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)

þ **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

o **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	41-1849591
(State of Incorporation)	(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 þ No o

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

Yes þ No o

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

Yes o No þ

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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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 informatio 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.

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Part I. Financial Information

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

METRIS COMPANIES INC. AND SUBSIDIARIES

Consolidated Balance Sheets

(In thousands, except share data)

	September 30, 2005 (unaudited)	December 31, 2004
Assets		
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
Total assets	$ 1,261,470	$ 1,481,479
Liabilities		
Debt	$	$ 373,624
Accounts payable	34,766	37,619
Accrued expenses and other liabilities	162,064	122,934
Total liabilities	196,830	534,177
Stockholders Equity		
Convertible preferred stock par value $.01 per share; 10,000,000 shares authorized, 1,476,680 and 1,381,327 shares issued and outstanding, repectively	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
Total stockholders equity	1,064,640	947,302

Total liabilities and stockholders equity	$ 1,261,470	$ 1,481,479

See accompanying Notes to Consolidated Financial Statements.

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METRIS COMPANIES INC. AND SUBSIDIARIES
Consolidated Statements of Income
(In thousands, except per-share data) (unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	**2004**	**2005**	**2004**
Revenues				
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	
Total revenues	184,509	194,448	513,984	399,826
Expenses				
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
Total expenses	110,279	109,259	347,431	346,775
Income before income taxes	74,230	85,189	166,553	53,051
Income tax expense	20,569	23,425	52,808	20,003
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

Earnings per share				
Distributed	$	$	$	$
Undistributed	0.40	0.49	0.75	0.01
Total Basic	$ 0.40	$ 0.49	$ 0.75	$ 0.01
Total Diluted	$ 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.

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METRIS COMPANIES INC. AND SUBSIDIARIES
Consolidated Statements of Changes in Stockholders Equity
(In thousands) (unaudited)

	Number of Shares Preferred	Number of Shares Common	Convertible Preferred Stock	Common Stock	Paid-In Capital	Unearned Compensation	Treasury Stock	Retained Earnings	Total Stockholders Equity
Balance at December 31, 2003	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
Balance at September 30, 2004	1,351	58,044	$ 503,222	$ 651	$ 233,042	$	$ (58,308)	$ 267,050	$ 945,657
Balance at December 31, 2004	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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METRIS COMPANIES INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(In thousands) (unaudited)

	Nine Months Ended September 30, 2005	Nine Months Ended September 30, 2004
Operating Activities		
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
Investing Activities		
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)
Financing Activities		
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.

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 produ

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.

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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 September 30,		Nine Months Ended September 30,	
(In thousands, except per share data)	**2005**	**2004**	**2005**	**2004**
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

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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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 September 30,		Nine Months Ended September 30,	
(In thousands, except per share data)	**2005**	**2004**	**2005**	**2004**
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.

	Fair Value and Cost of Available for Sale Securities Outstanding as of	
Debt Securities	**September 30, 2005**	**December 31, 2004**
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
Total Debt Securities	23,100	44,420
Equity Securities	38,000	261,989
Total Available for Sale Securities	$ 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.

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NOTE 5 ALLOWANCE FOR LOAN LOSSES

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
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 SECURITZED

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.

	September 30, 2005	December 31, 2004
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:

	September 30, 2005	December 31, 2004
Monthly principal payment rate	6.7%	5.9%
Gross yield [(1)]	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 [(2)]	12.7%	12.1%
Gross receivables held in the Metris Master Trust, net of discount [(3)]	94.0%	92.3%

(1) 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 interest 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.

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):

	Adverse Impact on Fair Value	
	10% Adverse Change	**20% Adverse Change**
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 September 30,		Nine Months Ended 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.

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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 o 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 petitioners 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 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.

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)

	Three Months Ended September 30,	
	2005	**2004**
Loss on new securitizations of receivables to the Metris Master Trust:		
Paired series transactions	$ (7,106)[1]	
	(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 [2]	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

[1] 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