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Discover Financial Services  
Form 10-Q  
April 29, 2014

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q  
(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended March 31, 2014
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 001-33378  
DISCOVER FINANCIAL SERVICES  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of incorporation or organization)

36-2517428  
(I.R.S. Employer Identification No.)

2500 Lake Cook Road,  
Riverwoods, Illinois 60015

(224) 405-0900

(Address of principal executive offices, including zip code) (Registrant's telephone number, including area code)  
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

As of April 25, 2014, there were 466,273,816 shares of the registrant's Common Stock, par value \$0.01 per share, outstanding.

DISCOVER FINANCIAL SERVICES

Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2014

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Except as otherwise indicated or unless the context otherwise requires, “Discover Financial Services,” “Discover,” “DFS,” “we,” “us,” “our,” and “the Company” refer to Discover Financial Services and its subsidiaries.

We own or have rights to use the trademarks, trade names and service marks that we use in conjunction with the operation of our business, including, but not limited to: Discover<sup>®</sup>, PULSE<sup>®</sup>, Cashback Bonus<sup>®</sup>, Discover Cashback Checking<sup>SM</sup>, Discover<sup>®</sup> More<sup>®</sup> Card, Discover it<sup>®</sup>, Discover<sup>®</sup> Motiva<sup>SM</sup> Card, Discover<sup>®</sup> Open Road<sup>®</sup> Card, Discover<sup>®</sup> Network and Diners Club International<sup>®</sup>. All other trademarks, trade names and service marks included in this quarterly report on Form 10-Q are the property of their respective owners.

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## Part I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## DISCOVER FINANCIAL SERVICES

## Condensed Consolidated Statements of Financial Condition

	March 31, 2014 (unaudited)	December 31, 2013 (unaudited)
	(dollars in millions, except share amounts)	
Assets		
Cash and cash equivalents	\$8,731	\$ 6,554
Restricted cash	1,163	182
Investment securities:		
Available-for-sale (amortized cost of \$3,868 and \$4,900 at March 31, 2014 and December 31, 2013, respectively)	3,902	4,931
Held-to-maturity (fair value of \$62 and \$58 at March 31, 2014 and December 31, 2013, respectively)	62	60
Total investment securities	3,964	4,991
Loan receivables:		
Mortgage loans held for sale, measured at fair value	133	148
Loan portfolio:		
Credit card	50,879	53,150
Other	8,794	8,295
Purchased credit-impaired loans	4,046	4,178
Total loan portfolio	63,719	65,623
Total loan receivables	63,852	65,771
Allowance for loan losses	(1,591)	(1,648)
Net loan receivables	62,261	64,123
Premises and equipment, net	668	654
Goodwill	284	284
Intangible assets, net	182	185
Other assets	2,331	2,367
Total assets	\$79,584	\$ 79,340
Liabilities and Stockholders' Equity		
Deposits:		
Interest-bearing deposit accounts	\$44,813	\$ 44,766
Non-interest bearing deposit accounts	171	193
Total deposits	44,984	44,959
Short-term borrowings	124	140
Long-term borrowings	20,182	20,474
Accrued expenses and other liabilities	3,273	2,958
Total liabilities	68,563	68,531
Commitments, contingencies and guarantees (Notes 8, 11, and 12)		
Stockholders' Equity:		
Common stock, par value \$0.01 per share; 2,000,000,000 shares authorized; 558,034,622 and 555,349,629 shares issued at March 31, 2014 and December 31, 2013, respectively	5	5
Preferred stock, par value \$0.01 per share; 200,000,000 shares authorized; 575,000 shares issued or outstanding and aggregate liquidation preference of \$575 at March 31, 2014 and December 31, 2013	560	560

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Additional paid-in capital	3,739	3,687
Retained earnings	10,138	9,611
Accumulated other comprehensive loss	(70	) (68
Treasury stock, at cost; 89,651,099 and 83,105,578 shares at March 31, 2014 and December 31, 2013, respectively	(3,351	) (2,986
Total stockholders' equity	11,021	10,809
Total liabilities and stockholders' equity	\$79,584	\$ 79,340

The table below presents the carrying amounts of certain assets and liabilities of Discover Financial Services' consolidated variable interest entities (VIEs) which are included in the condensed consolidated statements of financial condition above. The assets in the table below include those assets that can only be used to settle obligations of the consolidated VIEs. The liabilities in the table below include third party liabilities of consolidated VIEs only, and exclude intercompany balances that eliminate in consolidation. The liabilities also exclude amounts for which creditors have recourse to the general credit of Discover Financial Services.

	March 31, 2014 (unaudited)	December 31, 2013
	(dollars in millions)	
Assets		
Restricted cash	\$1,160	\$ 179
Credit card loan receivables	\$29,157	\$ 31,112
Purchased credit-impaired loans	\$2,177	\$ 2,248
Allowance for loan losses allocated to securitized loan receivables	\$(807	) \$(861
Other assets	\$37	\$ 34
Liabilities		
Long-term borrowings	\$16,295	\$ 16,986
Accrued interest payable	\$8	\$ 9

See Notes to the Condensed Consolidated Financial Statements.

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## DISCOVER FINANCIAL SERVICES

## Condensed Consolidated Statements of Income

	For the Three Months Ended March 31,	
	2014	2013
	(unaudited)	
	(dollars in millions, except per share amounts)	
Interest income:		
Credit card loans	\$1,537	\$1,451
Other loans	275	234
Investment securities	16	20
Other interest income	5	3
Total interest income	1,833	1,708
Interest expense:		
Deposits	153	186
Short-term borrowings	1	1
Long-term borrowings	116	111
Total interest expense	270	298
Net interest income	1,563	1,410
Provision for loan losses	272	159
Net interest income after provision for loan losses	1,291	1,251
Other income:		
Discount and interchange revenue, net	254	263
Protection products revenue	83	88
Loan fee income	83	81
Transaction processing revenue	44	53
Gain on investments	4	3
Gain on origination and sale of mortgage loans	16	51
Other income	31	43
Total other income	515	582
Other expense:		
Employee compensation and benefits	307	290
Marketing and business development	169	169
Information processing and communications	84	78
Professional fees	99	104
Premises and equipment	23	19
Other expense	102	93
Total other expense	784	753
Income before income tax expense	1,022	1,080
Income tax expense	391	407
Net income	\$631	\$673
Net income allocated to common stockholders	\$618	\$659
Basic earnings per common share	\$1.31	\$1.33
Diluted earnings per common share	\$1.31	\$1.33
Dividends declared per common share	\$0.20	\$—

See Notes to the Condensed Consolidated Financial Statements.



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DISCOVER FINANCIAL SERVICES

Condensed Consolidated Statements of Comprehensive Income

	For the Three Months Ended March 31,	
	2014	2013
	(unaudited)	
	(dollars in millions)	
Net income	\$631	\$673
Other comprehensive income (loss), net of taxes		
Unrealized gain (loss) on securities available for sale, net of tax	2	(11 )
Unrealized loss on cash flow hedges, net of tax	(4 )	(1 )
Other comprehensive loss	(2 )	(12 )
Comprehensive income	\$629	\$661

See Notes to the Condensed Consolidated Financial Statements.

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## DISCOVER FINANCIAL SERVICES

## Condensed Consolidated Statements of Changes in Stockholders' Equity

	Preferred Stock		Common Stock		Additional	Retained	Accumulated	Treasury	Total
	Shares	Amount	Shares	Amount	Paid-in	Earnings	Other	Stock	Stockholders'
					Capital		Comprehensive		Equity
							Income		
							(Loss)		
	(unaudited)								
	(dollars in millions, shares in thousands)								
Balance at December 31, 2012	575	\$560	553,351	\$5	\$3,598	\$7,472	\$ (72 )	\$(1,690 )	\$9,873
Net income	—	—	—	—	—	673	—	—	673
Other comprehensive loss	—	—	—	—	—	—	(12 )	—	(12 )
Purchases of treasury stock	—	—	—	—	—	—	—	(261 )	(261 )
Common stock issued under employee benefit plans	—	—	15	—	1	—	—	—	1
Common stock issued and stock-based compensation expense	—	—	1,490	1	33	—	—	—	34
Dividends — Series B preferred stock	—	—	—	—	—	(9 )	—	—	(9 )
Balance at March 31, 2013	575	\$560	554,856	\$6	\$3,632	\$8,136	\$ (84 )	\$(1,951 )	\$10,299
Balance at December 31, 2013	575	\$560	555,350	\$5	\$3,687	\$9,611	\$ (68 )	\$(2,986 )	\$10,809
Net income	—	—	—	—	—	631	—	—	631
Other comprehensive loss	—	—	—	—	—	—	(2 )	—	(2 )
Purchases of treasury stock	—	—	—	—	—	—	—	(365 )	(365 )
Common stock issued under employee benefit plans	—	—	14	—	1	—	—	—	1
Common stock issued and stock-based compensation expense	—	—	2,671	—	51	—	—	—	51
Dividends — common stock	—	—	—	—	—	(95 )	—	—	(95 )
	—	—	—	—	—	(9 )	—	—	(9 )



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Dividends — Series B  
preferred stock

Balance at March 31, 2014	575	\$560	558,035	\$5	\$ 3,739	\$10,138	\$ (70	)	\$(3,351)	\$ 11,021
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See Notes to the Condensed Consolidated Financial Statements.

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## DISCOVER FINANCIAL SERVICES

## Condensed Consolidated Statements of Cash Flows

	For the Three Months Ended March 31,	
	2014	2013
	(unaudited)	
	(dollars in millions)	
Cash flows from operating activities		
Net income	\$631	\$673
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	272	159
Deferred income taxes	23	121
Depreciation and amortization on premises and equipment	29	25
Amortization of deferred revenues	(51	) (48
Other depreciation and amortization	61	43
Accretion of accretable yield on acquired loans	(68	) (70
Gain on investments	(4	) (3
Loss on equity method and other investments	7	4
Gain on origination and sale of loans	(16	) (51
Stock-based compensation expense	18	17
Proceeds from sale of mortgage loans originated for sale	512	1,249
Net principal disbursed on mortgage loans originated for sale	(478	) (1,156
Changes in assets and liabilities:		
Increase in other assets	(41	) (88
Increase in accrued expenses and other liabilities	234	617
Net cash provided by operating activities	1,129	1,492
Cash flows from investing activities		
Maturities and sales of available-for-sale investment securities	1,276	1,015
Purchases of available-for-sale investment securities	(101	) (90
Maturities of held-to-maturity investment securities	5	13
Purchases of held-to-maturity investment securities	(8	) —
Net principal disbursed on loans originated for investment	1,692	2,102
Purchases of loan receivables	—	(133
Purchases of other investments	(29	) (31
Increase in restricted cash	(981	) (192
Purchases of premises and equipment	(43	) (59
Net cash provided by investing activities	1,811	2,625
Cash flows from financing activities		
Net decrease in short-term borrowings	(16	) (37
Proceeds from issuance of securitized debt	1,650	1,700
Maturities and repayment of securitized debt	(2,352	) (899
Proceeds from issuance of other long-term borrowings	399	750
Proceeds from issuance of common stock	1	5
Purchases of treasury stock	(365	) (261
Net increase in deposits	26	187
Dividends paid on common and preferred stock	(106	) (79
Net cash (used for) provided by financing activities	(763	) 1,366

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Net increase in cash and cash equivalents	2,177	5,483
Cash and cash equivalents, at beginning of period	6,554	2,584
Cash and cash equivalents, at end of period	\$8,731	\$8,067

See Notes to the Condensed Consolidated Financial Statements.

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Notes to the Condensed Consolidated Financial Statements  
(unaudited)

1. Background and Basis of Presentation

Description of Business

Discover Financial Services (“DFS” or the “Company”) is a direct banking and payment services company. The Company is a bank holding company under the Bank Holding Company Act of 1956 as well as a financial holding company under the Gramm-Leach-Bliley Act and therefore is subject to oversight, regulation and examination by the Board of Governors of the Federal Reserve System (the “Federal Reserve”). Through its Discover Bank subsidiary, a Delaware state-chartered bank, the Company offers its customers credit card loans, private student loans, personal loans, home equity loans and deposit products. Through its Discover Home Loans, Inc. subsidiary, the Company offers its customers home loans. Through its DFS Services LLC subsidiary and its subsidiaries, the Company operates the Discover Network, the PULSE network (“PULSE”), and Diners Club International (“Diners Club”). The Discover Network is a payment card transaction processing network for Discover branded credit cards and credit, debit and prepaid cards, issued by third parties, which the Company refers to as network partners. PULSE operates an electronic funds transfer network, providing financial institutions issuing debit cards on the PULSE network with access to ATMs domestically and internationally, as well as point-of-sale terminals at retail locations throughout the U.S. for debit card transactions. Diners Club is a global payments network of licensees that issue Diners Club branded charge cards and/or provide card acceptance services.

The Company’s business segments are Direct Banking and Payment Services. The Direct Banking segment includes consumer banking and lending products, specifically Discover branded credit cards issued to individuals and small businesses on the Discover Network and other consumer products and services, including private student loans, personal loans, home loans, home equity loans, prepaid cards and other consumer lending and deposit products. The majority of Direct Banking revenues relate to interest income earned on the segment’s loan products. Additionally, the Company’s credit card products generate substantially all revenues related to discount and interchange, protection products and loan fee income.

The Payment Services segment includes PULSE, Diners Club and the Company’s network partners business, which includes credit, debit and prepaid cards issued on the Discover Network by third parties. This segment also includes the business operations of Diners Club Italy, which primarily consist of issuing Diners Club charge cards. The majority of Payment Services revenues relate to transaction processing revenue from PULSE and royalty and licensee revenue (included in other income) from Diners Club.

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the financial statements reflect all adjustments which are necessary for a fair presentation of the results for the interim period. All such adjustments are of a normal, recurring nature. The preparation of financial statements in conformity with GAAP requires the Company to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and related disclosures. These estimates are based on information available as of the date of the condensed consolidated financial statements. The Company believes that the estimates used in the preparation of the condensed consolidated financial statements are reasonable. Actual results could differ from these estimates. These interim condensed consolidated financial statements should be read in conjunction with the Company’s 2013 audited consolidated financial statements filed with the Company’s annual report on Form 10-K for the calendar year ended December 31, 2013.

Recently Issued Accounting Pronouncements.

In January 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-01, Investments-Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects. This standard will permit a reporting entity to make an accounting policy election to account for investments in qualified affordable housing projects using the proportional amortization method if certain

conditions are met. Under this new method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). This treatment will replace the effective yield method currently permitted for certain investments of this kind. The Company has not historically utilized the effective yield method, and as a result, implementation of this ASU will not impact the Company's accounting for its investments in qualified affordable housing projects unless a subsequent election is made to apply it. In addition to establishing the conditions under which the proportional amortization method can be used, the ASU calls for additional disclosures that will enable the reader to understand the nature of the investment and the effect of its measurement and related tax credits on the company's financial position and results of operations. The new guidance is effective for annual reporting periods beginning after December 15, 2014 and interim periods within those periods, with early adoption permitted. The standard will require additional disclosure about the nature of the Company's affordable housing investments, but unless the Company subsequently decides to elect the new accounting model, the new guidance will have no effect on the Company's financial condition, results of operations or cash flows.

## 2. Investments

The Company's investment securities consist of the following (dollars in millions):

	March 31, 2014	December 31, 2013
U.S. Treasury securities <sup>(1)</sup>	\$1,343	\$2,058
U.S. government agency securities	1,047	1,561
States and political subdivisions of states	10	15
Other securities:		
Credit card asset-backed securities of other issuers	—	6
Residential mortgage-backed securities - Agency <sup>(2)</sup>	1,564	1,351
Total other securities	1,564	1,357
Total investment securities	\$3,964	\$4,991

(1) Includes \$7 million and \$9 million of U.S. Treasury securities that have been pledged as swap collateral in lieu of cash as of March 31, 2014 and December 31, 2013, respectively.

(2) Consists of residential mortgage-backed securities issued by Fannie Mae, Freddie Mac and Ginnie Mae.

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The amortized cost, gross unrealized gains and losses, and fair value of available-for-sale and held-to-maturity investment securities are as follows (dollars in millions):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
March 31, 2014				
Available-for-Sale Investment Securities <sup>(1)</sup>				
U.S. Treasury securities	\$1,320	\$22	\$—	\$1,342
U.S. government agency securities	1,025	22	—	1,047
Residential mortgage-backed securities - Agency	1,523	3	(13	) 1,513
Total available-for-sale investment securities	\$3,868	\$47	\$(13	) \$3,902
Held-to-Maturity Investment Securities <sup>(2)</sup>				
U.S. Treasury securities <sup>(3)</sup>	\$1	\$—	\$—	\$1
States and political subdivisions of states	10	—	—	10
Residential mortgage-backed securities - Agency <sup>(4)</sup>	51	—	—	51
Total held-to-maturity investment securities	\$62	\$—	\$—	\$62
December 31, 2013				
Available-for-Sale Investment Securities <sup>(1)</sup>				
U.S. Treasury securities	\$2,030	\$27	\$—	\$2,057
U.S. government agency securities	1,535	26	—	1,561
Credit card asset-backed securities of other issuers	6	—	—	6
Residential mortgage-backed securities - Agency	1,329	—	(22	) 1,307
Total available-for-sale investment securities	\$4,900	\$53	\$(22	) \$4,931
Held-to-Maturity Investment Securities <sup>(2)</sup>				
U.S. Treasury securities <sup>(3)</sup>	\$1	\$—	\$—	\$1
States and political subdivisions of states	15	—	(1	) 14
Residential mortgage-backed securities - Agency <sup>(4)</sup>	44	—	(1	) 43
Total held-to-maturity investment securities	\$60	\$—	\$(2	) \$58

(1) Available-for-sale investment securities are reported at fair value.

(2) Held-to-maturity investment securities are reported at amortized cost.

(3) Amount represents securities pledged as collateral to a government-related merchant for which transaction settlement occurs beyond the normal 24-hour period.

(4) Amounts represent residential mortgage-backed securities that were classified as held-to-maturity as they were entered into as a part of the Company's community reinvestment initiatives.

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The following table provides information about investment securities with aggregate gross unrealized losses and the length of time that individual investment securities have been in a continuous unrealized loss position (dollars in millions):

	Number of Securities in a Loss Position	Less than 12 months		More than 12 months	
		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
At March 31, 2014					
Available-for-Sale Investment Securities					
Residential mortgage-backed securities - Agency	22	\$999	\$(12 )	\$47	\$(1 )
Held-to-Maturity Investment Securities					
State and political subdivisions of states	4	\$5	\$—	\$3	\$—
Residential mortgage backed securities - Agency	5	\$29	\$—	\$—	\$—
At December 31, 2013					
Available-for-Sale Investment Securities					
Residential mortgage-backed securities - Agency	23	\$1,097	\$(20 )	\$48	\$(2 )
Held-to-Maturity Investment Securities					
State and political subdivisions of states	4	\$8	\$(1 )	\$3	\$—
Residential mortgage backed securities - Agency	2	\$40	\$(1 )	\$—	\$—

During the three months ended March 31, 2014, and 2013, the Company received \$60 million and \$309 million of proceeds related to maturities, or redemptions of investment securities. For the three months ended March 31, 2014, these proceeds primarily resulted from \$49 million maturities of residential mortgage-backed securities and \$6 million maturities of credit card asset-backed securities of other issuers. For the three months ended March 31, 2013, the proceeds primarily resulted from \$100 million maturities of U.S. government agency securities, \$82 million maturities of residential mortgage-backed securities, and \$75 million maturities of U.S. Treasury securities.

The Company records gains and losses on investment securities in other income when investments are sold or liquidated, when the Company believes an investment is other than temporarily impaired prior to the disposal of the investment, or in certain other circumstances. Proceeds from the sales of available-for-sale investment securities, comprised of U.S. Treasury securities and U.S. government agency securities, were \$1.2 billion and \$719 million during the three months ended March 31, 2014 and 2013, respectively. The Company recognized gains on sales of available-for-sale investment securities of \$4 million and \$2 million during the three months ended March 31, 2014 and 2013, respectively, which were calculated using the specific identification method and were recorded entirely in earnings. There were no gains or losses related to other-than-temporary impairments during the three months ended March 31, 2014 and 2013.

The Company records unrealized gains and losses on its available-for-sale investment securities in other comprehensive income. For the three months ended March 31, 2014, the Company recorded net unrealized gains of \$3 million (\$2 million after tax) in other comprehensive income. For the three months ended March 31, 2013, the Company recorded net unrealized losses of \$16 million (\$11 million after tax) in other comprehensive income.

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Maturities of available-for-sale debt securities and held-to-maturity debt securities at the end of the period are provided in the table below (dollars in millions):

	One Year or Less	After One Year Through Five Years	After Five Years Through Ten Years	After Ten Years	Total
At March 31, 2014					
Available-for-sale—Amortized Cost					
U.S. Treasury securities	\$126	\$1,194	\$—	\$—	\$1,320
U.S. government agency securities	102	923	—	—	1,025
Residential mortgage-backed securities - Agency	—	—	422	1,101	1,523
Total available-for-sale investment securities	\$228	\$2,117	\$422	\$1,101	\$3,868
Held-to-maturity—Amortized Cost					
U.S. Treasury securities	\$1	\$—	\$—	\$—	\$1
State and political subdivisions of states	—	—	—	10	10
Residential mortgage-backed securities - Agency	—	—	—	51	51
Total held-to-maturity investment securities	\$1	\$—	\$—	\$61	\$62
Available-for-sale—Fair Value <sup>(1)</sup>					
U.S. Treasury securities	\$127	\$1,215	\$—	\$—	\$1,342
U.S. government agency securities	103	944	—	—	1,047
Residential mortgage-backed securities - Agency	—	—	420	1,093	1,513
Total available-for-sale investment securities	\$230	\$2,159	\$420	\$1,093	\$3,902
Held-to-maturity—Fair Value <sup>(2)</sup>					
U.S. Treasury securities	\$1	\$—	\$—	\$—	\$1
State and political subdivisions of states	—	—	—	10	10
Residential mortgage-backed securities - Agency	—	—	—	51	51
Total held-to-maturity investment securities	\$1	\$—	\$—	\$61	\$62

(1) Available-for-sale investment securities are reported at fair value.

(2) Held-to-maturity investment securities are reported at amortized cost.

### Other Investments

As a part of the Company's community reinvestment initiatives, the Company has made equity investments in certain limited partnerships and limited liability companies that finance the construction and rehabilitation of affordable rental housing, as well as stimulate economic development in low to moderate income communities. These investments are accounted for using the equity method of accounting, and are recorded within other assets, and the related commitment for future investments is recorded in accrued expenses and other liabilities within the statement of financial condition. The portion of each investment's operating results allocable to the Company is recorded in other expense within the condensed consolidated statement of income. The Company earns a return primarily through the receipt of tax credits allocated to the affordable housing projects and the community revitalization projects. These investments are not consolidated as the Company does not have a controlling financial interest in the entities. As of March 31, 2014 and December 31, 2013, the Company had outstanding investments in these entities of \$300 million and \$308 million, respectively, and related contingent liabilities of \$28 million and \$52 million, respectively.

### 3. Loan Receivables

The Company has three portfolio segments: credit card loans, other loans and purchased credit-impaired ("PCI") student loans.





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The Company's classes of receivables within the three portfolio segments are depicted in the table below (dollars in millions):

	March 31, 2014	December 31, 2013
Mortgage loans held for sale <sup>(1)</sup>	\$ 133	\$ 148
Loan portfolio:		
Credit card loans:		
Discover card <sup>(2)</sup>	50,685	52,952
Discover business card	194	198
Total credit card loans	50,879	53,150
Other loans:		
Personal loans	4,310	4,191
Private student loans	4,326	3,969
Other	158	135
Total other loans	8,794	8,295
Purchased credit-impaired loans <sup>(3)</sup>	4,046	4,178
Total loan portfolio	63,719	65,623
Total loan receivables	63,852	65,771
Allowance for loan losses	(1,591)	(1,648)
Net loan receivables	\$ 62,261	\$ 64,123

(1) Substantially all mortgage loans held for sale are pledged as collateral against the warehouse line of credit used to fund consumer residential loans.

Amounts include \$19.6 billion and \$20.2 billion underlying investors' interest in trust debt at March 31, 2014 and December 31, 2013, respectively, and \$9.5 billion and \$10.9 billion in seller's interest at March 31, 2014 and

(2) December 31, 2013, respectively. See Note 4: Credit Card and Student Loan Securitization Activities for further information.

Amounts include \$2.2 billion of loans pledged as collateral against the notes issued from the Student Loan Corporation ("SLC") securitization trusts at March 31, 2014 and December 31, 2013. See Note 4: Credit Card and Student Loan Securitization Activities. Of the remaining \$1.8 billion and \$2.0 billion at March 31, 2014 and

(3) December 31, 2013, respectively, that were not pledged as collateral, approximately \$22 million for each period represents loans eligible for reimbursement through an indemnification claim. Discover Bank must purchase such loans from the trust before a claim may be filed.

#### Credit Quality Indicators

The Company regularly reviews its collection experience (including delinquencies and net charge-offs) in determining its allowance for loan losses. Credit card and closed-end consumer loan receivables are placed on nonaccrual status upon receipt of notification of the bankruptcy or death of a customer or suspected fraudulent activity on an account. Upon completion of the fraud investigation, non-fraudulent credit card and closed-end consumer loan receivables may resume accruing interest.

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Information related to the delinquent and non-accruing loans in the Company's loan portfolio, which excludes loans held for sale, is shown below by each class of loan receivables except for PCI student loans, which is shown under the heading "— Purchased Credit-Impaired Loans" (dollars in millions):

	30-89 Days Delinquent	90 or More Days Delinquent	Total Past Due	90 or More Days Delinquent and Accruing	Total Non-accruing <sup>(1)</sup>
At March 31, 2014					
Credit card loans:					
Discover card <sup>(2)</sup>	\$432	\$441	\$873	\$402	\$ 162
Discover business card	2	1	3	2	1
Total credit card loans	434	442	876	404	163
Other loans:					
Personal loans <sup>(3)</sup>	21	8	29	7	5
Private student loans (excluding PCI) <sup>(4)</sup>	51	26	77	26	—
Other	1	2	3	—	39
Total other loans (excluding PCI)	73	36	109	33	44
Total loan receivables (excluding PCI)	\$507	\$478	\$985	\$437	\$ 207
At December 31, 2013					
Credit card loans:					
Discover card <sup>(2)</sup>	\$464	\$445	\$909	\$406	\$ 154
Discover business card	1	2	3	2	1
Total credit card loans	465	447	912	408	155
Other loans:					
Personal loans <sup>(3)</sup>	21	8	29	8	5
Private student loans (excluding PCI) <sup>(4)</sup>	48	18	66	18	—
Other	1	2	3	—	40
Total other loans (excluding PCI)	70	28	98	26	45
Total loan receivables (excluding PCI)	\$535	\$475	\$1,010	\$434	\$ 200

The Company estimates that the gross interest income that would have been recorded in accordance with the original terms of non-accruing credit card loans was \$7 million and \$8 million for the three months ended (1) March 31, 2014 and 2013, respectively. The Company does not separately systematically compute the amount of gross interest income that would have been recorded in accordance with the original terms of loans. This amount was estimated based on customers' quarterly average balances and rates prior to non-accrual status.

Consumer credit card loans that are 90 or more days delinquent and accruing interest include \$42 million and \$41 (2) million of loans accounted for as troubled debt restructurings at March 31, 2014 and December 31, 2013, respectively.

(3) Personal loans that are 90 or more days delinquent and accruing interest include \$2 million of loans accounted for as troubled debt restructurings at March 31, 2014 and December 31, 2013.

(4) Private student loans that are 90 or more days delinquent and accruing interest include \$3 million of loans accounted for as troubled debt restructurings at March 31, 2014 and December 31, 2013.

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## Net Charge-offs

The Company's net charge-offs include the principal amount of loans charged off less principal recoveries and exclude charged-off interest and fees, recoveries of interest and fees and fraud losses. Charged-off and recovered interest and fees are recorded in interest income and loan fee income, respectively, which is effectively a reclassification of the loan loss provision, while fraud losses are recorded in other expense. Credit card loan receivables are charged off at the end of the month during which an account becomes 180 days contractually past due. Personal loans and private student loans, which are closed-end consumer loan receivables are generally charged off at the end of the month during which an account becomes 120 days contractually past due. Generally, customer bankruptcies and probate accounts are charged off at the end of the month 60 days following the receipt of notification of the bankruptcy or death but not later than the 180-day or 120-day contractual time frame.

Information related to the net charge-offs in the Company's loan portfolio, which excludes loans held for sale, is shown below by each class of loan receivables except for PCI student loans, which is shown under the heading "— Purchased Credit-Impaired Loans" (dollars in millions):

	For the Three Months Ended March 31,					
	2014		2013			
	Net Charge-offs	Net Charge-off Rate	Net Charge-offs	Net Charge-off Rate		
Credit card loans:						
Discover card	\$293	2.32	% \$286	2.36		%
Discover business card	1	1.76	% 1	2.66		%
Total credit card loans	294	2.32	% 287	2.36		%
Other loans:						
Personal loans	21	2.07	% 19	2.30		%
Private student loans (excluding PCI)	14	1.31	% 7	0.82		%
Total other loans (excluding PCI)	35	1.67	% 26	1.49		%
Net charge-offs as a percentage of total loans (excluding PCI)	\$329	2.22	% \$313	2.25		%
Net charge-offs as a percentage of total loans (including PCI)	\$329	2.08	% \$313	2.08		%

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As part of credit risk management activities, on an ongoing basis the Company reviews information related to the performance of a customer's account with the Company as well as information from credit bureaus, such as FICO or other credit scores, relating to the customer's broader credit performance. FICO scores are generally obtained at origination of the account and are refreshed monthly or quarterly thereafter to assist in predicting customer behavior. Historically, the Company has noted that a significant proportion of delinquent accounts have FICO scores below 660.

The following table provides the most recent FICO scores available for the Company's customers as a percentage of each class of loan receivables:

	Credit Risk Profile by FICO Score		
	660 and Above	Less than 660 or No Score	
March 31, 2014			
Discover card	82	% 18	%
Discover business card	92	% 8	%
Personal loans	97	% 3	%
Private student loans (excluding PCI) <sup>(1)</sup>	95	% 5	%
December 31, 2013			
Discover card	83	% 17	%
Discover business card	92	% 8	%
Personal loans	97	% 3	%
Private student loans (excluding PCI) <sup>(1)</sup>	95	% 5	%

(1)PCI loans are discussed under the heading "— Purchased Credit-Impaired Loans."

For private student loans, additional credit risk management activities include monitoring the amount of loans in forbearance. Forbearance allows borrowers experiencing temporary financial difficulties, but still willing to make payments, the ability to temporarily suspend payments. Eligible borrowers have a lifetime cap on forbearance of 12 months. At March 31, 2014 and December 31, 2013, there were \$77 million and \$110 million of private student loans, including PCI, in forbearance, respectively. In addition, at March 31, 2014 and December 31, 2013, there were 1.4% and 1.9% of private student loans in forbearance as a percentage of student loans in repayment and forbearance, respectively. At March 31, 2014, the dollar amount of loans in forbearance and loans in forbearance as a percentage of private student loans in repayment and forbearance were lower when compared to December 31, 2013 due the implementation of temporary reduced payment programs, which normally consist of a reduction of the minimum payment for a period of no longer than 12 months at a time. Loans in these programs are not considered to be in forbearance.

#### Allowance for Loan Losses

The Company maintains an allowance for loan losses at an appropriate level to absorb probable losses inherent in the loan portfolio. The Company considers the collectibility of all amounts contractually due on its loan receivables, including those components representing interest and fees. Accordingly, the allowance for loan losses represents the estimated uncollectible principal, interest and fee components of loan receivables. The allowance is evaluated monthly and is maintained through an adjustment to the provision for loan losses. Charge-offs of principal amounts of loans outstanding are deducted from the allowance and subsequent recoveries of such amounts increase the allowance. Charge-offs of loan balances representing unpaid interest and fees result in a reversal of interest and fee income, respectively, which is effectively a reclassification of provision for loan losses.

The Company bases its allowance for loan losses on several analyses that help estimate incurred losses as of the balance sheet date. While the Company's estimation process includes historical data and analysis, there is a significant amount of judgment applied in selecting inputs and analyzing the results produced by the models to determine the allowance. The Company uses a migration analysis to estimate the likelihood that a loan will progress through the

various stages of delinquency. The Company uses other analyses to estimate losses incurred on non-delinquent accounts. The considerations in these analyses include past performance, risk management techniques applied to various accounts, historical behavior of different account vintages, economic conditions, recent trends in delinquencies, bankruptcy filings, account collection management, policy changes, account seasoning, loan volume and amounts, payment rates, and forecasting uncertainties. The Company primarily estimates its allowance for loan losses on a pooled basis, which includes loans that are delinquent and/or

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no longer accruing interest and/or certain loans that have defaulted from a loan modification program, as discussed below under the section entitled "— Troubled Debt Restructurings." Certain other loans, including non-performing Diners Club licensee loans, are individually evaluated for impairment.

The following tables provide changes in the Company's allowance for loan losses (dollars in millions):

	For the Three Months Ended March 31, 2014				
	Credit Card	Personal Loans	Student Loans	Other	Total
Balance at beginning of period	\$1,406	\$112	\$113	\$17	\$1,648
Additions:					
Provision for loan losses	230	18	23	1	272
Deductions:					
Charge-offs	(408 )	(24 )	(15 )	—	(447 )
Recoveries	114	3	1	—	118
Net charge-offs	(294 )	(21 )	(14 )	—	(329 )
Balance at end of period	\$1,342	\$109	\$122	\$18	\$1,591

	For the Three Months Ended March 31, 2013				
	Credit Card	Personal Loans	Student Loans	Other	Total
Balance at beginning of period	\$1,613	\$99	\$75	\$1	\$1,788
Additions:					
Provision for loan losses	127	17	15	—	159
Deductions:					
Charge-offs	(422 )	(20 )	(7 )	—	(449 )
Recoveries	135	1	—	—	136
Net charge-offs	(287 )	(19 )	(7 )	—	(313 )
Balance at end of period	\$1,453	\$97	\$83	\$1	\$1,634

Net charge-offs of principal are recorded against the allowance for loan losses, as shown in the table above.

Information regarding net charge-offs of interest and fee revenues on credit card and other loans is as follows (dollars in millions):

	For the Three Months Ended March 31,	
	2014	2013
Interest and fees accrued subsequently charged off, net of recoveries (recorded as a reduction of interest income)	\$72	\$77
Fees accrued subsequently charged off, net of recoveries (recorded as a reduction to other income)	\$17	\$16

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The following tables provide additional detail of the Company's allowance for loan losses and recorded investment in its loan portfolio (which excludes loans held for sale) by impairment methodology (dollars in millions):

	Credit Card	Personal Loans	Student Loans	Other Loans	Total
At March 31, 2014					
Allowance for loans evaluated for impairment as:					
Collectively evaluated for impairment in accordance with ASC 450-20	\$ 1,164	\$ 104	\$ 84	\$ 1	\$ 1,353
Evaluated for impairment in accordance with ASC 310-10-35 <sup>(1)(2)</sup>	178	5	10	17	210
Acquired with deteriorated credit quality, evaluated in accordance with ASC 310-30	—	—	28	—	28
Total allowance for loan losses	\$ 1,342	\$ 109	\$ 122	\$ 18	\$ 1,591
Recorded investment in loans evaluated for impairment as:					
Collectively evaluated for impairment in accordance with ASC 450-20	\$ 49,791	\$ 4,265	\$ 4,296	\$ 80	\$ 58,432
Evaluated for impairment in accordance with ASC 310-10-35 <sup>(1)(2)</sup>	1,088	45	30	78	1,241
Acquired with deteriorated credit quality, evaluated in accordance with ASC 310-30	—	—	4,046	—	4,046
Total recorded investment	\$ 50,879	\$ 4,310	\$ 8,372	\$ 158	\$ 63,719
At December 31, 2013					
Allowance for loans evaluated for impairment as:					
Collectively evaluated for impairment in accordance with ASC 450-20	\$ 1,218	\$ 109	\$ 76	\$ 1	\$ 1,404
Evaluated for impairment in accordance with ASC 310-10-35 <sup>(1)(2)</sup>	188	3	9	16	216
Acquired with deteriorated credit quality, evaluated in accordance with ASC 310-30	—	—	28	—	28
Total allowance for loan losses	\$ 1,406	\$ 112	\$ 113	\$ 17	\$ 1,648
Recorded investment in loans evaluated for impairment as:					
Collectively evaluated for impairment in accordance with ASC 450-20	\$ 52,027	\$ 4,160	\$ 3,941	\$ 56	\$ 60,184
Evaluated for impairment in accordance with ASC 310-10-35 <sup>(1)(2)</sup>	1,123	31	28	79	1,261
Acquired with deteriorated credit quality, evaluated in accordance with ASC 310-30	—	—	4,178	—	4,178
Total recorded investment	\$ 53,150	\$ 4,191	\$ 8,147	\$ 135	\$ 65,623

Loan receivables evaluated for impairment in accordance with ASC 310-10-35 include credit card loans, personal loans and student loans collectively evaluated for impairment in accordance with ASC Subtopic 310-40, (1) Receivables, which consists of modified loans accounted for as troubled debt restructurings. Other loans are individually evaluated for impairment and generally do not represent troubled debt restructurings.

(2)



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The unpaid principal balance of credit card loans was \$919 million and \$900 million at March 31, 2014 and December 31, 2013, respectively. The unpaid principal balance of personal loans was \$44 million and \$31 million at March 31, 2014 and December 31, 2013, respectively. The unpaid principal balance of student loans was \$28 million and \$26 million at March 31, 2014 and December 31, 2013, respectively. All loans accounted for as troubled debt restructurings have a related allowance for loan losses.

### Troubled Debt Restructurings

Permanent and certain temporary modification programs for credit card loans as well as loans that defaulted or graduated from modification programs, certain grants of student loan forbearance and certain modifications to personal loans as well as those that defaulted or graduated from modification programs are considered troubled debt restructurings and are accounted for in accordance with ASC Subtopic 310-40, Troubled Debt Restructurings by Creditors. Generally, loans included in a loan modification program are considered to be individually impaired and are accounted for as troubled debt restructurings. The Company has both internal and external loan modification programs that provide relief to credit card and personal loan borrowers who are experiencing financial hardship. The internal loan modification programs include both temporary and permanent programs.

For credit card customers, the temporary hardship program primarily consists of a reduced minimum payment and an interest rate reduction, both lasting for a period no longer than 12 months. The permanent workout program involves changing the structure of the loan to a fixed payment loan with a maturity no longer than 60 months and reducing the interest

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rate on the loan. The permanent modification program does not normally provide for the forgiveness of unpaid principal, but may allow for the reversal of certain unpaid interest or fee assessments. The Company also makes loan modifications for customers who request financial assistance through external sources, such as a consumer credit counseling agency program (referred to here as external programs). These loans typically receive a reduced interest rate but continue to be subject to the original minimum payment terms and do not normally include waiver of unpaid principal, interest or fees.

To assist student loan borrowers who are experiencing temporary financial difficulties but are willing to resume making payments, the Company may offer forbearance periods of up to 12 months over the life of the loan. The Company does not anticipate significant shortfalls in the contractual amount due for borrowers using a first forbearance period as the historical performance of these borrowers is not significantly different from the overall portfolio. However, when a delinquent borrower is granted a second forbearance period, the forbearance is considered a troubled debt restructuring. In addition, we offer temporary reduced payment programs, which normally consist of a reduction of the minimum payment for a period of no longer than 12 months at a time. Student loans included in temporary reduced payment programs are not accounted for as troubled debt restructurings as long as the term of the program does not exceed 12 months.

For personal loan customers, the Company offers two temporary programs which normally consist of a reduction of the minimum payment for a period of no longer than 12 months with a final balloon payment required at the end of the loan term. In addition, the temporary APR reduction program also provides an interest rate reduction for up to 12 months. The permanent modification programs involve changing the terms of the loan in order to pay off the outstanding balance over the new term for a period no longer than 4 years. The total term, including both the original and renegotiated terms, generally does not exceed 9 years. The Company offers another permanent modification program which modifies the interest rate along with the term of the loan. The Company also allows loan modifications for personal loan customers who request financial assistance through external sources, similar to credit card customers discussed above. Payments are modified based on the new terms agreed upon with the credit counseling agency. Personal loans modified through temporary and permanent programs are accounted for as troubled debt restructurings. Beginning in first quarter of 2014, loan modifications through external sources are accounted for as troubled debt restructurings.

Loans classified as troubled debt restructurings are recorded at their present value with impairment measured as the difference between the loan balance and the discounted present value of cash flows expected to be collected. Consistent with the Company's measurement of impairment of modified loans on a pooled basis, the discount rate used for credit card loans in internal programs is the average current annual percentage rate applied to non-impaired credit card loans, which approximates what would have applied to the pool of modified loans prior to impairment. The discount rate used for credit card loans in external programs reflects a rate that is consistent with rates offered to lower risk cardmembers. For student and personal loans, the discount rate used is the average contractual rate prior to modification.

Interest income from loans accounted for as troubled debt restructurings is accounted for in the same manner as other accruing loans. Cash collections on these loans are allocated according to the same payment hierarchy methodology applied to loans that are not in such programs.

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Additional information about modified loans classified as troubled debt restructurings is shown below (dollars in millions):

	Average recorded investment in loans	Interest income recognized during period loans were impaired <sup>(1)</sup>	Gross interest income that would have been recorded with original terms <sup>(2)</sup>
For the Three Months Ended March 31, 2014			
Credit card loans			
Modified credit card loans <sup>(3)</sup>	\$256	\$11	\$1
Internal programs	\$454	\$3	\$15
External programs	\$394	\$7	\$3
Personal loans	\$44	\$1	\$—
Student loans <sup>(4)</sup>	\$29	\$1	N/A
For the Three Months Ended March 31, 2013			
Credit card loans			
Modified credit card loans <sup>(3)</sup>	\$279	\$13	\$1
Internal programs	\$490	\$3	\$17
External programs	\$507	\$10	\$3
Personal loans	\$22	\$1	\$—
Student loans <sup>(4)</sup>	\$18	\$—	N/A

- (1) The Company does not separately track interest income on loans in modification programs. Amounts shown are estimated by applying an average interest rate to the average loans in the various modification programs. The Company does not separately track the amount of gross interest income that would have been recorded if the loans in modification programs had not been restructured and interest had instead been recorded in accordance with (2) the original terms. Amounts shown are estimated by applying the difference between the average interest rate earned on non-impaired credit card loans and the average interest rate earned on loans in the modification programs to the average loans in the modification programs. This balance is considered impaired, but is excluded from the internal and external program amounts reflected in (3) this table. Represents credit card loans that were modified in troubled debt restructurings, but are no longer enrolled in troubled debt restructuring program due to noncompliance with the terms of the modification or successful completion of a program
- (4) Student loan customers who have been granted a forbearance are not given interest rate reductions.

In order to evaluate the primary financial effects that resulted from credit card loans entering into a loan modification program during the three months ended March 31, 2014 and 2013, the Company quantified the amount by which interest and fees were reduced during the periods. During the three months ended March 31, 2014 and 2013, the Company forgave approximately \$10 million and \$11 million, respectively, of interest and fees as a result of accounts entering into a credit card loan modification program.

The following table provides information on loans that entered a loan modification program during the period (dollars in millions):

	For the Three Months Ended March 31, 2014		2013	
	Number of Accounts	Balances	Number of Accounts	Balances

Accounts that entered a loan modification program during the period:

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Credit card:

Internal programs	12,436	\$81	10,402	\$66
External programs	8,431	\$44	9,531	\$52
Personal loans	712	\$8	443	\$6
Student loans	307	\$4	172	\$4

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The following table presents the carrying value of loans that experienced a payment default during the period that had been modified in a troubled debt restructuring during the 15 months preceding the end of each period (dollars in millions):

	For the Three Months Ended March 31,			
	2014		2013	
	Number of Accounts	Aggregated Outstanding Balances Upon Default	Number of Accounts	Aggregated Outstanding Balances Upon Default
Troubled debt restructurings that subsequently defaulted:				
Credit card:				
Internal programs <sup>(1)(2)</sup>	2,331	\$ 14	2,880	\$ 18
External programs <sup>(1)(2)</sup>	1,881	\$ 8	2,251	\$ 10
Personal loans <sup>(2)</sup>	106	\$ 1	24	\$—
Student loans <sup>(3)</sup>	311	\$ 5	135	\$ 3

The outstanding balance upon default is the loan balance at the end of the month prior to default. Terms revert back (1) to the pre-modification terms for customers who default from a temporary program and charging privileges remain revoked.

(2) A customer defaults from a modification program after two consecutive missed payments.

(3) Student loan defaults have been defined as loans that are 60 or more days delinquent.

Of the account balances that defaulted as shown above for the three months ended March 31, 2014 and 2013, approximately 34% and 45%, respectively, of the total balances charged off at the end of the month in which they defaulted. For accounts that have defaulted from a loan modification program and have not subsequently charged off, the balances are included in the allowance for loan loss analysis discussed above under "— Allowance for Loan Losses."

Purchased Credit-Impaired Loans

Purchased loans with evidence of credit deterioration since origination for which it is probable that not all contractually required payments will be collected are considered impaired at acquisition and are reported as PCI loans. The private student loans acquired in the SLC transaction as well as the additional private student loan portfolio acquired from Citibank, comprise the Company's only PCI loans at March 31, 2014 and December 31, 2013. Total PCI student loans had an outstanding balance of \$4.4 billion and \$4.6 billion, including accrued interest, and a related carrying amount of \$4.0 billion and \$4.2 billion as of March 31, 2014 and December 31, 2013, respectively.

The following table provides changes in accretable yield for the acquired loans during the period (dollars in millions):

	For the Three Months Ended March 31,	
	2014	2013
Balance at beginning of period	\$ 1,580	\$ 2,072
Accretion into interest income	(68	) (70
Other changes in expected cash flows	—	19
Balance at end of period	\$ 1,512	\$ 2,021

Periodically, the Company updates the estimate of cash flows expected to be collected based on management's latest expectations of future credit losses, borrower prepayments and certain other assumptions that affect cash flows. The Company recorded no provision expense during the three months ended March 31, 2014 and 2013. The allowance for PCI loan losses at March 31, 2014 and December 31, 2013 was \$28 million. There was no impact on accretable yield as a result of changes in cash flow assumptions for the three months ended March 31, 2014. For the three months ended March 31, 2013, changes to other cash flow assumptions resulted in an increase in accretable yield related to expected life of the loans. Changes to accretable yield are recognized prospectively as an adjustment to yield over the

remaining life of the pools.

At March 31, 2014, the 30 or more days delinquency and 90 or more days delinquency rates on PCI student loans (which includes loans not yet in repayment) were 2.19% and 0.79%, respectively. At December 31, 2013, the 30 or more days delinquency and 90 or more days delinquency rates on PCI student loans (which includes loans not yet in repayment) were 2.33% and 0.80%, respectively. These rates include private student loans that are greater than 120 days delinquent that are covered by an indemnification agreement or insurance arrangements through which the Company expects to recover a substantial portion of the loan. The net charge-off rate on PCI student loans was 0.75% and 1.43% for the three months ended

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March 31, 2014 and 2013, respectively. The decrease in net charge-off rate on PCI student loans is primarily due to seasoning of the portfolio and introduction of the temporary interest only programs, which reduce the borrower's minimum payment for a period of no longer than 12 months at a time.

**Mortgage Loans Held For Sale**

The Company originates all of its residential real estate loans, except for home equity loans, with the intent to sell them in the secondary market. Loans held for sale consist primarily of residential first mortgage loans that are secured by residential real estate throughout the United States. Mortgage loans are funded through a warehouse line of credit and are recorded at fair value. Changes in the fair value of mortgage loans are recorded through other income prior to the sale of the loans to investors. The gain or loss on the sale of loans is recognized on the date the loans are sold and is based on the difference between the sale proceeds received and the carrying value of the loans, adjusted for the impact of the related hedges. See Note 14: Derivatives and Hedging Activities for further discussion of the mortgage loan related hedging activities. The Company sells its loans on a servicing released basis in which the Company gives up the right to service the loans.

The following table provides a summary of the initial unpaid principal balance of mortgage loans sold during the period, by type of loan (dollars in millions):

	For the Three Months Ended March 31,					
	2014		2013			
	Amount	%	Amount	%	Amount	%
Conforming <sup>(1)</sup>	\$447	89.94	% \$665	55.51		%
FHA <sup>(2)</sup>	48	9.66	533	44.49		
Jumbo <sup>(3)</sup>	2	0.40	—	—		
Total	\$497	100.00	% \$1,198	100.00		%

(1) Conforming loans are loans that conform to Government Sponsored Enterprises guidelines.

(2) FHA loans are loans that are insured by the Federal Housing Administration and are typically made to borrowers with low down payments. The initial loan amount must be within certain limits.

(3) Jumbo loans are loans with an initial amount larger than the limits set by a Government Sponsored Enterprise.

The following table represents the loans held for sale by type of loan (dollars in millions):

	March 31, 2014		December 31, 2013			
	Amount	%	Amount	%	Amount	%
Conforming <sup>(1)</sup>	\$116	87.22	% \$136	91.89		%
FHA <sup>(2)</sup>	13	9.77	11	7.43		
Jumbo <sup>(3)</sup>	4	3.01	1	0.68		
Total	\$133	100.00	% \$148	100.00		%

(1) Conforming loans are loans that conform to Government Sponsored Enterprises guidelines.

(2) FHA loans are loans that are insured by the Federal Housing Administration and are typically made to borrowers with low down payments. The initial loan amount must be within certain limits.

(3) Jumbo loans are loans with an initial loan amount larger than the limits set by a Government Sponsored Enterprise.

**4. Credit Card and Student Loan Securitization Activities****Credit Card Securitization Activities**

The Company accesses the term asset securitization market through the Discover Card Master Trust I (“DCMT”) and the Discover Card Execution Note Trust (“DCENT”), which are trusts into which credit card loan receivables are transferred (or, in the case of DCENT, into which beneficial interests in DCMT are transferred) and from which beneficial interests are issued to investors.

The DCENT debt structure consists of four classes of securities (DiscoverSeries Class A, B, C and D notes), with the most senior class generally receiving a triple-A rating. In this structure, in order to issue senior, higher rated classes of notes, it is necessary to obtain the appropriate amount of credit enhancement, generally through the issuance of junior, lower rated or more highly subordinated classes of notes, the majority of which are held by wholly-owned subsidiaries

of Discover Bank. The DCMT structure consists of Class A, triple-A rated certificates and Class B, single-A rated certificates held by third



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parties. Credit enhancement is provided by the subordinated Class B certificates, cash collateral accounts, and more subordinated Series 2009-CE certificates that are held by a wholly-owned subsidiary of Discover Bank. The credit-related risk of loss associated with trust assets as of the balance sheet date to which the Company is exposed through the retention of these subordinated interests is fully captured in the allowance for loan losses recorded by the Company.

The Company's credit card securitizations are accounted for as secured borrowings and the trusts are treated as consolidated subsidiaries of the Company. The Company's retained interests in the assets of the trusts, principally consisting of investments in DCMT certificates and DCENT notes held by subsidiaries of Discover Bank, constitute intercompany positions which are eliminated in the preparation of the Company's condensed consolidated statement of financial condition.

Upon transfer of credit card loan receivables to the trust, the receivables and certain cash flows derived from them become restricted for use in meeting obligations to the trusts' creditors. Further, the transferred credit card loan receivables are owned by the trust and are not available to third party creditors of the Company. The trusts have ownership of cash balances that also have restrictions, the amounts of which are reported in restricted cash.

Investment of trust cash balances is limited to investments that are permitted under the governing documents of the trusts and which have maturities no later than the related date on which funds must be made available for distribution to trust investors. With the exception of the seller's interest in trust receivables, the Company's interests in trust assets are generally subordinate to the interests of third-party investors and, as such, may not be realized by the Company if needed to absorb deficiencies in cash flows that are allocated to the investors in the trusts' debt.

The carrying values of these restricted assets, which are presented on the Company's condensed consolidated statement of financial condition as relating to securitization activities, are shown in the table below (dollars in millions):

	March 31, 2014	December 31, 2013
Cash collateral accounts	\$8	\$59
Collections and interest funding accounts	1,061	31
Restricted cash	1,069	90
Investors' interests held by third-party investors	14,589	15,190
Investors' interests held by wholly-owned subsidiaries of Discover Bank	5,033	5,024
Seller's interest	9,535	10,898
Loan receivables <sup>(1)</sup>	29,157	31,112
Allowance for loan losses allocated to securitized loan receivables <sup>(1)</sup>	(779)	(833)
Net loan receivables	28,378	30,279
Other	37	34
Carrying value of assets of consolidated variable interest entities	\$29,484	\$30,403

The Company maintains its allowance for loan losses at an amount sufficient to absorb probable losses inherent in (1) all loan receivables, which includes all loan receivables in the trusts. Therefore, credit risk associated with the transferred receivables is fully reflected on the Company's balance sheet in accordance with GAAP.

The debt securities issued by the consolidated trusts are subject to credit, payment and interest rate risks on the transferred credit card loan receivables. To protect investors, the securitization structures include certain features that could result in earlier-than-expected repayment of the securities. The primary investor protection feature relates to the availability and adequacy of cash flows in the securitized pool of receivables to meet contractual requirements. Insufficient cash flows would trigger the early repayment of the securities. This is referred to as the "economic early amortization" feature.

Investors are allocated cash flows derived from activities related to the accounts comprising the securitized pool of receivables, the amounts of which reflect finance charges billed, certain fee assessments, allocations of merchant discount and interchange, and recoveries on charged-off accounts. From these cash flows, investors are reimbursed for charge-offs occurring within the securitized pool of receivables and receive a contractual rate of return and Discover

Bank is paid a servicing fee as servicer. Any cash flows remaining in excess of these requirements are reported to investors as excess spread. An excess spread rate of less than 0% for a contractually specified period, generally a three-month average, would trigger an economic early amortization event. In such an event, the Company would be required to seek immediate sources of replacement funding. Apart from the restricted assets related to securitization activities, the investors and the securitization trusts have no recourse to the Company's other assets or the Company's general credit for a shortage in cash flows.

The Company is required to maintain a contractual minimum level of receivables in the trust in excess of the face value of outstanding investors' interests. This excess is referred to as the minimum seller's interest requirement. The required

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minimum seller's interest in the pool of trust receivables, which is included in credit card loan receivables restricted for securitization investors, is set at approximately 7% in excess of the total investors' interests (which includes interests held by third parties as well as those certificated interests held by the Company). If the level of receivables in the trust was to fall below the required minimum, the Company would be required to add receivables from the unrestricted pool of receivables, which would increase the amount of credit card loan receivables restricted for securitization investors. A decline in the amount of the excess seller's interest could occur if balance repayments and charge-offs exceeded new lending on the securitized accounts or as a result of changes in total outstanding investors' interests. Seller's interest is impacted by seasonality as higher balance repayments tend to occur in the first calendar year quarter. If the Company could not add enough receivables to satisfy the requirement, an early amortization (or repayment) of investors' interests would be triggered. We retain significant exposure to the performance of trust assets through holdings of the seller's interest and subordinated security classes of DCMT and DCENT. In addition, the Company has the right to remove a random selection of accounts, which would serve to decrease the amount of credit card loan receivables restricted for securitization investors, subject to certain requirements including that the minimum seller's interest is still met.

Another feature of the Company's credit card securitization structure that is designed to protect investors' interests from loss, which is applicable only to the notes issued from DCENT, is a reserve account funding requirement in which excess cash flows generated by the transferred loan receivables are held at the trust. This funding requirement is triggered when DCENT's three-month average excess spread rate decreases to below 4.5%, with increasing funding requirements as excess spread levels decline below preset levels to 0%.

In addition to performance measures associated with the transferred credit card loan receivables or the inability to add receivables to satisfy the seller's interest requirement, there are other events or conditions which could trigger an early amortization event, such as non-payment of principal at expected maturity. As of March 31, 2014, no economic or other early amortization events have occurred.

The tables below provide information concerning investors' interests and related excess spreads at the end of the current period (dollars in millions):

March 31, 2014	Investors' Interests <sup>(1)</sup>	# of Series Outstanding
Discover Card Master Trust I	\$ 168	2
Discover Card Execution Note Trust (DiscoverSeries notes)	19,454	38
Total investors' interests	\$ 19,622	40

(1) Investors' interests include third-party interests and subordinated interests held by wholly-owned subsidiaries of Discover Bank.

	3-Month Rolling Average Excess Spread <sup>(1)</sup>	
Group excess spread percentage	13.47	%
DiscoverSeries excess spread percentage	13.46	%

DCMT certificates refer to the higher of the Group excess spread or their applicable series excess spread (not (1) shown) and DiscoverSeries notes refer to the higher of the Group or DiscoverSeries excess spread in assessing whether an economic early amortization has been triggered.

The Company continues to own and service the accounts that generate the loan receivables held by the trusts. Discover Bank receives servicing fees from the trusts based on a percentage of the monthly investor principal balance outstanding. Although the fee income to Discover Bank offsets the fee expense to the trusts and thus is eliminated in consolidation, failure to service the transferred loan receivables in accordance with contractual requirements could lead to a termination of the servicing rights and the loss of future servicing income, net of related expenses.

Student Loan Securitization Activities

The Company's student loan securitizations are accounted for as secured borrowings and the trusts are treated as consolidated subsidiaries of the Company. Trust receivables underlying third-party investors' interests are recorded in purchased credit-impaired loans, and the related debt issued by the trusts is reported in long-term borrowings. The assets of the Company's consolidated VIEs are restricted from being sold or pledged as collateral for other borrowings and the cash flows from these restricted assets may be used only to pay obligations of the trust.

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Currently there are three trusts from which securities were issued to investors. Principal payments on the long-term secured borrowings are made as cash is collected on the underlying loans that are used as collateral on the secured borrowings. The Company does not have access to cash collected by the securitization trusts until cash is released in accordance with the trust indenture agreements and, for certain securitizations, no cash will be released to the Company until all outstanding trust borrowings have been repaid. Similar to the credit card securitizations, the Company continues to own and service the accounts that generate the student loan receivables held by the trusts and receives servicing fees from the trusts based on either a percentage of the principal balance outstanding or a flat fee per borrower. Although the servicing fee income offsets the fee expense related to the trusts, failure to service the transferred loan receivables in accordance with contractual requirements could lead to a termination of the servicing rights.

Under terms of all the trust arrangements, the Company has the option, but not the obligation, to provide financial support to the trusts, but has never provided such support. A substantial portion of the credit risk associated with the securitized loans has been transferred to third parties under private credit insurance or indemnification arrangements. The carrying values of these restricted assets, which are presented on the Company's condensed consolidated statement of financial condition as relating to securitization activities, are shown in the table below (dollars in millions):

	March 31, 2014	December 31, 2013
Restricted cash	\$91	\$ 89
Student loan receivables	2,177	2,248
Allowance for loan losses allocated to securitized loan receivables <sup>(1)</sup>	(28	) (28
Net student loan receivables	2,149	2,220
Carrying value of assets of consolidated variable interest entities	\$2,240	\$ 2,309

The Company maintains its allowance for loan losses at an amount sufficient to absorb probable losses inherent in (1) all loan receivables, which includes all loan receivables in the trusts. Therefore, credit risk associated with the transferred receivables is fully reflected on the Company's balance sheet in accordance with GAAP.

#### 5. Deposits

The Company offers its deposit products to customers through two channels: (i) through direct marketing, internet origination and affinity relationships ("direct-to-consumer deposits"); and (ii) indirectly through contractual arrangements with securities brokerage firms ("brokered deposits"). Direct-to-consumer deposits include certificates of deposit, money market accounts, online savings and checking accounts, and IRA certificates of deposit, while brokered deposits include certificates of deposit, and sweep accounts.

As of March 31, 2014 and December 31, 2013, the Company had approximately \$28.7 billion and \$28.4 billion, respectively, of direct-to-consumer deposits. As of each of March 31, 2014 and December 31, 2013, the Company had approximately \$16.1 billion and \$16.4 billion, respectively, of brokered deposits.

A summary of interest-bearing deposit accounts is as follows (dollars in millions):

	March 31, 2014	December 31, 2013		
Certificates of deposit in amounts less than \$100,000 <sup>(1)</sup>	\$20,832	\$21,211		
Certificates of deposit from amounts of \$100,000 <sup>(1)</sup> to less than \$250,000 <sup>(1)</sup>	4,781	4,860		
Certificates of deposit in amounts of \$250,000 <sup>(1)</sup> or greater	1,163	1,180		
Savings deposits, including money market deposit accounts	18,037	17,515		
Total interest-bearing deposits	\$44,813	\$44,766		
Average annual interest rate	1.32	% 1.57	%	%

(1) \$100,000 represents the basic insurance amount previously covered by the FDIC. Effective July 21, 2010, the basic insurance per depositor was permanently increased to \$250,000.



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At the end of the current period, certificates of deposit maturing over the remainder of this year, over each of the next four years, and thereafter were as follows (dollars in millions):

Year	Amount
2014	\$9,925
2015	\$7,444
2016	\$3,768
2017	\$2,310
2018	\$1,728
Thereafter	\$1,601

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## 6. Long-Term Borrowings

Long-term borrowings consist of borrowings and capital leases having original maturities of one year or more. The following table provides a summary of the Company's long-term borrowings and weighted average interest rates on balances outstanding at period end (dollars in millions):

	March 31, 2014		December 31, 2013		Interest Rate Terms	Maturity
	Outstanding	Interest Rate	Outstanding	Interest Rate		
<b>Securitized Debt</b>						
<b>Fixed rate asset-backed securities</b>						
Principal value (including discount of \$1 at March 31, 2014 and December 31, 2013, respectively)	\$5,549	1.86 %	\$5,549	1.86 %	Various fixed rates	Various February 2015 - July 2019
Fair value adjustment <sup>(1)</sup>	5		5			
Book value	5,554		5,554			
Floating rate asset-backed securities	8,189	0.47 %	9,140	0.46 %	1-month LIBOR(2) + 15 to 58 basis points	Various April 2014 - January 2019
Floating rate asset-backed securities	850	0.40 %	—	—	3-month LIBOR(2) + 20 basis points	February 2017
Floating rate asset-backed securities	—	—	500	0.44 %	Commercial Paper rate + 30 basis points	March 2014
<b>Total Discover Card Master Trust I and Discover Card Execution Note Trust</b>						
Floating rate asset-backed securities (including discount of \$118 and \$129 at March 31, 2014 and December 31, 2013)	959	0.48 %	1,005	0.48 %	3-month LIBOR(2) + 12 to 45 basis points	Various January 2019 - July 2036 (3)
Floating rate asset-backed securities (including discount of \$2 and \$3 at March 31, 2014 and December 31, 2013)	410	4.25 %	434	4.25 %	Prime rate + 100 basis points	June 2031 (3)
Floating rate asset-backed securities (including premium of \$1 at March 31, 2014 and December 31, 2013)	100	4.00 %	105	4.00 %	Prime rate + 75 basis points	July 2042 (3)
Floating rate asset-backed securities (including premium of \$3 at March 31, 2014 and December 31, 2013)	233	3.66 %	248	3.66 %	1-month LIBOR(2) + 350 basis points	July 2042 (3)
	1,702		1,792			



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Total SLC Private Student Loan Trusts						
Total Long-Term Borrowings—owed to securitization investors						
	16,295			16,986		
Discover Financial Services (Parent Company)						
Fixed rate senior notes due 2017						
Principal value	400	6.45	% 400	6.45	% Fixed	June 2017
Fair value adjustment <sup>(1)</sup>	8		13			
Book value	408		413			
Fixed rate senior notes due 2019						
Fixed rate senior notes due 2022 (including discount of \$101 and \$103 at March 31, 2014 and December 31, 2013) <sup>(4)</sup>	78	10.25	% 78	10.25	% Fixed	July 2019
Fixed rate senior notes due 2022 (including discount of \$162 and \$165 at March 31, 2014 and December 31, 2013) <sup>(5)</sup>	221	5.20	% 219	5.20	% Fixed	April 2022
Discover Bank						
Senior bank notes due 2018	750	2.00	% 750	2.00	% Fixed	February 2018
Senior bank notes due 2023 (including discount of \$6 at March 31, 2014 and December 31, 2013)	994	4.20	% 994	4.20	% Fixed	August 2023
Senior bank notes due 2026 (including discount of \$1 at March 31, 2014)	399	4.25	% —	—	% Fixed	March 2026
Subordinated bank notes due 2019	200	8.70	% 200	8.70	% Fixed	November 2019
Subordinated bank notes due 2020 (including discount of \$2 at March 31, 2014 and December 31, 2013)	498	7.00	% 498	7.00	% Fixed	April 2020
Capital lease obligations	1	4.51	% 1	4.51	% Fixed	April 2016
Total long-term borrowings	\$20,182			\$20,474		

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- (1) The Company uses interest rate swaps to hedge portions of these long-term borrowings against changes in fair value attributable to changes in LIBOR. See Note 14: Derivatives and Hedging Activities.
- (2) London Interbank Offered Rate (“LIBOR”).
- (3) Repayment of this debt is dependent upon the timing of principal and interest payments on the underlying student loans. The dates shown represent final maturity dates.
- (4) Discount primarily relates to \$115 million cash premium paid at issuance as part of 2012 private exchange offer to replace higher rate borrowings with borrowings bearing lower interest rates. During the three months ended March 31, 2014 and 2013, respectively, \$2 million of the premium paid was amortized and included in interest expense in the condensed consolidated statements of income.
- (5) Discount primarily relates to \$176 million cash premium paid at issuance as part of 2012 private exchange offer to replace higher rate borrowings with borrowings bearing lower interest rates. During the three months ended March 31, 2014 and 2013, respectively, \$3 million of the premium paid was amortized and included in interest expense in the condensed consolidated statements of income.

## Maturities

Long-term borrowings had the following maturities at the end of the current period (dollars in millions):

Year	Amount
Due in 2014	\$2,040
Due in 2015	3,305
Due in 2016	3,050
Due in 2017	2,908
Due in 2018	2,650
Thereafter	6,229
Total	\$20,182

The Company has access to committed undrawn capacity through private securitizations to support the funding of its credit card loan receivables. As of March 31, 2014, the total commitment of secured credit facilities through private providers was \$7.5 billion, none of which had been used at March 31, 2014. Access to the unused portions of the secured credit facilities is subject to the terms of the agreements with each of the providers which have various expirations in 2015 and 2016. Borrowings outstanding under each facility bear interest at a margin above LIBOR or the asset-backed commercial paper costs of each individual conduit provider. The terms of each agreement provide for a commitment fee to be paid on the unused capacity, and include various affirmative and negative covenants, including performance metrics and legal requirements similar to those required to issue any term securitization transaction.

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## 7. Accumulated Other Comprehensive Income

Changes in each component of accumulated other comprehensive income (loss) were as follows (dollars in millions):

	Unrealized Gain (Loss) on Available-for-Sale Investment Securities, Net of Tax	Gain (Loss) on Cash Flow Hedges, Net of Tax	Foreign Currency Translation Adjustments, Net of Tax <sup>(1)</sup>	Pension and Post Retirement Plan Gain (Loss), Net of Tax	Accumulated Other Comprehensive Income (Loss)
Balance at December 31, 2012	\$ 71	\$3	—	\$(146 )	\$ (72 )
Net change	(11 )	(1 )	—	—	(12 )
Balance at March 31, 2013	\$ 60	\$2	—	\$(146 )	\$ (84 )
Balance at December 31, 2013	\$ 19	\$13	1	\$(101 )	\$ (68 )
Net change	2	(4 )	—	—	(2 )
Balance at March 31, 2014	\$ 21	\$9	1	\$(101 )	\$ (70 )

(1) Includes unrealized losses on hedge of net investment in foreign subsidiary, net of tax benefit and net gains on foreign currency translation adjustments.

The table below presents the other comprehensive income (loss) before reclassifications and amounts reclassified from AOCI for each component of OCI before- and after-tax (dollars in millions):

	Before Tax	Tax (Expense) Benefit	Net of Tax
For the Three Months Ended March 31, 2014			
Available-for-Sale Investment Securities:			
Net unrealized holding gains arising during the period	\$7	\$(3 )	\$4
Amounts reclassified from accumulated other comprehensive income	(4 )	2	(2 )
Net change	\$3	\$(1 )	\$2
Cash Flow Hedges:			
Net unrealized losses arising during the period	\$(13 )	\$5	\$(8 )
Amounts reclassified from accumulated other comprehensive income	7	(3 )	4
Net change	\$(6 )	\$2	\$(4 )
For the Three Months Ended March 31, 2013			
Available-for-Sale Investment Securities:			
Net unrealized holding losses arising during the period	\$(14 )	\$5	\$(9 )
Amounts reclassified from accumulated other comprehensive income	(2 )	—	(2 )
Net change	\$(16 )	\$5	\$(11 )
Cash Flow Hedges:			
Amounts reclassified from accumulated other comprehensive income	(2 )	1	(1 )
Net change	\$(2 )	\$1	\$(1 )

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## 8. Income Taxes

The following table presents the calculation of the Company's effective income tax rate (dollars in millions, except effective income tax rate):

	For the Three Months Ended March 31,		
	2014	2013	
Income before income tax expense	\$1,022	\$1,080	
Income tax expense	\$391	\$407	
Effective income tax rate	38.3	% 37.7	%

Income tax expense decreased \$16 million for the three months ended March 31, 2014, as compared to the same period in 2013, because of a decrease in pretax income. The effective tax rate increased from 37.7% for the three months ended March 31, 2013 to 38.3% for the three months ended March 31, 2014 due to deferred tax adjustments on limited partnership community reinvestment act investments.

The Company is subject to examination by the Internal Revenue Service ("IRS") and the tax authorities in various states. The tax years under examination vary by jurisdiction. The Company is pursuing an administrative appeal of the IRS's proposed assessment for the years 1999 through 2005, when Discover was a subsidiary of Morgan Stanley. It is reasonably possible that a settlement of the IRS appeal and certain state audits may be made within 12 months of the reporting date. At this time, the Company believes it is reasonably possible that a reduction in the amount of unrecognized tax benefits of \$99 million could be recognized as a result of such settlement.

The IRS is currently examining 2006 through June 20, 2007. This period is also part of a Morgan Stanley audit. A separate post-spin examination covers the years 2008 through 2010. The Company regularly assesses the likelihood of additional assessments or settlements in each of the taxing jurisdictions resulting from these and subsequent years' examinations. The Company believes that its reserves are sufficient to cover any tax, penalties and interest that could result from such examinations.

## 9. Earnings Per Share

The following table presents the calculation of basic and diluted earnings per share ("EPS") (in millions, except per share amounts):

	For the Three Months Ended March 31,	
	2014	2013
Numerator:		
Net income	\$631	\$673
Preferred stock dividends	(9	) (9
Net income available to common stockholders	622	664
Income allocated to participating securities	(4	) (5
Net income allocated to common stockholders	\$618	\$659
Denominator:		
Weighted average shares of common stock outstanding	471	496
Effect of dilutive common stock equivalents	1	1
Weighted average shares of common stock outstanding and common stock equivalents	472	497
Basic earnings per common share	\$1.31	\$1.33
Diluted earnings per common share	\$1.31	\$1.33

Anti-dilutive securities were not material and had no impact on the computation of diluted EPS for the three months ended March 31, 2014 and 2013, respectively.

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## 10. Capital Adequacy

The Company is subject to the capital adequacy guidelines of the Federal Reserve, and Discover Bank (the “Bank”), the Company’s main banking subsidiary, is subject to various regulatory capital requirements as administered by the Federal Deposit Insurance Corporation (the “FDIC”). Failure to meet minimum capital requirements can result in the initiation of certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the financial position and results of the Company and the Bank. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance sheet items, as calculated under regulatory accounting practices. Capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (as defined in the regulations) of total risk-based capital and Tier 1 capital to risk-weighted assets, and of Tier 1 capital to average assets. As of March 31, 2014, the Company and the Bank met all capital adequacy requirements to which they were subject. Under regulatory capital requirements, the Company and the Bank must maintain minimum levels of capital that are dependent upon the risk-weighted amount or average level of the financial institution’s assets, specifically (a) 8% to 10% of total risk-based capital to risk-weighted assets (“total risk-based capital ratio”), (b) 4% to 6% of Tier 1 capital to risk-weighted assets (“Tier 1 risk-based capital ratio”) and (c) 4% to 5% of Tier 1 capital to average assets (“Tier 1 leverage ratio”). To be categorized as “well-capitalized,” the Company and the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table below. As of March 31, 2014, the Company and the Bank met the requirements for well-capitalized status and there have been no conditions or events that management believes have changed the Company’s or the Bank’s category.

The following table shows the actual capital amounts and ratios of the Company and the Bank and comparisons of each to the regulatory minimum and “well-capitalized” requirements (dollars in millions):

	Actual		Minimum Capital Requirements		Capital Requirements To Be Classified as Well-Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
March 31, 2014						
Total capital (to risk-weighted assets)						
Discover Financial Services	\$ 12,175	18.1	% \$ 5,389	≥8.0%	\$ 6,736	≥10.0%
Discover Bank	\$ 10,705	16.1	% \$ 5,324	≥8.0%	\$ 6,655	≥10.0%
Tier 1 capital (to risk-weighted assets)						
Discover Financial Services	\$ 10,626	15.8	% \$ 2,695	≥4.0%	\$ 4,042	≥6.0%
Discover Bank	\$ 9,166	13.8	% \$ 2,662	≥4.0%	\$ 3,993	≥6.0%
Tier 1 capital (to average assets)						
Discover Financial Services	\$ 10,626	13.4	% \$ 3,173	≥4.0%	\$ 3,966	≥5.0%
Discover Bank	\$ 9,166	11.7	% \$ 3,137	≥4.0%	\$ 3,921	≥5.0%
December 31, 2013						
Total capital (to risk-weighted assets)						
Discover Financial Services	\$ 11,975	17.4	% \$ 5,492	≥8.0%	\$ 6,865	≥10.0%
Discover Bank	\$ 10,496	15.5	% \$ 5,428	≥8.0%	\$ 6,785	≥10.0%
Tier 1 capital (to risk-weighted assets)						
Discover Financial Services	\$ 10,409	15.2	% \$ 2,746	≥4.0%	\$ 4,119	≥6.0%

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Discover Bank	\$8,941	13.2	%	\$2,714	≥4.0%	\$4,071	≥6.0%
Tier 1 capital (to average assets)							
Discover Financial Services	\$10,409	13.4	%	\$3,116	≥4.0%	\$3,895	≥5.0%
Discover Bank	\$8,941	11.6	%	\$3,077	≥4.0%	\$3,847	≥5.0%

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## 11. Commitments, Contingencies and Guarantees

## Lease Commitments

The Company leases various office space and equipment under capital and non-cancelable operating leases, which expire at various dates through 2024. At the end of the current period, future minimum payments on leases with original terms in excess of one year consist of the following (dollars in millions):

	Capitalized Leases	Operating Leases
2014	\$—	\$ 12
2015	1	13
2016	—	12
2017	—	10
2018	—	7
Thereafter	—	12
Total minimum lease payments	1	\$66
Less: Amount representing interest	—	
Present value of net minimum lease payments	\$1	

## Unused Commitments to Extend Credit

At March 31, 2014, the Company had unused commitments to extend credit for loans of approximately \$166.5 billion. Such commitments arise primarily from agreements with customers for unused lines of credit on certain credit cards and certain other loan products, provided there is no violation of conditions in the related agreements. These commitments, substantially all of which the Company can terminate at any time and which do not necessarily represent future cash requirements, are periodically reviewed based on account usage, customer creditworthiness and loan qualification.

## Securitizations Representations and Warranties

As part of the Company's financing activities, the Company provides representations and warranties that certain assets pledged as collateral in secured borrowing arrangements conform to specified guidelines. Due diligence is performed by the Company which is intended to ensure that asset guideline qualifications are met. If the assets pledged as collateral do not meet certain conforming guidelines, the Company may be required to replace, repurchase or sell such assets. In its credit card securitization activities, the Company would replace nonconforming receivables through the allocation of excess seller's interest or from additional transfers from the unrestricted pool of receivables. If the Company could not add enough receivables to satisfy the requirement, an early amortization (or repayment) of investors' interests would be triggered. In its student loan securitizations, the Company would generally repurchase the loans from the trust at the outstanding principal amount plus interest.

The maximum potential amount of future payments the Company could be required to make would be equal to the current outstanding balances of third-party investor interests in credit card asset-backed securities plus the principal amount of any other outstanding secured borrowings. The Company has recorded substantially all of the maximum potential amount of future payments in long-term borrowings on the Company's statement of financial condition. The Company has not recorded any incremental contingent liability associated with its secured borrowing representations and warranties. Management believes that the probability of having to replace, repurchase or sell assets pledged as collateral under secured borrowing arrangements, including an early amortization event, is low.

## Mortgage Loans Representations and Warranties

The Company sells loans it originates to investors on a servicing released basis and the risk of loss or default by the borrower is generally transferred to the investor. However, the Company is required by these investors to make certain representations and warranties relating to credit information, loan documentation and collateral. These representations and warranties may extend through the contractual life of the mortgage loan. Subsequent to the sale, if underwriting deficiencies, borrower fraud or documentation defects are discovered in individual mortgage loans, the Company may be obligated to repurchase the respective mortgage loan or indemnify the investors for any losses from borrower defaults if such deficiency or defect cannot be cured within the specified period following discovery. The Company

has established a repurchase reserve

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based on expected losses. At March 31, 2014, this amount was not material and was included in accrued expenses and other liabilities on the condensed consolidated statements of financial condition. The related provision was included in other income on the condensed consolidated statements of income.

**Guarantees**

The Company has obligations under certain guarantee arrangements, including contracts and indemnification agreements, which contingently require the Company to make payments to the guaranteed party based on changes in an underlying asset, liability or equity security of a guaranteed party, rate or index. Also included as guarantees are contracts that contingently require the Company to make payments to a guaranteed party based on another entity's failure to perform under an agreement. The Company's use of guarantees is disclosed below by type of guarantee.

**Counterparty Settlement Guarantees**

Diners Club and DFS Services LLC (on behalf of PULSE) have various counterparty exposures, which are listed below.

**Merchant Guarantee.** Diners Club has entered into contractual relationships with certain international merchants, which generally include travel-related businesses, for the benefit of all Diners Club licensees. The licensees hold the primary liability to settle the transactions of their customers with these merchants. However, Diners Club retains a counterparty exposure if a licensee fails to meet its financial payment obligation to one of these merchants.

**ATM Guarantee.** PULSE entered into contractual relationships with certain international ATM acquirers in which DFS Services LLC retains counterparty exposure if an issuer fails to fulfill its settlement obligation.

The maximum potential amount of future payments related to such contingent obligations is dependent upon the transaction volume processed between the time a counterparty defaults on its settlement and the time at which the Company disables the settlement of any further transactions for the defaulting party, which could be one month depending on the type of guarantee/counterparty. However, there is no limitation on the maximum amount the Company may be liable to pay. The actual amount of the potential exposure cannot be quantified as the Company cannot determine whether particular counterparties will fail to meet their settlement obligations.

While the Company has some contractual remedies to offset these counterparty settlement exposures (such as letters of credit or pledged deposits), in the event that all licensees and/or issuers were to become unable to settle their transactions, the Company estimates its maximum potential counterparty exposures to these settlement guarantees, based on historical transaction volume, would be as follows (dollars in millions):

	March 31, 2014
Diners Club:	
Merchant guarantee	\$173
PULSE:	
ATM guarantee	\$1

With regard to the counterparty settlement guarantees discussed above, the Company believes that the estimated amounts of maximum potential future payments are not representative of the Company's actual potential loss exposure given Diners Club's and PULSE's insignificant historical losses from these counterparty exposures. As of March 31, 2014, the Company had not recorded any contingent liability in the condensed consolidated financial statements for these counterparty exposures, and management believes that the probability of any payments under these arrangements is low.

The Company also retains counterparty exposure for the obligations of Diners Club licensees that participate in the Citishare network, an electronic funds processing network. Through the Citishare network, Diners Club customers are able to access certain ATMs directly connected to the Citishare network. The Company's maximum potential future payment under this counterparty exposure is limited to \$15 million subject to annual adjustment based on actual transaction experience. However, as of March 31, 2014, the Company had not recorded any contingent liability in the condensed consolidated financial statements related to this counterparty exposure, and management believes that the probability of any payments under this arrangement is low.



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## Merchant Chargeback Guarantees

The Company operates the Discover Network, issues payment cards and permits third parties to issue payment cards. The Company is contingently liable for certain transactions processed on the Discover Network in the event of a dispute between the payment card customer and a merchant. The contingent liability arises if the disputed transaction involves a merchant or merchant acquirer with whom the Discover Network has a direct relationship. If a dispute is resolved in the customer's favor, the Discover Network will credit or refund the disputed amount to the Discover Network card issuer, who in turn credits its customer's account. The Discover Network will then charge back the disputed amount of the payment card transaction to the merchant or merchant acquirer, where permitted by the applicable agreement, to seek recovery of amounts already paid to the merchant for payment card transactions. If the Discover Network is unable to collect the amount subject to dispute from the merchant or merchant acquirer (e.g., in the event of merchant default or dissolution) or after expiration of the time period for chargebacks in the applicable agreement, the Discover Network will bear the loss for the amount credited or refunded to the customer. In most instances, a loss by the Discover Network is unlikely to arise in connection with payments on card transactions because most products or services are delivered when purchased, and credits are issued by merchants on returned items in a timely fashion, thus minimizing the likelihood of cardholder disputes with respect to amounts paid by the Discover Network. However, where the product or service is not scheduled to be provided to the customer until a later date following the purchase, the likelihood of a contingent payment obligation by the Discover Network increases. Losses related to merchant chargebacks were not material for the three months ended March 31, 2014 or 2013. The maximum potential amount of obligations of the Discover Network arising as a result of such contingent obligations is estimated to be the portion of the total Discover Network transaction volume processed to date for which timely and valid disputes may be raised under applicable law and relevant issuer and customer agreements. There is no limitation on the maximum amount the Company may be liable to pay to issuers. However, the Company believes that such amount is not representative of the Company's actual potential loss exposure based on the Company's historical experience. The actual amount of the potential exposure cannot be quantified as the Company cannot determine whether the current or cumulative transaction volumes may include or result in disputed transactions.

The table below summarizes certain information regarding merchant chargeback guarantees (in millions):

	For the Three Months Ended March 31,	
	2014	2013
Aggregate sales transaction volume <sup>(1)</sup>	\$28,154	\$27,228

(1) Represents period transactions processed on the Discover Network for which a potential liability exists that, in aggregate, can differ from credit card sales volume.

The Company did not record any contingent liability in the condensed consolidated financial statements for merchant chargeback guarantees as of March 31, 2014 or December 31, 2013. The Company mitigates the risk of potential loss exposure by withholding settlement from merchants, obtaining third-party guarantees, or obtaining escrow deposits or letters of credit from certain merchant acquirers or merchants that are considered higher risk due to various factors such as time delays in the delivery of products or services.

The table below provides information regarding settlement withholdings and escrow deposits, which are recorded in interest-bearing deposit accounts, and accrued expenses and other liabilities on the Company's condensed consolidated statements of financial condition (dollars in millions):

	March 31, 2014	December 31, 2013
Settlement withholdings and escrow deposits	\$21	\$17

## 12. Litigation and Regulatory Matters

In the normal course of business, from time to time, the Company has been named as a defendant in various legal actions, including arbitrations, class actions, and other litigation, arising in connection with its activities. Certain of the

actual or threatened legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. The Company contests liability and/or the amount of damages as appropriate in each pending matter.

The Company has historically relied on the arbitration clause in its cardmember agreements, which has in some instances limited the costs of, and the Company's exposure to, litigation, but there can be no assurance that the Company will continue to be successful in enforcing its arbitration clause in the future. Legal challenges to the enforceability of these clauses have led most card issuers, and may cause the Company, to discontinue their use. In addition, bills are periodically introduced in Congress to directly or indirectly prohibit the use of pre-dispute arbitration clauses, and the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Reform Act") authorized the Consumer Financial Protection Bureau (the "CFPB") to conduct a study on pre-dispute arbitration clauses and, based on the study, potentially limit or ban arbitration clauses. A preliminary report on arbitration agreements issued by the CFPB expressed concerns about these agreements that may signal the CFPB is contemplating taking such steps. Further, the Company is involved in pending legal actions challenging its arbitration clause.

The Company is also involved, from time to time, in other reviews, investigations and proceedings (both formal and informal) by governmental agencies regarding the Company's business including, among other matters, consumer regulatory, accounting, tax and other operational matters, some of which may result in significant adverse judgments, settlements, fines, penalties, injunctions, decreases in regulatory ratings, customer restitution or other relief, which could materially impact the Company's financial statements, increase its cost of operations, or limit its ability to execute its business strategies and engage in certain business activities. The FDIC is completing its annual anti-money laundering/Bank Secrecy Act examination of Discover Bank and has notified the Company of certain potential program deficiencies. The CFPB has issued a Civil Investigative Demand to Discover Bank seeking documents and information regarding certain of Discover Bank's student loan servicing practices. Discover Bank is cooperating with each of the agencies on these matters. If the FDIC or CFPB determines to bring an enforcement action, it could include demands for civil money penalties, changes to certain of Discover Bank's business practices and on the student loan servicing matter, customer restitution.

In accordance with applicable accounting guidance, the Company establishes an accrued liability for legal and regulatory matters when those matters present loss contingencies which are both probable and estimable. Litigation expense was not material for the three months ended March 31, 2014 and 2013.

There may be an exposure to loss in excess of any amounts accrued. The Company believes the estimate of the aggregate range of reasonably possible losses (meaning those losses the likelihood of which is more than remote but less than likely) in excess of the amounts that the Company has accrued for legal and regulatory proceedings is up to \$160 million. This estimated range of reasonably possible losses is based upon currently available information for those proceedings in which the Company is involved, takes into account the Company's best estimate of such losses for those matters for which an estimate can be made, and does not represent the Company's maximum potential loss exposure. Various aspects of the legal proceedings underlying the estimated range will change from time to time and actual results may vary significantly from the estimate.

The Company's estimated range above involves significant judgment, given the varying stages of the proceedings, the existence of numerous yet to be resolved issues, the breadth of the claims (often spanning multiple years and, in some cases, a wide range of business activities), unspecified damages and/or the novelty of the legal issues presented. The outcome of pending matters could be material to the Company's condensed consolidated financial condition, operating results and cash flows for a particular future period, depending on, among other things, the level of the Company's income for such period, and could adversely affect the Company's reputation.

The Company has been subject to two class action cases in relation to the Telephone Consumer Protection Act ("TCPA"). The cases were filed in the U.S. District Court for the Northern District of California on November 30, 2011 (Walter Bradley et al. v. Discover Financial Services) and on March 6, 2012 (Andrew Steinfeld v. Discover Financial Services, DFS Services LLC and Discover Bank). The plaintiff in each case alleges that the Company contacted him, and members of the class he seeks to represent, on their cellular telephones without their express consent in violation of the TCPA. The plaintiff in each case seeks statutory damages for alleged negligent and willful violations of the TCPA, attorneys' fees, costs and injunctive relief. The TCPA provides for statutory damages of \$500 for each violation (\$1,500 for willful violations). The Company and class counsel entered into a preliminary settlement of both pending

class actions. On September 10, 2013, the court granted preliminary approval of the settlement. On March 31, 2014, the court granted final approval of the settlement.

On July 5, 2012, the Antitrust Division of the United States Department of Justice (the "Division") issued a Civil Investigative Demand ("CID") to the Company seeking information regarding an investigation related to potential violations of Sections 1 and 2 of the Sherman Act, 15 U.S.C. §§1-2, by an unidentified party other than Discover. The CID seeks documents, data and narrative responses to several interrogatories and document requests, related to the debit card market. A CID is a request for information in the course of a civil investigation and does not constitute the commencement of legal proceedings. The Division is permitted by statute to issue a CID to anyone whom it believes may have information relevant to an investigation. The receipt of a CID does not presuppose that there is probable cause to believe that a violation of the antitrust laws has occurred or that a formal complaint ultimately will be filed. The Company is cooperating with the Division in connection with the CID.

On August 14, 2012, a purported shareholder, James Groen, filed a shareholder derivative action in the U.S. District Court for the Northern District of Illinois (Groen v. Nelms et al.) against the Company's board of directors, certain current and former officers and directors, and the Company as nominal defendant. On August 27, 2012, a second purported shareholder, the Charter Township of Clinton Police and Fire Retirement System, filed a substantially identical shareholder derivative action in the same court against the same parties (Charter Township of Clinton Police and Fire Retirement System v. Nelms et al.). On September 25, 2012, the actions were consolidated, and on February 19, 2013, the plaintiffs filed an amended consolidated complaint. The consolidated complaint asserts claims against the board of directors and certain current and former officers and directors for alleged breach of fiduciary duty, corporate waste, and unjust enrichment arising out of the Company's alleged violations of the law in connection with the marketing and sale of its protection products. The relief sought in the consolidated complaint includes changes to the Company's corporate governance procedures; unspecified damages, injunctive relief, restitution, and disgorgement from the individual defendants; and attorneys' fees. On April 5, 2013, the defendants filed a motion to dismiss the amended consolidated complaint, and on June 5, 2013, briefing on the motion to dismiss was completed. The motion to dismiss is currently pending.

### 13. Fair Value Measurements and Disclosures

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC Topic 820, Fair Value Measurement, provides a three-level hierarchy for classifying financial instruments, which is based on whether the inputs to the valuation techniques used to measure the fair value of each financial instrument are observable or unobservable. It also requires certain disclosures about those measurements. The three level valuation hierarchy is as follows:

• Level 1: Fair values determined by Level 1 inputs are defined as those that utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access.

• Level 2: Fair values determined by Level 2 inputs are those that utilize inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and liabilities in active or inactive markets, quoted prices for the identical assets in an inactive market, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals. The Company evaluates factors such as the frequency of transactions, the size of the bid-ask spread and the significance of adjustments made when considering transactions involving similar assets or liabilities to assess the relevance of those observed prices. If relevant and observable prices are available, the fair values of the related assets or liabilities would be classified as Level 2.

• Level 3: Fair values determined by Level 3 inputs are those based on unobservable inputs, and include situations where there is little, if any, market activity for the asset or liability being valued. In instances in which the inputs used to measure fair value may fall into different levels of the fair value hierarchy, the level in the fair value hierarchy within which the fair value measurement in its entirety is classified is based on the lowest level input that is significant to the fair value measurement in its entirety. The Company may utilize both observable and unobservable inputs in determining the fair values of financial instruments classified within the Level 3 category.

The determination of classification of its financial instruments within the fair value hierarchy is performed at least quarterly by the Company. For transfers in and out of the levels of the fair value hierarchy, the Company discloses the fair value measurement based on the value immediately preceding the transfer.

The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and involves consideration of factors specific to the asset or liability. Furthermore, certain techniques used to measure fair value involve some degree of judgment and, as a result, are not necessarily indicative of the amounts the Company would realize in a current market exchange.

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During the three months ended March 31, 2014, there were no changes to the Company's valuation techniques that had, or are expected to have, a material impact on the Company's condensed consolidated financial position or results of operations.

## Assets and Liabilities Measured at Fair Value on a Recurring Basis

Assets and liabilities measured at fair value on a recurring basis are as follows (dollars in millions):

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Balance at March 31, 2014				
Assets				
U.S Treasury securities	\$ 1,342	\$ —	\$ —	\$ 1,342
U.S government agency securities	1,047	—	—	1,047
Residential mortgage-backed securities - Agency	—	1,513	—	1,513
Available-for-sale investment securities	\$ 2,389	\$ 1,513	\$ —	\$ 3,902
Mortgage loans held for sale	\$ —	\$ 133	\$ —	\$ 133
Interest rate lock commitments	\$ —	\$ —	\$ 5	\$ 5
Forward delivery contracts	—	1	—	1
Other derivative financial instruments	—	67	—	67
Derivative financial instruments	\$ —	\$ 68	\$ 5	\$ 73
Liabilities				
Forward delivery contracts	\$ —	\$ 1	\$ —	\$ 1
Other derivative financial instruments	—	7	—	7
Derivative financial instruments	\$ —	\$ 8	\$ —	\$ 8
Balance at December 31, 2013				
Assets				
U.S Treasury securities	\$ 2,057	\$ —	\$ —	\$ 2,057
U.S government agency securities	1,561	—	—	1,561
Credit card asset-backed securities of other issuers	—	6	—	6
Residential mortgage-backed securities - Agency	—	1,307	—	1,307
Available-for-sale investment securities	\$ 3,618	\$ 1,313	\$ —	\$ 4,931
Mortgage loans held for sale	\$ —	\$ 148	\$ —	\$ 148
Interest rate lock commitments	\$ —	\$ —	\$ 4	\$ 4
Forward delivery contracts	—	5	—	5
Other derivative financial instruments	—	70	—	70
Derivative financial instruments	\$ —	\$ 75	\$ 4	\$ 79
Liabilities				
Forward delivery contracts	\$ —	\$ 1	\$ —	\$ 1
Other derivative financial instruments	—	6	—	6
Derivative financial instruments	\$ —	\$ 7	\$ —	\$ 7

There were no transfers between Levels 1 and 2 within the fair value hierarchy for the three months ended March 31, 2014 and 2013.

## Available-for-Sale Investment Securities

Investment securities classified as available-for-sale consist of U.S. Treasury and government agency securities, residential mortgage-backed securities, and credit card asset-backed securities issued by other financial institutions. The fair value estimates of investment securities classified as Level 1, consisting of U.S. Treasury and government agency securities, are determined based on quoted market prices for the same or similar securities. The Company

classifies all other available-for-sale investment securities as Level 2, the fair value estimates of which are primarily obtained from pricing services,

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where fair values are estimated using pricing models based on observable market inputs or recent trades of similar securities. The fair value estimates of mortgage-backed and credit card asset-backed securities are based on the best information available. This data may consist of observed market prices, broker quotes or discounted cash flow models that incorporate assumptions such as benchmark yields, issuer spreads, prepayment speeds, credit ratings and losses, the priority of which may vary based on availability of information.

The Company validates the fair value estimates provided by the pricing services primarily by comparison to valuations obtained through other pricing sources. The Company evaluates pricing variances amongst different pricing sources to ensure that the valuations utilized are reasonable. The Company also corroborates the reasonableness of the fair value estimates with analysis of trends of significant inputs, such as market interest rate curves. The Company further performs due diligence in understanding the procedures and techniques performed by the pricing services to derive fair value estimates.

At March 31, 2014, amounts reported in residential mortgage-backed securities reflect government-rated obligations issued by Fannie Mae, Freddie Mac and Ginnie Mae with a par value of \$1.5 billion, a weighted-average coupon of 2.79% and a weighted-average remaining maturity of four years.

#### Mortgage Loans Held for Sale and Related Derivative Instruments

The Company enters into commitments with consumers to originate mortgage loans at a specified interest rate, known as interest rate lock commitments (“IRLCs”). The Company reports IRLCs as derivative instruments at fair value with changes in fair value being recorded in other income. IRLCs and mortgage loans held for sale under certain loan programs are hedged in aggregate using “to be announced mortgage-backed securities” (“TBA MBS”). IRLCs and mortgage loans held for sale under loan programs that generally have lower volume are hedged on an individual loan level using best-efforts forward delivery contracts.

Fair values for each of these instruments are determined using quantitative risk models. The Company has various monitoring processes in place to validate these valuations, including valuations of Level 3 assets. Valuation results are reviewed in comparison to expected results, recent activity, and historical trends. Any significant or unusual fluctuations in value are analyzed.

Mortgage loans held for sale. Valuations of mortgage loans held for sale are based on the loan amount, note rate, loan program, expected sale date of the loan and, most significantly, investor pricing tables stratified by product, note rate and term, adjusted for current market conditions. Mortgage loans held for sale are classified as Level 2 as the investor pricing tables used to value them are an observable input. Impaired mortgage loans held for sale are classified as Level 3 as loss severity is an unobservable input used in valuation. The Company recognizes interest income separately from changes in fair value.

Interest rate lock commitments. IRLCs for loans to be sold to investors using a mandatory or assignment of trade method derive their base value from an underlying loan type with similar characteristics using the TBA MBS market, which is actively quoted and easily validated through external sources. The data inputs used in this valuation include, but are not limited to, loan type, underlying loan amount, note rate, loan program, and commitment term. IRLCs for loans to be sold to investors on a best-efforts basis derive their base value from the value of the underlying loans using investor pricing tables stratified by product, note rate and term, adjusted for current market conditions. These valuations are adjusted at the loan level to consider the servicing release premium and loan pricing adjustments specific to each loan. For all IRLCs, this base value is then adjusted for the anticipated loan funding probability, or pull through rate. The anticipated loan funding probability is an unobservable input based on historical experience, which results in classification of IRLCs as Level 3.

Forward delivery contracts. Under the Company's risk management policy, the Company economically hedges the changes in fair value of IRLCs and mortgage loans held for sale caused by changes in interest rates by using TBA MBS and entering into best-efforts forward delivery contracts. These hedging instruments are recorded at fair value with changes in fair value recorded in other income. TBA MBS used to hedge both IRLCs and loans held for sale are valued based primarily on observable inputs related to characteristics of the underlying MBS stratified by product, coupon and settlement date. Therefore, these derivatives are classified as Level 2. Best-efforts forward delivery contracts are valued based on investor pricing tables, which are observable inputs, stratified by product, note rate, and term, adjusted for current market conditions. An anticipated loan funding probability is applied to value best-efforts

contracts hedging IRLCs, which results in the classification of these contracts as Level 3. The current base loan price and, for best-efforts contracts hedging IRLCs, the anticipated loan funding probability, are the most significant assumptions affecting the value of the best-efforts contracts. The

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best-efforts forward delivery contracts hedging loans held for sale are classified as Level 2, so such contracts are transferred from Level 3 to Level 2 at the time the underlying loan is originated. For the purposes of the tables below, we refer to TBA MBS and best-efforts forward delivery contracts as forward delivery contracts.

**Other Derivative Financial Instruments**

The Company's other derivative financial instruments consist of interest rate swaps and foreign exchange forward contracts. The fair value of these instruments is estimated by a third-party valuation service that uses proprietary pricing models, where certain inputs to those models are readily observable market-based inputs, including interest rate curves, option volatility and foreign currency forward and spot rates. In determining fair values, the pricing models use widely accepted valuation techniques including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity and uses observable market-based inputs. The fair values of the interest rate swaps are determined using the market standard methodology of netting the discounted future fixed cash receipts (or payments) and the discounted expected variable cash payments (or receipts). The variable cash payments are based on an expectation of future interest rates derived from observable market interest rate curves. The Company considers collateral and master netting agreements that mitigate credit exposure to counterparties in determining the counterparty credit risk valuation adjustment. The fair values of the currency instruments are valued comparing the contracted forward exchange rate pertaining to the specific contract maturities to the current market exchange rate.

The Company validates the fair value estimates of interest rate swaps primarily through comparison to the fair value estimates computed by the counterparties to each of the derivative transactions. The Company evaluates pricing variances amongst different pricing sources to ensure that the valuations utilized are reasonable. The Company also corroborates the reasonableness of the fair value estimates with analysis of trends of significant inputs, such as market interest rate curves. The Company performs due diligence in understanding the impact to any changes to the valuation techniques performed by proprietary pricing models prior to implementation, working closely with the third-party valuation service, and reviews the control objectives of the service at least annually. The Company corroborates the fair value of foreign exchange forward contracts through independent calculation of the fair value estimates.

**Assets and Liabilities under the Fair Value Option**

The Company has elected to account for mortgage loans held for sale at fair value. Electing the fair value option allows a better offset of the changes in fair values of the loans and the forward delivery contracts used to economically hedge them without the burden of complying with the requirements for hedge accounting. At March 31, 2014 and December 31, 2013, the aggregate unpaid principal balance of loans held for sale for which the fair value option had been elected was \$129 million and \$146 million, respectively. At March 31, 2014 and December 31, 2013, the same loans had a fair value of \$133 million and \$148 million, respectively. For the three months ended March 31, 2014, and 2013, respectively, \$5 million of losses and \$6 million of gains from fair value adjustments on mortgage loans held for sale were recorded in other revenue on the condensed consolidated statements of income.

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## Level 3 Financial Instruments Only

## Changes in Level 3 Assets and Liabilities Measure at Fair Value on a Recurring Basis

The following tables provide changes in the Company's Level 3 assets and liabilities measured at fair value on a recurring basis (dollars in millions):

For the Three Months Ended March 31, 2014

	Balance at December 31, 2013	Transfers into Level 3	Transfers out of Level 3	Total Net Gains included in Earnings	Purchases	Sales	Settlements	Transfers of IRLCs to Closed Loans	Balance at March 31, 2014
Interest rate lock commitments	\$4	—	—	18	—	—	—	(17 )	\$5
Forward delivery contracts	\$—	—	(1 )	1	—	—	—	—	\$—
Mortgage loans held for sale	\$—	1	—	—	—	(1 )	—	—	\$—

For the Three Months Ended March 31, 2013

	Balance at December 31, 2012	Transfers into Level 3	Transfers out of Level 3	Total Net Gains included in Earnings	Purchases	Sales	Settlements	Transfers of IRLCs to Closed Loans	Balance at March 31, 2013
Interest rate lock commitments	\$12	—	—	48	—	—	3	(49 )	\$14
Mortgage loans held for sale	\$—	1	—	—	—	—	—	—	\$1

## Unobservable Inputs and Sensitivities

The following table presents information about significant unobservable inputs related to the Company's Level 3 financial assets and liabilities measured at fair value on a recurring and non-recurring basis at the end of the current period (dollars in millions):

March 31, 2014	Fair Value	Valuation Technique	Significant Unobservable Input	Ranges of Inputs		Weighted Average <sup>(1)</sup>
				Low	High	
Interest rate lock commitments	\$5	Quantitative risk models	Loan funding probability	8	% 100	% 59

(1) Weighted averages are calculated using notional amounts for derivative instruments.

The anticipated loan funding probability represents the Company's expectation regarding the percentage of IRLCs that will ultimately be funded. Generally, an increase in the anticipated loan funding probability would result in an increase in the magnitude of fair value measurements.

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis

The Company also has assets that under certain conditions are subject to measurement at fair value on a non-recurring basis. These assets include those associated with acquired businesses, including goodwill and other intangible assets. For these assets, measurement at fair value in periods subsequent to the initial recognition of the assets is applicable if one or more of the assets is determined to be impaired. During the three months ended March 31, 2014 and 2013, the Company had no material impairments related to these assets.

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## Financial Instruments Measured at Other Than Fair Value

The following tables disclose the estimated fair value of the Company's financial assets and financial liabilities that are not required to be carried at fair value (dollars in millions):

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	Carrying Value
Balance at March 31, 2014					
Assets					
U.S Treasury securities	\$ 1	\$—	\$—	\$ 1	\$ 1
States and political subdivisions of states	—	10	—	10	10
Residential mortgage-backed securities - Agency	—	51	—	51	51
Held-to-maturity investment securities	\$ 1	\$61	\$—	\$62	\$62
Cash and cash equivalents	\$ 8,731	\$—	\$—	\$8,731	\$8,731
Restricted cash	\$ 1,163	\$—	\$—	\$ 1,163	\$ 1,163
Net loan receivables <sup>(1)</sup>	\$—	\$—	\$49,785	\$49,785	\$62,128
Accrued interest receivables	\$—	\$560	\$—	\$560	\$560
Liabilities					
Deposits	\$—	\$45,232	\$—	\$45,232	\$44,984
Short-term borrowings	\$—	\$ 124	\$—	\$ 124	\$ 124
Long-term borrowings - owed to securitization investors	\$—	\$14,731	\$1,853	\$16,584	\$16,295
Other long-term borrowings	\$—	\$4,410	\$ 1	\$4,411	\$3,887
Accrued interest payables	\$—	\$ 129	\$—	\$ 129	\$ 129
Balance at December 31, 2013					
Assets					
U.S Treasury securities	\$ 1	\$—	\$—	\$ 1	\$ 1
States and political subdivisions of states	—	14	—	14	15
Residential mortgage-backed securities - Agency	—	43	—	43	44
Held-to-maturity investment securities	\$ 1	\$57	\$—	\$58	\$60
Cash and cash equivalents	\$ 6,554	\$—	\$—	\$6,554	\$6,554
Restricted cash	\$ 182	\$—	\$—	\$ 182	\$ 182
Net loan receivables <sup>(1)</sup>	\$—	\$—	\$64,968	\$64,968	\$63,975
Accrued interest receivables	\$—	\$556	\$—	\$556	\$556
Liabilities					
Deposits	\$—	\$45,231	\$—	\$45,231	\$44,959
Short-term borrowings	\$—	\$ 140	\$—	\$ 140	\$ 140
Long-term borrowings - owed to securitization investors	\$—	\$15,312	\$1,971	\$17,283	\$16,986
Other long-term borrowings	\$—	\$3,934	\$ 1	\$3,935	\$3,488
Accrued interest payables	\$—	\$ 117	\$—	\$ 117	\$ 117

(1) Net loan receivables exclude mortgage loans held for sale that are measured at fair value on a recurring basis. The fair values of these financial assets and liabilities, which are not carried at fair value on the condensed consolidated statements of financial condition, were determined by applying the fair value provisions discussed herein. The use of different assumptions or estimation techniques may have a material effect on these estimated fair value amounts. The following describes the valuation techniques of these financial instruments measured at other than fair value.

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Cash and Cash Equivalents

The carrying value of cash and cash equivalents approximates fair value due to the low level of risk these assets present to the Company as well as the relatively liquid nature of these assets, particularly given their short maturities.

Restricted Cash

The carrying value of restricted cash approximates fair value due to the low level of risk these assets present to the Company as well as the relatively liquid nature of these assets, particularly given their short maturities.

Held-to-Maturity Investment Securities

Held-to-maturity investment securities consist of residential mortgage-backed securities issued by agencies and municipal bonds. The fair value of residential mortgage-backed securities included in the held-to-maturity portfolio is estimated similarly to residential mortgage-backed securities carried at fair value on a recurring basis discussed herein. Municipal bonds are valued based on quoted market prices for the same or similar securities.

Total Loan Portfolio

The Company's loan receivables are comprised of credit card and installment loans, including the PCI student loans. Fair value estimates are derived utilizing discounted cash flow analyses, the calculations of which are performed on groupings of loan receivables that are similar in terms of loan type and characteristics. Inputs to the cash flow analysis of each grouping consider recent pre-payment and interest accrual trends and leverage forecasted loss estimates. The expected future cash flows, derived through the cash flow analysis, of each grouping are discounted at rates at which similar loans within each grouping could be originated under current market conditions. Significant inputs to the fair value measurement of the loan portfolio are unobservable, and as such are classified as Level 3.

Accrued Interest Receivable

The carrying value of accrued interest receivable, which is included in other assets on the statement of financial condition, approximates fair value as it is short term in nature and is due in less than one year.

Deposits

The carrying values of money market deposits, savings deposits and demand deposits approximate fair value due to the potentially liquid nature of these deposits. For time deposits for which readily available market rates do not exist, fair values are estimated by discounting expected future cash flows using market rates currently offered for deposits with similar remaining maturities.

Short-Term Borrowings

The carrying values of short-term borrowings approximate fair value as they are short term in nature and have maturities of less than one year.

Long-Term Borrowings-Owed to Securitization Investors

Fair values of long-term borrowings owed to credit card securitization investors are determined utilizing quoted market prices of the same transactions and, as such, are classified as Level 2. Fair values of long-term borrowings owed to student loan securitization investors are calculated by discounting cash flows using estimated assumptions including, among other things, maturity and market discount rates. A portion of the difference between the carrying value and the fair value of the long-term borrowings owed to student loan securitization investors relates to purchase accounting adjustments recorded in connection with the December 2010 purchase of SLC. Significant inputs to these fair value measurements are unobservable and, as such, are classified as Level 3.

Other Long-Term Borrowings

Fair values of other long-term borrowings, consistin