METRIS COMPANIES INC
Form 10-K
March 22, 2002
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10 K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2001	001-12351 Commission file number

METRIS COMPANIES INC.

(Exact name of registrant as specified in its charter)

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

10900 Wayzata Boulevard, Minnetonka, Minnesota 55305-1534
(Address of principal executive offices)

(952) 525-5020
(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, $.01 Par Value

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10 K or any amendment to this Form 10 K.

As of March 15, 2002, 62,225,770 shares of the Registrant s Common Stock were outstanding and the aggregate market value of common stock held by non affiliates of the Registrant on that date was approximately $1,448,927,016 based upon the closing price on the New York Stock Exchange on March 15, 2002.

DOCUMENTS INCORPORATED BY REFERENCE

Certain portions of the Proxy Statement for the Annual Meeting of Shareholders of Metris Companies Inc. to be held on May 7, 2002, which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2001, are incorporated by reference in Part III.

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PART I

Item 1. Business

Metris Companies Inc. (MCI) and its subsidiaries, which may be referred to as we, us, our, and the Company, is one of the nation s leading providers of financial services products and services. The company issues credit cards through its wholly owned subsidiary, Direct Merchants Credit Card Bank, National Association (Direct Merchants Bank), the 10th largest bankcard issuer in the United States. As a top-tier enhancement services company, MCI also offers consumers a variety of products, including credit card protection and insurance, extended service plans and membership clubs. Our credit card customers and prospects include individuals for whom credit bureau information is available (external prospects) and persons identified through other third-party sources including customer lists and databases. We market our enhancement services, including debt waiver programs, membership clubs, extended service plans and third-party insurance to our credit card customers, customers of third parties and the broad market.

MCI was incorporated in Delaware on August 20, 1996, and completed an initial public offering in October 1996. Our principal subsidiaries are Direct Merchants Bank, Metris Direct, Inc. and Metris Receivables, Inc.

Business Segments

We measure performance and operate in two business segments:

- **Consumer Lending Products**, which are primarily unsecured and partially secured credit cards issued by Direct Merchants Bank; and
- **Enhancement Services**, which include credit protection, membership clubs, extended service plans and third-party insurance offered to our credit card customers, customers of third parties and the broad market.

We generate income from our consumer lending products through:

- interest and other finance charges assessed on outstanding credit card loans;
- credit card fees (including annual membership, cash advances, overlimit fees, and late fees);
- interchange fees; and
- collections and sales on recovery assets.

The primary expenses of this business are:

- the costs of funding the loans;
- provisions for loan losses and operating expenses, including employee compensation, account solicitation and marketing expenses; and
- data processing and servicing expenses.

Profitability is affected by:

- response and approval rates to solicitation efforts;
- loan growth;

interest spreads on loans;

credit card usage;

credit quality (delinquencies and charge-offs);

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- card cancellations; and
- fraud losses.

Our consumer lending business primarily targets moderate-income consumers who we believe have historically been overlooked by other credit card companies. We target and evaluate prospective customers in this market by using our proprietary scoring techniques, together with information from credit bureaus and other customer lists and databases, to determine a potential customer s creditworthiness. We also use sophisticated modeling techniques to evaluate the expected risk, responsiveness and profitability of each prospective customer and to offer and price the products and services we believe to be appropriate for each customer. (See more detailed discussion following under the caption Business Lines on pages 4 through 14 of this Report.)

In addition to sales to third parties, the enhancement services business derives benefits from our consumer lending business because we cross-sell these services to our credit cardholders. Nonetheless, our two business segments are different with respect to the factors that affect profitability, including how income is generated and how expenses are incurred. These differences require us to manage our operations separately.

We receive revenue from our enhancement services through fees for those services.

Expenses include costs of:

- solicitation;
- underwriting and claims servicing expenses;
- fees paid to third parties; and
- other operating expenses.

The primary factors that affect profitability for this business are:

- response rates to solicitation efforts;
- returns or cancel rates;
- renewal rates; and
- claims rates.

Strategy

The principal components of our strategy are the following:

Identify and solicit additional external prospects for credit cards

We intend to continue adding credit card accounts through the use of our own internally developed risk models. We have developed our own proprietary credit risk modeling system. By incorporating individual credit information from the major credit bureaus into this proprietary modeling system, we expect to generate additional customer relationships from external prospects.

Use risk-based pricing

We determine the specific pricing for an individual s credit card offer through the prospective customer s risk profile and expected responsiveness prior to solicitation and continually monitor and adjust pricing as the relationship continues, a practice known as risk-based pricing. We believe the use of risk-based pricing allows us to maximize the profitability of a customer relationship.

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Pursue acquisitions of credit card portfolios or businesses

We pursue acquisitions of credit card portfolios or businesses whose customers fit our product and target market profile or which otherwise strategically fit with our business.

Increase the number of third-party customers using our products and services

We seek to access additional customers for our products and services by establishing relationships with third parties. Our strategy is to continue to use our proprietary risk, response and profitability models to solicit strategic partners customers for credit cards and to focus our cross-selling activities in order to increase the volume of enhancement services products purchased by these customers.

Sell multiple products and services to each customer

We intend to use interactions with our customers to sell additional products, thereby leveraging our account acquisition costs and infrastructure. Currently, we focus our efforts on selling enhancement services to our credit card customers and customers of third parties.

Diversify product offerings to our customers

We segment markets to expand the success of our existing consumer lending products and enhancement services. We analyze the data in our proprietary database and the databases of others to determine the needs of our target markets. Then we develop, test and effectively market these new products to our target markets.

Business Lines

We operate through two businesses: consumer lending products and enhancement services.

Consumer Lending Products

Products

Our consumer lending products are primarily unsecured and partially secured credit cards, including the Direct Merchants Bank MasterCard® and Visa®. We offer co branded credit cards and may also offer other consumer lending products either directly or through alliances with other companies. At December 31, 2001, we had approximately 4.9 million credit card accounts with approximately $11.9 billion in managed credit card receivables. According to the Nilson Report, at December 31, 2001, we were the 9th largest MasterCard® issuer in the United States based on the number of cards issued, and the 10th largest bankcard issuer based on managed credit card loan balances.

Prospects

Our primary sources of prospects to solicit for credit card offers are obtained from credit bureau queries and individuals in third-party customer lists and databases. Currently, our most significant source is the leads obtained from credit bureau inquiries.

Credit Scoring

We use internally and externally developed proprietary models to enhance our evaluation of prospects. These models help segment prospects into narrower ranges within each risk score provided by Fair, Isaac and Co. (FICO), allowing us to better evaluate individual credit risk and to tailor our risk-based pricing accordingly. We also use this segmentation to exclude certain individuals from our marketing solicitations.

We generate external prospects from lists obtained from the major credit bureaus based on criteria established by us as well as from other third-party sources. We use proprietary models and additional analysis in conjunction with the files obtained from credit bureaus to further segment prospects based upon their likelihood of default.

We believe our methods are effective in further segmenting and evaluating risk within risk score bands. We have and continue to use the results of our analysis of prospects to adjust the proprietary models to determine the pricing for various segments and to exclude certain segments from subsequent direct marketing efforts. While we believe that the proprietary models and additional analysis are valuable tools in analyzing relative risks, it is not possible to accurately predict which consumers will default or the overall level of defaults.

We believe that both the proprietary models and our internal credit score give us a competitive advantage in evaluating the credit risk of moderate-income consumers and thereby broaden our customer prospect base. After every marketing campaign, we monitor the performance of the proprietary models and continually re-evaluate the effectiveness of these models in segmenting credit risk, resulting in further refinements to our selection criteria for prospects. Over time, we believe that we will capture additional credit information on the behavioral characteristics of prospects which will allow us to further increase the effectiveness of our proprietary models.

Solicitation

Prospects for solicitation include both external prospects and customers of third parties. We contact prospects on a nationwide basis primarily through pre-screened direct mail, invitation to apply and telephone solicitations. We receive responses to our solicitations, perform fraud screening, verify name and address changes, and obtain any information which may be missing from the application. We then make the credit decisions and approve, deny or begin the exception processing. We process exceptions for, among other things, derogatory credit bureau information and fraud warnings. Our credit analysts process exception applications based on policies approved by our credit policy committee.

Pricing

Through risk-based pricing, we price credit card offers based upon a prospect s risk profile prior to solicitation or upon receipt of an application. We evaluate a prospect to determine credit needs, credit risk and existing credit availability, and then develop a customized offer that includes the most appropriate product, brand, pricing and credit line. We have numerous pricing structures on our credit card products. After credit card accounts are opened, we periodically monitor customers internal and external credit performance and recalculate delinquency, profitability, attrition and bankruptcy predictors. As customers evolve through the credit life cycle and are regularly rescored, the lending relationship may evolve to include more or less restrictive pricing and product configurations.

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Age of Portfolio

The following tables set forth, as of December 31, 2001 and 2000, the number of credit card accounts and the amount of outstanding loans based on the age of the managed accounts. (Accounts in acquired portfolios are presented based on when the account was originated with the previous issuer.)

(Dollars in thousands)

2001

Age Since Origination	Number of Accounts	Percentage of Accounts	Loans Outstanding	Percentage of Loans Outstanding
0-6 Months	587,942	11.9%	$ 576,621	4.8%
7-12 Months	466,773	9.5%	756,112	6.4%
13-18 Months	552,678	11.2%	976,050	8.2%
19-24 Months	547,183	11.1%	1,160,980	9.8%
25-36 Months	613,626	12.5%	1,767,649	14.8%
37+ Months	2,161,177	43.8%	6,668,741	56.0%
Total	4,929,379	100.0%	$ 11,906,153	100.0%

2000

Age Since Origination	Number of Accounts	Percentage of Accounts	Loans Outstanding	Percentage of Loans Outstanding
0-6 Months	754,748	16.9%	$ 626,709	6.8%
7-12 Months	700,055	15.7%	843,396	9.1%
13-18 Months	456,801	10.2%	819,667	8.8%
19-24 Months	252,058	5.6%	521,530	5.6%
25-36 Months	596,358	13.4%	1,672,647	18.0%
37+ Months	1,703,962	38.2%	4,789,159	51.7%
Total	4,463,982	100.0%	$ 9,273,108	100.0%

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Geographic Distribution

We solicit credit card customers on a national basis and, therefore, maintain a geographically diversified portfolio. The following tables show the distribution of accounts and amount of outstanding loans by state, as of December 31, 2001 and 2000.

(Dollars in thousands)
2001

State	Number of Accounts	Percentage of Accounts	Loans Outstanding	Percentage of Loans Outstanding
California	684,964	13.9%	$ 1,487,384	12.5%
New York	426,585	8.7%	1,001,146	8.4%
Texas	407,072	8.3%	963,379	8.1%
Florida	354,529	7.2%	866,722	7.3%
Illinois	210,230	4.3%	493,124	4.1%
Ohio	186,421	3.8%	483,621	4.1%
Pennsylvania	161,812	3.3%	407,574	3.4%
New Jersey	156,847	3.2%	354,337	3.0%
Michigan	135,341	2.7%	338,404	2.8%
Georgia	123,223	2.5%	320,815	2.7%
Virginia	122,899	2.5%	313,126	2.6%
All others (1)	1,959,456	39.6%	4,876,521	41.0%
Total	4,929,379	100.0%	$ 11,906,153	100.0%

2000

State	Number of Accounts	Percentage of Accounts	Loans Outstanding	Percentage of Loans Outstanding
California	607,333	13.6%	$ 1,170,856	12.6%
Texas	382,037	8.6%	789,888	8.5%
New York	373,952	8.4%	755,207	8.1%
Florida	325,352	7.3%	690,960	7.5%
Ohio	170,282	3.8%	375,759	4.1%
Illinois	180,612	4.0%	371,976	4.0%
Pennsylvania	142,140	3.2%	303,338	3.3%
Michigan	120,718	2.7%	257,569	2.8%
New Jersey	131,746	3.0%	254,643	2.7%
Georgia	116,016	2.6%	250,599	2.7%
Virginia	114,050	2.6%	245,829	2.7%
North Carolina	109,858	2.5%	231,943	2.5%
All others (1)	1,689,886	37.7%	3,574,541	38.5%
Total	4,463,982	100.0%	$ 9,273,108	100.0%

(1) No other state accounts for more than 2.5% of loans outstanding.

Credit Lines

Once we approve an account, we use automated screening and credit scoring techniques to establish an initial credit line based on the individual s risk profile. We may elect, at any time and without prior notice to a cardholder, to prevent or restrict further credit card use by the cardholder, usually as a result of poor payment performance or our concern over the creditworthiness of the cardholder. We manage credit lines based on the

results of the behavioral scoring analysis, and in accordance with our internally established criteria. These analytic models automatically and regularly assign credit line increases and decreases to individual customers, as well as determine the systematic collection steps to be taken at the various stages of delinquency. We use these models to manage the authorization of each transaction, as well as the collections strategies used for non-delinquent accounts with balances above their assigned credit lines.

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The following tables set forth information with respect to credit limit and account balance ranges of our managed loan portfolio, as of December 31, 2001 and 2000.

(Dollars in thousands)

2001

Credit Limit Range	Number of Accounts	Loans Outstanding	Percentage of Loans Outstanding	Open to Buy	Percentage Utilized
$1,000 or Less	480,909	$ 275,322	2.3%	$ 102,657	72.8%
$1,001-$2,000	566,593	558,262	4.7%	396,326	58.5%
$2,001-$3,500	774,180	1,097,179	9.2%	1,123,276	49.4%
$3,501-$5,000	768,475	1,439,888	12.1%	1,882,893	43.3%
$5,001-$10,000	1,585,518	4,508,918	37.9%	6,959,736	39.3%
Over $10,000	753,704	4,026,584	33.8%	5,213,070	43.6%
Total	4,929,379	$ 11,906,153	100.0%	$ 15,677,958	43.2%

2000

Credit Limit Range	Number of Accounts	Loans Outstanding	Percentage of Loans Outstanding	Open to Buy	Percentage Utilized
$1,000 or Less	742,667	$ 386,865	4.2%	$ 116,715	76.8%
$1,001-$2,000	614,746	673,919	7.2%	356,481	65.4%
$2,001-$3,500	804,028	1,323,157	14.3%	988,615	57.2%
$3,501-$5,000	731,754	1,698,768	18.3%	1,536,701	52.5%
$5,001-$10,000	1,405,708	4,636,867	50.0%	5,872,441	44.1%
Over $10,000	165,079	553,532	6.0%	1,986,399	21.8%
Total	4,463,982	$ 9,273,108	100.0%	$ 10,857,352	46.1%

(Dollars in thousands)

2001

Account Balance Range	Number of Accounts	Loans Outstanding	Percentage of Loans 1 Outstanding	Open to Buy	Percentage Utilized
Credit Balance	58,543	$ (5,782)	(0.1%)	$ 242,223	(2.4%)
No Balance	1,256,609			6,873,759	
$1,000 or Less	1,021,506	445,748	3.8%	3,399,472	11.6%
$1,001-$2,000	602,868	895,632	7.5%	1,349,978	39.9%
$2,001-$3,500	643,048	1,751,345	14.7%	1,382,679	55.9%
$3,501-$5,000	464,559	1,962,426	16.5%	998,741	66.3%
$5,001-$10,000	728,695	5,063,594	42.5%	1,310,997	79.4%
Over $10,000	153,551	1,793,190	15.1%	120,109	93.7%
Total	4,929,379	$ 11,906,153	100.0%	$ 15,677,958	43.2%

2000

Account Balance Range	Number of Accounts	Loans Outstanding	Percentage of Loans Outstanding	Open to Buy	Percentage Utilized

Credit Balance	60,809	$ (6,345)	(0.1%)	$ 208,754	(3.1%)
No Balance	854,604			4,926,960	
$1,000 or Less	1,232,581	571,426	6.2%	2,704,744	17.4%
$1,001-$2,000	631,019	978,220	10.5%	1,016,205	49.0%
$2,001-$3,500	673,321	1,890,114	20.4%	939,575	66.8%
$3,501-$5,000	460,109	1,996,404	21.5%	579,606	77.5%
$5,001-$10,000	536,680	3,612,067	39.0%	459,380	88.7%
Over $10,000	14,859	231,222	2.5%	22,128	91.3%
Total	4,463,982	$ 9,273,108	100.0%	$ 10,857,352	46.1%

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During 2000 and 2001, the Company completed an industry competitive analysis which indicated that our credit limits to our customers were significantly below those offered by our competitors to comparable customers. As a result, during 2001, the Company provided to its best customers credit line increases in line with our competitors. As a result of line increases and continued seasoning of the portfolio, during the past year, the amount of receivables attributed to accounts with balances in excess of $5,000 increased from 41.5% to 57.6% and accounts with balances in excess of $10,000 increased from 2.5% to 15.1%.

The average account balance as of December 31, 2001 was $2,415, and the average account balance as of December 31, 2000 was $2,007.

Servicing, Billing and Payment

We have established a relationship with First Data Resources, Inc. (FDR) for cardholder processing services. FDR is a subsidiary of First Data Corporation, a provider of information processing and related services, including cardholder processing (services for financial institutions which issue credit cards to cardholders), and merchant processing (services for financial institutions which make arrangements with merchants for the acceptance of credit cards as methods of payment). FDR provides the following services for us:

- data processing;
- credit card reissuance;
- monthly statements; and
- interbank settlement.

Our processing services agreement with FDR expires in 2011. We handle the following functions internally:

- applications processing; and
- back office support for mail inquiries and fraud management.

In addition, we handle most inbound customer service telephone calls for our customer base.

We generally assess periodic finance charges on an account if the cardholder has not paid the balance in full from the previous billing cycle. We base these finance charges on the average daily balance outstanding on the account during the monthly billing cycle.

If we are not paid in full prior to the due date, which is generally 25 days after the statement cycle date and applicable grace period, we impose finance charges on all purchases from the date of the transaction to the statement cycle date. We also impose finance charges on each cash advance from the day we make the advance until the cardholder pays the advance in full. We apply finance charges to the average daily balance. We do not impose a finance charge on purchases if cardholders pay the entire balance on the account by the due date.

We assess an annual fee on some credit card accounts. We may waive the annual fee, or a portion thereof, in connection with the solicitation of new accounts depending on the credit terms offered, which we determined based on the prospect s risk profile prior to solicitation, or when we determine a waiver to be appropriate considering the account s overall profitability. In addition to the annual fee, we charge accounts other fees, including:

- a late fee with respect to any unpaid monthly balance if we do not receive the required minimum monthly payment by the due date;

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- a cash advance fee for each cash advance;
- a fee with respect to each check submitted by a cardholder in payment of an account, which the cardholder s bank does not honor;
- an overlimit charge if, at any time during the billing cycle, the total amount owed exceeds the cardholder s credit line by an amount consistent with the cardholder agreement; and
- card processing or application fees for some credit card offers.

Each cardholder is subject to an agreement governing the terms and conditions of their account. Pursuant to the agreement, we reserve the right to change or terminate certain terms, conditions, services and features of the account (including periodic finance charges, late fees, returned check charges and any other charges, or the minimum payment), subject to the conditions set forth in the cardholder agreement.

FDR sends monthly billing statements to cardholders on our behalf. When we establish an account, we assign a billing cycle to it. Each of these cycles has a separate monthly billing date based on the business day of the calendar month on which the cycle begins. Each month, we send a statement to all accounts with an outstanding balance greater than $1. All cardholders with open accounts must make a minimum monthly payment, generally the greater of: $15, 2.5% of the outstanding balance, the finance charge or the balance of the account if the balance is less than $15, plus any past due amount. If we do not receive the minimum payment by the due date, we consider the account delinquent.

Most merchant transactions by cardholders are authorized online. The remaining transactions generally are low dollar amounts, typically below $50. All authorizations are handled through FDR s adaptive control and fraud detection systems.

Delinquency, Collections and Charge-offs

We consider an account delinquent if we do not receive a payment due within 25 days from the closing date of the statement. Once an account becomes delinquent, the equivalent of three minimum payments must be received before we re-age the account to current. We handle collections internally, and we determine the appropriate collection action to take by using the adaptive control system, which continually monitors all delinquent accounts. We close accounts that become 60 days contractually delinquent, but do not necessarily charge them off. We charge off and take accounts as a loss either:

- within 60 days after formal notification of bankruptcy;
- at the end of the month during which most unsecured accounts become contractually 180 days past due; or
- 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 and at the end of the month during which partially secured accounts become contractually 120 days past due.

We immediately reserve for and charge off accounts that we identify as fraud losses no later than 90 days after the last activity. We 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. Periodically, we sell a portion of our charged-off portfolio to third parties.

Asset Securitizations and Other Funding Vehicles

Our securitizations involve packaging and selling pools of both current and future receivable balances on credit card accounts, in which we retain the servicing of such receivables. Our securitizations are treated either as sales or collateralized borrowing agreements under accounting principles generally accepted in the United States of America. The securitized receivables accounted for as sales are removed from our balance sheet and treated as managed loans.

We primarily securitize receivables by selling the receivables either to our proprietary trust, the Metris Master Trust, or to bank sponsored single-seller and multi seller commercial paper conduits.

The Metris Master Trust

The Metris Master Trust (Master Trust) was formed in May 1995 pursuant to a pooling and servicing agreement, as amended. Metris Receivables, Inc. (MRI), one of our subsidiaries, transfers receivables in designated accounts to the Master Trust in exchange for proceeds and an interest in the Master Trust. MRI may then exchange portions of this interest for one or more series of securities which it may then sell publicly or privately to third party investors. The securities each represent undivided interests in all of the receivables in the Master Trust, and may be split into separate classes which have different terms. The different classes of an individual series are structured to obtain specific credit ratings. As of December 31, 2001, 15 series of publicly issued securities were outstanding. We currently retain the most subordinated class of securities in each series and sell all the other classes.

Generally, each series involves an initial reinvestment period, referred to as the revolving period, in which principal payments on receivables allocated to such series are returned to MRI and reinvested in new receivables arising in the accounts. After the revolving period ends, principal payments allocated to the series are then accumulated and used to repay the investors. This period is referred to as the accumulation period, and is followed by a controlled amortization period wherein investors are repaid their invested amount. Currently, the Master Trust has two series in an accumulation period and no series in a controlled amortization period. The scheduled accumulation and amortization periods are set in the agreements governing each series. However, all series set forth certain events by which accumulation and amortization can be accelerated, referred to as early amortization. Usually, this would occur if the portfolio collections, less charge-offs for bad debt, financing costs and operational costs, drop below zero. New receivables in designated accounts cannot be funded while a series is in early amortization. We currently do not have any series that are in early amortization.

On a monthly basis, each series is allocated its share of finance charge collections, which are used to pay investors interest on their securities, pay their share of servicing fees and reimburse investors for their share of losses due to charge-offs. Amounts remaining may be deposited in cash accounts of the Master Trust as additional protection for future losses. Once each of these obligations is fully met, any remaining finance charge collections, if any, are returned to us.

Bank Sponsored Conduit Programs

We maintain flexibility in our current funding program by maintaining primarily bank sponsored commercial paper conduits. These conduits purchase an interest in receivables arising in designated accounts. These transactions also feature a revolving period in which principal payments on receivables allocated to the conduits are returned to us and reinvested in new receivables. These agreements also have early amortization triggers. Finance charge collections are used to pay certain obligations, including servicing fees, interest on the principal amount of the conduits investment in the applicable receivables, and recouping charge-offs. After such allocation, remaining finance charge collections, if any, are returned to us.

Additional information regarding asset securitization is set forth under the caption Liquidity, Funding and Capital Resources on pages 43 through 47 of this Report.

Recovery Asset Collections and Sales

magnUS Services, Inc. (magnUS), our wholly-owned third-party collection agency, services both pre- and post-charged-off debt from a variety of sources. magnUS manages the Direct Merchants Bank charged off portfolio from initial charge-off through account resolution, as well as working pre-determined delinquent billing cycles, prior to an account being charged off. Additionally, magnUS services charged-off debt from other third

parties and purchased portfolios. magnUS uses sophisticated modeling techniques to target collection efforts toward customers with a high probability of securing payment. Revenue is generated based on collection efforts through contracted contingency rates with third parties. Revenue for purchased portfolios is recognized through accretion accounting.

Enhancement Services

We market enhancement services in three principal lines of business:

Credit protection and insurance products, including:

- credit account protection benefits arising from death, unemployment, disability or family leave; and
- third-party insurance offered directly to our credit card customers.

Membership products, including:

- membership benefit programs in categories such as credit bureau monitoring, fraud prevention and resolution, travel, credit card purchase protection or automotive assistance.

Warranty products, including:

- extended service plans for third party retail products; and
- warranties for home appliances, systems and electronics.

We currently market the following programs:

Credit Protection and Insurance Products

Credit protection and insurance products are sold exclusively to Direct Merchants Bank credit card customers.

Account Protection Plus[SM] is a program that will waive the balance of a customer s Direct Merchants Bank credit card account (up to the credit limit) in the event of the cardholder s death. It further protects this account in the event of involuntary unemployment, disability or the need to take a Family Medical Leave Act leave of absence from employment. In these situations, the customer s account is frozen with no payments due or interest accruing up to the maximum period of time permissible for each event.

Account Benefit Plan is a program that will waive the balance of a customer s Direct Merchants Bank credit card account (up to the credit limit) in the event of the cardholder s death.

Credit Life Insurance offers our credit card customers traditional life insurance benefits that will pay the balance of the Direct Merchants Bank credit card account in the event of the cardholder s death. Additional coverage may be available on a state-by-state basis that will pay the minimum payment due on the covered account in the event of unemployment or disability. The insurance benefits are offered by insurance companies that reinsure those policies with ICOM Limited, our captive insurance subsidiary.

Syndicated Insurance Products. We cooperate with a variety of insurance companies to sell their regulated products to Direct Merchants Bank customers. These transactions may follow different constructs. In the simplest, the insurance company pays us a fee for access to a select list of customers, the opportunity to leverage Direct Merchants Bank s name during solicitation and billing processes that we support. When it is in our best interest, we acquire the marketing margin associated with product sales. In this construct, our licensed insurance agency, MES Insurance Agency, LLC, manages all customer solicitation and its expense in exchange for commission. Lastly, in low risk products, our captive insurance company, ICOM Limited, re-insures the risk of the policies sold. This may range from a minority percentage to all risk of loss. In this situation, the administrative costs of servicing these policies are borne by us.

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Membership Products

Membership products are sold to customers of Direct Merchants Bank, customers of third-party partners, and directly to consumers.

DirectAlert® helps members monitor and review their credit report through the following benefits:

- unlimited access to their credit report in easy to read paper or electronic (online) formats;
- regular monitoring updates detailing changes in their credit bureau report;
- information about inquiries or new trade lines opened in their name; and
- access to expert information to assist with handling disputes.

*Fraud Alert Services*SM provides members with a comprehensive ability to deal with the risks associated with the sudden loss of personal financial information. Members receive personal computer firewall software to protect their home computers from attacks by hackers. If credit cards or wallets are lost or stolen, members can have all their issuers notified with a single call and emergency cash or airline tickets can be delivered to travelers away from home. Should any member become the victim of identity theft, experts will help members resolve these issues by assisting with law enforcement officials, credit bureaus and other necessary parties.

PurchaseShield® is a membership program that offers various levels of purchase protection to its members. Eligible purchases made on members credit cards are protected with the following benefits:

- extended manufacturers warranty;
- sale price protection; and
- product return guarantee.

In addition, *PurchaseShield*® offers its members a household repair rebate that can be used on certain in-home electro-mechanical item repairs. This program is administered internally, and all revenues and expenses are our responsibility.

*RoadSaver*SM provides members with emergency roadside assistance, an automotive mechanic helpline, customized trip planning, and car buyer information services. Members are covered regardless of the car in which they are travelling, and a single *RoadSaver*SM membership covers all household family members.

*TripSaver*SM gives members a broad array of travel benefits access to a full service travel agency, driving vacation packages, restaurant and entertainment discounts, automotive maintenance rebates and other special travel offers.

Warranty Products

Extended Service Plans. We issue and administer extended service plans that provide warranty coverage beyond the manufacturer s warranty period. In general, the extended service plans that we issue and administer provide customers with the right to have their covered purchases repaired, replaced, or in certain circumstances, the purchase price of the product refunded, within certain limits that we determine. The extended service plans that we have historically sold were to customers of Fingerhut, and with the likely conclusion of catalog sales operations at Fingerhut, we anticipate these programs to be in run-off. We will issue and administer the following programs over a period of up to three years based upon the original term purchased by a consumer. We are responsible for all claims made during this period.

ServiceEdge® is an extended service plan issued and administered by us for consumer electronics and other electro-mechanical items. *ServiceEdge*® customers have the right to have their purchases repaired or replaced in

the event of electrical or mechanical failure or defects in materials and workmanship for covered events after the manufacturer s warranty expires.

*Quality Furniture Care*SM is our extended service plan program for furniture. The services provided to *Quality Furniture Care*SM customers include stain cleaning, structural defect or damage repair, or replacement if the merchandise cannot be repaired.

*Quality Jewelry Care*SM is our extended service plan for jewelry. The services provided to *Quality Jewelry Care*SM customers include repair, soldering, ring sizing, prong re-tipping and cleaning.

Home Warranties offer consumers a bundled coverage of existing home appliances, electronics, heating, ventilation, or air conditioning systems, plumbing and electrical service. These are relatively common products that protect the consumer beyond the usual manufacturer s warranty. We issue and administer products that offer a variety of coverages. We are responsible for all revenues and claims costs of these products. These products are marketed to the customers of Direct Merchants Bank and our third party partners, as well as to the broad market.

*Home ServiceEdge*SM covers repairs for up to 11 major home appliances and systems. It is targeted towards homeowners or consumers who have responsibility for the upkeep of their kitchen and utility appliances, and home heating/cooling systems. The plan will assist the customer in locating and arranging for repair service for covered products. In the event that a covered product cannot be fixed, we will pay a set dollar amount towards the replacement of the product. *Home ServiceEdge*SM offers several different coverage and price point options to customers based upon their individual need.

Home Electronics Warranty covers common consumer home electronics, principally audio-visual products. We have designed this product to appeal to a broad spectrum of consumers, whether they are homeowners or renters.

Competition

As a marketer of consumer lending products, we compete with numerous providers of financial services, many of which have greater resources than we do. In particular, our credit card business competes with national, regional and local bankcard issuers as well as other general purpose credit and debit card issuers. In general, customers are attracted to credit card issuers largely on the basis of price, credit limit and other product features; as a result, customer loyalty is often limited. However, we believe that our strategy of focusing on the moderate-income sector and our proprietary prospect database, proprietary models and internal credit scores allow us to compete effectively in the market for moderate-income cardholders. There are numerous competitors in the enhancement services market, including insurance companies, financial services institutions and other membership based or consumer-enhancement service providers.

Regulation

The Company and Direct Merchants Bank

Direct Merchants Bank is a limited purpose credit card bank chartered as a national banking association. It is a member of the Federal Reserve System. Its deposits are insured by the Bank Insurance Fund which is administered by the Federal Deposit Insurance Corporation (FDIC) and it is subject to comprehensive regulation and periodic examination by the Office of the Comptroller of the Currency (OCC), its primary regulator. It is also subject to regulation by the FDIC, as a back-up regulator. Direct Merchants Bank is not a bank as defined under the Bank Holding Company Act of 1956 (BHCA), as amended, because it:

- engages only in credit card operations;
- does not accept demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others;

- does not accept any savings or time deposits of less than $100,000, except for deposits pledged as collateral for extensions of credit;
- maintains only one office that accepts deposits; and
- does not engage in the business of making commercial loans.

If Direct Merchants Bank failed to meet the credit card bank criteria described above, Direct Merchants Bank s status as an insured bank would make us subject to the provisions of the BHCA. We believe that becoming a bank holding company would limit our ability to pursue future opportunities.

The OCC, as our primary regulator, has established operating guidelines for national banks. As part of their normal periodic examination process, the OCC may, in its sole discretion, require banks to modify or stop current practices based on their interpretation of those guidelines. Such changes to our current or planned practices may have an impact on the capital, liquidity, earnings and management of Direct Merchants Bank, which in turn may impact MCI.

The OCC, the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision are expanding previously issued examination guidance for supervising subprime lending activities. This expanded guidance includes expectations for the allowance for loan losses and regulatory capital. Under the expanded guidance, the allowance for loan losses required for subprime loans should be sufficient to absorb at least all estimated credit losses on outstanding balances over the current operating cycle, typically 12 months. Each subprime lender is responsible for quantifying the amount of capital needed to offset the additional risk in subprime lending activities, and for fully documenting the methodology and analysis supporting the amounts specified. Given the higher risk inherent in subprime lending programs, examiners may expect that Direct Merchants Bank would hold capital against subprime portfolios in an amount that is one and one half to three times greater than what is appropriate for non-subprime assets of a similar type.

Exportation of Interest Rates and Fees

Under current judicial interpretations of federal law, national banks such as Direct Merchants Bank may charge interest at the rate allowed by the laws of the state where the bank is located and may export those interest rates on loans to borrowers in other states, without regard to the laws of such other states.

The United States Supreme Court has held that national banks may also impose late payment fees, overlimit fees, annual fees, cash advance fees and membership fees allowed by the laws of the state where the national bank is located on borrowers in other states, without regard to the laws of such other states. The Supreme Court based its opinion largely on its deference to a regulation adopted by the OCC that has been interpreted to permit national banks to export interest rates. As a result, national banks such as Direct Merchants Bank may export such fees.

Dividends and Transfers of Funds

There are various federal law limitations on the extent to which Direct Merchants Bank can finance or otherwise supply funds to MCI and its affiliates through dividends, loans or otherwise. These limitations include:

- minimum regulatory capital requirements;
- restrictions concerning the payment of dividends out of net profits or surplus; and
- Sections 23A and 23B of the Federal Reserve Act governing transactions between a bank and its affiliates.

In general, federal law prohibits a national bank such as Direct Merchants Bank from making dividend distributions on common stock if the dividend would exceed currently available undistributed profits. In addition,

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Direct Merchants Bank must get OCC approval prior to paying a dividend, if such distribution would exceed current year net income combined with retained earnings from the prior two years. Direct Merchants Bank cannot make a dividend if the distribution would cause it to fail to meet applicable capital adequacy standards. Finally, although not a regulatory restriction, the terms of certain debt agreements prohibit the payment of dividends in certain circumstances.

Capital Adequacy

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) requires the banking agencies to prescribe certain non-capital standards for safety and soundness relating generally to operations and management, asset quality and executive compensation. FDICIA also provides that regulatory action may be taken against a bank that does not meet such standards.

The OCC has adopted regulations that define the five capital categories (well-capitalized, adequately-capitalized, undercapitalized, significantly-undercapitalized and critically-undercapitalized) identified by FDICIA, using the total risk-based capital, Tier 1 risk-based capital and leveraged capital ratios as the relevant capital measures. Such regulations establish various degrees of corrective action to be taken when an institution is considered undercapitalized. Under the regulations, a well-capitalized institution must have a Tier 1 capital ratio of at least 6%, a total capital ratio of at least 10% and a leverage ratio of at least 5% and not be subject to a capital directive order. Under these guidelines, Direct Merchants Bank is considered well-capitalized.

The OCC s risk-based capital standards explicitly consider a bank s exposure to declines in the economic value of its capital due to changes in interest rates when evaluating a bank s capital adequacy. Interest rate risk is the exposure of a bank s current and future earnings and equity capital arising from adverse movements in interest rates. The evaluation will be made as a part of the institution s regular safety and soundness examination.

The FDICIA requires the FDIC to implement a system of risk based premiums for deposit insurance pursuant to which the premiums paid by a depository institution will be based on the probability that the FDIC will incur a loss in respect of such institution. The FDIC has adopted a system that imposes insurance premiums based upon a matrix that takes into account a bank s capital level and supervisory rating.

Under FDICIA, only well-capitalized and adequately-capitalized banks may accept brokered deposits. Direct Merchants Bank may accept deposits as part of its funding and began issuing certificates of deposit (CDs) in the first quarter of 1999. These CDs are issued through third-party registered deposit brokers and directly to the public in increments of $100,000 or more.

Lending Activities

Direct Merchants Bank s activities as a credit card lender are also subject to regulation under various federal consumer protection laws including the Truth in Lending Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Community Reinvestment Act (CRA) and the Soldiers and Sailors Civil Relief Act. Regulators are authorized to impose penalties for violations of these statutes and, in certain cases, to order Direct Merchants Bank to pay restitution to injured cardholders. Cardholders may also bring actions for certain alleged violations of such regulations. Federal and state bankruptcy and debtor relief laws also affect Direct Merchants Bank s ability to collect outstanding balances owed by cardholders who seek relief under these statutes.

The OCC s CRA regulations subject limited purpose banks, including Direct Merchants Bank, to a community development test for evaluating required CRA compliance. The community development performance of a limited purpose bank is evaluated pursuant to various criteria involving community development lending, qualified investments and community development services.

Legislation

Congress has passed a financial services law that will require many of our business groups to disclose our practices for collection and sharing of non-public customer information. The regulations associated with this law could require us to limit or substantially modify our enhancement services and credit card marketing activities and practices with third-party companies in ways that could adversely affect us if these changes result in limits on sharing information. Furthermore, there is similar or related legislation currently pending or under consideration at the federal and state level.

From time to time legislation has been proposed in Congress to limit interest rates and fees that could be charged on credit card accounts or otherwise restrict practices of credit card issuers. If this or similar legislation is adopted, our ability to collect on account balances or maintain previous levels of finance charges and other fees could be adversely affected.

Additionally, the U.S. Senate and House of Representatives have each passed legislation that would amend the federal bankruptcy laws. This legislation, a form of which is expected to be signed into law, is generally considered to be favorable to the credit card industry. However, any changes to state debtor relief and collection laws could adversely affect us if such changes result in, among other things, accounts being charged off as uncollectible and additional administrative expenses. Congress and the states may in the future consider other legislation that would materially affect the credit card and related enhancement services industries.

Consumer and Debtor Protection Laws

Various federal and state consumer protection laws limit our ability to offer and extend credit. In addition, the U.S. Congress and the states may decide to regulate further the credit card industry by enacting laws or amendments to existing laws to reduce finance charges or other fees or charges applicable to credit card and other consumer revolving loan accounts. These laws may adversely affect our ability to collect on account balances or maintain established levels of periodic rate finance charges and other fees and charges with respect to the accounts. Similarly, Congress, the OCC and/or the states may decide to further regulate our enhancement services.

Investment in the Company and Direct Merchants Bank

Certain acquisitions of capital stock may be subject to regulatory approval or notice under federal law. Investors are responsible for insuring that they do not directly or indirectly acquire shares of our capital stock in excess of the amount that can be acquired without regulatory approval.

Interstate Taxation

Several states have passed legislation attempting to tax the income from interstate financial activities, including credit cards, derived from accounts held by their residents. We believe this legislation will not materially affect us. Our belief is based upon current interpretations of the enforceability of this legislation, prior court decisions and the volume of business in states that have passed this legislation.

Licensing Requirements

Several state and local government regulators require our subsidiaries to be licensed in order to offer our enhancement services insurance and warranty products in these states. We are in the process of obtaining licenses for these products in the remainder of states. Our captive insurance subsidiary, ICOM Limited, is licensed in Bermuda under The Insurance Act of 1978 as a Class 2 Insurer. We are restricted from writing any long-term policies or pursuing any unrelated business in excess of certain limits under Bermuda law.

Fair Credit Reporting Act

The Fair Credit Reporting Act (FCRA) regulates consumer reporting agencies. Under the FCRA, an entity risks becoming a consumer reporting agency if it furnishes consumer reports to third parties. A consumer report is a communication of information which bears on a consumer s creditworthiness, credit capacity, credit standing or certain other characteristics and which is collected or used or expected to be used to determine the consumer s eligibility for credit, insurance, employment or certain other purposes. The FCRA explicitly excludes from the definition of consumer report a report containing information solely as to transactions or experiences between the consumer and the entity making the report. An entity may share consumer reports with any of its affiliates so long as that entity provides consumers with an appropriate disclosure and an opportunity to opt out of such affiliate sharing.

Our objective is to conduct our operations in a manner that would fall outside the definition of consumer reporting agency under the FCRA. If we were to become a consumer reporting agency, however, we would be subject to a number of complex and burdensome regulatory requirements and restrictions. Such restrictions could have a significant adverse economic impact on us.

Employees

As of December 31, 2001, we had over 4,000 employees located in Arizona, Florida, Illinois, Maryland, Minnesota and Oklahoma. None of our employees are represented by a collective bargaining agreement. We consider our relations with our employees to be good.

Trademarks, Trade Names and Service Marks

MCI and its subsidiaries have registered and continue to register, when appropriate, various trademarks, tradenames and service marks used in connection with its business and for private label marketing of certain of its products. We consider these trademarks and service marks to be readily identifiable with, and valuable to, our business.

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Executive Officers of the Registrant

The following table sets forth certain information concerning the persons who currently serve as our executive officers. Each executive officer serves at the discretion of our Board of Directors.

Name	Age	Position
Ronald N. Zebeck	47	Chairman and Chief Executive Officer
David D. Wesselink	59	Vice Chairman
William R. Anderson	44	Executive Vice President, Enhancement Services
Richard G. Evans	53	Executive Vice President, General Counsel and Secretary
Patrick J. Fox	46	Executive Vice President, Business Development; President, Direct Merchants Bank
Joseph A. Hoffman	44	Executive Vice President, Consumer Credit Card Marketing/Operations
Matthew S. Melius	36	Executive Vice President, Credit Risk Management
Jon B. Mendel	50	Executive Vice President, Human Resources
David R. Reak	43	Executive Vice President, Risk Management/Recovery
Benson K. Woo	47	Chief Financial Officer
Dan N. Piteleski	51	Senior Vice President, Chief Information Officer
Ralph A. Than	41	Senior Vice President, Treasurer
Mark P. Wagener	41	Senior Vice President, Controller

Ronald N. Zebeck has been our Chairman and Chief Executive Officer since May 2000 and previously served as President and Chief Executive Officer since our incorporation in August 1996. Mr. Zebeck has been President of Metris Direct, Inc. since March 1994 and has served as Chairman of the Board of Direct Merchants Bank since August 1995. Prior to joining us, Mr. Zebeck was Managing Director, GM Card Operations of General Motors Corporation from 1991 to 1993, Vice President, Marketing and Strategic Planning of Advanta Corporation (Colonial National Bank USA) from 1987 to 1991, Director of Strategic Planning of TSO Financial (later Advanta Corporation) from 1986 to 1987, and held various credit card and credit related positions at Citibank affiliates from 1976 to 1986. Mr. Zebeck is also a director of MasterCard International, Inc.

David D. Wesselink has been Vice Chairman of the Company since September 2000. Mr. Wesselink previously held the position of Executive Vice President, Chief Financial Officer from December 1998. Prior to joining us, Mr. Wesselink was Senior Vice President and Chief Financial Officer of Advanta Corporation from 1993 to 1998. Prior to Advanta Corporation, he held several positions at Household Finance Corp. and Household International, Inc. from 1971 to 1993, including Senior Vice President from 1986 to 1993 and Chief Financial Officer from 1982 to 1993.

William R. Anderson has been Executive Vice President, Enhancement Services since February 2002. Mr. Anderson previously served as Senior Vice President, Enhancement Services from October 1999 to February 2002, and Senior Vice President, E-Commerce from February 1999 to October 1999. Prior to joining us, Mr. Anderson was Executive Vice President and Director of Marketing at Bank of America from 1996 to 1999. Prior to Bank of America, Mr. Anderson was General Director of U.S. Consumer Marketing at the GM Card operations at General Motors Corporation.

Richard G. Evans has been Executive Vice President, General Counsel and Secretary since June 2001. Prior to joining us, Mr. Evans was Executive Vice President, General Counsel and Director of Green Tree Financial

Corporation from 1985 to 1999. Prior to Green Tree, Mr. Evans served as Special Assistant Attorney General for the State of Minnesota from 1974 to 1984.

Patrick J. Fox has been Executive Vice President, Business Development since September 2000. Mr. Fox previously served as Senior Vice President, Business Development from March 1998. Prior to joining us, Mr. Fox held executive positions in the credit card group of Bank of America from 1994 to March 1998, including Director of Product Management and Business Development. Prior to Bank of America, Mr. Fox held various marketing and sales management positions with Bank One, which he joined in 1992, Comerica Bank and Citibank. Mr. Fox has been President of Direct Merchants Bank since March 2000.

Joseph A. Hoffman has been Executive Vice President, Consumer Credit Card Marketing/Operations since October 1999. Mr. Hoffman previously served as Senior Vice President, Consumer Credit Marketing from April 1998. Prior to joining us, Mr. Hoffman was Vice President of Marketing at Advanta Corporation from June 1994 to April 1998, where he held a variety of positions including Director of Brand Management and Affinity and Co-Brand Marketing. Before that, Mr. Hoffman was Vice President, Area Director, in Citibank s Card Product Group, which he joined in 1980. During his fourteen-year tenure with Citibank, Mr. Hoffman held a variety of marketing and operations positions with Citibank s Bankcard and Private Label businesses.

Matthew S. Melius has been Executive Vice President, Credit Risk Management since January 2001. Mr. Melius previously served as Executive Vice President, E-Commerce from September 2000, Senior Vice President, E-Commerce from January 2000, Senior Vice President, Portfolio Marketing from January 1998, Vice President, Portfolio Marketing from January 1997, and Director, Portfolio Marketing from September 1995. Prior to joining us, Mr. Melius was Director, Customer Retention of First National Bank of Omaha in the Credit Card Division from 1989 to 1995.

Jon B. Mendel has been Executive Vice President, Human Resources since May 1998. Prior to joining us, Mr. Mendel was Senior Vice President, Human Resources at TCF Financial Corporation. Prior to TCF, Mr. Mendel held various positions at the St. Paul Companies, including Vice President, Human Resources of the St. Paul Fire and Marine Insurance Company.

David R. Reak has been Executive Vice President, Risk Management/Recovery since October 1999. Mr. Reak previously served as Senior Vice President, Credit Risk from November 1998. Mr. Reak was appointed Vice President, Credit Risk in October 1996 and previously served as Senior Director, Credit Risk of Metris Direct, Inc. from December 1995 to October 1996. Prior to joining us, he held several positions at American Express Travel Related Services Company, including Senior Manager, Credit Risk Management Europe and Middle East from 1994 to December 1995, Senior Manager, Credit Risk Management U.S. Consulting Group from 1992 to 1994, and Project Manager, Credit Research and Analysis from 1990 to 1992.

Benson K. Woo has been Chief Financial Officer since September 2000. Mr. Woo previously held the position of Senior Vice President, Finance from October 1999. Prior to joining us, Mr. Woo was Vice President and Chief Financial Officer of York International Corporation from 1998 to 1999. Prior to York International Corporation, he was Vice President and Treasurer of Case Corporation from 1994 to 1998. Prior to that, he held several positions at General Motors Corporation from 1979 to 1994, including Finance Director, GM Credit Card Operations from 1992 to 1994.

Dan N. Piteleski has been Senior Vice President, Chief Information Officer since April 2001. Prior to joining us, Mr. Piteleski was Vice President, Chief Information Officer of H.B. Fuller Company from 1995. Prior to H.B. Fuller, he was Vice President, Information Systems at Zenith Data Systems from 1992, and Manager, Information Systems and Technology at Apple Computer from 1988.

Ralph A. Than has been Senior Vice President, Treasurer since May 2000. Prior to joining us, Mr. Than was Vice President, Treasurer of CNH Capital Corporation, the finance subsidiary of CNH Global N.V. from 1998 to 2000. Before that, he was Group Controller of the Agricultural Systems Business Unit of Case Corporation from 1997 to 1998.

Mark P. Wagener has been Senior Vice President, Controller since October 2001. Mr. Wagener previously served as Vice President, Assistant Controller from June 2000. Prior to joining us, he held several positions at Norwest Corporation (Wells Fargo & Company) from 1988 to 1999. Prior to Norwest, Mr. Wagener was an audit manager at Arthur Andersen LLP from 1982 to 1987.

Our officers are elected by, and hold office at the will of, our Board of Directors and do not serve a term of office as such.

Risk Factors

This Annual Report on Form 10-K contains certain forward-looking statements and information relating to MCI that are based on the beliefs of our management as well as assumptions made by, and information currently available to, our management. These forward-looking statements involve risks and uncertainties that could cause our actual results to differ materially from such statements. You should not place undue reliance on these forward-looking statements as they speak only of our views as of the date the statement was made and are not a guarantee of future performance.

Forward-looking statements include statements and information as to our strategies and objectives, growth in earnings per share, return on equity, growth in our managed loan portfolio, net interest margins, funding costs, operating costs and marketing expenses, delinquencies and charge-offs and industry comparisons or projections. 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 express relate to the Company or our management. These statements reflect management s current views with respect to future events and are subject to certain risks, uncertainties and assumptions.

The factors discussed below, among others, could cause our actual results to differ materially from those expressed in any forward-looking statements. Although we have attempted to list comprehensively these important factors, we caution you that other factors may in the future prove to be important in affecting our results of operations. New factors emerge from time to time and it is not possible for us to predict all of these factors, nor can we assess the impact of each such factor on the business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statement.

Our Target Market for Consumer Lending Products Has Higher Default and Bankruptcy Rates

The primary risk associated with secured and unsecured lending to moderate-income consumers is higher default rates than other income classes of consumers, resulting in more accounts being charged off as uncollectible. In addition, general economic factors, such as the rate of inflation, unemployment levels and interest rates, may result in greater delinquencies and credit losses among moderate-income consumers than among other income classes of consumers. A recession or economic downturn may cause an increase in default rates and delinquencies. We may be unable to successfully identify and evaluate the creditworthiness of our target customers to minimize the expected higher delinquencies and losses. We also cannot assure you that our risk-based pricing system can offset the negative impact on profitability that the expected greater delinquencies and losses may have.

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We May Not be Able to Sustain and Manage Growth

In order to meet our strategic objectives, we plan to continue to expand our credit card loan portfolio. Continued growth in this area depends largely on:

- our ability to attract new cardholders;
- growth in both existing and new account balances;
- the degree to which we lose accounts and account balances to competing card issuers;
- levels of delinquencies and losses;
- the availability of funding, including securitizations, on favorable terms;
- general economic and other factors such as the rate of inflation, unemployment levels and interest rates, which are beyond our control;
- our ability to acquire and integrate portfolios; and
- stability and growth in management.

Our continued growth also depends on our ability to manage this growth effectively. Factors that affect our ability to successfully manage growth include:

- retaining and recruiting experienced management personnel;
- finding and adequately training new employees;
- cost-effectively expanding our facilities;
- growing and updating our management systems; and
- obtaining capital when needed.

We May Not be Able to Successfully Market Our Enhancement Services or Sign Additional Marketing Alliances

We target our enhancement services to our credit card customers and customers of third parties. Because of the variety of offers provided and the diversity of the customers targeted, we are uncertain about how many customers will respond to our offers for these enhancement services. We may experience higher than anticipated costs in connection with the internal administration and underwriting of these enhancement services and lower than anticipated response or retention rates.

Furthermore, we may be unable to expand the enhancement services business or maintain historical growth and stability levels if:

- we cannot successfully market credit cards to new customers;

existing credit card customers close accounts voluntarily or involuntarily;

existing enhancement services customers cancel their services;

we cannot form marketing alliances with other third parties or existing marketing alliances with third parties terminate; or

new or restrictive federal or state regulations limit our ability to market or sell enhancement services.

Our Profitability and Ability to Grow is Dependent on Our Funding Sources

Securitization Markets

As of December 31, 2001, 70% of our receivables were funded through the securitization market. These markets could undergo disruptions which adversely affected the ability of companies like us to raise money from

these sources. Factors impacting these markets include current economic conditions, the financial condition of other institutions accessing these markets and national/world events. Furthermore, our ability to securitize our receivables depends on the legal, regulatory and tax environment for such transactions.

In addition, even if we are able to securitize our receivables consistent with past practice, poor performance of our securitized receivables, including increased delinquencies and credit losses, lower payment rates or a decrease in excess spreads below certain thresholds could result in a downgrade or withdrawal of the ratings on the outstanding securities issued in our securitization transactions, cause early amortization of such securities or result in higher required credit enhancement levels. As a result, poor performance of our securitized receivables could divert significant amounts of cash that would otherwise be available to us. This could jeopardize our ability to complete other securitization transactions on acceptable terms, decrease our liquidity and force us to rely on other potentially more expensive funding sources, to the extent available. We cannot assure you that the securitization market will continue to offer suitable funding alternatives.

Credit Facility

We rely on our credit facility to fund our operations and growth. If we breach any of our covenants under our credit facility, including various financial covenants, the lenders may terminate the facility. Disruptions in the securitization market could negatively affect our ability to comply with these covenants, and therefore our ability to borrow or replace this facility could be adversely affected.

CD Program

Direct Merchants Bank issues certificates of deposit in increments of $100,000 or more. We expect to use the proceeds of these deposits to fund our operations and growth. In order to maintain our current level of access to the certificate of deposit market, Direct Merchants Bank must maintain a well-capitalized rating, as that rating is defined by the OCC. If it does not do so, Direct Merchants Bank may be required to modify the program and may not be able to accept additional deposits.

Other Funding Sources

We also expect to obtain financing by selling debt and equity securities. Our ability to obtain such financing is dependent upon many factors, including general market conditions. We cannot assure you that we will be able to obtain this financing on favorable terms or at all. In addition, restrictions contained in our debt agreements may adversely affect our ability to finance future operations or capital needs or to engage in other business activities.

Our ability to obtain financing from the various sources available to us is dependent upon many factors, including those outside of our control. In addition, disruptions or unfavorable conditions related to one financing source may negatively affect our ability to access other financing sources, or may increase our financing costs.

We Require a High Degree of Liquidity to Operate Our Business

We depend on cash flows from operations, asset securitizations, bank loans, subsidiary bank deposit programs, long-term debt and equity issuances to fund our operations and growth. The loss or interruption of any of these sources of funding could adversely affect our ability to operate.

Key elements of our strategy are dependent upon us having adequate available cash. These cash needs include:

- funding receivable growth through marketing campaigns;
- additional credit enhancement in the case of poor performance of our securitized assets;

- interest and principal payments under our securitizations, our credit agreement, our existing senior notes and other indebtedness;
- ongoing operating expenses;
- maintenance of the well-capitalized status of our subsidiary, Direct Merchants Bank, which is necessary to maintain the CD program;
- portfolio and business acquisitions;
- fees and expenses incurred in connection with the securitization of receivables and the servicing of them; and
- tax payments due on receipt of excess cash flow from securitization trusts.

Given these cash needs, we anticipate that we will need to enter into financing transactions on a regular basis. We cannot assure you that we will be able to secure funds to support our cash needs on terms as favorable as past transactions. Any adverse change in the funding sources we use could force us to rely on other potentially more expensive funding sources, to the extent available, and could have other adverse consequences. If any of our funding sources become limited it may require us to use more expensive sources of funding. Any material increase in our costs of financing beyond our expectations could negatively impact us.

Interest Rate Fluctuations Impact the Yield on Our Assets and Funding Expense

An increase or decrease in market interest rates could have a negative impact on the net interest spread between the yield on our assets and our cost of funding. A rise in market interest rates may indirectly impact the payment performance of our customers. We try to minimize the impact of changes in market interest rates on our cash flow, asset value and net income primarily by funding variable-rate assets with variable-rate funding sources and by using interest rate derivatives to match asset and liability repricings. However, changes in market interest rates may have a negative impact on us.

We May Not be Able to Successfully Integrate Portfolio Acquisitions

As previously mentioned, our growth may depend on our ability to acquire and successfully integrate new portfolios of credit card customers. Since our risk-based pricing system depends on information regarding customers, limited or unreliable historical information on customers within an acquired portfolio may have an impact on our ability to successfully and profitably integrate that portfolio. Our success also depends on whether the desirable customers of an acquired portfolio close their accounts after transfer of the portfolio. A large attrition rate would result in a lower borrowing base upon which to assess fees, higher costs relating to closing accounts and less potential for marketing enhancement services. In addition, if customers reduce their borrowings after the transfer of accounts, the acquired portfolio may be less profitable than originally expected.

Current and Proposed Regulation and Legislation Limit Our Business Activities, Product Offerings and Fees Charged

Various federal and state laws and regulations significantly limit the activities in which we and Direct Merchants Bank are permitted to engage. Such laws and regulations, among other things, limit the fees and other charges that we are allowed to charge, limit or prescribe certain other terms of our products and services, require specified disclosures to consumers, govern the sale and terms of products and services we offer and require that we maintain certain licenses, qualifications, or capital requirements (see Business Regulation on pages 14 through 18 of this Report). In some cases, the precise application of these statutes and regulations is not clear. In addition, the regulatory framework at the state and federal level regarding some of our enhancement services is evolving. The regulatory framework affects the design or profitability of such products and our ability to sell certain products. In addition, numerous legislative and regulatory proposals are advanced each year which, if

adopted, could adversely affect our profitability or further restrict the manner in which we conduct our activities. The failure to comply with, or adverse changes in, the laws or regulations to which our business is subject, or adverse changes in the interpretation thereof, could adversely affect our ability to collect our receivables and generate fees on the receivables which could have a material adverse effect on our business.

The Impact of Existing, Pending and Possible Future Privacy Laws Could Result in Lower Marketing Revenue and Penalties for Non-Compliance

Effective July 2001, the federal Gramm-Leach-Bliley Act requires many of our business groups to disclose our practices for collection and sharing of non-public customer information. Changes to this law, or enactment of new laws, have required and could further require us to limit or substantially modify our enhancement services and credit card marketing activities and practices with third-party companies in ways that would most likely decrease our revenue from that business. These initiatives could require us to end substantially all of our marketing efforts with third parties and may even adversely affect the ability of the subsidiary through which we issue our credit card products, Direct Merchants Bank, to share information about its customers with other MCI affiliates, particularly enhancement services. The curtailment of our marketing efforts directed to our customer base and third-party customers would significantly negatively impact our business.

The privacy laws require us to provide initial and continuing disclosures regarding our information sharing practices. The laws also require us to monitor these disclosures and customer responses so that we do not unlawfully disclose information about a customer who has directed us not to do so. If we do not adequately manage the requirements, we may face regulatory sanctions, including fines, and consumer class action litigation.

Other Industry Risks Related to Consumer Lending Products and Enhancement Services Could Negatively Impact Us

We face a number of risks associated with unsecured lending. These include the risk that delinquencies and credit losses will increase because of future economic downturns; the risk that an increasing number of customers will default on the payment of their outstanding balances or seek protection under bankruptcy laws; and the risk that fraud by cardholders and third parties will increase. We also face the risk that increased criticism from consumer advocates and the media could hurt consumer acceptance of our products, as well as the risk of litigation, including class action litigation, challenging our product terms, rates, disclosures, collections or other practices, under state and federal consumer protection statutes and other laws.

Due to Intense Competition in Our Consumer Lending Products and Enhancement Services Businesses, We May Not be Able to Compete Successfully

We face intense and increasing competition from numerous financial services providers, many of which have greater resources than us. In particular, our credit card business competes with national, regional and local bankcard issuers, as well as other general purpose and private label credit card issuers. There has been a recent increase in solicitations to moderate-income consumers, as competitors have increasingly focused on this market. Customers are attracted to credit card issuers largely on the basis of price, credit limit and other product features; as a result, customer loyalty is often limited. According to published reports, as of December 2001, the 20 largest issuers accounted for approximately 90% (based on receivables outstanding) of the market for general purpose credit cards. Many of these issuers are substantially larger, have more seasoned credit card portfolios and often compete for customers by offering lower interest rates and/or fee levels than us. We cannot assure you that we will be able to compete successfully in this environment.

We also face competition from numerous enhancement services providers, including insurance companies, financial services institutions and other membership-based or consumer services providers. As we continue to expand our extended service plan business to the customers of third-party retailers, we compete with manufacturers, financial institutions, insurance companies and a number of independent administrators.

Item 2. Properties

We currently lease our principal executive office space in Minnetonka, Minnesota, consisting of leases for approximately 300,000 and 19,000 square feet. These leases expire in December 2011 and March 2005, respectively. We also lease 15,000 square feet of warehouse space in Minnetonka, Minnesota, which expires in October 2003. Direct Merchants Bank leases office space in Scottsdale, Arizona, consisting of approximately 26,000 square feet. This lease will terminate by advance notice in June 2002. In addition, Direct Merchants Bank purchased a 130,000 square foot building in Scottsdale, Arizona in 1999. This building serves as western regional headquarters for us and Direct Merchants Bank s operation center. In addition, we lease facilities in Tulsa, Oklahoma, White Marsh, Maryland, Jacksonville, Florida, Champaign, Illinois, and Duluth, Minnesota, consisting of approximately 100,000, 115,000, 160,000, 15,000 and 20,000 square feet, respectively. These leases expire in December 2010, September 2007, June 2005, March 2002 and September 2006, respectively. The leased properties in Oklahoma, Maryland, Florida and Duluth, Minnesota support our collections, customer service and back office operations. We also own our Hispanic operations center in Orlando, Florida, which consists of approximately 25,000 square feet. We believe our facilities are suitable to our businesses and that we will be able to lease or purchase additional facilities as needed.

Item 3. Legal Proceedings

We are a party to various legal proceedings resulting from the ordinary business activities relating to our operations. In July 2000 an Amended Complaint was filed in Hennepin County District Court in Minneapolis, Minnesota against MCI and our subsidiaries Metris Direct, Inc. and Direct Merchants Bank. The complaint seeks damages in unascertained amounts and purports to be a class action complaint on behalf of all cardholders who were issued a credit card by Direct Merchants Bank and were allegedly assessed fees or charges that the cardholder did not authorize. Specifically, the complaint alleges violations of the Minnesota Prevention of Consumer Fraud Act, the Minnesota Deceptive Trade Practices Act and breach of contract. On February 1, 2002, preliminary approval of a class action settlement was signed by the Court whereby we will pay approximately $5.5 million for attorneys fees and costs incurred by attorneys for the plaintiffs in separate lawsuits filed in Arizona, California and Minnesota in 2000 and 2001. Under the terms of the settlement, we denied any wrongdoing or liability. A final settlement approval hearing is scheduled for May 30, 2002.

On May 3, 2001, Direct Merchants Bank entered into a consent order with the Office of the Comptroller of the Currency (OCC). The consent order required Direct Merchants Bank to pay approximately $3.2 million in restitution to approximately 62,000 credit card customers who applied for and received a credit card in connection with a series of limited test marketing campaigns from March 1999 to June 2000. Under the terms of the consent order, Direct Merchants Bank made no admission or agreement on the merits of the OCC s assertions. The restitution as required by the OCC consent order was paid and is reflected in our December 31, 2001 financial statements. We believe that Direct Merchants Bank s agreement with the OCC will not have a material adverse effect on the financial position of MCI or Direct Merchants Bank.

In May 2001, the OCC also indicated that it was considering whether to pursue an assessment of civil money penalties and gave Direct Merchants Bank the opportunity to provide information to the OCC bearing on whether imposing a penalty would be appropriate and the severity of any penalty. The statutory provisions pursuant to which a civil money penalty could be assessed give the OCC broad discretion in determining whether or not a penalty will be assessed and, if so, the amount of the penalty. Because we are unable at this time to determine whether or not any civil money penalty will be assessed, there can be no assurance that the resolution of this matter will not have a material adverse effect on our financial position.

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

No matter was submitted to a vote of security holders during the fourth quarter of our fiscal year ended December 31, 2001.

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PART II

Item 5. Market for Registrant s Common Equity and Related Stockholder Matters

The information required by Item 201 of Regulation S-K is set forth in the Summary of Consolidated Quarterly Financial Information and Stock Data on pages 86 and 87 of this Report.

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Item 6. Table 1: Selected Financial Data

Owned Basis

(In thousands, except EPS, dividends and stock prices)	Year Ended December 31, 2001	2000	1999	1998	1997	Four-Year Compound Growth Rate
Income Statement Data:						
Net interest income	$ 530,710	$ 371,772	$ 180,328	$ 82,698	$ 57,243	74.5%
Provision for loan losses	549,145	388,234	174,800	77,770	43,989	88.0
Other operating income	1,154,457	933,787	623,772	315,480	187,796	57.5
Other operating expense	714,154	594,414	437,984	227,160	139,167	50.5
Income before income taxes, extraordinary loss and cumulative effect of accounting changes	421,868	322,911	191,316	93,248	61,883	61.6
Tax rate	38.3%	38.5%	39.7%	38.5%	38.5%	
Net income (1)	$ 260,291	$ 198,591	$ 115,363	$ 57,348	$ 38,058	59.4
Per Common Share Statistics:						
EPS diluted (1)	$ 2.62	$ 2.15	$ 1.41	$ 0.94	$ 0.63	40.7
Stock price (year-end split adjusted)	25.71	26.31	23.79	16.77	11.42	22.5
Dividends paid (split adjusted)	0.040	0.033	0.017	0.013	0.010	
Book value per common share equivalent (split adjusted) (2)	12.00	9.68	7.38	5.85	3.05	40.8
Shares outstanding (year-end)	63,419	62,243	57,919	57,779	57,675	
Shares used to compute EPS (diluted)	99,366	92,582	76,324	59,905	60,715	
Selected Operating Data:						
Total accounts	4,929	4,464	3,680	2,972	2,293	21.1
Year-end loans	$ 4,010,311	$ 3,202,884	$ 1,763,009	$ 756,899	$ 480,626	70.0
Year-end assets	4,228,686	3,736,025	2,045,082	945,719	538,662	67.4
Average loans	3,605,126	2,484,292	1,167,072	596,380	356,817	78.3
Average interest-earning assets	3,955,328	2,707,769	1,303,528	636,133	403,375	77.0
Average assets	3,903,846	2,826,653	1,449,297	774,167	417,903	74.8
Average total equity	1,011,573	759,633	542,050	219,835	158,180	59.0
Year-end deposits	2,058,008	2,106,199	775,381			
Year-end debt	647,904	356,066	345,012	310,896	244,000	27.7
Year-end preferred stock	393,970	360,421	329,729	201,100		
Return on average assets (1)	6.7%	7.0%	8.0%	7.4%	9.1%	
Return on average total equity (1)	25.7%	26.1%	21.3%	26.1%	24.1%	
Selected Enhancement Services Data:						
Revenue:						
Credit protection	$ 202,300	$ 149,421	$ 109,502	$ 73,773	$ 47,550	43.6
Membership products	94,695	75,981	31,858	13,301	4,905	109.6
Warranty/other	43,137	40,798	33,731	22,049	12,077	37.5
Total revenue	340,132	266,200	175,091	109,123	64,532	51.5
Year-end deferred revenue	185,132	199,796	127,541	72,866	35,461	51.2
Year-end deferred acquisition costs	79,400	74,084	45,837	23,726	15,778	49.8%
Total enrollments	3,475	4,809	3,294	2,441	2,143	12.8
Third-party enrollments	1,398	1,675	1,336	1,316	1,124	5.6
Active members	5,775	6,067	4,902	3,619	2,997	17.8

(1) Excluding the one-time, non-cash accounting impacts from the adoption of SFAS 133 in January 2001 for our interest rate derivative instruments, the adoption of Staff Accounting Bulletin No. 101 for our debt waiver products in March 2000, and the extinguishment of the Series B Preferred Stock and 12% Senior Notes and the cancellation of warrants in June 1999. (Refer to Note 8 of the Consolidated Financial Statements for additional information.)

(2) Book value is calculated assuming conversion of preferred stock.

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Table 2: Selected Financial Data

Managed Basis (1)	Year Ended December 31,					Four-Year Compound Growth Rate
	2001	2000	1999	1998	1997	
(In thousands, except EPS)						
Income Statement Data:						
Net interest income	$ 1,492,935	$ 1,074,875	$ 828,246	$ 505,812	$ 306,361	48.6%
Provision for loan losses	1,309,728	917,905	742,537	534,124	319,299	42.3
Other operating income	952,815	760,355	543,591	348,720	213,988	45.3
Other operating expense	714,154	594,414	437,984	227,160	139,167	50.5
Income before income taxes, extra-ordinary loss and cumulative effect of accounting changes	421,868	322,911	191,316	93,248	61,883	61.6
Tax rate	38.3%	38.5%	39.7%	38.5%	38.5%	
Net income (2)	$ 260,291	$ 198,591	$ 115,363	$ 57,348	$ 38,058	59.4
Per Common Share Statistics:						
EPS diluted (2)	$ 2.62	$ 2.15	$ 1.41	$ 0.94	$ 0.63	40.7
Selected Operating Data:						
Year-end loans	$ 11,906,153	$ 9,273,108	$ 7,281,322	$ 5,315,042	$ 3,546,936	35.4
Year-end assets	12,124,528	9,806,249	7,563,394	5,503,862	3,604,972	35.4
Average loans	10,349,217	8,021,437	6,003,791	4,000,467	2,294,893	45.7
Average interest-earning assets	10,699,419	8,244,914	6,140,247	4,040,220	2,341,451	46.2
Average assets	10,656,156	8,332,500	6,269,760	4,159,171	2,355,978	45.8
Return on average assets (2)	2.4%	2.4%	1.8%	1.4%	1.6%	
Equity to managed assets	9.4%	9.0%	8.2%	7.9%	4.9%	
Net interest margin (3)	14.0%	13.0%	13.5%	12.5%	13.1%	
Loan loss reserves	$ 947,658	$ 763,975	$ 619,028	$ 393,283	$ 244,084	40.4
Reserves as a percent of 30-day plus receivables (4)	84%	100%	111%	109%	105%	
Delinquency ratio (4)(5)	9.4%	8.3%	7.6%	6.8%	6.6%	
Loan loss reserve ratio	8.0%	8.2%	8.5%	7.4%	6.9%	
Net charge-off ratio (6)	11.0%	9.7%	9.0%	10.1%	8.3%	

(1) MCI analyzes its financial performance on a managed loan portfolio basis whereby the income statement and balance sheet are adjusted to reverse the effects of sale accounting under SFAS 140.

(2) Excluding the one-time, non-cash accounting impacts from the adoption of SFAS 133 in January 2001 for our interest rate derivative instruments, the adoption of Staff Accounting Bulletin No. 101 for our debt waiver products in March 2000, and the extinguishment of the Series B Preferred Stock and 12% Senior Notes and the cancellation of warrants in June 1999. (Refer to Note 8 of the Consolidated Financial Statements for additional information.)

(3) Includes MCI s actual cost of funds plus all costs associated with asset securitizations, including the interest expense paid to certificate holders and amortization of the discount and fees.

(4) Figures as of December 31, 2001 reflect the adoption of FFIEC guidelines on re-aging accounts effective January 1, 2001. Excluding the re-age impact the delinquency ratio as of December 31, 2001 was 9.1%.

(5) Delinquency ratio represents credit card loans that were at least 30 days contractually past due at year-end as a percentage of year-end managed loans.

(6) Net charge-off ratio reflects actual principal amounts charged off, less recoveries, as a percentage of average managed credit card loans. The net charge-off ratio at December 31, 2001 reflects an additional write-off of $34 million resulting from a change in charge-off policy to 120 days from 180 days for accounts that enter into a credit counseling or similar program and later become delinquent.

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Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

Year Ended December 31, 2001 Compared to Year Ended December 31, 2000

Net income applicable to common stockholders for the year ended December 31, 2001 was $211.0 million, or $2.47 per diluted share, up from net income applicable to common stockholders of $163.5 million, or $2.11 per diluted share in 2000. The increase in net income results from an increase in net interest income and other operating income partially offset by increases in the provision for loan losses and other operating expenses. These increases are largely attributable to the growth in average managed loans. Average managed loans increased to $10.3 billion for the year ended December 31, 2001 from $8.0 billion in 2000, an increase of 29%. In addition, credit card charge volume was approximately $9.9 billion for the full year 2001, a 23% increase over the same period in 2000.

The provision for loan losses on a managed basis was $1.3 billion in 2001 compared to $0.9 billion in 2000. The increase relates to the estimated required balance in the allowance for loan losses to cover future charge-offs inherent in our owned loan portfolio and an amount to reduce the contractual value of the retained interests in securitized loans to fair value as of December 31, 2001. Higher credit card loan balances, increased net charge-offs, increased delinquency rate and the current economic environment were factors considered by management in determining the necessary balance in the allowance for loan losses. The managed net charge-off rate was 11.0% in 2001 compared to 9.7% in 2000. The delinquency ratio was 9.4% in 2001 compared to 8.3% in 2000. Excluding the FFIEC guidelines on re-aging accounts adopted January 1, 2001, which required us to report an additional $36.1 million in receivables as delinquent as of December 31, 2001, the delinquency ratio was 9.1% in 2001.

Other operating income on a managed basis increased $192.5 million, or 25%, to $952.8 million for the year ended December 31, 2001. This increase was primarily due to credit card fees, interchange fees and other credit card income, which increased to $613.4 million in 2001, up 21% over $505.2 million in 2000. Enhancement services revenues increased 28% to $340.1 million in 2001, up from $266.2 million in 2000. These increases were primarily due to the growth in total credit card accounts, an increase in outstanding receivables in the managed credit card loan portfolio, development of new third-party relationships and the creation of new products.

Other operating expenses increased to $714.2 million in 2001, compared to $594.4 million in 2000. This increase was primarily due to continued investments in our infrastructure in order to service the growth in our managed credit card loan portfolio, an increase in overall marketing expenditures and increased amortization on purchased portfolio premiums. Our managed operating efficiency ratio decreased to 31.1% in 2001 from 32.4% in 2000 due to increased economies of scale and management cost saving initiatives begun in the latter part of 2001.

On January 1, 2001, we adopted Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities,* which establishes accounting and reporting standards for derivative instruments. SFAS 133 requires enterprises to recognize all derivatives as either assets or liabilities in the statement of financial position and to measure those instruments at fair value. Prior to SFAS 133, we amortized the costs of interest rate contracts on a straight-line basis over the expected life of the contract. The adoption of SFAS 133 resulted in a one-time, non-cash, after-tax charge to earnings of $14.5 million reflected as a Cumulative effect of accounting change in the consolidated statements of income for the year ended December 31, 2001. During 2001, $1.2 million was recorded as a reduction to interest expense and a $13.6 million gain was recognized as a result of recording derivatives that did not qualify for hedge accounting treatment at fair value and hedge ineffectiveness.

In September 2000, the Financial Accounting Standards Board issued SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* which replaces SFAS 125, and revises the accounting standards and disclosure requirements for securitizations and transfers of financial assets and

collateral. It requires enterprises to recognize, upon transfer of financial assets, the financial and servicing assets it controls and the liabilities it has incurred, derecognize financial assets when control has been surrendered, and derecognize liabilities when extinguished. This statement is effective for transfers and servicing of financial assets and extinguishment of liabilities occurring after March 31, 2001. The recognition and reclassification of collateral and additional disclosures related to securitization transactions and collateral were effective for fiscal years ending after December 15, 2000. The adoption of the new standard did not have a material impact on our financial statements.

During the quarter ended March 31, 2000, we adopted Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements,* for our debt waiver products. This SAB formalized the accounting for services sold where the right to a full refund exists, requiring all companies to defer recognition of revenues until the cancellation period is complete. Previously, we recognized half of the revenues in the month billed and half in the following month. We now recognize all of the revenue the month following completion of the cancellation period. This change resulted in a one-time, non-cash net charge to earnings of $3.4 million, which is reflected as a Cumulative effect of accounting change in the consolidated statements of income for the year ended December 31, 2000. Because we have applied the provisions of this SAB to our membership programs since 1998, before the SEC formalized its guidance, we did not have to adjust our enhancement services revenues.

Critical Accounting Policies

The Company s accounting policies are identified on pages 55 through 60 of this Report, the most significant of which is our determination of the allowance for loan losses, valuation of retained interests and accounting for deferred origination costs.

Allowance for loan losses

We maintain the allowance for loan losses on our owned loan portfolio to cover management s estimate of the inherent losses as of the balance sheet date and an amount to reduce the contractual value of the retained interests in securitized loans to fair value. In evaluating the adequacy of the allowance for loan losses, we consider several factors, including: historical charge off and recovery activity by age (vintage) of each loan portfolio (noting any particular trends over recent periods); recent delinquency and collection trends by vintage; current economic conditions and the impact such conditions might have on borrowers ability to repay; the risk characteristics of the portfolios; overall payment trends; bankruptcy rates; and other factors. These factors are reflected in financial projections prepared by the Company to estimate future charge-offs in the portfolio, which the Company uses to support the amount of the allowance for loan losses as of the balance sheet date. Significant changes in these factors could impact our financial projections and thereby affect the adequacy of our allowance for loan losses.

Retained interest

We maintain an allowance for loan losses on our sold credit card receivables that effectively reduces our retained interests to fair value. The Company validates the fair value of the net retained interests by calculating the present value of future expected cash flows using management s best estimate of key assumptions including credit losses, net spreads, revolver rates and a discount rate commensurate with the risks involved. The

significant assumptions used at year-end for estimating the fair value of the retained interest in loans securitized are as follows:

	At December 31,	
	2001	2000
Annual discount rate	15%	15%
Monthly payment rate	7%	7%
Weighted-average spread (1)	20%	16%
Annual principal and finance charge default rate	18%	16%

(1) Includes finance charges, late fees and overlimit fees, less weighted-average cost of funds and 2% servicing fee.

At December 31, 2001, the sensitivity of the current fair value of the retained interests to immediate 10 percent changes are as follows:

	Impact on Fair Value (in millions) of a 10% Increase or Decrease
Annual discount rate	$ 15
Monthly payment rate	1
Weighted-average spread	164
Annual principal and finance charge default rate	183

As the sensitivity indicates, the value of the Company s retained interests on its balance sheet, as well as reported earnings, could differ significantly if different assumptions or conditions would prevail.

Deferred acquisition costs

We defer direct credit card origination costs associated with successful credit card solicitations that we incur in transactions with independent third parties, and certain other costs that we incur in connection with loan underwriting and the preparation and processing of loan documents. These costs, which relate directly to membership solicitations (direct response advertising costs), principally include postage, printing, mailings and telemarketing costs. The total amount of deferred costs as of December 31, 2001 and 2000 were $89.5 million and $79.2 million, respectively. The most significant assumption used by the Company in determining the realizability of these deferred costs is future revenues from our credit cards and enhancement services products. A significant reduction in revenues could have a material impact on the values of these balances.

Deferred revenue on Enhancement Services Products

Direct Merchants Bank offers various debt waiver products to its credit card customers. Revenue for such products is recognized in the month following completion of the cancellation period, and reserves are provided for pending claims based on Direct Merchants Bank s historical experience with settlement of such claims. Unearned revenues and reserves for pending claims are recorded as Deferred income and Accrued expenses and other liabilities, respectively. We record fees on membership programs as deferred income upon acceptance of membership and amortize them on a straight-line basis over the membership period beginning after the contractual cancellation period is complete. We defer and recognize extended service plan revenues and the incremental direct acquisition costs on a straight-line basis over the life of the related extended service plan contracts beginning after the expiration of any manufacturers warranty coverage.

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Managed Loan Portfolio and the Impact of Credit Card Securitizations

Securitization

A major source of our funding is the securitization of credit card loans. For securitizations accounted for as sales under SFAS 140, we are required to remove the related credit card loans from the consolidated balance sheet. The securitization and sale of credit card loans changes our interest in the loans from lender to servicer, with a corresponding change in how we report revenues and expenses in our statements of income. For securitized credit card loans accounted for as sales, amounts that we otherwise would have recorded as net interest income, fee income and provision for loan losses are instead reported in other operating income as net securitization and credit card servicing income. For further analysis, see Table 4: Impact of Credit Card Securitizations Accounted for as Sales on page 34 of this Report.

Managed Loan Portfolio

We analyze our financial performance on a managed loan portfolio basis. We do this by adjusting the income statement and balance sheet to reverse the effects of securitization. Our discussion of revenues, where applicable, and provision for loan losses include comparisons to amounts reported in our consolidated statements of income (owned basis   ), as well as on a managed basis.

Our managed loan portfolio is comprised of credit card loans, retained interests in loans securitized and the investors   interests in securitized loans accounted for as sales. The investors   interests in securitized loans accounted for as sales are not assets of the Company. Therefore, we do not show them on our consolidated balance sheets. Table 3 summarizes our managed loan portfolio:

Table 3: Managed Loan Portfolio

	December 31,		
	2001	**2000**	**1999**
(Dollars in thousands)			
Year-end balances:			
Credit card loans	$ 2,746,656	$ 1,179,203	$ 145,783
Retained interests in loans securitized	1,263,655	2,023,681	1,617,226
Investors interests in securitized loans accounted for as sales	7,895,842	6,070,224	5,518,313
Total managed loan portfolio	$ 11,906,153	$ 9,273,108	$ 7,281,322

	Year Ended December 31,		
	2001	**2000**	**1999**
(Dollars in thousands)			
Average balances:			
Credit card loans	$ 1,709,989	$ 614,991	$ 20,505
Retained interests in loans securitized	1,895,137	1,869,301	1,146,567
Investors interests in securitized loans accounted for as sales	6,744,091		