

Edgar Filing: Discover Financial Services - Form 10-Q

Discover Financial Services
Form 10-Q
April 30, 2013

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, 2013

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 36-2517428
(State or other jurisdiction of incorporation or (I.R.S. Employer Identification No.)
organization)

2500 Lake Cook Road, (224) 405-0900
Riverwoods, Illinois 60015
(Address of principal executive offices, including zip (Registrant's telephone number, including area code)
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 26, 2013, there were 490,424,845 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, 2013

TABLE OF CONTENTS

<u>Part I</u>	<u>FINANCIAL INFORMATION</u>	
<u>Item 1.</u>	<u>Financial Statements</u>	<u>1</u>
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>48</u>
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	<u>70</u>
<u>Item 4.</u>	<u>Controls and Procedures</u>	<u>70</u>
<u>Part II</u>	<u>OTHER INFORMATION</u>	
<u>Item 1.</u>	<u>Legal Proceedings</u>	<u>71</u>
<u>Item 1A.</u>	<u>Risk Factors</u>	<u>71</u>
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>71</u>
<u>Item 3.</u>	<u>Defaults Upon Senior Securities</u>	
<u>Item 4.</u>	<u>Mine Safety Disclosures</u>	<u>71</u>
<u>Item 5.</u>	<u>Other Information</u>	<u>71</u>
<u>Item 6.</u>	<u>Exhibits</u>	<u>71</u>

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®, PULSE®, Cashback Bonus®, Discover Cashback CheckingSM, Discover® More® Card, Discover itTM, Discover® MotivaSM Card, Discover® Open Road® Card, Discover® Network and Diners Club International®. All other trademarks, trade names and service marks included in this quarterly report on Form 10-Q are the property of their respective owners.

Table of Contents

Part I. FINANCIAL INFORMATION

Item 1. Financial Statements

DISCOVER FINANCIAL SERVICES

Condensed Consolidated Statements of Financial Condition

	March 31, 2013 (unaudited)	December 31, 2012	November 30, 2012
	(dollars in millions, except share amounts)		
Assets			
Cash and cash equivalents	\$8,067	\$ 2,584	\$ 3,926
Restricted cash	482	290	2,344
Investment securities:			
Available-for-sale (amortized cost of \$5,098, \$6,031 and \$6,015 at March 31, 2013, December 31, 2012 and November 30, 2012, respectively)	5,196	6,145	6,133
Held-to-maturity (fair value of \$76, \$89 and \$90 at March 31, 2013, December 31, 2012 and November 30, 2012, respectively)	74	87	88
Total investment securities	5,270	6,232	6,221
Loan receivables:			
Mortgage loans held for sale, measured at fair value	311	355	322
Loan portfolio:			
Credit card	48,655	51,135	49,642
Other	6,857	6,406	6,309
Purchased credit-impaired loans	4,561	4,702	4,744
Total loan portfolio	60,073	62,243	60,695
Total loan receivables	60,384	62,598	61,017
Allowance for loan losses	(1,634)	(1,788)	(1,725)
Net loan receivables	58,750	60,810	59,292
Premises and equipment, net	572	538	534
Goodwill	286	286	286
Intangible assets, net	187	189	190
Other assets	2,525	2,562	2,490
Total assets	\$76,139	\$ 73,491	\$ 75,283
Liabilities and Stockholders' Equity			
Deposits:			
Interest-bearing deposit accounts	\$42,255	\$ 42,077	\$ 42,034
Non-interest bearing deposit accounts	139	136	121
Total deposits	42,394	42,213	42,155
Short-term borrowings	290	327	284
Long-term borrowings	19,230	17,666	19,729
Accrued expenses and other liabilities	3,926	3,412	3,337
Total liabilities	65,840	63,618	65,505
Commitments, contingencies and guarantees (Notes 9, 12, and 13)			
Stockholders' Equity:			
Common stock, par value \$0.01 per share; 2,000,000,000 shares authorized; 554,855,707, 553,350,975 and 553,049,298 shares issued at March 31, 2013, 6 December 31, 2012 and November 30, 2012, 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	560	560	560

Edgar Filing: Discover Financial Services - Form 10-Q

\$575 at March 31, 2013, December 31, 2012 and November 30, 2012, respectively

Additional paid-in capital	3,632	3,598	3,593
Retained earnings	8,136	7,472	7,373
Accumulated other comprehensive loss	(84)	(72)	(75)
Treasury stock, at cost; 62,008,845, 55,489,104 and 55,177,937 shares at March 31, 2013, December 31, 2012 and November 30, 2012, respectively	(1,951)	(1,690)	(1,678)
Total stockholders' equity	10,299	9,873	9,778
Total liabilities and stockholders' equity	\$76,139	\$ 73,491	\$ 75,283

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, 2013 (unaudited)	December 31, 2012 (dollars in millions)	November 30, 2012
Assets			
Restricted cash	\$474	\$ 280	\$ 2,337
Credit card loan receivables	32,630	34,782	33,764
Purchased credit-impaired loans	2,461	2,539	2,563
Allowance for loan losses allocated to securitized loan receivables	(988)	(1,110)	(1,069)
Other assets	31	29	30
Liabilities			
Long-term borrowings	\$16,744	\$ 15,933	\$ 17,995
Accrued interest payable	11	11	13

See Notes to Condensed Consolidated Financial Statements.

Table of ContentsDISCOVER FINANCIAL SERVICES
Condensed Consolidated Statements of Income

	For the Three Months Ended March 31,		For the One Month Ended December 31,
	2013	2012	2012
	(unaudited)		
	(dollars in millions, except per share amounts)		
Interest income:			
Credit card loans	\$1,451	\$1,414	\$510
Other loans	234	205	78
Investment securities	20	18	7
Other interest income	3	4	—
Total interest income	1,708	1,641	595
Interest expense:			
Deposits	186	224	65
Short-term borrowings	1	—	—
Long-term borrowings	111	125	38
Total interest expense	298	349	103
Net interest income	1,410	1,292	492
Provision for loan losses	159	84	178
Net interest income after provision for loan losses	1,251	1,208	314
Other income:			
Discount and interchange revenue, net	263	240	82
Protection products revenue	88	103	33
Loan fee income	81	81	29
Transaction processing revenue	53	49	18
Gain on investments	3	—	2
Gain on origination and sale of mortgage loans	51	—	17
Other income	43	38	19
Total other income	582	511	200
Other expense:			
Employee compensation and benefits	290	246	87
Marketing and business development	169	128	51
Information processing and communications	78	72	25
Professional fees	104	104	34
Premises and equipment	19	18	8
Other expense	93	104	35
Total other expense	753	672	240
Income before income tax expense	1,080	1,047	274
Income tax expense	407	397	104
Net income	\$673	\$650	\$170
Net income allocated to common stockholders	\$659	\$644	\$168
Basic earnings per share	\$1.33	\$1.22	\$0.34
Diluted earnings per share	\$1.33	\$1.21	\$0.34
Dividends declared per share	\$—	\$0.10	\$0.14

See Notes to the Condensed Consolidated Financial Statements.

Table of Contents

DISCOVER FINANCIAL SERVICES

Condensed Consolidated Statements of Comprehensive Income

	For the Three Months Ended March 31,		For the One Month Ended December 31, 2012
	2013	2012	
	(unaudited)		
	(dollars in millions)		
Net income	\$673	\$650	\$170
Other comprehensive (loss) income, net of taxes			
Unrealized loss on securities available for sale, net of tax	(11	) (8	) (3
Unrealized loss on cash flow hedges, net of tax	(1	) (2) —
Unrealized pension and post-retirement plan gain, net of tax	—	1	6
Other comprehensive (loss) income	(12	) (9	) 3
Comprehensive income	\$661	\$641	\$173

See Notes to the Condensed Consolidated Financial Statements.

3

Table of Contents

DISCOVER FINANCIAL SERVICES

Condensed Consolidated Statements of Changes in Stockholders' Equity

	Preferred Stock		Common Stock			Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stockholders' Equity
	Shares	Amount	Shares	Amount	Additional Paid-in Capital				
(unaudited) (dollars in millions, shares in thousands)									
Balance at December 31, 2011	—	\$—	549,958	\$ 5	\$ 3,515	\$5,351	\$ (49)	\$(464)	\$ 8,358
Net income	—	—	—	—	—	650	—	—	650
Other comprehensive loss	—	—	—	—	—	—	(9)	—	(9)
Purchases of treasury stock ⁽¹⁾	—	—	—	—	(250)	—	—	(20)	(270)
Common stock issued under employee benefit plans	—	—	15	—	—	—	—	—	—
Common stock issued and stock-based compensation expense	—	—	2,069	—	25	—	—	—	25
Dividends declared—common stock	—	—	—	—	—	(51)	—	—	(51)
Balance at March 31, 2012	—	\$—	552,042	\$ 5	\$ 3,290	\$5,950	\$ (58)	\$(484)	\$ 8,703
Balance at November 30, 2012	575	\$560	553,049	\$ 5	\$ 3,593	\$7,373	\$ (75)	\$(1,678)	\$ 9,778
Net income	—	—	—	—	—	170	—	—	170
Other comprehensive income	—	—	—	—	—	—	3	—	3
Purchases of treasury stock	—	—	—	—	—	—	—	(12)	(12)
Common stock issued and stock-based compensation expense	—	—	302	—	5	—	—	—	5
Dividends declared—common and Series B preferred stock	—	—	—	—	—	(71)	—	—	(71)
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)
	—	—	15	—	1	—	—	—	1

Edgar Filing: Discover Financial Services - Form 10-Q

Common stock issued under employee benefit plans									
Common stock issued and stock-based compensation expense	—	—	1,490	1	33	—	—	—	34
Dividends declared — 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

During first quarter 2012, the Company executed an accelerated share repurchase agreement with an unaffiliated (1) financial institution to purchase \$250 million of outstanding shares of common stock. This transaction was not settled as of March 31, 2012 and was therefore reported as a reduction of additional paid-in capital.

See Notes to the Condensed Consolidated Financial Statements.

Table of Contents

DISCOVER FINANCIAL SERVICES

Condensed Consolidated Statements of Cash Flows

	For the Three Months Ended March 31,		For the One Month Ended December 31, 2012
	2013	2012	
	(unaudited)		
	(dollars in millions)		
Cash flows from operating activities			
Net income	\$673	\$650	\$170
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	159	84	178
Deferred income taxes	121	108	(12)
Depreciation and amortization on premises and equipment	25	23	9
Amortization of deferred revenues	(48)	(50)	(16)
Other depreciation and amortization	43	38	15
Accretion of accretable yield on acquired loans	(70)	(77)	(24)
Gain on investments	(3)	—	(2)
Loss on equity method and other investments	4	2	1
(Gain) loss on origination and sale of loans	(51)	1	(17)
Stock-based compensation expense	17	10	3
Proceeds from sale of mortgage loans originated for sale	1,249	—	378
Net principal disbursed on mortgage loans originated for sale	(1,156)	—	(392)
Changes in assets and liabilities:			
Increase in other assets	(88)	(16)	(68)
Increase (decrease) in accrued expenses and other liabilities	617	(68)	(1)
Net cash provided by operating activities	1,492	705	222
Cash flows from investing activities			
Maturities and sales of available-for-sale investment securities	1,015	440	112
Purchases of available-for-sale investment securities	(90)	(679)	(132)
Maturities of held-to-maturity investment securities	13	2	1
Proceeds from sale of student loans held for sale	—	268	—
Net principal disbursed on loans originated for investment	2,102	2,005	(1,599)
Purchases of loan receivables	(133)	(211)	(27)
Purchases of other investments	(31)	(8)	(4)
Proceeds from sale of other investments	—	—	17
(Increase) decrease in restricted cash	(192)	(483)	2,054
Purchases of premises and equipment	(59)	(31)	(13)
Net cash provided by investing activities	2,625	1,303	409
Cash flows from financing activities			
Net (decrease) increase in short-term borrowings	(37)	—	43
Proceeds from issuance of securitized debt	1,700	999	—
Maturities and repayment of securitized debt	(899)	(108)	(2,066)
Proceeds from issuance of other long-term borrowings	750	—	—
Repayment of long-term borrowings and bank notes	—	(5)	—
Proceeds from issuance of common stock	5	10	2

Edgar Filing: Discover Financial Services - Form 10-Q

Purchases of treasury stock	(261	)	(270	)	(12)
Net increase in deposits	187		970		65	
Dividends paid on common and preferred stock	(79	)	(53	)	(5)
Net cash provided by (used for) financing activities	1,366		1,543		(1,973)
Net increase (decrease) in cash and cash equivalents	5,483		3,551		(1,342)
Cash and cash equivalents, at beginning of period	2,584		2,335		3,926	
Cash and cash equivalents, at end of period	\$8,067		\$5,886		\$2,584	
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:						
Cash paid during the period for:						
Interest expense	\$231		\$303		\$81	
Income taxes, net of income tax refunds	\$113		\$378		\$(1)
Non-cash investing and financing transactions:						
Assumption of debt by buyer related to loans sold	\$—		\$425		\$—	

See Notes to the Condensed Consolidated Financial Statements.

Table of Contents

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, 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 card-branded and network partner credit, debit and prepaid cards. 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 credit 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 which includes Discover card-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, prepaid cards and other consumer lending and deposit products. The majority of Direct Banking revenues relate to interest income earned on its loan products. 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. The majority of Payment Services revenues relate to transaction processing revenue from PULSE and royalty and licensee revenue from Diners Club.

Change in Fiscal Year End. On December 3, 2012, the Company’s board of directors approved a change in the Company’s fiscal year end from November 30 to December 31 of each year. This fiscal year change was effective January 1, 2013. As a result of the change, the Company had a one month transition period in December 2012. The unaudited results for the one month ended December 31, 2012 and 2011 are included in this report. The audited results for the one month ended December 31, 2012 and the unaudited results for the one month ended December 31, 2011 will be included in the Company’s annual report on Form 10-K for the year ending December 31, 2013. For further information regarding the one month as of and ended December 31, 2012 and the one month as of and ended December 31, 2011, see Note 17: Transition Period Financial Information herein. In addition, the results for the quarter ended March 31, 2013 are compared with the results of the quarter ended March 31, 2012, which have been recast on a calendar basis due to the change in the Company’s fiscal year.

As a result of the fiscal year change, the quarterly dividend declaration dates were also changed to coincide with the calendar year reporting periods. As a result, a dividend was declared during the one month ended December 31, 2012 and no dividend was declared during the three months ended March 31, 2013.

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 quarter. 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 2012 audited consolidated financial statements filed with the Company's annual report on Form 10-K for the fiscal year ended November 30, 2012. Beginning with the 2012 Form 10-K, the Company began reporting all dollar amounts in millions. In certain circumstances, this change in rounding resulted in prior year disclosures being removed.

Recently Issued Accounting Pronouncements. In February 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. ASU 2013-02 requires an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in the consolidated statements of income if the amount being reclassified is required to be reclassified in its entirety to net income. For amounts that are not required to be reclassified to net income in their entirety in the same reporting period, an entity is required to cross-reference other disclosures that provide additional detail about those amounts. The new reporting requirements do not change the way in which net income or comprehensive income is derived. The new standard applies to both interim and annual financial statements and is effective for the Company beginning with this filing. Because this amendment impacted disclosures only, the adoption of this ASU had no effect on the Company's financial condition, results of operations or cash flows.

In July 2012, the FASB issued ASU No. 2012-02, Intangibles-Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment. ASU 2012-02 applies to long-lived intangible assets, other than goodwill, that are not subject to amortization on the basis that they have indefinite useful lives. This standard is intended to simplify impairment testing by adding a qualitative review step to assess whether the required quantitative impairment analysis that exists today is necessary. Under the new standard, a company will not be required to calculate the fair value of the intangible asset unless it concludes, based on the qualitative assessment, that it is more likely than not that the fair value of that asset is less than its book value. If such a decline in fair value is deemed more likely than not to have occurred, then the quantitative impairment test that exists under current GAAP must be completed; otherwise, the asset is deemed to be not impaired and no further testing is required until the next annual test date (or sooner if conditions or events before that date raise concerns of potential impairment of the asset). The amended impairment guidance does not affect the manner in which fair value is determined. The new guidance is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, with early adoption permitted. The Company's non-amortizable intangibles consist of \$155 million in acquired trade names and other assets associated with Diners Club. Because this standard impacts the impairment analysis only, it will have no effect on the Company's financial condition, results of operations or cash flows.

In December 2011, the FASB issued ASU No. 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. ASU 2011-11 adds certain additional disclosure requirements about financial instruments and derivatives instruments that are subject to netting arrangements. The Company has master netting arrangements pertaining to collateral posting requirements with its interest rate swap counterparties, as more fully discussed in Note 15: Derivatives and Hedging Activities. Additional details about these positions and how they are reported will be disclosed. This ASU is effective for the Company with this filing. Because this amendment impacted disclosures only, the adoption of this ASU had no effect on the Company's financial condition, results of operations or cash flows.

2. Business Combinations

Acquisition of the net assets of Home Loan Center, Inc. On June 6, 2012, through its Discover Home Loans, Inc. subsidiary, the Company acquired substantially all of the operating and related assets and certain liabilities of Home Loan Center, Inc. ("Home Loan Center"), a subsidiary of Tree.com, Inc., adding a residential mortgage lending component to the Company's direct banking business. In exchange for the net assets acquired, the Company paid an aggregate of \$49 million, including payments made prior to the closing that were applied to the closing price. A portion of such amount is being held in escrow pending Home Loan Center's ability to discharge certain contingent liabilities related to loans previously sold to secondary market investors. These contingent liabilities were not assumed by the Company. An additional \$10 million of purchase price will be due from the Company on the first anniversary of the closing, subject to certain conditions being satisfied. Since the acquisition date, the results of operations and cash flows of Home Loan Center have been included in the Company's consolidated results of operations and cash flows.

Table of Contents

3. Investments

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

	March 31, 2013	December 31, 2012	November 30, 2012
U.S. Treasury securities	\$2,082	\$2,460	\$2,463
U.S. government agency securities	1,704	2,233	2,237
States and political subdivisions of states	24	34	34
Other securities:			
Credit card asset-backed securities of other issuers	108	151	159
Corporate debt securities ⁽¹⁾	—	—	75
Residential mortgage-backed securities - Agency ⁽²⁾	1,352	1,354	1,253
Total other securities	1,460	1,505	1,487
Total investment securities	\$5,270	\$6,232	\$6,221

(1) Amount represents corporate debt obligations issued under the Temporary Liquidity Guarantee Program (TLGP) that are guaranteed by the Federal Deposit Insurance Corporation (FDIC).

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

Table of Contents

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
At March 31, 2013				
Available-for-Sale Investment Securities ⁽¹⁾				
U.S. Treasury securities	\$2,039	\$42	\$—	\$2,081
U.S. government agency securities	1,663	41	—	1,704
Credit card asset-backed securities of other issuers	107	1	—	108
Residential mortgage-backed securities - Agency	1,289	14	—	1,303
Total available-for-sale investment securities	\$5,098	\$98	\$—	\$5,196
Held-to-Maturity Investment Securities ⁽²⁾				
U.S. Treasury securities ⁽³⁾	\$1	\$—	\$—	\$1
States and political subdivisions of states	24	—	—	24
Residential mortgage-backed securities - Agency ⁽⁴⁾	49	2	—	51
Total held-to-maturity investment securities	\$74	\$2	\$—	\$76
At December 31, 2012				
Available-for-Sale Investment Securities ⁽¹⁾				
U.S. Treasury securities	\$2,413	\$46	\$—	\$2,459
U.S. government agency securities	2,187	46	—	2,233
Credit card asset-backed securities of other issuers	149	2	—	151
Residential mortgage-backed securities - Agency	1,282	20	—	1,302
Total available-for-sale investment securities	\$6,031	\$114	\$—	\$6,145
Held-to-Maturity Investment Securities ⁽²⁾				
U.S. Treasury securities ⁽³⁾	\$1	\$—	\$—	\$1
States and political subdivisions of states	34	—	—	34
Residential mortgage-backed securities - Agency ⁽⁴⁾	52	2	—	54
Total held-to-maturity investment securities	\$87	\$2	\$—	\$89

Table of Contents

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
At November 30, 2012				
Available-for-Sale Investment Securities ⁽¹⁾				
U.S. Treasury securities	\$2,414	\$48	\$—	\$2,462
U.S. government agency securities	2,189	48	—	2,237
Credit card asset-backed securities of other issuers	157	2	—	159
Corporate debt securities	75	—	—	75
Residential mortgage-backed securities - Agency	1,180	20	—	1,200
Total available-for-sale investment securities	\$6,015	\$118	\$—	\$6,133
Held-to-Maturity Investment Securities ⁽²⁾				
U.S. Treasury securities ⁽³⁾	\$1	\$—	\$—	\$1
States and political subdivisions of states	34	—	—	34
Residential mortgage-backed securities - Agency ⁽⁴⁾	53	2	—	55
Total held-to-maturity investment securities	\$88	\$2	\$—	\$90

(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.

During the three months ended March 31, 2013 and 2012 and the one month ended December 31, 2012, the Company received \$309 million, \$442 million, and \$113 million, respectively, of proceeds related to maturities, redemptions, or liquidation of investment securities. For the three months ended March 31, 2013, these 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. For the three months ended March 31, 2012, these proceeds primarily resulted from \$200 million maturities of U.S. Treasury securities, \$140 million maturities of U.S. government agency securities, and \$75 million maturities of corporate debt securities. For the one month ended December 31, 2012, \$75 million of these proceeds related to maturities of corporate debt 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, which were comprised of U.S. Treasury securities and U.S. government agency securities, were \$719 million during the three months ended March 31, 2013. The Company recognized gains on investments of \$3 million which were recorded entirely in earnings. These gains were driven primarily by gains on sales of available-for-sale investment securities of \$2 million which were calculated using the specific identification method. There were no gains or losses related to sales of investment securities during the three months ended March 31, 2012 or during the one month ended December 31, 2012. There were no gains or losses related to other than temporary impairments during the three months ended March 31, 2013, 2012 or during the one month ended December 31, 2012.

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, 2013 and 2012 and the one month ended December 31, 2012, the Company recorded net unrealized losses of \$16 million, \$12 million, and \$5 million (\$11 million, \$8 million, and \$3 million after tax), respectively, in other comprehensive income.

Table of Contents

Maturities of available-for-sale debt securities and held-to-maturity debt securities at March 31, 2013 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
Available-for-sale—Amortized Cost ⁽¹⁾					
U.S. Treasury securities	\$ 197	\$ 1,842	\$—	\$—	\$ 2,039
U.S. government agency securities	120	1,543	—	—	1,663
Credit card asset-backed securities of other issuers	107	—	—	—	107
Residential mortgage-backed securities - Agency	—	—	377	912	1,289
Total available-for-sale investment securities	\$ 424	\$ 3,385	\$ 377	\$ 912	\$ 5,098
Held-to-maturity—Amortized Cost ⁽²⁾					
U.S. Treasury securities	\$ 1	\$—	\$—	\$—	\$ 1
State and political subdivisions of states	1	1	—	22	24
Residential mortgage-backed securities - Agency ⁽³⁾	—	—	—	49	49
Total held-to-maturity investment securities	\$ 2	\$ 1	\$—	\$ 71	\$ 74
Available-for-sale—Fair Value ⁽³⁾					
U.S. Treasury securities	\$ 198	\$ 1,883	\$—	\$—	\$ 2,081
U.S. government agency securities	120	1,584	—	—	1,704
Credit card asset-backed securities of other issuers	108	—	—	—	108
Residential mortgage-backed securities - Agency	—	—	381	922	1,303
Total available-for-sale investment securities	\$ 426	\$ 3,467	\$ 381	\$ 922	\$ 5,196
Held-to-maturity—Fair Value ⁽³⁾					
U.S. Treasury securities	\$ 1	\$—	\$—	\$—	\$ 1
State and political subdivisions of states	1	1	—	22	24
Residential mortgage-backed securities - Agency ⁽³⁾	—	—	—	51	51
Total held-to-maturity investment securities	\$ 2	\$ 1	\$—	\$ 73	\$ 76

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

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

(3) 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.

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 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, 2013, December 31, 2012 and November 30, 2012, the Company had outstanding investments of \$262 million, \$259 million, and \$235 million respectively, in these entities, and the related contingent liability was \$65 million, \$79 million, and \$59 million respectively.

Table of Contents

4. Loan Receivables

The Company has three portfolio segments: credit card loans, other loans and PCI student loans acquired in The Student Loan Corporation ("SLC") transaction and in a separate portfolio acquisition. Within these portfolio segments, the Company has classes of receivables which are depicted in the table below (dollars in millions):

	March 31, 2013	December 31, 2012	November 30, 2012
Mortgage loans held for sale ⁽¹⁾	\$311	\$355	\$322
Loan portfolio:			
Credit card loans:			
Discover card ⁽²⁾	48,451	50,929	49,436
Discover business card	204	206	206
Total credit card loans	48,655	51,135	49,642
Other loans:			
Personal loans	3,395	3,296	3,272
Private student loans	3,426	3,072	3,000
Other	36	38	37
Total other loans	6,857	6,406	6,309
PCI student loans ⁽³⁾	4,561	4,702	4,744
Total loan portfolio	60,073	62,243	60,695
Total loan receivables	60,384	62,598	61,017
Allowance for loan losses	(1,634	) (1,788	) (1,725
Net loan receivables	\$58,750	\$60,810	\$59,292

⁽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 \$19.5 billion, \$18.8 billion and \$21.0 billion underlying investors' interest in trust debt at March 31, 2013, December 31, 2012 and November 30, 2012, respectively, and \$13.1 billion, \$16.0 billion and \$12.7 billion in seller's interest at March 31, 2013, December 31, 2012 and November 30, 2012, respectively. See Note 5: Credit Card and Student Loan Securitization Activities for further information.

⁽²⁾ Amounts include \$2.5 billion, \$2.5 billion and \$2.6 billion of loans pledged as collateral against the notes issued from the SLC securitization trusts at March 31, 2013, December 31, 2012 and November 30, 2012, respectively.

See Note 5: Credit Card and Student Loan Securitization Activities. Of the remaining \$2.1 billion, \$2.2 billion and \$2.1 billion at March 31, 2013, December 31, 2012 and November 30, 2012, respectively, that were not pledged as collateral, approximately \$18 million, \$17 million and \$16 million represent 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, credit card and closed-end consumer loan receivables may resume accruing interest.

Information related to the delinquencies and 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):

Table of Contents

Delinquent and Non-Accruing Loans:

	30-89 Days Delinquent	90 or More Days Delinquent	Total Past Due	90 or More Days Delinquent and Accruing	Total Non-accruing ⁽¹⁾
At March 31, 2013					
Credit card loans:					
Discover card ⁽²⁾	\$418	\$440	\$858	\$388	\$ 188
Discover business card	2	2	4	2	1
Total credit card loans	420	442	862	390	189
Other loans:					
Personal loans ⁽³⁾	19	7	26	7	5
Private student loans (excluding PCI) ⁽⁴⁾	32	19	51	14	5
Other	—	1	1	—	1
Total other loans (excluding PCI)	51	27	78	21	11
Total loan receivables (excluding PCI)	471	469	940	411	200
At December 31, 2012					
Credit card loans:					
Discover card ⁽²⁾	\$455	\$458	\$913	\$407	\$ 183
Discover business card	2	2	4	2	1
Total credit card loans	457	460	917	409	184
Other loans:					
Personal loans ⁽³⁾	18	8	26	7	4
Private student loans (excluding PCI) ⁽⁴⁾	28	9	37	7	2
Other	—	1	1	—	2
Total other loans (excluding PCI)	46	18	64	14	8
Total loan receivables (excluding PCI)	503	478	981	423	192
At November 30, 2012					
Credit card loans:					
Discover card ⁽²⁾	\$472	\$449	\$921	\$398	\$ 189
Discover business card	2	2	4	2	1
Total credit card loans	474	451	925	400	190
Other loans:					
Personal loans ⁽³⁾	17	8	25	7	4
Private student loans (excluding PCI) ⁽⁴⁾	24	8	32	6	2
Other	—	1	1	—	2
Total other loans (excluding PCI)	41	17	58	13	8
Total loan receivables (excluding PCI)	515	468	983	413	198

The Company estimates that the gross interest income that would have been recorded in accordance with the original terms of these credit card loans was \$8 million, \$8 million and \$3 million for the three months ended (1) March 31, 2013 and 2012 and the one month ended December 31, 2012, respectively. The Company does not separately track 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' current balances and most recent rates.

(2)

Edgar Filing: Discover Financial Services - Form 10-Q

Consumer credit card loans that are 90 or more days delinquent and accruing interest include \$50 million, \$52 million and \$55 million of loans accounted for as troubled debt restructurings at March 31, 2013, December 31, 2012 and November 30, 2012, respectively.

Personal loans that are 90 or more days delinquent and accruing interest include \$1 million, \$2 million and \$1 (3) million of loans accounted for as troubled debt restructurings at March 31, 2013, December 31, 2012 and November 30, 2012.

Private student loans that are 90 or more days delinquent and accruing interest include \$2 million, \$2 million and (4) \$2 million of loans accounted for as troubled debt restructurings at March 31, 2013, December 31, 2012 and November 30, 2012.

Table of Contents

Net Charge-offs. The Company's net charge-offs include the principal amount of losses 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. 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.

Net Charge-Offs:

	For the Three Months Ended March 31,				For the One Month Ended December 31,			
	2013		2012		2012			
	Net Charge-offs	Net Charge-off Rate	Net Charge-offs	Net Charge-off Rate	Net Charge-offs	Net Charge-off Rate		
Credit card loans:								
Discover card	\$286	2.36	% \$336	2.91	% \$106	2.48	%	
Discover business card	1	2.66	% 2	3.94	% —	2.08	%	
Total credit card loans	287	2.36	% 338	2.92	% 106	2.47	%	
Other loans:								
Personal loans	19	2.30	% 17	2.56	% 7	2.52	%	
Private student loans (excluding PCI)	7	0.82	% 3	0.48	% 2	0.81	%	
Total other loans (excluding PCI)	26	1.49	% 20	1.52	% 9	1.61	%	
Net charge-offs as a percentage of total loans (excluding PCI)	\$313	2.25	% \$358	2.77	% \$115	2.37	%	
Net charge-offs as a percentage of total loans (including PCI)	\$313	2.08	% \$358	2.52	% \$115	2.19	%	

Table of Contents

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 a 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	
At March 31, 2013			
Discover card	82	% 18	%
Discover business card	91	% 9	%
Personal loans	97	% 3	%
Private student loans (excluding PCI) ⁽¹⁾	95	% 5	%
At December 31, 2012			
Discover card	83	% 17	%
Discover business card	91	% 9	%
Personal loans	97	% 3	%
Private student loans (excluding PCI) ⁽¹⁾	95	% 5	%
At November 30, 2012			
Discover card	82	% 18	%
Discover business card	91	% 9	%
Personal loans	97	% 3	%
Private student loans (excluding PCI) ⁽¹⁾	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 and willing to make payments the ability to temporarily suspend payments. Eligible borrowers have a lifetime cap on forbearance of 12 months. At March 31, 2013, December 31, 2012 and November 30, 2012, there were \$148 million, \$183 million and \$142 million of loans in forbearance, respectively. In addition, at March 31, 2013, December 31, 2012 and November 30, 2012, there were 2.8%, 3.4% and 2.6% of private student loans in forbearance as a percentage of student loans in repayment and forbearance. At December 31, 2012, the dollar amount of loans in forbearance and loans in forbearance as a percentage of private student loans in repayment and forbearance were higher due to administrative forbearances that were offered to certain customers impacted by Hurricane Sandy.

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 loan balances used in the migration analysis represent all amounts contractually due and, as a result, the migration analysis captures principal, interest and fee components in estimating uncollectible accounts. The Company uses

Table of Contents

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, current 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 does not evaluate loans for impairment on an individual basis, but instead estimates its allowance for loan losses on a pooled basis, which includes loans that are delinquent and/or no longer accruing interest and/or certain loans that have defaulted from a loan modification program, as discussed below under the section entitled "- Impaired Loans and Troubled Debt Restructurings."

The following tables provide changes in the Company's allowance for loan losses for the three months ended March 31, 2013 and 2012 and the one month ended December 31, 2012, respectively (dollars in millions):

	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	
	For the Three Months Ended March 31, 2012					
	Credit Card	Personal Loans	Student Loans	Other	Total	
Balance at beginning of period	\$2,101	\$85	\$59	\$—	\$2,245	
Additions:						
Provision for loan losses	59	23	2	—	84	
Deductions:						
Charge-offs	(490) (18) (3) —	(511)
Recoveries	152	1	—	—	153	
Net charge-offs	(338) (17) (3) —	(358)
Balance at end of period	\$1,822	\$91	\$58	\$—	\$1,971	
	For the One Month Ended December 31, 2012					
	Credit Card	Personal Loans	Student Loans	Other	Total	
Balance at beginning of period	\$1,554	\$97	\$73	\$1	\$1,725	
Additions:						
Provision for loan losses	165	9	4	—	178	
Deductions:						
Charge-offs	(146) (8) (2) —	(156)
Recoveries	40	1	—	—	41	
Net charge-offs	(106) (7) (2) —	(115)
Balance at end of period	\$1,613	\$99	\$75	\$1	\$1,788	

Table of Contents

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,		For the One Month Ended December 31,
	2013	2012	2012
Interest and fees accrued subsequently charged off, net of recoveries (recorded as a reduction of interest income)	\$77	\$99	\$26
Fees accrued subsequently charged off, net of recoveries (recorded as a reduction to other income)	\$16	\$19	\$5

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, 2013					
Allowance for loans evaluated for impairment as:					
Collectively evaluated for impairment in accordance with ASC 450-20	\$1,266	\$93	\$78	\$1	\$1,438
Evaluated for impairment in accordance with ASC 310-10-35 ⁽¹⁾	187	4	5	—	196
Acquired with deteriorated credit quality, evaluated in accordance with ASC 310-30	—	—	—	—	—
Total allowance for loan losses	\$1,453	\$97	\$83	\$1	\$1,634
Recorded investment in loans evaluated for impairment as:					
Collectively evaluated for impairment in accordance with ASC 450-20	\$47,409	\$3,372	\$3,407	\$36	\$54,224
Evaluated for impairment in accordance with ASC 310-10-35 ⁽¹⁾	1,246	23	19	—	1,288
Acquired with deteriorated credit quality, evaluated in accordance with ASC 310-30	—	—	4,561	—	4,561
Total recorded investment	\$48,655	\$3,395	\$7,987	\$36	\$60,073
At December 31, 2012					
Allowance for loans evaluated for impairment as:					
Collectively evaluated for impairment in accordance with ASC 450-20	\$1,433	\$95	\$71	\$1	\$1,600
Evaluated for impairment in accordance with ASC 310-10-35 ⁽¹⁾	180	4	4	—	188
Acquired with deteriorated credit quality, evaluated in accordance with ASC 310-30	—	—	—	—	—
Total allowance for loan losses	\$1,613	\$99	\$75	\$1	\$1,788
Recorded investment in loans evaluated for impairment as:					
Collectively evaluated for impairment in accordance with ASC 450-20	\$49,826	\$3,275	\$3,056	\$38	\$56,195
	1,309	21	16	—	1,346

Edgar Filing: Discover Financial Services - Form 10-Q

Evaluated for impairment in accordance with ASC
310-10-35 ⁽¹⁾

Acquired with deteriorated credit quality, evaluated in
accordance with ASC 310-30

Total recorded investment	\$51,135	\$3,296	\$7,774	\$38	\$62,243
---------------------------	----------	---------	---------	------	----------

16

Table of Contents

	Credit Card	Personal Loans	Student Loans	Other Loans	Total
At November 30, 2012					
Allowance for loans evaluated for impairment as:					
Collectively evaluated for impairment in accordance with ASC 450-20	\$1,373	\$93	\$69	\$1	\$1,536
Evaluated for impairment in accordance with ASC 310-10-35 ⁽¹⁾	181	4	4	—	189
Acquired with deteriorated credit quality, evaluated in accordance with ASC 310-30	—	—	—	—	—
Total allowance for loan losses	\$1,554	\$97	\$73	\$1	\$1,725
Recorded investment in loans evaluated for impairment as:					
Collectively evaluated for impairment in accordance with ASC 450-20	\$48,310	\$3,251	\$2,985	\$37	\$54,583
Evaluated for impairment in accordance with ASC 310-10-35 ⁽¹⁾	1,332	21	15	—	1,368
Acquired with deteriorated credit quality, evaluated in accordance with ASC 310-30	—	—	4,744	—	4,744
Total recorded investment	\$49,642	\$3,272	\$7,744	\$37	\$60,695

Represents loans collectively evaluated for impairment in accordance with ASC 310-40, Receivables, which consists of modified loans accounted for as troubled debt restructurings. The unpaid principal balance of credit card loans was \$1.1 billion, \$1.1 billion and \$1.1 billion at March 31, 2013, December 31, 2012 and November 30, 2012, respectively. The unpaid principal balance of personal loans was \$23 million, \$21 million and \$21 million at ⁽¹⁾March 31, 2013, December 31, 2012 and November 30, 2012, respectively. The unpaid principal balance of student loans was \$18 million, \$15 million and \$14 million at March 31, 2013, December 31, 2012 and November 30, 2012, respectively. All loans accounted for as troubled debt restructurings have a related allowance for loan losses.

Impaired Loans and 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 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 our 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 rate on the loan. The permanent 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.

For our personal loan customers, we offer 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 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. We offer another permanent 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 our credit

Table of Contents

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 internal programs 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 it applies 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. 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 ⁽¹⁾	Gross interest income that would have been recorded with original terms ⁽²⁾
For the Three Months Ended March 31, 2013			
Credit card loans			
Modified credit card loans ⁽³⁾	\$279	\$13	\$1
Internal programs	\$490	\$3	\$17
External programs	\$507	\$10	\$3
Personal loans ⁽⁴⁾	\$22	\$1	N/A
Student loans ⁽⁴⁾	\$18	\$—	N/A
For the Three Months Ended March 31, 2012			
Credit card loans			
Modified credit card loans ⁽³⁾	\$274	\$12	\$1
Internal programs	\$570	\$4	\$18
External programs	\$631	\$14	\$2
Personal loans ⁽⁴⁾	\$12	\$—	N/A
Student loans ⁽⁴⁾	\$7	\$—	N/A
For the One Month Ended December 31, 2012			
Credit card loans			
Modified credit card loans ⁽³⁾	\$281	\$4	\$—
Internal programs	\$509	\$1	\$6
External programs	\$530	\$4	\$1
Personal loans ⁽⁴⁾	\$21	\$—	N/A
Student loans ⁽⁴⁾	\$16	\$—	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.

(2) 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

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.

(3) This balance is considered impaired, but is excluded from the internal and external program amounts reflected in this table. Represents credit card loans that were modified in troubled debt restructurings, but that have subsequently reverted back to the loans' pre-modification payment terms either due to noncompliance with the terms of the modification or successful completion of a temporary modification program.

(4) For personal loan customers in modification programs, gross interest income that would have been recorded with original terms is not significant for accounts in which there was an APR reduction. Student loan customers who have been granted a forbearance are not given interest rate reductions.

Table of Contents

In order to evaluate the primary financial effects which resulted from loans entering into a loan modification program during the three months ended March 31, 2013 and 2012 and the one month ended December 31, 2012, the Company quantified the amount by which interest and fees were reduced during the period. During the three months ended March 31, 2013 and 2012 and the one month ended December 31, 2012, the Company forgave approximately \$11 million, \$12 million and \$3 million, respectively, of interest and fees as a result of accounts entering into a 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,				For the One Month Ended December 31,	
	2013		2012		2012	
	Number of Accounts	Balances	Number of Accounts	Balances	Number of Accounts	Balances
Accounts that entered a loan modification program during the period:						
Credit card:						
Internal programs	10,402	\$66	15,150	\$106	3,078	\$19
External programs	9,531	\$52	10,950	\$63	2,614	\$14
Personal loans	443	\$6	424	\$5	120	\$2
Student loans	172	\$4	113	\$2	60	\$2

The following table presents the carrying value of loans that experienced a payment default during the three months ended March 31, 2013 and 2012 and the one month ended December 31, 2012 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,				For the One Month Ended December 31,	
	2013		2012		2012	
	Number of Accounts	Aggregated Outstanding Balances Upon Default	Number of Accounts	Aggregated Outstanding Balances Upon Default	Number of Accounts	Aggregated Outstanding Balances Upon Default
Troubled debt restructurings that subsequently defaulted:						
Credit card ⁽¹⁾⁽²⁾⁽³⁾ :						
Internal programs	2,880	\$18	4,381	\$30	945	\$6
External programs	2,251	\$10	2,781	\$13	722	\$3
Personal loans ⁽²⁾	24	\$—	35	\$—	22	\$—
Student loans ⁽⁴⁾	135	\$3	101	\$2	42	\$1

(1)The outstanding balance upon default is the loan balance at the end of the month prior to default.

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

(3) Terms revert back to the pre-modification terms for customers who default from a temporary program and charging privileges remain revoked.

(4)Student loan defaults have been defined as 60 or more days delinquent.

Of the account balances that defaulted as shown above for the three months ended March 31, 2013, approximately 45% of the total balances charged off at the end of the month in which they defaulted. Of the account balances that defaulted as shown above for the three months ended March 31, 2012, approximately 42% of the total balances

charged off at the end of the month in which they defaulted. Of the account balances that defaulted as shown above for the one month ended December 31, 2012, approximately 39% 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 that 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, 2013, December 31, 2012 and November 30,

Table of Contents

2012. Total PCI student loans had an outstanding balance of \$5.0 billion, \$5.2 billion and \$5.2 billion, including accrued interest, and a related carrying amount of \$4.6 billion, \$4.7 billion and \$4.7 billion as of March 31, 2013, December 31, 2012 and November 30, 2012, respectively.

Certain PCI student loans in one of the three SLC securitization trusts are covered by an indemnification agreement with Citibank for credit losses. The indemnified loans are presented along with all other PCI student loans and the related indemnification asset is recognized as a separate asset on the Company's condensed consolidated statement of financial condition.

The following table provides changes in accretable yield for the acquired loans for the three months ended March 31, 2013 and 2012 and the one month ended December 31, 2012 (dollars in millions):

	For the Three Months Ended March 31,		For the One Month Ended December 31,
	2013	2012	2012
Balance at beginning of period	\$2,072	\$2,554	\$2,096
Accretion into interest income	(70	) (77	) (24
Other changes in expected cash flows	19	(86) —
Balance at end of period	\$2,021	\$2,391	\$2,072

During each reporting period, 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. While there were no changes to overall credit loss assumptions during the periods presented, changes to other cash flow expectations resulted in the changes to accretable yield reflected in the table above. These amounts will be recognized prospectively as an adjustment to yield over the remaining life of the pools.

At March 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 2.18% and 0.80%, respectively. At December 31, 2012, 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 2.68% and 0.86%, respectively. At November 30, 2012, 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 2.86% and 0.86%, 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 1.43%, 1.31% and 1.53% for the three months ended March 31, 2013 and 2012 and the one month ended December 31, 2012, respectively.

Mortgage loans held for sale. The Company originates all of its residential real estate 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 15: 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.

Table of Contents

The following table provides a summary of the initial unpaid principal balance of mortgage loans sold by type of loan⁽¹⁾ (dollars in millions):

	For the Three Months Ended March 31, 2013		For the One Month Ended December 31, 2012		
	Amount	%	Amount	%	
Conforming ⁽²⁾	\$665	55.51 %	\$218	60.06 %	
FHA ⁽³⁾	533	44.49 %	145	39.94 %	
Total	\$1,198	100.00 %	\$363	100.00 %	

(1) There were no comparable balances to report for the three months ended March 31, 2012 as the acquisition of Home Loan Center assets did not close until June 6, 2012.

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

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

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

	March 31, 2013		December 31, 2012		November 30, 2012		
	Amount	%	Amount	%	Amount	%	
Conforming ⁽¹⁾	\$179	57.56 %	\$177	49.86 %	\$178	55.28 %	
FHA ⁽²⁾	132	42.44 %	178	50.14 %	144	44.72 %	
Total	\$311	100.00 %	\$355	100.00 %	\$322	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 loan amount must be within certain limits.

5. 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 these more highly subordinated classes of notes are held by 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 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.

Table of Contents

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. 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, 2013	December 31, 2012	November 30, 2012
Cash collateral accounts	\$84	\$93	\$148
Collections and interest funding accounts	291	91	2,111
Restricted cash	375	184	2,259
Investors' interests held by third-party investors	14,676	13,768	15,818
Investors' interests held by wholly owned subsidiaries of Discover Bank	4,844	5,038	5,209
Seller's interest	13,110	15,976	12,737
Loan receivables ⁽¹⁾	32,630	34,782	33,764
Allowance for loan losses allocated to securitized loan receivables ⁽¹⁾	(988)	(1,110)	(1,069)
Net loan receivables	31,642	33,672	32,695
Other	31	29	30
Carrying value of assets of consolidated variable interest entities	\$32,048	\$33,885	\$34,984

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 VIEs 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 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. Sellers' 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.

Table of Contents

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, 2013, no economic or other early amortization events have occurred.

The tables below provide information concerning investors' interests and related excess spreads at March 31, 2013 (dollars in millions):

	Investors' Interests ⁽¹⁾	# of Series Outstanding
Discover Card Master Trust I	\$1,310	3
Discover Card Execution Note Trust (DiscoverSeries notes)	18,210	37
Total investors' interests	\$19,520	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 ⁽¹⁾	
Group excess spread percentage	12.97	%
DiscoverSeries excess spread percentage	12.92	%

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.

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.

Table of Contents

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, 2013	December 31, 2012	November 30, 2012
Restricted cash	\$99	\$96	\$78
Student loan receivables	2,461	2,539	2,563
Carrying value of assets of consolidated variable interest entities	\$2,560	\$2,635	\$2,641

6. 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, 2013, December 31, 2012 and November 30, 2012, the Company had approximately \$28.7 billion, \$28.0 billion and \$27.9 billion, respectively, of direct-to-consumer deposits and approximately \$13.6 billion, \$14.1 billion and \$14.1 billion, respectively, of brokered deposits.

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

	March 31, 2013	December 31, 2012	November 30, 2012	
Certificates of deposit in amounts less than \$100,000 ⁽¹⁾	\$21,111	\$21,070	\$21,039	
Certificates of deposit from amounts of \$100,000 ⁽¹⁾ to less than \$250,000 ⁽¹⁾	5,613	5,508	5,460	
Certificates of deposit in amounts of \$250,000 ⁽¹⁾ or greater	1,328	1,280	1,276	
Savings deposits, including money market deposit accounts	14,203	14,219	14,259	
Total interest-bearing deposits	\$42,255	\$42,077	\$42,034	
Average annual interest rate	1.73	% 1.74	% 1.94	%

⁽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.

At March 31, 2013, certificates of deposit maturing over the remainder of 2013, over each of the next four years, and thereafter were as follows (dollars in millions):

Year	Amount
2013	\$10,662
2014	\$7,495
2015	\$4,280
2016	\$2,206
2017	\$1,879
Thereafter	\$1,530

Table of Contents

7. 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, 2013		December 31, 2012		Interest Rate Terms	Maturity
	Outstanding	Interest Rate	Outstanding	Interest Rate		
Securitized Debt						
Fixed rate asset-backed securities						
Principal value (including discount of \$1)	\$5,449	2.51 %	\$4,549	2.87 %	Various fixed rates	Various June 2013— July 2019
Fair value adjustment ⁽¹⁾	6		6			
Book value	5,455		4,555			
Floating rate asset-backed securities						
Floating rate asset-backed securities and other borrowings	750	0.62 %	750	0.64 %	1-month LIBOR(2) + 8 to 58 basis points Commercial Paper rate +30 to 70 basis points	Various May 2013— February 2018 April 2013— March 2014
Total Discover Card Master Trust I and Discover Card Execution Note Trust						
Floating rate asset-backed securities (including discount of \$161)	1,150	0.52 %	1,199	0.56 %	3-month LIBOR(2) + 12 to 45 basis points	Various January 2019— July 2036(3)
Floating rate asset-backed securities (including discount of \$3)	503	4.25 %	528	4.25 %	Prime rate +100 basis points	June 2031(3)
Floating rate asset-backed securities (including premium of \$2)	120	4.00 %	126	4.00 %	Prime rate + 75 basis points	July 2042(3)
Floating rate asset-backed securities (including premium of \$4)	290	3.70 %	307	3.71 %	1-month LIBOR(2) + 350 basis points	July 2042(3)
Total SLC Private Student Loan Trusts	2,063		2,160			
Total Long-Term Borrowings—owed to securitization investors 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 ⁽¹⁾	20		21			
Book value	420		421			
Fixed rate senior notes due 2019						
Principal value	78	10.25 %	78	10.25 %	Fixed	July 2019

Edgar Filing: Discover Financial Services - Form 10-Q

Fixed rate senior notes due 2022 (including discount of \$109)	213	5.20 %	211	5.20 %	Fixed	April 2022
Fixed rate senior notes due 2022 (including discount of \$174)	326	3.85 %	324	3.85 %	Fixed	November 2022
Discover Bank						
Senior bank notes due 2018	750	2.00 %	—	— %	Fixed	February 2018
Subordinated bank notes due 2019	200	8.70 %	200	8.70 %	Fixed	November 2019
Subordinated bank notes due 2020 (including discount of \$2)	498	7.00 %	497	7.00 %	Fixed	April 2020
Capital lease obligations	1	4.51 %	2	4.51 %	Fixed	April 2016
Total long-term borrowings	\$19,230		\$17,666			

Table of Contents

	November 30, 2012		
	Outstanding	Interest Rate	
Securitized Debt			
Fixed rate asset-backed securities			
Principal value	\$4,549	2.87	%
Fair value adjustment ⁽¹⁾	7		
Book value	4,556		
Floating rate asset-backed securities			
Floating rate asset-backed securities	9,268	0.49	%
Floating rate asset-backed securities	1,250	0.73	%
Floating rate asset-backed securities and other borrowings	750	0.63	%
Total Discover Card Master Trust I and Discover Card Execution Note Trust	15,824		
Floating rate asset-backed securities	1,195	0.56	%
Floating rate asset-backed securities	536	4.25	%
Floating rate asset-backed securities	128	4.00	%
Floating rate asset-backed securities	312	3.71	%
Total SLC Private Student Loan Trusts	2,171		
Total Long-Term Borrowings—owed to securitization investors	17,995		
Discover Financial Services			
(Parent Company)			
Fixed rate senior notes due 2017			
Principal value	400	6.45	%
Fair value adjustment ⁽¹⁾	23		
Book value	423		
Fixed rate senior notes due 2019	78	10.25	%
Fixed rate senior notes due 2022	211	5.20	%
Fixed rate senior notes due 2022	323	3.85	%
Discover Bank			
Subordinated bank notes due 2019	200	8.70	%
Subordinated bank notes due 2020	497	7.00	%
Capital lease obligations	2	4.51	%
Total long-term borrowings	\$19,729		

(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 15: 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.

Maturities. Long-term borrowings had the following maturities at March 31, 2013 (dollars in millions):

Year	Amount
Due in 2013	\$2,337
Due in 2014	4,290
Due in 2015	3,306
Due in 2016	1,300
Due in 2017	2,069
Thereafter	5,928

Total

\$19,230

26

Table of Contents

In the fourth quarter 2012, the Company completed a private exchange offer, resulting in the exchange of \$500 million outstanding aggregate principal amount of 8.70% Subordinated Notes due 2019 issued by Discover Bank for the same aggregate principal amount of new 3.85% Senior Notes due 2022 issued by Discover Financial Services and a cash premium paid of \$176 million. The exchange was accounted for as a debt modification and not as an extinguishment. The entire outstanding aggregate principal amount of these notes was subsequently exchanged for substantially identical notes that were registered under the Securities Act of 1933. During the three months ended March 31, 2013 and the one month ended December 31, 2012, respectively, \$3 million and \$1 million of the premium paid was amortized and included in interest expense on the condensed consolidated statement of income.

During second quarter 2012, the Company completed a private exchange offer, resulting in the exchange of \$322 million outstanding aggregate principal amount of 10.25% Senior Notes due 2019 for the same aggregate principal amount of new 5.20% Senior Notes due 2022 and a cash premium paid of \$115 million. On April 27, 2012, the Company issued \$308 million aggregate principal amount and, on May 8, 2012, the Company issued \$14 million aggregate principal amount, respectively, of the 5.20% Senior Notes due 2022. The exchange was accounted for as a debt modification and not as an extinguishment. Approximately \$318 million of these notes were subsequently exchanged for substantially identical notes that were registered under the Securities Act of 1933. During the three months ended March 31, 2013 and the one month ended December 31, 2012, respectively, \$2 million and \$1 million of the premium paid was amortized and included in interest expense on the condensed consolidated statement of income.

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, 2013, the total commitment of secured credit facilities through private providers was \$7.5 billion, of which \$750 million had been used and was included in long-term borrowings at March 31, 2013. Access to the unused portions of the secured credit facilities is dependent upon the agreement with each of the providers which have various expirations in 2014, 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.

Table of Contents

8. Accumulated Other Comprehensive Income

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

	Gain (Loss) on Available-for-Sale Investment Securities, Net of Tax	Gain (Loss) on Cash Flow Hedges, Net of Tax	Pension and Post Retirement Plan Gain (Loss), Net of Tax	Accumulated Other Comprehensive Income (Loss)
Balance at December 31, 2011	\$ 60	\$7	\$(116)	\$(49)
Net unrealized losses on investment securities, net of tax benefit of \$4 ⁽¹⁾	(8)	—	—	(8)
Unrealized losses on cash flow hedges, net of tax benefit of \$1 ⁽²⁾	—	(2)	—	(2)
Unrealized pension and postretirement plan gain, net of tax expense ⁽³⁾	—	—	1	1
Balance at March 31, 2012	\$ 52	\$5	\$(115)	\$(58)
Balance at November 30, 2012	\$ 74	\$3	\$(152)	\$(75)
Net unrealized losses on investment securities, net of tax benefit of \$2 ⁽¹⁾	(3)	—	—	(3)
Unrealized pension and postretirement plan gain, net of tax expense of \$4 ⁽³⁾	—	—	6	6
Balance at December 31, 2012	71	3	(146)	(72)
Other comprehensive income before reclassifications ⁽¹⁾⁽²⁾⁽³⁾⁽⁴⁾	(10)	—	—	(10)
Amounts reclassified from accumulated other comprehensive income ⁽⁵⁾	(1)	(1)	—	(2)
Balance at March 31, 2013	\$ 60	\$2	\$(146)	\$(84)

(1) Represents the difference between the fair value and amortized cost of available-for-sale investment securities.

(2) Represents unrealized gains (losses) related to effective portion of cash flow hedges.

(3) Reflects adjustments to the funded status of pension and postretirement plans, which is the difference between the fair value of the plan assets and the projected benefit obligation.

(4) Unrealized losses on available-for-sale investments are net of tax benefit of \$5 million for the three months ended March 31, 2013.

(5) Amounts reclassified out of accumulated other comprehensive income include unrealized gains of \$1 million (net of tax expense of \$1 million) on the sale of available-for-sale investments and unrealized gains of \$1 million (net of tax expense of \$1 million) on cash flow hedges recorded in other income and interest income, respectively, in the condensed consolidated statement of income.

Table of Contents

9. Income Taxes

Income tax expense consisted of the following (dollars in millions):

	For the Three Months Ended March 31,		For the One Month Ended December 31, 2012
	2013	2012	
Current:			
U.S. federal	\$247	\$249	\$101
U.S. state and local	38	39	15
International	1	1	—
Total	286	289	116
Deferred:			
U.S. federal	111	100	(11)
U.S. state and local	10	8	(1)
Total	121	108	(12)
Income tax expense	\$407	\$397	\$104

The following table reconciles the Company's effective tax rate to the U.S. federal statutory income tax rate:

	For the Three Months Ended March 31,		For the One Month Ended December 31,	
	2013	2012	2012	
U.S. federal statutory income tax rate	35.0	% 35.0	% 35.0	%
U.S. state, local and other income taxes, net of U.S. federal income tax benefits	3.3	3.3	3.2	
Other	(0.6)	(0.4)	(0.1))
Effective income tax rate	37.7	% 37.9	% 38.1	%

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. With respect to the issues still pending on appeal for the years 1999 through 2005, the ultimate outcome remains uncertain. 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 \$109 million could be recognized as a result of such settlements.

The IRS is currently examining 2006 through June 30, 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.

Table of Contents

10. 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		For the One
	March 31,		Month Ended
	2013	2012	December 31,
	2012		
Numerator:			
Net income	\$673	\$650	\$170
Preferred stock dividends	(9) —	—
Net income available to common stockholders	664	650	170
Income allocated to participating securities	(5	) (6	) (2
Net income allocated to common stockholders	\$659	\$644	\$168
Denominator:			
Weighted average shares of common stock outstanding	496	530	498
Effect of dilutive common stock equivalents	1	1	1
Weighted average shares of common stock outstanding and common stock equivalents	497	531	499
Basic earnings per share	\$1.33	\$1.22	\$0.34
Diluted earnings per share	\$1.33	\$1.21	\$0.34

Anti-dilutive securities were not material and had no impact on the computation of diluted EPS for the three months ended March 31, 2013 and 2012 or the one month ended December 31, 2012.

11. Capital Adequacy

The Company is subject to 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, 2013, 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, 2013, 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 as of March 31, 2013, December 31, 2012 and November 30, 2012 and comparisons of each to the regulatory minimum and "well-capitalized"

Edgar Filing: Discover Financial Services - Form 10-Q

requirements (dollars in millions):

	Actual		Minimum Capital Requirements		Capital Requirements To Be Classified as Well-Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
March 31, 2013						
Total capital (to risk-weighted assets)						
Discover Financial Services	\$11,411	17.9	% \$5,088	≥8.0%	\$6,360	≥10.0%
Discover Bank	\$9,926	15.8	% \$5,013	≥8.0%	\$6,266	≥10.0%
Tier 1 capital (to risk-weighted assets)						
Discover Financial Services	\$9,909	15.6	% \$2,544	≥4.0%	\$3,816	≥6.0%
Discover Bank	\$8,435	13.5	% \$2,507	≥4.0%	\$3,760	≥6.0%
Tier 1 capital (to average assets)						
Discover Financial Services	\$9,909	13.4	% \$2,963	≥4.0%	\$3,704	≥5.0%
Discover Bank	\$8,435	11.6	% \$2,922	≥4.0%	\$3,652	≥5.0%
December 31, 2012						
Total capital (to risk-weighted assets)						
Discover Financial Services	\$10,998	16.8	% \$5,242	≥8.0%	\$6,552	≥10.0%
Discover Bank	\$9,615	14.9	% \$5,172	≥8.0%	\$6,465	≥10.0%
Tier 1 capital (to risk-weighted assets)						
Discover Financial Services	\$9,470	14.5	% \$2,621	≥4.0%	\$3,931	≥6.0%
Discover Bank	\$8,097	12.5	% \$2,586	≥4.0%	\$3,879	≥6.0%
Tier 1 capital (to average assets)						
Discover Financial Services	\$9,470	12.7	% \$2,987	≥4.0%	\$3,734	≥5.0%
Discover Bank	\$8,097	11.0	% \$2,936	≥4.0%	\$3,670	≥5.0%
November 30, 2012						
Total capital (to risk-weighted assets)						
Discover Financial Services	\$10,899	16.8	% \$5,204	≥8.0%	\$6,505	≥10.0%
Discover Bank	\$9,455	14.7	% \$5,136	≥8.0%	\$6,420	≥10.0%
Tier 1 capital (to risk-weighted assets)						
Discover Financial Services	\$9,377	14.4	% \$2,602	≥4.0%	\$3,903	≥6.0%
Discover Bank	\$7,944	12.4	% \$2,568	≥4.0%	\$3,852	≥6.0%
Tier 1 capital (to average assets)						
Discover Financial Services	\$9,377	12.6	% \$2,984	≥4.0%	\$3,730	≥5.0%
Discover Bank	\$7,944	10.9	% \$2,928	≥4.0%	\$3,660	≥5.0%

Table of Contents

12. 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 2022. At March 31, 2013, future minimum payments on leases with original terms in excess of one year consist of the following (dollars in millions):

	Capitalized Leases	Operating Leases
2013	\$—	\$11
2014	1	14
2015	—	9
2016	—	9
2017	—	8
Thereafter	—	11
Total minimum lease payments	\$1	\$62
Less: Amount representing interest	—	
Present value of net minimum lease payments	\$1	

Unused commitments to extend credit. At March 31, 2013, the Company had unused commitments to extend credit for loans of approximately \$163.7 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 agreement. 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.

Commitments to purchase private student loans. On December 31, 2010, Discover Bank entered into an agreement with Citibank to purchase any private student loans originated subsequent to the contract date including a premium equal to 0.125%. The agreement expired on December 31, 2012. Although no loans were purchased by Discover Bank subsequent December 31, 2012, Discover Bank is obligated to disburse funds for previously purchased loans. As of March 31, 2013, Discover Bank had an outstanding commitment to disburse \$4 million for loans purchased prior to December 31, 2012. For the loans purchased under the agreement, the Company has limited involvement with respect to the underwriting and setting credit terms. The underwriting standards for these loans are based on Citibank's credit policy, and those standards are not substantially different than the Company's own underwriting criteria. Based on this and by virtue of the fact that the loans are newly originated at the time that the Company acquires them, the loans are not considered purchased credit-impaired.

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.

Table of Contents

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 based on expected losses. At March 31, 2013, this amount was not material and was included in other income on the condensed consolidated statements of income and in accrued expenses and other liabilities on the condensed consolidated statements of financial condition.

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 up to 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 of up to one month, would be as follows:

	March 31, 2013
Diners Club:	
Merchant guarantee (in millions)	\$242
PULSE:	
ATM guarantee (in millions)	\$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, 2013, 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, 2013, 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.

Merchant Chargeback Guarantees. The Company issues and permits third parties to issue payment cards and owns and operates the Discover Network. 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

Table of Contents

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, 2013, 2012 or for the one month ended December 31, 2012.

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,		For the One Month Ended December 31, 2012
	2013	2012	
Aggregate sales transaction volume ⁽¹⁾	\$27,228	\$26,013	\$11,521

⁽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 has not recorded any contingent liability in the condensed consolidated financial statements for merchant chargeback guarantees as of March 31, 2013, December 31, 2012 and November 30, 2012. 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, 2013	December 31, 2012	November 30, 2012
Settlement withholdings and escrow deposits	\$25	\$25	\$23

13. 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. 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, accounting, tax and operational matters, some of which may result in significant adverse judgments, settlements, fines, penalties, injunctions, decreases in regulatory ratings 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. Such matters related to the IRS are discussed in Note 9: Income Taxes.

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-related expense of \$25 million was recognized for the three months ended March 31, 2012. Litigation expense was not material for the three months ended March 31, 2013 or the one month ended December 31, 2012. 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 \$100 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.

On August 16, 2011, the Attorney General of West Virginia filed a lawsuit against the Company in the Circuit Court of Mason County, West Virginia (West Virginia v. Discover Financial Services, Inc., Discover Bank, DFS Services LLC et al.). The lawsuit asserts various claims related to the Company's marketing and administration of various protection products under West Virginia law. The relief sought in the lawsuit includes an injunction prohibiting the Company from engaging in the alleged violations, restitution and disgorgement of monies received from the complained of practices, civil penalties and costs. The Company will seek to vigorously defend all claims asserted against it in this matter.

On August 26, 2011, the Attorney General of Missouri issued a request for information to the Company in connection with an investigation to determine whether the Company has engaged in conduct that violates Missouri law in the marketing of its payment protection product to its credit card customers. The Company is cooperating with the Attorney General in the investigation.

On November 30, 2011, a class action lawsuit was filed against the Company by a cardmember in the U.S. District Court for the Northern District of California (Walter Bradley, et al. v. Discover Financial Services). The plaintiff

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 Telephone Consumer Protection Act (“TCPA”). Plaintiff 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).

On March 6, 2012, a class action lawsuit was filed against the Company by a cardmember in the U.S. District Court for the Northern District of California (Andrew Steinfeld, et al. v. Discover Financial Services, et al.). The plaintiff 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. Plaintiff 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).

On April 12, 2012, the Attorney General of Hawaii filed a lawsuit against the Company in the Circuit Court of the First Circuit, Hawaii (Hawaii v. Discover Financial Services, Inc., Discover Bank, DFS Services LLC et al.). The lawsuit asserts various claims related to the Company's marketing and administration of various protection products under Hawaii law. The relief sought in the lawsuit includes an injunction prohibiting named parties from engaging in the alleged violations, restitution and disgorgement of monies received from the complained of practices, civil penalties and costs. The Company will seek to vigorously defend against all claims asserted against it.

On June 28, 2012, the Attorney General of Mississippi filed a lawsuit against the Company in the Chancery Court of the First Judicial District of Hinds County, Mississippi (Mississippi v. Discover Financial Services, Inc., Discover Bank, DFS Services LLC et al.). The lawsuit asserts various claims related to the Company's marketing and administration of various protection products under Mississippi law. The relief sought in the lawsuit includes an injunction prohibiting the Company from engaging in the alleged violations, restitution and disgorgement of monies received from the complained-of practices, civil penalties and costs. The Company will seek to vigorously defend all claims asserted against it.

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 November 8, 2012, the plaintiffs filed a 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 December 21, 2012, the defendants filed a motion to dismiss the complaint. Rather than respond to the defendants' motion to dismiss, on February 19, 2013, the plaintiffs filed an amended consolidated complaint raising the same claims against the same defendants. On April 5, 2013, the defendants filed a motion to dismiss the amended consolidated complaint.

On April 17, 2013, the Attorney General of New Mexico filed a lawsuit against the Company in the First Judicial District Court, County of Santa Fe, New Mexico (New Mexico v. Discover Financial Services, Inc., Discover Bank, DFS Services LLC et al.). The lawsuit asserts various claims related to the Company's marketing and administration of various protection products under New Mexico law. The relief sought in the lawsuit includes an injunction

prohibiting the Company from engaging in the alleged violations, civil penalties and costs. The Company will seek to vigorously defend all claims asserted against it in this matter.

14. Fair Value 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.

Table of Contents

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.

During the three months ended March 31, 2013, there were no changes to the Company valuation techniques that had, or are expected to have, a material impact on its 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, 2013				
Assets				
U.S Treasury securities	\$ 2,081	\$ —	\$ —	\$2,081
U.S government agency securities	1,704	—	—	1,704
Credit card asset-backed securities of other issuers	—	108	—	108
Residential mortgage-backed securities - Agency	—	1,303	—	1,303
Available-for-sale investment securities	\$ 3,785	\$ 1,411	\$ —	\$5,196
Mortgage loans held for sale	\$ —	\$ 310	\$ 1	\$311
Interest rate lock commitments	\$ —	\$ —	\$ 14	\$14
Forward delivery contracts	—	1	—	1
Other derivative financial instruments	—	93	—	93
Derivative financial instruments	\$ —	\$ 94	\$ 14	\$108
Liabilities				
Forward delivery contracts	\$ —	\$ 2	\$ —	\$2
Other derivative financial instruments	—	1	—	1
Derivative financial instruments	\$ —	\$ 3	\$ —	\$3

Table of Contents

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Balance at December 31, 2012				
Assets				
U.S Treasury securities	\$ 2,459	\$ —	\$ —	\$2,459
U.S government agency securities	2,233	—	—	2,233
Credit card asset-backed securities of other issuers	—	151	—	151
Residential mortgage-backed securities - Agency	—	1,302	—	1,302
Available-for-sale investment securities	\$ 4,692	\$ 1,453	\$ —	\$6,145
Mortgage loans held for sale	\$ —	\$ 355	\$ —	\$355
Interest rate lock commitments	\$ —	\$ —	\$ 12	\$12
Forward delivery contracts	—	1	—	1
Other derivative financial instruments	—	98	—	98
Derivative financial instruments	\$ —	\$ 99	\$ 12	\$111
Liabilities				
Forward delivery contracts	\$ —	\$ 2	\$ —	\$2
Other derivative financial instruments	—	1	—	1
Derivative financial instruments	\$ —	\$ 3	\$ —	\$3
Balance at November 30, 2012				
Assets				
U.S Treasury securities	\$ 2,462	\$ —	\$ —	\$2,462
U.S government agency securities	2,237	—	—	2,237
Credit card asset-backed securities of other issuers	—	159	—	159
Corporate debt securities	—	75	—	75
Residential mortgage-backed securities - Agency	—	1,200	—	1,200
Available-for-sale investment securities	\$ 4,699	\$ 1,434	\$ —	\$6,133
Mortgage loans held for sale	\$ —	\$ 322	\$ —	\$322
Interest rate lock commitments	\$ —	\$ —	\$ 15	\$15
Forward delivery contracts	—	1	—	1
Other derivative financial instruments	—	116	—	116
Derivative financial instruments	\$ —	\$ 117	\$ 15	\$132
Liabilities				
Forward delivery contracts	\$ —	\$ 4	\$ —	\$4
Other derivative financial instruments	—	1	—	1
Derivative financial instruments	\$ —	\$ 5	\$ —	\$5

There were no transfers between Levels 1 and 2 within the fair value hierarchy during the three months ended March 31, 2013 and 2012, or the one month ended December 31, 2012.

Table of Contents

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, corporate debt and credit card asset-back 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, 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 fair value estimates for corporate debt obligations issued under the Temporary Liquidity Guarantee Program are derived utilizing a spread relative to an underlying benchmark curve which reflects the terms and conditions of specific instruments being valued.

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, 2013, amounts reported in credit card asset-backed securities issued by other institutions reflected senior-rated Class A securities having a par value of \$101 million and more junior-rated Class B and Class C securities with par values of \$6 million and \$1 million, respectively. The Class A securities had a weighted-average coupon of 0.46% and a weighted-average remaining maturity of three months; the Class B, 0.40% and ten months, respectively; and the Class C, 0.60% and five months, respectively. The assets underlying these securities are predominantly prime general-purpose credit card loan receivables. 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 \$1.2 billion, a weighted-average coupon of 2.84% 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 expected sale date of the loan. 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

Table of Contents

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 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 currency 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 which may include 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 legally enforceable 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 counterparty's 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 currency 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, 2013, December 31, 2012 and November 30, 2012, the aggregate unpaid principal balance of loans held for sale for which the fair value option had been elected was \$299 million, \$337 million and \$305 million, respectively. At March 31, 2013, December 31, 2012 and November 30, 2012, the same loans had a fair value of \$311 million, \$355 million and \$322 million, respectively. For the three months ended March 31, 2013 and the one month ended December 31, 2012, respectively, \$6 million and \$1 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. There were no loans held for sale accounted for under the fair value option at any time during the three months ended March 31, 2012.

Table of Contents

Level 3 Financial Instruments Only

The following tables provide changes in the Company's Level 3 assets and liabilities measured at fair value on a recurring basis.

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

(dollars in millions)

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 (losses) 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

For the One Month Ended December 31, 2012

	Balance at November 30, 2012	Transfers into Level 3	Transfers out of Level 3	Total net gains (losses) included in earnings	Purchases	Sales	Settlements	Transfers of IRLCs to closed loans	Balance at December 31, 2012
Interest rate lock commitments	\$ 15	—	—	17	—	—	1	(21)	\$ 12

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 as of March 31, 2013 (dollars in millions):

	Fair Value	Valuation Technique	Significant Unobservable Input	Ranges of Inputs		
				Low	High	
Interest rate lock commitments	\$ 14	Quantitative risk models	Loan funding probability	20	% 95	%
Mortgage loans held for sale	\$ 1	Market comparables	Loss severity	20	% 55	%

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 their initial recognition is applicable if one or more is determined to be impaired. During the three months ended March 31, 2013 and 2012, and the one month ended December 31, 2012, the Company had no impairments related to these assets.

Table of Contents

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, as of March 31, 2013, December 31, 2012 and November 30, 2012 (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, 2013					
Assets					
U.S Treasury securities	\$ 1	\$—	\$—	\$1	\$1
States and political subdivisions of states	—	24	—	24	24
Residential mortgage-backed securities - Agency	—	51	—	51	49
Held-to-maturity investment securities	\$ 1	\$75	\$—	\$76	\$74
Cash and cash equivalents	\$ 8,067	\$—	\$—	\$8,067	\$8,067
Restricted cash	\$ 482	\$—	\$—	\$482	\$482
Net loan receivables ⁽¹⁾	\$ —	\$—	\$60,903	\$60,903	\$58,439
Accrued interest receivables	\$ —	\$505	\$—	\$505	\$505
Liabilities					
Deposits	\$ —	\$42,814	\$—	\$42,814	\$42,394
Short-term borrowings	\$ —	\$290	\$—	\$290	\$290
Long-term borrowings - owed to securitization investors	\$ —	\$14,931	\$2,310	\$17,241	\$16,744
Other long-term borrowings	\$ —	\$3,090	\$2	\$3,092	\$2,486
Accrued interest payables	\$ —	\$145	\$—	\$145	\$145

	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 December 31, 2012					
Assets					
U.S Treasury securities	\$ 1	\$—	\$—	\$1	\$1
States and political subdivisions of states	—	34	—	34	34
Residential mortgage-backed securities - Agency	—	54	—	54	52
Held-to-maturity investment securities	\$ 1	\$88	\$—	\$89	\$87
Cash and cash equivalents	\$ 2,584	\$—	\$—	\$2,584	\$2,584
Restricted cash	\$ 290	\$—	\$—	\$290	\$290
Net loan receivables ⁽¹⁾	\$ —	\$—	\$62,619	\$62,619	\$60,455
Accrued interest receivables	\$ —	\$500	\$—	\$500	\$500
Liabilities					

Edgar Filing: Discover Financial Services - Form 10-Q

Deposits	\$ —	\$42,671	\$—	\$42,671	\$42,213
Short-term borrowings	\$ —	\$327	\$—	\$327	\$327
Long-term borrowings - owed to securitization investors	\$ —	\$14,033	\$2,337	\$16,370	\$15,933
Other long-term borrowings	\$ —	\$2,332	\$2	\$2,334	\$1,733
Accrued interest payables	\$ —	\$126	\$—	\$126	\$126

Table of Contents

	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 November 30, 2012					
Assets					
U.S Treasury securities	\$ 1	\$ —	\$ —	\$ 1	\$ 1
States and political subdivisions of states	—	34	—	34	34
Residential mortgage-backed securities - Agency	—	55	—	55	53
Held-to-maturity investment securities	\$ 1	\$ 89	\$ —	\$ 90	\$ 88
Cash and cash equivalents	\$ 3,926	\$ —	\$ —	\$ 3,926	\$ 3,926
Restricted cash	\$ 2,344	\$ —	\$ —	\$ 2,344	\$ 2,344
Net loan receivables ⁽¹⁾	\$ —	\$ —	\$ 61,378	\$ 61,378	\$ 58,970
Accrued interest receivables	\$ —	\$ 466	\$ —	\$ 466	\$ 466
Liabilities					
Deposits	\$ —	\$ 42,630	\$ —	\$ 42,630	\$ 42,155
Short-term borrowings	\$ —	\$ 284	\$ —	\$ 284	\$ 284
Long-term borrowings - owed to securitization investors	\$ —	\$ 16,108	\$ 2,353	\$ 18,461	\$ 17,995
Other long-term borrowings	\$ —	\$ 2,337	\$ 2	\$ 2,339	\$ 1,734
Accrued interest payables	\$ —	\$ 128	\$ —	\$ 128	\$ 128

(1) Net loan receivables excludes 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.

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 of each grouping are discounted at rates at which similar loans within

each grouping could be made 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. For the Company's accrued interest receivable, which is included in other assets on the statement of financial condition, the carrying value 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

Table of Contents

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. 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, consisting of subordinated debt and unsecured debt, are determined utilizing current observable market prices for those transactions, and as such are classified as Level 2. A portion of the difference between the carrying value and the fair value of the subordinated debt relates to the cash premiums paid in connection with the second and fourth quarter debt exchanges as discussed in further detail in Note 7: Long-Term Borrowings. Fair values of other long-term borrowing for which there are no observable market transactions, namely capitalized leases, are determined by discounting cash flows of future interest accruals at market rates currently offered for borrowings with similar credit risks, remaining maturities and repricing terms. As the significant inputs to these fair value measurements are unobservable, they are classified as Level 3.

Accrued interest payable. The Company's accrued interest payable, which is included in other liabilities on the statement of financial condition, carrying value approximates fair value as it is short term in nature and is payable in less than one year.

15. Derivatives and Hedging Activities

The Company uses derivatives to manage its exposure to various financial risks. The Company does not enter into derivatives for trading or speculative purposes. Certain derivatives used to manage the Company's exposure to interest rate movements and other identified risks are not designated as hedges and do not qualify for hedge accounting. All derivatives are recorded in other assets at their gross positive fair values and in accrued expenses and other liabilities at their gross negative fair values.

Derivatives may give rise to counterparty credit risk, which generally is addressed through collateral arrangements as described under the sub-heading "Collateral Requirements and Credit-Risk Related Contingency Features." The Company enters into derivative transactions with established dealers that meet minimum credit criteria established by the Company. All counterparties must be pre-approved prior to engaging in any transaction with the Company. Counterparties are monitored on a regular basis by the Company to ensure compliance with the Company's risk policies and limits. In determining the counterparty credit risk valuation adjustment for the fair values of derivatives, the Company considers collateral and legally enforceable master netting agreements that mitigate credit exposure to counterparties.

Derivatives Designated as Hedges

Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges.

Cash Flow Hedges. The Company uses interest rate swaps to manage its exposure to changes in interest rates related to future cash flows resulting from credit card loan receivables. The Company's current cash flow hedges are for a maximum period of three years. The derivatives are designated as a hedge of the risk of overall changes in cash flows on the Company's portfolios of prime-based interest receipts and qualify for hedge accounting in accordance with ASC Topic 815, Derivatives and Hedging ("ASC 815").

The effective portion of the change in the fair value of derivatives designated as cash flow hedges is recorded in other comprehensive income and is subsequently reclassified into earnings in the period that the hedged forecasted cash flows affect earnings. The ineffective portion of the change in fair value of the derivative, if any, is recognized directly in earnings. Amounts reported in accumulated other comprehensive income related to derivatives at March 31, 2013

will be reclassified to interest income as interest payments are received on certain of the Company's floating rate credit card loan receivables. During the next 12 months, the Company estimates it will reclassify to earnings \$2 million of pretax gains related to its derivatives designated as cash flow hedges.

Fair Value Hedges. The Company is exposed to changes in fair value of certain of its fixed rate debt obligations due to changes in interest rates. During the three months ended March 31, 2013, the Company used interest rate swaps to manage its

Table of Contents

exposure to changes in fair value of certain fixed rate senior notes, securitized debt and interest-bearing brokered deposits attributable to changes in LIBOR, a benchmark interest rate as defined by ASC 815. The interest rate swaps involve the receipt of fixed rate amounts from the respective counterparties in exchange for the Company making payments of variable rate amounts over the life of the agreements without exchange of the underlying notional amounts. These interest rate swaps qualify as fair value hedges in accordance with ASC 815. Changes in both (i) the fair values of the derivatives and (ii) the hedged fixed rate senior notes, securitized debt and interest-bearing brokered deposits relating to the risk being hedged were recorded in interest expense. The changes provided substantial offset to one another. Ineffectiveness related to these fair value hedges was recorded in interest expense. Any basis differences between the fair value and the carrying amount of the hedged fixed rate senior notes, securitized debt and interest-bearing brokered deposits at the inception of the hedging relationship is amortized and recorded in interest expense.

Derivatives Not Designated as Hedges

Interest rate lock commitments. The Company enters into commitments with consumers to originate loans at a specified interest rate. The Company reports IRLCs as derivative instruments at fair value with changes in fair value recorded in other income.

Forward delivery contracts. 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 commitments. These hedging instruments are recorded at fair value with changes in fair value recorded in other income.

Interest rate swaps. The Company also may have from time to time interest rate swap agreements that are not designated as hedges. As part of its acquisition of SLC, the Company also acquired an interest rate swap related to the securitized debt assumed in the SLC transaction. Such agreements are not speculative and are also used to manage interest rate risk but are not designated for hedge accounting. Changes in the fair value of these contracts are recorded in other income.

Foreign exchange forward contracts. The Company has foreign exchange forward contracts that are economic hedges and are not designated as hedges for accounting purposes. The Company enters into foreign exchange forward contracts to manage foreign currency risk. Foreign exchange forward contracts involve the purchase or sale of a designated currency at an agreed upon rate for settlement on a specified date. Changes in the fair value of these contracts are recorded in other income.

Table of Contents

The following table summarizes the fair value (including accrued interest) and related outstanding notional amounts of derivative instruments and indicates where within the statement of financial condition each is reported as of March 31, 2013, December 31, 2012 and November 30, 2012. See Note 14: Fair Value Disclosures for a description of the valuation methodologies of derivatives (dollars in millions):

	March 31, 2013				December 31, 2012		
	Notional Amount	Number of Transactions	Balance Sheet Location		Notional Amount	Balance Sheet Location	
Other Assets (At Fair Value)			Accrued Expenses and Other Liabilities (At Fair Value)	Other Assets (At Fair Value)		Accrued Expenses and Other Liabilities (At Fair Value)	
Derivatives designated as hedges:							
Interest rate swaps—cash flow hedge	\$1,750	7	\$3	\$—	\$1,750	\$5	\$—
Interest rate swaps—fair value hedge	\$7,956	285	\$90	\$—	\$7,859	\$93	\$—
Derivatives not designated as hedges:							
Foreign exchange forward contracts ⁽¹⁾	\$40	7	\$—	\$—	\$40	\$—	\$—
Interest rate swap	\$966	1	\$—	\$1	\$1,027	\$—	\$1
Forward delivery contracts	\$726	635	\$1	\$2	\$774	\$1	\$2
Interest rate lock commitments	\$539	2,625	\$14	\$—	\$414	\$12	\$—

	November 30, 2012		
	Notional Amount	Balance Sheet Location	
Other Assets (At Fair Value)		Accrued Expenses and Other Liabilities (At Fair Value)	
Derivatives designated as hedges:			
Interest rate swaps—cash flow hedge	\$1,750	\$6	\$—
Interest rate swaps—fair value hedge	\$7,859	\$110	\$—
Derivatives not designated as hedges:			
Foreign exchange forward contracts ⁽¹⁾	\$37	\$—	\$—
Interest rate swap	\$1,027	\$—	\$1
Forward delivery contracts	\$557	\$1	\$4
Interest rate lock commitments	\$483	\$15	\$—

(1) The foreign exchange forward contracts have notional amounts of EUR 18 million, GBP 10 million and SGD 2 million as of March 31, 2013, EUR 18 million, GBP 9 million and SGD 2 million as of December 31, 2012, and

EUR 18 million, GBP 8 million, and SGD 2 million as of November 30, 2012.

Table of Contents

The following table summarizes the impact of the derivative instruments on income, and indicates where within the consolidated statements of income such impact is reported for the three months ended March 31, 2013 and 2012 and the one month ended December 31, 2012 (dollars in millions):

	Location	For the Three Months Ended March 31,		For the One Month Ended December 31, 2012
		2013	2012	
Derivatives designated as hedges:				
Interest rate swaps—cash flow hedges:				
Total losses recognized in other comprehensive income after amounts reclassified into earnings, pre-tax	Other Comprehensive Income	\$(2)	\$(3)	\$(1)
Total losses recognized in other comprehensive income		\$(2)	\$(3)	\$(1)
Amount reclassified from other comprehensive income into income	Interest Income	\$2	\$2	\$1
Interest rate swaps—fair value hedges:				
Interest expense—ineffectiveness		(8)	(4)	(9)
Interest expense—other		10	6	3
Gain (loss) on interest rate swaps	Interest Expense	2	2	(6)
Interest expense—ineffectiveness		9	5	10
Interest expense—other		(1)	(2)	(1)
Gain on hedged item	Interest Expense	8	3	9
Total gains recognized in income		\$12	\$7	\$4
Derivatives not designated as hedges:				
Gain (loss) on forward contracts	Other Income	\$2	\$(1)	\$(1)
Loss on interest rate swaps	Other Income	—	(5)	—
(Loss) gain on forward delivery contracts	Other Income	(1)	—	2
Gain on interest rate lock commitments	Other Income	48	—	17
Total gains (losses) on derivatives not designated as hedges recognized in income		\$49	\$(6)	\$18

Collateral Requirements and Credit-Risk Related Contingency Features. For its fair value and cash flow hedge interest rate swaps, the Company has master netting arrangements and minimum collateral posting thresholds with its counterparties. The Company does not offset any of these positions for financial reporting purposes. Collateral is required by either the Company or the counterparty depending on the net fair value position of all interest rate swaps held with that counterparty. The Company may also be required to post collateral with a counterparty depending on the credit rating it or Discover Bank receives from specified major credit rating agencies. Collateral amounts recorded in the condensed consolidated statement of financial condition are based on the net collateral receivable or payable position for each applicable legal entity's master netting arrangement with each counterparty. Collateral receivable or payable amounts are not offset against the fair value of the interest rate swap, but are recorded separately in other assets or deposits.

As of March 31, 2013, DFS had a right to reclaim \$4 million of cash collateral that had been posted (net of amounts required to be posted by the counterparty) because the credit rating of DFS did not meet specified thresholds. At March 31, 2013, Discover Bank's credit rating met specified thresholds set by its counterparties. However, if Discover Bank's credit rating is reduced by one ratings notch, Discover Bank would be required to post additional collateral, which would have been \$111 million as of March 31, 2013. The Company had an obligation to return \$87 million cash collateral deposited with the Company (net of \$4 million referenced above) as of March 31, 2013.

Edgar Filing: Discover Financial Services - Form 10-Q

As of March 31, 2013, the Company had interest rate swaps in a net asset position with all of its counterparties, inclusive of accrued interest. If the Company had breached any provisions of the derivative agreements, there would have been no obligation to settle termination values since none of the derivative agreements were in net liability positions as of March 31, 2013.

The Company also has agreements with certain of its derivative counterparties that contain a provision where if the Company defaults on any of its indebtedness, including default where repayment of the indebtedness has not been accelerated by the lender, then the Company could also be declared in default on its derivative obligations.

Table of Contents

16. Segment Disclosures

The Company's business activities are managed in two segments: Direct Banking and Payment Services.

Direct Banking. The Direct Banking segment includes Discover card-branded credit cards issued to individuals and small businesses and other consumer products and services, including home loans, personal loans, student loans, prepaid cards and other consumer lending and deposit products. The majority of the Direct Banking revenues relate to interest income earned on each of its loan products. Additionally, the Company's credit card products generate substantially all of the Company's revenues related to discount and interchange, protection products and loan fee income.

Payment Services. The Payment Services segment includes PULSE, an automated teller machine, debit and electronic funds transfer network; Diners Club, a global payments network; and the Company's network partners business, which includes credit, debit and prepaid cards issued on the Discover Network by third parties. The majority of the Payment Services revenues relate to transaction processing revenue from PULSE and royalty and licensee revenue (included in other income) from Diners Club.

The business segment reporting provided to and used by the Company's chief operating decision maker is prepared using the following principles and allocation conventions:

• Corporate overhead is not allocated between segments; all corporate overhead is included in the Direct Banking segment.

• Through its operation of the Discover Network, the Direct Banking segment incurs fixed marketing, servicing and infrastructure costs that are not specifically allocated among the segments.

• The assets of the Company are not allocated among the operating segments in the information reviewed by the Company's chief operating decision maker.

• The revenues of each segment are derived from external sources. The segments do not earn revenue from intercompany sources.

• Income taxes are not specifically allocated among the operating segments in the information reviewed by the Company's chief operating decision maker.

The following table presents segment data for the three months ended March 31, 2013 and 2012 and the one month ended December 31, 2012 (dollars in millions):

For the Three Months Ended	Direct Banking	Payment Services	Total
March 31, 2013			
Interest income			
Credit card	\$1,451	\$—	\$1,451
Private student loans	58	—	58
PCI student loans	70	—	70
Personal loans	103	—	103
Other	26	—	26
Total interest income	1,708	—	1,708
Interest expense	298	—	298
Net interest income	1,410	—	1,410
Provision for loan losses	159	—	159
Other income	495	87	582
Other expense	713	40	753
Income before income tax expense	\$1,033	\$47	\$1,080

Table of Contents

For the Three Months Ended	Direct Banking	Payment Services	Total
March 31, 2012			
Interest income			
Credit card	\$1,414	\$—	\$1,414
Private student loans	43	—	43
PCI student loans	77	—	77
Personal loans	84	—	84
Other	23	—	23
Total interest income	1,641	—	1,641
Interest expense	349	—	349
Net interest income	1,292	—	1,292
Provision for loan losses	84	—	84
Other income	429	82	511
Other expense	638	34	672
Income before income tax expense	\$999	\$48	\$1,047
For the One Month Ended			
December 31, 2012			
Interest income			
Credit card	\$510	\$—	\$510
Private student loans	18	—	18
PCI student loans	24	—	24
Personal loans	34	—	34
Other	9	—	9
Total interest income	595	—	595
Interest expense	103	—	103
Net interest income	492	—	492
Provision for loan losses	178	—	178
Other income	169	31	200
Other expense	224	16	240
Income before income tax expense	\$259	\$15	\$274

Table of Contents

17. Transition Period Financial Information

The following table presents selected financial data for the one month as of and ended December 31, 2012 and the one month as of and ended December 31, 2011 (in millions, except per share data):

	One Month Ended December 31,	
	2012	2011
Statement of Income Data:		
Net interest income	\$492	\$442
Provision for loan losses	178	173
Other income	200	211
Other expense	240	217
Income before income tax expense	274	263
Income tax expense	104	99
Net income	\$170	\$164
Net income allocated to common stockholders	\$168	\$162
Per Share of Common Stock:		
Basic EPS	\$0.34	\$0.31
Diluted EPS	\$0.34	\$0.30
Weighted average shares outstanding	498	529
Weighted average shares outstanding (fully diluted)	499	530
Statement of Financial Condition Data (as of):		
Total loan receivables	\$62,598	\$59,372
Allowance for loan losses	\$(1,788)	\$(2,245)
Total assets	\$73,491	\$69,473
Long-term borrowings	\$17,666	\$18,265
Total liabilities	\$63,618	\$61,115
Total stockholders' equity	\$9,873	\$8,358

18. Subsequent Events

Dividends. On April 16, 2013, the Company announced a quarterly cash dividend of \$0.20 per share of common stock, payable on May 23, 2013 to holders of record on May 9, 2013. Also on April 16, 2013, the Company announced a quarterly cash dividend on its preferred stock in the amount of \$16.25 per share, equal to \$.40625 per depositary share, payable on June 3, 2013 to holders of record on May 17, 2013.

Table of Contents

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and related notes included elsewhere in this quarterly report. This quarterly report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements, which speak to our expected business and financial performance, among other matters, contain words such as "believe," "expect," "anticipate," "intend," "plan," "aim," "will," "may," "should," "could," "would," "likely," and similar expressions. Such statements are based upon the current beliefs and expectations of our management and are subject to significant risks and uncertainties. Actual results may differ materially from those set forth in the forward-looking statements. These forward-looking statements speak only as of the date of this quarterly report, and there is no undertaking to update or revise them as more information becomes available.

The following factors, among others, could cause actual results to differ materially from those set forth in the forward-looking statements: changes in economic variables, such as the availability of consumer credit, the housing market, energy costs, the number and size of personal bankruptcy filings, the rate of unemployment and the levels of consumer confidence and consumer debt, and investor sentiment; the impact of current, pending and future legislation, regulation, supervisory guidance, and regulatory and legal actions, including, but not limited to, those related to financial regulatory reform, consumer financial services practices, anti-corruption, and funding, capital and liquidity; the actions and initiatives of current and potential competitors; our ability to manage our expenses; our ability to successfully achieve card acceptance across our networks and maintain relationships with network participants; our ability to sustain and grow our private student loan portfolio and mortgage loan products; losses as a result of mortgage loan repurchase and indemnification obligations to secondary market purchasers; our ability to manage our credit risk, market risk, liquidity risk, operational risk, legal and compliance risk, and strategic risk; the availability and cost of funding and capital; access to deposit, securitization, equity, debt and credit markets; the impact of rating agency actions; the level and volatility of equity prices, commodity prices and interest rates, currency values, investments, other market fluctuations and other market indices; losses in our investment portfolio; limits on our ability to pay dividends and repurchase our common stock; limits on our ability to receive payments from our subsidiaries; fraudulent activities or material security breaches of key systems; our ability to increase or sustain Discover card usage or attract new customers; our ability to maintain relationships with current merchants; the effect of political, economic and market conditions, geopolitical events and unforeseen or catastrophic events; our ability to introduce new products and services; our ability to manage our relationships with third-party vendors; our ability to maintain current technology and integrate new and acquired systems; our ability to collect amounts for disputed transactions from merchants and merchant acquirers; our ability to attract and retain employees; our ability to protect our reputation and our intellectual property; difficulty obtaining regulatory approval for, financing, transitioning, integrating or managing the expenses of acquisitions of or investments in new businesses, products or technologies; and new lawsuits, investigations or similar matters or unanticipated developments related to current matters. We routinely evaluate and may pursue acquisitions of or investments in businesses, products, technologies, loan portfolios or deposits, which may involve payment in cash or our debt or equity securities.

Additional factors that could cause our results to differ materially from those described below can be found in this section in this quarterly report and in "Risk Factors," "Business—Competition," "Business—Supervision and Regulation" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our annual report on Form 10-K for the year ended November 30, 2012, filed with the SEC and available at the SEC's internet site (<http://www.sec.gov>).

Introduction and Overview

Discover Financial Services is a direct banking and payment services company. Through our Discover Bank subsidiary, we offer our customers credit card loans, private student loans, personal loans and deposit products. Through our Discover Home Loans, Inc. subsidiary, we offer our customers home loans. Through our DFS Services

LLC subsidiary and its subsidiaries, we operate 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 card-branded and network partner credit, debit and prepaid cards. 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, which are generally financial institutions, that issue Diners Club branded credit cards and/or provide card acceptance services.

Our primary revenues consist of interest income earned on loan receivables and fees earned from customers, merchants and issuers. The primary expenses required to operate our business include funding costs (interest expense), loan loss provisions, customer rewards, and expenses incurred to grow, manage and service our loan receivables and networks. Our business activities are funded primarily through consumer deposits, securitization of loan receivables and the issuance of unsecured debt.

Table of Contents

Change in Fiscal Year

On December 3, 2012, our board of directors approved a change in our fiscal year end from November 30 to December 31. This fiscal year change was effective January 1, 2013. As a result of the change, we had a one month transition period in December 2012. The unaudited results for the one month ended December 31, 2012 and 2011 are included in this report. The audited results for the one month ended December 31, 2012 and the unaudited results for the one month ended December 31, 2011 will be included in our annual report on Form 10-K for the year ended December 31, 2013. In addition, the results for the quarter ended March 31, 2013 are compared with the results of the quarter ended March 31, 2012 in this report, which have been recast on a calendar basis due to the change in our fiscal year.

Comparison of One Month Ended December 31, 2012 to December 31, 2011

In comparing the one month as of and ended December 31, 2012 to the one month as of and ended December 31, 2011, there was a decrease of approximately \$400 million in the allowance for loan losses. The allowance for loan losses at December 31, 2012 was \$1.8 billion compared to \$2.2 billion at December 31, 2011, reflecting the improved credit performance experienced in 2012. The provision for loan losses was relatively flat for the one month ended December 31, 2012 as compared to the same period in 2011. In addition, the acquisition and integration of Home Loan Center in June 2012 (see Note 2: Business Combinations to our condensed consolidated financial statements) drove marginal increases in other income and other expense. The increase in other income was more than offset by an increase in promotional Cashback Bonus rewards earned by our customers which resulted in an overall decrease in other income. For additional information regarding the one month as of and ended December 31, 2012 and the one month as of and ended December 31, 2011, see Note 17: Transition Period Financial Information to our condensed consolidated financial statements.

Quarter Highlights

Net income for the first quarter of 2013 was \$673 million, compared to \$650 million for the first quarter of 2012.

Credit card loans grew \$2.4 billion to \$48.7 billion and Discover card sales volume increased 4% from the prior year.

Credit card loan delinquencies over 30 days past due reached a historic low of 1.77%. Credit card net charge-off rate increased 5 basis points sequentially to 2.36%.

Payment services pretax income was down 2% from the prior year to \$47 million. Transaction dollar volume for the segment was \$48.8 billion in the quarter, an increase of 2% from the prior year.

We repurchased approximately 6 million shares of common stock for \$238 million, reducing our number of shares outstanding by 1% from the prior quarter.

Our capital market activities included issuances of approximately \$1.7 billion in public credit card asset backed securities. Discover Bank issued \$750 million in senior bank notes.

We received non-objection from the Federal Reserve with respect to our proposed capital actions through March 31, 2014.

Our board of directors approved a new two-year share repurchase program authorizing the repurchase of up to \$2.4 billion of our outstanding shares of common stock.

Recent Developments

On April 16, 2013, we announced a quarterly cash dividend of \$0.20 per share of common stock, payable on May 23, 2013 to holders of record on May 9, 2013.

Also on April 16, 2013, we announced a quarterly cash dividend on our preferred stock in the amount of \$16.25 per share, equal to \$.40625 per depositary share, payable on June 3, 2013 to holders of record on May 17, 2013.

Outlook

Edgar Filing: Discover Financial Services - Form 10-Q

Credit performance continued to improve in the first quarter of 2013 as we reached a historic low in delinquency rates on our credit card loans. As our loan portfolio continues to grow and credit losses begin to move away from the historic lows that we have been experiencing, we would expect to build reserves. We believe investments in marketing will contribute to our receivables growth and we are focused on continuing this trend through new account acquisitions, wallet share gains, and the

49

Table of Contents

launch of our new flagship card Discover it. We are also targeting solid growth and strong returns in our private student and personal loan portfolios. The expansion of our direct banking product offerings remains a priority, highlighted by the recent launch of Discover Cashback Checking.

We anticipate modest total yield compression in 2013 due to a decline in card yield and expected growth in private student loans, which tend to carry lower interest rates. We expect this yield compression to be offset by continued funding cost improvements. Funding costs are expected to remain at low levels in 2013 as we benefit from the interest rate environment and replace higher-priced time deposits with lower-cost borrowings. We intend to continue to maintain a strong capital level in 2013, while targeting investments for future growth and returning capital to shareholders through our share repurchase program and quarterly dividends.

In our payments business, we continue to explore opportunities to leverage our network infrastructure, as evidenced by our previously announced service arrangement with PayPal. We also continue to invest in global brand awareness and acceptance through support of our Diners Club network and arrangements with other banks, networks and merchant acquirers. We expect the growth rate to be slower in 2013 in comparison to 2012 for PULSE transaction volume as a result of actions by competitors with regard to merchant and acquirer pricing and transaction routing strategies, as well as our focus on profitable business rather than solely volume growth. While the environment remains challenging, we are pursuing a number of debit strategies.

We continue to monitor the political and economic situation in Europe and work with our local Diners Club licensees with regard to their ability to maintain financing sufficient to support business operations. The inability of certain licensees to maintain operating financing could adversely impact our payment services business. From time to time, we provide financial assistance to licensees when we deem it beneficial to our global payments strategy. For example, we have provided loans to certain licensees and we entered into an agreement to purchase one of our licensees. Such arrangements may cause us to incur financial losses.

Regulatory Environment and Developments

Overview

The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Reform Act") contains a comprehensive set of provisions designed to govern the practices and oversight of financial institutions and other participants in the financial markets. The Reform Act addresses risks to the economy and the payments system posed by large systemically significant financial firms, including us, through a variety of measures, including increased capital and liquidity requirements, limits on leverage, and enhanced supervisory authority. The Reform Act also established a new financial industry regulator, the Consumer Financial Protection Bureau (the "CFPB"), and new requirements for debit card transactions, which impact our core businesses. Additional legislative or regulatory action that may impact our business may result from the multiple studies mandated under the Reform Act.

The evolving regulatory environment causes uncertainty with respect to the manner in which we conduct our businesses and may potentially increase the risk that we may be subject to criticism by our banking regulators. Our banking regulators have introduced and continue to introduce new regulations, supervisory guidance and enforcement actions. We are unable to predict the nature, extent or impact of any additional changes to statutes or regulations, including the interpretation, implementation or enforcement thereof, which may occur in the future.

The impact that the regulatory environment ultimately has on our business and operations depends upon final implementing regulations, the actions of our competitors and the behavior of consumers and other marketplace participants. Regulatory actions could require us to limit or change our business practices, limit our ability to pursue business opportunities, limit our product offerings, require continued investment of management time and resources in compliance efforts, limit fees we can charge for services, require us to meet more stringent capital, liquidity and leverage ratio requirements (including those under Basel III), increase costs, restrict our ability to access the securitization markets for our funding, impact the value of our assets, or otherwise adversely affect our businesses. To date, compliance requirements and expenditures have increased for financial services firms, including Discover, and we expect them to continue to increase. In September 2012, Discover Bank entered into a consent order with the Federal Deposit Insurance Corporation (the "FDIC") and CFPB with respect to the marketing of our protection products, which required us to provide refunds of approximately \$200 million to eligible customers, pay a \$14 million civil monetary penalty and enhance our business processes. We may face additional compliance and regulatory risk to

the extent that we enter into new lines of business or new business arrangements with third-party service providers, alternative payment providers or other industry participants, including providers or participants that may not be regulated financial institutions. The additional expense, time and resources needed to comply with ongoing regulatory requirements may adversely impact our business and results of operations.

Table of Contents

Consumer Financial Services

The Reform Act established the CFPB, which regulates consumer financial products and services and certain financial services providers, including Discover. The CFPB is authorized to prevent "unfair, deceptive or abusive acts or practices" and ensure consistent enforcement of laws so that all consumers have access to markets for consumer financial products and services that are fair, transparent and competitive. The CFPB has rulemaking and interpretive authority under the Reform Act and other federal consumer financial services laws, as well as broad supervisory, examination and enforcement authority over large providers of consumer financial products and services, such as Discover. In addition, the CFPB has an online complaint system that allows consumers to log complaints with respect to the products we offer. The system could inform future agency decisions with respect to regulatory, enforcement or examination focus. Although the CFPB has begun to implement its regulatory, supervisory, examination and enforcement authority, there continues to be significant uncertainty as to how the agency's strategies and priorities will impact our businesses. The CFPB has recently focused on the marketing of protection products. In September 2012, Discover Bank entered into a consent order with the FDIC and CFPB with respect to the marketing of our protection products, as referenced above.

Student Loans. There is significant legislative and regulatory focus on the student loan market, including by the CFPB, which has made it a priority area of focus. The Reform Act created a "Private Education Ombudsman" within the CFPB to receive and attempt to informally resolve complaints about private student loans, and the Ombudsman issued a report in October 2012 summarizing the complaints that have been received. The October report recommended that congressional committees identify opportunities to spur the availability of loan modification and refinance options for student loan borrowers. In addition, the report recommends that the CFPB and other regulatory agencies assess whether efforts to correct problems in mortgage servicing could be applied to improve the quality of student loan servicing.

In July 2012, the CFPB and the U.S. Department of Education released a comprehensive report on private student lending, which recommended that Congress re-assess the current bankruptcy exemption for private student loans. The July report also recommends that Congress consider requiring private student lenders to obtain school certification that the amount of a student loan does not exceed student need; that more and better information about post-graduate outcomes be made available to students, lenders, and regulators in order to inform students' choice of school and lenders' underwriting capabilities; that schools should determine whether students have exhausted federal aid and certify the need for a private student loan; and that private lenders should disclose the availability of federal aid. Additionally, as directed by the Reform Act, the CFPB reviewed the use of schools' cohort default rates in private loan underwriting. The "cohort default rate" for each school is the average rate of default on federal loans by all student borrowers attending that school, measured for each school year and published by the Department of Education. The July report concluded that the general reliance of many private student lenders on cohort default rates for eligibility cutoffs for students at specific schools may raise a threshold fair lending concern, meriting further analysis by private student lenders to provide evidence of business need. Like other private student lenders, we utilize cohort default rates in the determination of eligibility, and we have reviewed our business needs supporting their use.

Congress or the Administration may take actions as a result of these studies, or otherwise, that impact the student loan market in the future. Legislation has been proposed in past Congresses that would make it easier to discharge private student loan debt in bankruptcy, by repealing the current requirement that this relief is available only to those for whom repaying such loans would be an "undue hardship." This legislation has been introduced in both the House and the Senate, though it is uncertain whether it will pass. If the legislation did pass and was enacted as law, we believe our underwriting practices and the high percentage of our loans that have cosigners reduce potential risk to our business. Any such actions, however, could cause us to restructure our private student loan product in ways that we may not currently anticipate.

Home Loans. The CFPB has indicated that the mortgage industry is an area of supervisory focus and that it will concentrate its examinations and rulemaking efforts on the variety of mortgage-related topics required under the Reform Act including steering consumers to less favorable products, discrimination, abusive or unfair lending practices, predatory lending, origination disclosures, minimum mortgage underwriting standards, mortgage loan origination compensation and servicing practices. The CFPB recently published several final rules impacting the

mortgage industry, including rules related to ability-to-repay, mortgage servicing and mortgage loan originator compensation. The ability-to-repay rule makes lenders liable if they fail to assess ability to repay under a prescribed test but also creates a safe harbor for so-called "qualified mortgages." The "qualified mortgages" standards include a tiered cap structure that places limits on the total amount of certain fees that can be charged on a loan, a 43% cap on debt-to-income (i.e., total monthly payments on debt to monthly gross income), exclusion of interest-only products and other requirements. The 43% debt-to-income cap does not apply for the first seven years the rule is in effect for loans that are eligible for sale to Fannie Mae or Freddie Mac or eligible for government guarantee through the Federal Housing Administration (the "FHA") or the Veterans Administration. Failure to comply with the ability-to-repay rule may result in possible CFPB enforcement action and special statutory damages plus actual, class action and attorney fee damages, all of which a borrower may claim in defense of a foreclosure action at any time. We are currently assessing the impact of these requirements on our mortgage business. It is uncertain what the impact of these requirements will be on the secondary market into which we sell mortgages we originate.

Table of Contents

In addition, the Federal Reserve and other federal agencies have issued a proposed rule under the Reform Act that would exempt "qualified residential mortgages" from the Reform Act requirement that the securitizer of assets retain an economic interest in a portion of the assets. The final definition of what constitutes a "qualified residential mortgage" may impact the pricing and depth of the secondary mortgage market. At this time, we cannot predict the final content of proposed rules issued by the regulatory agencies or the impacts they might have on our business practices or financial results.

Future regulatory initiatives that could significantly affect the mortgage industry include proposals to reform the housing finance market in the United States. These proposals, among other things, consider winding down the government-sponsored enterprises, Fannie Mae and Freddie Mac (collectively, the "GSEs"). In addition, the FHA may take action to further restrict the availability of FHA loan products in order to shrink the FHA's presence in the mortgage market. The extent and timing of any regulatory reform or the adoption of any legislation regarding the GSEs, changes to the FHA mortgage product, and/or the home mortgage market, as well as any effect on our business and financial results, are uncertain at this time.

Payment Networks

Following the implementation of the Federal Reserve regulations related to debit routing and fees in October 2011 and April 2012, large competing networks began to implement new merchant and acquirer pricing and transaction routing strategies. We are closely monitoring the implementation of these strategies in order to assess their impact on our business and on competition in the marketplace. The U.S. Department of Justice is examining some of these competitor pricing strategies. While we are still assessing all of our options for responding to these developments, they have adversely impacted and we expect that they may continue to adversely impact PULSE's ability to compete for issuer participation and merchant and acquirer routing.

Capital

In June 2012, the Federal Reserve approved proposed rules that would substantially amend the regulatory risk-based capital rules applicable to us and Discover Bank. The FDIC and the Office of the Comptroller of the Currency (the "OCC") subsequently approved these proposed rules. The proposed rules implement Basel III regulatory capital reforms and changes required by the Reform Act. "Basel III" refers to two consultative documents released by the Basel Committee on Banking Supervision in December 2009, the rules text released in December 2010 and loss absorbency rules issued in January 2011, which include significant changes to bank capital, leverage and liquidity requirements.

The proposed rules include new risk-based capital and leverage ratios, which would be phased in from 2013 to 2019, and would refine the definition of what constitutes "capital" for purposes of calculating those ratios. The proposed new minimum capital level requirements applicable to us and Discover Bank under the proposals would be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4% for all institutions. The proposed rules would also establish a "capital conservation buffer" of 2.5% above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier 1 capital and would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase by that amount each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions. The proposed rules received extensive comments. Industry participants are expecting the issuance of these final rules sometime in 2013. Based on our current capital composition and levels, we believe that we would be in compliance with the requirements as set forth in the proposed rules if they were presently in effect.

In October 2012, the Federal Reserve issued final rules implementing the stress test requirements under the Reform Act for bank holding companies with \$50 billion or more in total consolidated assets, including Discover. Under the final rule, the Federal Reserve will conduct annual supervisory stress tests for the 19 bank holding companies that participated in the 2009 Supervisory Capital Assessment Program and subsequent Comprehensive Capital Analysis

and Reviews ("CCAR BHCs") and will publish the results of such stress tests in March each year, beginning in 2013. In addition, the CCAR BHCs will be required to conduct their own stress tests twice per year and publish the results of these company-run stress tests in March and September each year, beginning in 2013. However, the Federal Reserve delayed implementation of these requirements for bank holding companies like Discover that have \$50 billion or more in total consolidated assets, but are not CCAR BHCs, for one year.

In October 2012, the FDIC also issued final rules implementing the stress test requirements under the Reform Act for state nonmember banks with \$50 billion or more in total consolidated assets, like our subsidiary, Discover Bank. The FDIC's stress test rule is similar to the Federal Reserve's stress test rule, except that in general it requires large banks like Discover Bank to comply with stress test requirements under the same timeline as required for the CCAR BHCs. However, the FDIC

Table of Contents

reserved authority in the final rule to permit subsidiary banks of non-CCAR BHCs, such as Discover Bank, to delay the application of the requirements of the final rule on a case-by-case basis. We sought and obtained FDIC approval to delay the application of certain stress test requirements to Discover Bank to align with the Federal Reserve stress test requirements that apply to us. In this regard, Discover Bank will not be required to comply with the requirements for the publication of stress test results until 2014.

In January 2013, we submitted a capital plan to the Federal Reserve under the Federal Reserve 2013 Capital Plan Review, or CapPR, program, which included planned dividends and share repurchases over the planning horizon. On March 14, 2013, we received non-objection from the Federal Reserve with respect to our proposed capital actions through March 31, 2014. In 2014, in addition to the stress test requirements described above, we expect our annual capital plan to be reviewed under the enhanced standards applied to the capital plans of CCAR BHCs under the Federal Reserve's 2013 Comprehensive Capital Analysis and Review, or CCAR, program. Therefore, the Federal Reserve will apply enhanced standards to our future capital plan submissions, including evaluation based on results of supervisory stress tests and enhanced documentation and process standards. Our ability to make capital distributions, including our ability to pay dividends or repurchase shares of our common stock, will continue to be subject to the Federal Reserve's review and non-objection of the actions that we propose each year in our annual capital plan.

There is significant legislative and regulatory focus on capital matters. For example, legislation was recently proposed that includes minimum requirements for the ratio of equity capital to total consolidated assets for large bank holding companies. We are not able to predict whether this or future legislative or regulatory initiatives will be adopted and whether any adopted legislation or final regulatory initiatives will require us to hold higher amounts of capital or reconfigure our capital structure, which could significantly impact our return on equity, financial condition, operations, capital position and ability to pursue business opportunities.

Resolution Plans

Under Federal Reserve and FDIC rules implementing Section 165(d) of the Reform Act, bank holding companies with \$50 billion or more in consolidated assets (including us) and certain other financial companies are required to submit a resolution plan (or so-called "living will") to the FDIC, the Federal Reserve, and the Financial Stability Oversight Council for their rapid and orderly liquidation in the event of material financial distress or failure. In addition, under a separate FDIC rule, an insured depository institution with \$50 billion or more in total assets, such as Discover Bank, is required to submit to the FDIC periodic contingency plans for resolution in the event of the institution's failure. Under these rules, the initial resolution plans for us and Discover Bank are required to be submitted on or before December 31, 2013. Thereafter, we and Discover Bank are required to update such plans annually and, in certain circumstances, more frequently. The consequences of these new rules and the agencies' review of resolution plans on the financial services industry and us is unclear. Failure to provide resolution plans that satisfy regulatory requirements may result in imposition of more stringent capital, leverage, or liquidity requirements, growth restrictions or ordered divestiture of assets and operations.

Segments

We manage our business activities in two segments: Direct Banking and Payment Services. In compiling the segment results that follow, our Direct Banking segment bears all overhead costs that are not specifically associated with a particular segment and all costs associated with Discover Network marketing, servicing and infrastructure, with the exception of an allocation of direct and incremental costs driven by our Payment Services segment.

Direct Banking. Our Direct Banking segment includes Discover card-branded credit cards issued to individuals and small businesses and other consumer products and services, including private student loans, personal loans, home loans, prepaid cards and other consumer lending and deposit products. The majority of our Direct Banking revenues relate to interest income earned on each of our loan products. Additionally, our credit card products generate substantially all of our revenues related to discount and interchange, protection products and loan fee income.

Payment Services. Our Payment Services segment includes PULSE, an automated teller machine, debit and electronic funds transfer network; Diners Club, a global payments network; and our network partner business, which includes credit, debit and prepaid cards issued on the Discover Network by third parties. The majority of our Payment Services revenues relate to transaction processing revenue from PULSE and royalty and licensee revenue (included in other income) from Diners Club.

Table of Contents

The following table presents segment data (dollars in millions):

	For the Three Months Ended March 31,		For the One Month Ended December 31,
	2013	2012	2012
Direct Banking			
Interest income			
Credit card	\$1,451	\$1,414	\$510
Private student loans	58	43	18
PCI student loans	70	77	24
Personal loans	103	84	34
Other	26	23	9
Total interest income	1,708	1,641	595
Interest expense	298	349	103
Net interest income	1,410	1,292	492
Provision for loan losses	159	84	178
Other income	495	429	169
Other expense	713	638	224
Income before income tax expense	1,033	999	259
Payment Services			
Other income	87	82	31
Other expense	40	34	16
Income before income tax expense	47	48	15
Total income before income tax expense	\$1,080	\$1,047	\$274

The following table presents information on transaction volume (in millions):

	For the Three Months Ended March 31,		For the One Month Ended December 31,
	2013	2012	2012
Network Transaction Volume			
PULSE Network	\$39,919	\$38,550	\$14,133
Network Partners	2,246	2,004	885
Diners Club ⁽¹⁾	6,644	7,067	2,274
Total Payment Services	48,809	47,621	17,292
Discover Network—Proprietary ⁽²⁾	25,738	24,690	10,987
Total Volume	\$74,547	\$72,311	\$28,279
Transactions Processed on Networks			
Discover Network	442	417	183
PULSE Network	1,023	1,028	357
Total	1,465	1,445	540
Credit Card Volume			
Discover Card Volume ⁽³⁾	\$26,880	\$25,730	\$11,384
Discover Card Sales Volume ⁽⁴⁾	\$24,864	\$23,891	\$10,657

(1) Diners Club volume is derived from data provided by licensees for Diners Club branded cards issued outside North America and is subject to subsequent revision or amendment.

(2) Represents gross proprietary sales volume on the Discover Network.

(3) Represents Discover card activity related to net sales, balance transfers, cash advances and other activity.

(4) Represents Discover card activity related to net sales.

Table of Contents

Direct Banking

Our Direct Banking segment reported pretax income of \$1.0 billion for the three months ended March 31, 2013, which was relatively unchanged compared to the three months ended March 31, 2012.

Loan receivables totaled \$60.4 billion at March 31, 2013, which was down from \$62.6 billion at December 30, 2012, primarily due to a decrease in credit card loan receivables, which was driven by a seasonal increase in payments. The decrease in credit card loans was partially offset by growth within both personal loans and private student loans.

Discover card sales volume was \$24.9 billion for the three months ended March 31, 2013, an increase of 4% as compared to the same period in 2012. This growth was driven primarily by an increase in the number of existing customers using their Discover card.

Net interest margin increased for the three months ended March 31, 2013 as compared to the same period in 2012.

This increase was primarily driven by decreased funding costs partially offset by lower total loan receivables yield.

The decrease in total yield was driven primarily by credit card yield which decreased due to an increase in promotional rate balances and a decline in higher rate balances. The factors contributing to the decrease in credit card yield were partially offset by a decline in charge-offs. There was an increase in interest income relating to credit card loan receivables largely driven by a higher average level of loans which was partially offset by lower yield. There was also an increase in interest income related to private student and personal loans during the three months ended March 31, 2013 as compared to the same period in 2012 attributable to organic growth in these classes of loans. The decrease in interest income from purchased credit-impaired loans ("PCI") student loans was driven by a decline in the outstanding PCI loan balances as this is a static portfolio, partially offset by an increase in yield. Interest expense decreased for the three months ended March 31, 2013, as compared to the same period in 2012, as interest costs for all funding sources decreased. Interest costs related to deposits decreased as maturities of deposits bearing higher interest rates were replaced by funding from deposits with lower interest rates. Interest costs related to securitized borrowings decreased due to issuances of credit card securitized borrowings, net of maturities, at lower interest rates and pay downs of student loan securitized borrowings at higher interest rates. Interest costs related to other borrowings decreased due to 2012 debt exchanges that replaced higher rate borrowings with funding from borrowings bearing lower interest rates.

At March 31, 2013, our delinquency rate for credit card loans over 30 days past due was 1.77% as compared to 1.79% at December 31, 2012, reflective of continuing trends of strong credit performance. For the three months ended March 31, 2013, our net charge-off rate on credit cards declined to 2.36%, as compared to 2.92% for the same period in 2012. The provision for loan losses for the three month period ended March 31, 2013, as compared to the same period in 2012 increased due to a decline in reserve releases partially offset by a decline in the level of net charge-offs. For a more detailed discussion on provision for loan losses, see "- Loan Quality - Provision and Allowance for Loan Losses."

Total other income increased for the three months ended March 31, 2013 as compared to the same period in 2012, primarily due to revenue related to the acquisition and integration of the assets of Home Loan Center in June 2012 (see Note 2: Business Combinations to our condensed consolidated financial statements). The increase related to the acquisition of Home Loan Center included a net gain on the origination and sale of loans. Additionally, other income increased due to higher discount and interchange revenue resulting from higher sales volume for the current period. These increases were partially offset by a decrease in protection product revenue, reflecting the impact of changes in our offer strategies, which reduced selling over the last few years and ceased at the end of 2012.

Total other expense increased for the three months ended March 31, 2013 as compared to the same period in 2012 primarily due to increased compensation expenses and marketing expenses, partially offset by decreased legal expenses. Compensation costs rose due to an increase in headcount, which was partially related to the acquisition of the assets of Home Loan Center, referenced above. Marketing and business development expenses increased due to growth initiatives. Legal expenses decreased due to the settlement of the FDIC and CFPB matter in September 2012.

Payment Services

Pretax income for our Payment Services segment was \$47 million for the three months ended March 31, 2013, which was relatively flat compared to the same period during 2012. Total other income increased as the result of a greater number of point-of-sale transactions on the PULSE network combined with an increase in network partner fees. Total

other expense increased primarily due to higher professional fees and marketing expenses related to new partnership and growth initiatives.

Transaction dollar volume increased \$1.2 billion for the three months ended March 31, 2013 as compared to the same period during 2012, primarily driven by increased PULSE point-of-sale volume. The number of transactions processed on the PULSE network was relatively flat for the three months ended March 31, 2013, as compared to the same period during 2012.

Table of Contents

Critical Accounting Estimates

In preparing our condensed consolidated financial statements in conformity with GAAP, management must make judgments and use estimates and assumptions about the effects of matters that are uncertain. For estimates that involve a high degree of judgment and subjectivity, it is possible that different estimates could reasonably be derived for the same period. For estimates that are particularly sensitive to changes in economic or market conditions, significant changes to the estimated amount from period to period are also possible. Management believes the current assumptions and other considerations used to estimate amounts reflected in our condensed consolidated financial statements are appropriate. However, if actual experience differs from the assumptions and other considerations used in estimating amounts in our condensed consolidated financial statements, the resulting changes could have a material effect on our consolidated results of operations and, in certain cases, could have a material effect on our consolidated financial condition. Management has identified the estimates related to our allowance for loan losses, the accrual of credit card customer rewards cost, the evaluation of goodwill and other nonamortizable intangible assets for potential impairment, the accrual of income taxes, estimates of future cash flows associated with purchased credit-impaired loans, and the fair value estimates of loan commitments and mortgages held for sale as critical accounting estimates. These critical accounting estimates are discussed in greater detail in our annual report on Form 10-K for the fiscal year ended November 30, 2012. That discussion can be found within "Management's Discussion and Analysis of Financial Condition and Results of Operations" under the heading "Critical Accounting Estimates." There have not been any material changes in the methods used to formulate these critical accounting estimates from those discussed in our annual report on Form 10-K for the fiscal year ended November 30, 2012.

Earnings Summary

The following table outlines changes in our condensed consolidated statements of income for the periods presented (dollars in millions):

	For the Three Months Ended March 31,		2013 vs. 2012 increase (decrease)		For the One Month Ended December 31, 2012
	2013	2012	\$	%	%
Interest income	\$1,708	\$1,641	\$67	4	% \$595
Interest expense	298	349	(51)	(15)	)% 103
Net interest income	1,410	1,292	118	9	% 492
Provision for loan losses	159	84	75	89	% 178
Net interest income after provision for loan losses	1,251	1,208	43	4	% 314
Other income	582	511	71	14	% 200
Other expense	753	672	81	12	% 240
Income before income tax expense	1,080	1,047	33	3	% 274
Income tax expense	407	397	10	3	% 104
Net income	\$673	\$650	\$23	4	% \$170

Net Interest Income

The tables that follow this section have been provided to supplement the discussion below and provide further analysis of net interest income, net interest margin and the impact of rate and volume changes on net interest income. Net interest income represents the difference between interest income earned on our interest-earning assets and the interest expense incurred to finance those assets. We analyze net interest income in total by calculating net interest margin (net interest income as a percentage of average total loan receivables) and net yield on interest-bearing assets (net interest income as a percentage of average total interest-earning assets). We also separately consider the impact of the level of loan receivables and the related interest yield and the impact of the cost of funds related to each of our funding sources, along with the income generated by our liquidity portfolio, on net interest income.

Our interest-earning assets consist of: (i) cash and cash equivalents, which includes amounts on deposit with the Federal Reserve, highly rated certificates of deposit, and triple-A rated government mutual funds, (ii) restricted cash, (iii) short-term investments, (iv) investment securities and (v) loan receivables. Our interest-bearing liabilities consist primarily of deposits, both direct-to-consumer and brokered, and long-term borrowings, including amounts owed to securitization investors. Net interest income is influenced by the following:

- The level and composition of loan receivables, including the proportion of credit card loans to other loans, as well as the proportion of loan receivables bearing interest at promotional rates as compared to standard rates;
- The credit performance of our loans, particularly with regard to charge-offs of finance charges, which reduce interest income;
- The terms of long-term borrowings and certificates of deposit upon initial offering, including maturity and interest rate;
- The level and composition of other interest-bearing assets and liabilities, including our liquidity portfolio;
- Changes in the interest rate environment, including the levels of interest rates and the relationships among interest rate indices, such as the prime rate, the Federal Funds rate and LIBOR;
- The effectiveness of interest rate swaps in our interest rate risk management program; and
- The difference between the carrying amount and future cash flows expected to be collected on PCI loans.

Net interest margin increased for the three months ended March 31, 2013 as compared to the same period in 2012. This increase was primarily driven by decreased funding costs partially offset by lower total loan receivables yield. The decrease in total yield was driven primarily by credit card yield which decreased due to an increase in promotional rate balances and a decline in higher rate balances. The factors contributing to the decrease in credit card yield were partially offset by a decline in charge-offs.

Interest income increased for the three months ended March 31, 2013, as compared to the same period in 2012, driven primarily by higher interest income from credit card loans, personal loans, and private student loans due to increased loan balances across these products. The increase in interest income from these products was slightly offset by a decrease in interest income from PCI student loans. The increase in interest income on credit card loans was also driven by lower interest charge-offs, offset in part by a decrease in yield. The increase in interest income from private student loans was slightly offset by a decrease in yield due to the seasoning of our student loan portfolio. The decrease in interest income from PCI student loans was driven by a decline in the outstanding PCI loans balance and was partially offset by an increase in yield.

Interest income on other interest-earning assets, which is comprised of investment income from our liquidity portfolio and interest-earning cash balances, remained relatively flat for the three months ended March 31, 2013, as compared to the same period in 2012. Interest expense decreased for the three months ended March 31, 2013, as compared to the same period in 2012, due to a decrease in funding rates on new deposits, and was partially offset by an increase in the balance of these deposits.

Edgar Filing: Discover Financial Services - Form 10-Q

Table of Contents

Average Balance Sheet Analysis

(dollars in millions)

	For the Three Months Ended March 31,						For the One Month Ended December 31,			
	2013			2012			2012			
	Average Balance	Rate	Interest	Average Balance	Rate	Interest	Average Balance	Rate	Interest	
Assets										
Interest-earning assets:										
Cash and cash equivalents	\$4,788	0.25 %	\$3	\$4,583	0.27 %	\$3	\$2,704	0.25 %	\$—	
Restricted cash	720	0.10 %	—	555	0.20 %	1	1,400	0.11 %	—	
Investment securities	5,709	1.42 %	20	6,344	1.14 %	18	6,247	1.34 %	7	
Loan receivables ⁽¹⁾ :										
Credit card ⁽²⁾⁽³⁾	49,267	11.94 %	1,451	46,604	12.21 %	1,414	50,494	11.92 %	510	
Personal loans	3,344	12.45 %	103	2,762	12.28 %	84	3,290	12.43 %	35	
Federal student loans	—	— %	—	245	1.64 %	1	—	— %	—	
Private student loans	3,356	7.03 %	58	2,394	7.21 %	43	3,021	7.22 %	18	
PCI student loans	4,633	6.15 %	70	5,146	6.02 %	77	4,724	5.96 %	24	
Mortgage loans held for sale	265	3.15 %	2	—	— %	—	310	3.05 %	1	
Other	38	6.06 %	1	24	3.65 %	—	38	5.24 %	—	
Total loan receivables	60,903	11.22 %	1,685	57,175	11.39 %	1,619	61,877	11.21 %	588	
Total interest-earning assets	72,120	9.60 %	1,708	68,657	9.61 %	1,641	72,228	9.73 %	595	
Allowance for loan losses	(1,822)			(2,161)			(1,725)			
Other assets	4,362			3,967			4,234			
Total assets	\$74,660			\$70,463			\$74,737			
Liabilities and Stockholders' Equity										
Interest-bearing liabilities:										
Interest-bearing deposits:										
Time deposits ⁽⁴⁾	\$27,825	2.24 %	154	\$26,146	2.84 %	185	\$27,849	2.29 %	54	
Money market deposits	5,242	0.88 %	11	5,462	0.97 %	13	5,368	0.88 %	4	
Other interest-bearing savings deposits	8,987	0.97 %	21	8,370	1.25 %	26	8,864	1.00 %	7	
Total interest-bearing deposits ⁽⁵⁾	42,054	1.80 %	186	39,978	2.25 %	224	42,081	1.84 %	65	
Borrowings:										
Short-term borrowings	240	1.45 %	1	—	— %	—	283	1.36 %	—	
Securitized borrowings	16,574	1.84 %	75	16,338	2.08 %	85	16,998	1.80 %	26	
Other long-term borrowings ⁽⁴⁾	2,059	7.04 %	36	2,159	7.55 %	40	1,733	7.82 %	12	
Total borrowings	18,873	2.41 %	112	18,497	2.72 %	125	19,014	2.34 %	38	
Total interest-bearing liabilities	60,927	1.99 %	298	58,475	2.40 %	349	61,095	1.99 %	103	
Other liabilities and stockholders' equity	13,733			11,988			13,642			
Total liabilities and stockholders' equity	\$74,660			\$70,463			\$74,737			
Net interest income			\$1,410			\$1,292			\$492	
Net interest margin ⁽⁶⁾		9.39 %			9.09 %			9.39 %		
		7.93 %			7.57 %			8.05 %		

Net yield on interest-bearing
assets ⁽⁷⁾

Interest rate spread ⁽⁸⁾	7.61 %	7.21 %	7.74 %
-------------------------------------	--------	--------	--------

Average balances of loan receivables include non-accruing loans, which are included in the yield calculations. If (1) the non-accruing loan balances were excluded, there would not be a material impact on the amounts reported above.

Interest income on credit card loans includes \$41.3 million, \$43.8 million and \$13.9 million of amortization of (2) balance transfer fees for the three months ended March 31, 2013 and 2012 and the one month ended December 31, 2012, respectively.

(3) Includes the impact of interest rate swap agreements used to change a portion of certain floating-rate credit card loan receivables to fixed-rate.

(4) Includes the impact of interest rate swap agreements used to change a portion of fixed-rate funding to floating-rate funding.

(5) Includes the impact of FDIC insurance premiums and special assessments.

(6) Net interest margin represents net interest income as a percentage of average total loan receivables.

(7) Net yield on interest-bearing assets represents net interest income as a percentage of average total interest-earning assets.

(8) Interest rate spread represents the difference between the rate on total interest-earning assets and the rate on total interest-bearing liabilities.

Table of ContentsRate/Volume Variance Analysis ⁽¹⁾

	For the Three Months Ended March 31, 2013 vs. March 31, 2012		
	Volume	Rate	Total
Increase/(decrease) in net interest income due to changes in:			
Interest-earning assets:			
Cash and cash equivalents	\$1	\$(1)) \$—
Restricted cash	—	(1)	) (1)
Investment securities	(10)	) 12	2
Loan receivables:			
Credit card	204	(167)	) 37
Personal loans	18	1	19
Federal student loans	(1)	) —	(1)
Private student loans	22	(7)	) 15
PCI student loans	(17)	) 10	(7)
Mortgage loans held for sale	2	—	2
Other	—	1	1
Total loan receivables	228	(162)	) 66
Total interest income	219	(152)	) 67
Interest-bearing liabilities:			
Interest-bearing deposits:			
Time deposits	66	(97)	) (31)
Money market deposits	(1)	) (1)	(2)
Other interest-bearing savings deposits	10	(15)	) (5)
Total interest-bearing deposits	75	(113)	) (38)
Borrowings:			
Short-term borrowings	1	—	1
Securitized borrowings	7	(17)	) (10)
Other long-term borrowings	(2)	) (2)	(4)
Total borrowings	6	(19)	) (13)
Total interest expense	81	(132)	) (51)
Net interest income	\$138	\$(20)	) \$118

The rate/volume variance for each category has been allocated on a consistent basis between rate and volume (1) variances between March 31, 2013 and March 31, 2012 based on the percentage of the rate or volume variance to the sum of the two absolute variances.

Table of Contents

Loan Quality

Loan receivables consist of the following (dollars in millions):

	March 31, 2013	December 31, 2012	November 30, 2012
Mortgage loans held for sale	\$311	\$355	\$322
Loan portfolio:			
Credit card loans:			
Discover card	48,451	50,929	49,436
Discover business card	204	206	206
Total credit card loans	48,655	51,135	49,642
Other loans:			
Personal loans	3,395	3,296	3,272
Private student loans	3,426	3,072	3,000
Other	36	38	37
Total other loans	6,857	6,406	6,309
PCI student loans ⁽¹⁾	4,561	4,702	4,744
Total loan portfolio	60,073	62,243	60,695
Total loan receivables	60,384	62,598	61,017
Allowance for loan losses	(1,634)	(1,788)	(1,725)
Net loan receivables	\$58,750	\$60,810	\$59,292

(1) Represents purchased credit-impaired private student loans which do not have a related allowance for loan losses or charge-offs (see Note 4: Loan Receivables to our condensed consolidated financial statements).

Provision and Allowance for Loan Losses

Provision for loan losses is the expense related to maintaining the allowance for loan losses at an appropriate level to absorb the estimated probable losses in the loan portfolio at each period end date. Factors that influence the provision for loan losses include:

- The impact of general economic conditions on the consumer, including unemployment levels, bankruptcy trends and interest rate movements;

- Changes in consumer spending and payment behaviors;

- Changes in our loan portfolio, including the overall mix of accounts, products and loan balances within the portfolio;

- The level and direction of historical and anticipated loan delinquencies and charge-offs;

- The credit quality of the loan portfolio, which reflects, among other factors, our credit granting practices and effectiveness of collection efforts; and

- Regulatory changes or new regulatory guidance.

In calculating the allowance for loan losses, we estimate probable losses separately for segments of the loan portfolio that have similar risk characteristics, such as credit card and other loans. We use a migration analysis to estimate the likelihood that a loan will progress through the various stages of delinquency. We use other analyses to estimate losses incurred from non-delinquent accounts which adds to the identification of loss emergence. We use these analyses together as a basis for determining our allowance for loan losses.

The allowance for loan loss was \$1.6 billion at March 31, 2013, which reflects a \$154 million reserve release over the amount of the allowance for loan loss at December 31, 2012. The reserve release, which primarily related to credit card loan receivables, was driven by favorability in credit performance of the portfolio and an improvement in the outlook of certain economic factors that impact our customers.

Table of Contents

The provision for loan loss is the amount of expense realized after considering the level of net charge-offs in the period and the required amount of allowance for loan loss at the balance sheet date. For the three months ended March 31, 2013, the provision for loan losses increased by \$75 million, or 89%, as compared to the three months ended March 31, 2012 primarily due to lower reserve releases over the comparative period offset in part by a decline in net charge-offs in the current quarter. For the one month ended December 31, 2012, the provision for loan losses was \$178 million, which included a reserve build of \$63 million. This reserve build was due to an increase in the forecast for net charge-offs due to loan growth.

At March 31, 2013, the level of the allowance related to personal loans decreased slightly as compared to December 31, 2012, primarily driven by improvement in credit quality trends. The level of allowance attributable to student loans for the same period increased due to growth and continued seasoning of the portfolio. "Seasoning" refers to the maturing of a loan portfolio as, in general, loans do not begin to show signs of credit deterioration or default until they have been in repayment for some period of time. For student loans, payments are not required while the borrower is still in school; therefore, this loan portfolio matures at a slower pace than our other loan portfolios.

The following tables provide changes in our allowance for loan losses for the periods presented (dollars in millions):

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

For the Three Months Ended March 31, 2012

	Credit Card	Personal Loans	Student Loans	Other	Total
Balance at beginning of period	\$2,101	\$85	\$59	\$—	\$2,245
Additions:					
Provision for loan losses	59	23	2	—	84
Deductions:					
Charge-offs	(490)	(18)	(3)	—	(511)
Recoveries	152	1	—	—	153
Net charge-offs	(338)	(17)	(3)	—	(358)
Balance at end of period	\$1,822	\$91	\$58	\$—	\$1,971

For the One Month Ended December 31, 2012

	Credit Card	Personal Loans	Student Loans	Other	Total
Balance at beginning of period	\$1,554	\$97	\$73	\$1	\$1,725
Additions:					
Provision for loan losses	165	9	4	—	178
Deductions:					
Charge-offs	(146)	(8)	(2)	—	(156)
Recoveries	40	1	—	—	41
Net charge-offs	(106)	(7)	(2)	—	(115)
Balance at end of period	\$1,613	\$99	\$75	\$1	\$1,788

Table of Contents

Net Charge-offs

Our net charge-offs include the principal amount of losses 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 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. 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.

The following table presents amounts and rates of net charge-offs of key loan products (dollars in millions):

	For the Three Months Ended March 31,				For the One Month Ended December 31,	
	2013		2012		2012	
	\$	%	\$	%	\$	%
Credit card loans	\$287	2.36 %	\$338	2.92 %	\$106	2.47 %
Personal loans	\$19	2.30 %	\$17	2.56 %	\$7	2.52 %
Private student loans (excluding PCI ⁽¹⁾)	\$7	0.82 %	\$3	0.48 %	\$2	0.81 %

Charge-offs for PCI loans did not result in a charge to earnings during any of the years presented and are therefore (1) excluded from the calculation. See Note 4: Loan Receivables to our condensed consolidated financial statements for more information regarding the accounting for charge-offs on PCI loans.

The net charge-off rate on our credit card loan receivables decreased 56 basis points for the three months ended March 31, 2013 as compared to the three months ended March 31, 2012. The decrease in net charge-offs was attributable to an overall improvement in credit quality.

Table of Contents

Delinquencies

Delinquencies are an indicator of credit quality at a point in time. Loan balances are considered delinquent when contractual payments on the loan become 30 days past due.

The following table presents the amounts and delinquency rates of key loan products that are 30 and 90 days or more delinquent, loan receivables that are not accruing interest, regardless of delinquency and restructured loans (dollars in millions):

	March 31, 2013		December 31, 2012		November 30, 2012	
	\$	%	\$	%	\$	%
Loans 30 days delinquent or more:						
Credit card loans	\$862	1.77 %	\$917	1.79 %	\$925	1.86 %
Personal loans	\$26	0.76 %	\$26	0.77 %	\$25	0.76 %
Private student loans (excluding PCI loans ⁽¹⁾)	\$51	1.48 %	\$37	1.22 %	\$32	1.07 %
Loans 90 days delinquent or more:						
Credit card loans	\$442	0.91 %	\$460	0.90 %	\$451	0.91 %
Personal loans	\$7	0.22 %	\$8	0.23 %	\$8	0.23 %
Private student loans (excluding PCI loans ⁽¹⁾)	\$19	0.54 %	\$9	0.29 %	\$8	0.27 %
Loans not accruing interest	\$200	0.36 %	\$192	0.33 %	\$198	0.35 %
Restructured loans:						
Credit card loans ⁽²⁾	\$1,246	2.56 %	\$1,309	2.56 %	\$1,332	2.68 %
Personal loans ⁽³⁾	\$23	0.68 %	\$21	0.65 %	\$21	0.64 %
Private student loans (excluding PCI loans ⁽¹⁾) ⁽⁴⁾	\$19	0.56 %	\$16	0.53 %	\$15	0.50 %

(1) Excludes PCI loans which are accounted for on a pooled basis. Since a pool is accounted for as a single asset with a single composite interest rate and aggregate expectation of cash flows, the past-due status of a pool, or that of the individual loans within a pool, is not meaningful. Because we are recognizing interest income on a pool of loans, it is all considered to be performing.

(2) Restructured credit card loans include \$53 million, \$54 million and \$56 million at March 31, 2013, December 31, 2012 and November 30, 2012, respectively, that are also included in loans over 90 days delinquent or more.

(3) Restructured personal loans include \$1 million, \$2 million and \$1 million at March 31, 2013, December 31, 2012 and November 30, 2012, respectively, that are also included in loans over 90 days delinquent or more.

(4) Restructured private student loans include \$2 million, \$2 million and \$2 million at March 31, 2013, December 31, 2012 and November 30, 2012, respectively, that are also included in loans over 90 days delinquent or more.

Both credit card and personal loan receivables delinquency rates at March 31, 2013 were flat as compared to December 31, 2012. The delinquency rates for private student loan balances at March 31, 2013 increased as compared to December 31, 2012 due to the seasoning of our loan portfolio and as more loans have entered repayment.

Restructured credit card loans at March 31, 2013 decreased slightly compared to December 31, 2012 due to continued improvement in customer credit performance.

Table of Contents

Modified and Restructured Loans

We have loan modification programs that provide for temporary or permanent hardship relief for our credit card loans to borrowers experiencing financial difficulties. 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 rate on the loan. The permanent programs do not normally provide for the forgiveness of unpaid principal, but may allow for the reversal of certain unpaid interest or fee assessments. We also make loan modifications for customers who request financial assistance through external sources, such as a consumer credit counseling agency program. These loans continue to be subject to the original minimum payment terms and do not normally include waiver of unpaid principal, interest or fees. For additional information regarding the accounting treatment for these loans as well as amounts recorded in the financial statements related to these loans, see Note 4:

Loan Receivables to our condensed consolidated financial statements.

For student loan borrowers, in certain situations we offer payment forbearance to borrowers who are experiencing temporary financial difficulties and are willing to resume making payments. When a delinquent borrower is granted a second forbearance period, we classify these loans as troubled debt restructurings.

For personal loan customers, in certain situations we offer various payment programs, including temporary and permanent programs. The temporary programs 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 and in certain circumstances reducing the interest rate on the loan. The permanent program involves changing the terms of the loan in order to payoff the outstanding balance over the new term for a period no longer than four years and also in certain circumstances reducing the interest rate on the loan. The total term may not exceed nine years. We also allow loan modifications for customers who request financial assistance through external sources, similar to our credit card customers discussed above. Payments are modified based on the new terms agreed upon with the credit counseling agency. Personal loans included in temporary and permanent programs are accounted for as troubled debt restructurings.

Borrower performance after using payment programs or forbearance is monitored and we believe the programs help to prevent defaults and are useful in assisting customers experiencing financial difficulties. We plan to continue to use payment programs and forbearance and, as a result, we expect to have additional loans classified as troubled debt restructurings in the future.

Other Income

The following table presents the components of other income for the periods presented (dollars in millions):

	For the Three Months		2013 vs. 2012		For the One Month Ended December 31, 2012
	Ended March 31,		increase (decrease)		
	2013	2012	\$	%	
Discount and interchange revenue ⁽¹⁾	\$263	\$240	\$23	10 %	\$82
Protection products revenue	88	103	(15)	(15) %	33
Loan fee income	81	81	—	— %	29
Transaction processing revenue	53	49	4	8 %	18
Gain (loss) on investments	3	—	3	NM	2
Gain on origination and sale of mortgage loans	51	—	51	NM	17
Other income	43	38	5	13 %	19
Total other income	\$582	\$511	\$71	14 %	\$200

(1)

Edgar Filing: Discover Financial Services - Form 10-Q

Net of rewards, including Cashback Bonus rewards, of \$229 million, \$231 million and \$123 million for the three months ended March 31, 2013, March 31, 2012 and the one month ended December 31, 2012, respectively.

Total other income increased \$71 million during the three months ended March 31, 2013, as compared to the three months ended March 31, 2012, primarily due to the revenue related to the acquisition and integration of Home Loan Center in June 2012 (see Note 2: Business Combinations to our condensed consolidated financial statements). This increase included a net gain on the origination and sale of loans. In addition, other income increased due to higher discount and interchange revenue resulting from higher sales volume. These increases were partially offset by decreases in protection product revenue reflecting the impact of changes in our offer strategies, which reduced selling over the last few years and ceased at the end of 2012.

Table of Contents

Other Expense

The following table represents the components of other expense for the periods presented (dollars in millions):

	For the Three Months Ended March 31,		2013 vs. 2012 increase (decrease)		For the One Month Ended December 31,
	2013	2012	\$	%	2012
Employee compensation and benefits	\$290	\$246	\$44	18	% \$87
Marketing and business development	169	128	41	32	% 51
Information processing and communications	78	72	6	8	% 25
Professional fees	104	104	—	—	% 34
Premises and equipment	19	18	1	6	% 8
Other expense	93	104	(11)	(11)	)% 35
Total other expense	\$753	\$672	\$81	12	% \$240

Total other expense increased \$81 million for the three month period due to various factors. Employee compensation costs increased resulting from an increase in headcount, which was partially related to the acquisition and integration of Home Loan Center. There was an increase in marketing-related expenses related to growth initiatives. These increases were partially offset by decreased legal expenses due to the settlement of the FDIC and CFPB matter in September 2012.

Income Tax Expense

The following table reconciles our effective tax rate to the U.S. federal statutory income tax rate:

	For the Three Months Ended March 31,		For the One Month Ended December 31,	
	2013	2012	2012	2012
U.S. federal statutory income tax rate	35.0	% 35.0	% 35.0	%
U.S. state and local income taxes and other income taxes, net of U.S. federal income tax benefits	3.3	3.3	3.2	
Other	(0.6)	) (0.4)	) (0.1))
Effective income tax rate	37.7	% 37.9	% 38.1	%

Income tax expense increased \$10 million for the three months ended March 31, 2013 as compared to the first quarter 2012, as a result of the increase in pretax income. The effective tax rate decreased from 37.9% for the three months ended March 31, 2012 to 37.7% for the three months ended March 31, 2013 as a result of an increase in tax credits (see Note 3: Investments for further discussion on tax credits related to other investments).

Liquidity and Capital Resources

Funding and Liquidity

We seek to maintain diversified funding sources and a strong liquidity profile in order to fund our business and repay or refinance our maturing obligations. In addition, we seek to achieve an appropriate maturity profile and utilize a cost-effective mix of funding sources. Our primary funding sources include deposits, sourced directly from consumers

or through brokers, term asset-backed securitizations, private asset-backed securitizations and short- and long-term borrowings.

Table of Contents

Funding Sources

Deposits. We offer 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.

At March 31, 2013, we had \$28.7 billion of direct-to-consumer deposits and \$13.6 billion of brokered deposits. Maturities of our certificates of deposit range from one month to ten years, with a weighted average maturity of 21 months. The following table summarizes deposits by contractual maturity as of March 31, 2013 (dollars in millions):

	Total	Three Months or Less	Over Three Months Through Six Months	Over Six Months Through Twelve Months	Over Twelve Months	Indeterminate
Certificates of deposit in amounts less than \$100,000 ⁽¹⁾	\$21,111	\$2,935	\$3,216	\$3,332	\$11,628	\$—
Certificates of deposit in amounts of \$100,000 to less than \$250,000 ⁽¹⁾	5,613	511	855	1,442	2,805	—
Certificates of deposit in amounts of \$250,000 ⁽¹⁾ or greater	1,328	104	178	349	697	—
Savings deposits, including money market deposit accounts ⁽²⁾	14,203	—	—	—	—	14,203
Total interest-bearing deposits	\$42,255	\$3,550	\$4,249	\$5,123	\$15,130	\$14,203

⁽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.

⁽²⁾ Represents deposits with no contractual maturity.

Credit Card Securitization Financing. We use the securitization of credit card receivables as an additional source of funding. We access the asset-backed securitization market using the Discover Card Master Trust I ("DCMT") and the Discover Card Execution Note Trust ("DCENT"), through which we issue asset-backed securities both publicly and through private transactions. 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.

The securitization structures include certain features designed to protect investors. The primary feature relates to the availability and adequacy of cash flows in the securitized pool of receivables to meet contractual requirements, the insufficiency of which triggers early repayment of the securities. We refer to this as "economic early amortization," which is based on excess spread levels. Excess spread is the amount by which income received by a trust during a collection period, including interest collections, fees and interchange, exceeds the fees and expenses of the trust during such collection period, including interest expense, servicing fees and charged-off receivables. In the event of an economic early amortization, which would occur if the excess spread fell below 0% on a three-month rolling average basis, we would be required to repay the affected outstanding securitized borrowings using available collections received by the trust (the period of ultimate repayment would be determined by the amount and timing of collections received). An early amortization event would negatively impact our liquidity, and require us to utilize our available non-securitization related contingent liquidity or rely on alternative funding sources, which may or may not be available at the time. As of March 31, 2013, the three-month rolling average excess spread was 12.97%.

Another feature of our securitization structure, which is applicable only to the notes issued from DCENT, is a reserve account funding requirement in which, in limited circumstances, 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 4.50%, with increasing funding requirements as excess spread levels decline below preset levels to 0%. See Note 5: Credit Card and Student Loan Securitization Activities to our condensed consolidated financial statements for additional information regarding the structures of DCMT and DCENT and for tables providing information concerning investors' interests and related excess spreads at March 31, 2013.

Table of Contents

At March 31, 2013, we had \$13.9 billion of outstanding public asset-backed securities, \$750 million of outstanding private asset-backed securitizations and \$4.8 billion of outstanding asset-backed securities that had been issued to our wholly-owned subsidiaries. The following table summarizes expected contractual maturities of the investors' interests in credit card securitizations excluding those that have been issued to our wholly-owned subsidiaries at March 31, 2013 (dollars in millions):

	Total	Less Than One Year	One Year Through Three Years	Four Years Through Five Years	After Five Years
Scheduled maturities of long-term borrowings—owed to credit card securitization investors	\$ 14,681	\$ 4,587	\$ 6,245	\$ 2,849	\$ 1,000

At March 31, 2013, we had capacity to issue up to \$4.3 billion in triple-A rated asset-backed securities from DCENT without the issuance of additional Class B or Class C notes as subordination. The triple-A rating of DCENT Class A Notes issued to date has been based, in part, on an FDIC rule which created a safe harbor that provides that the FDIC, as conservator or receiver, will not, using its power to disaffirm or repudiate contracts, seek to reclaim or recover assets transferred in connection with a securitization, or recharacterize them as assets of the insured depository institution, provided such transfer satisfies the conditions for sale accounting treatment under previous GAAP. Although the implementation of Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards No. 166, Accounting for Transfers of Financial Assets - an amendment of FASB Statement No. 140 ("Statement No. 166") (codified under the FASB Accounting Standards Codification ("ASC") Section 860, Transfers and Servicing) on December 1, 2009, no longer qualified certain transfers of assets for sale accounting treatment, the FDIC approved a final rule that preserved the safe-harbor treatment applicable to revolving trusts and master trusts, including DCMT, so long as those trusts would have satisfied the original FDIC safe harbor if evaluated under GAAP pertaining to transfers of financial assets in effect prior to December 1, 2009. Other legislative and regulatory developments may, however, impact our ability and/or desire to issue asset-backed securities in the future.

Corporate and Bank Debt. At March 31, 2013, we had \$1.3 billion in principal amount of senior unsecured notes outstanding. Discover Bank had \$750 million in principal amount of senior notes (issued during the first quarter 2013) and \$700 million in principal amount of subordinated notes outstanding.

At March 31, 2013, our senior unsecured notes are comprised of a \$400 million issuance due in June 2017, a \$78 million issuance due in July 2019, a \$322 million issuance due in April 2022 and a \$500 million issuance due in November 2022. The senior unsecured notes require us to offer to repurchase the notes at a price equal to 101% of their aggregate principal amount plus accrued and unpaid interest in the event of a change of control involving us and a corresponding ratings downgrade to below investment grade. Discover Bank's senior notes are comprised of a \$750 million issuance due February 2018 and the subordinated notes are comprised of a \$200 million issuance due in November 2019 and a \$500 million issuance due in April 2020. For more information, see Note 7: Long-Term Borrowings to our condensed consolidated financial statements.

Other Long-Term Borrowings—Student Loans. At March 31, 2013, we had \$2.2 billion of remaining principal balance outstanding on securitized debt assumed as part of the SLC acquisition. Principal and interest payments on the underlying student loans will reduce the balance of these secured borrowings over time.

Short-Term Borrowings. We utilize a \$400 million warehouse line of credit as our primary form of short-term borrowings. This line of credit is used for the sole purpose of funding consumer residential loans. The warehouse line of credit had an outstanding balance of \$290 million as of March 31, 2013. In addition, we may access short-term borrowings through the Federal Funds market or through repurchase agreements. At March 31, 2013, December 31, 2012 and November 30, 2012, there were no outstanding balances under the Federal Funds market or repurchase agreements.

Additional Funding Sources

Private Asset-Backed Securitizations. We have access to committed undrawn capacity through privately placed asset-backed securitizations to support the funding of our credit card loan receivables. Under these arrangements, we had used \$750 million of capacity and had undrawn capacity of \$6.8 billion at March 31, 2013.

Federal Reserve. Discover Bank has access to the Federal Reserve Bank of Philadelphia's discount window. As of March 31, 2013, Discover Bank had \$10.7 billion of available capacity through the discount window based on the amount and type of assets pledged. We have no borrowings outstanding under the discount window.

Table of Contents

Credit Ratings

Our borrowing costs and capacity in certain funding markets, including securitizations and senior and subordinated debt, may be affected by the credit ratings of DFS, Discover Bank and the securitization trusts. Downgrades in these credit ratings could result in higher interest expense on our unsecured debt and asset securitizations, as well as potentially higher fees related to borrowings under our lines of credit. In addition to increased funding costs, deterioration in credit ratings could reduce our borrowing capacity in the unsecured debt and asset securitization capital markets.

We also have agreements with certain of our derivative counterparties that contain provisions that require DFS and Discover Bank's debt to maintain an investment grade credit rating from specified major credit rating agencies. Because the credit rating of DFS did not meet the specified thresholds, we had posted \$4 million of collateral with our counterparties at March 31, 2013. Discover Bank's credit rating met specified thresholds set by its counterparties. However, if Discover Bank's credit rating is reduced by one ratings notch, it would be required to post additional collateral, which, as of March 31, 2013, would have been \$111 million.

A credit rating is not a recommendation to buy, sell or hold securities, may be subject to revision or withdrawal at any time by the assigning rating organization, and each rating should be evaluated independently of any other rating. The credit ratings are summarized in the following table:

	Moody's Investors Service	Standard & Poor's Fitch Ratings	
Senior Unsecured Debt			
Discover Financial Services	Ba1	BBB-	BBB
Discover Bank	Baa3	BBB	BBB
Outlook for Senior Unsecured Debt	Stable	Stable	Stable
Subordinated Debt			
Discover Bank	Ba1	BBB-	BBB-
Discover Card Master Trust I			
Class A ⁽¹⁾	Aaa(sf)	AAA(sf)	AAAsf
Class B ⁽¹⁾	A1(sf)	AA+(sf)	AAsf
Discover Card Execution Note Trust			
Class A ⁽¹⁾	Aaa(sf)	AAA(sf)	AAAsf
Class B ⁽¹⁾	A1(sf)	AA+(sf)	AA-sf
Class C	N/A ⁽²⁾	N/A ⁽²⁾	N/A ⁽²⁾

(1) An "sf" in the rating denotes rating agency identification for structured finance product ratings.

(2) All Class C notes are currently held by subsidiaries of Discover Bank and, therefore, are not publicly rated.

Liquidity

We seek to ensure that we have adequate liquidity to sustain business operations, fund asset growth and satisfy debt obligations under normal and stress conditions both at the parent company and on a consolidated basis. In addition to the funding sources discussed above, we also maintain highly liquid unencumbered assets in our investment portfolio. We employ a variety of metrics to monitor and manage liquidity. Regular liquidity stress testing and contingency funding planning is performed as part of our liquidity management process. We evaluate a range of stress scenarios including company specific and systemic events that could impact funding sources and our ability to meet liquidity needs. These scenarios measure the liquidity position over a two-year horizon by analyzing the stress on liquidity versus the ability to generate contingent liquidity. We maintain contingent funding sources, including our liquidity portfolio, private securitizations with unused capacity and Federal Reserve discount window capacity, which we could utilize to satisfy liquidity needs during such stress events. We expect to be able to satisfy all maturing obligations and fund business operations during the next 12 months by utilizing the funding sources that are currently available to us.

We maintain policies outlining the overall framework and general principles for managing liquidity risk across our business, which is the responsibility of our Asset and Liability Management Committee (the "ALCO"). We seek to balance the

67

Table of Contents

trade-offs between maintaining too much liquidity, which may limit financial flexibility and be costly, with having too little liquidity that could cause financial distress. Liquidity risk is centrally managed by the ALCO, which is chaired by our Treasurer and has cross-functional membership. The ALCO monitors positions and determines any actions that may need to be taken.

At March 31, 2013, our liquidity portfolio was comprised of cash and cash equivalents and high quality, liquid investment securities. Cash and cash equivalents were primarily in the form of deposits with the Federal Reserve. Investment securities primarily included debt obligations of the U.S. Treasury and U.S. government agencies and residential mortgage-backed securities issued by U.S. government agencies. These investments are considered highly liquid, and we have the ability to raise cash by utilizing repurchase agreements, pledging certain of these investments to access the secured funding markets or selling them. The level of our liquidity portfolio may fluctuate based upon the level of expected maturities of our funding sources as well as operational requirements and market conditions. At March 31, 2013, our liquidity portfolio and undrawn credit facilities were \$29.9 billion, which was \$4.4 billion higher than the balance at December 31, 2012, due primarily to the issuance of \$1.7 billion of public credit card asset-backed securities and \$750 million of senior bank notes in the first quarter 2013. In the first quarter 2013, we sold \$715 million of investment securities that had remaining maturities of less than one year, the proceeds of which are included in cash and cash equivalents at March 31, 2013. During the three months ended March 31, 2013, the average balance of our liquidity portfolio was \$10.8 billion.

	March 31, 2013	December 31, 2012	November 30, 2012
	(dollars in millions)		
Liquidity portfolio			
Cash and cash equivalents ⁽¹⁾	\$7,334	\$2,187	\$3,492
Investment securities	5,196	6,145	6,133
Total liquidity portfolio	12,530	8,332	9,625
Undrawn credit facilities ⁽²⁾			
Private asset-backed securitizations	6,750	6,750	6,750
Federal Reserve discount window ⁽³⁾	10,665	10,487	10,240
Total undrawn credit facilities	17,415	17,237	16,990
Total liquidity portfolio and undrawn credit facilities	\$29,945	\$25,569	\$26,615

(1) Cash-in-process is excluded from cash and cash equivalents for liquidity purposes.

(2) See "—Funding Sources—Additional Funding Sources" for additional information.

Excludes \$105 million, \$146 million and \$154 million of investments accounted for in the liquidity portfolio that (3) were pledged to the Federal Reserve as of March 31, 2013, December 31, 2012 and November 30, 2012, respectively.

Capital

Our primary sources of capital are from the earnings generated by our businesses and common and preferred stock issuances in the capital markets. We seek to manage capital to a level and composition sufficient to support the risks of our businesses, meet regulatory requirements, meet rating agency targets and support future business growth. Within these constraints, we are focused on deploying capital in a manner that provides attractive returns to our stockholders. The level, composition and utilization of capital are influenced by changes in the economic environment, strategic initiatives, and legislative and regulatory developments.

Under regulatory capital requirements adopted by the FDIC, the Federal Reserve and other bank regulatory agencies, we, along with Discover Bank, must maintain minimum levels of capital. 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 limit our business activities and have a direct material effect on our financial position and results. We must meet specific capital guidelines that involve quantitative measures of assets and liabilities 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.

Our capital adequacy assessment also includes tax and accounting considerations in accordance with regulatory guidance. We maintain a substantial deferred tax asset on our balance sheet, and we include this asset when calculating our regulatory capital levels. However, for regulatory capital purposes, deferred tax assets that are dependent on future taxable income are currently limited to the lesser of: (i) the amount of deferred tax assets we expect to realize within one year of the calendar quarter-end date, based on our projected future taxable income for that year; or (ii) 10% of the amount of our Tier 1 capital. At March 31, 2013, no portion of our deferred tax asset was disallowed for regulatory capital purposes.

Table of Contents

At March 31, 2013, Discover Financial Services and Discover Bank met the requirements for "well-capitalized" status, exceeding the regulatory minimums to which they were subject under Basel I.

Current or future legislative or regulatory initiatives may require us to hold more capital in the future. In June 2012, the Federal Reserve, FDIC and the OCC proposed rules to implement the provisions of the Basel III regulatory capital reforms that would be applicable to us and Discover Bank. The proposed rules include new minimum and "well-capitalized" risk-based capital and leverage ratios, which would be phased in from 2013 to 2019, and refine the definition of what constitutes "capital" for purposes of calculating those ratios. The proposed rules received extensive comments. Industry participants are expecting the issuance of these final rules sometime in 2013. In October 2012, the Federal Reserve and the FDIC issued final rules implementing the stress test requirements under the Reform Act. For additional information, see "Management's Discussion and Analysis of Financial Condition and Results of Operations - Regulatory Environment and Developments - Capital."

Additionally, we are required to submit an annual capital plan to the Federal Reserve that includes an assessment of our expected uses and sources of capital over the planning horizon. In 2013, we submitted a capital plan to the Federal Reserve under the Federal Reserve 2013 Capital Plan Review, or CapPR, program, which included planned dividends and share repurchases. On March 14, 2013, we received non-objection from the Federal Reserve with respect to our proposed capital actions through March 31, 2014. In 2014, in addition to the stress test requirements described above, we expect our annual capital plan to be reviewed under the enhanced standards applied to the capital plans of CCAR BHCs under the Federal Reserve's 2013 Comprehensive Capital Analysis and Review, or CCAR, program. Therefore, the Federal Reserve will apply enhanced standards to our future capital plan submissions, including evaluation based on results of supervisory stress tests and enhanced documentation and process standards. Our ability to make capital distributions, including our ability to pay dividends or repurchase shares of our common stock, will continue to be subject to the Federal Reserve's review and non-objection of the actions that we propose each year in our annual capital plan.

We recently declared a quarterly cash dividend on our common stock of \$.20 per share, payable on May 23, 2013 to holders of record on May 9, 2013, which is an increase from \$.14 per share paid in the first quarter. We also recently declared a quarterly cash dividend on our preferred stock of \$16.25 per share, equal to \$.40625 per depositary share, payable on June 3, 2013 to holders of record on May 17, 2013, which was the same amount paid on our preferred stock in the first quarter.

On March 14, 2013, our board of directors approved a new two-year share repurchase program authorizing the repurchase of up to \$2.4 billion of our outstanding shares of common stock. The program expires on March 31, 2015, and may be terminated at any time. This program replaced the prior \$2 billion program, which had nearly \$600 million of remaining authorization. During the one month ended December 31, 2012, we repurchased approximately 0.3 million shares of our outstanding common stock for \$12 million. During the three months ended March 31, 2013, we repurchased approximately 6 million shares, or 1%, of our outstanding common stock for \$238 million. We expect to continue to make share repurchases under our repurchase program from time to time based on market conditions and other factors, subject to legal and regulatory requirements and restrictions. Share repurchases under the program may be made through a variety of methods, including open market purchases, privately negotiated transactions or other purchases, including block trades, accelerated share repurchase transactions, or any combination of such methods. Any share repurchases after March 31, 2014 will be subject to receiving Federal Reserve non-objection with respect to our proposed capital actions through March 31, 2015.

The declaration and payment of future dividends, as well as the amount thereof, are subject to the discretion of our board of directors. The amount and size of any future dividends and share repurchases will depend upon our results of operations, financial condition, capital levels, cash requirements, future prospects and other factors. Holders of our shares of common stock are subject to the prior dividend rights of holders of our preferred stock or the depositary shares representing such preferred stock outstanding, and if full dividends have not been declared and paid on all outstanding shares of preferred stock in any dividend period, no dividend may be declared or paid or set aside for payment on our common stock. In addition, as noted above, banking laws and regulations and our banking regulators may limit our ability to pay dividends and make share repurchases, including limitations on the extent to which our banking subsidiaries can provide funds to us through dividends, loans or otherwise. Further, also noted above, current

or future regulatory initiatives may require us to hold more capital in the future. There can be no assurance that we will declare and pay any dividends or repurchase any shares of our common stock in the future.

Table of Contents

Certain Off-Balance Sheet Arrangements

Guarantees

Guarantees are contracts or indemnification agreements that contingently require us to make payments to a guaranteed party based on changes in an underlying asset, liability, or equity security of a guaranteed party, rate or index. Also included in guarantees are contracts that contingently require the guarantor to make payments to a guaranteed party based on another entity's failure to perform under an agreement. Our guarantees relate to transactions processed on the Discover Network and certain transactions processed by PULSE and Diners Club. See Note 12: Commitments, Contingencies and Guarantees to our condensed consolidated financial statements for further discussion regarding our guarantees.

Contractual Obligations and Contingent Liabilities and Commitments

In the normal course of business, we enter into various contractual obligations that may require future cash payments. Contractual obligations at March 31, 2013, which include deposits, borrowings, operating and capital lease obligations, interest payments on fixed rate debt, purchase obligations and other long-term liabilities, were \$64.0 billion. For a description of our contractual obligations, see our annual report on Form 10-K for the year ended November 30, 2012 under "Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources—Contractual Obligations and Contingent Liabilities and Commitments."

We extend credit for consumer and commercial loans, primarily arising from agreements with customers for unused lines of credit on certain credit cards, provided there is no violation of conditions established in the related agreement. At March 31, 2013, our unused commitments were \$163.7 billion. These commitments, substantially all of which we can terminate at any time and which do not necessarily represent future cash requirements, are periodically reviewed based on account usage and customer creditworthiness. In addition, in the ordinary course of business, we guarantee payment on behalf of subsidiaries relating to contractual obligations with external parties. The activities of the subsidiaries covered by any such guarantees are included in our condensed consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market risk refers to the risk that a change in the level of one or more market prices, rates, indices, correlations or other market factors will result in losses for a position or portfolio. We are exposed to market risk primarily from changes in interest rates.

Interest Rate Risk. We borrow money from a variety of depositors and institutions in order to provide loans to our customers, as well as invest in other assets and our business. These loans and other assets earn interest, which we use to pay interest on the money borrowed. Our net interest income and, therefore, earnings, will be negatively affected if the interest rate earned on assets increases at a slower pace than increases to the interest rate we owe on our borrowings. Changes in interest rates and competitor responses to those changes may influence customer payment rates, loan balances or deposit account activity. We may face higher-cost alternative sources of funding as a result, which has the potential to decrease earnings.

Our interest rate risk management policies are designed to measure and manage the potential volatility of earnings that may arise from changes in interest rates by having a financing portfolio that reflects the mix of variable and fixed rate assets. To the extent that asset and related financing repricing characteristics of a particular portfolio are not matched effectively, we may utilize interest rate derivative contracts, such as swap agreements, to achieve our objectives.

Interest rate swap agreements effectively convert the underlying asset or liability from fixed to floating rate or from floating to fixed rate. See Note 15: Derivatives and Hedging Activities to our condensed consolidated financial statements for information on our derivatives activity.

We use an interest rate sensitivity simulation to assess our interest rate risk exposure. For purposes of presenting the possible earnings effect of a hypothetical, adverse change in interest rates over the 12-month period from our reporting date, we assume that all interest rate sensitive assets and liabilities will be impacted by a hypothetical, immediate 100 basis point increase in interest rates as of the beginning of the period. The sensitivity is based upon the hypothetical assumption that all relevant types of interest rates that affect our results would increase instantaneously, simultaneously and to the same degree.

Our interest rate sensitive assets include our variable rate loan receivables and the assets that make up our liquidity portfolio. We have restrictions on our ability to mitigate interest rate risk by adjusting rates on existing balances. At March 31, 2013, the majority of our credit card and student loans were at variable rates. Assets with rates that are fixed at period end but which will mature, or otherwise contractually reset to a market-based indexed rate or other fixed rate prior to the end of the 12-month period, are considered to be rate sensitive. The latter category includes certain credit card loans that may be offered at below-market rates for an introductory period, such as balance transfers and special promotional programs, after which the loans will contractually reprice in accordance with our normal market-based pricing structure. For purposes of measuring rate sensitivity for such loans, only the effect of the hypothetical 100 basis point change in the underlying market-based indexed rate or other fixed rate has been considered rather than the full change in the rate to which the loan would contractually reprice. For assets that have a fixed interest rate at the fiscal period end but which contractually will, or are assumed to, reset to a market-based indexed rate or other fixed rate during the next 12 months, earnings sensitivity is measured from the expected repricing date. In addition, for all interest rate sensitive assets, earnings sensitivity is calculated net of expected loan losses.

Interest rate sensitive liabilities are assumed to be those for which the stated interest rate is not contractually fixed for the next 12-month period. Thus, liabilities that vary with changes in a market-based index, such as Federal Funds or LIBOR, which will reset before the end of the 12-month period, or liabilities whose rates are fixed at the fiscal period end but which will mature and are assumed to be replaced with a market-based indexed rate prior to the end of the 12-month period, also are considered to be rate sensitive. For these fixed rate liabilities, earnings sensitivity is measured from the expected repricing date.

Assuming an immediate 100 basis point increase in the interest rates affecting all interest rate sensitive assets and liabilities at March 31, 2013, we estimate that net interest income over the following 12-month period would increase by approximately \$63 million, or 1%. Assuming an immediate 100 basis point increase in the interest rates affecting all interest rate sensitive assets and liabilities at December 31, 2012, we estimated that net interest income over the following 12-month period would increase by approximately \$41 million, or 1%. Assuming an immediate 100 basis point increase in the interest rates affecting all interest rate sensitive assets and liabilities at November 30, 2012, we estimated that net interest income over the following 12-month period would increase by approximately \$42 million, or 1%. We have not provided an estimate of any impact on net interest income of a decrease in interest rates as many of our interest rate sensitive assets and liabilities are tied to interest rates that are already at or near their minimum levels (i.e., Prime and LIBOR) and, therefore, could not materially decrease further.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")), which are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting (as such term is defined in Exchange Act Rule 13a-15(f) and 15d-15(f)) that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

Part II. OTHER INFORMATION

Item 1. Legal Proceedings

For a description of legal proceedings, see Note 13: Litigation and Regulatory Matters to our condensed consolidated financial statements.

Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in our annual report on Form 10-K for the fiscal year ended November 30, 2012.

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

Issuer Purchases of Equity Securities

The table below sets forth information regarding purchases of our common stock related to our share repurchase program and employee transactions that were made by us or on our behalf during the four months ended March 31, 2013.

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan or Program ⁽¹⁾	Maximum Dollar Value of Shares that may yet be purchased under the Plans or Programs ⁽¹⁾
December 1- 31, 2012				
Repurchase program ⁽¹⁾	311,167	\$38.56	311,167	\$790,552,775
Employee transactions ⁽²⁾	—	\$—	N/A	N/A
January 1 - 31, 2013				
Repurchase program ⁽¹⁾	2,227,455	\$39.07	2,227,455	\$703,516,845
Employee transactions ⁽²⁾	569,511	\$39.52	N/A	N/A
February 1 - 28, 2013				
Repurchase program ⁽¹⁾	1,872,165	\$38.98	1,872,165	\$630,531,002
Employee transactions ⁽²⁾	622	\$38.45	N/A	N/A
March 1 - 31, 2013				
Repurchase program ⁽¹⁾	1,848,364	\$42.08	1,848,364	\$2,366,900,502
Employee transactions ⁽²⁾	1,624	\$39.08	N/A	N/A
Total				
Repurchase program ⁽¹⁾	6,259,151	\$39.91	6,259,151	\$2,366,900,502
Employee transactions ⁽²⁾	571,757	\$39.52	N/A	N/A

(1) On March 13, 2012, our board of directors approved a share repurchase program authorizing the repurchase of up to \$2.0 billion of our outstanding shares of common stock. This share repurchase program was replaced on March 14, 2013, as our board of directors approved a new share repurchase program authorizing the purchase of up to \$2.4 billion of our outstanding shares of common stock. The new share repurchase program expires on March 31, 2015 and may be terminated at any time.

(2) Reflects shares withheld (under the terms of grants under employee stock compensation plans) to offset tax withholding obligations that occur upon the delivery of outstanding shares underlying restricted stock units or upon the exercise of stock options.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

Item 6. Exhibits

See "Exhibit Index" for documents filed herewith and incorporated herein by reference.

71

Table of Contents

Signature

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Discover Financial Services
(Registrant)

By: /s/ R. MARK GRAF
R. Mark Graf
Executive Vice President and Chief Financial
Officer

Date: April 30, 2013

Table of Contents

Exhibit Index

Exhibit Number	Description
4.1	Fiscal and Paying Agency Agreement between Discover Bank and U.S. Bank National Association dated as of February 21, 2013 (filed as Exhibit 4.1 to Discover Financial Services' Current Report on Form 8-K filed on February 21, 2013 and incorporated herein by reference thereto).
10.1	Form 2013 Award Certificate for Restricted Stock Units Under Discover Financial Services Amended and Restated 2007 Omnibus Incentive Plan
10.2	Form 2013 Award Certificate for Performance Stock Units Under Discover Financial Services Amended and Restated 2007 Omnibus Incentive Plan
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code.
101.INS	XBRL Instance Document.
101.SCH	XBRL Taxonomy Extension Schema Document.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.