris Preferred Capital Corporation's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and

c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. Harris Preferred Capital Corporation's other certifying officer and I have disclosed, based on our most recent evaluation, to Harris Preferred Capital Corporation's auditors and the audit committee of Harris Preferred Capital Corporation's board of directors:

a) all significant deficiencies in the design or operation of internal controls which could adversely affect Harris Preferred Capital Corporation's ability to record, process, summarize and report financial data and have identified for Harris Preferred Capital Corporation's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in Harris Preferred Capital Corporation's internal controls; and

6. Harris Preferred Capital Corporation's other certifying officer and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date:

/s/ Paul R. Skubic

Chairman of the Board and President

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CERTIFICATIONS

HARRIS PREFERRED CAPITAL CORPORATION

I, Pamela C. Piarowski, certify that:

1. I have reviewed this annual report on Form 10-K of Harris Preferred Capital Corporation;

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period

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covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of Harris Preferred Capital Corporation as of, and for, the periods presented in this annual report;

4. Harris Preferred Capital Corporation's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for Harris Preferred Capital Corporation and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to Harris Preferred Capital Corporation, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

b) evaluated the effectiveness of Harris Preferred Capital Corporation's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and

c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. Harris Preferred Capital Corporation's other certifying officer and I have disclosed, based on our most recent evaluation, to Harris Preferred Capital Corporation's auditors and the audit committee of Harris Preferred Capital Corporation's board of directors:

a) all significant deficiencies in the design or operation of internal controls which could adversely affect Harris Preferred Capital Corporation's ability to record, process, summarize and report financial data and have identified for Harris Preferred Capital Corporation's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in Harris Preferred Capital Corporation's internal controls; and

6. Harris Preferred Capital Corporation's other certifying officer and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date:

/s/ Pamela C. Piarowski

Chief Financial Officer

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INDEX TO FINANCIAL STATEMENTS

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

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HARRIS PREFERRED CAPITAL CORPORATION

Financial Statements

Report of Independent Accountants

Balance Sheets

Statements of Operations and Comprehensive Income

Statements of Changes in Stockholders' Equity

Statements of Cash Flows

Notes to Financial Statements

HARRIS TRUST AND SAVINGS BANK

Financial Review

Financial Statements

Joint Independent Auditors

Report of Independent Accountants

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 Financial Statements

All other 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 financial statements and notes hereof.

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REPORT OF INDEPENDENT ACCOUNTANTS

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

In our opinion, the accompanying balance sheets and the related 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") at December 31, 2002 and 2001, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2002 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

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auditing standards generally accepted in the United States of America, which 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
PricewaterhouseCoopers LLP

January 10, 2003
Chicago, Illinois

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HARRIS PREFERRED CAPITAL CORPORATION BALANCE SHEETS

	DECEMBER 31	
	2002	2001
	(IN THOUSANDS, EXCEPT SHARE DATA)	
ASSETS		
Cash on deposit with Harris Trust and Savings Bank.....	\$ 728	\$ 506
Securities purchased from Harris Trust and Savings Bank under agreement to resell.....	20,000	21,000
Notes receivable from Harris Trust and Savings Bank.....	31,078	55,962
Securities available-for-sale:		
Mortgage-backed.....	365,383	319,644
U.S. Treasury.....	79,976	84,932
Securing mortgage collections due from Harris Trust and Savings Bank.....	2,930	5,353
Other assets.....	1,947	1,945
	-----	-----
TOTAL ASSETS.....	\$502,042	\$489,342
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accrued expenses.....	\$ 96	\$ 100
	-----	-----
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
Earnings in excess of distributions.....	850	385
Accumulated other comprehensive income -- net unrealized gains (losses) on available-for-sale securities.....	10,362	(1,877)
	-----	-----
TOTAL STOCKHOLDERS' EQUITY.....	501,946	489,242
	-----	-----

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TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY.....	\$502,042	\$489,342
	=====	=====

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

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HARRIS PREFERRED CAPITAL CORPORATION

STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME

	FOR THE YEARS ENDED DECEMBER 31		
	2002	2001	2000
	(IN THOUSANDS, EXCEPT SHARE DATA)		
INTEREST INCOME:			
Securities purchased from Harris Trust and Savings Bank under agreement to resell.....	\$ 2,063	\$ 1,566	\$ 1,907
Notes receivable from Harris Trust and Savings Bank.....	2,776	5,208	7,807
Securities available-for-sale:			
Mortgage-backed.....	14,693	20,828	22,287
U.S. Treasury.....	402	1,113	311
	-----	-----	-----
Total interest income.....	19,934	28,715	32,312
NON-INTEREST INCOME:			
Gain on sale of securities.....	2,677	4,796	257
	-----	-----	-----
	2,677	4,796	257
OPERATING EXPENSES:			
Loan servicing fees paid to Harris Trust and Savings Bank.....	131	243	373
Advisory fees paid to Harris Trust and Savings Bank.....	43	35	57
General and administrative.....	314	300	290
	-----	-----	-----
Total operating expenses.....	488	578	720
Net income.....	22,123	32,933	31,849
Preferred dividends.....	18,438	18,438	18,438
	-----	-----	-----
NET INCOME AVAILABLE TO COMMON STOCKHOLDER.....	\$ 3,685	\$ 14,495	\$ 13,411
	=====	=====	=====
Basic and diluted earnings per common share.....	\$3,685.00	\$14,495.00	\$13,411.00
	=====	=====	=====
Net income.....	\$ 22,123	\$ 32,933	\$ 31,849
Other comprehensive income/(loss) -- net unrealized gains/(losses) on available-for-sale securities.....	12,239	(431)	15,746
	-----	-----	-----
Comprehensive income.....	\$ 34,362	\$ 32,502	\$ 47,595
	=====	=====	=====

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

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HARRIS PREFERRED CAPITAL CORPORATION

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

	PREFERRED STOCK	COMMON STOCK	ADDITIONAL PAID-IN CAPITAL	EARNINGS IN EXCESS OF DISTRIBUTIONS	ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)
	-----	-----	-----	-----	-----
(IN THOUSANDS EXCEPT PER SHARE DATA)					
BALANCE AT DECEMBER 31, 1999...	\$250,000	\$ 1	\$240,733	\$ 349	\$ (17,192)
Net income.....	--	--	--	31,849	--
Other comprehensive income...	--	--	--	--	15,746
Dividends declared on common stock (\$13,224.00 per share).....	--	--	--	(13,224)	--
Dividends declared on preferred stock (\$1.8438 per share).....	--	--	--	(18,438)	--
BALANCE AT DECEMBER 31, 2000...	=====	===	=====	=====	=====
Net income.....	--	--	--	32,933	--
Other comprehensive loss.....	--	--	--	--	(431)
Dividends declared on common stock (\$14,646.00 per share).....	--	--	--	(14,646)	--
Dividends declared on preferred stock (\$1.8438 per share).....	--	--	--	(18,438)	--
BALANCE AT DECEMBER 31, 2001...	=====	===	=====	=====	=====
Net income.....	--	--	--	22,123	--
Other comprehensive income...	--	--	--	--	12,239
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	\$ 10,362

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

HARRIS PREFERRED CAPITAL CORPORATION
STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31

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	2002	2001	2000
	-----	-----	-----
	(IN THOUSANDS)		
OPERATING ACTIVITIES:			
Net income.....	\$ 22,123	\$ 32,933	\$ 31,849
Adjustments to reconcile net income to net cash provided by operating activities:			
Gain on sale of securities.....	(2,677)	(4,796)	(257)
Net (increase) decrease in other assets.....	(2)	614	28
Net (decrease) increase in accrued expenses.....	(4)	(15)	18
	-----	-----	-----
Net cash provided by operating activities.....	19,440	28,736	31,638
	-----	-----	-----
INVESTING ACTIVITIES:			
Net decrease (increase) in securities purchased from Harris Trust and Savings Bank under agreement to resell.....	1,000	(18,000)	12,000
Repayments of notes receivable from Harris Trust and Savings Bank.....	24,884	46,998	33,789
Decrease (increase) in securing mortgage collections due from Harris Trust and Savings Bank.....	2,423	(2,567)	339
Purchases of securities available-for-sale.....	(848,215)	(897,270)	(169,678)
Proceeds from maturities and sales of securities available-for-sale.....	822,348	874,874	123,131
	-----	-----	-----
Net cash provided by/(used in) investing activities.....	2,440	4,035	(419)
	-----	-----	-----
FINANCING ACTIVITIES:			
Cash dividends paid on preferred stock.....	(18,438)	(18,438)	(18,438)
Cash dividends paid on common stock.....	(3,220)	(14,646)	(13,224)
	-----	-----	-----
Net cash used by financing activities.....	(21,658)	(33,084)	(31,662)
	-----	-----	-----
Net increase (decrease) in cash on deposit with Harris Trust and Savings Bank.....	222	(313)	(443)
Cash on deposit with Harris Trust and Savings Bank at beginning of period.....	506	819	1,262
	-----	-----	-----
Cash on deposit with Harris Trust and Savings Bank at end of period.....	\$ 728	\$ 506	\$ 819
	=====	=====	=====

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

HARRIS PREFERRED CAPITAL CORPORATION

NOTES TO 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

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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 Internal Revenue 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 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 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

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, 2002 and 2001, 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 Internal Revenue 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 Internal Revenue Code of 1986, as amended, 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 starting in calendar year 2001.

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 securities gains, 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 receivables in the balance sheets. Securities purchased under agreement to resell totaled \$20 million at December 31, 2002 compared to \$21 million at December 31, 2001. 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 sheets.

NEW ACCOUNTING PRONOUNCEMENTS

The Company 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. The Company does not expect the implementation of this Statement to have a material effect on its financial position or results of operations.

The Company 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 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 is accounted for under SFAS No. 142. The Company does not expect the implementation of this Statement to have a material effect on its financial position or results of operations.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." The Statement addresses financial accounting and reporting for costs associated with exit or disposal activities and requires that liabilities for those costs be recognized when the liability

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is incurred, as defined in Concepts Statement 6. It nullifies Emerging Issues Task Force (EITF) Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." The Statement is effective for exit or disposal activities initiated after December 31, 2002. The Company does not expect the implementation of this Statement to have a material effect on its financial position or results of operations.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation -- Transition and Disclosure -- an amendment of FASB Statement No. 123." The Statement provides

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alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based compensation and requires additional disclosures in annual and interim financial statements. The disclosure requirements are effective for financial statements for fiscal years ending after December 15, 2002. 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 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.

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 2002, the Company received repayments on the Notes of \$25 million compared to 2001 repayments of \$47 million. For years ended December 31, 2002, 2001 and 2000, the Bank paid interest on the Notes in the amount of \$2.8 million, \$5.2 million and \$7.8 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 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.

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The balance of Securing Mortgage Loans at December 31, 2002 and 2001 was \$39 million and \$70 million, respectively. The weighted average interest rate on those loans at December 31, 2002 and 2001 was 6.930% and 7.611%, respectively.

None of the Securing Mortgage Loans collateralizing the Notes were on nonaccrual status at December 31, 2002 or 2001.

A majority of the collateral securing the underlying mortgage loans is located in Illinois and Arizona. The financial viability of customers in these states is, in part, dependent on those states' economies. The Company's maximum risk of accounting loss, should all customers in Illinois and Arizona fail to perform according to contract terms and all collateral prove to be worthless, was approximately \$26 million and \$7 million, respectively, at December 31, 2002 and \$46 million and \$12 million, respectively, as of December 31, 2001.

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4. SECURITIES

	DECEMBER 31, 2002				DECEMBER 31, 2001	
	AMORTIZED COST	UNREALIZED GAINS	UNREALIZED LOSSES	FAIR VALUE	AMORTIZED COST	UNREALIZED GAINS
	(IN THOUSANDS)					
Available-for-Sale Securities						
Mortgage-backed.....	\$355,018	\$10,365	\$--	\$365,383	\$321,516	\$33,869
U.S. Treasury.....	\$ 79,979	\$ --	\$ 3	\$ 79,976	\$ 84,937	\$ --
	-----	-----	---	-----	-----	-----
Total Securities.....	\$434,997	\$10,365	\$ 3	\$445,359	\$406,453	\$33,869
	=====	=====	===	=====	=====	=====

Mortgage-backed securities include ("GNMA") Government National Mortgage Association Platinum Certificates and Federal National Mortgage Association ("Fannie Mae"). The contractual maturities of the mortgage-backed securities exceed ten years. 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, 2002 mature within the next twelve months.

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. Except upon the occurrence of certain events, the Preferred Shares are not redeemable by the Company prior to March 30, 2003. On or after such date, the Preferred Shares will be 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

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rights. The Preferred Shares are automatically exchangeable for a new series of preferred stock of the Bank upon the occurrence of certain events.

Holder 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, 2002 and 2001 were \$18,438,000 in both years. The allocations of the distributions declared and paid for income tax purposes for December 31, 2002 and 2001 were 90% of ordinary income and 10% of long-term capital gain and 88% of ordinary income and 12% of long term 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 dividends have been paid. A Common Stock dividend of \$3,090 per common share was declared on December 4, 2002, to the stockholder of record on December 15, 2002 and paid on December 27, 2002. The allocations of the distribution declared and paid for income tax purposes were 90% of ordinary income and 10% of long-term capital gain. A Common Stock dividend of \$14,300 per common share was declared on December 4, 2001, to the stockholder of record on December 15, 2001 and paid on December 31, 2001. The allocations of the distribution declared and paid for income tax purposes were 88% of ordinary income and 12% of long-term capital gain. In addition, on September 12, 2002 and September 12, 2001, the Company paid a cash dividend of \$130 thousand and \$346 thousand, respectively, on the outstanding common shares to the stockholder of record on September 4, 2002 and September 4, 2001, respectively. These dividends were paid on the Company's 2001 and 2000 REIT ordinary taxable income.

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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 during 2002, 2001 and 2000 entitled the Bank to receive advisory fees of \$43,000, \$35,000 and \$57,000, respectively. For 2003, advisory fees are estimated to be \$45,000.

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 2002, 2001 and 2000 the Bank received payments of \$131 thousand, \$243 thousand and \$373 thousand, respectively.

The Company purchases U.S. Treasury and Federal agency securities from the

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Bank under agreements to resell identical securities. At December 31, 2002, the Company held \$20 million of such assets and had earned \$2.1 million of interest from the Bank during 2002. At December 31, 2001 the Company held \$21 million of such assets and earned \$1.6 million of interest for 2001. At December 31, 2000, the Company held \$3 thousand of such assets and earned \$1.9 million of interest from the Bank. The Company receives rates on these assets comparable to the rates that the Bank offers to unrelated counterparties under similar circumstances.

During 2002 and 2001, the Company acquired \$253 million and \$273 million, respectively, of GNMA and Fannie Mae securities at fair value from the Bank. During 2002 and 2001, the Company acquired \$595 million and \$624 million of U.S. Treasury securities at fair value from the Bank.

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.

8. COMMITMENTS AND CONTINGENCIES

Legal proceedings in which the Company is a defendant may arise in the normal course of business. At December 31, 2002 and 2001, 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, 2002				YEAR ENDED DEC	
	FIRST QUARTER	SECOND QUARTER	THIRD QUARTER	FOURTH QUARTER	FIRST QUARTER	SECOND QUARTER
	(IN THOUSANDS EXCEPT PER SHARE DATA)					
Total interest						
income.....	\$ 5,945	\$ 4,686	\$ 4,459	\$4,844	\$ 7,863	\$ 7,724
Total noninterest						
income (loss).....	--	2,695	(17)	(1)	2,203	--
Total operating						
expenses.....	126	101	86	175	160	106
Net income.....	5,819	7,280	4,356	4,668	9,906	7,618
Preferred						
dividends.....	4,609	4,609	4,609	4,611	4,609	4,609
Net income (loss)						
available to common						
stockholder.....	1,210	2,671	(253)	57	5,297	3,009
Basic and diluted						
income (loss) per						
common share.....	\$1,210.00	\$2,671.00	\$(253.00)	\$57.00	\$5,297.00	\$3,009.00

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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. Harris Bankcorp, Inc. is a wholly-owned subsidiary of Bankmont Financial Corp. ("Bankmont"). Harris Bankcorp, Inc. also owns 27 other banks, 26 in the counties surrounding Chicago and one in Arizona. On July 1, 2000, Bankmont contributed 100 percent of the common stock of its wholly-owned subsidiary, Harris Bankmont, Inc., a Chicago metropolitan area multibank holding company, to Harris Bankcorp, Inc. Immediately thereafter, Harris Bankmont, Inc. was liquidated and dissolved into Harris Bankcorp, Inc. under the corporation law of Delaware. Harris Bankcorp, Inc. was the surviving corporation. The assets of Harris Bankmont, Inc. consisted primarily of the stock of its thirteen community banks. This combination was accounted for at historical cost, similar to a pooling of interests. Bankmont is a wholly-owned subsidiary of Bank of Montreal. At December 31, 2002, Harris Bankcorp's assets amounted to \$29.01 billion, with the Bank representing approximately 66 percent of that total.

The Bank, an Illinois state-chartered bank has its principal office, 50 domestic branch offices and 101 automated teller machines located in the Chicago area. The Bank also has offices in Atlanta, Detroit, Los Angeles and San Francisco; a foreign branch office in Nassau; and an Edge Act subsidiary, Harris Bank International Corporation ("HBIC"), engaged in international banking and finance in New York. At December 31, 2002, the Bank had total assets of \$19.03 billion, total deposits of \$11.04 billion, total loans of \$9.61 billion and equity capital of \$1.58 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

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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.

Although primarily focusing on U.S. domestic customers, identifiable foreign assets accounted for 2.94 percent of the Bank's total consolidated assets at December 31, 2002 and foreign net income was approximately 5.37 percent of the Bank's consolidated net income for the year then ended. Foreign net income

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is generated from three primary sources: (i) lending to foreign banks and other financial institutions; (ii) time deposits held in foreign banks; and (iii) foreign exchange trading profits of approximately \$7.2 million.

Corporate Trust Sale

In March 2000, Bankcorp sold its corporate trust business. In separate and unrelated transactions, the indenture trust business was sold to a subsidiary of The Bank of New York Company, Inc., and the shareholder services business to Computershare Limited. The combined sales resulted in a pre-tax gain to Bankcorp of \$47.0 million. The Bank recognized \$45.6 million of that gain. The Bank does not believe that the sale of the corporate trust business will have a material impact on the results of operations for future periods.

Merchant Card Sale

In December 2000, the Bank sold its merchant card business to a credit card processing joint venture (Moneris) formed between Bank of Montreal and Royal Bank of Canada. The sale resulted in a pretax gain to the Bank of \$60.2 million, which was eliminated in the consolidation of the Bank's results with Bank of Montreal. The Bank does not believe that the sale of the merchant card business will have a material impact on the results of operations for future periods.

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

2002 COMPARED TO 2001

Summary

The Bank's 2002 net income was \$171.8 million, up \$89.6 million from 2001. Earnings comparability for 2002 and 2001 was affected by a third quarter 2001

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special provision for loan losses of \$121 million and a special pretax charge of \$3.2 million in the fourth quarter 2001 relating to impairments in the value of certain equity investments. Excluding the effect of these special charges, earnings grew 6 percent over last year. This increase was attributable to continued strong business growth in consumer, mortgage and small business loans and retail deposits, and a reduction in the provision for loan losses and increased earnings from treasury activities. Return on average common equity ("ROE") for 2002 was 11.02 percent and 10.41 percent in 2001 excluding the special charges described above. Return on average assets ("ROA") was 0.95 percent in 2002 and 0.80 percent in 2001 excluding the special charges described above.

Earnings before amortization of goodwill and other valuation intangibles ("cash earnings") were \$181.4 million in 2002, a 3 percent increase compared to 2001, excluding the special charges described above. 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 13.32 percent in 2002 compared to 13.13 percent in 2001, excluding the special charges.

For 2002, net interest income on a fully taxable equivalent basis of \$465.2 million was down 5 percent from 2001. Net interest margin rose from 2.80 percent to 2.99 percent in 2002, reflecting the impact of a declining rate environment during the past year. Average earning assets declined \$1.85 billion million or 11 percent to \$15.58 billion in the current year, attributable to a decrease of \$1.17 billion in investment securities and \$799 million in average loans.

Noninterest income increased \$55.3 million to \$512.5 million for 2002. Excluding the special \$3.2 million writedown of equity securities in 2001, noninterest income increased 11 percent from 2001. Net gains from portfolio securities increased \$25.9 million, service charge fees increased \$19.8 million and trading profits decreased \$9.3 million. Inter-corporate service charges increased \$13.2 million. Trust and investment management fees decreased \$6.0 million.

Total noninterest expenses were \$656.4 million, up \$24.1 million or 4 percent from 2001. Income taxes were \$67.3 million, up \$57.1 million from 2001, reflecting substantially higher pretax income in 2002.

The provision for loan losses was \$71.2 million in 2002 compared to \$203.5 million in 2001. Third quarter 2001 results included a \$121 million special provision for loan losses. Net loan charge-offs during the current year were \$91.6 million compared to \$95.1 million in 2001 reflecting higher recoveries in the commercial loan portfolio.

Nonperforming assets at December 31, 2002 totaled \$172 million, or 1.79 percent of total loans compared to \$205 million or 2.05 percent a year earlier. At December 31, 2002, the allowance for possible loan losses was \$207 million or 2.15 percent of total loans outstanding compared to \$227 million or 2.28 percent of loans at the end of 2000. As a result, the ratio of the allowance for possible loan losses to nonperforming assets increased slightly from a multiple of 1.1 at December 31, 2001 to 1.2 at December 31, 2002.

At December 31, 2002, the Bank's equity capital amounted to \$1.58 billion, up slightly from \$1.56 billion at December 31, 2001. Unrealized securities gains, net of tax, were \$73.0 million at December 31, 2002 compared to \$20.1 million at December 31, 2001. 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 16 to Financial Statements). The preferred stock qualifies as Tier 1 capital for U.S. banking regulatory purposes.

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The Bank's regulatory capital leverage ratio was 8.64 percent compared to 8.23 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, 2002, the Bank's Tier 1 and total risk-based capital ratios were 10.19 percent and 12.50 percent, respectively, compared to respective ratios of 9.80 percent and 12.26 percent at December 31, 2001. The 2002 year-end risk-based capital ratios substantially exceeded minimum required regulatory ratios of 4.0 percent and 8.0 percent, respectively.

2001 COMPARED TO 2000

Summary

The Bank's 2001 net income was \$82.3 million, down \$144.2 million, or 64 percent from 2000. Earnings comparability for 2001 and 2000 was affected by both the sale of the Bank's corporate trust business in first quarter 2000 and the sale of its merchant card business in December 2000. Excluding the effect of the \$45.6 million pretax gain on sale of the corporate trust business and related charges, and the \$60.2 million pretax gain from the sale of the merchant card business and related operating results, year 2000 earnings were \$159.2 million. In addition, the Bank had special charges for 2001, a third quarter special provision for loan losses of \$121 million and a special pretax charge of \$3.2 million in the fourth quarter relating to impairments in the value of certain equity investments. Excluding the effect of these special charges and the impact of divested businesses, earnings were \$167.1 million, representing an increase of 5 percent over 2000. This increase was attributable to continued strong business growth in consumer, mortgage and small business loans and retail deposits, and a more favorable interest rate environment that contributed to greater earnings from treasury and trading activities. These were largely offset by an increased loan loss provision associated with the impact of a weakened economy primarily on the Bank's corporate loan portfolio, and by expenses related to business growth and expansion. Excluding the special charges, gains and related operating results for businesses sold in 2000, return on average common equity ("ROE") for 2001 and 2000 was 10.72 percent and 12.04 percent, respectively. Excluding the special charges described above and gains and related operating results for businesses sold in 2000, return on average assets ("ROA") was 0.82 percent and 0.76 percent, respectively.

Excluding the special charges described above and gains and related operating results for businesses sold in 2000, earnings before amortization of goodwill and other valuation intangibles ("cash earnings") were \$181.3 million in 2001, a 5 percent increase compared to 2000. 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. Excluding the special charges described above and gains and related operating results for businesses sold in 2000, cash ROE was 13.49 percent in 2001 compared to 15.78 percent in 2000.

For 2001, net interest income on a fully taxable equivalent basis of \$487.5 million was up 10 percent from 2000. Net interest margin rose from 2.47 percent to 2.80 percent in 2001, reflecting the impact of a declining rate environment during 2001. Average earning assets declined \$580 million or 3 percent to \$17.43 billion in 2001, attributable to a decrease of 2 percent or \$186 million in average loans and \$532 million in investment securities.

Noninterest income decreased \$60.9 million to \$457.2 million for 2001. Excluding the effect of the special items, gains and operating results from the

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corporate trust and merchant card businesses sold in 2000, noninterest income increased 20 percent from 2000. Net gains from sales of investment securities increased \$20.6 million, trading profits increased \$8.0 million and service charges on deposits increased \$2.4 million. Inter-corporate service charges increased \$32.4 million. Trust and investment management fees decreased \$9.4 million and merchant and charge card fees declined \$21.0 million, both declines resulting from divested businesses in 2000.

Total noninterest expenses were \$632.2 million, up \$44.4 million or 8 percent from 2000. Excluding the expenses associated with businesses sold in 2000, noninterest expenses increased 13 percent, reflecting expansion initiatives in our retail, private client and corporate and investment banking businesses. Income taxes were \$10.2 million, down \$87.1 million from 2000, reflecting substantially lower pretax income in 2001.

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The provision for loan losses was \$203.5 million in 2001, including the \$121 million special provision for loan losses in the third quarter 2001, compared to \$29.7 million in 2000. Net loan charge-offs during 2001 were \$95.1 million compared to \$24.4 million in 2000 reflecting higher write-offs in the commercial loan portfolio.

Nonperforming assets at December 31, 2001 totaled \$205 million, or 2.05 percent of total loans compared to \$101 million or 0.94 percent at December 31, 2000. Most of the increase from December 31, 2000 is comprised of loans to corporate borrowers in different industry sectors experiencing the effects of a weakened economy. At December 31, 2001, the allowance for possible loan losses was \$227 million or 2.28 percent of total loans outstanding compared to \$119 million or 1.10 percent of loans at the end of 2000. As a result, the ratio of the allowance for possible loan losses to nonperforming assets declined slightly from a multiple of 1.2 at December 31, 2000 to 1.1 at December 31, 2001.

At December 31, 2001, the Bank's equity capital amounted to \$1.57 billion, up from \$1.52 billion at December 31, 2000. Unrealized securities gains/(losses), net of tax, were \$20.1 million at December 31, 2001 compared to (\$11) million at December 31, 2000. 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 16 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 8.23 percent compared to 7.40 percent one year earlier. Regulators require most banking institutions to maintain capital leverage ratios of not less than 4.0 percent. At December 31, 2001, the Bank's Tier 1 and total risk-based capital ratios were 9.80 percent and 12.26 percent, respectively, compared to respective ratios of 9.06 percent and 10.98 percent at December 31, 2000. The 2001 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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JOINT INDEPENDENT AUDITORS

The Board of Directors of Harris Trust and Savings Bank engaged the firms of KPMG LLP and PricewaterhouseCoopers LLP to serve as joint auditors for each of the years in the three year period ended December 31, 2002.

The Bank's ultimate parent company, Bank of Montreal ("BMO"), has elected

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to appoint two firms of independent public auditors to be auditors of BMO and all significant subsidiaries. The Bank's independent public auditors reflect the appointments made by BMO.

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 and Subsidiaries as of December 31, 2002 and 2001, 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, 2002. 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, 2002 and 2001, and the results of their operations and their cash flows for each of the years in the three year period ended December 31, 2002 in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to Financial Statements, Harris Trust and Savings Bank and Subsidiaries adopted Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets," on January 1, 2002.

/s/ KPMG LLP

/s/ PRICEWATERHOUSECOOPERS LLP

Chicago, Illinois
January 15, 2003

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FINANCIAL STATEMENTS HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CONDITION

DECEMBER 31

2002 2001

(IN THOUSANDS EXCEPT SHARE
DATA)

ASSETS

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Cash and demand balances due from banks.....	\$ 1,057,254	\$ 1,203,946
Money market assets:		
Interest-bearing deposits at banks.....	417,206	195,723
Federal funds sold and securities purchased under agreement to resell.....	237,950	579,750
Securities available-for-sale (including \$4.39 billion and \$3.21 billion of securities pledged as collateral for repurchase agreements at December 31, 2002 and December 31, 2001, respectively).....	5,781,360	5,822,229
Trading account assets.....	42,423	90,562
Loans.....	9,607,887	9,972,473
Allowance for possible loan losses.....	(206,999)	(227,374)
	-----	-----
Net loans.....	9,400,888	9,745,099
Premises and equipment.....	298,414	287,549
Customers' liability on acceptances.....	16,168	13,365
Bank-owned insurance.....	994,185	952,225
Loans held for sale.....	149,311	121,588
Goodwill and other valuation intangibles.....	187,317	206,119
Other assets.....	444,542	518,016
	-----	-----
TOTAL ASSETS.....	\$19,027,018	\$19,736,171
	=====	=====
LIABILITIES		
Deposits in domestic offices -- noninterest-bearing.....	\$ 2,085,400	\$ 3,170,649
-- interest-bearing.....	7,736,930	6,311,796
Deposits in foreign offices -- noninterest-bearing.....	31,383	38,063
-- interest-bearing.....	1,184,571	1,670,352
	-----	-----
Total deposits.....	11,038,284	11,190,860
Federal funds purchased.....	872,096	857,049
Securities sold under agreement to repurchase.....	4,188,688	3,566,302
Short-term borrowings.....	300,694	704,699
Short-term notes -- senior.....	200,000	860,000
Acceptances outstanding.....	16,168	13,365
Accrued interest, taxes and other expenses.....	153,148	335,931
Other liabilities.....	200,286	167,288
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.....	225,000	225,000
	-----	-----
TOTAL LIABILITIES.....	17,449,364	18,175,494
	-----	-----
STOCKHOLDER'S EQUITY		
Common stock (\$10 par value); 10,000,000 shares authorized, issued and outstanding.....	100,000	100,000
Surplus.....	626,640	620,586
Retained earnings.....	803,249	819,991
Accumulated other comprehensive income.....	47,765	20,100
	-----	-----
TOTAL STOCKHOLDER'S EQUITY.....	1,577,654	1,560,677
	-----	-----
TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY.....	\$19,027,018	\$19,736,171
	=====	=====

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

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CONSOLIDATED STATEMENTS OF INCOME

	FOR THE YEARS ENDED DECEMBER 31		
	2002	2001	2000
	(IN THOUSANDS EXCEPT SHARE DATA)		
INTEREST INCOME			
Loans, including fees.....	\$512,946	\$ 726,403	\$ 905,942
Money market assets:			
Deposits at banks.....	2,066	3,537	5,580
Federal funds sold and securities purchased under agreement to resell.....	7,938	13,672	17,534
Trading account.....	2,031	3,277	3,214
Securities available-for-sale:			
U.S. Treasury and federal agency.....	195,336	340,398	417,577
State and municipal.....	24	99	949
Other.....	2,243	2,128	1,472
Total interest income.....	722,584	1,089,514	1,352,268
INTEREST EXPENSE			
Deposits.....	162,267	339,445	480,551
Short-term borrowings.....	64,262	212,635	362,132
Senior notes.....	12,144	33,997	52,309
Minority interest -- dividends on preferred stock of subsidiary.....	18,438	18,438	18,437
Long-term notes.....	11,257	13,929	15,615
Total interest expense.....	268,368	618,444	929,044
NET INTEREST INCOME.....	454,216	471,070	423,224
Provision for loan losses.....	71,220	203,508	29,689
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES.....	382,996	267,562	393,535
NONINTEREST INCOME			
Trust and investment management fees.....	82,829	88,846	98,226
Money market and bond trading.....	9,347	17,016	9,066
Foreign exchange.....	7,155	8,833	7,225
Merchant and charge card fees.....	--	66	21,025
Service fees and charges.....	118,635	98,823	96,410
Securities gains.....	61,272	35,397	14,780
Gain on sale of corporate trust business.....	--	--	45,615
Gain on sale of merchant card business.....	--	--	60,162
Bank-owned insurance.....	50,713	47,226	45,076
Foreign fees.....	24,399	21,305	20,998
Syndication fees.....	6,289	6,584	8,667
Other.....	151,869	133,089	90,800
Total noninterest income.....	512,508	457,185	518,050
NONINTEREST EXPENSES			
Salaries and other compensation.....	310,116	293,247	272,130
Pension, profit sharing and other employee benefits.....	61,279	51,328	49,833
Net occupancy.....	41,727	34,473	40,281
Equipment.....	53,531	53,329	50,515
Marketing.....	29,165	34,310	28,392

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Communication and delivery.....	22,593	19,992	21,232
Expert services.....	28,328	25,600	21,378
Contract programming.....	29,105	31,479	17,589
Other.....	64,516	64,731	63,774
	-----	-----	-----
	640,360	608,489	565,124
Goodwill and other valuation intangibles.....	16,004	23,752	22,683
	-----	-----	-----
Total noninterest expenses.....	656,364	632,241	587,807
	-----	-----	-----
Income before income taxes.....	239,140	92,506	323,778
Applicable income taxes.....	67,306	10,234	97,334
	-----	-----	-----
NET INCOME.....	\$171,834	\$ 82,272	\$ 226,444
	=====	=====	=====
BASIC EARNINGS PER COMMON SHARE (based on 10,000,000 average shares outstanding)			
Net income.....	\$ 17.18	\$ 8.23	\$ 22.64
	=====	=====	=====

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

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HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

CONSOLIDATED STATEMENTS
OF COMPREHENSIVE INCOME

	FOR THE YEARS ENDED DECEMBER 31		
	2002	2001	2000
	-----	-----	-----
	(IN THOUSANDS)		
NET INCOME.....	\$171,834	\$ 82,272	\$226,444
Other comprehensive income:			
Cash flow hedges:			
Cumulative effect of accounting change.....	--	(7,976)	--
Net unrealized gain on derivative instruments, net of tax expense of zero in 2002, \$4,684 in 2001 and zero in 2000.....	--	7,976	--
Minimum pension liability adjustment net of tax benefit of \$16,618 in 2002 and zero in 2001 and 2000.....	(25,194)	--	--
Unrealized gains on available-for-sale securities:			
Unrealized holding gains arising during period, net of tax expense of \$58,702 in 2002, \$34,589 in 2001 and \$89,016 in 2000.....	90,296	52,388	136,063
Less reclassification adjustment for gains included in net income, net of tax expense of \$23,835 in 2002, \$13,769 in 2001 and \$5,749 in 2000.....	(37,437)	(21,627)	(9,031)
	-----	-----	-----
Other comprehensive income.....	27,665	30,761	127,032
	-----	-----	-----
Comprehensive income.....	\$199,499	\$113,033	\$353,476
	=====	=====	=====

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

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HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

STATEMENTS OF CHANGES IN STOCKHOLDER'S EQUITY

	COMMON STOCK	SURPLUS	RETAINED EARNINGS	ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)	TOTAL STOCKHOLDER'S EQUITY
(IN THOUSANDS EXCEPT PER SHARE DATA)					
BALANCE AT DECEMBER 31, 1999.....	\$100,000	\$610,512	\$ 678,275	\$ (137,693)	\$1,251,099
Contribution to capital surplus	--	2,853	--	--	2,853
Net income.....	--	--	226,444	--	226,444
Dividends -- (\$8.30 per common share).....	--	--	(83,000)	--	(83,000)
Other comprehensive income.....	--	--	--	127,032	127,032
BALANCE AT DECEMBER 31, 2000.....	100,000	613,365	821,719	(10,661)	1,524,423
Contribution to capital surplus	--	7,221	--	--	7,221
Net income.....	--	--	82,272	--	82,272
Dividends -- (\$8.40 per common share).....	--	--	(84,000)	--	(84,000)
Other comprehensive income.....	--	--	--	30,761	30,761
BALANCE AT DECEMBER 31, 2001.....	100,000	620,586	819,991	20,100	1,560,677
Contribution to capital surplus	--	6,054	--	--	6,054
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

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

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HARRIS TRUST AND SAVINGS BANK AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31

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	2002	2001	2000
	-----	-----	-----
	(IN THOUSANDS)		
OPERATING ACTIVITIES:			
Net Income.....	\$ 171,834	\$ 82,272	\$ 226,000
Adjustments to reconcile net income to net cash provided (used) by operating activities:			
Provision for loan losses.....	71,220	203,508	29,000
Depreciation and amortization, including intangibles....	61,892	71,054	70,000
Deferred tax expense (benefit).....	6,435	(24,783)	1,000
Gain on sales of securities.....	(61,272)	(35,397)	(14,000)
Gain on sale of corporate trust business.....	--	--	(45,000)
Gain on sale of merchant card business.....	--	--	(60,000)
Increase in bank-owned insurance.....	(47,046)	(47,162)	(44,000)
Trading account net cash (purchases) sales.....	(35,099)	74,649	1,000
Decrease (increase) in interest receivable.....	19,811	70,082	(18,000)
Decrease in interest payable.....	(22,155)	(18,506)	(18,000)
(Increase) decrease in loans held for sale.....	(27,723)	120,683	(242,000)
Other, net.....	(25,189)	(28,206)	(23,000)
	-----	-----	-----
Net cash provided (used) by operating activities.....	112,708	468,194	(137,000)
	-----	-----	-----
INVESTING ACTIVITIES:			
Net (increase) decrease in interest-bearing deposits at banks.....	(221,483)	(54,375)	98,000
Net decrease (increase) in Federal funds sold and securities purchased under agreement to resell.....	341,800	(88,675)	(193,000)
Proceeds from sales of securities available-for-sale....	2,678,763	1,898,048	662,000
Proceeds from maturities of securities available-for-sale.....	7,453,346	7,707,315	7,017,000
Purchases of securities available-for-sale.....	(9,942,243)	(8,840,451)	(7,690,000)
Net decrease (increase) in loans.....	272,991	701,154	(729,000)
Proceeds from sale of bank premises.....	--	32,276	--
Purchases of premises and equipment.....	(56,753)	(63,106)	(50,000)
Additional investment in bank-owned insurance.....	--	--	(90,000)
Other, net.....	(18,673)	32,448	(19,000)
	-----	-----	-----
Net cash provided (used) by investing activities.....	507,748	1,324,634	(994,000)
	-----	-----	-----
FINANCING ACTIVITIES:			
Net (decrease) increase in deposits.....	(152,576)	(1,302,517)	1,363,000
Net increase (decrease) in Federal funds purchased and securities sold under agreement to repurchase.....	637,433	(185,528)	(130,000)
Net (decrease) increase in other short-term borrowings.....	(404,005)	(785,031)	808,000
Proceeds from issuance of senior notes.....	750,000	2,308,500	3,186,000
Repayment of senior notes.....	(1,410,000)	(1,838,000)	(4,297,000)
Net cash proceeds from sale of corporate trust business.....	--	--	88,000
Proceeds from sale of merchant card business.....	--	--	64,000
Proceeds from the issuance of preferred stock of subsidiary.....	--	5,000	--
Cash dividends paid on common stock.....	(188,000)	(84,000)	(83,000)
	-----	-----	-----
Net cash (used) provided by financing activities.....	(767,148)	(1,881,576)	1,000,000
	-----	-----	-----
Net decrease in cash and demand balances due from banks.....	(146,692)	(88,748)	(130,000)
Cash and demand balances due from banks at January 1....	1,203,946	1,292,694	1,423,000
	-----	-----	-----
Cash and demand balances due from banks at December			

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31.....	\$ 1,057,254	\$ 1,203,946	\$ 1,292,254
	=====	=====	=====
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
Cash paid during the year for:			
Interest (net of amount capitalized).....	\$ 290,524	\$ 636,949	\$ 947,254
Income taxes.....	\$ 67,056	\$ 69,310	\$ 76,310

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

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HARRIS PREFERRED CAPITAL CORPORATION

NOTES TO THE 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 subsidiary of Bankmont Financial Corp. ("Bankmont"), a Delaware corporation which is a wholly-owned subsidiary of Bank of Montreal ("BMO"). Throughout these Notes to 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 22 to the Financial Statements for additional information on business combinations and Note 23 for additional information on related party transactions.

The Bank provides banking, trust and other services domestically and internationally through the main banking facility, 6 active nonbank subsidiaries and an Edge Act subsidiary, Harris Bank International Corporation ("HBIC"), in New York. 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 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, forward, futures, option contracts and swaps are revalued monthly using prevailing market

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rates. Exchange adjustments are included with foreign exchange 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 include futures, forwards, forward rate agreements, option contracts, caps, floors, collars and swaps. Foreign exchange contracts include spot, futures, forwards, option contracts and swaps. Equity contracts include option contracts and swaps. Commodity contracts include swaps.

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

Derivative instruments that are used in the management of the Bank's risk strategy may qualify for hedge accounting if the derivatives are designated as hedges and applicable hedge criteria are met. On the date that the Bank enters into a derivative contract, it designates the derivative as a hedge of the fair 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

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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 only until earnings are recognized from the underlying hedged item. Net gains or losses resulting from hedge ineffectiveness are recorded in current period earnings. Changes in the fair value of a derivative that is highly effective (as defined) and qualifies as a foreign currency hedge are recorded in either current period earnings or other comprehensive income depending on whether the hedging relationship meets the criteria for a fair value or cash flow hedge.

The Bank formally documents all hedging relationships at inception of hedge transactions. The process includes documenting the risk management objective and strategy for undertaking the hedge transaction and identifying the specific derivative instrument and the specific underlying asset, liability, firm commitment or forecasted transaction. The Bank formally assesses, both at inception and on an ongoing quarterly basis, whether the derivative hedging instruments have been highly effective in offsetting changes in the fair value or cash flows of the hedged items and whether the derivatives are expected to remain highly effective in future periods.

Hedge accounting is discontinued prospectively when the Bank determines that the hedge is no longer highly effective, the derivative instrument expires or is sold, terminated or exercised, it is no longer probable that the forecasted transaction will occur, the hedged firm commitment no longer meets the definition of a firm commitment, or the designation of the derivative as a hedging instrument is no longer appropriate.

When hedge accounting is discontinued because a fair value hedge is no longer highly effective, the derivative instrument will continue to be recorded on the balance sheet at fair value but the underlying hedged item will no longer be adjusted for changes in fair value. When hedge accounting is discontinued because the hedged item in a fair value hedge no longer meets the definition of

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a firm commitment, the derivative instrument will continue to be recorded on the balance sheet at fair value and any asset or liability that was recorded to recognize the firm commitment will be removed from the balance sheet and recognized as a gain or loss in current period earnings. When hedge accounting is discontinued because it is no longer probable that the forecasted transaction in a cash flow hedge will occur, the gain or loss on the derivative that was in accumulated other comprehensive income 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 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 Bank adopted Statement of Financial Accounting Standards ("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.

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,

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most acquisitions of financial institutions are removed from the scope of SFAS No. 72 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).

In June 2002, the Financial Accounting Standards Board ("FASB") issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." The Statement addresses financial accounting and reporting for costs associated with exit or disposal activities and requires that liabilities for those costs be recognized when the liability is incurred, as defined in Concepts Statement 6. It nullifies Emerging Issues Task Force ("EITF") Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." The Statement is effective for exit or disposal activities initiated after December 31, 2002. The Bank does not expect the implementation of this Statement to have a material

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effect on its financial position or results of operations.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation -- Transition and Disclosure -- an amendment of FASB Statement No. 123." The Statement provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based compensation and requires additional disclosures in annual and interim financial statements. The disclosure requirements are effective for financial statements for fiscal years ending after December 15, 2002. During the first quarter of 1996, the Bank adopted SFAS No. 123 and elected the fair value based method of accounting for stock-based compensation plans. The Bank does not expect the implementation of this Statement to have a material effect on its financial position or results of operations.

The Bank adopted FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57 and 107 and rescission of FASB Interpretation No. 34" ("FIN 45") issued on November 25, 2002. FIN 45 expands existing disclosure requirements at December 31, 2002 for guarantees and provides initial recognition and measurement provisions to be applied on a prospective basis for guarantees issued or modified after December 31, 2002. Management has evaluated the effect of adopting FIN 45 and has determined that the effect on the financial position and results of operations of the Bank is not material.

In January 2003, the FASB released FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46"). This Interpretation changes the method of determining whether certain entities, including securitization entities, should be consolidated in the Corporation's financial statements. An entity is subject to FIN 46 and is called a variable interest entity ("VIE") if it has (1) equity that is insufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, or (2) equity investors that cannot make decisions about the entity's operations, or that do not absorb the expected losses or receive the expected returns of the entity. A VIE is consolidated by its primary beneficiary, which is the party involved with the VIE that has a majority interest in the expected losses or the expected residual returns or both. The Bank does not have an interest in a VIE and is not subject to the provisions of FIN 46.

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

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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.

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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 on commercial loans, loan commitments, mortgage loans and standby letters of credit, that are not 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, 2002 and 2001, the Bank's Consolidated Statements of Condition included approximately \$15 million and \$18 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 available-for-sale and are included in "Other Assets" 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.

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 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 charged to interest income. Such loans are not normally placed on nonaccrual status.

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

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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. Both 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 possible loan losses.

ALLOWANCE FOR POSSIBLE LOAN LOSSES

The allowance for possible loan losses is maintained at a level considered adequate to provide for estimated 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.

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. 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. 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. Intangible assets with indefinite useful lives are not amortized and are reviewed for impairment annually or more frequently if events indicate impairment.

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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 expense.

Loans intended to be sold in the secondary market are classified as available-for-sale and are included in "Loans held for sale" on the Consolidated Statements of Condition. The loans are carried at lower of allocated cost or current market value, on a portfolio basis. The Bank has qualifying mortgage loan commitments that

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are intended to be sold in the secondary market. These loan commitments are derivatives and are accounted for at fair value.

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.

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 Bankmont. 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 possible loan losses, income taxes, pension cost, postemployment benefits, valuation of intangible assets, fair values and temporary vs. other-than-temporary impairment.

RECLASSIFICATIONS

Certain reclassifications were made to conform prior years' financial

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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, 2002			FAIR VALUE	DECEMBER 31, 2001	
	AMORTIZED COST	UNREALIZED GAINS	UNREALIZED LOSSES		AMORTIZED COST	UNREALIZED GAINS
	(IN THOUSANDS)					
U.S. Treasury.....	\$2,562,541	\$ 92,622	\$3	\$2,655,160	\$1,390,397	\$32,622
Federal agency.....	2,677,716	16,318	--	2,694,034	2,543,823	3,711
Mortgage-backed.....	392,106	12,107	--	404,213	1,825,389	1,100
State and municipal.....	627	--	--	627	3,600	--
Other.....	27,287	39	--	27,326	25,663	1,663
Total securities.....	\$5,660,277	\$121,086	\$3	\$5,781,360	\$5,788,872	\$36,696

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At December 31, 2002 and 2001, available-for-sale and trading account securities having a carrying amount of \$4.39 billion and \$3.75 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, 2002, 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, 2002	
	AMORTIZED COST	FAIR VALUE
	(IN THOUSANDS)	
Maturities:		
Within 1 year.....	\$1,495,326	\$1,500,713
1 to 5 years.....	2,947,912	3,015,514
5 to 10 years.....	1,154,464	1,200,855
Over 10 years.....	35,288	36,952
Other securities without stated maturity.....	27,287	27,326
Total securities.....	\$5,660,277	\$5,781,360

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In 2002, 2001 and 2000, proceeds from the sale of securities available-for-sale amounted to \$2.68 billion, \$1.90 billion and \$662 million, respectively. Gross gains of \$63.0 million and gross losses of \$1.7 million were realized on these sales in 2002, gross gains of \$35.4 million and no gross losses were realized on these sales in 2001 and gross gains of \$14.8 million and no gross losses were realized on these sales in 2000. Net unrealized holding gains on trading securities decreased during 2002 from an unrealized gain of \$1.1 million at December 31, 2001 to an unrealized gain of \$0.9 million at December 31, 2002. The decrease of \$0.2 million has been included in 2002 earnings.

3. LOANS

The following table summarizes loan balances by category:

	DECEMBER 31	
	2002	2001
(IN THOUSANDS)		
Domestic loans:		
Commercial, financial, agricultural, brokers and dealers.....	\$5,641,852	\$6,283,468
Real estate construction.....	241,278	188,187
Real estate mortgages.....	2,854,919	2,459,369
Installment.....	740,414	1,016,637
Foreign loans:		
Banks and other financial institutions.....	100,488	10,039
Other, primarily commercial and industrial.....	28,936	14,773
Total loans.....	9,607,887	9,972,473
Less allowance for possible loan losses.....	206,999	227,374
Loans, net of allowance for possible loan losses.....	\$9,400,888	\$9,745,099

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

	YEARS ENDED DECEMBER 31		
	2002	2001	2000
(IN THOUSANDS)			
Nonaccrual loans.....	\$169,588	\$202,320	\$ 95,850
Restructured loans.....	--	2,309	2,349
Total nonperforming loans.....	169,588	204,629	98,199
Other assets received in satisfaction of debt.....	1,975	140	3,125
Total nonperforming assets.....	\$171,563	\$204,769	\$101,324

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	=====	=====	=====
Gross amount of interest income that would have been recorded if year-end nonperforming loans had been accruing interest at their original terms.....	\$ 8,496	\$ 14,306	\$ 5,789
Interest income actually recognized.....	--	--	--
Interest shortfall.....	\$ 8,496	\$ 14,306	\$ 5,789

At December 31, 2002 and 2001, the Bank had no aggregate public and private sector outstandings to any single country experiencing a liquidity problem which exceeded one percent of the Corporation's consolidated assets. At December 31, 2002 and 2001 commercial loans with a carrying value of \$3.74 billion and \$4.16 billion, respectively, were pledged to secure potential borrowings with the Federal Reserve.

MORTGAGE SERVICING RIGHTS

The carrying amount of mortgage servicing rights was \$12.9 million and \$21.6 million at December 31, 2002 and 2001, respectively. The fair value of those rights equaled or exceeded the carrying amount at both December 31, 2002 and December 31, 2001. Mortgage servicing rights, included in other assets, of \$4.5 million and \$8.5 million were capitalized during 2002 and 2001, respectively. Amortization expense associated with the mortgage servicing rights was \$5.9 million and \$4.2 million in 2002 and 2001, respectively. There were no direct write-downs in 2002 or 2001. During 2002, impairment expense for mortgage servicing rights totaling \$7.3 million was recorded in a valuation allowance to reflect the excess of carrying value over estimated fair value.

4. ALLOWANCE FOR POSSIBLE LOAN LOSSES

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

	YEARS ENDED DECEMBER 31		
	2002	2001	2000
	(IN THOUSANDS)		
Balance, beginning of year.....	\$ 227,374	\$118,951	\$113,702
Charge-offs.....	(106,650)	(98,814)	(30,128)
Recoveries.....	15,055	3,729	5,688
Net charge-offs.....	(91,595)	(95,085)	(24,440)
Provisions charged to operations.....	71,220	203,508	29,689
Balance, end of year.....	\$ 206,999	\$227,374	\$118,951

Details on impaired loans and related allowance are as follows:

IMPAIRED LOANS

IMPAIRED LOANS

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	FOR WHICH THERE IS A RELATED ALLOWANCE	FOR WHICH THERE IS NO RELATED ALLOWANCE	

			(IN THOUSANDS)
December 31, 2002			
Balance.....	\$156,306	\$13,282	\$
Related allowance.....	76,538	--	
	-----	-----	
Balance, net of allowance.....	\$ 79,768	\$13,282	\$
	=====	=====	
December 31, 2001			
Balance.....	\$159,817	\$44,812	\$
Related allowance.....	72,620	--	
	-----	-----	
Balance, net of allowance.....	\$ 87,197	\$44,812	\$
	=====	=====	

	YEARS ENDED DECEMBER 31		
	-----	-----	-----
	2002	2001	2000
	-----	-----	-----
	(IN THOUSANDS)		
Average impaired loans.....	\$191,493	\$153,920	\$55,434
	=====	=====	=====
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	
	-----	-----
	2002	2001
	-----	-----
	(IN THOUSANDS)	
Land.....	\$ 23,183	\$ 23,183
Premises.....	203,089	195,790
Equipment.....	385,907	340,427
Leasehold improvements.....	41,331	35,627
	-----	-----
Total.....	653,510	595,027
Accumulated depreciation and amortization.....	355,096	307,478
	-----	-----
Premises and equipment.....	\$298,414	\$287,549
	=====	=====

Depreciation and amortization expense was \$46.3 million in 2002, \$48.3 million in 2001 and \$46.7 million in 2000.

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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 of \$15.7 million and \$17 million, respectively, as of December 31, 2002 and 2001.

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.

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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 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 2002. The fair value of the reporting unit was estimated using a valuation technique based on multiples of book value. The test did not identify potential impairment and no impairment loss was recognized in 2002.

For the years ended December 31, 2002, 2001 and 2000, the Bank's net income and earnings per share on a proforma basis adjusted to exclude the amortization of goodwill are included in the following table:

	YEARS ENDED DECEMBER 31		
	2002	2001	2000
	(IN THOUSANDS EXCEPT SHARE DATA)		
Net income.....	\$171,834	\$82,272	\$226,444
Plus goodwill amortization.....	--	5,639	5,639

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Adjusted net income.....	\$171,834	\$87,911	\$232,083
Earnings per common share:			
Net income applicable to common stock.....	\$ 17.18	\$ 8.23	\$ 22.64
Plus goodwill amortization.....	--	0.56	0.56
Adjusted net income applicable to common stock.....	\$ 17.18	\$ 8.79	\$ 23.20

The carrying value of the Bank's goodwill as of December 31, 2002 was \$89.3 million.

As of December 31, 2002, the gross carrying amount and accumulated amortization of the Bank's amortizable intangible assets were \$202.1 million and \$104.1 million, respectively.

Total amortization expense for the Bank's intangible assets was \$16.0 million for the year ended December 31, 2002.

Estimated intangible asset amortization expense for the years ending December 31, 2003, 2004, 2005, 2006 and 2007 is \$16.2 million, \$16.4 million, \$16.5 million, \$16.7 million and \$16.9 million, respectively.

7. DEPOSITS

The following table summarizes average deposit balances by category:

	DECEMBER 31		INCREASE (DE
	2002	2001	2002 VS.
			AMOUNT
	(DAILY AVERAGES, IN THOUSANDS)		
Demand deposits.....	\$ 1,694,134	\$ 2,495,840	\$ (801,706)
Interest-bearing checking deposits.....	91,585	114,038	(22,453)
Money market accounts.....	3,121,634	2,513,755	607,879
Passbook and statement savings accounts.....	1,431,676	958,843	472,833
Savings certificates.....	1,756,401	1,871,431	(115,030)
Other time deposits.....	1,692,695	1,559,212	133,483
Deposits in foreign offices.....	1,179,766	2,104,640	(924,874)
Total deposits.....	\$10,967,891	\$11,617,759	\$ (649,868)

Certificates of deposit in denominations exceeding \$100,000 issued by domestic offices totaled \$1.5 billion at December 31, 2002. Total interest expense on domestic office certificates of deposit of \$100,000 or more amounted to approximately \$51 million compared to \$65 million in 2001. Virtually all time deposits in foreign offices were in denominations exceeding \$100,000.

The remaining maturity of domestic office certificates of deposit exceeding \$100,000 is as follows:

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Domestic Office Certificates of Deposit

	DECEMBER 31	
	2002	2001
	(IN MILLIONS)	
Maturities:		
3 months or less.....	\$ 827	\$ 578
3 to 6 months.....	111	136
6 to 12 months.....	506	776
Over 12 months.....	99	69
	-----	-----
Total.....	\$1,543	\$1,559
	=====	=====

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

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, 2002 and December 31, 2001. 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.

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 \$4.19 billion and \$3.57 billion at December 31, 2002 and 2001, 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.

Securities Purchased Under Agreement to Resell

	2002	2001
	-----	-----
	(IN THOUSANDS)	
Amount outstanding at end of year.....	\$ --	\$ --
Highest amount outstanding as of any month-end during the year.....	\$405,063	\$ --
Daily average amount outstanding during the year.....	\$ 7,598	\$ 293
Daily average annualized rate of interest.....	1.62%	2.60%
Average rate of interest on amount outstanding at end of year.....	--	--

Securities Sold Under Agreement to Repurchase

	2002	2001
	-----	-----
	(IN THOUSANDS)	
Amount outstanding at end of year.....	\$4,188,688	\$3,566,303
Highest amount outstanding as of any month-end during the year.....	\$4,188,688	\$4,085,612
Daily average amount outstanding during the year.....	\$3,125,430	\$3,595,769
Daily average annualized rate of interest.....	1.52%	3.90%
Average rate of interest on amount outstanding at end of year.....	1.19%	1.71%

9. SENIOR NOTES AND LONG-TERM NOTES

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

	DECEMBER 31	
	2002	2001
	-----	-----
	(IN THOUSANDS)	
Floating rate subordinated note to Bankcorp due March 31, 2005.....	\$ 50,000	\$ 50,000
Floating rate subordinated note to Bankcorp due December 1, 2006.....	50,000	50,000
Fixed rate 6 1/2% subordinated note to Bankcorp due December 27, 2007.....	60,000	60,000
Fixed rate 7 5/8% subordinated note to Bankcorp due June 27, 2008.....	15,000	15,000
Fixed rate 7 1/8% subordinated note to Bankcorp due June 30, 2009.....	50,000	50,000
Total.....	\$225,000	\$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 notes reprices semiannually and floats at 50 basis points above 180 day London Interbank Offering Rate ("LIBOR"). At year-end 2002, 180 day LIBOR was 1.38 percent.

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 \$1.5 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, 2002, \$200 million of senior short-term notes were outstanding with original

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maturities of 64 days (remaining maturities of 22 days) and stated interest rates of 1.33 percent. As of December 31, 2001, \$860 million of senior short-term notes were outstanding with original maturities ranging from 365 to 392 days (remaining maturities ranging from 99 to 207 days) and stated interest rates ranging from 1.78 percent to 4.41 percent.

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 reported on the Bank's 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.

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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 customers' liability on acceptances and acceptances outstanding approximate carrying value due to the short-term nature of these assets and liabilities and the generally negligible credit losses associated with them.

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 values of bank-owned insurance investments 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.

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The fair value of 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.

The fair value of 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 are presented as an obligation in order to represent the approximate cost the Bank would incur 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, 2002 and 2001 are presented in the following table. See Note 11 to Financial Statements for additional information regarding fair values of off-balance-sheet financial instruments.

	DECEMBER 31			
	2002		2001	
	CARRYING VALUE	FAIR VALUE	CARRYING VALUE	FAIR VALUE
	(IN THOUSANDS)			
ASSETS				
Cash and demand balances due from banks.....	\$ 1,057,254	\$ 1,057,254	\$ 1,203,946	\$ 1,203,946
Money market assets:				
Interest-bearing deposits at banks.....	417,206	417,206	195,723	195,723
Federal funds sold and securities purchased under agreement to resell.....	237,950	237,950	579,750	579,750
Securities available-for-sale.....	5,781,360	5,781,360	5,822,229	5,822,229
Trading account assets.....	42,423	42,423	90,562	90,562
Loans, net of unearned income and allowance for possible loan losses.....	9,400,888	9,455,610	9,745,099	9,769,519
Customers' liability on acceptances.....	16,168	16,168	13,365	13,365
Accrued interest receivable.....	76,649	76,649	96,460	96,460
Loans held for sale.....	149,311	149,311	121,588	121,588
Bank-owned insurance.....	994,185	994,185	952,225	952,225
	-----	-----	-----	-----
Total on-balance-sheet financial assets.....	\$18,173,394	\$18,228,116	\$18,820,947	\$18,845,367
	=====	=====	=====	=====
LIABILITIES				
Deposits:				
Demand deposits.....	\$ 6,988,180	\$ 6,988,180	\$ 6,670,214	\$ 6,670,214
Time deposits.....	4,050,104	4,080,992	4,520,646	4,548,598
Federal funds purchased.....	872,096	872,096	857,049	857,049
Securities sold under agreement to repurchase.....	4,188,688	4,188,688	3,566,302	3,566,302

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Short-term borrowings.....	300,694	300,694	704,699	704,699
Acceptances outstanding.....	16,168	16,168	13,365	13,365
Accrued interest payable.....	15,920	15,920	38,075	38,075
Short-term notes -- senior.....	200,000	200,000	860,000	860,000
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.....	225,000	237,173	225,000	230,135
	-----	-----	-----	-----
Total on-balance-sheet financial liabilities.....	\$17,111,850	\$17,154,911	\$17,710,350	\$17,743,437
	=====	=====	=====	=====
OFF-BALANCE-SHEET CREDIT FACILITIES (POSITIVE POSITIONS/(OBLIGATIONS))				
Loan commitments.....	\$ (13,957)	\$ (13,957)	\$ (17,641)	\$ (17,641)
Standby letters of credit.....	(854)	(854)	(695)	(695)
Commercial letter of credits.....	(44)	(44)	(48)	(48)
	-----	-----	-----	-----
Total off-balance-sheet credit facilities.....	\$ (14,855)	\$ (14,855)	\$ (18,384)	\$ (18,384)
	=====	=====	=====	=====

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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 a) meet its customers' financing and risk management needs, b) reduce its own risk exposure, and c) produce fee income and trading profits. The Bank's major categories of financial instruments with off-balance-sheet risk include credit facilities and various securities-related activities. Fair values of off-balance-sheet instruments are based on fees currently charged to enter into similar agreements, market prices of comparable instruments, pricing models using year-end rates and counterparty credit ratings.

Credit Facilities

Credit facilities with off-balance-sheet risk include commitments to extend credit, standby letters of 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 Bank's maximum risk of accounting loss is represented by the total contractual amount of commitments, which was \$8.0 billion and \$7.6 billion at December 31, 2002 and 2001, 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, 2002, totaled \$667 million and at December 31, 2001, totaled \$632 million.

Standby letters of credit are unconditional commitments which 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, construction contract performance and trade agreement performance. The Bank's

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maximum risk of accounting loss for these items is represented by the total commitments outstanding of \$2.66 billion at December 31, 2002 and \$2.30 billion at December 31, 2001. Risks associated with standby letters of credit are reduced by participations to third parties which totaled \$881 million at December 31, 2002 and \$664 million at December 31, 2001.

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 \$41 million at December 31, 2002 and \$36 million at December 31, 2001.

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 \$14.9 million at December 31, 2002 and \$18.4 million at December 31, 2001.

Derivative Financial Instruments

The Bank adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," on January 1, 2001. Under this standard, all derivative instruments are recognized at fair value in the

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Consolidated Statements of Condition. All derivative instruments are designated either as hedges or held for trading or non-hedging purposes.

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 include futures, forwards, forward rate agreements, option contracts, caps, floors, collars and swaps. Foreign exchange contracts include spot, futures, forwards, option contracts and swaps. Equity contracts include options and swaps. Commodity contracts include swaps.

At December 31, 2002 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 \$147.2 million in other assets and derivative instrument liabilities of \$151.9 million in other liabilities. At December 31, 2001 the Bank recorded the fair value of derivative instrument assets of \$117.3 million in other assets and derivative instrument liabilities of \$121.5 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

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to Certain Contracts," have been met. At December 31, 2002, derivative contracts with BMO represent \$20.3 million and \$136.7 million of unrealized gains and unrealized losses, respectively. At December 31, 2001, derivative contracts with BMO represent \$14.8 million and \$95.3 million of unrealized gains and unrealized losses, respectively.

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, 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

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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 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 April 2, 2003, 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, 2002 and December 31, 2001, totaled \$7.2 million and \$8.8 million, respectively, of net profit under the aforementioned agreement with BMO.

At December 31, 2002, approximately 98 percent of the Bank's gross notional positions in foreign currency contracts are represented by eight currencies: Eurodollar, Canadian dollars, British pounds, Australian dollar, Swiss francs, Swedish krona, Japanese yen and the Mexican peso.

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

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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.

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 revenue earned on certain long-term, fixed rate loans. Interest rate swaps convert the fixed rate loans into variable rate loans. Interest rate swap contracts generally involve the exchange of fixed and variable rate interest payments between two parties, based on a common notional amount and maturity date.

For fair value hedges, as of December 31, 2002 and December 31, 2001, the Bank recorded the fair value of derivative instrument liabilities of \$14.9 million and \$8.2 million respectively, in other liabilities. Net losses recorded for the year-to-date periods ended December 31, 2002 and December 31, 2001 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 had no cash flow hedges during 2002. Prior to 2002, the Bank had used a total return swap to reduce the variability associated with the cash flows from an equity security. The total return swap converted the cash flows received on an available-for-sale equity security from variable to fixed. Changes in the fair value of the swap were recorded in other comprehensive income. The unrealized holding gain (loss) on the available-for-sale equity security was recorded in other comprehensive income. Prior to September 30, 2001 the Bank removed the hedge designation due to the expectation of diminished cash

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flows from the equity security. The unrealized loss in accumulated other comprehensive income related to the total return swap was not material to the consolidated financial statements of the Bank. As of September 30, 2001 the swap, designated a nonhedging derivative, was marked to market and the resulting unrealized gain was recorded in noninterest income.

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

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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 accounted for 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.

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 \$37 million at December 31, 2002 and \$51 million at December 31, 2001.

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 no short position at December 31, 2002 or 2001.

12. CONCENTRATIONS OF CREDIT RISK IN FINANCIAL INSTRUMENTS

The Bank had one major concentration of credit risk arising from financial instruments at December 31, 2002 and 2001. 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

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economy. Corporate customers headquartered in the region and serving a national or international market are not included in this concentration because their business is broad-based and not 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 \$13.4 billion or 50 percent of the Bank's total credit exposure at December 31, 2002 and \$14.0 billion or 51 percent of the Bank's total credit exposure at December 31, 2001.

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 10 to Financial Statements for information on collateral supporting credit facilities.

13. EMPLOYEE BENEFIT PLANS

The Bank has noncontributory defined benefit pension plans covering virtually all its employees as of December 31, 2002. Most of the employees participating in retirement plans were included in one primary plan ("primary plan") during the three-year period ended December 31, 2002. The plan is a multiple-employer plan covering the Bank's employees as well as persons employed by certain affiliated entities.

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Effective January 1, 2002, the plan's benefit formula 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 is a final average pay formula. It is 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.

The policy for this plan is to have the participating entities, at a minimum, fund annually an amount necessary to satisfy the requirements under ERISA, without regard to prior years' contributions in excess of the minimum. For 2002, 2001 and 2000, cumulative contributions were greater than the amounts recorded as primary pension expense for financial reporting purposes. The total consolidated pension expense of the Bank, including the supplemental plan (excluding settlement losses and curtailment gains), for 2002, 2001, and 2000 was \$11.7 million, \$7.1 million and \$8.2 million, respectively.

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).

Curtailment gains amounting to \$7.3 million and \$2.3 million for pension plan and postretirement medical plan, respectively, were recognized in 2000 due to the sale of corporate trust business, the sale of merchant card business and the outsourcing arrangement with Alltel. Of those totals, \$2.2 million and \$0.5 million, respectively, were recognized as a direct reduction of benefit expense. Settlement losses amounting to \$0.1 million for the supplemental plan were recognized in 2000.

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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		
	2002***	2001***	2000***	2002***	2001***	2000***
	(IN THOUSANDS)					
CHANGE IN BENEFIT OBLIGATION*						
Benefit obligation at beginning of year.....	\$ 248,377	\$224,002	\$227,701	\$ 38,389	\$ 32,933	\$ 35,238
Service cost.....	10,871	8,812	9,373	1,259	1,280	1,346
Interest cost.....	18,451	16,419	16,643	2,799	2,471	2,453
Plan Amendments.....	1,585	4,033	--	--	--	--
Acquisitions/transfers.....	--	94	--	--	--	--
Curtailment (gain) or loss...	--	--	(7,348)	--	--	(2,276)
Benefits paid (net of participant contributions).....	(19,065)	(13,035)	(19,595)	(2,863)	(2,003)	(3,322)
Actuarial (gain) or loss.....	51,347	8,052	(2,772)	4,777	3,708	(506)
	\$ 311,566	\$248,377	\$224,002	\$ 44,361	\$ 38,389	\$ 32,933
	=====	=====	=====	=====	=====	=====

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	PENSION BENEFITS			POSTRETIREMENT MEDICAL BENEFITS		
	2002***	2001***	2000***	2002***	2001***	2000***
	(IN THOUSANDS)					
CHANGE IN PLAN ASSETS						
Fair value of plan assets at beginning of year.....	\$ 236,956	\$246,912	\$226,449	\$ 25,962	\$ 25,209	\$ 21,022
Actual return on plan assets.....	(14,316)	(1,361)	27,559	(3,579)	(1,463)	2,614
Acquisitions/transfers.....	--	1,192	--	--	--	--
Employer contribution.....	7,269	3,248	12,499	2,023	2,216	1,573
Benefits paid.....	(19,065)	(13,035)	(19,595)	--	--	--
	\$ 210,844	\$236,956	\$246,912	\$ 24,406	\$ 25,962	\$ 25,209
	=====	=====	=====	=====	=====	=====
Funded Status.....	\$ (100,722)	\$ (11,421)	\$ 22,910	\$ (19,955)	\$ (12,427)	\$ (7,724)
Contributions made between measurement date (September 30) and end of year.....	--	--	--	--	--	--
Unrecognized actuarial (gain) or loss.....	117,006	29,580	1,097	5,079	(5,589)	(13,780)
Unrecognized transition (asset) or obligation.....	--	(85)	(397)	17,392	19,143	20,893

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Unrecognized prior service cost.....	2,556	691	(4,072)	1,184	1,354	1,523
	-----	-----	-----	-----	-----	-----
Net amount at year-end.....	\$ 18,840	\$ 18,765	\$ 19,538	\$ 3,700	\$ 2,481	\$ 912
	=====	=====	=====	=====	=====	=====
AMOUNTS RECOGNIZED IN THE STATEMENT OF CONDITION CONSIST OF:						
Prepaid benefit cost.....	\$ --	\$ 18,765	\$ 19,538	\$ 3,700	\$ 2,481	\$ 912
Accrued benefit liability....	(25,528)	--	--	--	--	--
Intangible asset.....	2,556	--	--	--	--	--
Accumulated other comprehensive income (gross of tax).....	41,812	--	--	--	--	--
	-----	-----	-----	-----	-----	-----
Net amount recognized at year-end.....	\$ 18,840	\$ 18,765	\$ 19,538	\$ 3,700	\$ 2,481	\$ 912
	=====	=====	=====	=====	=====	=====
Other comprehensive income attributable to change in additional minimum liability (gross of tax)...	\$ 41,812	\$ --	\$ --	\$ --	\$ --	\$ --

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	PENSION BENEFITS			POSTRETIREMENT MEDICAL BENEFITS		
	2002***	2001***	2000***	2002***	2001***	2000***
	-----	-----	-----	-----	-----	-----
	(IN THOUSANDS)					
COMPONENTS OF NET PERIODIC BENEFIT COST						
Service cost.....	\$ 10,871	\$ 8,812	\$ 9,373	\$ 1,259	\$ 1,280	\$ 1,346
Interest cost.....	18,451	16,419	16,643	2,799	2,471	2,453
Expected return on plan assets.....	(21,778)	(20,066)	(19,527)	(2,077)	(2,017)	(1,686)
Amortization of prior service cost.....	(280)	(745)	(743)	169	169	169
Amortization of transition (asset) or obligation.....	(85)	(313)	(312)	1,751	1,751	1,751
Recognized actuarial (gain) or loss.....	--	(75)	(62)	(233)	(548)	(489)
	-----	-----	-----	-----	-----	-----
Net periodic benefit cost....	\$ 7,179	\$ 4,032	\$ 5,372	\$ 3,668	\$ 3,106	\$ 3,544
	=====	=====	=====	=====	=====	=====
Additional (gain) recognized due to:						
Curtailment.....	\$ --	\$ --	\$ (2,223)	\$ --	\$ --	\$ (524)

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

** Plan assets consist primarily of participation units in collective trust funds or mutual funds administered by HTSB.

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

	PENSION BENEFITS			POSTRETIREMENT MEDICAL BENEFITS		
	2002	2001	2000	2002	2001	2000
WEIGHTED-AVERAGE ASSUMPTIONS AS OF DECEMBER 31						
Discount rate*	6.75%	7.50%	7.75%	6.75%	7.50%	7.75%
Expected return on plan assets	9.00%	9.00%	9.00%	8.00%	8.00%	8.00%
Rate of compensation increase	5.50%	5.50%	5.50%	4.00%	4.00%	4.00%

* Discount rates are used to determine service costs for the subsequent year.

For measurement purposes, a 10.0 percent annual rate of increase for pre 65 and a 13.0 percent annual rate of increase for post 65 in the per capita cost of covered health care benefits was assumed for 2002. The rate will be graded down to 5.5 percent for pre 65 and 6.5 percent for post 65 in 2011 and 2009, 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	\$ 728	\$ (574)
Effect on postretirement benefit obligation	\$7,361	\$ (5,888)

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

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statutory limitations for qualified funded plans. The following table sets forth the status of this supplemental plan:

SUPPLEMENTAL UNFUNDED RETIREMENT BENEFITS		
2002	2001	2000
(IN THOUSANDS)		

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CHANGE IN BENEFIT OBLIGATION

Benefit 1,893,339

Total Diversified Financial Services			
Diversified Telecommunication Services - 2.0%			
5,260	Centaur Funding Corporation, Series B, 144A	9.080%	4/21/20
Insurance - 12.8%			
3,450	Ace Capital Trust II	9.700%	4/01/30
500	Allstate Financing II	7.830%	12/01/45
750	Mangrove Bay, Class 3, 144A	6.102%	7/15/33
10,000	MIC Financing Trust I	8.375%	2/01/27
1,500	Prudential plc	6.500%	6/29/49
3,000	RenaissanceRe Capital Trust	8.540%	3/01/27
10,000	Sun Life Canada Capital Trust, Capital Securities, 144A	8.526%	5/06/47
10,500	Zurich Capital Trust I, 144A	8.376%	6/01/37
Total Insurance			

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Nuveen Quality Preferred Income Fund 3 (JHP) (continued)

Portfolio of Investments December 31, 2005

Principal Amount (000)/ Shares	Description (1)	Coupon	Maturity
Oil, Gas & Consumable Fuels - 2.4%			
3,000	KN Capital Trust III	7.630%	4/15/28
4,500	Phillips 66 Capital Trust II	8.000%	1/15/37
Total Oil, Gas & Consumable Fuels			
Thriffs & Mortgage Finance - 1.7%			
1,000	Countrywide Capital Trust I	8.000%	12/15/26
4,225	Dime Capital Trust I, Series A	9.330%	5/06/27
Total Thriffs & Mortgage Finance			
U.S. Agency - 0.1%			
6,700	Fannie Mae	5.100%	4/15/49
Total Capital Preferred Securities (cost \$177,335,449)			

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Principal Amount (000)	Description (1)	Coupon	Maturity
	Short-Term Investments - 2.2% (1.5% of Total Investments)		
\$ 7,473	Repurchase Agreement with State Street Bank, dated 12/30/05, repurchase price \$7,475,919, collateralized by \$7,730,000 U.S. Treasury Bonds, 4.000%, due 11/15/12, valued at \$7,623,713	3.250%	1/03/06
=====			
	Total Short-Term Investments (cost \$7,473,220)		
	Total Investments (cost \$496,145,353) - 147.3%		
	Other Assets Less Liabilities - 1.8%		
	Preferred Shares, at Liquidation Value - (49.1)%		
	Net Assets Applicable to Common Shares - 100%		
=====			

Interest Rate Swap Contracts Outstanding at December 31, 2005:

Counterparty	Notional Amount	Fixed Rate by the Fund (annualized)	Fixed Rate Payment Frequency	Floating Rate Received by the Fund(4)	Floating Rate Payment Frequency
Citigroup Inc.	\$42,000,000	2.413%	Monthly	4.320%	Monthly
Citigroup Inc.	42,000,000	3.255%	Monthly	4.320%	Monthly
Citigroup Inc.	42,000,000	3.815%	Monthly	4.320%	Monthly

(1) All percentages shown in the Portfolio of Investments are based on net assets applicable to Common shares unless otherwise noted.

(2) Ratings (not covered by the report of independent registered public accounting firm): Using the higher of Standard & Poor's or Moody's rating. Ratings below Baa by Moody's Investor Service, Inc. or BBB by Standard & Poor's Group are considered to be below investment grade.

(3) Security is eligible for the Dividends Received Deduction.

(4) Based on LIBOR (London Inter-Bank Offered Rate).

N/R Investment is not rated.

144A Securities are exempt from registration under Rule 144A of the Securities Act of 1933, as amended. These securities may only be resold in transactions exempt from registration which are normally those transactions with qualified institutional buyers.

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CBTCS Corporate Backed Trust Certificates.
 CORTS Corporate Backed Trust Securities.
 PCARS Public Credit and Repackaged Securities.
 PPLUS PreferredPlus Trust.
 SATURNS Structured Asset Trust Unit Repackaging.

See accompanying notes to financial statements.

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Statement of
 Assets and Liabilities December 31, 2005

	Quality Preferred Income (JTP)	Quality Preferred Income 2 (JPS)
Assets		
Investments, at value (cost \$1,318,535,020, \$2,477,619,478 and \$496,145,353, respectively)	\$ 1,342,619,630	\$ 2,538,352,882
Unrealized appreciation on interest rate swaps	3,011,102	10,954,666
Receivables:		
Dividends	2,447,827	3,593,038
Interest	8,532,353	12,466,203
Investments sold	1,043,564	2,169,024
Reclaims	--	40,864
Other assets	74,448	137,423
Total assets	1,357,728,924	2,567,714,100
Liabilities		
Payable for investments purchased	944,577	80,213
Accrued expenses:		
Management fees	627,585	1,131,305
Other	356,508	626,382
FundPreferred share dividends payable	202,530	333,691
Total liabilities	2,131,200	2,171,591
FundPreferred shares, at liquidation value	440,000,000	800,000,000
Net assets applicable to Common shares	\$ 915,597,724	\$ 1,765,542,509
Common shares outstanding	64,462,104	119,541,842
Net asset value per Common share outstanding (net assets applicable to Common shares, divided by Common shares outstanding)	\$ 14.20	\$ 14.77

Net assets applicable to Common shares consist of:

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Common shares, \$.01 par value per share	\$	644,621	\$	1,195,418
Paid-in surplus		911,539,984		1,693,035,834
Undistributed (Over-distribution of) net investment income		8,725,182		12,953,839
Accumulated net realized gain (loss) from investments and derivative transactions		(32,407,775)		(13,330,652)
Net unrealized appreciation (depreciation) of investments and derivative transactions		27,095,712		71,688,070

Net assets applicable to Common shares	\$	915,597,724	\$	1,765,542,509
=====				
Authorized shares:				
Common		Unlimited		Unlimited
FundPreferred shares		Unlimited		Unlimited
=====				

See accompanying notes to financial statements.

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Statement of
Operations Year Ended December 31, 2005

		Quality Preferred Income (JTP)		Quality Preferred Income 2 (JPS)

Investment Income				
Dividends (net of foreign tax withheld of \$8,366, \$11,731 and \$4,093, respectively)	\$	50,776,468	\$	101,881,541
Interest		42,452,437		75,760,522

Total investment income		93,228,905		177,642,063

Expenses				
Management fees		11,946,853		22,017,335
FundPreferred shares - auction fees		1,091,225		1,986,947
FundPreferred shares - dividend disbursing agent fees		26,082		38,501
Shareholders' servicing agent fees and expenses		11,499		13,868
Custodian's fees and expenses		314,871		566,887
Trustees' fees and expenses		26,237		50,116
Professional fees		64,571		102,260
Shareholders' reports - printing and mailing expenses		226,225		432,052
Stock exchange listing fees		25,069		46,238
Investor relations expense		203,091		327,484
Other expenses		41,529		67,882

Total expenses before custodian fee credit and expense reimbursement		13,977,252		25,649,570
Custodian fee credit		(706)		(1,575)
Expense reimbursement		(4,404,201)		(8,403,718)

Net expenses		9,572,345		17,244,277

Net investment income		83,656,560		160,397,786

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Realized and Unrealized Gain (Loss)		
Net realized gain (loss) from:		
Investments	10,256,942	29,542,155
Futures	--	626,810
Interest rate swaps	(1,997,325)	(1,219,301)
Change in net unrealized appreciation (depreciation) of:		
Investments	(58,087,700)	(120,450,106)
Futures	--	313,500
Interest rate swaps	6,484,892	9,852,715

Net realized and unrealized gain (loss)	(43,343,191)	(81,334,227)

Distributions to FundPreferred Shareholders		
From net investment income	(13,746,475)	(21,967,419)
From accumulated net realized gains	--	(2,969,505)

Decrease in net assets applicable to Common shares from		
distributions to FundPreferred shareholders	(13,746,475)	(24,936,924)

Net increase (decrease) in net assets applicable to		
Common shares from operations	\$ 26,566,894	\$ 54,126,635
=====		

See accompanying notes to financial statements.

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Statement of
Changes in Net Assets

Quality Preferred Income (

	Year Ended 12/31/05	Five Months Ended 12/31/04

Operations		
Net investment income	\$ 83,656,560	\$ 38,406,778
Net realized gain (loss) from:		
Investments	10,256,942	(789,063)
Futures	--	--
Interest rate swaps	(1,997,325)	(2,754,561)
Change in net unrealized appreciation (depreciation) of:		
Investments	(58,087,700)	34,446,726
Futures	--	--
Interest rate swaps	6,484,892	(130,099)
Distributions to FundPreferred shareholders:		
From net investment income	(13,746,475)	(3,338,840)
From accumulated net realized gains	--	--

Net increase (decrease) in net assets		

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applicable to Common shares from operations	26,566,894	65,840,941

Distributions to Common Shareholders		
From net investment income	(72,552,099)	(32,291,619)
From accumulated net realized gains	--	--

Decrease in net assets applicable to Common shares from distributions to Common shareholders	(72,552,099)	(32,291,619)

Capital Share Transactions		
Common shares:		
Offering costs adjustments	--	--
Net proceeds from shares issued to shareholders due to reinvestment of distributions	--	141,543
FundPreferred shares offering costs adjustments	--	92

Net increase (decrease) in net assets applicable to Common shares from capital share transactions	--	141,635

Net increase (decrease) in net assets applicable to Common shares	(45,985,205)	33,690,957
Net assets applicable to Common shares at the beginning of period	961,582,929	927,891,972

Net assets applicable to Common shares at the end of period	\$ 915,597,724	\$ 961,582,929
=====		
Undistributed (Over-distribution of) net investment income at the end of period	\$ 8,725,182	\$ 6,133,164
=====		

Quality Preferred Income 2

	Year Ended 12/31/05	Five Months Ended 12/31/04

Operations		
Net investment income	\$ 160,397,786	\$ 71,895,333
Net realized gain (loss) from:		
Investments	29,542,155	35,993
Futures	626,810	--
Interest rate swaps	(1,219,301)	(4,109,979)
Change in net unrealized appreciation (depreciation) of:		
Investments	(120,450,106)	66,169,186
Futures	313,500	(313,500)
Interest rate swaps	9,852,715	(1,229,256)
Distributions to FundPreferred shareholders:		
From net investment income	(21,967,419)	(4,886,184)
From accumulated net realized gains	(2,969,505)	(1,197,900)

Net increase (decrease) in net assets applicable to Common shares from operations	54,126,635	126,363,693

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Distributions to Common Shareholders		
From net investment income	(138,788,080)	(62,896,099)
From accumulated net realized gains	(22,079,378)	(22,062,289)

Decrease in net assets applicable to Common shares from distributions to Common shareholders	(160,867,458)	(84,958,388)

Capital Share Transactions		
Common shares:		
Offering costs adjustments	--	--
Net proceeds from shares issued to shareholders due to reinvestment of distributions	--	--
FundPreferred shares offering costs adjustments	--	92

Net increase (decrease) in net assets applicable to Common shares from capital share transactions	--	92

Net increase (decrease) in net assets applicable to Common shares	(106,740,823)	41,405,397
Net assets applicable to Common shares at the beginning of period	1,872,283,332	1,830,877,935

Net assets applicable to Common shares at the end of period	\$ 1,765,542,509	\$ 1,872,283,332
=====		
Undistributed (Over-distribution of) net investment income at the end of period	\$ 12,953,839	\$ 7,485,948
=====		

See accompanying notes to financial statements.

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Statement of
Changes in Net Assets (continued)

	Quality Preferred Income 3	
	Year Ended 12/31/05	Five Months Ended 12/31/04

Operations		
Net investment income	\$ 31,177,398	\$ 14,203,151
Net realized gain (loss) from:		
Investments	2,801,561	(292,843)
Futures	--	--
Interest rate swaps	(22,484)	(785,894)
Change in net unrealized appreciation (depreciation) of:		
Investments	(21,236,219)	12,474,854

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Futures	--	--
Interest rate swaps	2,007,568	(494,654)
Distributions to FundPreferred shareholders:		
From net investment income	(4,959,898)	(1,232,711)
From accumulated net realized gains	(324,959)	(79,282)

Net increase (decrease) in net assets applicable to Common shares from operations	9,442,967	23,792,621

Distributions to Common Shareholders		
From net investment income	(27,602,875)	(12,158,797)
From accumulated net realized gains	(2,179,859)	(1,336,468)

Decrease in net assets applicable to Common shares from distributions to Common shareholders	(29,782,734)	(13,495,265)

Capital Share Transactions		
Common shares:		
Offering costs adjustments	--	--
Net proceeds from shares issued to shareholders due to reinvestment of distributions	--	--
FundPreferred shares offering costs adjustments	--	--

Net increase (decrease) in net assets applicable to Common shares from capital share transactions	--	--

Net increase (decrease) in net assets applicable to Common shares	(20,339,767)	10,297,356
Net assets applicable to Common shares at the beginning of period	358,197,431	347,900,075

Net assets applicable to Common shares at the end of period	\$ 337,857,664	\$ 358,197,431
=====		
Undistributed (Over-distribution of) net investment income at the end of period	\$ 1,949,002	\$ 2,985,426
=====		

See accompanying notes to financial statements.

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Notes to
Financial Statements

1. General Information and Significant Accounting Policies

The funds (the "Funds") covered in this report and their corresponding Common share New York Stock Exchange symbols are Nuveen Quality Preferred Income Fund (JTP), Nuveen Quality Preferred Income Fund 2 (JPS) and Nuveen Quality Preferred Income Fund 3 (JHP). The Funds are registered under the Investment Company Act of 1940, as amended, as non-diversified, closed-end management investment companies.

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Each Fund seeks to provide high current income consistent with capital preservation by investing primarily in a portfolio of preferred securities, debt securities including convertible debt securities and convertible preferred securities.

The Board of Trustees of the Funds approved a change in the Funds' fiscal year end from July 31 to December 31 upon completion of the Funds' July 31, 2004 fiscal year.

Effective January 1, 2005, Nuveen Institutional Advisory Corp. ("NIAC"), the Funds' previous Adviser, and its affiliate, Nuveen Advisory Corp. ("NAC"), were merged into Nuveen Asset Management ("NAM"), each wholly owned subsidiaries of Nuveen Investments, Inc. ("Nuveen"). As a result of the merger, NAM is now the Adviser to all funds previously advised by either NIAC or NAC.

The following is a summary of significant accounting policies followed by the Funds in the preparation of their financial statements in accordance with U.S. generally accepted accounting principles.

Investment Valuation

Exchange-listed securities and instruments, other than futures, are generally valued at the last sales price on the exchange on which such securities or instruments are primarily traded. Securities or instruments traded on an exchange for which there are no transactions on a given day or securities or instruments not listed on an exchange are valued at the mean of the closing bid and asked prices. Securities traded on Nasdaq are valued at the Nasdaq Official Closing Price. Futures contracts are valued using the closing settlement price or, in the absence of such a price, at the mean of the bid and asked prices. Prices of the other derivative instruments are provided by an independent pricing service approved by the Funds' Board of Trustees. The prices of fixed-income securities are generally also provided by an independent pricing service approved by the Funds' Board of Trustees and based on the mean between the bid and asked prices. When price quotes are not readily available, the pricing service or, in the absence of a pricing service for a particular security or instrument, the Board of Trustees of the Funds, or its designee, may establish fair market value using a wide variety of market data including yields or prices of securities of comparable quality, type of issue, coupon, maturity and rating, market quotes or indications of value from security dealers, evaluations of anticipated cash flows or collateral, general market conditions and other information and analysis, including the obligor's credit characteristics considered relevant by the pricing service or the Board of Trustee's designee. Short-term investments are valued at amortized cost, which approximates market value.

Investment Transactions

Investment transactions are recorded on a trade date basis. Realized gains and losses from investment transactions are determined on the specific identification method. Investments purchased on a when-issued or delayed delivery basis may have extended settlement periods. Any investments so purchased are subject to market fluctuation during this period. The Funds have instructed the custodian to segregate assets with a current value at least equal to the amount of the when-issued and delayed delivery purchase commitments. At December 31, 2005, the Funds' had no such outstanding purchase commitments.

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Investment Income

Dividend income is recorded on the ex-dividend date or, for foreign securities, when information is available. Interest income, which includes the amortization of premiums and accretion of discounts for financial reporting purposes, is recorded on an accrual basis.

Professional Fees

Professional fees presented in the Statement of Operations consist of legal fees incurred in the normal course of operations, audit fees, tax consulting fees and, in some cases, workout expenditures. Workout expenditures are incurred in an attempt to protect or enhance an investment, or to pursue other claims or legal actions on behalf of Fund shareholders.

Federal Income Taxes

Each Fund is a separate taxpayer for federal income tax purposes. Each Fund intends to distribute substantially all net investment income and net capital gains to shareholders and to otherwise comply with the requirements of Subchapter M of the Internal Revenue Code applicable to regulated investment companies. Therefore, no federal income tax provision is required.

Dividends and Distributions to Common Shareholders

Distributions to Common shareholders are recorded on the ex-dividend date. The amount and timing of distributions are determined in accordance with federal income tax regulations, which may differ from U.S. generally accepted accounting principles.

Distributions to Common shareholders are declared monthly. With respect to the Real Estate Investment Trust ("REIT") securities held in the Funds' Portfolio of Investments, distributions received by the Funds are generally comprised of ordinary income, long-term and short-term capital gains, and a return of REIT capital. The actual character of amounts received during the period is not known until after the fiscal year-end. For the fiscal year ended December 31, 2005, the character of distributions to the Funds from the REITs was as follows:

	Quality Preferred Income (JTP)	Quality Preferred Income 2 (JPS)	Quality Preferred Income 3 (JHP)
Ordinary income	77.28%	74.67%	78.86%
Long-term and short-term capital gains	22.72	25.33	21.14
Return of REIT capital	--	--	--

For the fiscal year ended December 31, 2004, the character of distributions to the Funds from the REITs was as follows:

	Quality Preferred Income (JTP)	Quality Preferred Income 2 (JPS)	Quality Preferred Income 3 (JHP)
Ordinary income	91.42%	91.38%	84.61%
Long-term and short-term capital gains	8.37	7.83	14.31
Return of REIT capital	.21	.79	1.08

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For the fiscal year ended July 31, 2004, the character of distributions to the Funds from the REITs was as follows:

	Quality Preferred Income (JTP)	Quality Preferred Income 2 (JPS)	Quality Preferred Income 3 (JHP)

Ordinary income	88.48%	90.38%	79.75%
Long-term and short-term capital gains	11.31	8.93	19.20
Return of REIT capital	.21	.69	1.05
=====			

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For the fiscal year ended December 31, 2005, and the fiscal period ended December 31, 2004, each Fund applied the actual character of distributions reported by the REITs in which the Fund invests to its receipts from the REITs. If a REIT held in the portfolio of investments did not report the actual character of its distributions during the period, the Fund treated the distributions as ordinary income.

For fiscal year ended July 31, 2004, each Fund applied a percentage estimate for the breakdown of income type, to its receipts from the REITs and treated as income in the Statement of Operations only the amount of ordinary income so calculated. Each Fund adjusted that estimated breakdown of income type (and consequently its net investment income) as necessary in the following calendar year when the REITs informed their shareholders of the actual breakdown of income type.

For the fiscal year ended December 31, 2005, and the fiscal period ended December 31, 2004, each Fund applied the actual character of distributions reported by the REITs in which the Fund invests to the distributions paid to each Funds shareholders.

With respect to the portion of each Fund's monthly distribution to its shareholders derived from the Fund's investments in REIT securities for the fiscal year ended July 31, 2004, each Fund treated that portion of its distribution as being entirely from net investment income. The Funds recharacterized those distributions as being from ordinary income, long-term and short-term capital gains, and return of capital, if necessary, in the subsequent calendar year, based upon the income type breakdown information conveyed at that time by the REITs whose securities were held in each Fund's portfolio.

FundPreferred Shares

The Funds have issued and outstanding FundPreferred shares, \$25,000 stated value per share, as a means of effecting financial leverage. Each Fund's FundPreferred shares are issued in more than one Series. The dividend rate paid by the Fund on each Series is determined every seven days, pursuant to a dutch auction process overseen by the auction agent, and is payable at the end of each rate period. The number of shares outstanding, by Series and in total, for each Fund is as follows:

	Quality Preferred Income (JTP)	Quality Preferred Income 2 (JPS)	Quality Preferred Income 3 (JHP)

Number of shares:			

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Series M	3,520	4,800	3,320
Series T	3,520	4,800	--
Series T2	--	4,000	--
Series W	3,520	4,800	--
Series TH	3,520	4,800	3,320
Series TH2	--	4,000	--
Series F	3,520	4,800	--

Total	17,600	32,000	6,640
=====			

Interest Rate Swap Transactions

The Funds may invest in certain derivative financial instruments. The Funds' use of interest rate swap transactions is intended to mitigate the negative impact that an increase in short-term interest rates could have on Common share net earnings as a result of leverage. Interest rate swap transactions involve each Fund's agreement with the counterparty to pay a fixed rate payment in exchange for the counterparty paying the Fund a variable rate payment that is intended to approximate each Fund's variable rate payment obligation on Fund Preferred shares or any variable rate borrowing. The payment obligation is based on the notional amount of the interest rate swap contract. Interest rate swaps do not involve the delivery of securities or other underlying assets or principal. Accordingly, the risk of loss with respect to the swap counterparty on such transactions is limited to the net amount of interest payments that each Fund is to receive. Interest rate swap positions are valued daily. Although there are economic advantages of entering into interest rate swap transactions, there are also additional risks. The Funds help manage the credit risks associated with interest rate swap transactions by entering into agreements only with counterparties the Adviser believes have the financial resources to honor their obligations and by having the Adviser continually monitor the financial stability of the swap counterparties.

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Notes to
Financial Statements (continued)

Due to clarification provided by the SEC to regulated investment companies, effective with the July 31, 2004 reporting period, the Funds changed the way they present net interest expense on interest rate swap transactions in the financial statements. Net interest expense amounts paid during the year are included in "Net realized gain (loss) from interest rate swap transactions". Net interest expense amounts accrued, but not yet paid, at the end of the fiscal year, are included in "Change in net unrealized appreciation (depreciation) of interest rate swap transactions". Previously, net interest expense was presented in "Expenses" and reported as "Net interest expense on interest rate swap transactions". This reclassification does not alter the tax treatment of interest rate payments on swap transactions which is to include such payments as an operating expense for tax purposes.

For the fiscal year ended July 31, 2004, this reclassification, for financial reporting purposes only, resulted in increases to net investment income, decreases to net realized gain (loss) from interest rate swap transactions and decreases to change in net unrealized appreciation (depreciation) of interest rate swap transactions as follows:

Quality

Quality

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	Preferred Income (JTP)	Preferred Income 2 (JPS)	
Net investment income	\$ 8,892,767	\$ 13,237,853	\$
Net realized gain (loss) from interest rate swap transactions	(8,829,243)	(12,395,021)	(
Change in net unrealized appreciation (depreciation) of interest rate swap transactions	(63,524)	(842,832)	

Futures Contracts

Each Fund may use futures contracts to hedge against changes in the values of securities the Fund owns. Each Fund bears the market risk arising from changes in the value of these financial instruments. At the time a Fund enters into a futures contract, the Fund deposits and maintains as collateral an initial margin as required by the exchange on which the transaction is affected. Pursuant to the contract, the Fund agrees to receive from or pay to the broker an amount of cash equal to the daily fluctuation in the value of the contract. Such receipts or payments are known as variation margin and are recorded by the Fund as unrealized gains or losses on futures contracts. Risk may arise from the potential inability of the counterparty to meet the terms of the contract. When a contract is closed, the Fund records a realized gain or loss equal to the difference between the value of the contract at the time it was opened and the time it was closed. At December 31, 2005, there were no open futures contracts in any of the Funds.

Repurchase Agreements

In connection with transactions in repurchase agreements, it is the Funds' policy that its custodian take possession of the underlying collateral securities, the fair value of which exceeds the principal amount of the repurchase transaction, including accrued interest, at all times. If the seller defaults, and the fair value of the collateral declines, realization of the collateral may be delayed or limited.

Custodian Fee Credit

Each Fund has an arrangement with the custodian bank whereby certain custodian fees and expenses are reduced by credits earned on each Fund's cash on deposit with the bank. Such deposit arrangements are an alternative to overnight investments.

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Indemnifications

Under the Funds' organizational documents, their Officers and Trustees are indemnified against certain liabilities arising out of the performance of their duties to the Funds. In addition, in the normal course of business, the Funds enter into contracts that provide general indemnifications to other parties. The Funds' maximum exposure under these arrangements is unknown as this would involve future claims that may be made against the Funds that have not yet occurred. However, the Funds have not had prior claims or losses pursuant to these contracts and expect the risk of loss to be remote.

Use of Estimates

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The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of increases and decreases in net assets applicable to Common shares from operations during the reporting period. Actual results may differ from those estimates.

2. Fund Shares

Transactions in Common shares were as follows:

	Quality Preferred Income (JTP)			Quality Preferred Income 2 (JP)	
	Year	Five Months	Year	Year	Five Months
	Ended	Ended	Ended	Ended	Ended
	12/31/05	12/31/04	7/31/04	12/31/05	12/31/04
Common shares issued to shareholders due to reinvestment of distributions	--	9,641	95,759	--	--

	Quality Preferred Income 3 (JH)	
	Year	Five Months
	Ended	Ended
	12/31/05	12/31/04
Common shares issued to shareholders due to reinvestment of distributions	--	--

3. Investment Transactions

Purchases and sales (including maturities but excluding short-term investments and derivative transactions) during the fiscal year ended December 31, 2005, were as follows:

	Quality Preferred Income (JTP)	Quality Preferred Income 2 (JPS)
Purchases	\$ 255,175,849	\$ 425,983,525
Sales and maturities	269,429,029	493,256,057

Notes to
Financial Statements (continued)

4. Income Tax Information

The following information is presented on an income tax basis based on the information currently available to the Funds. Differences between amounts for financial statement and federal income tax purposes are primarily due to timing differences in the recognition of income and timing differences in recognizing certain gains and losses on investment transactions.

At December 31, 2005, the cost of investments was as follows:

	Quality Preferred Income (JTP)	Quality Preferred Income 2 (JPS)

Cost of investments	\$1,325,016,071	\$2,485,900,712
=====		

Gross unrealized appreciation and gross unrealized depreciation of investments at December 31, 2005, were as follows:

	Quality Preferred Income (JTP)	Quality Preferred Income 2 (JPS)

Gross unrealized:		
Appreciation	\$ 38,901,473	\$ 87,309,497
Depreciation	(21,297,914)	(34,857,327)

Net unrealized appreciation (depreciation) of investments	\$ 17,603,559	\$ 52,452,170
=====		

The tax components of undistributed net ordinary income and net realized gains at July 31, 2005, the Funds' last tax year end, were as follows:

	Quality Preferred Income (JTP)	Quality Preferred Income 2 (JPS)

Undistributed net ordinary income *	\$3,556,793	\$ 8,682,726
Undistributed net long-term capital gains	--	19,370,073

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* Net ordinary income consists of net taxable income derived from dividends, interest and net short-term capital gains, if any.

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The tax character of distributions paid during the tax years ended July 31, 2005 and July 31, 2004, was designated for purposes of the dividends paid deduction as follows:

July 31, 2005	Quality Preferred Income (JTP)	Quality Preferred Income 2 (JPS)
Distributions from net ordinary income *	\$86,458,729	\$168,985,896
Distributions from net long-term capital gains	--	19,485,262

July 31, 2004	Quality Preferred Income (JTP)	Quality Preferred Income 2 (JPS)
Distributions from net ordinary income *	\$86,134,890	\$171,962,461
Distributions from net long-term capital gains	--	--

* Net ordinary income consists of net taxable income derived from dividends, interest and net short-term capital gains, if any.

At July 31, 2005, the Funds' last tax year end, Quality Preferred Income (JTP) had unused capital loss carryforwards of \$22,268,801 available for federal income tax purposes to be applied against future capital gains, if any. If not applied, the carryforwards will expire in the year 2012.

Calculation of certain of the amounts presented above (namely, undistributed net ordinary income for tax purposes) involves the application of complex aspects of the Internal Revenue Code to certain securities held by the Funds. In calculating the amount of taxable income derived from these securities, management made assumptions as to the correct tax treatment of certain of those securities and made estimates about the tax characteristics of income received from those securities, based on information currently available to the Funds. The use of these assumptions and estimates will not affect the qualification of the Funds as regulated investment companies under Subchapter M of the Internal Revenue Code, nor is it expected that these assumptions and estimates will be used in computing taxable income for purposes of preparing the federal and state income and excise tax returns.

5. Management Fee and Other Transactions with Affiliates

Each Fund's management fee is separated into two components - a complex-level

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component, based on the aggregate amount of all fund assets managed by the Adviser, and a specific fund-level component, based only on the amount of assets within each individual fund. This pricing structure enables Nuveen fund shareholders to benefit from growth in the assets within each individual fund as well as from growth in the amount of complex-wide assets managed by the Adviser.

The annual fund-level fee, payable monthly, for each Fund is based upon the average daily Managed Assets of each Fund as follows:

Average Daily Managed Assets	Fund-Level Fee Rate
For the first \$500 million	.7000%
For the next \$500 million	.6750
For the next \$500 million	.6500
For the next \$500 million	.6250
For Managed Assets over \$2 billion	.6000

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Notes to Financial Statements (continued)

The annual complex-level fee, payable monthly, which is additive to the fund-level fee, for all Nuveen sponsored funds in the U.S., is based on the aggregate amount of total fund assets managed as stated in the table below. As of December 31, 2005, the complex-level fee rate was .1895%.

Complex-Level Assets(1)	Complex-Level Fee Rate
For the first \$55 billion	.2000%
For the next \$1 billion	.1800
For the next \$1 billion	.1600
For the next \$3 billion	.1425
For the next \$3 billion	.1325
For the next \$3 billion	.1250
For the next \$5 billion	.1200
For the next \$5 billion	.1175
For the next \$15 billion	.1150
For Managed Assets over \$91 billion(2)	.1400

(1) The complex-level fee component of the management fee for the funds is calculated based upon the aggregate Managed Assets ("Managed Assets" means the average daily net assets of each fund including assets attributable to all types of leverage used by the Nuveen funds) of Nuveen-sponsored funds in the U.S.

(2) With respect to the complex-wide Managed Assets over \$91 billion, the fee rate or rates that will apply to such assets will be determined at a later date. In the unlikely event that complex-wide Managed Assets reach \$91 billion prior to a determination of the complex-level fee rate or rates to be applied to Managed Assets in excess of \$91 billion, the complex-level fee rate for such complex-wide Managed Assets shall be .1400% until such time as a different rate or rates is determined.

The management fee compensates the Adviser for overall investment advisory and administrative services and general office facilities. The Adviser has entered into Sub-Advisory Agreements with Spectrum Asset Management, Inc. ("Spectrum"), under which Spectrum manages the investment portfolios of the Funds. Spectrum is

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compensated for its services to the Funds from the management fees paid to the Adviser. Spectrum also receives compensation on certain portfolio transactions for providing brokerage services to the Funds.

The Funds pay no compensation directly to those of its Trustees who are affiliated with the Adviser or to its officers, all of whom receive remuneration for their services to the Funds from the Adviser or its affiliates. The Board of Trustees has adopted a deferred compensation plan for independent Trustees that enables Trustees to elect to defer receipt of all or a portion of the annual compensation they are entitled to receive from certain Nuveen advised Funds. Under the plan, deferred amounts are treated as though equal dollar amounts had been invested in shares of select Nuveen advised Funds.

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For the first eight years of Quality Preferred Income's (JTP) operations, the Adviser has agreed to reimburse the Fund, as a percentage of average daily Managed Assets, for fees and expenses in the amounts and for the time periods set forth below:

Year Ending June 30,	Year Ending June 30,		
2002*	.32%	2007	.32%
2003	.32	2008	.24
2004	.32	2009	.16
2005	.32	2010	.08
2006	.32		

* From the commencement of operations.

The Adviser has not agreed to reimburse Quality Preferred Income (JTP) for any portion of its fees and expenses beyond June 30, 2010.

For the first eight years of Quality Preferred Income 2's (JPS) operations, the Adviser has agreed to reimburse the Fund, as a percentage of average daily Managed Assets, for fees and expenses in the amounts and for the time periods set forth below:

Year Ending September 30,	Year Ending September 30,		
2002*	.32%	2007	.32%
2003	.32	2008	.24
2004	.32	2009	.16
2005	.32	2010	.08
2006	.32		

* From the commencement of operations.

The Adviser has not agreed to reimburse Quality Preferred Income 2 (JPS) for any portion of its fees and expenses beyond September 30, 2010.

For the first eight years of Quality Preferred Income 3's (JHP) operations, the Adviser has agreed to reimburse the Fund, as a percentage of average daily Managed Assets, for fees and expenses in the amounts and for the time periods set forth below:

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Year Ending December 31,		Year Ending December 31,	
2002*	.32%	2007	.32%
2003	.32	2008	.24
2004	.32	2009	.16
2005	.32	2010	.08
2006	.32		

* From the commencement of operations.

The Adviser has not agreed to reimburse Quality Preferred Income 3 (JHP) for any portion of its fees and expenses beyond December 31, 2010.

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Notes to
Financial Statements (continued)

6. Announcement Regarding Parent Company of Adviser

In early April, 2005, The St. Paul Travelers Companies, Inc. ("St. Paul Travelers"), which owned 79% of Nuveen, (A) completed a public offering of a substantial portion of its equity stake in Nuveen, (B) sold Nuveen \$200 million of its Nuveen shares, (C) entered into an agreement with Nuveen to sell an additional \$400 million of its Nuveen shares on a "forward" basis with payment for and settlement of these shares delayed for several months, and (D) entered into agreements with two unaffiliated investment banking firms to sell an amount equal to most or all of its remaining Nuveen shares for current payment but for future settlement. Transactions (C) and (D) above were settled in late July, which effectively reduced St. Paul Travelers' controlling stake in Nuveen and was deemed an "assignment" (as defined in the 1940 Act) of the investment management agreements between the Funds and the Adviser, which resulted in the automatic termination of each agreement under the 1940 Act. In anticipation of such deemed assignment, the Board of Trustees had approved new ongoing investment management agreements for each Fund and the submission of those agreements for approval by each respective Fund's shareholders, which shareholder approval was received prior to the settlement of transactions (C) and (D). The new ongoing management agreements took effect upon such settlement.

7. Subsequent Events - Distributions to Common Shareholders

The Funds declared Common share distributions which were paid on February 1, 2006, to shareholders of record on January 15, 2006, as follows:

	Quality Preferred Income (JTP)	Quality Preferred Income 2 (JPS)	Quality Preferred Income 3 (JHP)
July 31, 2005			
Distributions per share	\$.0900	\$.0930	\$.0945

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Financial
Highlights

Financial
Highlights

Selected data for a Common share outstanding throughout each period:

	Investment Operations				
	Beginning Common Share Net Asset Value	Net Investment Income (a)	Net Realized/ Unrealized Gain (Loss)	Distributions from Net Investment Income to FundPreferred Share- holders+	Distributions from Capital Gains to FundPreferred Share- holders+

Quality Preferred Income (JTP)					

Year ended 12/31:					
2005	\$ 14.92	\$ 1.30	\$ (.68)	\$ (.21)	\$ --
8/1/04-12/31/04	14.40	.60	.47	(.05)	--
Year Ended 7/31:					
2004 (b)	14.10	1.37	.26	(.08)	--
2003	14.12	1.31	.16	(.09)	--
2002 (c)	14.33	.06	(.25)	--	--

Quality Preferred Income 2 (JPS)					

Year ended 12/31:					
2005	15.66	1.34	(.69)	(.18)	(.02)
8/1/04-12/31/04	15.32	.60	.50	(.04)	(.01)
Year Ended 7/31:					
2004 (b)	14.97	1.42	.37	(.08)	--
2003 (d)	14.33	1.02	.79	(.07)	--

Quality Preferred Income 3 (JHP)					

Year ended 12/31:					
2005	15.15	1.32	(.70)	(.21)	(.01)
8/1/04-12/31/04	14.71	.60	.46	(.05)	--
Year Ended 7/31:					
2004 (b)	14.38	1.38	.40	(.08)	(.01)
2003 (e)	14.33	.67	.22	(.04)	--
=====					
Less Distributions					

	Net Investment Income to Common	Capital Gains to Common Share-		Offering Costs and FundPreferred Share Underwriting	Endin Commo Shar Net Asse

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	Shareholders	holders	Total	Discounts	Valu

Quality Preferred Income (JTP)					

Year ended 12/31:					
2005	\$ (1.13)	\$ --	\$ (1.13)	\$ --	\$ 14.2
8/1/04-12/31/04	(.50)	--	(.50)	--	14.9
Year Ended 7/31:					
2004 (b)	(1.25)	--	(1.25)	--	14.4
2003	(1.25)	--	(1.25)	(.15)	14.1
2002 (c)	--	--	--	(.02)	14.1

Quality Preferred Income 2 (JPS)					

Year ended 12/31:					
2005	(1.16)	(.18)	(1.34)	--	14.7
8/1/04-12/31/04	(.53)	(.18)	(.71)	--	15.6
Year Ended 7/31:					
2004 (b)	(1.32)	(.04)	(1.36)	--	15.3
2003 (d)	(.95)	--	(.95)	(.15)	14.9

Quality Preferred Income 3 (JHP)					

Year ended 12/31:					
2005	(1.17)	(.09)	(1.26)	--	14.2
8/1/04-12/31/04	(.51)	(.06)	(.57)	--	15.1
Year Ended 7/31:					
2004 (b)	(1.24)	(.12)	(1.36)	--	14.7
2003 (e)	(.62)	--	(.62)	(.18)	14.3
=====					

* Annualized.

** Total Return on Market Value is the combination of changes in the market price per share and the effect of reinvested dividend income and reinvested capital gains distributions, if any, at the average price paid per share at the time of reinvestment. Total Return on Common Share Net Asset Value is the combination of changes in Common Share net asset value, reinvested dividend income at net asset value and reinvested capital gains distributions at net asset value, if any. Total returns are not annualized.

*** After custodian fee credit and expense reimbursement, where applicable.

+ The amounts shown are based on Common share equivalents.

++ o Ratios do not reflect the effect of dividend payments to FundPreferred shareholders.

o Income ratios reflect income earned on assets attributable to FundPreferred shares.

o For the periods presented below each ratio includes the effect of the interest expense paid on interest rate swap transactions as follows:

Ratio of Net Interest Expense to Average
Net Assets Applicable to Common Shares

Quality Preferred Income (JTP)
Year Ended 7/31:

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2003	.80%
2002(c)	--
Quality Preferred Income 2 (JPS)	
Year Ended 7/31:	
2003(d)	.58*
Quality Preferred Income 3 (JHP)	
Year Ended 7/31:	
2003(e)	.51*

- (a) Per share Net Investment Income is calculated using the average daily shares method.
- (b) As discussed in the accompanying notes to financial statements the Funds changed their method of presentation for net interest expense on interest rate swap transactions. The effect of this reclassification for the fiscal year ended July 31, 2004, was as follows:

	Quality Preferred Income (JTP)	Quality Preferred Income 2 (JPS)
Increase of Net Investment Income per share with a corresponding decrease in Net Realized/Unrealized Investment Gain (Loss)	\$.14	\$.11
Decrease in each of the Ratios of Expenses to Average Net Assets Applicable to Common Shares with a corresponding increase in each of the Ratios of Net Investment Income to Average Net Assets Applicable to Common Shares	.94%	.71%

- (c) For the period June 25, 2002 (commencement of operations) through July 31, 2002.
- (d) For the period September 24, 2002 (commencement of operations) through July 31, 2003.
- (e) For the period December 18, 2002 (commencement of operations) through July 31, 2003.

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	Total Returns	
	Based on Market Value**	Based on Share Net Asset Value**
Quality Preferred Income (JTP)		
Year ended 12/31:		
2005	(3.69)%	2.89%

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8/1/04-12/31/04	3.79	7.10
Year Ended 7/31:		
2004 (b)	4.20	11.17
2003	4.95	9.15
2002 (c)	1.00	(1.47)

Quality Preferred Income 2 (JPS)

Year ended 12/31:		
2005	(2.06)	3.01
8/1/04-12/31/04	3.34	6.94
Year Ended 7/31:		
2004 (b)	8.98	11.60
2003 (d)	4.02	11.22

Quality Preferred Income 3 (JHP)

Year ended 12/31:		
2005	(2.16)	2.88
8/1/04-12/31/04	4.64	6.81
Year Ended 7/31:		
2004 (b)	9.36	11.93
2003 (e)	(.19)	4.62

Ratios/Supplemental Data

	Before Credit/Reimbursement	After Credit
	Ratio of Expenses to Average Net Assets Applicable to Common Shares (000)	Ratio of Investment Income to Average Net Assets Applicable to Common Shares++

Quality Preferred Income (JTP)

Year ended 12/31:				
2005	\$ 915,598	1.49%	8.47%	1.02
8/1/04-12/31/04	961,583	1.49*	9.15*	1.02
Year Ended 7/31:				
2004 (b)	927,892	1.51	8.87	1.04
2003	907,746	2.38	8.84	1.91
2002 (c)	880,006	.96*	4.51*	.64

Quality Preferred Income 2 (JPS)

Year ended 12/31:				
2005	1,765,543	1.40	8.32	.94
8/1/04-12/31/04	1,872,283	1.40*	8.69*	.94
Year Ended 7/31:				
2004 (b)	1,830,878	1.41	8.64	.95
2003 (d)	1,789,809	1.99*	7.59*	1.54

Quality Preferred Income 3 (JHP)

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Year ended 12/31:				
2005	337,858	1.54	8.48	1.07
8/1/04-12/31/04	358,197	1.54*	9.03*	1.07
Year Ended 7/31:				
2004 (b)	347,900	1.55	8.75	1.08
2003 (e)	339,499	1.97*	7.14*	1.53

Fund Preferred Shares at End of Period

	Aggregate Amount Outstanding (000)	Liquidation and Market Value Per Share	Asset Coverage Per Share
Quality Preferred Income (JTP)			
Year ended 12/31:			
2005	\$ 440,000	\$ 25,000	\$ 77,023
8/1/04-12/31/04	440,000	25,000	79,635
Year Ended 7/31:			
2004 (b)	440,000	25,000	77,721
2003	440,000	25,000	76,577
2002 (c)	--	--	--

Quality Preferred Income 2 (JPS)

Year ended 12/31:			
2005	800,000	25,000	80,173
8/1/04-12/31/04	800,000	25,000	83,509
Year Ended 7/31:			
2004 (b)	800,000	25,000	82,215
2003 (d)	800,000	25,000	80,932

Quality Preferred Income 3 (JHP)

Year ended 12/31:			
2005	166,000	25,000	75,882
8/1/04-12/31/04	166,000	25,000	78,945
Year Ended 7/31:			
2004 (b)	166,000	25,000	77,395
2003 (e)	166,000	25,000	76,129

See accompanying notes to financial statements.

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Board Members
and Officers

The management of the Funds, including general supervision of the duties performed for the Funds by the Adviser, is the responsibility of the Board Members of the Funds. The number of board members of the Fund is currently set at nine. None of the board members who are not "interested" persons of the Funds has ever been a director or employee of, or consultant to, Nuveen or its affiliates. The names and business addresses of the board members and officers

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of the Funds, their principal occupations and other affiliations during the past five years, the number of portfolios each oversees and other directorships they hold are set forth below.

Name, Birthdate and Address	Position(s) Held with the Funds	Year First Elected or Appointed(2)	Principal Occupation(s) Including other Directorships During Past 5 Years

Board members who is an interested person of the Funds:			

Timothy R. Schwertfeger(1) 3/28/49 333 W. Wacker Drive Chicago, IL 60606	Chairman of the Board and Trustee	1994	Chairman (since 1996) and Director Investments, Inc., Nuveen Investme Nuveen Advisory Corp. and Nuveen I Advisory Corp.(3); Director (since Institutional Capital Corporation; Director (since 1997) of Nuveen AS Management; Chairman and Director Asset Management, Inc. (since 1999 Nuveen Investments Advisers Inc. (
Board members who are not interested persons of the Funds:			

Robert P. Bremner 8/22/40 333 W. Wacker Drive Chicago, IL 60606	Board member	1997	Private Investor and Management Co

Lawrence H. Brown 7/29/34 333 W. Wacker Drive Chicago, IL 60606	Board member	1993	Retired (since 1989) as Senior Vic The Northern Trust Company; Direct 2002) Community Advisory Board for and Highwood, United Way of the No

Jack B. Evans 10/22/48 333 W. Wacker Drive Chicago, IL 60606	Board member	1999	President, The Hall-Perrine Founda private philanthropic corporation Director and Vice Chairman, United publicly held company; Adjunct Fac University of Iowa; Director, Gaze Life Trustee of Coe College and Io Foundation; formerly, Director, Al formerly, Director, Federal Reserv Chicago; formerly, President and C Officer, SCI Financial Group, Inc. financial services firm.

William C. Hunter 3/6/48 333 W. Wacker Drive Chicago, IL 60606	Board member	2004	Dean and Distinguished Professor o School of Business at the Universi Connecticut (since 2002); previous Vice President and Director of Res Federal Reserve Bank of Chicago (1 Director (since 1997), Credit Rese Georgetown University; Director (s Xerox Corporation; Director SS&C T Inc. (May 2005–October 2005).

David J. Kundert 10/28/42 333 W. Wacker Drive	Board member	2005	Retired (since 2004) as Chairman, Fleming Asset Management, Presiden Banc One Investment Advisors Corpo

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Chicago, IL 60606

President, One Group Mutual Funds; thereto, Executive Vice President, Corporation and Chairman and CEO, Investment Management Group; Board Luther College; member of the Wisconsin Association; member of Board of Directors Friends of Boerner Botanical Garden

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Name, Birthdate and Address	Position(s) Held with the Funds	Year First Elected or Appointed(2)	Principal Occupation(s) Including other Directorships During Past 5 Years
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Board members who are not interested persons of the Funds (continued):

William J. Schneider 9/24/44 333 W. Wacker Drive Chicago, IL 60606	Board member	1997	Chairman of Miller-Valentine Partners, a real estate investment company; formerly, Senior Partner and Chief Operating Officer (retired, December 2004), of Miller-Valentine Group; formerly, Vice President, Miller-Valentine Realty; Board Member of the Finance Committee and member of the Committee of Premier Health Partners, a not-for-profit company of Miami Valley Hospital; Vice President, Dayton Philharmonic Orchestra Association; Board Member of the Leaders Forum, which promotes cooperative economic development issues; Director of the Development Coalition; formerly, Member of the Community Advisory Board, National Business Center, Dayton, Ohio and Business Advisory Board, Cleveland Federal Reserve Bank.
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Judith M. Stockdale 12/29/47 333 W. Wacker Drive Chicago, IL 60606	Board member	1997	Executive Director, Gaylord and Donnelley Foundation (since 1994); formerly, Executive Director, Great Lakes Protection Fund (from 1990 to 1994)
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Eugene S. Sunshine 1/22/50 333 W. Wacker Drive Chicago, IL 60606	Board member	2005	Senior Vice President for Business Development, Northwestern University (since 1999); formerly, Director (since 2003), Chicago Board Options Exchange (since 2003), National Merit Corporation Holdings, a privately-held, national provider of home and community-based services (since 1997), Board of Directors, Pure Captive Insurance Company owned by Northwestern University; Director of the Evanston Chamber of Commerce and Entrepreneurship, a business development
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Name, Birthdate and Address	Position(s) Held with the Funds	Year First Elected or Appointed(4)	Principal Occupation(s) During Past 5 Years
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Officers of the Funds

Gifford R. Zimmerman 9/9/56 333 W. Wacker Drive Chicago, IL 60606	Chief Administrative Officer	1988	Managing Director (since 2002), As Secretary and Associate General Co formerly, Vice President and Assis Counsel, of Nuveen Investments, LL Director (2002-2004), General Coun (1998-2004) and Assistant Secretar Vice President of Nuveen Advisory Nuveen Institutional Advisory Corp Managing Director (since 2002) and Secretary and Associate General Co formerly, Vice President (since 19 Nuveen Asset Management; Managing (since 2004) and Assistant Secreta 1994) of Nuveen Investments, Inc.; Secretary of NWQ Investment Manage LLC. (since 2002); Vice President Secretary of Nuveen Investments Ad (since 2002); Managing Director, A General Counsel and Assistant Sec Rittenhouse Asset Management, Inc. 2003); Chartered Financial Analyst
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Board Members
and Officers (continued)

Name, Birthdate and Address	Position(s) Held with the Funds	Year First Elected or Appointed(4)	Principal Occupation(s) During Past 5 Years
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Officers of the Funds (continued):

Julia L. Antonatos 9/22/63 333 W. Wacker Drive Chicago, IL 60606	Vice President	2004	Managing Director (since 2005), fo President (since 2002); formerly, President (since 2000) of Nuveen I LLC; Chartered Financial Analyst.
Michael T. Atkinson 2/3/66 333 W. Wacker Drive Chicago, IL 60606	Vice President and Assistant Secretary	2000	Vice President (since 2002), forme Vice President (since 2000) of Nu Investments, LLC.
Peter H. D'Arrigo 11/28/67 333 W. Wacker Drive Chicago, IL 60606	Vice President and Treasurer	1999	Vice President of Nuveen Investmen 1999); Vice President and Treasur of Nuveen Investments, Inc.; Vice Treasurer (1999-2004) of Nuveen Ad

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and Nuveen Institutional Advisory
 President and Treasurer of Nuveen
 Management (since 2002) and of Nuve
 Investments Advisers Inc. (since 2
 Assistant Treasurer of NWQ Investm
 Company, LLC. (since 2002); Vice P
 Treasurer of Nuveen Rittenhouse As
 Management, Inc. (since 2003); Cha
 Financial Analyst.

John N. Desmond 8/24/61 333 W. Wacker Drive Chicago, IL 60606	Vice President	2005	Vice President, Director of Invest Operations, Nuveen Investments, LL January 2005); formerly, Director, Manager, Deutsche Asset Management Director, Business Development and Transformation, Deutsche Trust Ban (2002-2003); previously, Senior Vi Head of Investment Operations and Scudder Investments Japan, (2000-2 Vice President, Head of Plan Admin Participant Services, Scudder Inve (1995-2002).
Jessica R. Droeger 9/24/64 333 W. Wacker Drive Chicago, IL 60606	Vice President and Secretary	1998	Vice President (since 2002), Assis and Assistant General Counsel (sin formerly, Assistant Vice President of Nuveen Investments, LLC; Vice P (2002-2004) and Assistant Secretar formerly, Assistant Vice President Advisory Corp. and Nuveen Institut Corp.(3); Vice President and Assis (since 2005) of Nuveen Asset Manag
Lorna C. Ferguson 10/24/45 333 W. Wacker Drive Chicago, IL 60606	Vice President	1998	Managing Director (since 2004), fo President of Nuveen Investments, L Director (2004) formerly, Vice Pre (1998-2004) of Nuveen Advisory Cor Institutional Advisory Corp.(3); M Director (since 2005) of Nuveen As Management.
William M. Fitzgerald 3/2/64 333 W. Wacker Drive Chicago, IL 60606	Vice President	1995	Managing Director (since 2002), fo President of Nuveen Investments; M Director (1997-2004) of Nuveen Adv and Nuveen Institutional Advisory Managing Director of Nuveen Asset (since 2001); Vice President of Nu Investments Advisers Inc. (since 2 Chartered Financial Analyst.

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Name, Birthdate and Address	Position(s) Held with the Funds	Year First Elected or Appointed(4)	Principal Occupation(s) During Past 5 Years
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Officers of the Funds (continued):

<p>Stephen D. Foy 5/31/54 333 W. Wacker Drive Chicago, IL 60606</p>	<p>Vice President and Controller</p>	<p>1998</p>	<p>Vice President (since 1993) and Fu (since 1998) of Nuveen Investments formerly, Vice President and Funds (1998-2004) of Nuveen Investments, Certified Public Accountant.</p>
<p>James D. Grassi 4/13/56 333 W. Wacker Drive Chicago, IL 60606</p>	<p>Vice President and Chief Compliance Officer</p>	<p>2004</p>	<p>Vice President and Deputy Director (since 2004) of Nuveen Investments Investments Advisers Inc., Nuveen Management and Rittenhouse Asset M Inc.; previously, Vice President a Director of Compliance (2004) of N Corp. and Nuveen Institutional Adv Corp.(3); formerly, Senior Attorne The Northern Trust Company.</p>
<p>David J. Lamb 3/22/63 333 W. Wacker Drive Chicago, IL 60606</p>	<p>Vice President</p>	<p>2000</p>	<p>Vice President (since 2000) of Nuve Investments, LLC; Certified Public</p>
<p>Tina M. Lazar 8/27/61 333 W. Wacker Drive Chicago, IL 60606</p>	<p>Vice President</p>	<p>2002</p>	<p>Vice President of Nuveen Investmen 1999).</p>
<p>Larry W. Martin 7/27/51 333 W. Wacker Drive Chicago, IL 60606</p>	<p>Vice President and Assistant Secretary</p>	<p>1988</p>	<p>Vice President, Assistant Secretar Assistant General Counsel of Nuvee LLC; Vice President and Assistant Nuveen Advisory Corp. and Nuveen I Advisory Corp.(3); Vice President and Assistant Secretary of Nuveen Inc.; Vice President (since 2005) Secretary (since 1997) of Nuveen A Management; Vice President (since Assistant Secretary and Assistant Counsel (since 1998) of Rittenhous Management, Inc.; Vice President a Secretary of Nuveen Investments Ad (since 2002); Assistant Secretary Investment Management Company, LLC</p>

- (1) Mr. Schwertfeger is an "interested person" of the Funds, as defined in the Investment Company Act of 1940, because he is an officer and board member of the Adviser.
- (2) Board members serve an indefinite term until his/her successor is elected. The year first elected or appointed represents the year in which the board member was first elected or appointed to any fund in the Nuveen Complex.
- (3) Nuveen Advisory Corp. and Nuveen Institutional Advisory Corp. were reorganized into Nuveen Asset Management, effective January 1, 2005.
- (4) Officers serve one year terms through July of each year. The year first elected or appointed represents the year in which the Officer was first elected or appointed to any fund in the Nuveen Complex.

Reinvest Automatically
Easily and Conveniently

Nuveen makes
reinvesting easy.
A phone call is
all it takes to
set up your
reinvestment
account

Nuveen Exchange-Traded Closed-End Funds
Dividend Reinvestment Plan

Your Nuveen Exchange-Traded Closed-End Fund allows you to conveniently reinvest dividends and/or capital gains distributions in additional fund shares

By choosing to reinvest, you'll be able to invest money regularly and automatically, and watch your investment grow through the power of compounding.

It is important to note that an automatic reinvestment plan does not ensure a profit, nor does it protect you against loss in a declining market.

Easy and convenient

To make recordkeeping easy and convenient, each month you'll receive a statement showing your total dividends and distributions, the date of investment, the shares acquired and the price per share, and the total number of shares you own.

How shares are purchased

The shares you acquire by reinvesting will either be purchased on the open market or newly issued by the Fund. If the shares are trading at or above net asset value at the time of valuation, the Fund will issue new shares at the greater of the net asset value or 95% of the then-current market price. If the shares are trading at less than net asset value, shares for your account will be purchased on the open market. Dividends and distributions received to purchase shares in the open market will normally be invested shortly after the dividend payment date. No interest will be paid on dividends and distributions awaiting reinvestment. Because the market price of the shares may increase before purchases are completed, the average purchase price per share may exceed the market price at the time of valuation, resulting in the acquisition of fewer shares than if the dividend or distribution had been paid in shares issued by the Fund. A pro rata portion of any applicable brokerage commissions on open market purchases will be paid by Plan participants. These commissions usually will be lower than those charged on individual transactions.

Flexible

You may change your distribution option or withdraw from the Plan at any time, should your needs or situation change. Should you withdraw, you can receive a certificate for all whole shares credited to your reinvestment account and cash payment for fractional shares, or cash payment for all reinvestment account shares, less brokerage commissions and a \$2.50 service fee.

You can reinvest whether your shares are registered in your name, or in the name of a brokerage firm, bank, or other nominee. Ask your investment advisor if his or her firm will participate on your behalf. Participants whose shares are registered in the name of one firm may not be able to transfer the shares to

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another firm and continue to participate in the Plan.

The Fund reserves the right to amend or terminate the Plan at any time. Although the Fund reserves the right to amend the Plan to include a service charge payable by the participants, there is no direct service charge to participants in the Plan at this time.

Call today to start reinvesting dividends and/or distributions

For more information on the Nuveen Automatic Reinvestment Plan or to enroll in or withdraw from the Plan, speak with your financial advisor or call us at (800) 257-8787.

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Other Useful Information

In April, 2005, The St. Paul Travelers Companies, Inc. ("St. Paul Travelers") sold the majority of its controlling equity interest in Nuveen Investments, Inc. ("Nuveen") to the general public. Nuveen is the parent of Nuveen Asset Management ("NAM"), which is each Fund's investment manager. This sale was deemed to be an "assignment" of the investment management agreement between each Fund and NAM and, if applicable, of the sub-advisory agreement between NAM and the Fund's sub-adviser. As required by law, the shareholders of each Fund were asked to approve a new investment management agreement and, if applicable, a new subadvisory agreement that reflected this change in ownership. The shareholders of each Fund voted this approval at a Shareholders' Meeting on July 26, 2005. There were no changes to the investment objectives or management of any Fund as a result of these actions.

Quarterly Portfolio of Investments and Proxy voting information

The Fund's (i) quarterly portfolio of investments, (ii) information regarding how the Funds voted proxies relating to portfolio securities held during the most recent 12-month period ended June 30, 2005, and (iii) a description of the policies and procedures that the Fund used to determine how to vote proxies relating to portfolio securities are available without charge, upon request, by calling Nuveen Investments toll-free at (800) 257-8787 or on Nuveen's website at www.nuveen.com.

You may also obtain this and other Fund information directly from the Securities and Exchange Commission ("SEC"). The SEC may charge a copying fee for this information. Visit the SEC on-line at <http://www.sec.gov> or in person at the SEC's Public Reference Room in Washington, D.C. Call the SEC at 1-202-942-8090 for room hours and operation. You may also request Fund information by sending an e-mail request to publicinfo@sec.gov or by writing to the SEC's Public Reference Section at 450 Fifth Street NW, Washington, D.C. 20549.

CEO Certification Disclosure

Each Fund's Chief Executive Officer has submitted to the New York Stock Exchange the annual CEO certification as required by Section 303A.12(a) of the NYSE Listed Company Manual.

Each Fund has filed with the Securities and Exchange Commission the certification of its Chief Executive Officer and Chief Financial Officer required by Section 302 of the Sarbanes-Oxley Act.

Distribution Information

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Nuveen Quality Preferred Income Fund (JTP), Nuveen Quality Preferred Income Fund 2 (JPS) and Nuveen Quality Preferred Income Fund 3 (JHP) designate 15.22%, 12.12% and 11.60%, respectively, of dividends declared from net investment income as dividends qualifying for the 70% dividends received deduction for corporations and 21.15%, 17.41% and 17.85%, respectively, as qualified dividend income for individuals under the Jobs and Growth Tax Relief Reconciliation Act of 2003.

Board of Trustees

Robert P. Bremner
Lawrence H. Brown
Jack B. Evans
William C. Hunter
David J. Kundert
William J. Schneider
Timothy R. Schwertfeger
Judith M. Stockdale
Eugene S. Sunshine

Fund Manager

Nuveen Asset Management
333 West Wacker Drive
Chicago, IL 60606

Custodian

State Street Bank & Trust Company
Boston, MA

Transfer Agent and Shareholder Services

State Street Bank & Trust Company
Nuveen Funds
P.O. Box 43071
Providence, RI 02940-3071
(800) 257-8787

Legal Counsel

Chapman and Cutler LLP
Chicago, IL

Independent Registered Public Accounting Firm

Ernst & Young LLP
Chicago, IL

The Fund intends to repurchase shares of its own common or preferred stock in the future at such times and in such amounts as is deemed advisable. No shares were repurchased during the period covered by this report. Any future repurchases will be reported to shareholders in the next annual or semiannual report.

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[GRAPHIC OMITTED]

Learn more
about Nuveen Funds at
www.nuveen.com/etf

Nuveen Investments:

SERVING Investors
For GENERATIONS

Since 1898, financial advisors and their clients have relied on Nuveen Investments to provide dependable investment solutions. For the past century, Nuveen Investments has adhered to the belief that the best approach to investing is to apply conservative risk-management principles to help minimize volatility.

Building on this tradition, we today offer a range of high quality equity and fixed-income solutions that are integral to a well-diversified core portfolio. Our clients have come to appreciate this diversity, as well as our continued adherence to proven, long-term investing principles.

We offer many different investing solutions for our clients' different needs.

Managing more than \$135 billion in assets, Nuveen Investments offers access to a number of different asset classes and investing solutions through a variety of products. Nuveen Investments markets its capabilities under four distinct brands: Nuveen, a leader in fixed-income investments; NWQ, a leader in value-style equities; Rittenhouse, a leader in growth-style equities; and Symphony, a leading institutional manager of market-neutral alternative investment portfolios.

Find out how we can help you reach your financial goals.

To learn more about the products and services Nuveen Investments offers, talk to your financial advisor, or call us at (800) 257-8787. Please read the information provided carefully before you invest.

Be sure to obtain a prospectus, where applicable. Investors should consider the investment objective and policies, risk considerations, charges and expenses of the Fund carefully before investing. The prospectus contains this and other information relevant to an investment in the Fund. For a prospectus, please contact your securities representative or Nuveen Investments, 333 W. Wacker Dr., Chicago, IL 60606. Please read the prospectus carefully before you invest or send money.

- o Share prices
- o Fund details
- o Daily financial news
- o Investor education
- o Interactive planning tools

[LOGO]
NUVEEN
Investments

EAN-E-1205D

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ITEM 2. CODE OF ETHICS.

As of the end of the period covered by this report, the registrant has adopted a code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. There were no amendments to or waivers from the Code during the period covered by this report. The registrant has posted the code of ethics on its website at www.nuveen.com/etf. (To view the code, click on the Investor Resources drop down menu box, click on Fund Governance and then click on Code of Conduct.)

ITEM 3. AUDIT COMMITTEE FINANCIAL EXPERT.

The registrant's Board of Directors or Trustees determined that the registrant has at least one "audit committee financial expert" (as defined in Item 3 of Form N-CSR) serving on its Audit Committee. The registrant's audit committee financial expert is Jack B. Evans, Chairman of the Audit Committee, who is "independent" for purposes of Item 3 of Form N-CSR.

Mr. Evans was formerly President and Chief Operating Officer of SCI Financial Group, Inc., a full service registered broker-dealer and registered investment adviser ("SCI"). As part of his role as President and Chief Operating Officer, Mr. Evans actively supervised the Chief Financial Officer (the "CFO") and actively supervised the CFO's preparation of financial statements and other filings with various regulatory authorities. In such capacity, Mr. Evans was actively involved in the preparation of SCI's financial statements and the resolution of issues raised in connection therewith. Mr. Evans has also served on the audit committee of various reporting companies. At such companies, Mr. Evans was involved in the oversight of audits, audit plans, and the preparation of financial statements. Mr. Evans also formerly chaired the audit committee of the Federal Reserve Bank of Chicago.

ITEM 4. PRINCIPAL ACCOUNTANT FEES AND SERVICES.

Nuveen Quality Preferred Income Fund 2

The following tables show the amount of fees that Ernst & Young LLP, the Fund's auditor, billed to the Fund during the Fund's last two full fiscal years. For engagements with Ernst & Young LLP the Audit Committee approved in advance all audit services and non-audit services that Ernst & Young LLP provided to the Fund, except for those non-audit services that were subject to the pre-approval exception under Rule 2-01 of Regulation S-X (the "pre-approval exception"). The pre-approval exception for services provided directly to the Fund waives the pre-approval requirement for services other than audit, review or attest services if: (A) the aggregate amount of all such services provided constitutes no more than 5% of the total amount of revenues paid by the Fund to its accountant during the fiscal year in which the services are provided; (B) the Fund did not recognize the services as non-audit services at the time of the engagement; and (C) the services are promptly brought to the Audit Committee's attention, and the Committee (or its delegate) approves the services before the audit is completed.

The Audit Committee has delegated certain pre-approval responsibilities to its Chairman (or, in his absence, any other member of the Audit Committee).

SERVICES THAT THE FUND'S AUDITOR BILLED TO THE FUND

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FISCAL YEAR ENDED	AUDIT FEES BILLED TO FUND	AUDIT-RELATED FEES BILLED TO FUND	TAX FEES BILLED TO FUND
December 31, 2005	\$ 28,211	\$ 0	\$ 0
Percentage approved pursuant to pre-approval exception		0%	
December 31, 2004 (1)	\$ 26,088	\$ 0	\$ 0
Percentage approved pursuant to pre-approval exception		0%	

The above "Tax Fees" were billed for professional services for tax advice, tax compliance, and tax planning.

- (1) This fund changed its fiscal year end from July 31 to December 31. For the stub period ending, 12/31/04 the fund incurred the following fees : Audit fees of \$26,088 ; Tax fees of \$3,676 ; and All Other fees of \$1,800.

SERVICES THAT THE FUND'S AUDITOR BILLED TO THE ADVISER AND AFFILIATED FUND SERVICE PROVIDERS

The following tables show the amount of fees billed by Ernst & Young LLP to Nuveen Asset Management ("NAM" or the "Adviser"), and any entity controlling, controlled by or under common control with NAM ("Control Affiliate") that provides ongoing services to the Fund ("Affiliated Fund Service Provider"), for engagements directly related to the Fund's operations and financial reporting, during the Fund's last two full fiscal years.

The tables also show the percentage of fees subject to the pre-approval exception. The pre-approval exception for services provided to the Adviser and any Affiliated Fund Service Provider (other than audit, review or attest services) waives the pre-approval requirement if: (A) the aggregate amount of all such services provided constitutes no more than 5% of the total amount of revenues paid to Ernst & Young LLP by the Fund, the Adviser and Affiliated Fund Service Providers during the fiscal year in which the services are provided that would have to be pre-approved by the Audit Committee; (B) the Fund did not recognize the services as non-audit services at the time of the engagement; and (C) the services are promptly brought to the Audit Committee's attention, and the Committee (or its delegate) approves the services before the Fund's audit is completed.

FISCAL YEAR ENDED	AUDIT-RELATED FEES BILLED TO ADVISER AND AFFILIATED FUND SERVICE PROVIDERS	TAX FEES BILLED TO ADVISER AND AFFILIATED FUND SERVICE PROVIDERS	ALL OTHER FEES BILLED TO ADVISER AND AFFILIATED FUND SERVICE PROVIDERS
December 31, 2005	\$ 0	\$ 282,575	\$ 0

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Percentage approved pursuant to pre-approval exception	0%	0%
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December 31, 2004	\$ 0	\$ 0
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Percentage approved pursuant to pre-approval exception	0%	0%
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The above "Tax Fees" are primarily fees billed to the Adviser for Fund tax return preparation.

NON-AUDIT SERVICES

The following table shows the amount of fees that Ernst & Young LLP billed during the Fund's last two full fiscal years for non-audit services. For engagements entered into on or after May 6, 2003, the Audit Committee is required to pre-approve non-audit services that Ernst & Young LLP provides to the Adviser and any Affiliated Fund Services Provider, if the engagement related directly to the Fund's operations and financial reporting (except for those subject to the de minimis exception described above). The Audit Committee requested and received information from Ernst & Young LLP about any non-audit services that Ernst & Young LLP rendered during the Fund's last fiscal year to the Adviser and any Affiliated Fund Service Provider. The Committee considered this information in evaluating Ernst & Young LLP's independence.

FISCAL YEAR ENDED	TOTAL NON-AUDIT FEES BILLED TO FUND	TOTAL NON-AUDIT FEES BILLED TO ADVISER AND AFFILIATED FUND SERVICE PROVIDERS (ENGAGEMENTS RELATED DIRECTLY TO THE OPERATIONS AND FINANCIAL REPORTING OF THE FUND)	TOTAL NON-BILLED TO AFFILIATED PROVIDERS ENGA
December 31, 2005	\$ 7,573	\$ 282,575	
December 31, 2004 (2)	\$ 12,548	\$ 0	

The above "Non-Audit Fees billed to Adviser" for 2005 include "Tax-Fees" billed to Adviser in the amount of \$282,575 from previous table.

- (2) This fund changed its fiscal year end from July 31 to December 31. For the stub period ending, 12/31/04 the fund incurred total Non-Audit fees of \$5,476.

Audit Committee Pre-Approval Policies and Procedures. Generally, the Audit Committee must approve (i) all non-audit services to be performed for the Fund by the Fund's independent accountants and (ii) all audit and non-audit services to be performed by the Fund's independent accountants for the Affiliated Fund Service Providers with respect to operations and financial reporting of the Fund. Regarding tax and research projects conducted by the independent accountants for the Fund and Affiliated Fund Service Providers (with respect to

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operations and financial reports of the Fund) such engagements will be (i) pre-approved by the Audit Committee if they are expected to be for amounts greater than \$10,000; (ii) reported to the Audit Committee chairman for his verbal approval prior to engagement if they are expected to be for amounts under \$10,000 but greater than \$5,000; and (iii) reported to the Audit Committee at the next Audit Committee meeting if they are expected to be for an amount under \$5,000.

ITEM 5. AUDIT COMMITTEE OF LISTED REGISTRANTS.

The registrant's Board of Directors or Trustees has a separately designated Audit Committee established in accordance with Section 3(a)(58)(A) of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78c(a)(58)(A)). The members of the audit committee are Robert P. Bremner, Lawrence H. Brown, Jack B. Evans, William J. Schneider and Eugene S. Sunshine.

ITEM 6. SCHEDULE OF INVESTMENTS.

See Portfolio of Investments in Item 1.

ITEM 7. DISCLOSURE OF PROXY VOTING POLICIES AND PROCEDURES FOR CLOSED-END MANAGEMENT INVESTMENT COMPANIES.

The Adviser has engaged Spectrum Asset Management, Inc. ("Spectrum" or "Sub-Adviser") as Sub-Adviser to provide discretionary investment advisory services. As part of these services, the Adviser has also delegated to the Sub-Adviser the full responsibility for proxy voting and related duties in accordance with the Sub-Adviser's policy and procedures. The Adviser periodically will monitor the Sub-Adviser's voting to ensure that they are carrying out their duties. The Sub-Adviser's proxy voting policies and procedures are summarized as follows:

Spectrum has adopted a Policy on Proxy Voting for Investment Advisory Clients (the "Voting Policy"), which provides that Spectrum aims to ensure that, when delegated proxy voting authority by a client, Spectrum acts (1) solely in the interest of the client in providing for ultimate long-term stockholder value, and (2) without undue influence from individuals or groups who may have an economic interest in the outcome of a proxy vote. Spectrum relies on the custodian bank to deliver proxies to Spectrum for voting.

Spectrum has selected Institutional Shareholder Services, Inc. ("ISS") to assist with Spectrum's proxy voting responsibilities. Spectrum generally follows ISS standard proxy voting guidelines which embody the positions and factors Spectrum considers important in casting proxy votes. In connection with each proxy vote, ISS prepares a written analysis and recommendation based on its guidelines. In order to avoid any conflict of interest for ISS, the CCO will require ISS to deliver additional information or certify that ISS has adopted policies and procedures to detect and mitigate such conflicts of interest in issuing voting recommendations. Spectrum also may obtain voting recommendations from two proxy voting services as an additional check on the independence of ISS' voting recommendations.

Spectrum may, on any particular proxy vote, diverge from ISS' guidelines or recommendations. In such a case, Spectrum's Voting Policy requires that: (i) the requesting party document the reason for the request; (ii) the approval of the Chief Investment Officer; (iii) notification to appropriate compliance personnel; (iv) a determination that the decision is not influenced by any conflict of interest; and (v) a written record of the process.

When Spectrum determines not to follow ISS' guidelines or recommendations, Spectrum classifies proxy voting issues into three broad categories: (1) Routine Administrative Items; (2) Special Interest Issues; and (3) Issues having the

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Potential for Significant Economic Impact, and casts proxy votes in accordance with the philosophy and decision guidelines developed for that category in the Voting Policy.

- o Routine Administrative Items. Spectrum is willing to defer to management on matters of a routine administrative nature. Examples of issues on which Spectrum will normally defer to management's recommendation include selection of auditors, increasing the authorized number of common shares and the election of unopposed directors.
- o Special Interest Issues. In general, Spectrum will abstain from voting on shareholder social, political, environmental proposals because their long-term impact on share value cannot be calculated with any reasonable degree of confidence.
- o Issues Having the Potential for Significant Economic Impact. Spectrum is not willing to defer to management on proposals which have the potential for major economic impact on the corporation and value of its shares and believes such issues should be carefully analyzed and decided by shareholders. Examples of such issues are classification of board of directors' cumulative voting and supermajority provisions, defensive strategies (e.g., greenmail prevention), business combinations and restructurings and executive and director compensation.

Conflicts of Interest. There may be a material conflict of interest when Spectrum votes, on behalf of a client, a proxy that is solicited by an affiliated person of Spectrum or another Spectrum client. To avoid such conflicts, Spectrum has established procedures under its Voting Policy to seek to ensure that voting decisions are based on a client's best interests and are not the product of a material conflict. In addition to employee monitoring for potential conflicts, the CCO reviews Spectrum's and its affiliates' material business relationships and personal and financial relationships of senior personnel of Spectrum and its affiliates to monitor for conflicts of interest.

If a conflict of interest is identified, Spectrum considers both financial and non-financial materiality to determine if a conflict of interest is material. If a material conflict of interest is found to exist, the CCO discloses the conflict to affected clients and obtains consent from each client in the manner in which Spectrum proposed to vote.

Spectrum clients can obtain a copy of the Voting Policy or information on how Spectrum voted their proxies by calling Spectrum's Compliance Department at (203) 322-0189.

ITEM 8. PORTFOLIO MANAGERS OF CLOSED-END MANAGEMENT INVESTMENT COMPANIES.

SPECTRUM ASSET MANAGEMENT

A. PORTFOLIO MANAGER BIOGRAPHY

BERNARD M. SUSSMAN is Chief Investment Officer and Chairman of Spectrum's Investment Committee. Prior to joining Spectrum in 1995, Mr. Sussman was with Goldman Sachs & Co. for nearly 18 years.

MARK A. LIEB is Chief Financial Officer and is responsible for business development. Prior to founding Spectrum in 1987, Mr. Lieb was a Founder, Director and Partner of DBL Preferred Management, Inc., a wholly owned corporate cash management subsidiary of Drexel Burnham Lambert, Inc.

L. PHILLIP JACOBY, IV is a Senior Vice President and joined Spectrum in 1995.

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From 1989-1995, Mr. Jacoby was a Senior Investment Officer at USL Capital Corporation (a subsidiary of Ford Motor Corporation) and was co-portfolio manager of a \$600 million preferred stock portfolio.

B. OTHER ACCOUNTS MANAGED BY SPECTRUM

(a) (1) Identify portfolio manager(s) of the Adviser to be named in the Fund prospectus

(a) (2) For each person identified in column (a) (1), provide number of accounts other than the Funds managed by the person within each category below and the total assets in the accounts managed within each category below

(a) (3) PERFORMANCE FEEDBACK: Provide the categories in column (a) (3) of accounts and the total assets with respect to which the Adviser has ON THE PERFORMANCE OF

	Registered Investment Companies		Other Pooled Investment Vehicles		Other Accounts		Registered Investment Companies		Other
	Number of Accounts	Total Assets (\$mills)	Number of Accounts	Total Assets (\$mill)	Number of Accounts	Total Assets (\$mill)	Number of Accounts	Total Assets	
Bernard M. Sussman	10	\$8.12	16	\$2.52	42	\$2.58	-	-	
Mark A. Lieb	10	\$8.12	16	\$2.52	42	\$2.58	-	-	
Phil Jacoby	10	\$8.12	16	\$2.52	38	\$2.57	-	-	

C. POTENTIAL MATERIAL CONFLICTS OF INTEREST

As described above, the portfolio manager may manage other accounts with investment strategies similar to the Fund, including other investment companies and separately managed accounts. Fees earned by the sub-advisers may vary among these accounts and the portfolio managers may personally invest in some but not all of these accounts. These factors could create conflicts of interest because a portfolio manager may have incentives to favor certain accounts over others, resulting in other accounts outperforming the Fund. A conflict may also exist if a portfolio manager identified a limited investment opportunity that may be appropriate for more than one account, but the Fund is not able to take full advantage of that opportunity due to the need to allocate that opportunity among multiple accounts. In addition, the portfolio manager may execute transactions for another account that may adversely impact the value of securities held by the Fund. However, the sub-advisers believe that these risks are mitigated by the fact that accounts with like investment strategies managed by a particular portfolio manager are generally managed in a similar fashion, subject to exceptions to account for particular investment restrictions or policies applicable only to certain accounts, differences in cash flows and account sizes, and similar factors. In addition, each sub-adviser has adopted trade allocation procedures that require equitable allocation of trade orders for a particular security among participating accounts.

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D. FUND MANAGER COMPENSATION

All employees of Spectrum Asset Management are paid a base salary and discretionary bonus. The bonus is paid quarterly and may represent a significant proportion of an individual's total annual compensation. Discretionary bonuses are determined by management after consideration of several factors including but not necessarily limited to:

- o Changes in overall firm assets under management (employees have no direct incentive to increase assets)
- o Portfolio performance relative to benchmarks
- o Contribution to client servicing
- o Compliance with firm and/or regulatory policies and procedures
- o Work ethic
- o Seniority and length of service
- o Contribution to overall functioning of organization

E. OWNERSHIP OF JPS SECURITIES AS DECEMBER 31, 2005.

	None	\$1-\$10,000	\$10,001-\$50,000	\$50,001-\$100,000	\$100,001-\$500,000
Portfolio Manager					
Bernard M. Sussman					X
Mark A. Lieb					X
Phil Jacoby	X				

ITEM 9. PURCHASES OF EQUITY SECURITIES BY CLOSED-END MANAGEMENT INVESTMENT COMPANY AND AFFILIATED PURCHASERS.

Not applicable.

ITEM 10. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

There were no material changes to the procedures by which shareholders may recommend nominees to the registrant's Board during the reporting period and implemented after the registrant last provided disclosure in response to this Item.

ITEM 11. CONTROLS AND PROCEDURES.

- (a) The registrant's principal executive and principal financial officers, or persons performing similar functions, have concluded that the registrant's disclosure controls and procedures (as defined in Rule 30a-3(c) under the Investment Company Act of 1940, as amended (the "1940 Act") (17 CFR 270.30a-3(c))) are effective, as of a date within 90 days of the filing date of this report that includes the disclosure required by this paragraph, based on their evaluation of the controls and procedures required by Rule 30a-3(b) under the 1940 Act (17 CFR 270.30a-3(b)) and Rules 13a-15(b) or 15d-15(b) under the Securities Exchange Act of 1934, as amended (the "Exchange Act") (17 CFR 240.13a-15(b) or 240.15d-15(b)).
- (b) There were no changes in the registrant's internal control over financial reporting (as defined in Rule 30a-3(d) under the 1940 Act

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(17 CFR 270.30a-3(d)) that occurred during the second fiscal quarter of the period covered by this report that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.

ITEM 12. EXHIBITS.

File the exhibits listed below as part of this Form. Letter or number the exhibits in the sequence indicated.

(a)(1) Any code of ethics, or amendment thereto, that is the subject of the disclosure required by Item 2, to the extent that the registrant intends to satisfy the Item 2 requirements through filing of an exhibit: Not applicable because the code is posted on registrant's website at www.nuveen.com/etf and there were no amendments during the period covered by this report. (To view the code, click on the Investor Resources drop down menu box, click on Fund Governance and then Code of Conduct.)

(a)(2) A separate certification for each principal executive officer and principal financial officer of the registrant as required by Rule 30a-2(a) under the 1940 Act (17 CFR 270.30a-2(a)) in the exact form set forth below: Ex-99.CERT Attached hereto.

(a)(3) Any written solicitation to purchase securities under Rule 23c-1 under the 1940 Act (17 CFR 270.23c-1) sent or given during the period covered by the report by or on behalf of the registrant to 10 or more persons. Not applicable.

(b) If the report is filed under Section 13(a) or 15(d) of the Exchange Act, provide the certifications required by Rule 30a-2(b) under the 1940 Act (17 CFR 270.30a-2(b)); Rule 13a-14(b) or Rule 15d-14(b) under the Exchange Act (17 CFR 240.13a-14(b) or 240.15d-14(b)), and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350) as an exhibit. A certification furnished pursuant to this paragraph will not be deemed "filed" for purposes of Section 18 of the Exchange Act (15 U.S.C. 78r), or otherwise subject to the liability of that section. Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference. Ex-99.906 CERT attached hereto.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934 and the Investment Company Act of 1940, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

(Registrant) Nuveen Quality Preferred Income Fund 2

By (Signature and Title)* /s/ Jessica R. Droeger

Jessica R. Droeger
Vice President and Secretary

Date: March 8, 2006

Pursuant to the requirements of the Securities Exchange Act of 1934 and the Investment Company Act of 1940, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the

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dates indicated.

By (Signature and Title)* /s/ Gifford R. Zimmerman

Gifford R. Zimmerman
Chief Administrative Officer
(principal executive officer)

Date: March 8, 2006

By (Signature and Title)* /s/ Stephen D. Foy

Stephen D. Foy
Vice President and Controller
(principal financial officer)

Date: March 8, 2006

* Print the name and title of each signing officer under his or her signature.