

Edgar Filing: METRIS COMPANIES INC - Form 10-Q

METRIS COMPANIES INC  
Form 10-Q  
August 14, 2003

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

FORM 10-Q

[X] Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2003

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 \_\_\_\_\_  
-----

As of July 31, 2003, 57,798,577 shares of the registrant's common stock, par

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value \$.01 per share, were outstanding.

METRIS COMPANIES INC.

FORM 10-Q

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## Part I. Financial Information

## ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

## METRIS COMPANIES INC. AND SUBSIDIARIES

## Consolidated Balance Sheets

(Dollars in thousands) (Unaudited)

	June 30, 2003 ----	December 31, 2002 ----
<b>Assets:</b>		
Cash and due from banks .....	\$ 86,518	\$ 62,813
Federal funds sold .....	33,700	88,000
Short-term investments .....	346,963	429,419
	-----	-----
Cash and cash equivalents .....	467,181	580,232
	-----	-----
Retained interests in loans securitized .....	1,623,652	1,736,912
Less: Valuation allowance .....	858,605	986,517
	-----	-----
Net retained interests in loans securitized .....	765,047	750,395
	-----	-----
Credit card loans .....	632,913	846,417
Less: Allowance for loan losses .....	109,162	90,315
	-----	-----
Net credit card loans .....	523,751	756,102
	-----	-----
Property and equipment, net .....	51,510	83,831
Purchased portfolio premium, net .....	51,584	64,579
Other receivables due from credit card securitizations, net .....	281,233	184,220
Other assets .....	167,783	174,987
	-----	-----
Total assets .....	\$ 2,308,089	\$ 2,594,346
	=====	=====
<b>Liabilities:</b>		
Deposits .....	\$ 641,934	\$ 892,754
Debt .....	383,237	357,649
Accounts payable .....	49,996	53,589
Deferred income .....	119,807	159,267
Accrued expenses and other liabilities .....	92,173	72,062
	-----	-----
Total liabilities .....	1,287,147	1,535,321
	-----	-----
<b>Stockholders' Equity:</b>		
Convertible preferred stock - Series C, par value \$.01 per share; 10,000,000 shares authorized, 1,208,695 and 1,156,086 shares issued and outstanding, respectively ...	450,239	430,642
Common stock, par value \$.01 per share; 300,000,000 shares authorized, 64,853,877 and		

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64,223,231 shares issued, respectively .....	648	642
Paid-in capital .....	230,241	227,376
Unearned compensation .....	(292)	--
Treasury stock - 7,055,300 shares .....	(58,308)	(58,308)
Retained earnings .....	398,414	458,673
	-----	-----
Total stockholders' equity .....	1,020,942	1,059,025
	-----	-----
Total liabilities and stockholders' equity ....	\$ 2,308,089	\$ 2,594,346
	=====	=====

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		Six Months Ended	
	June 30,		June 30,	
	2003	2002	2003	2002
	----	----	----	----
Interest Income:				
Credit card loans .....	\$ 29,713	\$ 66,324	\$ 59,620	\$ 154,850
Federal funds sold .....	165	110	524	224
Other .....	1,556	2,359	3,451	3,563
	-----	-----	-----	-----
Total interest income .....	31,434	68,793	63,595	158,637
	-----	-----	-----	-----
Deposit interest expense .....	9,597	18,335	20,505	41,988
Other interest expense .....	9,120	8,620	17,553	17,132
	-----	-----	-----	-----
Total interest expense .....	18,717	26,955	38,058	59,120
	-----	-----	-----	-----
Net Interest Income .....	12,717	41,838	25,537	99,517
Provision for loan losses .....	30,033	90,601	74,819	202,477
	-----	-----	-----	-----
Net Interest Expense After Provision for Loan Losses .....	(17,316)	(48,763)	(49,282)	(102,960)
	-----	-----	-----	-----
Other Operating Income:				
Net securitization and credit card servicing income .....	31,110	71,223	87,506	228,642
Credit card fees, interchange and other credit card income.....	20,146	32,759	41,903	93,759
Enhancement services revenue .....	84,954	95,649	178,638	190,645
	-----	-----	-----	-----
	136,210	199,631	308,047	513,046
	-----	-----	-----	-----
Other Operating Expense:				
Credit card account and other product solicitation and marketing expenses...	28,138	56,193	64,192	96,745
Employee compensation .....	45,721	54,365	99,102	110,913
Data processing services and communications	17,034	20,795	36,212	43,101

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Enhancement services claims expense .....	8,087	15,917	21,109	27,124
Occupancy and equipment .....	8,924	12,291	18,537	25,088
Purchased portfolio premium amortization ..	6,499	7,743	12,995	16,198
MasterCard/Visa assessment and fees .....	2,231	3,583	4,646	7,417
Credit card fraud losses .....	1,069	2,953	2,009	5,181
Asset impairments, lease write-offs and severance.....	6,011	9,523	22,788	9,523
Other .....	18,866	26,161	38,505	42,622
	-----	-----	-----	-----
	142,580	209,524	320,095	383,912
	-----	-----	-----	-----
(Loss) Income Before Income Taxes .....	(23,686)	(58,656)	(61,330)	26,174
Income tax (benefit) expense .....	(7,982)	(22,282)	(20,668)	10,208
	-----	-----	-----	-----
Net (Loss) Income .....	(15,704)	(36,374)	(40,662)	15,966
Convertible preferred stock dividends .....	9,908	9,394	19,597	18,582
	-----	-----	-----	-----
Net Loss Applicable to Common Stockholders	\$ (25,612)	\$ (45,768)	\$ (60,259)	\$ (2,616)
	=====	=====	=====	=====
Loss per share:				
Basic .....	\$ (0.44)	\$ (0.74)	\$ (1.05)	\$ (0.04)
Diluted .....	\$ (0.44)	\$ (0.74)	\$ (1.05)	\$ (0.04)
Shares used to compute loss per share:				
Basic .....	57,462	61,503	57,360	61,844
Diluted .....	57,462	61,503	57,360	61,844
Dividends declared per common share .....	--	\$ 0.01	--	\$ 0.02

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	Common	Paid-in	Unearned	
	Preferred	Stock	Stock	Capital	Compensation	
-----						
BALANCE AT						
DECEMBER 31, 2001 .....	1,058	63,419	\$ 393,970	\$ 642	\$ 232,413	\$ (4,980)
Net income .....	--	--	--	--	--	--
Cash dividends .....	--	--	--	--	--	--
Common stock repurchased ....	--	(2,720)	--	--	--	--
Preferred dividends in kind .	48	--	17,928	--	--	--
Issuance of common stock under employee benefit plans .....	--	161	--	2	2,255	--
Deferred compensation obligations .....	--	76	--	1	967	(968)
Amortization of restricted stock .....	--	--	--	--	--	911
	-----	-----	-----	-----	-----	-----
BALANCE AT JUNE 30, 2002 ....	1,106	60,936	\$ 411,898	\$ 645	\$ 235,635	\$ (5,037)
	=====	=====	=====	=====	=====	=====

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BALANCE AT							
DECEMBER 31, 2002 .....	1,156	57,168	\$ 430,642	\$ 642	\$ 227,376	\$	--
Net loss .....	--	--	--	--	--	--	--
Preferred dividends in kind .	53	--	19,597	--	--	--	--
Issuance of common stock under employee benefit plans .....	--	352	--	3	2,367	--	--
Deferred compensation obligations .....	--	303	--	3	546	(549)	
Restricted stock forfeitures .....	--	(24)	--	--	(48)	46	
Amortization of restricted stock .....	--	--	--	--	--	211	
	-----	-----	-----	-----	-----	-----	-----
BALANCE AT JUNE 30, 2003 ....	1,209	57,799	\$ 450,239	\$ 648	\$ 230,241	\$	(292)
	=====	=====	=====	=====	=====	=====	=====

See accompanying Notes to Consolidated Financial Statements.

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METRIS COMPANIES INC. AND SUBSIDIARIES  
Consolidated Statements of Cash Flows  
(Dollars in thousands) (Unaudited)

	Six Months Ended June 30,	
	2003	2002
	----	----
Operating Activities:		
Net (loss) income .....	\$ (40,662)	\$ 15,966
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization .....	67,518	52,374
Provision for loan losses .....	74,819	202,477
Retained interests valuation (income) expense .....	(131,893)	38,126
Asset impairments, lease write-offs, and severance ....	22,788	9,523
Changes in operating assets and liabilities, net:		
Other receivables due from credit card securitizations	(104,500)	54,024
Accounts payable and accrued expenses .....	(2,111)	43,770
Deferred income .....	(39,460)	(17,045)
Other .....	(29,477)	36,398
	-----	-----
Net cash provided by (used in) operating activities ...	(182,978)	435,613
	-----	-----
Investing Activities:		

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Proceeds from transfers of portfolios to the Metris Master Trust.....	315,065	1,486,993
Net proceeds from sales and repayments of securitized loans.....	(773,955)	(785,856)
Net loans collected .....	733,600	337,903
Disposal of premises .....	19,252	--
Additions to premises and equipment .....	(727)	(3,538)
	-----	-----
Net cash provided by investing activities .....	293,235	1,035,502
	-----	-----
Financing Activities:		
Proceeds from issuance of debt .....	125,348	153
Repayment of debt .....	(100,206)	(292,000)
Net decrease in deposits .....	(250,820)	(736,147)
Cash dividends paid .....	--	(1,892)
Proceeds from issuance of common stock .....	2,370	2,257
Repurchase of common stock .....	--	(32,951)
	-----	-----
Net cash used in financing activities .....	(223,308)	(1,060,580)
	-----	-----
Net increase (decrease) in cash and cash equivalents.....	(113,051)	410,535
Cash and cash equivalents at beginning of period .....	580,232	488,086
	-----	-----
Cash and cash equivalents at end of period .....	\$ 467,181	\$ 898,621
	=====	=====
Supplemental disclosures and cash flow information:		
Cash paid (received) during the period for:		
Interest .....	\$ 21,019	\$ 61,345
Income taxes .....	(31,846)	(16,488)
Tax benefit from employee stock option exercises .....	1	174

See accompanying Notes to Consolidated Financial Statements.

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METRIS COMPANIES INC. AND SUBSIDIARIES  
Notes to Consolidated Financial Statements  
(Dollars 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, including Direct Merchants Credit Card Bank, National Association ("Direct Merchants Bank" or "DMCCB" or the "Bank"), which may be referred to as "we," "us," "our" or the "Company." We are an information-based direct marketer of consumer lending products and enhancement services.

We have eliminated all significant intercompany balances and transactions in consolidation. We have reclassified certain prior-period amounts to conform with the current period's presentation. In prior periods, we classified interest income, provision for loan losses, and related credit card loan fees generated from retained interests in loans securitized on the income statement as "Interest income-credit card loans and retained interests in loans securitized," "Provision for loan losses" and "Credit card fees, interchange and other credit card income." We have reclassified these amounts to "Net securitization and credit card servicing income." In the second quarter of 2003, certain subsidiaries were designated as guarantors which had previously been classified

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as non-guarantors. The supplemental consolidating financial statements have been reclassified for all periods presented.

### 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 and the rules and regulations of the Securities and Exchange Commission ("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 financial statements and the notes thereto contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2002. The nature of our business 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 accounting principles generally accepted in the United States of America, which require 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 adequacy of the allowance for loan losses and our determination of the fair value of retained interests from assets securitized including the fair value of cash restricted in the Metris Master Trust. The significant factors susceptible to future change that have an impact on these estimates include default rates, net interest spreads, liquidity and overall economic conditions. As a result, the actual losses in our loan portfolio and the fair value of our retained interests as of June 30, 2003 and December 31, 2002 could materially differ from these estimates.

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### Comprehensive Income

SFAS No. 130 "Reporting Comprehensive Income," does not apply to our current financial results and therefore, net income equals comprehensive income.

### NOTE 2 - EARNINGS PER SHARE

The earnings per share calculation for the three- and six-month periods ended June 30, 2003 and 2002 excludes the assumed conversion of the convertible preferred stock and the outstanding stock options, as they are anti-dilutive.

### NOTE 3 - Stock-Based Compensation Plans

We recognize compensation cost for stock-based employee compensation plans based on the difference, if any, between the quoted market price of the stock on the date of grant and the amount an employee must pay to acquire the stock. No expense was reflected in net income related to stock options as all options granted had an exercise price equal to the market value of the underlying common stock on the date of grant. We recorded \$0.2 million of amortization of deferred compensation obligation, net of related tax benefit, in employee compensation related to restricted stock granted in 2003.

Pro forma information regarding net (loss) income and (loss) earnings per share has been determined as if we accounted for our employee stock options under the fair value method. The fair value of the options was estimated at the



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grant date using a Black-Scholes option pricing model. The fair value of the options is amortized to expense over the options' vesting periods. Under the fair value method, our net (loss) earnings and (loss) earnings per share would have been recorded at the pro forma amounts indicated below:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Net (loss) income, as reported .....	\$ (15,704)	\$ (36,374)	\$ (40,662)	\$ 1
Deduct: Annual stock-based employee compensation expense (benefit) determined based on the fair value for all awards, net of related tax effects.....	3,003	8,631	(4,894)	1
Pro forma net (loss) income .....	\$ (18,707)	\$ (45,005)	\$ (35,768)	\$
Loss per share:				
Basic-as reported .....	(0.44)	(0.74)	(1.05)	---
Basic-pro forma .....	(0.50)	(0.88)	(0.97)	---
Diluted-as reported .....	(0.44)	(0.74)	(1.05)	---
Diluted-pro forma .....	(0.50)	(0.88)	(0.97)	---
Weighted-average assumptions in option valuation:				
Risk-free interest rates .....	1.5%	3.7%	1.5%	---
Dividend yields .....	--	1.6%	--	---
Stock volatility factor .....	124.2%	92.9%	110.1%	---
Expected life of options (in years) .....	2.7	6.0	4.2	---

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

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#### NOTE 4 - ACCOUNTING CHANGES

On January 1, 2002, we adopted SFAS No. 142, "Goodwill and Other Intangible Assets," which establishes accounting and reporting standards for goodwill and other intangible assets. It requires enterprises to test these assets for impairment upon adoption of SFAS 142 as well as on an annual basis, and reduce the carrying amount of these assets if they are found to be impaired. Goodwill and other intangible assets with an indefinite useful life will no longer be amortized. Other intangible assets with an estimable useful life will continue to be amortized over their useful lives. The adoption of the new standard did not have a material impact on our financial statements.

On January 1, 2002, we adopted SFAS No. 144, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," which supersedes FASB Statement No. 121, and provides a single accounting model for long-lived assets which are to be disposed. The adoption of the new standard did not have a material impact on our financial statements.

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In July 2002, the Financial Accounting Standards Board ("FASB") issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." The statement addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies EITF Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when a liability is incurred. Under EITF Issue No. 94-3, a liability for an exit cost as generally defined in Issue No. 94-3 was recognized at the date of an entity's commitment to an exit plan. The provisions of SFAS No. 146 are effective for exit or disposal activities that are initiated after December 31, 2002. The adoption of this standard did not have a material impact on our financial statements.

In January 2003, FASB issued SFAS No. 148 "Accounting for Stock-Based Compensation-Transition and Disclosure," which amends SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require more prominent and more frequent disclosures in financial statements about the effects of stock-based compensation. SFAS No. 148 requirements are effective for fiscal years ending after December 15, 2002. There was not a material impact on our financial statements upon adoption of SFAS No. 148.

In January 2003, the Federal Financial Institutions Examination Council ("FFIEC") issued guidance with respect to account management, risk management, and loss allowance practices for institutions engaged in credit card lending. The guidance provides requirements for certain operational and accounting policies, which are designed to bring consistency in practice between institutions. At this time we are reviewing the impact of the guidance and there can be no assurance that adoption of the guidance will not have a material adverse effect on our financial condition.

In January 2003, FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities" in an effort to expand upon and strengthen existing accounting guidance that addresses when a company should include in its financial statements the assets, liabilities and activities of another entity. FASB Interpretation No. 46 requires a variable interest entity to be consolidated by a company, if that company is subject to a majority of the risk of loss from the variable interest entity activities or entitled to receive a majority of the entity's residual returns or both. The

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Interpretation also requires disclosures about variable interest entities that the company is not required to consolidate, but in which it has a significant variable interest. The consolidation requirements of Interpretation No. 46 apply immediately to variable interest entities created after January 31, 2003, and apply to existing variable interest entities in the first fiscal year or interim period beginning after June 15, 2003. Interpretation No. 46 provides a specific exemption for entities qualifying as Qualified Special Purpose Entities as described in SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125." All of our non-consolidated entities are Qualified Special Purpose Entities under the definition in SFAS No. 140. We do not expect the adoption of this Interpretation to have a material impact on our financial statements.

In April 2003, FASB issued SFAS No. 149 "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative

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instruments embedded in other contracts, and for hedging activities under SFAS No. 133. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003. In addition, certain provisions relating to forward purchases or sales of when-issued securities or other securities that do not yet exist, should be applied to existing contracts as well as new contracts entered into after June 30, 2003. We do not expect the adoption of SFAS No. 149 to have a material impact on our financial statements.

In May 2003, FASB issued SFAS No. 150 "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." This Statement establishes standards for classification and measurement of certain instruments with characteristics of both liabilities and equity. It requires that financial instruments within its scope be classified as a liability (or asset in some circumstances). Many of those instruments were classified as equity under previous accounting guidance. The statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of SFAS No. 150 does not have a material impact on our financial statements at this time.

### NOTE 5 - ALLOWANCE FOR LOAN LOSSES

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Balance at beginning of period .....	\$ 125,357	\$ 416,914	\$ 90,315	\$ 410,159
Allowance related to assets transferred to the Metris Master Trust.....	(2,526)	(147,137)	(3,981)	(168,580)
Provision for loan losses .....	30,033	90,601	74,819	202,477
Principal receivables charged-off .....	(44,789)	(91,595)	(53,470)	(180,486)
Recoveries .....	1,087	6,496	1,479	11,709
	(43,702)	(85,099)	(51,991)	(168,777)
Balance at end of period .....	\$ 109,162	\$ 275,279	\$ 109,162	\$ 275,279

Credit card loans greater than 30 days contractually past due for the periods ended June 30, 2003, December 31, 2002 and June 30, 2002 were \$48.3 million, \$7.9 and \$148.9 million, respectively.

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### NOTE 6 - RETAINED INTERESTS IN LOANS SECURITIZED

Activity in retained interests is as follows:

June 30,		December 31,
2003	Change	2002

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	-----	-----	-----
Contractual retained interests...	\$ 920,908	\$ (70,145)	\$ 991,053
Excess transferor's interests....	76,140	29,680	46,460
Finance charge receivables .....	626,604	(72,795)	699,399
	-----	-----	-----
Gross retained interests .....	1,623,652	(113,260)	1,736,912
Valuation allowance .....	(858,605)	127,912	(986,517)
	-----	-----	-----
Net retained interests .....	\$ 765,047	\$ 14,652	\$ 750,395
	=====	=====	=====

	June 30,		December 31,
	-----		-----
	2002	Change	2001
	----	-----	----
Contractual retained interests...	\$ 903,629	\$ 126,220	\$ 777,409
Excess transferor's interests....	18,807	(21,117)	39,924
Finance charge receivables .....	630,124	108,279	521,845
	-----	-----	-----
Gross retained interests .....	1,552,560	213,382	1,339,178
Valuation allowance .....	(744,205)	(206,706)	(537,499)
	-----	-----	-----
Net retained interests .....	\$ 808,355	\$ 6,676	\$ 801,679
	=====	=====	=====

Activity in the valuation allowance on retained interests in loans securitized is as follows:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	-----	-----	-----	-----
	2003	2002	2003	2002
	----	----	----	----
Balance at beginning of period .....	\$ 931,052	\$ 551,385	\$ 986,517	\$ 537,499
Transfers related to assets transferred to the Metris Master Trust.....	2,526	147,137	3,981	168,580
Retained interests valuation (income) expense.....	(74,973)	45,683	(131,893)	38,126
	-----	-----	-----	-----
Balance at end of period .....	\$ 858,605	\$ 744,205	\$ 858,605	\$ 744,205
	=====	=====	=====	=====

NOTE 7 - SEGMENTS

We operate in two principal areas: consumer lending products and enhancement services. Our consumer lending products are primarily unsecured and secured credit cards, including the Direct Merchants Bank MasterCard(R) and Visa(R). Our credit cardholders include customers obtained from third-party lists and other customers for whom general credit bureau information is available.

We market our enhancement services, including: (1) debt waiver protection for unemployment, disability, death and family leave; (2) membership programs such as card registration, purchase protection and other club memberships; and (3) third-party insurance, directly to our credit card customers and customers of third parties. We administer extended service plans issued through a third

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party retailer, which are no longer being sold, and will expire by first quarter, 2005. We sell extended service plans for homeowners through third party distribution partnerships as well as directly to consumers.

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On July 29, 2003, CPP Holdings Limited, a privately owned provider of assistance products and services throughout Europe, and CPP US Operations Group (collectively with CPP Holdings Limited "CPP") purchased the membership and warranty products and operations of the Company's enhancement services segment. Further details are described in Footnote 8 "Subsequent Events." The Company will retain the credit protection and insurance business, and CPP will become the Company's preferred provider of membership and warranty products.

We have presented the segment information reported below on a managed basis. We use this basis to review segment performance and to make operating decisions. In doing so, the income statement and balance sheet are adjusted to reverse the effects of securitizations. Presentation on a managed basis is not in conformity with accounting principles generally accepted in the United States of America. The adjustment columns in the segment table include adjustments to present the information on an owned basis as reported in the financial statements of this quarterly report.

We do not allocate the expenses, assets and liabilities attributable to corporate functions to the operating segments, such as employee compensation, data processing services and communications, third-party servicing expenses, and other expenses including occupancy, depreciation and amortization, professional fees, and other general and administrative expenses. We include these expenses in the reconciliation of the income before income taxes, for the reported segments to the consolidated total. We do not allocate capital expenditures for leasehold improvements, capitalized software and furniture and equipment to operating segments. There were no material operating assets located outside of the United States for the periods presented.

The enhancement services operating segment has paid fees to our consumer lending products segment for successful marketing efforts to cardholders at a rate similar to those paid to other third parties. The enhancement services segment reports interest income and our consumer lending products segment reports interest expense at our weighted-average borrowing rate for the excess cash flow generated by the enhancement services segment and used by the consumer lending products segment to fund the growth of cardholder balances.

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Three Months Ended June 30,					
2003					
----					
	Consumer Lending Products	Enhancement Services	Securitization Adjustments (a)	Other Adjustments (b)	Consolidated
	-----	-----	-----	-----	-----
Interest income.	\$ 451,205	\$ 34	\$ (419,771)	\$ (34)	\$ 31,434
Interest expense ....	60,198	--	(41,447)	(34)	18,717
	-----	-----	-----	-----	-----

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Net interest income .....	391,007	34	(378,324)	--	12,717
Other operating income.....	88,293	84,954	(37,037)	--	136,210
Total revenue...	479,300	84,988	(415,361)	--	148,927
Income before income taxes..	22,968 (c)	58,632 (c)	--	(105,286)	(23,686)
Total assets ...	\$ 9,502,200	\$ 77,614	\$ (7,860,000)	\$ 588,275 (d)	\$ 2,308,089

Three Months Ended June 30,  
2002

	Consumer Lending Products	Enhancement Services	Securitization Adjustments (a)	Other Adjustments (b)	Consolidated
Interest income.	\$ 509,821	\$ 58	\$ (441,028)	\$ (58)	\$ 68,793
Interest expense .....	81,005	--	(53,992)	(58)	26,955
Net interest income .....	428,816	58	(387,036)	--	41,838
Other operating income.....	119,317	95,649	(15,335)	--	199,631
Total revenue ..	548,133	95,707	(402,371)	--	241,469
Income before income taxes..	21,145 (c)	54,660 (c)	--	(134,461)	(58,656)
Total assets ...	\$10,985,709	\$ 142,705	\$ (8,924,497)	\$ 1,007,792 (d)	\$ 3,211,709

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Six Months Ended June 30,  
2003

	Consumer Lending Products	Enhancement Services	Securitization Adjustments (a)	Other Adjustments (b)	Consolidated
Interest income	\$ 936,434	\$ 63	\$ (872,839)	\$ (63)	\$ 63,595
Interest expense .....	124,209	--	(86,088)	(63)	38,058
Net interest income .....	812,225	63	(786,751)	--	25,537
Other operating income.....	187,583	178,638	(58,174)	--	308,047

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Total revenue ..	999,808	178,701	(844,925)	--	333,584
Income before income taxes.	61,478 (c)	109,977 (c)	--	(232,785)	(61,330)
Total assets ...	\$ 9,502,200	\$ 77,614	\$ (7,860,000)	\$ 588,275 (d)	\$ 2,308,089

Six Months Ended June 30,  
2002

	Consumer Lending Products -----	Enhancement Services -----	Securitization Adjustments (a) -----	Other Adjustments (b) -----	Consolidated -----
Interest income.	\$ 1,036,499	\$ 2,386	\$ (877,862)	\$ (2,386)	\$ 158,637
Interest expense ....	171,737	--	(110,231)	(2,386)	59,120
Net interest income .....	864,762	2,386	(767,631)	--	99,517
Other operating income.....	250,080	190,645	72,321	--	513,046
Total revenue ..	1,114,842	193,031	(695,310)	--	612,563
Income before income taxes	161,469 (c)	119,567 (c)	--	(254,862)	26,174
Total assets ...	\$10,985,709	\$ 142,705	\$ (8,924,497)	\$ 1,007,792 (d)	\$3,211,709

(a) This column reflects adjustments to the Company's internal financial statements, which are prepared on a managed basis, to eliminate investors' interests in securitized loans.

(b) The other adjustments column includes: intercompany eliminations and amounts not allocated to segments.

(c) Income before income taxes includes intercompany commissions paid by the enhancement services segment to the consumer lending products segment for successful marketing efforts to cardholders of \$3.1 million for the three months ended June 30, 2003 and \$3.0 million for the three months ended June 30, 2002, \$6.1 million for the six months ended June 30, 2003 and \$6.3 million for the six months ended June 30, 2002.

(d) Total assets include the assets attributable to corporate functions not allocated to operating segments and the removal of investors' interests in securitized loans to present total assets on an owned basis.

NOTE 8 - SUBSEQUENT EVENTS

On July 29, 2003, we announced the sale of the membership and warranty business of the Enhancement Services segment for proceeds of approximately \$45.0 million. We anticipate being able to record a gain related to the sale in the third quarter, 2003.

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In July of 2003, the Office of the Comptroller of the Currency ("OCC") requested and Direct Merchants Bank agreed to eliminate federally insured deposits at the Bank, or the risk thereof to the Federal Deposit Insurance Corporation ("FDIC"), by September 30, 2003. We have received preliminary proposals from financing sources, and we are working with our financial advisors on a variety of options to achieve this goal, however, there can be no assurance that we will be successful. These options may include additional conduit financing or the sale of credit card receivables to third parties.

NOTE 9 - SUPPLEMENTAL CONSOLIDATING FINANCIAL STATEMENTS

We have various indirect subsidiaries that do not guarantee Company debt. We have prepared condensed consolidating financial statements of the Company, the Guarantor subsidiaries and the non-guarantor subsidiaries for purposes of complying with SEC reporting requirements. Separate financial statements of the guaranteeing subsidiaries and non-guaranteeing subsidiaries are not presented because we have determined that the subsidiaries' financial information would not be material to investors. In the second quarter of 2003, certain subsidiaries were designated as guarantors which had previously been classified as non-guarantors. The supplemental consolidating financial statements have been reclassified for all periods presented.

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METRIS COMPANIES INC.  
Supplemental Consolidating Balance Sheets  
June 30, 2003  
(Dollars in thousands)  
Unaudited

	Metris Companies Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Elimin
	----	-----	-----	-----
<b>Assets:</b>				
Cash and cash equivalents .....	\$ (49)	\$ 1,234	\$ 465,996	\$
Net retained interests in loans securitized.....	31,883	--	733,164	
Net credit card loans .....	8,393	--	515,358	
Property and equipment, net .....	--	50,997	513	
Purchased portfolio premium, net.....	107	--	51,477	
Other receivables due from credit card securitizations, net.....	7	--	281,226	
Other assets .....	38,277	38,285	130,630	(3
Investment in subsidiaries .....	1,409,140	1,016,665	--	(2,42
	-----	-----	-----	-----
Total assets .....	\$ 1,487,758	\$ 1,107,181	\$ 2,178,364	\$ (2,46
	=====	=====	=====	=====
<b>Liabilities:</b>				
Deposits .....	\$ (1,000)	\$ --	\$ 642,934	\$
Debt .....	417,023	9,214	--	(4
Accounts payable .....	97	22,026	32,230	(
Deferred income .....	--	10,003	111,879	(
Accrued expenses and other liabilities				



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	50,696	(343,202)	374,656	1
Total liabilities .....	466,816	(301,959)	1,161,699	(3
Total stockholders' equity .....	1,020,942	1,409,140	1,016,665	(2,42
Total liabilities and stockholders' equity.....	\$ 1,487,758	\$ 1,107,181	\$ 2,178,364	\$ (2,46

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METRIS COMPANIES INC.  
Supplemental Consolidating Balance Sheets  
December 31, 2002  
(Dollars in thousands)  
Unaudited

	Metris Companies Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Elimin
<b>Assets:</b>				
Cash and cash equivalents .....	\$ (3,795)	\$ 8,109	575,918	\$
Net retained interests in loans securitized.....	--	--	750,395	
Net credit card loans .....	3,814	--	752,288	
Property and equipment, net .....	--	63,395	20,436	
Purchased portfolio premium, net.....	129	--	64,450	
Other receivables due from credit card securitizations, net.....	13	--	184,207	
Other assets .....	10,098	44,738	181,278	(61
Investment in subsidiaries .....	1,606,930	1,580,650	--	(3,187
Total assets .....	\$ 1,617,189	\$ 1,696,892	\$ 2,528,972	\$ (3,248
<b>Liabilities:</b>				
Deposits .....	\$ (1,000)	\$ --	\$ 893,754	\$
Debt .....	391,228	9,421	--	(43
Accounts payable .....	71	20,683	38,949	(6
Deferred income .....	--	16,681	146,097	(3
Accrued expenses and other liabilities.....	167,865	43,177	(130,478)	(8
Total liabilities .....	558,164	89,962	948,322	(61
Total stockholders' equity .....	1,059,025	1,606,930	1,580,650	(3,187
Total liabilities and stockholders' equity.....	\$ 1,617,189	\$ 1,696,892	\$ 2,528,972	\$ (3,248

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METRIS COMPANIES INC.  
 Supplemental Consolidating Statements of Income  
 Three Months Ended June 30, 2003  
 (Dollars in thousands)  
 Unaudited

	Metris Companies Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Elimin
	-----	-----	-----	-----
Net Interest Income (Expense).....	\$ (8,682)	\$ 915	\$ 20,484	\$
Provision for loan losses .....	540	--	29,759	(2
	-----	-----	-----	-----
Net Interest Expense After Provision for Loan Losses .....	(9,222)	915	(9,275)	2
	-----	-----	-----	-----
Other Operating Income:				
Net securitization and credit card servicing income.....	(539)	--	33,009	(1,3
Credit card fees, interchange and other credit card income.....	1,036	19,004	18,162	(18,0
Enhancement services revenues.....	--	7,100	80,120	(2,2
Intercompany allocations .....	5,264	73,725	8,247	(87,2
	-----	-----	-----	-----
	5,761	99,829	139,538	(108,9
	-----	-----	-----	-----
Other Operating Expense:				
Credit card account and other product solicitation and marketing expenses.....	--	14,315	32,733	(18,9
Employee compensation .....	--	40,971	4,750	
Data processing services and communications.....	5	(19,716)	39,061	(2,3
Enhancement services claims expense.....	--	(97)	8,184	
Occupancy and equipment .....	--	8,844	80	
Purchased portfolio premium amortization .....	10	--	7,621	(1,1
MasterCard/Visa assessment and fees.....	--	--	2,231	
Credit card fraud losses .....	10	--	1,059	
Asset impairments, lease write-offs and severance .....	5,128	889	(6)	
Other .....	130	16,498	2,245	
Intercompany allocations .....	24	27,420	59,792	(87,2
	-----	-----	-----	-----
	5,307	89,124	157,750	(109,6
	-----	-----	-----	-----

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(Loss) Income Before Income Tax Benefit and Equity in				
Loss of Subsidiaries.....	(8,768)	11,620	(27,487)	9
Income tax (benefit) expense.....	(2,955)	1,989	(7,337)	3
Equity in loss of subsidiaries.....	(9,891)	(20,150)	--	30,0
Net Loss .....	\$ (15,704)	\$ (10,519)	\$ (20,150)	\$ 30,6

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METRIS COMPANIES INC.  
Supplemental Consolidating Statements of Income  
Three Months Ended June 30, 2002  
(Dollars in thousands)  
Unaudited

	Metris Companies Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminati
Net Interest (Expense) Income.....	\$ (3,017)	\$ (60)	\$ 44,915	\$ -
Provision for loan losses .....	(797)	--	91,398	-
Net Interest Expense After Provision for Loan Losses .....	(2,220)	(60)	(46,483)	-
Other Operating Income:				
Net securitization and credit card servicing income.....	(1,777)	--	73,000	-
Credit card fees, interchange and other credit card income.....	189	5,796	31,474	(4,70
Enhancement services revenues.....	--	2,662	92,987	-
Intercompany allocations .....	41	72,193	15,127	(87,36
	(1,547)	80,651	212,588	(92,06
Other Operating Expense:				
Credit card account and other product solicitation and marketing expenses.....	--	4,594	51,653	(5
Employee compensation .....	(1,505)	45,753	10,117	-
Data processing services and communications.....	13	(23,809)	43,018	1,57
Enhancement services claims expense.....	--	444	15,473	-
Occupancy and equipment .....	--	11,399	892	-
Purchased portfolio premium amortization .....	--	--	8,568	(82
MasterCard/Visa assessment and fees.....	--	--	3,583	-
Credit card fraud losses .....	135	--	2,818	-
Asset impairments, lease write-offs and severance .....	--	9,523	--	-
Other .....	(153)	27,325	5,218	(6,22

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Intercompany allocations .....	555	23,510	63,296	(87,36)
	-----	-----	-----	-----
	(955)	98,739	204,636	(92,89)
	-----	-----	-----	-----
(Loss) Before Income Taxes and Equity in (Loss) Income of Subsidiaries.....	(2,812)	(18,148)	(38,531)	83
Income tax (benefit) expense.....	(1,134)	12,591	(14,487)	(19,25)
Equity in income of subsidiaries.....	(34,696)	(24,044)	--	58,74
	-----	-----	-----	-----
Net Loss .....	\$ (36,374)	\$ (54,783)	\$ (24,044)	\$ 78,82
	=====	=====	=====	=====

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METRIS COMPANIES INC.  
Supplemental Consolidating Statements of Income  
Six Months Ended June 30, 2003  
(Dollars in thousands)  
Unaudited

	Metris Companies Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminati
	-----	-----	-----	-----
Net Interest Income (Expense) .....	\$ (17,388)	\$ 98	\$ 42,827	\$ -
Provision for loan losses .....	1,387	--	73,534	(10
	-----	-----	-----	-----
Net Interest Expense After Provision for Loan Losses .....	(18,775)	98	(30,707)	10
	-----	-----	-----	-----
Other Operating Income:				
Net securitization and credit card servicing income.....	(2,863)	--	92,408	(2,03
Credit card fees, interchange and other credit card income.....	1,091	31,547	40,050	(30,78
Enhancement services revenues.....	--	16,279	168,377	(6,01
Intercompany allocations .....	5,340	139,332	18,237	(162,90
	-----	-----	-----	-----
	3,568	187,158	319,072	(201,75
	-----	-----	-----	-----
Other Operating Expense:				
Credit card account and other product solicitation and marketing expenses.....	--	28,902	66,489	(31,19
Employee compensation .....	--	88,539	10,563	-
Data processing services and communications.....	4	(41,704)	83,713	(5,80
Enhancement services claims expense.....	--	12	21,097	-
Occupancy and equipment .....	--	18,373	164	-
Purchased portfolio premium amortization .....	21	--	15,318	(2,34
MasterCard/Visa assessment and fees.....	--	--	4,646	-

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Credit card fraud losses .....	11	--	1,998	--
Asset impairments, lease write-offs and severance .....	5,129	16,527	1,132	--
Other .....	213	34,073	4,226	(
Intercompany allocations .....	35	53,047	109,827	(162,90
	-----	-----	-----	-----
	5,413	197,769	319,173	(202,26
	-----	-----	-----	-----
Loss Before Income Tax				
Benefit and Equity in Loss of Subsidiaries.....	(20,620)	(10,513)	(30,808)	61
Income tax benefit .....	(6,949)	(6,968)	(6,957)	20
Equity in loss of subsidiaries.....	(26,991)	(23,851)	--	50,84
	-----	-----	-----	-----
Net Loss .....	\$ (40,662)	\$ (27,396)	\$ (23,851)	\$ 51,24
	=====	=====	=====	=====

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METRIS COMPANIES INC.  
Supplemental Consolidating Statements of Income  
Six Months Ended June 30, 2002  
(Dollars in thousands)  
Unaudited

	Metris Companies Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminati
	-----	-----	-----	-----
Net Interest (Expense) Income .....	\$ (8,499)	\$ (1,456)	\$ 109,472	\$ --
Provision for loan losses .....	(732)	--	153,209	50,00
	-----	-----	-----	-----
Net Interest Expense After Provision for Loan Losses .....	(7,767)	(1,456)	(43,737)	(50,00
	-----	-----	-----	-----
Other Operating Income:				
Net securitization and credit card servicing income .....	(1,742)	--	230,384	--
Credit card fees, interchange and other credit card income.....	452	13,719	90,722	(11,13
Enhancement services revenues.....	--	18,826	171,819	--
Intercompany allocations .....	72	125,266	24,788	(150,12
	-----	-----	-----	-----
	(1,218)	157,811	517,713	(161,26
	-----	-----	-----	-----
Other Operating Expense:				
Credit card account and other product solicitation and marketing expenses.....	--	7,254	89,545	(5

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Employee compensation .....	(1,101)	94,921	17,093	—
Data processing services and communications.....	36	(43,371)	88,230	(1,79
Enhancement services claims expense.....	--	500	26,624	—
Occupancy and equipment .....	--	23,205	1,883	—
Purchased portfolio premium amortization .....	--	--	17,930	(1,73
MasterCard/Visa assessment and fees.....	--	--	7,417	—
Credit card fraud losses .....	127	--	5,054	—
Asset impairments, lease write-offs and severance .....	--	9,523	--	—
Other .....	(110)	41,826	9,094	(8,18
Intercompany allocations .....	46	41,588	108,491	(150,12
	<u>(1,002)</u>	<u>175,446</u>	<u>371,361</u>	<u>(161,89</u>
(Loss) Income Before Income Taxes and Equity in (Loss)				
Income of Subsidiaries.....	(7,983)	(19,091)	102,615	(49,36
Income tax (benefit) expense.....	(3,114)	(8,207)	40,781	(19,25
Equity in income of subsidiaries.....	20,835	61,834	--	(82,66
Net Income .....	<u>\$ 15,966</u>	<u>\$ 50,950</u>	<u>\$ 61,834</u>	<u>\$ (112,78</u>

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METRIS COMPANIES INC.  
Supplemental Condensed Consolidating Statements of Cash Flows  
Six Months Ended June 30, 2003  
(Dollars in thousands)  
Unaudited

	Metris Companies Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminati
	<u>-----</u>	<u>-----</u>	<u>-----</u>	<u>-----</u>
Operating Activities:				
Net cash (used in) provided by operating activities .....	<u>\$ (201,937)</u>	<u>\$ (8,440)</u>	<u>\$ 344,956</u>	<u>\$ (317,55</u>
Investing Activities:				
Net proceeds from sales and repayments of securitized loans .....	(34,950)	--	(423,940)	—
Net loans (originated) collected .....	(6,632)	--	740,232	—
Additions to (disposals of) property and equipment .....	--	(1,259)	19,784	—
Investment in subsidiaries .....	219,546	173,426	--	(392,97
Net cash provided by investing activities.....	<u>177,964</u>	<u>172,167</u>	<u>336,076</u>	<u>(392,97</u>

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Financing Activities:				
Net increase (decrease) in				
debt.....	25,349	(207)	--	--
Net decrease in deposits .....	--	--	(250,820)	--
Proceeds from issuance of				
common stock.....	2,370	--	--	--
Capital contributions .....	--	(170,395)	(540,134)	710,520
Net cash (used in) provided				
by financing activities .....	27,719	(170,602)	(790,954)	710,520
Net (decrease) increase in				
cash and cash equivalents .....	3,746	(6,875)	(109,922)	--
Cash and cash equivalents at				
beginning of period .....	(3,795)	8,109	575,918	--
Cash and cash equivalents at				
end of period.....	\$ (49)	\$ 1,234	\$ 465,996	\$ --

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METRIS COMPANIES INC.  
Supplemental Condensed Consolidating Statements of Cash Flows  
Six Months Ended June 30, 2002  
(Dollars in thousands)  
Unaudited

	Metris Companies Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminati
Operating Activities:				
Net cash provided by				
operating activities.....	\$ 195,499	\$ 67,362	\$ 285,536	\$ (1,000)
Investing Activities:				
Net proceeds from sales and				
repayments of securitized				
loans.....	--	--	701,137	--
Net loans (originated)				
collected.....	120	(2)	337,785	--
Additions to (disposals of)				
property and equipment .....	--	(4,776)	1,238	--
Investment in subsidiaries .....	(23,855)	(34,721)	--	--
Net cash (used in) provided				
by investing activities .....	(23,735)	(39,499)	1,040,160	--
Financing Activities:				
Increase (decrease) in debt .....	447	(294)	(292,000)	--

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Decrease in deposits .....	--	--	(736,147)	
Cash dividends paid .....	(1,892)	--	--	
Proceeds from issuance of common stock.....	2,257	--	--	
Repurchase of common stock .....	(32,951)	--	--	
Capital contributions .....	--	(27,096)	(27,112)	
	-----	-----	-----	-----
Net cash (used in) provided by financing activities .....	(32,139)	(27,390)	(1,055,259)	
	-----	-----	-----	-----
Net increase in cash and cash equivalents.....	139,625	473	270,437	
Cash and cash equivalents at beginning of period .....	17,613	1,505	468,968	
	-----	-----	-----	-----
Cash and cash equivalents at end of period.....	\$ 157,238	\$ 1,978	\$ 739,405	\$
	=====	=====	=====	=====

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ITEM 2.

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

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") and its subsidiaries, including Direct Merchants Credit Card Bank, National Association ("Direct Merchants Bank" or "DMCCB" or the "Bank"), which may be referred to as "we," "us," "our" or the "Company." You should read this discussion along with the following documents for a full understanding of our financial condition and results of operations: 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, 2002; and our Proxy Statement for the 2003 Annual Meeting of Stockholders. In addition, you should read this discussion along with our Quarterly Report on Form 10-Q for the period ended June 30, 2003, of which this commentary is a part, and the condensed consolidated financial statements and related notes thereto.

Results of Operations

Net loss for the three months ended June 30, 2003 was \$15.7 million, down from a net loss of \$36.4 million for the second quarter of 2002. Diluted loss per share for the three months ended June 30, 2003 was \$0.44 compared to a diluted loss per share of \$0.74 for the second quarter of 2002. The decrease in net loss is primarily due to a decrease in the provision for loan losses and reduction in operating expense, partially offset by a decrease in net interest margin and a decrease in net securitization and credit card servicing income. Net margin has declined due to a decrease in average interest-earning assets of \$1.0 billion. The decrease of \$40.1 million in net securitization revenue is primarily due to decreases in excess spread as a result of an increased default



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rate and credit card receivables attrition in the Master Trust. In addition, the credit card receivables attrition in the Master Trust caused a decrease in servicing fees. The provision for loan losses decreased 66.9% to \$30 million for the second quarter of 2003 from \$90.6 million for the same period in 2002. The decrease is primarily due to a \$684 million decline in owned credit card receivables and lower delinquency levels, partially offset by higher charge-off rates. Total other operating expenses decreased to \$142.6 million in the second quarter of 2003 from \$209.5 million for the same period in 2002. During the second quarter of 2003, credit card account and other product solicitation and marketing expenses decreased \$28.1 million, largely due to a decrease in credit card marketing expenditures and decreased enhancement services marketing. Employee compensation decreased \$8.6 million for the three months ended June 30, 2003, due to lower staffing requirements. Enhancement services claims expense decreased \$7.8 million for the three months ended June 30, 2003, primarily due to a decrease in covered receivable balances on our debt waiver products.

Net loss for the six months ended June 30, 2003 was \$40.7 million, down from net income of \$16.0 million for the first six months of 2002. Diluted loss per share for the six months ended June 30, 2003 was \$1.05 compared to diluted loss per share of \$0.04 for the six months ended June 30, 2002. The \$56.7 million decrease in net income primarily relates to a \$141.1 million reduction in net securitization and credit card servicing income, a decrease of \$74.0 million in net interest income and a \$51.9 million decrease in credit card fees and interchange revenues, offset by a \$127.7 million decrease in provision for loan losses and a \$63.8 million decrease in operating expenses.

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### Critical Accounting Policies

The Company's most significant accounting policies are our determination of the allowance for loan losses, valuation of retained interests and accounting for deferred acquisition costs and revenue recognition on enhancement services products.

#### Allowance for loan losses

We maintain an allowance for loan losses sufficient to absorb anticipated probable loan losses inherent in the credit card loan portfolio as of the balance sheet date. At the time of charge-off, all principal balances are written off against the allowance and all fees and finance charges are netted against the applicable income statement line item. The allowance is based on management's consideration of all relevant factors including management's assessment of applicable economic and seasonal trends.

We segment the loan portfolio into several individual liquidating pools with similar credit risk characteristics, and estimate (based on historical experience for similar pools and existing environmental conditions) the dollar amount of principal, accrued finance charges and fees that will ultimately charge-off. We then aggregate these pools into prime and subprime portfolios based on the prescribed FICO score cuts, credit counseling and various pools of other receivables. We also isolate other potentially higher risk segments such as accounts that are over their credit limit by more than 10%, accounts in suspended status under our debt waiver benefits and other programs as deemed necessary. We separately analyze the reserve requirement on each of these groups or portfolios.

We continually evaluate the homogenous liquidating risk pools using a roll-rate model which uses historical delinquency levels and pay-down levels (12 months of historical data, with influence given to the last six months'

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performance to capture current economic and seasonal trends), loan seasoning and other measures of asset quality to estimate charge-offs for both credit losses and bankruptcy losses.

Additionally, in evaluating the adequacy of the loan loss reserves, we consider several subjective factors which may be overlaid into the credit risk roll-rate model in determining the necessary loan loss reserve, including:

- o national and economic trends and business conditions, including the condition of various market segments;
- o changes in lending policies and procedures, including those for underwriting, collection, charge-off and recovery, as well as in the experience, ability and depth of lending management and staff;
- o trends in volume and the product pricing of accounts, including any concentrations of credit; and
- o impacts from external factors - such as changes in competition, and legal and regulatory requirements - on the level of estimated credit losses in the current portfolio.

Significant changes in these factors could impact our financial projections and thereby affect the adequacy of our allowance for loan losses.

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### Valuation of Retained Interests

We determine the fair value of the net retained interests in loans securitized by calculating the present value of future expected cash flows using management's best estimate of key assumptions including credit losses, gross yield, interest expense, servicing fees, payment rates and a discount rate commensurate with the risks involved. Our fair value analysis considers cash flows associated with the current receivable balances as of the balance sheet date. We assume no new sales or increases in outstanding receivables in conjunction with the accounts in the portfolio. The significant assumptions are applied to the existing receivable balance to determine the expected future cash flows. Our funding costs are primarily variable based on the London Interbank Offered Rate ("LIBOR"), and the income earned on our receivable balance is substantially variable based on Prime. We assume a flat interest rate environment and when interest rates change, we assume our assets and liabilities will reprice in a consistent manner.

Our estimate of the assumptions considers several subjective factors, including:

- o national and economic trends and business conditions, including the condition of various market segments;
- o changes in lending policies and procedures, including those for underwriting, collection, charge-off and recovery, as well as changes in the experience, ability and depth of lending management and staff;
- o trends in volume and the product pricing of accounts, including any concentrations of credit; and
- o impacts from external factors, such as changes in competition, and legal and regulatory requirements.

Furthermore, we consider the impact of conduit/asset-backed transaction enhancement levels. Significant changes in these factors could impact our financial projections and thereby affect the valuation of the retained interests. At June 30, 2003, \$214.4 million of cash was trapped in the Master Trust and is recorded at a discounted value of \$179.0 million and classified as "Other due from credit card securitizations, net" on the consolidated balance

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sheets.

The significant assumptions used for estimating the fair value of the retained interests in loans securitized are as follows:

	June 30, 2003 ----	December 31, 2002 ----
Annual discount rate .....	20.0%	20.0%
Monthly payment rate .....	6.8%	6.8%
Gross yield (1) .....	21.1%	21.4%
Annual interest expense and servicing fees...	4.1%	4.3%
Annual gross principal default rate .....	20.6%	19.9%

- (1) Includes finance charges, late and overlimit fees and bad debt recoveries, net of finance charge and fee charge-offs. Gross yield for purposes of our valuation does not include interchange income, debt waiver fees, or cash advance fees.

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### Deferred Acquisition Costs on Enhancement Services Products

We defer qualifying acquisition costs associated with our enhancement services products. These costs, which relate directly to membership solicitations (direct response advertising costs), principally include postage, printing, mailing, telemarketing costs, and commissions paid to third parties. The total amount of enhancement services deferred costs as of June 30, 2003 and December 31, 2002 were \$46.9 million and \$73.2 million, respectively. If deferred acquisition costs were to exceed forecasted future cash flows, we would make an appropriate adjustment for impairment. The most significant assumption used by the Company in determining the realizability of these deferred costs is future revenues from our enhancement services products. A significant reduction in revenues could have a material impact on the values of these balances.

#### Debt Waiver Products

Qualifying membership acquisition costs are deferred and charged to expense as debt waiver product fees are recognized. We amortize these costs using an accelerated methodology, which approximates our historical cancellation experience for debt waiver products. Amortization of debt waiver acquisition costs was \$1.3 million and \$2.7 million for the three- and six-month periods ended June 30, 2003. All other debt waiver acquisition costs are expensed as incurred. Deferred debt waiver acquisition costs were \$2.3 million and \$2.6 million as of June 30, 2003 and December 31, 2002, respectively, and were classified as "Other assets" on the consolidated balance sheets.

#### Membership Program Products

Qualifying membership acquisition costs are deferred and charged to expense as membership fees are recognized. We amortize all deferred costs on a straight-line basis for all annually billed products, and on an accelerated method for all monthly billed products, which approximates our historical cancellation experience for membership program products. Amortization of membership deferred costs was \$13.3 million and \$11.9 million for the three months ended June 30, 2003 and 2002, respectively. Amortization of membership deferred costs was \$33.9 million and \$19.7 million for the six months ended June 30, 2003 and 2002, respectively. All other membership acquisition costs are expensed as incurred. Deferred membership acquisition costs were \$42.8 million and \$66.9 million as of

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June 30, 2003 and December 31, 2002, respectively, and were classified as "Other assets" on the consolidated balance sheets.

### Warranty Products

Qualifying warranty acquisition costs are deferred and charged to expense as warranty product fees are recognized. Those direct acquisition costs that cannot be associated with a successful contract, are charged to expense as incurred. A successful effort conversion percentage is applied to these incremental direct acquisition costs, which approximates our historical successful effort rate percentage in selling warranty products. We amortize these deferred costs using an accelerated amortization methodology, which approximates our historical cancellation experience following the expiration of the manufacturer's contractual cancellation period for the warranty products. Amortization of warranty acquisition costs were \$0.8 million and \$3.0 million for the three months ended June 30, 2003 and 2002, respectively. Amortization of warranty acquisition costs were \$2.8 million and \$6.1 million for the six months ended June 30, 2003 and 2002, respectively. All other warranty acquisition costs are

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expensed as incurred. Deferred warranty acquisition costs amount to \$1.4 million and \$3.0 million as of June 30, 2003 and December 31, 2002, respectively, and were classified as "Other assets" on the consolidated balance sheets.

### Revenue Recognition on Enhancement Services Products

#### Debt Waiver Products

Direct Merchants Bank offers various debt waiver products on receivables it owns as well as securitized receivables. Direct Merchants Bank records deferred revenue when the debt waiver customer is billed. Revenue is recognized in the month following the completion of the cancellation period, which is one-month. Direct Merchants Bank incurs the related claims and marketing expenses. A reserve is maintained for future death and finance charge claims based on Direct Merchants Bank's historical experience with settlement of such claims. Revenues recorded for debt waiver products are included in the consolidated statements of income under "Enhancement services revenues" and were \$45.3 million and \$58.9 million for the three months ended June 30, 2003 and 2002, respectively. Revenues were \$95.4 million and \$119.6 million for the six months ended June 30, 2003 and 2002, respectively. Unearned revenues and reserves for pending claims and incurred but not reported claims are recorded in the consolidated balance sheets in "Deferred income" and "Accrued expenses and other liabilities," respectively. Unearned revenues as of June 30, 2003 were \$14.4 million compared to \$16.9 million as of December 31, 2002. Reserves for pending and incurred but not reported claims were \$7.8 million as of June 30, 2003, compared to \$8.2 million as of December 31, 2002.

#### Membership Program Products

We bill membership fees for enhancement services products through financial institutions, including Direct Merchants Bank, and other cardholder-based institutions. We record these fees as deferred membership income upon acceptance of membership and amortize them on a straight-line basis for all annually billed products, and on an accelerated amortization method for all monthly billed products over the membership period beginning after the contractual cancellation period is complete. A liability is established and netted against the related receivable in the consolidated balance sheets in "Other assets" from inception of the membership through the end of the cancellation period that reflects our historical

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cancellation experience with these products. Gross receivables as of June 30, 2003 on the membership program products were \$13.3 million compared to \$22.0 million as of December 31, 2002. Cancellation reserves were \$11.3 million and \$19.5 million as of June 30, 2003 and December 31, 2002, respectively. Revenues recorded for membership products are included in the consolidated statements of income under "Enhancement services revenues" and were \$28.6 million and \$21.1 million for the three months ended June 30, 2003 and 2002, respectively. Revenues for membership products were \$59.2 million and \$38.3 million for the six months ended June 30, 2003 and 2002, respectively. Unearned revenues on membership program products are recorded in the consolidated balance sheets in "Deferred income." Unearned revenues as of June 30, 2003 were \$85.3 million compared to \$114.2 million as of December 31, 2002.

### Warranty Products

We coordinate the marketing activities for Direct Merchants Bank and third-party sales of extended service plans. We perform administrative services and retain the claims risk for all extended service plans sold. As a result, we defer and recognize extended service plan revenues and the incremental direct acquisition

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costs on an accelerated amortization method over the life of the related extended service plan contracts beginning after the expiration of any manufacturer's warranty coverage. A liability is established and netted against the related receivable in the consolidated balance sheets in "Other assets" from inception of the extended service plan through the end of the cancellation period that reflects our historical cancellation experience with these products. Gross receivables as of June 30, 2003 on the warranty products were \$3.3 million compared to \$3.8 million as of December 31, 2002. Cancellation reserves were \$3.0 million and \$5.3 million as of June 30, 2003 and December 31, 2002, respectively. Revenues recorded for warranty products are included in the consolidated statements of income under "Enhancement services revenues" and were \$8.4 million and \$12.0 million for the three months ended June 30, 2003 and 2002, respectively. Revenues for warranty were \$18.4 million and \$25.0 million for the six months ended June 30, 2003 and 2002, respectively. Unearned revenues on warranty products are recorded in the consolidated balance sheets in "Deferred income." Unearned revenues as of June 30, 2003 were \$10.4 million compared to \$17.6 million as of December 31, 2002. Reserves for pending and incurred but not reported claims, included in "Accrued expenses and other liabilities," were \$0.4 and \$0.7 million as of June 30, 2003 and December 31, 2002, respectively.

### Net Interest Income

Net interest income consists primarily of interest earned on our credit card loans, less interest expense on borrowings to fund loans. Table 1 provides an analysis of interest income and expense, net interest spread, net interest margin and average balance sheet data for the three- and six-month periods ended June 30, 2003 and 2002.

Table 1: Analysis of Average Balances, Interest and Average Yields and Rates  
(Dollars in thousands)

2003		Three Months Ended June 30,	
Average Balance	Interest	Yield/ Rate	Average Balance

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Assets:				
Interest-earning assets:				
Federal funds sold .....	\$ 53,441	\$ 165	1.2%	\$ 28,222
Short-term investments .....	448,612	1,556	1.4%	477,642
Credit card loans .....	690,903	29,713	17.2%	1,737,626
	-----	-----	----	-----
Total interest-earning assets.	\$ 1,192,956	\$ 31,434	10.6%	\$ 2,243,490
Other assets .....	1,395,501			1,534,543
Allowances for loan losses .....	(124,485)			(309,827)
	-----			-----
Total assets .....	\$ 2,463,972			\$ 3,468,206
	=====			=====
Liabilities and Equity:				
Interest-bearing liabilities:				
Deposits .....	\$ 729,021	\$ 9,597	5.3%	\$ 1,518,104
Debt .....	359,378	9,120	10.2%	356,693
	-----	-----	----	-----
Total interest-bearing liabilities .....	\$ 1,088,399	\$ 18,717	6.9%	\$ 1,874,797
Other liabilities .....	269,420			434,407
	-----			-----
Total liabilities .....	1,357,819			2,309,204
Stockholders' equity .....	1,106,153			1,159,002
	-----			-----
Total liabilities and equity..	\$ 2,463,972			\$ 3,468,206
	=====			=====
Net interest income and interest margin (1) .....		\$ 12,717	4.3%	\$
Net interest rate spread (2)..			3.7%	

(1) We compute "net interest margin" by dividing annualized net interest income by average total interest-earning assets.

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(2) The "net interest rate spread" is the annualized yield on average interest-earning assets minus the annualized funding rate on average interest-bearing liabilities.

Net interest income decreased from \$41.8 million for the three months ended June 30, 2002 to \$12.7 million for the three months ended June 30, 2003. The decrease is primarily due to a decrease in average interest-earning assets of \$1.1 billion and a 320 basis point reduction in net interest margin. The decrease in average interest-earning assets is primarily due to the transfer of \$1.0 billion of receivables to the Master Trust since June 30, 2002. The decrease in margin is primarily due to a \$1.0 billion reduction in average credit card loans, which has resulted in short-term, lower yielding investments increasing to 42% of average interest-earning assets, versus 23% in the second quarter of 2002. In addition, we have experienced a 110 basis point increase in our funding costs versus the second quarter of 2002.

Table 1: Analysis of Average Balances, Interest and Average Yields and Rates  
(cont'd)  
(Dollars in thousands)

Six Months Ended June 30,  
2003

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	Average Balance	Interest	Yield/ Rate	Average Balance	Int
<b>Assets:</b>					
Interest-earning assets:					
Federal funds sold .....	\$ 85,370	\$ 524	1.2%	\$ 28,326	\$
Short-term investments .....	493,723	3,451	1.4%	375,204	
Credit card loans .....	721,121	59,620	16.7%	2,115,683	15
	-----	-----	----	-----	-----
Total interest-earning assets.	\$ 1,300,214	\$ 63,595	9.9%	\$ 2,519,213	\$ 15
Other assets .....	1,383,374			1,551,933	
Allowances for loan losses .....	(118,572)			(358,577)	
	-----			-----	
Total assets .....	\$ 2,565,016			\$ 3,712,569	
	=====			=====	
<b>Liabilities and Equity:</b>					
Interest-bearing liabilities:					
Deposits .....	\$ 783,951	\$ 20,505	5.3%	\$ 1,722,869	\$ 4
Debt .....	374,425	17,553	9.5%	403,824	1
	-----	-----	----	-----	-----
Total interest-bearing liabilities .....	\$ 1,158,376	\$ 38,058	6.6%	\$ 2,126,693	\$ 5
Other liabilities .....	330,288			429,177	
	-----			-----	
Total liabilities .....	1,488,664			2,555,870	
Stockholders' equity .....	1,076,352			1,156,699	
	-----			-----	
Total liabilities and equity..	\$ 2,565,016			\$ 3,712,569	
	=====			=====	
Net interest income and interest margin (1) .....		\$ 25,537	4.0%		\$ 9
Net interest rate spread (2)..			3.3%		

(1) We compute "net interest margin" by dividing annualized net interest income by average total interest-earning assets.

(2) The "net interest rate spread" is the annualized yield on average interest-earning assets minus the annualized funding rate on average interest-bearing liabilities.

Net interest income decreased from \$99.5 million for the six months ended June 30, 2002 to \$25.5 million for the six months ended June 30, 2003. The decrease is primarily due to a decrease in average interest-earning assets of \$1.2 billion and a 400 basis point reduction in net interest margin. The decrease in average interest-earning assets is primarily due to the transfer of \$1.0 billion of receivables to the Master Trust since June 30, 2002. The decrease in margin is primarily due to a \$1.4 billion reduction in average credit card loans, which has resulted in short-term, lower

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yielding investments increasing to 45% of average interest-earning assets, versus 16% for the six months ended June 30, 2002. In addition, we have experienced a 100 basis point increase in our funding costs versus the same period in 2002.

Other Operating Income

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Other operating income represented 91.5% and 92.3% of revenues for the three- and six-month periods ended June 30, 2003, versus 82.7% and 83.8% for the same periods in 2002, respectively.

Other operating income decreased \$63.4 million and \$205.0 million for the three- and six-month periods ended June 30, 2003 compared to the same periods in 2002. For the three-month period ended June 30, 2003, net securitization and credit card servicing income decreased \$40.1 million primarily due to a decrease in excess spread on securitized receivables caused by an increased default rate and attrition in the Master Trust. In addition, credit card receivables attrition in the Master Trust has caused a decrease in servicing income of \$2.2 million. For the six-month period ended June 30, 2003, net securitization and credit card servicing income decreased \$141.1 million primarily due to lower excess spreads caused by increased default rates on securitized receivables.

Credit card fees and interchange revenue decreased \$12.6 million and \$51.9 million for the three- and six-month periods ended June 30, 2003 compared to the same periods in 2002. The decrease in credit card fees, interchange and other credit card income, for both the three- and six-month periods, is primarily due to a decrease in average owned credit card receivables of \$1.0 billion and \$1.4 billion for the respective three- and six-month periods. Partially offsetting this decline was an amendment to the core transaction documents of the Master Trust agreement, effective June 2002, resulting in interchange income earned on receivables held by the Master Trust being recorded as contribution to the excess spread earned.

Enhancement services revenues decreased by \$10.7 million and \$12.0 million for the three- and six-months ended June 30, 2003. This decrease was primarily due to a decrease in credit card receivables covered by our debt waiver products due to portfolio attrition, as well as a decrease in ServiceEdge(R) revenue due to the expiration of the ServiceEdge(R) extended warranty contracts.

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Table 2: Enhancement Services Revenues and Active Memberships (In thousands)

Revenues	Three Months Ended June 30,		Six Months Ended June 30,	
	2003 ----	2002 ----	2003 ----	2002 ----
Credit Protection Products..	\$ 46,148	\$ 59,859	\$ 97,124	\$121,542
Membership Program Products.	28,609	21,108	59,163	38,268
Warranty / Other .....	10,197	14,682	22,351	30,835
	-----	-----	-----	-----
Total .....	\$ 84,954	\$ 95,649	\$178,638	\$190,645
	=====	=====	=====	=====
Active Memberships	June 30, 2003 ----	December 31, 2002 ----	June 30, 2002 ----	
Credit Protection Products..	773	905	1,056	
Membership Program Products.	2,823	3,248	3,085	
Warranty / Other .....	686	941	1,346	



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Total .....	4,282	5,094	5,487
	=====	=====	=====

Other Operating Expense

Total other operating expenses for the three- and six-month periods ended June 30, 2003, decreased \$66.9 million and \$63.8 million over the comparable periods in 2002. Credit card account and other product solicitation and marketing expenses decreased \$28.1 million and \$32.6 million over the comparable periods in 2002, largely due to fewer new credit card accounts and decreased enhancement services marketing expenses. Employee compensation decreased \$8.6 million and \$11.8 million over comparable periods in 2002, due to lower staffing requirements. Data processing services and communications decreased \$3.8 million and \$6.9 million for the three- and six-month periods ended June 30, 2003, primarily due to the reduction in our credit card portfolio. Enhancement services claims expense decreased \$7.8 million and \$6.0 million for the three- and six-month periods ended June 30, 2003, primarily due to a decrease in receivable balances covered by our debt waiver products. Occupancy and Equipment expenses decreased \$3.4 million and \$6.6 million over comparable periods in 2002 due to decreased space requirements. Asset impairments, lease write-offs and severance decreased \$3.5 million and increased \$13.3 million for the three- and six-month periods ended June 30, 2003 to \$6.0 million and \$22.8 million from \$9.5 million and \$9.5 million for the same periods in 2002. During the first quarter of 2003, we recorded approximately \$12.0 million of write-downs of excess property, equipment, and operating leases and a \$4.8 million charge for a workforce reduction. In the second quarter of 2003, we recorded an additional \$0.9 million for a workforce reduction and wrote off the unamortized portion of the commitment fee of \$5.1 million related to a backup financing facility entered into in March of 2003 with Thomas H. Lee Equity Fund IV, L.P. The commitment was replaced in June 2003. In the second quarter of 2002, a write-down of \$10 million was taken for portfolios of charged-off loans purchased in 2001 and 2000. Other expenses decreased \$7.3 million and \$4.1 million for the three- and six-month periods ended June 30, 2003, compared to comparable periods in 2002. The decreases were primarily due to reductions in professional fees of \$5.3 million and \$1.5 million and travel and entertainment of \$1.2 million and \$2.2 million for the three- and six-month periods ended June 30, 2003, respectively.

Asset Quality

Our delinquency and net loan charge-off rates at any point in time reflect, among other factors, the credit risk of loans, the average age of our various credit card account portfolios, the success of our collection and recovery efforts, and general economic conditions. The average age of our credit card portfolio affects the stability of delinquency and loss rates. In order to minimize losses, we continue to focus our resources on refining our credit underwriting standards for new accounts, and on collections and post charge-off recovery efforts. At June 30, 2003, 47% of our outstanding receivables balance were from credit card accounts that have been with us in excess of two years, and 22% of outstanding receivables were with us in excess of four years.

We use credit line analyses, account management and customer transaction authorization procedures to minimize loan losses. Our risk models determine initial credit lines at the time of underwriting. We manage credit lines on an ongoing basis and adjust them based on customer usage and payment patterns. We continually monitor customer accounts and initiate appropriate collection activities when an account is delinquent or overlimit.

Delinquencies

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It is our policy to accrue interest and fee income on all credit card accounts, except in limited circumstances, until we charge-off the account. In November 2002, we stopped billing late fees once an account became 120 days contractually delinquent and in March 2003, we stopped billing overlimit fees once an account became 120 days contractually delinquent. Past due accounts are re-aged to current status only after we receive at least three minimum payments or the equivalent cumulative amount. Accounts can only be re-aged to current status once every twelve months and two times every five years. Accounts entering long-term fixed payment forbearance programs may receive a workout re-age upon entering the debt management program ("workout re-age"). Workout re-ages can only occur after receipt of at least three consecutive minimum monthly payments, or the equivalent cumulative amount, as defined by the debt management program. Workout re-ages can only occur once in five years. This is in accordance with FFIEC guidance. Table 3 presents the delinquency trends of our credit card loan portfolio.

Table 3: Loan Delinquency  
(Dollars in thousands)

	June 30, 2003 ----	% of Total -----	December 31, 2002 ----	% of Total -----	June 30, 2002 ----	% of Total -----
Loans outstanding ....	\$ 632,913	100%	\$ 846,417	100%	\$1,317,238	100%
Loans contractually delinquent:						
30 to 59 days ...	19,699	3.1%	1,673	0.2%	41,382	3.1%
60 to 89 days ...	17,668	2.8%	2,121	0.2%	35,161	2.7%
90 or more days..	10,899	1.7%	4,082	0.5%	72,360	5.5%
	-----	-----	-----	-----	-----	-----
Total .....	\$ 48,266	7.6%	\$ 7,876	0.9%	\$ 148,903	11.3%
	=====	=====	=====	=====	=====	=====

The decrease in the delinquency rates as of June 30, 2003 and December 31, 2002 compared to June 30, 2002, primarily reflects the sale of approximately \$120 million delinquent receivables during September and December 2002 and an additional sale of \$29.1 million of delinquent receivables in July 2003. These receivables were accounted

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for as held-for-sale as of June 30, 2003 and are recorded at fair value in other assets.

### Net Charge-Offs

Net charge-offs are the principal amount of losses from cardholders unwilling or unable to make minimum payments, bankrupt cardholders and deceased cardholders, less current period recoveries. Net charge-offs exclude accrued finance charges and fees, which are charged-off against the applicable revenue line item at the time of charge-off. We charge-off and take accounts as a loss either 60 days after formal notification of bankruptcy, at the end of the month during which most unsecured accounts become contractually 180 days past due, at the end of the month during which unsecured accounts that have entered into a credit counseling or other similar program and later become contractually 120 days past due, or at the end of the month during which secured accounts become contractually 120 days past due after first reducing the loss by the secured deposit.

Charge-offs due to bankruptcies were \$6.8 million, representing 15.1% of total gross charge-offs for the three-month period ended June 30, 2003 and \$16.6

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million, representing 18.1% of total gross charge-offs for the three-month period ended June 30, 2002. Charge-offs due to bankruptcies were \$12.3 million, representing 23.4% of total gross charge-offs for the six-month period ended June 30, 2003 and \$41.9 million, representing 23.2% of total gross charge-offs for the six-month period ended June 30, 2002. We charge-off accounts that are identified as fraud losses no later than 90 days after the last activity. We enter into forward flow agreements with third parties for the sale of a majority of charged-off credit card receivables. We also refer charged-off accounts to our recovery unit for coordination of collection efforts to recover the amounts owed. When appropriate, we place accounts with external collection agencies or attorneys.

Table 4: Net Charge-offs  
(Dollars in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003 ----	2002 ----	2003 ----	2002 ----
Average credit card loans..	\$ 690,903	\$1,737,626	\$ 721,121	\$2,115,683
Net charge-offs.....	43,702	85,099	51,991	168,777
Net charge-off ratio.....	25.4%	19.6%	14.5%	16.1%
	=====	=====	=====	=====

The increase in the net charge-off ratio for the three months ended June 30, 2003 is primarily due to a \$27.0 million charge-off related to the sale of approximately \$29.1 million of delinquent receivables in July 2003, which were accounted for as held-for-sale as of June 30, 2003. The decrease in the charge-off ratio for the six-month period ended June 30, 2003 is primarily due to the sale of approximately \$120.0 million of delinquent receivables in September and December of 2002 which reduced the charge-offs required in the first six months of 2003, offset by charge-offs related to the \$29.1 million of delinquent assets held-for-sale at June 30, 2003.

### Provision and Allowance for Loan Losses

We record provisions for loan losses in amounts necessary to maintain the allowance at a level sufficient to absorb anticipated probable loan losses inherent in the existing loan portfolio as of the balance sheet date.

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In order to mitigate credit losses, we have expanded our collections strategies to aggressively address any potential delinquency increases. We also leverage forbearance programs and credit counseling services for qualifying cardholders that are experiencing payment difficulties. These programs include reduced interest rates, reduced or suspended fees and other incentives to induce the customer to continue making payments. The amount of customer receivables in debt forbearance programs was \$33.8 million or 5% of total credit card loans as of June 30, 2003, compared to \$34.7 million or 4% of total credit card loans as of December 31, 2002. All delinquent receivables in debt forbearance programs are included in Table 3.

The provision for loan losses was \$30.0 million and \$74.8 million for the three- and six-month periods ended June 30, 2003, compared to a provision of \$90.6 million and \$202.5 million for the same periods in 2002. The decrease in the provision for loan losses in 2003 compared to 2002 is primarily due to lower credit card loans. The allowance for loan losses was \$109 million as of June 30, 2003, versus \$90 million as of December 31, 2002. Our roll-rate models, including management contingency, indicated our required allowance for loan losses was in the range of \$99 million to \$109 million as of June 30, 2003, versus \$75 million to \$90 million as of December 31, 2002. The ratio of

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allowance for loan losses to period-end credit card loans was 17.2% at June 30, 2003, compared to 10.7% at December 31, 2002. The allowance for loan losses as a percentage of 30-day plus receivables was 226.2% at June 30, 2003, compared to 1146.7% at December 31, 2002.

We believe the allowance for loan losses is adequate to cover probable future losses inherent in the loan portfolio under current conditions. However, we cannot give assurance as to future credit losses that may be incurred in connection with our loan portfolio, nor can we provide assurance that the established allowance for loan losses will be sufficient to absorb future losses.

### Retained Interests Valuation

We record a valuation allowance to reduce the contractual value of the retained interests in loans securitized to fair value. The following summarizes our retained interests as of June 30, 2003, December 31, 2002, June 30, 2002 and December 31, 2001.

	June 30, 2003 ----	Change -----	December 31, 2002 ----
Contractual retained interests..	\$ 920,908	\$ (70,145)	\$ 991,053
Excess transferor's interests...	76,140	29,680	46,460
Finance charge receivables.....	626,604	(72,795)	699,399
	-----	-----	-----
Gross retained interests.....	\$ 1,623,652	\$ (113,260)	\$ 1,736,912
Valuation allowance.....	(858,605)	127,912	(986,517)
	-----	-----	-----
Net retained interests.....	\$ 765,047	\$ 14,652	\$ 750,395
	=====	=====	=====

	June 30, 2002 ----	Change -----	December 31, 2001 ----
Contractual retained interests.	\$ 903,629	\$ 126,220	\$ 777,409
Excess transferor's interests..	18,807	(21,117)	39,924
Finance charge receivables.....	630,124	108,279	521,845
	-----	-----	-----
Gross retained interests.....	\$ 1,552,560	\$ 213,382	\$ 1,339,178
Valuation allowance.....	(744,205)	(206,706)	(537,499)
	-----	-----	-----
Net retained interests.....	\$ 808,355	\$ 6,676	\$ 801,679
	=====	=====	=====

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Gross retained interests in loans securitized decreased by \$113.3 million between December 31, 2002 and June 30, 2003, to \$1.6 billion. The decrease reflects a \$1.1 billion reduction in loans in the Master Trust partially offset by higher conduit enhancement levels. The \$213.4 million increase in gross retained interests during the six months ended June 30, 2002 was due to the sale of approximately \$1.6 billion of receivables from Direct Merchants Bank to the Master Trust during the six months ended June 30, 2002.

During the six months ended June 30, 2003, the valuation allowance decreased by \$127.9 million, of which \$64.3 million was due to the decrease in the gross retained interests and \$63.6 million due to a decrease in projected funding costs due to lower projected LIBOR, partially offset by higher projected

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default rates. The higher default rates are due to a slower than expected economic recovery. During the six months ended June 30, 2002, the valuation allowance increased \$206.7 million, primarily due to the higher gross retained interests and narrowing excess spreads in the Master Trust due to increased default rates. In addition, at June 30, 2003, \$214.4 million of cash was trapped in the Master Trust and is recorded at a discounted value of \$179 million and classified as "Other due from credit card securitizations, net" on the consolidated balance sheets, as of June 30, 2003.

### Balance Sheet Analysis

#### Cash and Cash Equivalents

Cash and cash equivalents decreased \$113.0 million to \$467.2 million as of June 30, 2003, compared to \$580.2 million as of December 31, 2002. The decrease is primarily due to the reduction in deposits of \$250.9 million offset by sales of receivables from Direct Merchants Bank to the Master Trust.

#### Credit Card Loans

Credit card loans were \$632.9 million as of June 30, 2003, compared to \$846.4 million as of December 31, 2002. The \$213.5 million decrease is primarily a result of the transfer of \$319.6 million of receivables from Direct Merchants Bank to the Master Trust.

#### Deposits

Deposits decreased \$250.9 million to \$641.9 million as of June 30, 2003, from \$892.8 million as of December 31, 2002. The decrease relates to a shift in funding from certificates of deposit ("CDs") to off-balance sheet asset-backed securitizations.

#### Property and equipment

Property and equipment decreased to \$51.5 million at June 30, 2003, mainly due to the sale of our Arizona facility on May 1, 2003 for cash proceeds of \$19.3 million, which approximated its carrying value.

#### Deferred Income

Deferred income decreased \$39.5 million to \$119.8 million as of June 30, 2003 compared to \$159.3 million as of December 31, 2002. The decrease primarily relates to declining enhancement services enrollments, decrease in covered receivables under our debt waiver product, our migration from annual-billed to monthly-billed enhancement service products and the expiration of the ServiceEdge(R) extended warranty contracts.

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### Liquidity, Funding and Capital Resources

One of our primary financial goals is to maintain an adequate level of liquidity through active management of assets and liabilities. Liquidity management is a dynamic process, affected by changes in the characteristics of our assets and liabilities and short- and long-term interest rates. We use a variety of financing sources to manage liquidity, funding, and interest rate risks. Table 5 summarizes our funding and liquidity as of June 30, 2003 and December 31, 2002:

Table 5: Liquidity, Funding and Capital Resources

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	June 30, 2003			December 31, 2002		
	DMCCB	Other	Consolidated	DMCCB	Other	
Cash and due from banks.....	\$ 85,412	\$ 1,106	\$ 86,518	\$ 58,399	\$ 4,414	
Federal funds sold.....	33,700	--	33,700	88,000	--	
Short-term investments.....	289,747	57,216	346,963	322,039	107,380	
Total cash and cash equivalents...	\$ 408,859	\$ 58,322	\$ 467,181	\$ 468,438	\$ 111,794	

	June 30, 2003		December 31, 2002	
On-balance sheet funding	Outstanding	Unused Capacity	Outstanding	Unused Capacity
Revolving credit line - July 2003.....	\$ --	\$ --	\$ --	\$ 162,696
Term loan - June 2003 .....	--	N/A	100,000	N/A
10% senior notes - November 2004.....	100,000	N/A	100,000	N/A
10.125% senior notes - July 2006 .....	147,270	N/A	146,824	N/A
Term loan - June 2004 .....	125,000	N/A	--	--
Other .....	10,967	N/A	10,825	N/A
Deposits - various maturities through February 2007 .....	641,934	N/A	892,754	N/A
Subtotal .....	\$ 1,025,171	\$ --	\$ 1,250,403	\$ 162,696
Off-balance sheet funding				
Master Trust:				
Term asset backed securitizations - various maturities through January 2009.....	7,010,000	--	7,610,000	--
Conduits - various maturities through March 2004.....	850,000	--	1,177,957	422,043
Metris facility - March 2003 ....	--	--	48,900	26,100
Subtotal .....	7,860,000	--	8,836,857	448,143
Total .....	\$ 8,885,171	\$ --	\$ 10,087,260	\$ 610,839

For the six months ended June 30, 2003 and 2002, we had net repayments of

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approximately \$977.0 million and net proceeds of approximately \$737.0 million respectively, from sales of credit card loans to the Master Trust and the Metris facility referred to in the above table.

Our contractual cash obligations during the next twelve months as of June 30, 2003 are as follows:

Long-term debt....	\$126,167
Operating leases..	13,019
Deposits .....	182,705
	-----
Total .....	\$321,891
	=====

In addition to the contractual cash obligations, open-to-buy on credit card accounts as of June 30, 2003 was \$10.1 billion.

As of June 30, 2003, \$2.0 billion of off-balance sheet funding in the Master Trust is scheduled to amortize over the next twelve months. We base the amortization amounts on estimated amortization periods, which are subject to change based on the Master Trust performance.

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

(In thousands)	Three Months Ended June 30,			
	2003		2002	
	----		----	
Gross yield (1) .....	\$ 608,762	26.86%	\$ 616,011	25.98%
Annual principal defaults ....	477,392	21.06%	373,257	15.74%
	-----		-----	
Net portfolio yield .....	131,370	5.80%	242,754	10.24%
Annual interest expense and servicing fees.....	83,575	3.86%	100,048	4.33%
	-----		-----	
Net excess spread .....	\$ 47,795	1.94%	\$ 142,706	5.91%
	=====		=====	

(In thousands)	Six Months Ended June 30,			
	2003		2002	
	----		----	
Gross yield (1) .....	\$1,266,543	27.29%	\$1,202,691	26.27%
Annual principal defaults ....	985,592	21.23%	687,636	15.02%
	-----		-----	
Net portfolio yield .....	280,951	6.06%	515,055	11.25%
Annual interest expense and servicing fees.....	171,744	3.90%	206,350	4.54%
	-----		-----	
Net excess spread .....	\$ 109,207	2.16%	\$ 308,705	6.71%
	=====		=====	

(1) Includes finance charges, late, overlimit and cash advance fees, bad debt recoveries, interchange income and debt waiver fees, less finance charge and fee charge-offs.

The Master Trust and the associated off-balance sheet debt provide for early amortization if certain events occur. These events are described in the applicable series supplement of each securitization transaction. The significant events are (i) three-month average excess spreads below levels between 0.0% and 1.0%, (ii) negative transferor's interest within the Master Trust or (iii) failure to obtain funding during an accumulation period for a maturing term asset-backed securitization. In addition, there are various triggers within our

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securitization agreements that, if broken, would restrict the release of cash to us from the Master Trust. This restricted cash provides additional security to the investors in the Master Trust. We reflect cash restricted from release in the Master Trust as "Other receivables due from credit card

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securitizations, net" in the consolidated balance sheet. The restricted cash is discounted to reflect the present value of the future cash release. The triggers are primarily related to the performance of the Master Trust, in particular the average of net 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 Master Trust on a cash basis. During periods of lower excess spreads, the required amount of cash to be restricted in the Master Trust may not be achieved. During those periods, all excess cash normally released to Metris Receivables, Inc. ("MRI") will be restricted from release. Once the maximum required amount of cash is restricted from release or excess spreads improve, cash can again be released to us. Based on the performance of our Master Trust, the amount of cash required to be restricted was \$463 million at June 30, 2003 and \$304 million at December 31, 2002. As of June 30, 2003, \$177.1 million has been restricted from release in the Master Trust due to performance, \$21.4 million has been restricted from release in the Master Trust due to corporate debt ratings at the inception of the securitization transactions and \$15.9 million has been restricted from release in the Master Trust for maturity reserves. As of December 31, 2002, \$29.1 million had been restricted from release in the Master Trust due to performance and \$21.4 million had been restricted from release in the Master Trust due to corporate debt ratings at the inception of the securitization transactions. The \$148.0 million increase in this restricted cash is a result of approximately \$109.2 million of net excess cash generated by the Master Trust being restricted within the Master Trust and approximately \$38.8 million that was funded as additional enhancements. We expect all cash basis excess spread to be restricted from release to us until at least 2004.

On March 17, 2003 we obtained a \$425 million extension through March 2004 of an \$850 million conduit which was scheduled to mature in June of 2003. We also secured a \$425 million conduit through March 2004, which replaced conduits and warehouse facilities that matured during March through May 2003. Furthermore, these conduits provided for the financing of a term asset-backed securitization that matured in July 2003. The continued availability of funding under these facilities is subject to various conditions, including a minimum three-month average excess spread of 1% and a commitment, no later than September 30, 2003, for funding of a \$610 million term asset backed securitization that matures in January and February 2004. On June 26, 2003, we paid approximately \$4.3 million of prepaid interest and related fees to reduce the interest rate on one of these financing facilities.

On March 31, 2003, Thomas H. Lee Equity Fund IV, L.P. ("THL Fund IV") committed to provide a term loan to the Company in an aggregate amount of \$125 million as a backup financing facility, secured by assets of the Company. On June 27, 2003 the term loan commitment was terminated and replaced with a \$125 million senior secured loan funded by a consortium of lenders. With the termination of the THL Fund IV commitment, we wrote off \$5.1 million of capitalized commitment fees.

The \$125 million term loan was issued pursuant to an Amended and Restated Senior Secured Credit Agreement dated as of June 18, 2003 (the "Credit Agreement"). The loan matures June 27, 2004 and carries a fixed interest rate of 12% plus a monthly performance interest payment, which is indexed to the monthly excess spread in the Master Trust. The funds were used to pay off a \$100 million term loan that matured in June of 2003. The terms of the Credit Agreement, under



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which the loan was issued, require mandatory prepayment of a portion of the principal if the Company receives funds due to the sale of certain Company assets. We were therefore required to make a \$22.5 million principal repayment from the proceeds of the sale of our membership and warranty business in July, 2003. We are bound by certain covenants under the Credit Agreement as filed July 11, 2003 on Form 8-K. As of June 30, 2003, we were in compliance with all

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covenants under the Credit Agreement. In addition, under the Agreement, DirectMerchants Bank dividends paid to MCI are limited to Bank earnings not to exceed \$20 million per quarter.

The Internal Revenue Service ("IRS") has recently completed its examination of the Company's tax returns through December 31, 1998. The IRS has proposed adjustments to increase the Company's federal income tax by \$42.9 million, plus interest of more than \$15 million, pertaining to the Company's treatment of certain credit card fees as original issue discount ("OID"). Although these fees are primarily reported as income when billed for financial reporting purposes, we believe the fees constitute OID and must be deferred and amortized over the life of the underlying credit card receivables for tax purposes. Cumulatively through the year ended December 31, 2002, the Company has deferred more than \$212 million in federal income tax under the OID rules.

The Company believes its treatment of the fees is inappropriate and continues to work with the IRS to resolve the proposed adjustments. The Company's position on the treatment of credit card fees is consistent with that of many other U.S. credit card issuers. We do not expect any additional tax to be paid or settlement to be reached over the next twelve months. However, both the timing and amount of the final resolution of this matter is uncertain.

In July of 2003, the OCC requested and Direct Merchants Bank agreed to eliminate federally insured deposits at the Bank, or the risk thereof to the FDIC, by September 30, 2003. The Bank estimates that it will have approximately \$565 million of insured deposits at September 30, 2003. The Bank also estimates it will have approximately \$375 million of unencumbered cash and approximately \$500 million of available gross receivables at September 30, 2003 to meet this obligation. We have received preliminary proposals from financing sources, and we are working with our financial advisors on a variety of options to achieve this goal. These options may include additional conduit financing or the sale of credit card receivables to third parties.

During the next twelve months we have contractual cash obligations of \$322 million and off-balance sheet funding scheduled to amortize of \$2.0 billion, which includes funding for a \$610 million term asset-backed securitization maturing in January and February 2004. In addition, we require funding for approximately \$565 million of deposits to be paid-off or defeased by September 30, 2003. We have historically utilized a variety of funding vehicles, as well as ongoing cash generated from operations, to finance credit card receivables, maturing debt obligations and general operating needs. During the next twelve months we intend to reduce outstanding credit card receivables in the Master Trust through lower credit card account acquisitions, attrition in the portfolio and third party sales as necessary. This reduction in the size of the portfolio will significantly reduce our need for additional bank conduits or the issuance of new asset-backed securities. We believe that we will be able to obtain the requisite funding that will provide us with adequate liquidity to meet anticipated cash needs, although no assurance can be given to that effect.

### Capital Adequacy

In the normal course of business, Direct Merchants Bank enters into agreements, or is subject to regulatory requirements, that result in cash, debt

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and dividend or other capital restrictions.

The Federal Reserve Act imposes various legal limitations on the extent to which banks can finance or otherwise supply funds to their affiliates. In particular, Direct Merchants Bank is subject to certain restrictions on any extensions of credit to or other covered transactions, such as certain purchases of assets, with MCI and its

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affiliates. Such restrictions limit Direct Merchants Bank's ability to lend to MCI and its affiliates. Additionally, Direct Merchants Bank is limited in its ability to declare dividends to MCI in accordance with the national bank dividend provisions.

Direct Merchants Bank is subject to certain capital adequacy guidelines adopted by the OCC. At June 30, 2003 and December 31, 2002, Direct Merchants Bank's Tier 1 risk-based capital ratio, risk-based total capital ratio and Tier 1 leverage ratio exceeded the minimum required capital levels, as illustrated in the following table.

Under capital adequacy guidelines and the regulatory framework for prompt corrective action, Direct Merchants Bank must meet specific capital guidelines that involve quantitative measures of assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. Direct Merchants Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Additionally, the Bank must maintain minimum capital in the aggregate amount of (i) liquid assets deposited pursuant to the Liquidity Reserve Deposit Agreement discussed below; (ii) the capital required as a result of the 200% risk-weight applied to on-book subprime credit card receivables; and (iii) the minimum capital required under Federal law for a "well capitalized" institution for all remaining assets owned by the Bank. Under these more stringent guidelines, Direct Merchants Bank's total capital ratio as of June 30, 2003 was 17.2%, and Direct Merchants Bank was considered a "well-capitalized" depository institution under regulations of the OCC (including FFIEC subprime guidelines).

Quantitative measures established by regulation to ensure capital adequacy require Direct Merchants Bank to maintain minimum amounts and ratios (set forth in the following table) 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 initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material adverse effect on our financial statements.

Additional information about Direct Merchants Bank's actual capital amounts and ratios are presented in the following table:

As of June 30, 2003	Actual		To be Adequately Capitalized		To Be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	-----	-----	-----	-----	-----	-----
Total Capital .....	\$259,364	39.4%	\$ 52,614	8.0%	\$ 65,768	10.0%
(to risk-weighted assets)						
Tier 1 Capital ....	249,917	38.0%	26,307	4.0%	39,461	6.0%
(to risk-weighted assets)						

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assets)

Tier 1 Capital . . . . (to average assets)	249,917	21.8%	45,841	4.0%	57,301	5.0%
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	Actual		To be Adequately Capitalized		To Be Well Capitalized	
As of December 31, 2002	Amount	Ratio	Amount	Ratio	Amount	Ratio
	-----	-----	-----	-----	-----	-----
Total Capital . . . . . (to risk-weighted assets)	\$402,891	30.9%	\$104,465	8.0%	\$130,581	10.0%
Tier 1 Capital . . . . . (to risk-weighted assets)	385,658	29.5%	52,233	4.0%	78,349	6.0%
Tier 1 Capital . . . . . (to average assets)	385,658	24.4%	63,219	4.0%	79,024	5.0%

### Regulatory Matters

On March 18, 2003, we entered into an operating agreement with the OCC designed to ensure that Direct Merchants Bank continues to operate in a safe and sound manner.

The operating agreement requires, among other things, the following:

- o The Bank must reduce its on-balance-sheet credit card receivables to no more than \$550 million by December 31, 2003 and to zero by December 31, 2004. During the time the Bank is reducing these receivables, the mix of subprime receivables may not exceed 60% of all credit card receivables. As of June 30, 2003, 56.2% of the Bank's credit card receivables were subprime. The Bank will continue to sell credit card receivables on a daily basis to MCI under the purchase agreement currently in effect between MCI and the Bank.
- o The Bank must maintain minimum capital in the aggregate amount of (i) liquid assets deposited pursuant to the Liquidity Reserve Deposit Agreement discussed below; (ii) the capital required as a result of the 200% risk-weight applied to on-book subprime credit card receivables; and (iii) the minimum capital required under Federal law for a "well capitalized" institution for all remaining assets owned by the Bank.
- o The Bank must meet certain liquidity requirements, including maintaining, on a daily basis, liquid assets of not less than 100% of the deposits and other liabilities coming due within the next 30 days, maintaining marketable assets in an amount equal to or in excess of the Bank's insured deposits, maintaining cash and cash equivalents in excess of 46% of outstanding CDs, and entering into the Liquidity Reserve Deposit Agreement discussed below to support the Bank's credit card receivables funding needs.
- o The Bank is working with the OCC to develop a written strategic plan establishing objectives for the Bank's overall risk profile, earning

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performance, growth, balance sheet mix, off-balance sheet activities, liability structure, capital adequacy, product line development and marketing segments.

The terms of the operating agreement required Direct Merchants Bank and MCI to enter into a Capital Assurance and Liquidity Maintenance Agreement ("CALMA") which also was executed on March 18, 2003. The effect of the CALMA is to potentially require MCI

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to make such capital infusions or provide Direct Merchants Bank with financial assistance so as to permit Direct Merchants Bank to meet its liquidity requirements.

As required by the operating agreement, Direct Merchants Bank, a third-party depository bank and the OCC executed a Liquidity Reserve Deposit Agreement ("LRDA").

If the OCC were to conclude that the Bank failed to implement any provision of the agreement, the OCC could pursue various enforcement options.

Upon signing these agreements Direct Merchants Bank declared and paid a \$155 million dividend to us. An additional dividend of \$15.8 million was declared and paid during the second quarter of 2003.

In July of 2003, the OCC requested and Direct Merchants Bank agreed to eliminate federally insured deposits at the Bank, or the risk thereof to the FDIC, by September 30, 2003. The Bank estimates that it will have approximately \$565 million of insured deposits at September 30, 2003. The Bank also estimates it will have approximately \$375 million of unencumbered cash and approximately \$500 million of available gross receivables at September 30, 2003 to meet this obligation. We have received preliminary proposals from financing sources, and we are working with our financial advisors on a variety of options to achieve this goal. These options may include additional conduit financing or the sale of credit card receivables to third parties. If we do not eliminate federally insured deposits, or the risk thereof by September 30, 2003, the OCC could pursue various enforcement options.

On August 5, 2003, we received notification from the Securities and Exchange Commission that we are the subject of a formal, nonpublic investigation. We believe that this investigation relates primarily to the Company's treatment of loan loss allowances in 2001 and subsequent years, the Company's 2001 credit line increase program and other related matters.

The SEC specifically advised us that this is a fact-finding inquiry and that it has not reached any conclusions related to this matter. We are cooperating fully with the SEC in this investigation.

### 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," 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

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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," "intends," "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 high liquidity requirement; our higher delinquency rate, credit loss rates and charge-off rates of our

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credit card receivables; the higher charge-off and bankruptcy rates of the Company's target market of moderate-income consumers; the success and impact of our existing or modified strategic initiatives; risks associated with Direct Merchants Bank's ability to comply with its agreement with regulators regarding the safety and soundness of its operations; interest rate risks; risks associated with acquired portfolios; dependence on the securitization markets and other funding sources to fund our business, including the refinancing of existing indebtedness; the effects of government policy and regulation, whether of general applicability or specific to us, including restrictions and/or limitations relating to our minimum capital requirements, deposit taking abilities, reserving methodologies, dividend policies and payments, growth, and/or underwriting criteria; reduced funding availability and increased funding costs; privacy laws that could result in lower marketing revenue and penalties for non-compliance; and general economic conditions that can have a negative impact on the performance of loans and marketing of enhancement services.

These and other risks and uncertainties are discussed in "Legal Proceedings" (page 48), "Management's Discussion and Analysis of Financial Condition and Results of Operations" (pages 24-46) and "Quantitative and Qualitative Disclosures About Market Risk" (pages 46-47). 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.

### 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, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." 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 accounting principles generally accepted in the United States of America, however, we believe the information is relevant to understanding the overall financial condition and results of operations of the Company.

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Table 6: Managed Loan Portfolio  
(Dollars in thousands)

	June 30, 2003 ----	% of Total -----	December 31, 2002 ----	% of Total -----	June 30, 2002 ----
Period-end balances:					
Credit card loans .....	\$ 632,913		\$ 846,417		\$ 1,317,238
Retained interests and investors' interests in loans securitized.....	9,483,652		10,573,769		10,477,057
Managed .....	<u>\$10,116,565</u>		<u>\$11,420,186</u>		<u>\$11,794,295</u>
Loans contractually delinquent:					
Credit card loans .....	48,266	7.6%	7,876	0.9%	148,903
Retained interests and investors' interests in loans securitized.....	1,084,241	11.4%	1,252,073	11.8%	1,047,236
Managed .....	<u>\$ 1,132,507</u>	<u>11.2%</u>	<u>\$ 1,259,949</u>	<u>11.0%</u>	<u>\$ 1,196,139</u>
Three Months Ended June 30, -----					
	2003 ----		2002 ----		2003 ----
Average balances:					
Credit card loans .....	\$ 690,903		\$ 1,737,626		\$ 721,121
Retained interests and investors' interests in loans securitized.....	9,771,210		10,163,087		10,086,551
Managed .....	<u>\$10,462,113</u>		<u>\$11,900,713</u>		<u>\$10,807,672</u>
Net charge-offs:					
Credit card loans .....	\$ 43,702	25.4%	\$ 85,099	19.6%	\$ 51,991
Retained interests and investors' interests in loans securitized.....	454,914	18.7%	356,688	14.1%	942,431
Managed .....	<u>\$ 498,616</u>	<u>19.1%</u>	<u>\$ 441,787</u>	<u>14.9%</u>	<u>\$ 994,422</u>

The increase in the managed delinquency rates as of June 30, 2003 over December 31, 2002 and June 30, 2002 reflects various factors, including

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declining receivable balances, a deterioration in the economy and the impact of our 2001 credit line increase program. The credit line increase program added pressure to our customers due to increased average outstanding balances, which require higher monthly payments. This, along with a deteriorating economy, has made our collections efforts more difficult, resulting in higher delinquencies.

Total managed loans decreased \$1.3 billion to \$10.1 billion as of June 30, 2003, compared to \$11.4 billion as of December 31, 2002. This was primarily due to a reduction in credit lines, tighter underwriting standards implemented in 2002 and lower new accounts. The amount of credit card receivables in debt forbearance programs was \$856.0 million or 8.5% of total managed loans as of June 30, 2003, compared with \$860.1 million or 7.5% of managed loans as of December 31, 2002. All delinquent receivables in debt forbearance programs are included in Table 6.

Managed net charge-offs increased \$56.8 million and \$168.0 million for the three- and six-month periods ended June 30, 2003 compared to the same periods in 2002 primarily due to the impact of the 2001 credit line increase program and deterioration in the economy.

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We charge-off bankrupt accounts 60 days following formal notification. Charge-offs due to bankruptcies were \$181.2 million, representing 34.5% of total managed gross charge-offs for the three months ended June 30, 2003 and \$133.2 million, representing 25.3% of total managed gross charge-offs for the three months ended June 30, 2002. Charge-offs due to bankruptcies were \$367.2 million, representing 35.1% of total managed gross charge-offs for the six months ended June 30, 2003 and \$285.8 million, representing 32.8% of total managed gross charge-offs for the six months ended June 30, 2002. In addition to those bankrupt accounts that were charged-off, we received formal notification of \$89.7 million and \$103.3 million of managed bankrupt accounts as of June 30, 2003 and 2002, respectively.

Net Interest Income

Table 7: Analysis of Average Balances, Interest and Average Yields and Rates

	Three Months Ended June 30,		
	2003	2002	2001
	-----	-----	-----
(Dollars in thousands)			
Average interest-earning assets:			
Owned .....	\$ 1,192,956	\$ 2,243,490	\$ 1,300,000
Retained interests and investors' interests in loans securitized.....	9,771,210	10,163,201	10,000,000
	-----	-----	-----
Managed .....	\$10,964,166	\$12,406,691	\$11,300,000
	=====	=====	=====
 Net interest income:			
Owned .....	\$ 12,717	\$ 41,838	\$ 100,000
Retained interests and investors' interests in loans securitized.....	378,324	387,036	700,000
	-----	-----	-----
Managed .....	\$ 391,041	\$ 428,874	\$ 800,000
	=====	=====	=====
 Net interest margin (1):			

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Owned .....	4.3%	7.5%
Retained interests and investors'		
interests in loans securitized .....	15.5%	15.3%
Managed .....	14.3%	13.9%

(1) We compute net interest margin by dividing annualized net interest income by average total interest-earning assets.

Managed net interest income decreased \$37.8 million and \$54.9 million for the three- and six-month periods ended June 30, 2003, compared to the same periods in 2002. Net interest income consists primarily of interest earned on our credit card loans less interest expense on borrowing to fund the loans. The decrease is primarily due to a \$1.4 billion and \$989.0 million decrease in managed average interest-earning assets, for the three- and six-month periods ended June 30, 2003, compared to the same periods in 2003.

### 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.

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To manage our direct risk to market interest rates, management actively monitors the interest rates and the interest sensitive components of our owned and managed balance sheet to minimize 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 repricings.

Our primary managed assets are credit card loans, which are virtually all priced at rates indexed to the variable Prime rate. We fund credit card loans through a combination of cash flows from operations, asset securitizations, bank loans, subsidiary bank deposits, long-term debt and equity issuances. Our securitized loans are owned by the Master Trust and bank-sponsored multi-seller receivables conduits within the Master Trust, which have committed funding primarily indexed to variable commercial paper rates and LIBOR. The long-term debt is at fixed interest rates. At June 30, 2003 and 2002, none of the securities issued out of the Master Trust and conduit funding of securitized receivables was funded with fixed rate securities.

In an interest rate environment with rates significantly above current rates, the potential negative impact on earnings of higher interest expense is partially mitigated by fixed rate funding and interest rate cap contracts.

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 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 zero percent. Assuming that we take no counteractive measures, as of June 30, 2003, a 200-basis-point increase in interest rates affecting our floating rate financial instruments, including both debt obligations and loans, would result in a decrease in net income of approximately \$24.1 million relative to a base case over the next 12 months, compared to an approximate \$11.0 million decrease as of December 31, 2002 relative to a base case over the next 12 months. A decrease of 200 basis points would result in an increase in net income of approximately \$35.6 million as of June 30, 2003, and an increase of \$55.0 million as of December 31, 2002.



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The change in the 12 month sensitivity to both a 200 basis point increase and decrease in the market interest rate is mainly due to an increase in loan balances in the second quarter where the interest rate charged on customer loan balances is below the floor rate and a continued decrease in the forecasted future loan balances. You should not construe our use of this methodology to quantify the market risk of financial instruments as an endorsement of its accuracy or the accuracy of the related assumptions. In addition, this methodology does not take into account the indirect impact interest rates may have on the payment performance of our cardholders, or the fact that LIBOR and Prime rates may not move in tandem in an increasing or decreasing rate environment. The quantitative information about market risk is necessarily limited because it does not take into account operating transactions or other costs associated with managing immediate changes in interest rates.

### 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. Based on that evaluation, the Company's management, including the CEO and CFO, have concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed in the reports it files under the

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Securities Exchange Act of 1934 as amended (the "Exchange Act") are recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. During the quarter ended June 30, 2003, there has been no change in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) or 15d-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

## Part II. Other Information

### Item 1. Legal Proceedings

There were no material changes in the status of any legal proceedings as of June 30, 2003.

### Item 2. Changes in Securities Not applicable

### Item 3. Defaults Upon Senior Securities Not applicable

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

- (a) The Company held its annual meeting of shareholders on June 4, 2003 and the following matters were voted on at that meeting.
- (b) The directors listed below were elected at that meeting.

(1) The holders of our Common Stock elected six directors for a one-year term:

Lee R. Anderson, Sr.  
John A. Cleary  
Walter M. Hoff

Edward B. Speno  
Frank D. Trestman  
David D. Wesselink

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(2) The holders of our Series C Preferred Stock elected four directors for a one-year term:

C. Hunter Boll  
Thomas M. Hagerty

David V. Harkins  
Thomas H. Lee

(c) Matters Voted Upon:

(1) Amendment to the Company's Amended and Restated Certificate of Incorporation to declassify the Board of Directors and provide for one-year terms of office for all directors.

For ---	Against -----	Withheld -----	Abstentions -----	Broker Non-Vote -----
81,712,933	1,439,178	None	76,558	None

(2) The election of the following directors who will serve until their successors are elected and qualified, or their earlier death or resignation:

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Director -----	For ---	Against -----	Withheld -----	Abstentions -----	Broker Non-Vote -----
Lee R. Anderson, Sr.	51,948,579	None	1,366,628	None	None
John A. Cleary	45,405,966	None	7,909,241	None	None
Walter M. Hoff	41,037,943	None	12,277,264	None	None
Edward B. Speno	45,352,848	None	7,962,359	None	None
Frank D. Trestman	51,918,402	None	1,396,805	None	None
David D. Wesselink	51,589,291	None	1,725,916	None	None
C. Hunter Boll	29,913,461	None	None	None	None
Thomas M. Hagerty	29,913,461	None	None	None	None
David V. Harkins	29,913,461	None	None	None	None
Thomas H. Lee	29,913,461	None	None	None	None

(3) Ratification of the selection of KPMG LLP as independent auditor of the Company for the fiscal year ending December 31, 2003:

For ---	Against -----	Withheld -----	Abstentions -----	Broker Non-Vote -----
81,794,163	1,396,435	None	38,069	None

Item 5. Other Information  
Not applicable

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

10.1 Amended and Restated Senior Secured Credit Agreement, dated as of June 18, 2003, among Metris Companies Inc., the Lenders from time to time parties thereto, Goldman Sachs Credit Partners L.P. as Administrative Agent, and Deutsche Bank Trust Companies America as Collateral Agent

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(Incorporated by reference to Exhibit 10 to MCI's Current Report on Form 8-K dated July 11, 2003 (File No. 1-12351).

- 10.2 First Amendment to the Amended and Restated Senior Secured Credit Agreement and to credit Agreement Reserve Securities Account Control Agreement, dated as of July 29, 2003 among Metris Companies Inc., the Lenders from time to time parties to the Senior Secured Credit Agreement, Goldman Sachs Credit Partners L.P. as Administrative Agent, and Deutsche Bank Trust Companies America as Collateral Agent
- 10.3 Asset Purchase Agreement Dated July 29, 2003 by and among Metris Companies Inc., Metris Direct, Inc., Metris Direct Services, Inc., Metris Travel Services Inc., Metris Club Services, Inc., Metris Warranty Services, Inc., and Metris Warranty Services of Florida, Inc., CPP Holdings Limited and CPP US Operations Group, LLC
- 10.4 Transition Services Agreement dated July 29, 2003 by and among CPP Holdings Limited and CPP US Operations Group, LLC and Metris Companies Inc. and MES Insurance Agency, LLC

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- 10.5 Employee Leasing Agreement dated July 29, 2003, by and between CPP Holdings Limited and CPP US Operations Group, LLC and Metris Companies Inc.
- 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.

(b) Reports on Form 8-K:

On April 16, 2003, we filed a Current Report on Form 8-K to report the submission of unaudited financial statements in a press release dated April 16, 2003.

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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: August 14, 2003

By: /s/ John A. Witham  
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John A. Witham  
Executive Vice President, Chief Financial Officer  
Principal Financial Officer

Date: August 14, 2003

By: /s/ Mark P. Wagener  
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Mark P. Wagener  
Senior Vice President, Controller  
Principal Accounting Officer