

METRIS COMPANIES INC

Form 10-Q

November 09, 2005

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

**FORM 10-Q**

(Mark One)

**Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended September 30, 2005**

**or**

**Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number: 001-12351**

**METRIS COMPANIES INC.**

(Exact name of Registrant as specified in its charter)

Delaware (State of Incorporation) 41-1849591 (I.R.S. Employer Identification No.)

10900 Wayzata Boulevard, Minnetonka, Minnesota 55305-1534

(Address of principal executive offices)

(952) 525-5020

(Registrant's telephone number)

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  No

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

Yes  No

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of October 31, 2005, 58,492,676 shares of the Registrant's common stock, par value \$.01 per share, were outstanding.

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**METRIS COMPANIES INC.**

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**Forward-Looking Statements**

This Quarterly Report on Form 10-Q contains certain forward-looking statements 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, which are subject to the safe harbor created by those sections. Forward-looking statements include, without limitation: expressions of the belief, anticipation, intent, or expectations of management; statements and information as to our strategies and objectives; return on equity; changes in our managed loan portfolio; net interest margins; funding costs; liquidity; cash flow; operating costs and marketing expenses; delinquencies and charge-offs and industry comparisons or projections; statements as to industry trends or future results of operations of the Company and its subsidiaries; and other statements that are not historical fact. Forward-looking statements may be identified by the use of terminology such as may, will, believes, does not believe, no reason to believe, expects, plans, estimates, anticipated, or anticipates and similar expressions, as they relate to the Company or our management. Forward-looking statements are based on certain assumptions by management and are subject to risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements.

These risks and uncertainties include, but are not limited to: our actions, combined with the actions of other credit card companies, to change cardholder terms and conditions in order to comply with regulations issued by the Federal Financial Institutions Examination Council ( FFIEC ) create additional uncertainty regarding future levels of delinquencies, charge-offs and excess spread and the performance of our credit card portfolio in the future; the potential impact of any failure to operate in accordance with directives from the Office of the Comptroller of the Currency ( OCC ), including those in our Modified Operating Agreement; the ability of regulators to impose restrictions on Direct Merchants Credit Card Bank, National Association, that could negatively impact our operations or financial results; the risk that failure to comply with applicable laws, regulations, and credit card association bylaws and adverse changes in those laws, regulations, or credit card association bylaws could have a negative impact on our financial results and could adversely affect our ability to conduct our business in a profitable manner; that the occurrence of certain events could result in early amortization (required repayment) of the securities issued by the Metris Master Trust; that credit card receivables generated by our target consumers generally have higher default rates and our target consumers may be impacted more by general economic and social factors than higher credit quality consumers; that we require a high degree of liquidity to operate our business, and an inability to access funding at the times and in the amounts that we need could adversely affect our ability to operate or our financial results; that changes in the interest rates on the funds we borrow and the amounts we loan to our credit card customers could adversely affect our financial results; the fact that we face intense competition; the fact that our financial results could be negatively impacted by fluctuations in the valuation of our retained interests in our securitizations; the fact that changes in the credit card market as a result of recent judicial decisions with MasterCard® and Visa® could adversely affect our financial results; the long-term impact from recent changes in bankruptcy legislation could adversely impact the excess spread generated in the Metris Master Trust; and the fact that we are exposed to other industry-wide risks that could adversely affect our financial performance.

In addition, our proposed merger with HSBC Finance Corporation entails the following additional risks and uncertainties: the fact that completion of the merger is dependent on, among other things, receipt of stockholder and regulatory approvals, the timing of which cannot be predicted with precision and which may not be received at all; the occurrence of any circumstance or event that would constitute a material adverse effect with respect to the Company for purposes of the merger agreement; adverse governmental or regulatory policies; failure to resolve the Company's pending Securities and Exchange Commission ( SEC ) investigation in the manner contemplated by the terms of the merger agreement; and the loss of key employees as the result of the announcement of the proposed merger.

The risks and uncertainties not associated with completion of the merger with HSBC Finance Corporation are discussed in our Annual Report on Form 10-K for the year ended December 31, 2004 in Item 1 of such report under the heading Risk Factors. Certain of these and other risks and uncertainties, including matters related to the completion of the merger with HSBC Finance Corporation, are also discussed herein in Legal Proceedings on pages 39-40, Management's Discussion and Analysis of Financial Condition and Results of Operations on pages 16-38 hereof, and Quantitative and Qualitative Disclosures About Market Risk on page 38-39 hereof. Although we have attempted to list comprehensively the major risks and uncertainties, other factors may in the future prove to be

important in causing actual results to differ materially from those contained in any forward-looking statement. Readers are cautioned not to place undue reliance on any forward-looking statement, which speaks only as of the date thereof. We undertake no obligation to update any forward-looking statements, whether as a result of new information, future events or otherwise.

**Table of Contents****Part I. Financial Information****ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS  
METRIS COMPANIES INC. AND SUBSIDIARIES**

Consolidated Balance Sheets

*(In thousands, except share data)*

	<b>September 30, 2005 (unaudited)</b>	<b>December 31, 2004</b>
<b>Assets</b>		
Cash and due from banks	\$ 25,248	\$ 25,198
Federal funds sold	22,005	22,450
Short-term investments	58,786	43,070
Cash and cash equivalents	106,039	90,718
Available for sale securities	61,100	306,409
Liquidity reserve deposit	86,284	79,746
Credit card loans, net of allowance of \$1,645 and \$12,409, respectively	2,586	55,821
Retained interests in loans securitized	851,143	784,135
Property and equipment, net	21,737	24,135
Other receivables due from credit card securitizations, net	80,874	68,021
Other assets	51,707	72,494
<b>Total assets</b>	<b>\$ 1,261,470</b>	<b>\$ 1,481,479</b>
<b>Liabilities</b>		
Debt	\$	\$ 373,624
Accounts payable	34,766	37,619
Accrued expenses and other liabilities	162,064	122,934
<b>Total liabilities</b>	<b>196,830</b>	<b>534,177</b>
<b>Stockholders Equity</b>		
Convertible preferred stock par value \$.01 per share; 10,000,000 shares authorized, 1,476,680 and 1,381,327 shares issued and outstanding, respectively	550,064	514,545
Common stock, par value \$.01 per share; 300,000,000 shares authorized, 65,547,601 and 65,182,416 shares issued, respectively	655	652
Paid-in capital	237,865	233,989
Unearned compensation	(286)	
Treasury stock - 7,055,300 shares	(58,308)	(58,308)
Retained earnings	334,650	256,424
<b>Total stockholders equity</b>	<b>1,064,640</b>	<b>947,302</b>

<b>Total liabilities and stockholders equity</b>	\$ 1,261,470	\$ 1,481,479
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See accompanying Notes to Consolidated Financial Statements.

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## Consolidated Statements of Income

*(In thousands, except per-share data) (unaudited)*

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
<b>Revenues</b>				
Loss on new securitizations of receivables to the Metris Master Trust	\$ (7,106)	\$	\$ (49,313)	\$ (91,886)
Gain (loss) on replenishment of receivables to the Metris Master Trust	736	(21,972)	(21,890)	(71,353)
Discount accretion	58,355	63,747	180,187	185,287
Interest-only revenue	121,798	87,316	307,186	217,385
Change in fair value of retained interests in loans securitized	(20,027)	25,518	781	94,202
Transaction and other costs	(2,755)	(6,634)	(15,253)	(91,018)
Securitization income	151,001	147,975	401,698	242,617
Servicing income on securitized receivables	27,947	32,496	85,640	102,580
Credit card loan and other interest income	2,161	4,549	10,320	14,665
Credit card loan fees, interchange and other income	652	3,736	5,352	19,816
Enhancement services income	2,748	5,692	9,174	20,148
Gain on sale of membership and warranty business			1,800	
<b>Total revenues</b>	<b>184,509</b>	<b>194,448</b>	<b>513,984</b>	<b>399,826</b>
<b>Expenses</b>				
Interest	456	14,056	16,357	46,701
(Benefit) provision for loan losses	(771)	1,408	(6,322)	(5,175)
Marketing	34,455	17,190	87,526	48,848
Employee compensation	36,501	31,554	111,096	106,222
Data processing services and communications	12,608	12,203	36,440	42,452
Credit protection claims	4,063	3,421	13,506	14,805
Occupancy and equipment	4,621	5,442	14,275	17,827
Other	18,346	23,985	74,553	75,095
<b>Total expenses</b>	<b>110,279</b>	<b>109,259</b>	<b>347,431</b>	<b>346,775</b>
<b>Income before income taxes</b>	<b>74,230</b>	<b>85,189</b>	<b>166,553</b>	<b>53,051</b>
Income tax expense	20,569	23,425	52,808	20,003
<b>Net income</b>	<b>53,661</b>	<b>61,764</b>	<b>113,745</b>	<b>33,048</b>
Convertible preferred stock dividends	12,104	11,073	35,519	32,494
<b>Net income after preferred dividends</b>	<b>41,557</b>	<b>50,691</b>	<b>78,226</b>	<b>554</b>



**Earnings per share**

Distributed	\$		\$		\$		\$	
Undistributed		0.40		0.49		0.75		0.01
<b>Total Basic</b>	\$	0.40	\$	0.49	\$	0.75	\$	0.01
<b>Total Diluted</b>	\$	0.39	\$	0.48	\$	0.74	\$	0.01

**Shares used to compute earnings per share**

Basic	58,435	57,981	58,293	57,899
Diluted	59,361	58,915	59,095	58,830

See accompanying Notes to Consolidated Financial Statements.

**Table of Contents****METRIS COMPANIES INC. AND SUBSIDIARIES**

Consolidated Statements of Changes in Stockholders' Equity

*(In thousands) (unaudited)*

	Number of		Convertible				Treasury	Retained	Total
	Preferred	Common	Preferred	Common	Paid-In	Unearned			
	Shares	Shares	Stock	Stock	Capital	Compensation	Stock		Equity
<b>Balance at December 31, 2003</b>	1,264	57,807	\$ 470,728	\$ 649	\$ 229,655	\$ (27)	\$ (58,308)	\$ 266,496	\$ 909,193
Net loss								33,048	33,048
Convertible preferred stock dividends	87		32,494					(32,494)	
Issuance of common stock under employee benefit plans		287		2	3,477				3,479
Deferred compensation obligations						(85)			(85)
Restricted stock forfeitures		(50)			(5)	4			(1)
Amortization of restricted stock						23			23
<b>Balance at September 30, 2004</b>	1,351	58,044	\$ 503,222	\$ 651	\$ 233,042	\$	\$ (58,308)	\$ 267,050	\$ 945,657
<b>Balance at December 31, 2004</b>	1,381	58,127	\$ 514,545	\$ 652	\$ 233,989	\$	\$ (58,308)	\$ 256,424	\$ 947,302
Net income								113,745	113,745
Convertible preferred stock dividends	96		35,519					(35,519)	
Issuance of common stock under employee benefit plans		327		3	3,408				3,411
Issuance of restricted stock		38			468	(468)			
Amortization of restricted stock						182			182
	1,477	58,492	\$ 550,064	\$ 655	\$ 237,865	\$ (286)	\$ (58,308)	\$ 334,650	\$ 1,064,640

**Balance at  
September 30,  
2005**

See accompanying Notes to Consolidated Financial Statements.

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## Consolidated Statements of Cash Flows

*(In thousands) (unaudited)*

	<b>Nine Months Ended September 30,</b>	
	<b>2005</b>	<b>2004</b>
<b>Operating Activities</b>		
Net income	\$ 113,745	\$ 33,048
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	(159,273)	(157,845)
Benefit for loan losses	(6,322)	(5,175)
Loss from credit card securitizations	71,203	163,239
Gain on sale of membership and warranty business	(1,800)	
Market loss on derivative financial instruments	1,297	8,564
Changes in operating assets and liabilities, net:		
Liquidity reserve deposit	(6,538)	503
Fair value of retained interests in loans securitized	(781)	(94,202)
Spread accounts receivable	21,024	207,520
Other receivables due from credit card securitizations, net	(12,853)	5,773
Accounts payable	(2,853)	5,883
Accrued expenses and other liabilities	34,199	16,290
Other	16,223	20,825
Net cash provided by operating activities	67,271	204,423
<b>Investing Activities</b>		
Proceeds from sales of available for sale securities	1,743,076	1,982,187
Purchases of available for sale securities	(1,497,767)	(2,097,891)
Net loans collected	708,692	1,125,207
Net repayments of securitized loans	(627,402)	(1,215,200)
Proceeds from sales of credit card portfolios to third parties		27,870
Net additions to property and equipment	(4,230)	(1,984)
Net cash provided by (used in) investing activities	322,369	(179,811)
<b>Financing Activities</b>		
Proceeds from issuance of debt		283,974
Repayment of debt	(375,000)	(202,724)
Proceeds from issuance of common stock	681	3,479
Net cash (used in) provided by financing activities	(374,319)	84,729
Net increase in cash and cash equivalents	15,321	109,341
Cash and cash equivalents at beginning of period	90,718	130,510
Cash and cash equivalents at end of period	\$ 106,039	\$ 239,851

**Supplemental disclosures and cash flow information**

Cash paid (received) during the period for:

Interest	\$	24,124	\$	36,945
Income taxes		15,956		(34,997)

See accompanying Notes to Consolidated Financial Statements.

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**METRIS COMPANIES INC. AND SUBSIDIARIES**

Notes to Consolidated Financial Statements

*(In thousands, except as noted) (unaudited)*

**NOTE 1 ORGANIZATION AND BASIS OF PRESENTATION**

The consolidated financial statements include the accounts of Metris Companies Inc. ( MCI ) and its subsidiaries. MCI s principal subsidiaries are Direct Merchants Credit Card Bank, National Association ( Direct Merchants Bank or Bank ), Metris Direct, Inc., and Metris Receivables, Inc. ( MRI ). MCI and its subsidiaries, as applicable, may be referred to as we, us, our or the Company. We are an information-based direct marketer of consumer lending products.

All dollar amounts are presented as pre-tax amounts unless otherwise noted. We have eliminated all intercompany balances and transactions in consolidation.

During the first quarter of 2005, we reclassified certain financial statement line items to reflect the continuing operations of our business. In prior periods, we classified purchased portfolio premium as an individual line item in Total assets. For all periods presented, purchased portfolio premium is classified as Other assets on the consolidated balance sheets. In prior periods, we classified deposits and deferred income as individual line items in Total liabilities. For all periods presented, deposits and deferred income are classified as Accrued expenses and other liabilities. In prior periods, we classified purchased portfolio premium amortization and asset impairments, lease write-offs and severance as individual line items in Total expenses. For all periods presented, purchased portfolio premium amortization and asset impairments, lease write-offs and severance are classified as Other expenses on the consolidated statements of income.

**Interim Financial Statements**

We have prepared the unaudited interim consolidated financial statements and related unaudited financial information in the footnotes in accordance with accounting principles generally accepted in the United States of America ( GAAP ) and the rules and regulations of the SEC for interim financial statements. These interim financial statements reflect all adjustments consisting of normal recurring accruals, which, in the opinion of management, are necessary to present fairly our consolidated financial position and the results of our operations and our cash flows for the interim periods. You should read these consolidated financial statements in conjunction with the consolidated financial statements and the notes thereto contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004. The nature of our business, including the timing of asset-backed securitization transactions and seasonal payment patterns, is such that the results of any interim period may not be indicative of the results to be expected for the entire year.

**Pervasiveness of Estimates**

We have prepared the consolidated financial statements in accordance with GAAP, which requires us to make estimates and assumptions that affect the reported amounts in the consolidated financial statements and accompanying notes. The most significant and subjective of these estimates is our determination of the fair value of Retained interests in loans securitized. The significant factors susceptible to future change that have an impact on this estimate include default rates, net interest spreads, payment rates, liquidity and the ability to finance future receivables activity and overall economic conditions. As a result, the fair value of our Retained interests in loans securitized as of September 30, 2005 and December 31, 2004, could materially differ from these estimates.

**Comprehensive Income**

During the three- and nine-month periods ended September 30, 2005 and 2004, we did not have any other comprehensive income as defined by Statement of Financial Accounting Standards ( SFAS ) No. 130 Reporting Comprehensive Income. As such, net income equals comprehensive income for all periods presented.

**Table of Contents****NOTE 2 EARNINGS PER SHARE**

We calculate earnings per share in accordance with Emerging Issues Task Force Issue No. 03-6 *Participating Securities and the two-class method under FASB Statement 128*. This method requires net income to be reduced by the amount of dividends declared in the current period for each class of stock and by the contractual amount of dividends or other participation payments that are paid or accumulated for the current period. Undistributed earnings for the period are allocated to participating securities based on the contractual participation rights of the security to share in those current earnings assuming all earnings for the period are distributed. Our preferred stockholders have contractual participation rights on a converted basis that are equivalent to those of common stockholders. Therefore, we allocate undistributed earnings to preferred and common stockholders based on their respective ownership percentage, on a converted basis, as of the end of the period.

The following table presents the computation of earnings per share.

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2005	2004	2005	2004
<i>(In thousands, except per share data)</i>				
Net income	\$ 53,661	\$ 61,764	\$ 113,745	\$ 33,048
Convertible preferred stock dividends	12,104	11,073	35,519	32,494
Net income after preferred dividends	\$ 41,557	\$ 50,691	\$ 78,226	\$ 554
Convertible preferred stock dividends	\$ 12,104	\$ 11,073	\$ 35,519	\$ 32,494
Weighted average preferred shares	1,444	1,321	1,413	1,293
Distributed earnings per share Preferred	8.38	8.38	25.14	25.13
Undistributed income	\$ 41,557	\$ 50,691	\$ 78,226	\$ 554
Preferred ownership on a converted basis	44%	44%	44%	44%
Preferred stockholders interest in undistributed income	\$ 18,285	\$ 22,304	\$ 34,419	\$ 244
Weighted average preferred shares	1,444	1,321	1,413	1,293
Undistributed earnings per share Preferred	\$ 12.66	\$ 16.88	\$ 24.36	\$ 0.19
Undistributed income	\$ 41,557	\$ 50,691	\$ 78,226	\$ 554
Common ownership	56%	56%	56%	56%
Common stockholder interest in undistributed income	\$ 23,272	\$ 28,387	\$ 43,807	\$ 310
Weighted average common shares outstanding Basic	58,435	57,981	58,293	57,899
Common share equivalents	926	934	802	931
Shares used to compute earnings per common share Diluted	59,361	58,915	59,095	58,830

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Total basic earnings per share	Common	\$ 0.40	\$ 0.49	\$ 0.75	\$ 0.01
Total diluted earnings per share	Common	\$ 0.39	\$ 0.48	\$ 0.74	\$ 0.01

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**Table of Contents****NOTE 3 SHARE-BASED COMPENSATION PLANS**

We recognize compensation expense for share-based employee compensation plans based on the difference, if any, between the quoted market price of the stock on the measurement date and the amount an employee must pay to acquire the stock. No expense has been recorded related to stock options as all options granted had an exercise price equal to the market value of the underlying common stock on the measurement date. During the three-month period ended September 30, 2005, we did not issue any restricted stock units to employees, compared to 100,000 for the comparable period in 2004. During the nine-month period ended September 30, 2005, we issued approximately 496,000 restricted stock units to employees, compared to 958,000 for the comparable period in 2004. The restricted stock units vest over one to eight and one- to six-year periods, respectively, if certain earnings targets are met, or in some cases, if a change of control occurs. If certain earnings targets are not met, the restricted stock units are cancelled. Upon vesting, each restricted stock unit converts to one share of common stock that is distributable to the employee. The fair value of the restricted stock units is expensed over the expected vesting period and included in

Employee compensation on the consolidated statements of income and Accrued expenses and other liabilities on the consolidated balance sheets. We recognized approximately \$1.5 million and \$0.6 million in expenses related to restricted stock units, net of related tax benefit, for the three-month periods ended September 30, 2005 and 2004, respectively, and approximately \$4.5 million and \$0.8 million in expense related to restricted stock units, net of related tax benefit, for the nine-month periods ended September 30, 2005 and 2004, respectively.

The Company's Employee Stock Purchase Plan and Non-Qualified Employee Stock Purchase Plan were suspended during the quarter ended September 30, 2005. The suspension of both programs occurred as a result of the Company entering into a definitive agreement to be acquired by HSBC Finance Corporation. This suspension had no impact on our consolidated financial statements.

The following table provides pro forma net income and earnings per share as if we accounted for our equity compensation instruments under the fair value method. The fair value of these instruments was estimated at the grant date using a Black-Scholes option pricing model. The fair value of these instruments is amortized to expense over the options' vesting periods. Under the fair value method, our Net income and Earnings per share would have been recorded at the pro forma amounts indicated below:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2005	2004	2005	2004
<i>(In thousands, except per share data)</i>				
Net income	\$ 53,661	\$ 61,764	\$ 113,745	\$ 33,048
Add: Share-based employee compensation expense included in reported net income, net of related tax effects	1,463	551	4,475	836
Deduct: Annual share-based employee compensation expense (benefit) determined based on the fair value for all awards, net of related tax effects	1,052	1,666	2,788	(3,212)
Pro forma net income	\$ 54,072	\$ 60,649	\$ 115,432	\$ 37,096
Earnings per share:				
Basic as reported	\$ 0.40	\$ 0.49	\$ 0.75	\$ 0.01
Basic pro forma	\$ 0.40	\$ 0.48	\$ 0.77	\$ 0.04
Diluted as reported	\$ 0.39	\$ 0.48	\$ 0.74	\$ 0.01
Diluted pro forma	\$ 0.40	\$ 0.47	\$ 0.76	\$ 0.04

Weighted-average assumptions in option valuation:

Risk-free interest rates	4.3%	3.0%	4.3%	3.0%
Stock volatility factor	82.1%	127.4%	82.1%	128.0%
Expected life of options (in years)	2.8	2.7	2.8	2.7

The above pro forma amounts may not be representative of the effects on net earnings for future periods.

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In December 2004, the Financial Accounting Standards Board issued SFAS No. 123 (Revised 2004), *Share-Based Payment* ( SFAS 123R ). SFAS 123R is a revision of SFAS No. 123 *Accounting for Stock-Based Compensation*, and supersedes Accounting Principles Board Opinion No. 25 *Accounting for Stock Issued to Employees* and its related implementation guidance. SFAS 123R was originally intended to be effective as of the beginning of the first interim or annual reporting period that began after June 15, 2005. On April 15, 2005, the SEC amended the date for compliance with SFAS 123R, such that each registrant that is not a small business issuer will be required to prepare financial statements in accordance with the guidance beginning with the interim or annual reporting period of the first fiscal year beginning on or after June 15, 2005. The amendment results in a six month delay for required compliance from the original effective date of July 1, 2005. The Company intends to adopt the provisions of SFAS 123R effective January 1, 2006. The impact on compensation expense related to the equity instruments outstanding as of December 31, 2005 is not expected to be material. However, the final impact to compensation expense will be dependent on the number of equity instruments granted during any year, including their timing and vesting period, and the method used to calculate the fair value of the awards, among other factors.

**NOTE 4 AVAILABLE FOR SALE SECURITIES**

Our Available for sale securities portfolio consists solely of investments in AA/Aa2 or higher rated auction rate securities. Auction rate securities are term debt and/or equity securities earning income at a rate that is frequently reset to reflect current market conditions via an auction. Equity securities available for sale are those auction rate securities with perpetual maturity dates. The following table shows the fair value and cost of term debt and equity auction rate securities outstanding at September 30, 2005 and December 31, 2004, respectively.

	<b>Fair Value and Cost of Available for Sale</b>	
	<b>Securities Outstanding as of</b>	
	<b>September</b>	<b>December 31,</b>
	<b>30,</b>	<b>2004</b>
	<b>2005</b>	<b>2004</b>
<b>Debt Securities</b>		
Legal Final Maturity Date Less than 1 year	\$	\$ 10,000
1 year - 5 years		10,000
5 years - 10 years		
Over 10 years	23,100	24,420
<b>Total Debt Securities</b>	23,100	44,420
<b>Equity Securities</b>	38,000	261,989
<b>Total Available for Sale Securities</b>	\$ 61,100	\$ 306,409

Actual maturities of our available for sale debt securities will vary from their legal final maturity because on each reset date, we buy and sell securities at par. As of September 30, 2005 and December 31, 2004, reset dates ranged from two to 31 days. At all times, we invest in securities with reset dates of 90 days or less. Due to the frequency with which the yields on these securities reset, cost approximates fair market value, and there is no resulting other comprehensive income.

**Table of Contents****NOTE 5 ALLOWANCE FOR LOAN LOSSES**

The activity in the allowance for loan losses is as follows:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Balance at beginning of period	\$ 3,751	\$ 15,375	\$ 12,409	\$ 45,492
Allowance related to assets re-acquired		1	(170)	1,946
(Benefit) provision for loan losses	(771)	1,408	(6,322)	(5,175)
Principal receivables charged-off	(1,613)	(2,983)	(6,726)	(29,904)
Recoveries	278	492	2,454	1,934
Net principal receivables charged-off	(1,335)	(2,491)	(4,272)	(27,970)
Balance at end of period	\$ 1,645	\$ 14,293	\$ 1,645	\$ 14,293

Credit card loans greater than 30 days contractually past due for the periods ended September 30, 2005 and 2004, were \$0.9 million and \$8.8 million, respectively. On May 2, 2005, we sold approximately \$52 million in credit card receivables from Direct Merchants Bank to MCI. MCI subsequently sold a majority of those loans to the Metris Master Trust. Included in principal receivables charged-off for the nine-month period ended September 30, 2005, is the impact of selling these loans. On April 30, 2004, we sold approximately \$38 million of Credit card loans, which had a carrying value of \$27.7 million, from Direct Merchants Bank to a third party. Proceeds from the sale were approximately \$27.9 million. Included in principal receivables charged-off for the nine-month period ended September 30, 2004, is the impact of selling these loans.

**NOTE 6 RETAINED INTERESTS IN LOANS SECURITIZED**

The following table shows the fair value of the components of the Retained interests in loans securitized as of September 30, 2005 and December 31, 2004, respectively.

	<b>September</b>	<b>December</b>
	<b>30,</b>	<b>31,</b>
	<b>2005</b>	<b>2004</b>
Contractual retained interests	\$ 542,129	\$ 537,945
Excess transferor's interest	146,056	105,237
Interest-only strip receivable	110,330	82,672
Spread accounts receivable	52,628	58,281
Retained interests in loans securitized	\$ 851,143	\$ 784,135

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The significant assumptions used in estimating the fair value of Retained interests in loans securitized as of September 30, 2005 and December 31, 2004, are as follows:

	<b>September 30, 2005</b>	<b>December 31, 2004</b>
Monthly principal payment rate	6.7%	5.9%
Gross yield <sup>(1)</sup>	26.2%	25.9%
Annual interest expense and servicing fees	5.8%	5.0%
Annual gross principal default rate	16.7%	18.4%
Discount rate:		
Contractual retained interests/Excess transferor's interest/ Spread accounts receivable	15.0%	16.0%
Interest-only strip receivable	30.0%	30.0%
Weighted average months-to-maturity	13.7	20.1
Weighted average enhancement level <sup>(2)</sup>	12.7%	12.1%
Gross receivables held in the Metris Master Trust, net of discount <sup>(3)</sup>	94.0%	92.3%

<sup>(1)</sup> Includes expected cash flows from finance charges, late and overlimit fees, debt waiver premiums and bad debt recoveries.

Gross yield for purposes of estimating fair value does not include cash flows from interchange income or cash advance fees.

<sup>(2)</sup> Includes contractual retained interest and required minimum spread reserve deposits.

<sup>(3)</sup> Represents the ratio of Retained interests in loans

securitized  
(contractual  
retained  
interests, excess  
transferor's  
interest, spread  
accounts  
receivable and  
interest-only  
strip receivable)  
plus investors  
interests in  
securitized  
receivables  
accounted for as  
sales to gross  
receivables in  
the Metris  
Master Trust  
plus the gross  
spread accounts  
receivable.

At September 30, 2005, the sensitivity of the current fair value of the retained interests to immediate 10% and 20% adverse changes are as follows (in millions):

	<b>Adverse Impact on Fair Value</b>	
	<b>10%</b>	
	<b>Adverse Change</b>	<b>20% Adverse Change</b>
Annual discount rate	\$ 14.8	\$ 29.2
Monthly principal payment rate	4.2	9.1
Annual gross yield	83.0	160.9
Annual interest expense and servicing fees	29.2	57.9
Annual gross principal default rate	51.7	98.1

As the sensitivity indicates, the value of the Company's Retained interests in loans securitized on its consolidated balance sheets, as well as the potential impact to reported earnings, could differ significantly if different assumptions or conditions prevailed.

#### **NOTE 7 CONVERTIBLE PREFERRED STOCK**

Investors in a Thomas H. Lee Partners, L.P. (THL Partners) fund hold 100% of the outstanding shares of our preferred stock. In general, the preferred stockholders are entitled to receive quarterly dividends payable in additional shares of preferred stock (dividends in-kind). The annual dividend rate is 9% through December 8, 2008, and 15% thereafter (except following a Change in Control Triggering event, as described below). Preferred stockholders are also entitled to receive cash dividends paid on our common stock based on the number of shares of common stock into which the preferred stock would convert on the record date of the dividend. The preferred stockholders may also receive, in lieu of a dividend in-kind, dividends payable in cash, property or other securities equivalent to a dividend in-kind if approved by 80% of the MCI Board of Directors, which must include a majority of the directors elected by the preferred stockholders.

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So long as THL Partners or its affiliates own at least 25% of the originally issued preferred stock (or any shares of common stock issued upon conversion thereof), the holders of a majority of the shares of preferred stock are entitled to elect four of 11 directors of the MCI's Board of Directors. So long as THL Partners or its affiliates own at least 10% but less than 25% of the originally issued preferred stock (or any shares of common stock issued upon conversion thereof), the holders of a majority of the shares of preferred stock are entitled to elect one director of MCI's Board of Directors. Preferred stockholders have the right to vote on general corporate matters with common stockholders on a converted basis.

Each share of preferred stock is convertible into 30 shares of common stock and, if converted on or before December 9, 2005, a premium amount guaranteeing dividends at the 9% rate through December 9, 2005. The preferred stockholders are able to convert at any time, and the preferred shares automatically convert into common shares after December 9, 2005, if the common stock trades at a share price of \$21.33 or more for 20 consecutive days. As of September 30, 2005, the preferred stock is convertible into 45,053,541 common shares, or approximately 43.5% of the outstanding common stock on a converted basis.

Before December 9, 2008, all of the preferred stock may be redeemed by paying 103% of the redemption price of \$372.50 per share and any accrued dividends at the time of redemption, but only when (i) the common stock has traded at a share price of \$21.33 or more for the most recent 20 consecutive trading days, and (ii) MCI has an unsecured corporate debt rating of at least Baa3 from Moody's Investors Service, Inc. (Moody's) and BBB- from Standard & Poor's Rating Services (S&P). After December 9, 2008, we also have the option to redeem the preferred stock without restriction, and without a premium, at \$372.50 per share and any accrued dividends.

If a Change in Control were to occur, we are obligated to offer redemption of the preferred stock for cash at 101% of the greater of (i) the as-converted value of the preferred stock, or (ii) \$372.50 per share of preferred stock plus accrued and unpaid dividends payable at the rate of 9% per annum through December 9, 2005 (such greater amount referred to as the Liquidation Preference). THL Partners has the right, but is not obligated, to accept redemption of the preferred stock. If an offer of redemption is not made, a Change in Control Trigger Event occurs and, as a result, (i) additional shares of preferred stock are issued to the holders of preferred stock such that the total number of outstanding shares of preferred stock equals the Liquidation Preference divided by \$372.50, (ii) the preferred stock dividend rate increases to 11.5% before December 9, 2008, and 15% thereafter, and dividends are due quarterly in cash, and (iii) MCI becomes subject to limitations on indebtedness, the issuance of capital stock and we cannot pay any dividends or make distributions on stock. If MCI fails to comply with any of the changes in terms, the dividend rate increases another 2% and THL Partners can require the Company to purchase the preferred stock at 101% of the Liquidation Preference.

**NOTE 8 INCOME TAXES**

A reconciliation of our effective income tax rate compared to the statutory federal income tax rate is as follows:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2005	2004	2005	2004
Statutory federal income tax rate	35.0%	35.0%	35.0%	35.0%
State income taxes, net of federal benefit	0.8	0.5	0.8	0.8
Valuation allowance	(2.0)	(9.1)	(2.1)	
Tax reserve reduction	(6.3)		(2.8)	
Other, net	0.2	1.1	0.8	1.9
Effective income tax rate	27.7%	27.5%	31.7%	37.7%

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The Company's 1998 through 2003 federal income tax returns are under examination by the Internal Revenue Service ( IRS ). The IRS has been reviewing the Company's tax treatment of certain credit card fees as original issue discount ( OID ). The fees at issue include late, overlimit, interchange, cash advance, annual and insufficient funds fees. Although these fees are primarily reported as income when billed for financial reporting purposes, we believe the fees create OID that should be deferred and amortized over the remaining life of the underlying credit card loans for tax purposes.

In May 2005, the Company received a copy of a Technical Advice Memorandum Ruling ( TAM ) requested by the local IRS exam team from the IRS National Office. The TAM concludes that the Company's late, overlimit, cash advance and insufficient funds fees should be treated as OID but that the Company's interchange and annual fees should not be treated as OID. The TAM's conclusions were consistent with our expectations of how the IRS would rule on this issue. We plan to continue to pursue treatment of interchange and annual fees as OID.

The Company has proposed OID-related adjustments in the form of refund claims for some of these years. A refund for the earliest period was approved by the staff of the Congressional Joint Committee on Taxation in September 2005. As a result, the Company reduced its tax liability by \$4.7 million, including interest income, in the quarter ended September 30, 2005. As of September 30, 2005 and December 31, 2004, the Company had deferred cumulative federal income tax related to this issue of approximately \$97 million and \$129 million, respectively.

The valuation allowance benefits for the three- and nine-month periods ended September 30, 2005 relate to reductions in the December 31, 2004 valuation allowance, primarily associated with alternative minimum tax credit carryforwards. The valuation allowance benefit for the three-month period ended September 30, 2004 relates to reductions in the valuation allowance from the Company's net operating loss carryforwards. This valuation allowance was initially recorded during the three months ended June 30, 2004.

**NOTE 9 MERGER UPDATE**

In a Current Report on Form 8-K filed with the SEC on August 4, 2005, the Company announced that it reached a definitive agreement with HSBC Finance Corporation ( HSBC Finance ) for HSBC Finance to acquire Metris in an all-cash transaction. Upon completion of the transaction, Metris will become a wholly-owned subsidiary of HSBC Finance. Under terms of the merger agreement, Metris common stockholders will be entitled to receive \$15.00 for each share of Metris common stock if the transaction closes on or before December 9, 2005. After December 9, 2005, the price per common share to the common stockholders will decrease by an amount based on the dividends in-kind that accumulate on Metris' Series C Preferred Stock in accordance with its terms. The Board of Directors of Metris has unanimously approved the transaction, as has the Board of Directors of HSBC Finance. As part of the total consideration, the convertible preferred stock held by Thomas H. Lee Partners, L.P. will receive, in accordance with its terms, approximately \$682.6 million, 101% of \$15 per-share, if the transaction closes on or before December 9, 2005. Thereafter, the amount payable on the convertible preferred stock will be increased based on the dividends in-kind that accrue on such stock in accordance with its terms. The holders of the convertible preferred stock have given an irrevocable proxy to HSBC Finance to vote in favor of the transaction. Those shares represent approximately 44% of the voting rights of Metris stockholders. Total consideration payable to common stockholders, on or before December 9, 2005, is approximately \$910.4 million. The acquisition is subject to certain conditions, including resolution of the potential civil injunctive action of the SEC against Metris as disclosed by the Company on July 12, 2005, approval by the stockholders of Metris, and various regulatory consents. Metris and HSBC Finance have made all regulatory filings required to date. On November 3, 2005, the OCC gave its approval for the merger of Direct Merchants Bank with and into HSBC Bank Nevada, N.A. immediately subsequent to the merger itself. That approval is a condition to consummation of the merger. The Metris Board of Directors has set November 30, 2005, as the date for Metris stockholders to vote on the proposed transaction. If the merger is approved at the stockholder meeting, subject to receipt of regulatory consents and satisfaction of other conditions, Metris and HSBC Finance expect to complete the merger in early December.



**Table of Contents****ITEM 2.**

**METRIS COMPANIES INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Business Overview**

The following discussion and analysis provides information management believes to be relevant to understanding the financial condition and results of operations of Metris Companies Inc. ( MCI or Metris ) and its subsidiaries. MCI's principal subsidiaries are Direct Merchants Credit Card Bank, National Association ( Direct Merchants Bank or Bank ), Metris Direct, Inc. and Metris Receivables, Inc. ( MRI ). MCI and its subsidiaries, as applicable, may be referred to as we, us, our or the Company. You should read this discussion along with Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004, filed with the Securities and Exchange Commission on March 11, 2005, for a full understanding of our financial condition and results of operations. In addition, you should read this discussion along with our consolidated financial statements and related notes thereto for the period ended September 30, 2005, included herein.

MCI was incorporated in Delaware on August 20, 1996, and completed an initial public offering in October 1996. MCI and its subsidiaries provide financial products and services to middle market consumers throughout the United States. Our financial products and services are primarily unsecured credit cards, including the Direct Merchants Bank MasterCard® and Visa® credit cards. We also offer co-branded credit cards through partnerships with other companies. Our credit cards generate consumer loans through Direct Merchants Bank. These loans in turn generate income and cash flow from principal, interest and fee payments. The sales of our other consumer financial products, such as credit protection products, generate additional cash flow. Our earnings may fluctuate based on several factors, including securitization activity. When securitization transactions occur, we currently incur Loss on new securitizations to the Metris Master Trust and increased transaction costs.

Our business results have strengthened over the last two years resulting in the improved level of net income and earnings per share in the three- and nine-month periods ended September 30, 2005. We believe this improvement has been driven by improved credit quality resulting from several factors. These factors include the operating strategies with which we manage our portfolio, significantly enhanced collection efforts and improvements in the economy. The average excess spread in the Metris Master Trust for the quarter ended September 30, 2005, was 8.49% compared to 6.83% reported for the previous quarter, and 5.58% reported for the third quarter of 2004. The increase in the excess spread has been driven primarily by improvements in the overall credit quality of the portfolio. As of September 30, 2005, the first-cycle delinquency rate in the Metris Master Trust was 4.7%, compared to 4.4% as of December 31, 2004, and 4.9% as of September 30, 2004. The two-cycle plus delinquency rate in the Metris Master Trust decreased to 8.0% as of September 30, 2005, compared to 9.2% as of December 31, 2004, and 9.7% as of September 30, 2004. The average principal default rate in the Metris Master Trust was 13.9% for the quarter ended September 30, 2005, compared to 15.5% in the prior quarter and 16.8% for the comparable period in 2004. Principal payment rates in the Metris Master Trust were 7.0% for the quarter ended September 30, 2005, compared to 6.5% for the prior quarter and 5.8% for the quarter ended September 30, 2004. Gross yield improved to 28.49% for the quarter ended September 30, 2005, from 27.99% for the quarter ended June 30, 2005, and 26.49% for the quarter ended September 30, 2004. We continue to expect monthly and quarterly fluctuations in both excess spread and delinquencies resulting from several factors, including seasonal trends.

On October 17, 2005, the federal *Bankruptcy Abuse Prevention and Consumer Protection Act* became law. The purpose of this new law was to establish income measures that determine a petitioner's eligibility to file for Chapter 7 bankruptcy protection. As a result of the then pending deadline to file bankruptcy under the previous law, we saw a significant increase in bankruptcy filings during the September and October time periods. Specifically, we saw a 49.3% and a 160.7% increase in the percentage of our credit card accounts filing bankruptcy during September and October, respectively, over the comparable prior year periods. We believe the majority of these filings represent an acceleration of first and second quarter 2006 charge-offs into the fourth quarter of 2005. This belief is due to the fact that approximately 84% of these filings were related to credit card receivables that were two-cycle plus delinquent, which has historically been an indication that many of these receivables would ultimately charge-off. As a result of

these higher filings and the related charge-offs, we expect the fourth quarter average excess spread in the Metris Master Trust to decrease between 350 and 450 basis-points from the third quarter of 2005, with the low point in excess spread being the month of December 2005 at an estimated range of zero to 2%. We expect the resulting excess spreads will have no effect on the

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payment of principal or interest on any outstanding asset-backed securities issued by the Metris Master Trust and we do not expect that an amortization event will occur with respect to any outstanding series of the Metris Master Trust. Furthermore, we expect this lower excess spread will restrict the release of approximately \$50 million to \$75 million in cash restricted due to performance from the Metris Master Trust during the first half of 2006. We expect to have adequate liquidity during the period that cash is restricted from release to the Company.

During the quarter ended September 30, 2005, there have been several environmental factors, including the impact of hurricanes in the Gulf Coast region, which have negatively impacted our customers. The Company has taken action to proactively waive approximately \$3.0 million in fee and interest payments for many of our customers affected by Hurricane Katrina, and has decided to allow the deferral of approximately \$3.3 million in payments for customers most affected by the storms. We believe approximately 2% of our managed receivables may have been directly affected by the impact of Hurricane Katrina, and although we cannot predict how quickly people will recover from these natural disasters, we do believe the actions taken will mitigate some of the negative impact to our portfolio.

The effects of Hurricane Katrina have also contributed to the ongoing higher level of energy costs that the country has experienced over the last few months. We have noticed a trend in customer spending that is consistent with third-party reports regarding the impact of higher gas and oil prices on consumers' finances. Our customers' average gasoline purchase has increased approximately six dollars per transaction over the last 12 to 15 months, and the number of gasoline transactions as a percentage of total transactions on our credit cards has also increased approximately 20% during that same time. However, our analysis shows that our customers have reduced spending on other items to manage the impact on their overall debt burden, and continue to show improved payment characteristics resulting in the highest portfolio payment rates in Company history.

The one-month London Interbank Offered Rate ( LIBOR ), the index which primarily drives our cost of funds, increased to 3.86% as of September 30, 2005, from 2.40% at December 31, 2004. This increase, and potential future increases, will result in a higher cost of funds on securities issued out of the Metris Master Trust, which is partially offset by higher yields on our credit card portfolio. We believe the impacts to our financial statements that result from increases in interest rates may be mitigated by a variety of management strategies, including, but not limited to, interest rate caps, portfolio re-pricing or the future issuance of fixed rate asset backed securities debt. For further information on the impact to us resulting from changes in interest rates, refer to *Item 3 Quantitative and Qualitative Disclosures about Market Risk* on pages 38-39 of this Report.

In January 2003, the FFIEC issued guidance with respect to various account management practices for financial institutions engaged in credit card lending. The guidance provides requirements for certain operational and accounting policies, including requirements for credit card lenders to ensure cardholder balances amortize over time. The guidance is designed to bring consistency in practice among credit card lenders. We are in compliance with most aspects of the FFIEC guidance and have been moving ahead with a multi-phased approach to address the receivable amortization aspects of the guidance. Full implementation should occur by year-end 2005, at which time our portfolio will be operating under minimum payment terms that should satisfy the amortization timeframes set forth by our regulators. We will deploy various strategies intended to minimize the increased delinquency that otherwise may result from our changes in contractual terms for our cardholders. These strategies will include limiting fee billings, modifying minimum payment requirements, and / or reducing customers' interest rates. Such changes will have a significant impact on billed revenues, but a smaller impact on cash collected. This impact on cash collected will be reflected in our interest-only revenues. Furthermore, other credit card companies will be implementing similar changes to their customer accounts. The actions of other credit card companies, combined with our changes, create additional uncertainty regarding future levels of delinquencies and charge-offs. We do not anticipate any significant impact to 2005 excess spread due to these changes. However, we believe the changes will negatively impact the trend we otherwise would have seen in Metris Master Trust excess spread in 2006 and subsequent years. The impact of fully adopting this guidance on our customers and the performance of our portfolio will not occur until 2006.

The improvements we have seen in our cash flow, and lower capital requirements at Direct Merchants Bank, allowed us to eliminate our remaining corporate debt during the third quarter of 2005. In July 2005, the Company made an optional prepayment of \$30.0 million on its Senior Notes due July 2006. On August 15, 2005, an additional optional prepayment of \$49.1 million was made on the Senior Notes, paying off those Senior Notes in full.



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The continued improvements in our business results have also allowed us to invest more heavily in new marketing programs. During the quarter ended September 30, 2005, we generated approximately 249,000 new credit card accounts, compared to 118,000 new credit card accounts for the same period in 2004. For the nine-month period ended September 30, 2005, we generated approximately 577,000 new credit card accounts compared to 272,000 new credit card accounts for the comparable prior year period. Our new credit card account growth remains focused on our traditional target market, the middle-market consumer. We are comfortable increasing our new credit card account originations due to the continued strong results we are experiencing in our 2003 and 2004 vintages, our improved liquidity position and the improved performance of the Metris Master Trust. We have also experienced an improvement in delinquencies in comparing our 2003 and 2004 vintages to our 2002 vintages at the same point in time. Credit card account originations in 2005 continue to reflect the discipline exhibited in our 2003 and 2004 originations and we expect these improved results to create a more reliable, predictable and long-term receivables base. We will continue to leverage our account origination strategies, including our efforts to penetrate the Hispanic customer segment, our partnership and third-party marketing efforts and test additional products, channels and incremental prospects. During 2005, we made significant progress in our efforts to increase our partnership marketing efforts by signing new partnership agreements, by extending our relationship with existing partners and by expanding the network through which we issue our credit cards.

On July 12, 2005, the Company announced that it had received a Wells Notice from the staff of the SEC in connection with the previously-disclosed SEC investigation concerning the Company's reporting and treatment of its allowance for loan losses for 2001, its valuation of Retained interests in loans securitized and other matters. The staff has subsequently informed the Company that it is the intention of the staff not to recommend that the SEC bring an enforcement action against the Company with respect to that investigation. The staff's recommendation is subject to review and final action by the SEC, and there can be no assurance that the SEC will follow the staff's recommendation.

In a Current Report on Form 8-K filed with the SEC on August 4, 2005, the Company announced that it reached a definitive agreement with HSBC Finance Corporation (HSBC Finance) for HSBC Finance to acquire Metris in an all-cash transaction. Upon completion of the transaction, Metris will become a wholly-owned subsidiary of HSBC Finance. Under terms of the merger agreement, Metris common stockholders will be entitled to receive \$15.00 for each share of Metris common stock if the transaction closes on or before December 9, 2005. After December 9, 2005, the price per common share to the common stockholders will decrease by an amount based on the dividends in-kind that accumulate on Metris Series C Preferred Stock in accordance with its terms. The Board of Directors of Metris has unanimously approved the transaction, as has the Board of Directors of HSBC Finance. As part of the total consideration, the convertible preferred stock held by Thomas H. Lee Partners, L.P. will receive, in accordance with its terms, approximately \$682.6 million, 101% of \$15 per-share, if the transaction closes on or before December 9, 2005. Thereafter, the amount payable on the convertible preferred stock will be increased based on the dividends in-kind that accrue on such stock in accordance with its terms. The holders of the convertible preferred stock have given an irrevocable proxy to HSBC Finance to vote in favor of the transaction. Those shares represent approximately 44% of the voting rights of Metris stockholders. Total consideration payable to common stockholders, on or before December 9, 2005, is approximately \$910.4 million. The acquisition is subject to certain conditions, including resolution of the potential civil injunctive action of the SEC against Metris as discussed above, approval by the stockholders of Metris, and various regulatory consents. Metris and HSBC Finance have made all regulatory filings required to date. On November 3, 2005, the OCC gave its approval for the merger of Direct Merchants Bank with and into HSBC Bank Nevada, N.A. immediately subsequent to the merger itself. That approval is a condition to consummation of the merger. The Metris Board of Directors has set November 30, 2005, as the date for Metris stockholders to vote on the proposed transaction. If the merger is approved at the stockholder meeting, subject to receipt of regulatory consents and satisfaction of other conditions, Metris and HSBC Finance expect to complete the merger in early December.

**Table of Contents****Critical Accounting Estimates**

The Company's most critical accounting estimate is the valuation of our Retained interests in loans securitized on our consolidated balance sheets. This valuation is associated with our securitization transactions and includes contractual retained interests, excess transferor's interest, interest-only strip receivable and spread accounts receivable. We determine the fair value of each component of the Retained interests in loans securitized at the time a securitization transaction or replenishment sale is completed, using a discounted cash flow valuation model, and on a quarterly basis thereafter. Increases to the fair value of each of the assets related to discount accretion are recorded in Discount accretion. Any other changes in the fair value are recorded in the Change in fair value of retained interests in loans securitized.

The discounted cash flow valuation is limited to the receivables that exist and have been sold to the Metris Master Trust. Therefore, the model assumes the current principal receivable balance as of the balance sheet date amortizes with no new sales, interchange fees or cash advances. The future cash flows are modeled in accordance with the Metris Master Trust's debt series legal documents and are applied to all series on a pro-rata basis. The valuation model assumes that we repurchase the outstanding principal receivables within each series at face value according to the clean-up call provisions contained in the respective security series legal documents.

The contractual retained interests represent subordinated securities held by us. There is no stated interest or coupon rate associated with these securities and they are not rated. They are subordinate to all other securities and, accordingly, are repaid last. Their fair value is determined by discounting the expected future cash flows using a discount rate commensurate with the risks of the underlying assets and the expected timing of repayment based on the scheduled maturity date for the underlying securitization. If these securities are recoverable based on the Metris Master Trust forecasts, cash flows related to the entire subordinated principal balance are used in determining their fair value.

Transferor's interest represents an undivided interest in receivables that are not pledged to support a specific series or class, and represent our interest in the excess principal receivables held in the Metris Master Trust. The fair value is determined in the same manner as the contractual retained interests and is discounted based on 12 months to maturity. We have subordinated our rights to the excess cash flows on the receivables underlying the transferor's interest, thus they are included in the value of the interest-only strip receivable.

Spread account receivable balances represent interest-earning cash held by the Metris Master Trust Trustee due to performance of the Metris Master Trust and minimum spread reserve deposits required by certain security series. Their fair value is determined by discounting the expected future cash flows using a discount rate commensurate with the risks of the underlying assets and the expected timing based on the scheduled maturity date for the underlying securitization. The expected future cash flows include the release of the spread account receivable balance on the scheduled maturity date and estimated interest earned on the cash balances.

The interest-only strip receivable represents the contractual right to receive excess spread cash flows (portfolio collections, less principal charge-offs, financing costs and servicing costs) from customer receivables over the estimated life of the amortizing receivables. The fair value is determined by discounting the expected future cash flows using a discount rate commensurate with the risks of the underlying assets based on the expected timing of cash flows in the retained interests valuation model. Within the model, future excess spread cash flows are first applied to meet spread accounts receivable requirements in accordance with the relevant Metris Master Trust debt series legal documents. When the spread accounts receivable requirements are met, cash is returned to us and is valued as the interest-only strip receivable. We determine upper and lower valuation limits of the interest-only strip receivable based on historical and forecasted excess spreads, excluding interchange and cash advance fee collections. We then determine the best estimate within the range, weighted heavily toward the low end of the range.

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At least quarterly, we adjust our valuation of the Retained interests in loans securitized to reflect changes in the amount and expected timing of future cash flows. The significant factors that affect the timing and amount of cash flows relate to collateral assumptions, which include payment rate, default rate, gross yield and discount rate. These values can, and will, vary as a result of changes in the amount and timing of the cash flows and the underlying economic assumptions. The discount rates used to estimate the fair value of the Retained interests in loans securitized are commensurate with the risk associated with the underlying expected future cash flows. Indicators of the level of risk inherent in the portfolio include delinquency and loss rates and expectations surrounding interest rates. Other factors that would impact the risk assessment include changes to our corporate capital structure, corporate debt ratings or securitization enhancement levels. Changes in expectations as to the level of risk related to future cash flows may result in changes to the discount rate assumptions.

**Results of Operations****Three Months Ended September 30, 2005 and 2004**

Net income for the quarter ended September 30, 2005, was \$53.7 million, an \$8.1 million decrease from \$61.8 million for the quarter ended September 30, 2004.

Securitization income was \$151.0 million for the quarter ended September 30, 2005, compared to \$148.0 million for the comparable period in 2004. The following table details Securitization income for the quarters ended September 30, 2005 and 2004, respectively.

**Table 1: Analysis of Securitization Income**

(In thousands)

	<b>Three Months Ended September 30,</b>	
	<b>2005</b>	<b>2004</b>
Loss on new securitizations of receivables to the Metris Master Trust: Paired series transactions	\$ (7,106) <sup>(1)</sup>	
	(7,106)	
Gain (loss) on replenishment of receivables to the Metris Master Trust	736	(21,972)
Discount accretion	58,355	63,747
Interest-only revenue:		
Gross yield <sup>(2)</sup>	393,419	428,183
Principal defaults	(193,587)	(275,075)
Interest expense and servicing fees	(78,034)	(65,792)
	121,798	87,316
Change in fair value of retained interests in loans securitized	(20,027)	25,518
Transaction and other costs	(2,755)	(6,634)
Securitization income	\$ 151,001	\$ 147,975

<sup>(1)</sup> Loss represents \$73.8 million retained bond (9.0% to 9.5% required subordination)

discounted at  
15% for  
2.3 months and a  
\$4.6 million  
decrease in the  
interest-only  
strip receivable.

(2) Includes cash  
flows from  
finance charges,  
late, overlimit,  
debt waiver and  
cash advance  
fees, bad debt  
recoveries and  
interchange  
income.



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Loss on new securitizations of receivables to the Metris Master Trust was \$7.1 million for the quarter ended September 30, 2005, a decrease of \$7.1 million from \$0 for the quarter ended September 30, 2004. The decrease was caused by the fact that there was no securitization activity during the third quarter of 2004.

Discount accretion was \$58.4 million for the quarter ended September 30, 2005, a \$5.3 million decrease from \$63.7 million for the quarter ended September 30, 2004. The decrease was primarily due to lower securitization borrowing levels.

Gain (loss) on replenishment of receivables to the Metris Master Trust was income of \$0.7 million for the quarter ended September 30, 2005, a \$22.7 million increase from a loss of \$22.0 million for the quarter ended September 30, 2004. The increase was primarily due to higher excess spread assumptions and lower weighted average months to maturity used in calculating the loss on replenishment.

Interest-only revenue was \$121.8 million for the quarter ended September 30, 2005, a \$34.5 million or 39.5% increase from \$87.3 million for the quarter ended September 30, 2004. The increase was primarily due to a 291-basis-point increase in the three month average excess spread in the Metris Master Trust, partially offset by a \$918 million reduction in average principal receivables held by the Metris Master Trust between the two periods.

Change in fair value of retained interests in loans securitized was a loss of \$20.0 million for the quarter ended September 30, 2005, a \$45.5 million decrease from income of \$25.5 million for the quarter ended September 30, 2004. The decrease was primarily due to a \$15.3 million decrease in the change in fair market value associated with the impact of receivable attrition on a higher interest-only strip receivable, an \$18.1 million smaller increase in the change in the fair market value of the interest-only strip receivable related to a smaller increase in excess spread assumptions for the quarter, and a \$12.1 million decrease related to lower spread reserve releases in the third quarter of 2005.

Transaction and other costs were \$2.8 million for the quarter ended September 30, 2005, a \$3.8 million or 57.6% decrease from \$6.6 million for the quarter ended September 30, 2004. The decrease is primarily due to a reduction in monthly facility fees incurred related to our variable funding conduit.

Servicing income on securitized receivables was \$27.9 million for the quarter ended September 30, 2005, a \$4.6 million or 14.2% decrease from \$32.5 million for the quarter ended September 30, 2004. This decrease reflects a \$918 million reduction in average principal receivables held by the Metris Master Trust between the two periods.

Credit card loan and other interest income and Credit card loan fees, interchange and other income, totaled \$2.8 million for the quarter ended September 30, 2005, a \$5.5 million or 66.3% decrease from \$8.3 million for the quarter ended September 30, 2004. This cumulative decrease resulted primarily from the \$67.0 million reduction in average owned credit card loans between the two periods.

Enhancement services income was \$2.7 million for the quarter ended September 30, 2005, a \$3.0 million or 52.6% decrease from \$5.7 million for the quarter ended September 30, 2004. The decrease resulted primarily from the declining number of memberships in a declining portfolio following the sale of our membership club and warranty business in 2003.

Interest expense was \$0.5 million for the quarter ended September 30, 2005, a \$13.6 million or 96.4% decrease from \$14.1 million for the quarter ended September 30, 2004. This decrease resulted primarily from a \$432.0 million reduction in average debt outstanding between the two periods.

Marketing expenses were \$34.5 million for the quarter ended September 30, 2005, a \$17.3 million or 100.6% increase from \$17.2 million for the quarter ended September 30, 2004. This increase resulted from an increase in new credit card account marketing efforts.

Employee compensation was \$36.5 million for the quarter ended September 30, 2005, a \$4.9 million or 15.5% increase from \$31.6 million for the quarter ended September 30, 2004. This increase resulted from an increase in performance based compensation, partially offset by a reduction in the number of employees.

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Other expenses were \$18.3 million for the quarter ended September 30, 2005, a \$5.7 million or 23.8% decrease from \$24.0 million for the quarter ended September 30, 2004. The following table illustrates the components of Other expenses for the quarters ended September 30, 2005 and 2004, respectively.

**Table 2: Other Expenses**

(In thousands)

	<b>Three Months Ended September 30,</b>	
	<b>2005</b>	<b>2004</b>
MasterCard / Visa assessment and fees	\$ 2,136	\$ 1,625
Credit card fraud losses	636	696
Legal fees	2,220	2,788
Collection and risk management	2,741	3,301
Other professional fees	5,183	5,318
Purchased portfolio premium amortization	1,393	2,241
Asset impairment, lease write-offs and severance	259	1,263
Debt prepayment expenses	786	
General and administrative expenses and other	2,992	6,753
Total other expenses	\$ 18,346	\$ 23,985

The debt prepayment expenses for the three months ended September 30, 2005 related entirely to the \$79.1 million in optional prepayments made on our Senior Notes due July 2006.

The decrease in general and administrative expenses and other for the three months ended September 30, 2005, compared to the three months ended September 30, 2004, resulted primarily from a \$1.2 million reduction in expenses related to the mark to market on interest rate caps and a \$0.7 million reduction in insurance costs.

***Nine Months Ended September 30, 2005 and 2004***

Net income for the nine months ended September 30, 2005, was \$113.7 million, an \$80.7 million increase from \$33.0 million for the nine months ended September 30, 2004.

Securitization income was \$401.7 million for the nine-month period ended September 30, 2005, compared to \$242.6 million for the comparable period in 2004. The following table details Securitization income for the nine-month periods ended September 30, 2005 and 2004, respectively.

**Table of Contents****Table 3: Analysis of Securitization Income***(In thousands)*

	<b>Nine Months Ended September 30,</b>	
	<b>2005</b>	<b>2004</b>
Loss on new securitizations of receivables to the Metris Master Trust:		
Defeasance of maturing ABS series into conduit	\$ (34,525) <sup>(1)</sup>	\$ (78,008) <sup>(5)</sup>
Amortizing term series financing		(1,246) <sup>(6)</sup>
New Term ABS transactions	(13,046) <sup>(2)</sup>	(12,632) <sup>(7)</sup>
Issuance of BB bonds	5,364 <sup>(3)</sup>	
Paired series transactions	(7,106) <sup>(4)</sup>	
	(49,313)	(91,886)
Loss on replenishment of receivables to the Metris Master Trust	(21,890)	(71,353)
Discount accretion	180,187	185,287
Interest-only revenue:		
Gross yield <sup>(8)</sup>	1,198,785	1,363,721
Principal defaults	(662,263)	(955,505)
Interest expense and servicing fees	(229,336)	(190,831)
	307,186	217,385
Change in fair value of retained interests in loans securitized	781	94,202
Transaction and other costs	(15,253)	(91,018)
Securitization income	\$ 401,698	\$ 242,617

(1) Loss represents \$204 million retained bond (18.5% required subordination) discounted at 16% for 15 months and a \$33 million spread account floor discounted at 16% for 15 months, partially offset by the present value of future 15 months assumed excess

spread  
discounted at  
30%.

(2) Loss  
represents  
\$89 million  
retained bond  
(14.0% required  
subordination,  
including the  
issuance of BB  
bonds)  
discounted at  
15% for  
23 months,  
partially offset  
by the present  
value of future  
20 months  
assumed excess  
spread  
discounted at  
30%.

(3) Gain  
represents the  
reversal of the  
remaining  
discount (16%  
over 21 months)  
on a \$53 million  
retained bond,  
partially offset  
by a \$7 million  
interest reserve  
account  
discounted at  
16% for  
21 months and  
increased  
interest expense  
on \$53 million  
of BB bonds  
discounted  
monthly at 30%.

(4) Loss  
represents  
\$74 million  
retained bond

(9.0 to 9.5% required subordination) discounted at 15% for 2.3 months and a \$4.6 million decrease in the interest-only strip receivable.

(5) Loss represents discount on a \$250 million retained bond (18.5% required subordination) at 16% for 24 months and a \$47 million spread account floor discounted at 15.25% for 24 months, partially offset by the present value of future 24 months assumed excess spread discounted at 30%.

(6) Loss represents discount on a \$113 million retained bond (18.5% required subordination) at 16% for one month, partially offset by the present value of future assumed excess spread discounted at 30%.

(7) Loss represents discount on \$27 million retained bond (12% required subordination) discounted at 16% for 36 months and a \$7 million spread account floor discounted at 15.25% for 36 months, partially offset by the present value of future 36 months assumed excess spread discounted at 30%.

(8) Includes cash flows from finance charges, late, overlimit, debt waiver and cash advance fees, bad debt recoveries and interchange income.

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Loss on new securitizations of receivables to the Metris Master Trust was \$49.3 million for the nine-month period ended September 30, 2005, a decrease of \$42.6 million or 46.4% from \$91.9 million for the nine-month period ended September 30, 2004. The improvement was primarily due to lower weighted average months to maturity and enhancement levels on securitization transactions and higher excess spread assumptions used in calculating the loss on new securitization.

Loss on replenishment of receivables to the Metris Master Trust was \$21.9 million for the nine-month period ended September 30, 2005, a decrease of \$49.5 million or 69.3% from \$71.4 million for the nine-month period ended September 30, 2004. The improvement was primarily due to higher excess spread assumptions and lower weighted average months to maturity on outstanding securitization transactions used in calculating the loss on replenishment.

Discount accretion was \$180.2 million for the nine months ended September 30, 2005, a \$5.1 million decrease from \$185.3 million for the nine months ended September 30, 2004. The decrease was primarily due to lower securitization borrowing and restricted cash levels.

Interest-only revenue was \$307.2 million for the nine-month period ended September 30, 2005, an \$89.8 million or 41.3% increase from \$217.4 million for the nine-month period ended September 30, 2004. The increase was primarily due to a 260-basis-point increase in average excess spread in the Metris Master Trust, partially offset by a \$1.1 billion reduction in average principal receivables in the Metris Master Trust.

Change in fair value of retained interests in loans securitized was \$0.8 million for the nine-month period ended September 30, 2005, a \$93.4 million or 99.2% decrease from \$94.2 million for the nine-month period ended September 30, 2004. The decrease is primarily due to an \$88.5 million larger reduction in fair market value primarily related to the impact of receivable attrition on a higher interest-only strip receivable and a \$25.5 million smaller increase in the fair market value of the interest-only strip receivable related to a smaller change in excess spread assumptions for the nine-month period. These decreases were partially offset by a \$10.3 million increase in fair value associated with a decrease in the discount rate on contractual retained interest, excess transferor's interest and spread accounts receivable in the first quarter of 2005 and a \$10.2 million larger increase in fair value primarily related to interest earned on cash balances at the Metris Master Trust.

Transaction and other costs were \$15.3 million for the nine-month period ended September 30, 2005, a \$75.7 million or 83.2% decrease from \$91.0 million for the nine-month period ended September 30, 2004. The decrease is primarily due to fees incurred in 2004 related to establishing a two-year financing conduit and commitment fees to insure future asset-backed transactions.

Servicing income on securitized receivables was \$85.6 million for the nine-month period ended September 30, 2005, a \$17.0 million or 16.6% decrease from \$102.6 million for the nine-month period ended September 30, 2004. This decrease reflects a \$1.1 billion reduction in average principal receivables held by the Metris Master Trust between the two periods.

Credit card loan and other interest income and Credit card loan fees, interchange and other income, totaled \$15.7 million for the nine-month period ended September 30, 2005, an \$18.8 million or 54.5% decrease from \$34.5 million for the nine-month period ended September 30, 2004. The cumulative decrease resulted primarily from the \$61.4 million reduction in average owned credit card loans between the two periods.

Enhancement services income was \$9.2 million for the nine-month period ended September 30, 2005, a \$10.9 million or 54.2% decrease from \$20.1 million for the nine-month period ended September 30, 2004. The decrease resulted primarily from the declining number of memberships in a declining portfolio following the sale of our membership club and warranty business in 2003.

Interest expense was \$16.4 million for the nine-month period ended September 30, 2005, a \$30.3 million or 64.9% decrease from \$46.7 million for the nine-month period ended September 30, 2004. This decrease resulted primarily from the \$238.5 million decrease in average debt outstanding between the two periods.

Marketing expenses were \$87.5 million for the nine-month period ended September 30, 2005, a \$38.7 million or 79.3% increase from \$48.8 million for the nine-month period ended September 30, 2004. This increase resulted from an increase in new credit card accounts, an increase in overall account marketing to offset a decline in customer response rates consistent with current trends in the industry and an increase in partnership marketing expenditures during the nine-month period. This increase was partially offset by a reduction in expenses associated with the

termination of our obligations under a temporary servicing arrangement with the purchaser of our membership club and warranty business.



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Data processing services and communications, Credit protection claims expense and Occupancy and equipment totaled \$64.2 million for the nine-month period ended September 30, 2005, a \$10.9 million or 14.5% decrease from \$75.1 million for the nine-month period ended September 30, 2004. This decrease resulted primarily from a reduction in the costs required to service fewer average gross active accounts.

Other expenses were \$74.6 million for the nine-month period ended September 30, 2005, a \$0.5 million or 0.7% decrease from \$75.1 million for the nine-month period ended September 30, 2004. The following table illustrates the components of Other expenses for the nine-month periods ended September 30, 2005 and 2004, respectively.

**Table 4: Other Expenses**

(In thousands)

	<b>Nine Months Ended September 30,</b>	
	<b>2005</b>	<b>2004</b>
MasterCard / Visa assessment and fees	\$ 5,864	\$ 4,981
Credit card fraud losses	1,624	1,639
Legal fees	5,139	4,935
Collection and risk management	8,721	10,568
Other professional fees	14,314	14,727
Purchased portfolio premium amortization	4,560	6,743
Asset impairment, lease write-offs and severance	283	4,515
Debt prepayment expenses	21,027	4,879
General and administrative expenses and other	13,021	22,108
Total other expenses	\$ 74,553	\$ 75,095

Included in debt prepayment expenses for the nine months ended September 30, 2005, is approximately \$18 million related to prepayments on our Term Loan due May 2007. The remaining debt prepayment expenses for the nine-month period related to prepayments on our Senior Notes due July 2006. Included in debt prepayment expenses for the nine months ended September 30, 2004, are \$4.5 million in costs related to the prepayment of our \$125 million senior secured credit agreement due June 2004. The remainder of the debt prepayment costs for the nine months ended September 30, 2004, related to the prepayment of our \$100 million 10% senior notes due November 2004.

Included in asset impairment, lease write-offs and severance for the nine-month period ended September 30, 2004, is approximately \$3.9 million of severance related expenses.

The decrease in general and administrative expenses and other for the nine months ended September 30, 2005, compared to the nine months ended September 30, 2004, resulted primarily from a \$2.3 million decrease related to technology licensing fees, a \$2.0 million reduction in certain insurance costs, a \$0.9 million reduction in the mark to market on interest rate caps and a \$0.9 million reduction in claims expense associated with our declining enhancement services business.

Income tax expense was \$52.8 million for the nine months ended September 30, 2005, compared to \$20.0 million for the prior year period. This resulted in an effective tax rate of 31.7% for the nine-month period ended September 30, 2005, compared to 37.7% in the prior year period. The decrease in the effective tax rate is primarily due to a \$4.7 million reduction in tax liabilities, including interest income, associated with approval of a federal tax refund and \$3.4 million from a reduction in the deferred tax asset valuation allowance based on current earnings for the nine-month period ended September 30, 2005.

**Table of Contents***Retained Interests in Loans Securitized*

Our credit card receivables are primarily funded through asset-backed securitizations. Upon securitization, we remove the applicable credit card loans from our consolidated balance sheets and recognize the Retained interests in loans securitized at their allocated carrying value in accordance with SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* a replacement of FASB Statement No. 125 ( SFAS No. 140 ). We sell some assets to the Metris Master Trust at the inception of a securitization series. We also sell receivables to the Metris Master Trust on a daily basis to replenish principal receivable balances that have decreased due to payments and charge-offs. The difference between the allocated carrying value and the proceeds from the assets sold is recorded as a gain or loss on sale and is included in Securitization income. At the same time, we recognize Retained interests in loans securitized. The Retained interests in loans securitized are financial assets measured at fair value consistent with trading securities in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and include our contractual retained interests, an interest-only strip receivable, excess transferor s interests, and spread accounts receivable. The contractual retained interests consist of non-interest bearing securities held by us. The interest-only strip receivable represents the present value of the excess of the estimated future interest and fee collections expected to be generated by the securitized loans over the period such loans are projected to be outstanding, over the interest paid on investor certificates, credit losses, contractual servicing fees and other expenses. The excess transferor s interests represent principal receivables held in the Metris Master Trust in excess of the contractual retained interests. Spread accounts receivable represent restricted cash reserve accounts held by the Metris Master Trust Trustee that can be used to fund payments due securitization investors and credit enhancers if cash flows are insufficient. Cash held in spread accounts is released to us if certain conditions are met or a securitization series terminates with amounts remaining in the related spread accounts. The fair value of the Retained interests in loans securitized is determined through estimated cash flows discounted at rates that reflect the level of subordination, projected repayment term and credit risk of the securitized loans.

The following table summarizes our Retained interests in loans securitized as of September 30, 2005, and December 31, 2004, respectively.

**Table 5: Retained interest in loans securitized***(In thousands)*

	<b>September 30, 2005</b>	<b>December 31, 2004</b>
Contractual retained interests	\$ 542,129	\$ 537,945
Excess transferor s interests	146,056	105,237
Interest-only strip receivable	110,330	82,672
Spread accounts receivable	52,628	58,281
<b>Retained interests in loans securitized</b>	<b>\$ 851,143</b>	<b>\$ 784,135</b>

The contractual retained interests were \$542.1 million as of September 30, 2005, a \$4.2 million or 0.8% increase from \$537.9 million as of December 31, 2004. The increase resulted from a slight increase in the weighted average enhancement level and a 6.4 month decrease in the weighted average months to maturity on the outstanding series in the Metris Master Trust, partially offset by a \$623 million reduction in securitization borrowings outstanding in the Metris Master Trust.

The excess transferor s interests were \$146.1 million as of September 30, 2005, a \$40.9 million or 38.9% increase from \$105.2 million as of December 31, 2004. The increase was due primarily to the pay down of our variable funding conduits.

The interest-only strip receivable was \$110.3 million as of September 30, 2005, a \$27.6 million or 33.4% increase from \$82.7 million as of December 31, 2004. The increase was due to higher projected excess spreads from receivables held in the Metris Master Trust, partially offset by a \$639.0 million reduction in ending principal

receivables in the Metris Master Trust. The projected excess spread has increased from 2.58% at December 31, 2004, to 3.77% at September 30, 2005, primarily due to a decrease in the projected principal default rates, partially offset by a net yield compression resulting from a projected increase in interest rates.

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Spread accounts receivable were \$52.6 million as of September 30, 2005, a \$5.7 million or 9.8% decrease from \$58.3 million as of December 31, 2004. The decrease is primarily due to the release of all cash restricted due to performance, partially offset by an increase in cash restricted related to our paired series financing. For more information on cash restricted from release, see the *Off-Balance Sheet Arrangements* section of *Management's Discussion and Analysis of Financial Condition and Results of Operations* on page 30.

At least quarterly, we adjust our valuation of the Retained interests in loans securitized to reflect changes in the amount and expected timing of future cash flows. The significant factors that affect the timing and amount of cash flows relate to collateral assumptions, which include payment rate, default rate, gross yield and discount rate. These values can, and will, vary as a result of changes in the amount and timing of the cash flows and the underlying economic assumptions. The discount rates used to estimate the fair value of the retained interest assets are commensurate with the risk associated with the underlying expected future cash flows. Indicators of the level of risk inherent in the portfolio include delinquency and loss rates and expectations surrounding interest rates. Other factors that would impact the risk assessment include changes to our corporate capital structure, corporate debt ratings or securitization enhancement levels. Changes in expectations as to the level of risk related to future cash flows may result in changes to the discount rate assumptions. (See *Critical Accounting Estimates* on pages 19-20 for more information on the valuation of Retained interests in loans securitized. )

The significant assumptions we used in estimating the fair value of the Retained interests in loans securitized as of September 30, 2005 and December 31, 2004, are as follows:

**Table 6: Significant assumptions used for estimating the fair value of retained interests**

	<b>September 30, 2005</b>	<b>December 31, 2004</b>
Monthly principal payment rate	6.7%	5.9%
Gross yield <sup>(1)</sup>	26.2%	25.9%
Annual interest expense and servicing fees	5.8%	5.0%
Annual gross principal default rate	16.7%	18.4%
Discount rate:		
Contractual retained interests / Excess transferor's interests / Spread accounts receivable	15.0%	16.0%
Interest-only strip receivable	30.0%	30.0%
Weighted average months-to-maturity	13.7	20.1
Weighted average enhancement level <sup>(2)</sup>	12.7%	12.1%
Gross receivables held in the Metris Master Trust, net of discount <sup>(3)</sup>	94.0%	92.3%

<sup>(1)</sup> Includes expected cash flows from finance charges, late and overlimit fees, debt waiver premiums and bad debt recoveries.  
Gross yield for purposes of estimating fair value does not

include cash flows from interchange income or cash advance fees.

(2) Includes contractual retained interests and required minimum spread reserve deposits.

(3) Represents the ratio of Retained interests in loans securitized (contractual retained interests, excess transferor's interest, spread accounts receivable and interest-only strip receivable) plus investors' interests in securitized receivables accounted for as sales to gross receivables in the Metris Master Trust plus the gross spread accounts receivable.

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At least quarterly, we review and adjust, as appropriate, the assumptions and estimates used in our model based on a variety of internal and external factors, including national and economic trends and business conditions, current lending policies, procedures and strategies, historical trends and assumptions about future trends, competition and legal and regulatory requirements. Effective March 31, 2005, we reduced the discount rate applied to the contractual retained interests, excess transferor's interest and spread accounts receivable from 16.0% to 15.0%. The discount rates were reduced to reflect a decrease in the overall risk of the assets in the Metris Master Trust. Indicators of the reduced level of risk in the portfolio include improvements in credit quality and excess spreads, corporate debt rating upgrades, improvements in securitization enhancement levels (required subordination levels determined by our rating agencies) and improved access to the securitization markets.

Subsequent to September 30, 2005, the Company closed on Series 2005-2. This transaction included bonds issued from AAA to BBB and was priced at a weighted average spread to LIBOR of 16 basis-points and required a 17.5% enhancement level excluding BB bonds and an 11.0% enhancement level including BB bonds, which were structured but not sold. These enhancement levels represent improvements of 350 basis-points and 300 basis-points, respectively, over Series 2005-1 levels. As the transaction was closed in the fourth quarter of 2005, discount rates will be reassessed during the fourth quarter of 2005 as it relates to the improvement in the enhancement levels among other factors.

**Credit card receivables**

Direct Merchants Bank originates all of our credit card accounts. The receivables on nearly all of those accounts are currently being funded through asset-backed securitizations with one of our special purpose entity subsidiaries, MRI, and the Metris Master Trust. These securitizations are treated as sales under GAAP and the receivables are removed from our consolidated balance sheets when transferred to the Metris Master Trust. Following the sale, the Bank retains ownership of the cardholder relationship and services all receivables held by the Metris Master Trust.

As a result of our current funding strategies, our owned credit card receivable portfolio has decreased significantly over the past two years. Currently, the receivables held by Direct Merchants Bank are primarily secured credit card receivables which are secured by a cardholder deposit held by the Bank. Also, within the normal course of business, MCI and its other non-bank subsidiaries may hold receivables on their balance sheets.

The following tables illustrate the credit card loans outstanding, delinquency ratios and net charge-offs of our owned credit card receivables portfolio as of the dates and for the periods indicated.

**Table 7: Loan Delinquency**

*(Dollars in thousands)*

	<b>September 30, 2005</b>	<b>% of Total</b>	<b>December 31, 2004</b>	<b>% of Total</b>	<b>September 30, 2004</b>	<b>% of Total</b>
Loans outstanding	\$ 4,231	100%	\$ 68,230	100%	\$ 70,389	100%
Loans contractually delinquent:						
30 to 59 days	194	4.6%	1,750	2.6%	2,445	3.5%
60 to 89 days	191	4.5%	1,722	2.5%	1,873	2.6%
90 or more days	525	12.4%	4,309	6.3%	4,568	6.5%
Total	\$ 910	21.5%	\$ 7,781	11.4%	\$ 8,886	12.6%

The increase in the owned delinquency rate as of September 30, 2005 compared to both December 31, 2004, and September 30, 2004, resulted from the sale of approximately \$52 million in credit card loans from Direct Merchants Bank to MCI, and subsequently to the Metris Master Trust, during the quarter ended June 30, 2005. The increased delinquency rate results from the nature and credit quality of the remaining owned credit card receivables.

**Table of Contents****Table 8: Net Charge-offs***(Dollars in thousands)*

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Average credit card loans	\$ 5,588	\$ 72,581	\$ 32,010	\$ 93,363
Net charge-offs	1,335	2,491	4,272	27,970
Net charge-off ratio (annualized)	94.8%	13.6%	17.8%	40.0%

**Balance Sheet Analysis***Cash and Cash Equivalents and Available for Sale Securities*

Cash and cash equivalents and Available for sale securities totaled \$167.1 million as of September 30, 2005, a decrease of \$230.0 million or 57.9% from \$397.1 million as of December 31, 2004. This decrease resulted primarily from the \$375.0 million in optional debt prepayments made between the two periods, partially offset by \$147.6 million of cash generated from operations and net receivable attrition.

*Net Credit Card Loans*

Credit card loans, net of allowance for loan losses of \$1,645 and \$12,409, respectively were \$2.6 million as of September 30, 2005, a decrease of \$53.2 million or 95.3% from \$55.8 million at December 31, 2004. The decrease resulted primarily from the sale of approximately \$52 million of credit card loans from Direct Merchants Bank to MCI, and subsequently to the Metris Master Trust, during the second quarter of 2005.

*Other Receivables due from Credit Card Securitizations, Net*

Other receivables due from credit card securitizations, net were \$80.9 million as of September 30, 2005, an increase of \$12.9 million or 19.0% from \$68.0 million at December 31, 2004. The increase resulted primarily from the 363-basis-point improvement in the three month average excess spread in the Metris Master Trust of 8.49% as of September 30, 2005 compared to 4.86% as of December 31, 2004.

*Other Assets*

Other assets were \$51.7 million as of September 30, 2005, a decrease of \$20.8 million or 28.7% from \$72.5 million at December 31, 2004. This decrease resulted primarily from a \$10.4 million reduction in capitalized debt fees following the prepayment of corporate debt, a \$4.6 million decrease related to amortization of purchase portfolio premium and a \$4.1 million reduction in certain receivables related to the termination of our obligations under a temporary servicing arrangement with the third-party purchaser of our membership club and warranty business.

*Debt*

Debt decreased \$373.6 million from December 31, 2004. This decrease resulted primarily from the optional prepayments totaling \$225 million made on our Term Loan due May 2007 and the \$150 million in optional prepayments and repurchases made on our Senior Notes due July 2006 during the nine-months ended September 30, 2005.

*Accrued Expenses and Other Liabilities*

Accrued expenses and other liabilities were \$162.1 million at September 30, 2005, an increase of \$39.2 million or 31.9% from \$122.9 million at December 31, 2004. The increase was due primarily to a \$36.5 million increase in tax related liabilities.

**Table of Contents****Off-Balance Sheet Arrangements**

Our operations are funded primarily through asset-backed securitizations of principal receivables on credit card accounts. Our securitizations involve selling pools of both current and future principal receivable balances on credit card accounts. We retain the servicing of the receivables, and we also currently maintain a qualified back-up servicer. Our securitizations are treated as sales under GAAP and the receivables are removed from our consolidated balance sheets (except for any retained interests in the securitization).

The Metris Master Trust was formed in May 1995 pursuant to a pooling and servicing agreement, as amended. MRI, one of our special purpose entity subsidiaries, transfers receivables in designated accounts to the Metris Master Trust. The Metris Master Trust may, and does from time to time, issue securities that represent undivided interests in the receivables in the Metris Master Trust. These securities are issued by series, and each series typically has multiple classes of securities. Each series, or class within a series, may have different terms. The different classes of an individual series are structured to obtain specific debt ratings. As of September 30, 2005, 14 series of publicly and privately issued securities were outstanding. MRI currently retains the most subordinated class of securities in each series and the Class D securities in Series 2005-2. All other classes are issued to non-affiliated third parties. The securities issued are interests in the Metris Master Trust only and are not obligations of MRI, MCI, Direct Merchants Bank or any other subsidiary of the Company. The interests in the Metris Master Trust not represented by any series of securities issued by the Metris Master Trust, known as the excess transferor's interests, as well as the most subordinate class required for all issued securities, known as retained interests, belong to MRI.

Generally, each series involves an initial reinvestment period, referred to as the revolving period, in which principal payments on receivables allocated to such series are returned to MRI and reinvested in new principal receivables arising in the accounts. After the revolving period ends, principal payments allocated to the series are then accumulated and used to repay the investors. This period is referred to as the accumulation period, which is followed by a controlled amortization period wherein investors are repaid their invested amount. As of September 30, 2005, the Metris Master Trust had two series in an accumulation period and did not have any series in a controlled amortization period. As of September 30, 2005 Series 2000-3 was fully accumulated at \$500 million, in advance of its October and November 2005 maturities. Series 1999-3 was partially accumulated at \$104 million and the Series will be fully accumulated in advance of its November 2005 maturity. The scheduled accumulation and amortization periods are set forth in the securitization agreements governing each series. However, all series set forth certain events by which amortization can be accelerated, referred to as early amortization. Reasons early amortization could occur include: (i) three-month average of portfolio collections, less principal and finance charge charge-offs, financing costs and servicing costs, would drop below levels between 0.0% and 1.0%; (ii) negative transferor's interest within the Metris Master Trust, or; (iii) failure to obtain funding during an accumulation period for a maturing series. New receivables in designated accounts cannot be funded from a series that is in early amortization. We do not currently have any series that are in early amortization.

In addition, there are various triggers within our securitization agreements that, if broken, would restrict the release of cash to us from the Metris Master Trust. This restricted cash provides additional security to the investors in the Metris Master Trust. We include cash restricted from release in the Metris Master Trust at its fair value within Retained interests in loans securitized on our consolidated balance sheets. The triggers are usually related to the performance of the Metris Master Trust, specifically the average excess spread over a one- to three-month period.

The cash restricted from release is limited to the amount of excess spread generated in the Metris Master Trust on a cash basis. During periods of lower excess spreads, the maximum amount of cash required to be restricted in the Metris Master Trust may not be generated. During those periods, all excess cash normally released to MRI will be restricted from release. Once the maximum amount of cash required to be restricted is restricted from release or excess spreads improve, cash can again be released to MRI. Table 9 presents the cash restricted from release as of September 30, 2005 and December 31, 2004, respectively.



**Table of Contents****Table 9: Cash Restricted from Release***(In thousands)*

	September 30, 2005	December 31, 2004
Cash restricted due to performance	\$	\$ 36,367
Cash restricted due to corporate debt ratings	13,187	13,187
Other non-performance based cash restricted	53,114	37,770
Total cash restricted	\$ 66,301	\$ 87,324

The \$36.4 million decrease in total cash restricted due to performance from December 31, 2004 to September 30, 2005, resulted from improving excess spreads in the Metris Master Trust. The increase in other non-performance based cash restricted primarily relates to cash required to be restricted on our paired series financing.

The following table generally illustrates the maximum amount of cash (as a percentage of outstanding securitized principal receivables) that could be held by the Metris Master Trust Trustee as additional collateral if the one-month or three-month average excess spread of the Metris Master Trust were within various ranges:

**Table 10: Maximum Cash Restricted in the Metris Master Trust**

<b>Cash Basis Net Excess Spread</b>	<b>Maximum Restricted</b>
greater than 5.5%	
5.0% - 5.5%	0.5% - 1.0%
4.5% - 5.0%	0.5% - 1.5%
4.0% - 4.5%	1.0% - 2.0%
3.5% - 4.0%	1.0% - 3.0%
3.0% - 3.5%	1.0% - 4.0%
less than 3.0%	4.5% - 5.0%

As a result of the recent increase in bankruptcy filings, we expect the fourth quarter 2005 excess spread in the Metris Master Trust to be at levels that will require us to restrict additional cash during the first half of 2006. We expect to have adequate liquidity during the period cash is restricted from release to the Company. For more information on the impact of increased bankruptcy filings see the *Business Overview* section of *Management's Discussion and Analysis of Financial Condition and Results of Operations* on pages 16-17.

On a monthly basis, each series is allocated its share of finance charge and fee collections, which are used to pay investors interest on their securities, pay their share of servicing fees and reimburse them for their share of losses due to charge-offs. Amounts remaining may be deposited in cash accounts of the Metris Master Trust as additional protection for future losses. Once each of these obligations is fully met, remaining finance charge collections, if any, are returned to us. Principal receivables held by the Metris Master Trust were \$5.5 billion and \$6.1 billion as of September 30, 2005 and December 31, 2004, respectively.

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The following table shows the average annualized yields, defaults, costs and excess spreads for the Metris Master Trust on a cash basis:

**Table 11: Weighted Average Annualized Yields, Defaults, Costs and Excess Spreads***(In thousands)*

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2005	2004	2005	2004
Gross yield (1)	28.49%	26.49%	28.40%	26.91%
Annual principal defaults	13.88%	16.79%	15.50%	18.43%
Net portfolio yield	14.61%	9.70%	12.90%	8.48%
Annual interest expense and servicing fees	6.12%	4.12%	5.63%	3.81%
Net excess spread	8.49%	5.58%	7.27%	4.67%

(1) Includes cash flows from finance charges, late, overlimit, debt waiver and cash advance fees, bad debt recoveries and interchange income.

The following table shows the principal receivables and delinquent principal receivables in the Metris Master Trust:

**Table 12: Principal Receivables***(Dollars in thousands)*

	September 30, 2005	December 31, 2004	September 30, 2004
Principal receivables	\$ 5,478,683	\$ 6,117,669	\$ 6,304,711
2-cycle plus delinquent principal receivables	\$ 369,568	\$ 470,442	\$ 514,011
Principal delinquency ratio	6.8%	7.7%	8.2%

Additional information regarding off-balance sheet arrangements is set forth under *Liquidity, Funding and Capital Resources* below. Additional information regarding the accounting for our Retained interests in loans securitized can be found under *Critical Accounting Estimates* on pages 19-20 of this Report.

**Liquidity, Funding and Capital Resources**

One of our primary financial goals is to maintain an adequate level of liquidity through active management of our assets and liabilities. Liquidity management is a dynamic process, affected by changes in the characteristics of our assets and liabilities, short- and long-term interest rates and by the capital markets. We use a variety of financing resources to manage liquidity, funding and interest rate risks. Table 13 summarizes our funding and liquidity as of September 30, 2005 and December 31, 2004, respectively.

**Table of Contents****Table 13: Liquidity, Funding and Capital Resources***(In thousands)*

	DMCCB	September 30, 2005 MCI and non-bank subsidiaries	Consolidated	DMCCB	December 31, 2004 MCI and non-bank subsidiaries	Consolidated
Cash and due from banks	\$ 25,427	\$ (179)	25,248	\$ 25,340	\$ (142)	25,198
Federal funds sold	22,005		22,005	22,450		22,450
Short-term investments	1,248	57,538	58,786	12,599	30,471	43,070
Available for sale securities	26,000	35,100	61,100	107,138	199,271	306,409
Total liquid assets	\$ 74,680	\$ 92,459	\$ 167,139	\$ 167,527	\$ 229,600	\$ 397,127

The following tables detail our outstanding on- and off-balance sheet funding as of September 30, 2005 and December 31, 2004, respectively, including any unused capacity as of those dates.

**Table 14: Outstanding On- and Off-Balance Sheet Funding***(In thousands)*

	September 30, 2005		December 31, 2004	
	Outstanding	Unused Capacity	Outstanding	Unused Capacity
<b>On-balance sheet funding</b>				
10.125% senior notes July 2006		N/A	148,624	N/A
Term loan May 2007		N/A	225,000	N/A
Total	\$	N/A	\$ 373,624	N/A
<b>Off-balance sheet asset-backed funding</b>				
Metris Master Trust:				
Term asset-backed securitizations with various maturities through February 2009	4,647,150		4,950,000	
Conduits maturing April 2006	40,000	160,000	360,000	840,000
Total	\$ 4,687,150	\$ 160,000	\$ 5,310,000	\$ 840,000
<b>Off-balance sheet paired series conduit funding</b>				
Series 05-A (paired with Series 2000-3), matures November 2005	500,000			
Series 05-B (paired with Series 1999-3), matures December 2005	100,000	200,000		
Total	\$ 600,000	\$ 200,000	\$	\$



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We had the following term asset-backed securitizations outstanding as of September 30, 2005:

**Table 15: Outstanding Term Asset-Backed Securitizations**

<b>Term asset-backed securitization</b>	<b>Amount (in thousands)</b>	<b>Expected final payment date(s)</b>
Series 2000-3	\$ 500,000	October 20, 2005 and November 21, 2005
Series 1999-3	300,000	November 21, 2005
Series 2001-2	750,000	May 22, 2006 and June 20, 2006
Series 1999-2	500,000	July 20, 2006
Series 2004-2	652,800	October 20, 2006
Series 2005-1	544,350	March 20, 2007
Series 2004-1	200,000	April 20, 2007
Series 2002-4	600,000	May 21, 2007
Series 2002-1	300,000	January 20, 2009 and February 20, 2009
Series 2002-2	300,000	January 20, 2009 and February 20, 2009
<b>Total</b>	<b>\$ 4,647,150</b>	

Our term asset-backed securitizations require the accumulation of principal cash payments received by the Metris Master Trust to fund the repayment of these obligations at the time of maturity. We typically achieve this by either obtaining a paired series funding vehicle or defeasing the maturing bonds with draw downs on existing conduit facilities or other funding vehicles prior to the start of the accumulation period.

As of September 30, 2005 and December 31, 2004, we had \$4.7 million and \$5.5 million in letters of credit issued, respectively, under a letter of credit facility agreement. We have pledged 100% collateral against our letters of credit, which is classified in Other assets on the consolidated balance sheets.

As of September 30, 2005, our contractual cash obligations during the next 12 months are as follows:

**Table 16: Contractual Cash Obligations**

(In thousands)

Operating leases	\$ 7,610
Deposits	2,225
Contractual purchase obligations	50,144
<b>Total</b>	<b>\$ 59,979</b>

In addition to contractual cash obligations, open-to-buy on credit card accounts was \$6.6 billion as of September 30, 2005. While these amounts represent the total lines of credit available to our customers, we have not experienced, and do not anticipate that we would experience, all of our customers exercising their entire available credit line at any given point in time. We also have the right to increase, reduce, cancel, alter or amend the terms for those available lines of credit at any time.

The Company issued \$52.8 million of asset-backed securities from the Metris Secured Note Trust 2004-2 during January 2005. These asset-backed securities are set to mature on October 20, 2006, and were rated Ba2/BB+ by Moody's and Fitch Inc. (Fitch), respectively. Proceeds from the issuance were used to make an optional \$50 million prepayment on the Company's Senior Notes due 2006. In February 2005, we announced the defeasance of the \$900 million Series 2002-3 asset-backed securities from the Metris Master Trust. Series 2002-3 was defeased through use of the two-year conduit facility and was scheduled to mature in May 2005. Also in February 2005, the Company reduced its conduit capacity from \$1.2 billion to \$1.0 billion. In April 2005, the Company issued \$544 million in

Series 2005-1 asset-backed securities from the Metris Master Trust. In October 2005, the Company issued \$500 million in Series 2005-2 asset-backed securities from the Metris Master Trust. We expect our receivable funding needs for the remainder of 2005 and 2006 will be covered by future asset-backed securitizations ( ABS ) issuances and, to a lesser extent, further portfolio attrition. The Company currently has \$160 million of conduit capacity available and will have an additional \$800 million in conduit capacity available following the fourth quarter 2005 term ABS maturities. The Company also has \$900 million in remaining commitment from MBIA to provide insurance coverage on future ABS transactions, of which \$600 million is currently available. An additional \$300 million will become available when series 1999-3 matures on November 21, 2005.

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During the second quarter of 2005, the Company used proceeds from the Bank's permanent capital reduction and existing Short-term investments to make optional prepayments totaling \$225 million on its Term Loan due May 2007, resulting in approximately \$18.0 million in costs and charges. As a result of the cumulative prepayments, MCI paid off, in full, its remaining obligations owed under its \$300 million senior secured credit agreement, effectively terminating the credit agreement. During May 2005, the Company made three optional prepayments totaling \$21 million on its unsecured 10.125% Senior Notes due July 2006. During the third quarter of 2005, the Company made additional optional prepayments of \$30.0 million and \$49.1 million on its Senior Notes. As a result of these prepayments, the Company eliminated all of its corporate debt.

Our deposits and unsecured debt are rated by Moody's, S&P and Fitch. Factors affecting the various ratings include the overall health of the global and national economy, specific economic conditions impacting the subprime consumer finance industry and our overall financial performance, including earnings, credit losses, delinquencies, excess spreads in the Metris Master Trust and our overall liquidity. Certain of our term asset-backed securitizations require the restriction of cash if our corporate debt ratings fall below certain levels. The following illustrates the current debt and long-term deposit ratings of MCI and Direct Merchants Bank:

	<b>Moody's</b>	<b>S &amp; P</b>	<b>Fitch</b>
<b>Metris Companies Inc.</b>			
Senior unsecured debt	B3	B-	B-
<b>Direct Merchants Bank</b>			
Long-term deposits	Ba3	BB-	B

As of September 30, 2005, the Company's Total stockholders' equity was \$1.1 billion, or 17.9% of total managed assets, compared to \$947.3 million or 13.9% of total managed assets as of December 31, 2004. In the normal course of business, Direct Merchants Bank enters into agreements, or is subject to regulatory requirements, that result in cash, debt, dividend or other capital restrictions. Direct Merchants Bank and MCI have entered into a Capital Assurance and Liquidity Maintenance Agreement ( CALMA ) that requires MCI to make such capital infusions or provide the Bank with financial assistance so as to permit the Bank to meet its liquidity and capital requirements. Direct Merchants Bank also entered into a Liquidity Reserve Deposit Agreement ( LRDA ) under which the Bank has established restricted deposits with third-party depository institutions for the purpose of supporting Direct Merchants Bank's funding needs. These deposits are invested in short-term liquid assets and are classified on the consolidated balance sheets as the Liquidity reserve deposit. As of September 30, 2005 and December 31, 2004, the balance in the liquidity reserve accounts was \$86.3 million and \$79.7 million, respectively.

MCI and Direct Merchants Bank have a Modified Operating Agreement with the Office of the Comptroller of the Currency ( OCC ), which was amended on April 7, 2005, and requires, among other things, that:

The Bank must maintain minimum Tier 1 capital of \$100 million, unless otherwise approved by the OCC.

The Bank may continue to pay dividends in accordance with applicable statutory and regulatory requirements provided capital remains at the required level.

The Bank must maintain liquid assets at the greater of \$35 million or 100% of the average highest daily funding requirement for managed receivables, which was \$34.5 million at September 30, 2005.

The Bank must comply with the terms of the LRDA and the CALMA.

MCI must comply with the CALMA.

Direct Merchants Bank and the Company believe they are currently in compliance with all of the terms of the Modified Operating Agreement, as amended. If the OCC were to conclude that the Bank failed to adhere to any provisions of the Modified Operating Agreement, the OCC could pursue various enforcement options. If any of those options were to be pursued by the OCC, it could have a material adverse effect on our operations or capital position.





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On April 7, 2005, the Modified Operating Agreement was amended to reduce the minimum amount of capital required to be held by Direct Merchants Bank from \$213 million to \$100 million. As a result of the change to the Bank's minimum capital requirements, the OCC approved a permanent capital reduction of \$130 million concurrent with the transfer of all eligible credit card receivables from the Company to the Metris Master Trust, which occurred in May 2005. The permanent capital reduction was completed in May 2005.

Direct Merchants Bank is subject to certain capital adequacy guidelines issued by the OCC. Quantitative measures established by regulation to ensure capital adequacy require Direct Merchants Bank to maintain minimum amounts and ratios of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined) and of Tier 1 leverage capital (as defined) to average assets (as defined). Failure to meet minimum capital requirements can result in certain mandatory and possibly additional discretionary action, by regulators that, if undertaken, could have a direct material adverse effect on our financial condition. Furthermore, FFIEC guidelines indicate that an institution with a concentration in subprime lending should hold one and one-half to three times the normal minimum capital required. At both September 30, 2005 and December 31, 2004, Direct Merchants Bank Tier 1 risk-based capital ratio (of 168.9% and 112.3%, respectively), risk-based total capital ratio (of 169.3% and 113.6%, respectively) and Tier 1 leverage ratio (of 53.1% and 70.5%, respectively) far exceeded the minimum required capital levels, and Direct Merchants Bank was considered a well-capitalized depository institution under regulation of the OCC.

**Selected Operating Data – Managed Basis**

In addition to analyzing the Company's performance on an owned basis, we analyze the Company's financial performance on a managed loan portfolio basis. On a managed basis, the balance sheets and income statements include other investors' interests in securitized loans that are not assets of the Company, thereby reversing the effects of sale accounting under SFAS No. 140. We believe this information is meaningful to the reader of the financial statements. We service the receivables that have been securitized and sold and own the right to the cash flows from those receivables sold in excess of amounts owed to security holders.

The following information is not in conformity with GAAP, however, we believe the information is relevant to understanding the overall financial condition and results of operations of the Company.

**Table 17: Managed Loan Portfolio**

*(Dollars and accounts in thousands)*

	Three Months Ended		Nine Months Ended	
	September 30, 2005	September 30, 2004	September 30, 2005	September 30, 2004
<b>Account Originations:</b>				
Partner	63	28	135	52
Non-partner	186	90	442	220
Total account originations	249	118	577	272
	September 30, 2005	As of December 31, 2004	September 30, 2004	
<b>Gross active accounts:</b>				
Historical vintages <sup>(1)</sup>		1,355	1,678	1,802
New vintages <sup>(1)</sup>		858	499	375
		2,213	2,177	2,177

**Period-end loans**

Historical vintages <sup>(1)</sup>	\$ 4,576,709	\$ 5,787,904	\$ 6,164,106
New vintages <sup>(1)</sup>	1,251,844	792,316	617,358
	\$ 5,828,553	\$ 6,580,220	\$ 6,781,464

<sup>(1)</sup> New vintages include credit card account originations between 2003 and 2005. Historical vintages include credit card account originations and portfolio purchases prior to 2003.

**Table of Contents****Table 17: Managed Loan Portfolio (continued)***(Dollars in thousands)*

	<b>September 30, 2005</b>	<b>% of Total</b>	<b>December 31, 2004</b>	<b>% of Total</b>	<b>September 30, 2004</b>	<b>% of Total</b>
<b>Period-end balances:</b>						
Credit card loans	\$ 4,231		\$ 68,230		\$ 70,389	
Receivables held by the Metris Master Trust	5,824,322		6,511,990		6,711,075	
Managed	\$ 5,828,553		\$ 6,580,220		\$ 6,781,464	
<b>Loans contractually delinquent:</b>						
Credit card loans	\$ 910	21.5%	\$ 7,781	11.4%	\$ 8,886	12.6%
Receivables held by the Metris Master Trust	466,414	8.0%	593,819	9.1%	648,321	9.7%
Managed	\$ 467,324	8.0%	\$ 601,600	9.1%	\$ 657,207	9.7%

The decrease in the managed delinquency rates as of September 30, 2005 over December 31, 2004 and September 30, 2004, primarily reflects an improvement in credit quality in the Metris Master Trust. Management believes the improvement in credit quality is more than seasonal and reflects the improvements we have made in collections, account management and new credit card account underwriting. The increased delinquency rate in the owned credit card loans results from the nature and credit quality of the remaining owned credit card receivables.

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>					
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>				
<b>Average balances:</b>								
Credit card loans	\$ 5,588	\$ 72,581	\$ 32,010	\$ 93,363				
Receivables held in the Metris Master Trust	5,889,518	6,892,481	6,084,169	7,311,173				
Managed	\$ 5,895,106	\$ 6,965,062	\$ 6,116,179	\$ 7,404,536				
<b>Net charge-offs:</b>								
Credit card loans	\$ 1,335	94.8%	\$ 2,491	13.6%	\$ 4,272	17.8%	\$ 27,970	40.0%
Receivables held in the Metris Master Trust	177,632	12.0%	253,781	14.6%	607,620	13.4%	888,952	16.3%
Managed	\$ 178,967	12.0%	\$ 256,272	14.6%	\$ 611,892	13.4%	\$ 916,922	16.5%

The managed net charge-off rate was 12.0% for the three-month period ended September 30, 2005, compared to 13.5% for the prior quarter and 14.6% for the quarter ended September 30, 2004. For the nine-month period ended

September 30, 2005 and September 30, 2004, the managed net charge-off ratio was 13.4% and 16.5%, respectively. These improvements resulted primarily from the improved credit quality of receivables in the Metris Master Trust.

We charge-off bankrupt accounts within 60 days of formal notification. Charge-offs due to bankruptcies were \$82.1 million or 32.4% of total managed gross charge-offs for the quarter ended September 30, 2005, and \$94.4 million or 26.0% of total managed gross charge-offs for the quarter ended September 30, 2004. Charge-offs due to bankruptcies were \$250.7 million or 32.4% of total managed gross charge-offs for the nine-month period ended September 30, 2005, and \$310.0 million or 24.3% of managed gross charge-offs for the nine-month period ended September 30, 2004. In addition to those bankrupt accounts that were charged-off, we received formal notification of \$53.4 million and \$49.7 million of managed bankrupt accounts that had not been charged off as of September 30, 2005 and 2004, respectively.

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Total managed loans decreased \$751.7 million and \$952.9 million to \$5.8 billion as of September 30, 2005, compared to \$6.6 billion and \$6.8 billion as of December 31, 2004 and September 30, 2004, respectively. The decrease in managed loans from both December 31, 2004, and September 30, 2004, to September 30, 2005, resulted primarily from the charging-off of higher balance historical vintage receivables, which are being replaced with new vintage lower balance receivables. These decreases also resulted from an increase in payment rates in the managed loan portfolio between the respective periods. The amount of credit card receivables in debt management programs was \$404.6 million or 6.9% of total managed loans as of September 30, 2005, compared with \$540.3 million or 8.2% of managed loans as of December 31, 2004. All delinquent receivables in debt management programs are included in Table 17.

**Table 18: Equity Ratios**

*(Dollar and share counts in thousands, except per share amounts)*

	<b>September 30, 2005</b>	<b>December 31, 2004</b>	<b>September 30, 2004</b>
<b>Equity to managed assets:</b>			
Total equity	\$ 1,064,640	\$ 947,302	\$ 945,657
Total managed assets	\$ 5,948,620	\$ 6,791,478	\$ 7,042,176
Ratio of equity to managed assets	17.9%	13.9%	13.4%
<b>Common stockholders book value:</b>			
Common stockholders equity	\$ 514,578	\$ 432,757	\$ 442,435
Common shares outstanding	58,492	58,127	58,044
Common stockholders book value per share	\$ 8.80	\$ 7.45	\$ 7.62

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risk is the risk of loss from adverse changes in market prices and rates. Our principal market risk is due to changes in interest rates. This affects us directly in our lending and borrowing activities, as well as indirectly, as interest rates may impact the payment performance of our cardholders.

To manage our direct risk to market interest rates, management actively monitors the interest rates and the interest-sensitive components of our consolidated balance sheets and the impact that changes in interest rates have on the fair value of assets, net income and cash flow. We seek to minimize that impact primarily by matching asset and liability re-pricings.

Our primary assets are Credit card loans and Retained interests in loans securitized. The majority of our owned receivables and the receivables held by the Metris Master Trust are priced at rates indexed to the variable Prime Rate. We fund Credit card loans through a combination of cash flows from operations, bank loans, long-term debt and equity issuances. Our securitized loans are held by the Metris Master Trust and bank-sponsored multi-seller commercial paper conduits and investors in term series securities issued by the Metris Master Trust, which have committed funding primarily indexed to variable commercial paper rates and LIBOR. As of September 30, 2005, the Company had no long-term debt. At September 30, 2005 and 2004, none of the securities issued out of the Metris Master Trust and conduit funding of securitized receivables were funded with fixed rate securities.

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In an interest rate environment with rates significantly above current rates, we partially mitigate the negative impact on earnings from higher interest expense by entering into interest rate cap contracts and, to a lesser extent, reviewing fixed rate funding alternatives.

The approach we use to quantify interest rate risk is a sensitivity analysis, which we believe best reflects the risk inherent in our business. This approach calculates the impact on net income before income taxes from an instantaneous and sustained change in interest rates of 200-basis-points. In this analysis, interest rates on our floating rate debt are not allowed to decrease below 0%. Assuming that we take no counteractive measures, as of September 30, 2005, a 200-basis-point increase in interest rates affecting our floating rate financial instruments, including both debt obligations and receivables, would result in a decrease in net income before income taxes of approximately \$22.4 million over the next 12 months relative to a base case, compared to an approximate \$18.2 million decrease as of September 30, 2004. A decrease of 200-basis-points would result in an increase in net income before income taxes of approximately \$18.4 million as of September 30, 2005, compared to an increase of \$58.9 million as of September 30, 2004.

The change in sensitivity for the 200-basis-point increase is primarily due to a smaller receivable base generating less incremental revenue and additional credit card receivables limited by interest rate caps, partially offset by less floating rate debt. The change in sensitivity for the 200-basis-point decrease is due to less receivables limited by interest rate floors and less floating rate debt.

**ITEM 4. CONTROLS AND PROCEDURES**

Under the supervision and with the participation of the Company's management, including the Chairman and Chief Executive Officer ( CEO ) and the Chief Financial Officer ( CFO ), we evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934, as amended ( Exchange Act )) as of September 30, 2005. Based on that evaluation, our management, including the CEO and CFO, have concluded that, as of September 30, 2005, our disclosure controls and procedures were effective. During the quarter ended September 30, 2005, there were no changes in our internal controls over financial reporting (as defined in Rule 13a-15(f) or 15d-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

**Part II. Other Information****Item 1. Legal Proceedings**

Reference is made to Part 1, Item 3 Business, Legal Proceedings of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2004, which summarizes a pending lawsuit initiated by the Company's former chairman and chief executive officer against the Company, certain members of its current and/or former board of directors, and a number of other entities. Pretrial discovery in that lawsuit is scheduled to conclude December 1, 2005.

In September 2002, a shareholder lawsuit was filed in the United States District Court for the District of Minnesota, naming the Company, Ronald N. Zebeck and David D. Wesselink as defendants. The plaintiffs represent a class of purchasers of Company common stock between November 5, 2001 and July 17, 2002. The lawsuit seeks damages in an unspecified amount. The complaint, as amended, alleges that defendants violated the federal securities laws in connection with statements made by the Company about its projected earnings during the periodic OCC Safety & Soundness Examination begun on or about November 5, 2001, which related to the Company's reserve methodology and certain accounting practices, and in connection with the Company's alleged failure to timely disclose the resulting impact of the OCC Report of Examination issued at the conclusion of its examination. On September 21, 2005, defendants filed motions for summary judgment, which are under consideration by the court.

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On July 12, 2005, the Company announced that it had received a Wells Notice from the staff of the SEC in connection with the previously-disclosed SEC investigation concerning the Company's reporting and treatment of its allowance for loan losses for 2001, its valuation of Retained interests in loans securitized and other matters. The staff has subsequently informed the Company that it is the intention of the staff not to recommend that the SEC bring an enforcement action against the Company with respect to that investigation. The staff's recommendation is subject to review and final action by the SEC, and there can be no assurance that the SEC will follow the staff's recommendation.

The Company currently is not otherwise subject to any pending litigation other than routine litigation arising in the ordinary course of business. Because at this time we are unable to estimate damages that may result from the resolution of the matters outlined above, there can be no assurance that defense or resolution of these matters will not have a material adverse effect on our financial position.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Submission of Matters to a Vote of Security Holders**

None

**Item 5. Other Information**

None

**Item 6. Exhibits**

Plan of Acquisition

- 2.1 Agreement and Plan of Merger dated as of August 4, 2005 by and among HSBC Finance Corporation, HSBC Corporation I and Metris Companies Inc. (Incorporated by reference to Exhibit 2.1 to MCI's Current Report on Form 8-K filed with the SEC on August 4, 2005 (File No. 1-12351)).

Charter Documents:

- 3.1 Amended and Restated Certificate of Incorporation of the Company (incorporated by reference to Exhibit 3.1 to the Company's Registration Statement on Form 8-A12B dated April 26, 1999 (File No. 1-12351)).
- (a) Certificate of Amendment to the Amended and Restated Certificate of Incorporation of the Company dated June 4, 2003 (incorporated by reference to Exhibit 3.1 to the Company's Report on Form 10-K dated April 12, 2004 (File No. 1-12351)).
- (b) Certificate of Amendment to the Amended and Restated Certificate of Incorporation of the Company dated September 19, 2000 (incorporated by reference to Exhibit 3.3 to the Company's Registration Statement on Form S-3 dated September 29, 2000 (File No. 1-12351)).
- (c) Certificate of Amendment to the Amended and Restated Certificate of Incorporation of the Company dated March 24, 1999 (incorporated by reference to Exhibit 3.1 to the Company's Registration Statement on Form 8-A12B dated April 26, 1999 (File No. 1-12351)).
- 3.2 Amended and Restated Bylaws of the Company (incorporated by reference to Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q for the period ended June 30, 1999 (File No. 1-12351)).

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**Instruments Defining Rights:**

- 4.1 Certificate of Designation of Series C Perpetual Preferred Stock (incorporated by reference to Exhibit 4.2 of MCI's Current Report on Form 8-K dated December 22, 1998 (File No. 1-12351)).
  - (a) Amended and Restated Certificate of Designation of Series C Perpetual Convertible Preferred Stock (incorporated by reference to Exhibit 3.3 to MCI's Registration Statement on Form S-3 (File No. 333-82007)).
- 4.2 Certificate of Designation of Series D Junior Participating Convertible Preferred Stock (incorporated by reference to Exhibit 4.3 of MCI's Current Report on Form 8-K dated December 22, 1998 (File No. 1-12351)).
- 4.3 Registration Rights Agreement, dated as of December 9, 1998, between MCI and the Investors named therein (incorporated by reference to Exhibit 10.3 to MCI's Current Report on Form 8-K dated December 22, 1998 (File No. 1-12351)).
- 4.4 Form of common stock certificate of MCI (incorporated by reference to Exhibit 4.3 to MCI's Registration Statement on Form S-8 (File No. 333-91917)).

**Material Contracts:**

- 10.1 Amendment to the Modified Operating Agreement between Direct Merchants Credit Card Bank, National Association and the Office of the Comptroller of the Currency dated April 7, 2005 (Incorporated by reference to Exhibit 99.1 to MCI's Current Report on Form 8-K filed with the SEC on April 11, 2005 (File No. 1-12351)).

**Certifications:**

- 31.1 Certification of Principal Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a).
- 31.2 Certification of Principal Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a).
- 32.1 Certification of Principal Executive Officer Pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code.
- 32.2 Certification of Principal Financial Officer Pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code.



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**SIGNATURES**

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

**METRIS COMPANIES INC.**  
(Registrant)

Date: November 9, 2005

By: /s/ William A. Houlihan

William A. Houlihan  
Executive Vice President and Chief Financial  
Officer  
(Principal Financial Officer and Authorized  
Officer of Registrant)

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