

**DISCOVER FINANCIAL SERVICES**

**Basel III Regulatory Capital Disclosures**

**For the Quarterly Period Ended December 31, 2018**

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

## Disclosure Road Map

The following table provides page references for disclosures that can be found in the Company's Annual Report on Form 10-K relating to topics addressed in this Basel III disclosure report:

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## Overview

### Introduction

Discover Financial Services ("DFS" or the "Company") is a direct banking and payment services company. We were incorporated in Delaware in 1960. We are a bank holding company ("BHC") under the Bank Holding Company Act of 1956 as well as a financial holding company under the Gramm-Leach-Bliley Act and therefore are subject to oversight, regulation and examination by the Board of Governors of the Federal Reserve System (the "Federal Reserve"). We provide direct banking products and services and payment services through our subsidiaries. We offer our customers credit card loans, private student loans, personal loans, home equity loans and deposit products. We operate the Discover Network, the PULSE network ("PULSE"), and Diners Club International ("Diners Club"). The Discover Network processes transactions for Discover-branded credit and debit cards and provides payment transaction processing and settlement services. 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 charge cards and/or provide card acceptance services.

Our main banking subsidiary, Discover Bank, offers credit card loans, student loans, personal loans and home equity loans as well as certificates of deposit, savings and checking accounts and other types of deposit accounts. Discover Bank is chartered and regulated by the Office of the Delaware State Bank Commissioner, and is also regulated by the Federal Deposit Insurance Corporation (the "FDIC"), which insures its deposits up to applicable limits and serves as the bank's primary federal banking regulator.

### Basel III and Regulatory Capital Disclosure Report

The Federal Reserve, the Office of the Comptroller of the Currency ("OCC") and the FDIC adopted risk-based capital standards under Basel III ("Basel III rules") and replaced Basel I regulatory capital calculations for banking organizations in July 2013. The effective date of the Basel III rules, for the Company, was January 2015 with various phase-in or transitional requirements becoming effective through 2019. This timing is based on the Company being classified as a "Standardized Approach" bank, defined as a U.S. banking organization with consolidated total assets over \$50 billion but not exceeding \$250 billion and consolidated total on-balance sheet foreign exposures less than \$10 billion. One such phase-in requirement is the capital conservation buffer. This is an additional capital requirement on top of the minimum risk-weighted assets ("RWA") ratios designed to absorb losses during periods of economic stress. The conservation buffer became effective January 2016.

The Basel III rules substantially revised the risk-based capital requirements applicable to each impacted BHC and their depository institution subsidiaries including, but not limited to, a new minimum capital ratio of common equity tier 1 ("CET1") to RWA, raising the minimum ratio of tier 1 capital to RWA and establishing a capital conservation buffer. See Note 17: Capital Adequacy of the Annual Report on Form 10-K for the year ended December 31, 2018 ("2018 Form 10-K") for a detailed discussion of Basel III requirements.

The Basel III rules are designed to establish a more risk-sensitive approach to capital management and require the Company to publicly disclose certain qualitative and quantitative information regarding its capital structure and adequacy, credit risk and related mitigation policies, securitizations, equity exposures, operational risk, and other matters. The qualitative and quantitative information included are commonly referred to as the "Pillar 3 Disclosures." The U.S. regulators have required the Pillar 3 Disclosures, with an expressed objective of improving market discipline and encouraging sound risk management practices. This report provides the required disclosures or references to other publicly-available documents where they are located and includes information on the methodologies used to calculate RWA.

This report should be read in conjunction with the 2018 Form 10-K, Federal Reserve FR Y-9C form for the year-to-date period ended December 31, 2018 and Discover Bank's Call Report ("Call Report") for the year-to-date period ended December 31, 2018, which include important information on risk management policies and practices and regulatory capital ratios. A disclosure road map is contained herein.

## Scope of Application

### Basis of Consolidation

The basis of consolidation used for regulatory reporting is the same as that used under U.S. Generally Accepted Accounting Principles ("GAAP"). See Note 1: Background and Basis of Presentation in the 2018 Form 10-K for details on the Company's principles of consolidation.

### Capital in Subsidiaries

At December 31, 2018, the Company did not have any subsidiaries whose regulatory capital was less than the minimum required regulatory capital amount. The Company does not have any insurance subsidiaries subject to the Basel III rules.

### Restrictions on Capital

The Federal Reserve requires a BHC to inform and consult with the Federal Reserve before declaring and paying any dividends that would cause an institution to be inadequately capitalized. The declaration and payment of future dividends are subject to the discretion of our board of directors and the Federal Reserve's non-objection to our capital plan. 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, regulatory review and other factors as further described in "Business — Supervision and Regulation — Capital, Dividends and Share Repurchases" in the 2018 Form 10-K. 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 our preferred stock in any dividend period, no dividend may be declared or paid on or set aside for payment on our common stock. Banking laws and regulations and our banking regulators may limit or prohibit our payment of dividends on or our repurchase of our stock at any time. There can be no assurance that we will declare and pay any dividends on or repurchase our stock in the future. At December 31, 2018, the Company was "well-capitalized" as defined in Regulation Y.

Discover Financial Services, our parent holding company, depends on dividends, distributions and other payments from its subsidiaries, particularly Discover Bank, to fund dividend payments, share repurchases, payments on its obligations, including debt obligations, and to provide funding and capital as needed to its operating subsidiaries. Banking laws and regulations and our banking regulators may limit or prohibit our transfer of funds freely, either to or from our subsidiaries, at any time. These laws, regulations and rules may hinder our ability to access funds that we may need to make payments on our obligations or otherwise achieve strategic objectives. For more information, see "Business — Supervision and Regulation — Capital, Dividends and Share Repurchases" in the 2018 Form 10-K.

The Federal Deposit Insurance Act ("FDIA") imposes various requirements on insured depository institutions. For example, the FDIA requires, among other things, the federal banking agencies to take "prompt corrective action" in respect of depository institutions that do not meet minimum capital requirements. The FDIA sets forth the following five capital tiers: "well-capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" and "critically undercapitalized." A depository institution's capital tier will depend upon how its capital levels compare with various relevant capital measures and certain other factors that are established by regulation. At December 31, 2018, Discover Bank met all applicable requirements to be deemed "well-capitalized."

The FDIA also prohibits any depository institution from making any capital distributions (including payment of a dividend) or paying any management fee to its parent holding company if the depository institution would thereafter be "undercapitalized." "Undercapitalized" institutions are subject to growth limitations and are required to submit a capital restoration plan. For a capital restoration plan to be acceptable, among other things, the depository institution's parent holding company must guarantee that the institution will comply with the capital restoration plan. For more information on FDIA regulations, see "Business — Supervision and Regulation — FDIA" in the 2018 Form 10-K.

## Capital Structure

### Regulatory Capital Instruments

The Company's regulatory capital instruments consist of common stock, preferred stock and subordinated debt. The following table presents components of the Company's capital structure on a transitional basis (dollars in millions):

	December 31, 2018
Common stock	\$ 6
Additional paid-in capital	4,130
Retained earnings	18,906
Accumulated other comprehensive (loss) income	(156)
Treasury stock	(12,319)
Common shareholder's equity	10,567
Less: Deductions for goodwill and intangible assets, net of deferred tax liabilities	391
Less: Deductions for AOCI related adjustments	(156)
Common equity tier 1	10,332
Perpetual non-cumulative preferred stock	563
Tier 1 capital	10,895
Qualifying subordinated debt	450
Other elements of tier 2 capital	1,187
Tier 2 capital	1,637
Total capital	\$ 12,532

The dividend rights of holders of our common stock are conditional to prior dividend rights of holders of our preferred stock or the depositary shares representing such preferred stock outstanding. Our preferred stock is redeemable at the Company's option, subject to regulatory approval, either (i) in whole or in part on any dividend payment date on or after October 30, 2027 or (ii) in whole but not in part, at any time within 90 days following a regulatory capital event (as defined in the certificate of designations for the preferred stock). For additional details related to the Company's common and preferred stock, refer to Note 12: Common and Preferred Stock in the 2018 Form 10-K.

The following table presents the terms and conditions of the Company's qualifying subordinated debt (dollars in millions):

	Issuance Date	Interest Rate	Interest Rate Terms	Maturity	Par
<b>At December 31, 2018</b>					
<i>Discover Bank</i>					
Subordinated bank notes due 2019	November 16, 2009	8.70%	Fixed	November 18, 2019	\$ 200
Subordinated bank notes due 2020	April 15, 2010	7.00%	Fixed	April 15, 2020	\$ 500
Subordinated bank notes due 2028	August 9, 2018	4.68%	Fixed	August 9, 2028	\$ 500

The first two tranches of subordinated debt entered a five year amortization period and therefore are subject to a haircut for capital inclusion, in accordance with the Basel III rules. In addition, the subordinated debt is subject to a Basel III provision that limits its amount that can be included on the BHC level. That limitation is imposed on capital instruments issued by a consolidated bank subsidiary of BHC as availability of this capital might be limited to the BHC.

## Regulatory Capital Ratios

For the Company's capital ratios and related components, as of December 31, 2018, see Note 17: Capital Adequacy in the 2018 Form 10-K and Schedule HC-R in the 4Q18 FR Y-9C report.

## Capital Adequacy

### Capital Planning and Management

Discover's capital planning and management framework is designed to ensure that the Company maintains sufficient capital consistent with its risk profile and all applicable regulatory standards and guidelines. The framework encompasses forecasting capital levels, establishing capital targets, monitoring capital adequacy against targets, maintaining appropriate contingency capital plans and identifying strategic options to deploy excess capital.

The Company's capital distributions are subject to regulation by the Federal Reserve, including regulations pertaining to capital planning and stress testing. On February 5, 2019, the Federal Reserve announced that certain less complex firms subject to Comprehensive Capital Analysis and Review ("CCAR"), generally those with total consolidated assets between \$100 billion and \$250 billion, have been provided relief from certain components of the Federal Reserve's capital planning and stress testing framework for the 2019 stress test cycle. The Federal Reserve issued a temporary order granting Discover relief from the regulatory requirements related to supervisory stress testing and company-run stress testing for the 2019 stress test cycle and provided Discover a one-year extension of the requirement to submit a capital plan to the Federal Reserve until April 5, 2020. Additionally, Discover is not required to participate in the Federal Reserve's 2019 CCAR process. Notwithstanding this relief, the Company is still required to prepare a capital plan to be approved by its Board of Directors, containing planned capital distributions for the period from July 1, 2019 to June 30, 2020. Under the terms of the Federal Reserve's order, Discover's capital distributions during this period will be limited based on a formula that is largely based on results from the Federal Reserve's 2018 supervisory stress test. The Federal Reserve will continue to review Discover's capital planning and risk-management practices through the regular supervisory process and has stated that it will propose a final rule to address these matters for the 2020 stress test cycle and beyond. For more information, see "Management's Discussion and Analysis of Financial Condition and Results of Operations — Regulatory Environment and Developments — Capital" in the 2018 Form 10-K.

## Standardized Approach Risk-Weighted Assets

RWA are an institution's assets and off-balance-sheet exposures, weighted according to the risk categories prescribed in the Basel III rules. Percentage of RWA is used to determine minimum capital requirements.

The following table presents components of Discover's RWA in accordance with the standardized approach, subject to transitional provisions (dollars in millions):

	December 31, 2018
On-balance sheet:	
Exposure to depository institutions and foreign banks	\$ 582
Exposures to GSE <sup>(1)</sup> and PSE <sup>(2)</sup>	96
Credit card receivable	71,686
Personal and student loans receivable	16,716
Residential mortgage exposure	702
Retail exposure	89,104
Past due exposure <sup>(3)</sup>	1,743
Equity exposures	361
Other exposures <sup>(4)</sup>	2,943
Off-balance sheet:	
Off-balance sheet derivatives	3
Off-balance sheet commitments	146
Allowance for loan losses excluded from RWA	(1,853)
Total standardized risk-weighted assets	<u>\$ 93,125</u>

(1) Government -sponsored entity ("GSE")

(2) Public sector entity ("PSE")

(3) Includes 90 days past due and non-accruing loans.

(4) Includes \$143 million of business card receivables classified as commercial loans under regulatory guidelines.

## Risk-Based Capital Ratios

For CET1, tier 1 and total risk-based capital ratios as of December 31, 2018, as calculated under the Basel III Standardized Approach framework for Discover Financial Services and Discover Bank, see Note 17: Capital Adequacy in the 2018 Form 10-K.

## Capital Conservation Buffer

Per the Basel III rules, effective January 2016, the Company and its Bank subsidiary are subject to a capital conservation buffer. Under this requirement, a covered institution will be subject to limitations on its ability to make distributions of capital or make discretionary bonus payments unless it maintains a buffer of capital, composed solely of CET1, sufficient to exceed each of the minimum regulatory capital ratios applicable to the institution by more than 2.5%. The capital conservation buffer is subject to a gradual phase-in period. In 2018, the capital conservation buffer threshold is 1.875%. The full 2.5% buffer requirement will not be fully phased-in until January 2019. The capital conservation buffer is a complementary requirement to the Prompt Corrective Action ("PCA") framework described in Basel III rules. There is a proposal under regulatory review that is expected to replace the capital conservation buffer with the stress capital buffer. For more information, see "Management's Discussion and Analysis of Financial Condition and Results of Operations — Liquidity and Capital Resources" in the 2018 Form 10-K.



The Company and its Bank subsidiary each maintained a buffer of CET1 capital sufficient to meet the capital conservation buffer requirements as of December 31, 2018. For Discover Financial Services' capital conservation buffer, see Schedule HC-R Part I in the 4Q18 FR Y-9C report. For Discover Bank's capital conservation buffer, see Schedule RC-R Part I in the 4Q18 Call Report.

The Company's eligible retained income at December 31, 2018 was negative \$267 million. The Company is not subject to any limitations on distributions and discretionary bonus payments resulting from the capital conservation buffer framework.

## Credit Risk: General Disclosures

### Credit Risk Management Objectives and Policies

Credit risk management is a critical component of our management and growth strategy. Credit risk refers to the risk of loss arising from borrower default when borrowers are unable or unwilling to meet their financial obligations to us. Our credit risk arising from consumer lending products is generally highly diversified across millions of accounts without significant individual exposures. We manage credit risk primarily based on customer segments and product types. See "Business — Credit Risk Management" and "Business — Risk Management" in the 2018 Form 10-K for more information regarding how we define and manage our credit and other risks.

### Past Due and Impaired Loans

For the Company's significant accounting policies regarding past due, non-accrual and impaired loans and charge-offs of uncollectible amounts, see Note 2: Summary of Significant Accounting Policies and Note 4: Loan Receivables in the 2018 Form 10-K.

### Allowance for Loan Losses

For the Company's significant accounting policies regarding the allowance for loan losses, see Note 2: Summary of Significant Accounting Policies in the 2018 Form 10-K.

### Credit Risk Exposures

The following table presents the major types of credit exposure relevant to the Company (dollars in millions):

	December 31, 2018	QTD Average
Cash and cash equivalents <sup>(1)</sup>	\$ 1,167	\$ 1,327
Loans held for investment ("LHFI") <sup>(2)</sup>	\$ 90,512	\$ 88,207
Unused commitments <sup>(3)</sup>	\$ 196,424	\$ 196,542
Debt securities	\$ 3,370	\$ 2,602

(1) Excludes cash held with the Federal Reserve.

(2) Includes credit card, student, personal and other loans.

(3) Primarily includes credit cards.

Virtually all of the Company's unused commitments are unconditionally cancellable and receive zero conversion factor for the purpose of capital risk-based calculations.

The following table presents the geographic distribution of the loans held for investment (dollars in millions):

	LHFI <sup>(1)</sup>	Unused commitments <sup>(2)</sup>
<b>At December 31, 2018</b>		
California	\$ 8,276	\$ 18,811
Texas	7,226	15,561
New York	6,874	13,004
Florida	5,653	13,256
Illinois	4,976	11,024
Pennsylvania	4,933	10,739
Ohio	3,737	8,834
New Jersey	3,586	7,330
Michigan	2,602	5,841
Georgia	2,586	5,181
Other	40,063	86,843
<b>Total</b>	<b>\$ 90,512</b>	<b>\$ 196,424</b>

(1) Includes credit card, student, personal and other loans.

(2) Primarily includes credit cards.

All debt securities held by the Company are issued by domestic parties. Cash and cash equivalents held in accounts located outside of U.S. by all Discover entities amounted to \$38.1 million as of December 31, 2018.

The following table presents the counterparty type distribution of credit exposures (dollars in millions):

	Retail	Sovereign (including GSE)	Banks & Brokerage companies <sup>(1)</sup>	Other
<b>At December 31, 2018</b>				
Cash and cash equivalents <sup>(1)</sup>	\$ —	\$ —	\$ 1,167	\$ —
LHFI	\$ 90,313	\$ —	\$ —	\$ 199
Unused commitments	\$ 195,490	\$ —	\$ —	\$ 934
Debt securities	\$ —	\$ 3,370	\$ —	\$ —
Loans past due 90 days and non-accruing	\$ 110	\$ —	\$ —	\$ —
Loans past due 90 days and still accruing <sup>(2)</sup>	\$ 863	\$ —	\$ —	\$ 1

(1) Excludes cash held with the Federal Reserve.

(2) Includes purchased credit-impaired ("PCI") loans.

The following table presents the remaining contractual maturity delineation of the LHFI portfolio<sup>(1)</sup> (dollars in millions):

	December 31, 2018
One year or less	\$ 65,116
Over one year through five years	\$ 13,773
Over five years	\$ 11,321

(1) Includes fixed rate credit cards in the over one year through five years classification per Call Report guidelines and excludes loans in non-accrual status.

See the following references to the Company's 2018 Form 10-K for quantitative information regarding credit risk exposures, which are presented in accordance with U.S. GAAP.

### *Loan Receivables*

- See Note 4: Loan Receivables for information on loans outstanding, non-accrual, delinquent, impaired and PCI loans, and charge-offs during the period. Discover does not identify impaired or past due loans by significant geographic area.

### *Allowance for Loan Losses*

- See Note 4: Loan Receivables for a reconciliation of changes in the allowance for loan losses and for a disaggregation of the allowance for loan losses by impairment methodology.

## **Counterparty Credit Risk-Related Exposures: General Disclosures**

### **Counterparty Credit Risk Exposures**

With respect to derivatives, counterparty credit risk is the risk that the counterparty to a derivative transaction could default before final settlement of the transaction's cash flows. For derivatives, the Company's counterparty credit risk arises primarily from interest rate swap transactions and foreign exchange forward transactions. For non-cleared transactions, the Company has master netting arrangements and minimum collateral posting thresholds with its derivative counterparties for these fair value and cash flow hedge interest rate swaps and foreign exchange forward contracts. For cleared transactions, the Company trades through clearing members of a central counterparty (CCP) exchange such that all positions traded through the CCP clearing member are netted and collateralized per the rules of the exchange. Certain cash collateral amounts associated with derivative positions that are cleared through a CCP exchange are legally characterized as settlement of the derivative positions and are reflected as offsets to the associated derivatives balances recorded in other assets or in accrued expenses and other liabilities, instead of as collateral in other assets or deposits. For more information on the Company's counterparty credit risk-related exposures for derivatives, see Note 21: Derivatives and Hedging Activities in the 2018 Form 10-K.

With respect to securities repurchase and reverse repurchase transactions, counterparty credit risk is the risk that the counterparty to a transaction could default before the securities and cash (plus interest) in the transaction have been returned to their original owners. For securities repurchase and reverse repurchase transactions, the Company's counterparty credit risk arises from its use of securities repurchase and reverse repurchase agreements with major broker-dealer counterparties or central banks using primarily U.S. Treasury and/or Agency securities as collateral.

### **Methodology Used to Assign Counterparty Credit Limits**

The process for approving a counterparty's credit risk exposure limit is guided by: core credit policies, procedures and standards as well as the experience and judgment of credit risk professionals. The process applies to all investment and hedging activities conducted by the Company's Treasury group and includes the determination of maximum potential exposure to each counterparty after taking into account market volatility, netting agreements and collateral support as appropriate.

Internal ratings are assigned to each counterparty and reflect a range of factors including the financial condition of the counterparty, the strength of its management, the business profile of the counterparty and the regulatory environment facing the counterparty. These factors are taken into consideration in setting counterparty credit exposure limits, which drive internal approval levels.

Credit risk analysts conduct daily monitoring of exposures versus limits and any resulting issues are escalated per policy to risk officers and senior management as appropriate.

### **Policies for Securing, Valuing and Managing Collateral and Establishing Credit Reserves**

The Company's policies and procedures cover management and governance of financial assets (including securing and valuing collateral) utilized for the purpose of mitigating counterparty credit risk. Specifically, the Company's Corporate Risk Management group considers standard eligibility criteria and market value haircuts for any collateral used to reduce estimated net exposures in the Company's transactions. Industry standard legal agreements combined with internal reviews for legal enforceability are employed to ensure that the Company's rights to collateral are appropriately protected.

Where collateral is used to offset estimated net exposure, the current market value of collateral is monitored on a regular basis. Margin procedures have been established by the Company's Treasury group for managing margin calls in order to maintain an appropriate level of collateral coverage in light of market value fluctuations and CCP exchange

rules. Trades are reconciled on a daily basis, consistent with regulatory guidance and industry best practice, and margin dispute processes are in place. Counterparty credit risk arising from derivative transactions, and securities repurchase and reverse repurchase transactions is mitigated through these margining processes and the regular monitoring of exposures.

### **Primary Types of Collateral for Derivatives Exposures**

Cash collateral and U.S. Treasury securities are used to secure the net open exposure of non-cleared derivative transactions. Cleared transactions are cash settled on a daily basis, cash and U.S. Treasury securities are used to meet daily margin requirements, per CCP exchange rules.

### **Impact of Downgrade in Creditworthiness on Derivatives Collateral**

Some of the Company's agreements with derivatives counterparties contain provisions that require DFS or Discover Bank to post additional collateral if a specified minimum credit rating is not maintained with certain major credit rating agencies.

Discover Bank's credit rating met all specified ratings thresholds set by its derivatives counterparties at December 31, 2018. However, if Discover Bank's credit rating were reduced below investment grade, Discover Bank would be required to post additional collateral with its derivatives counterparties, which, as of December 31, 2018, would have been \$20 million. DFS (Parent Company) had no outstanding derivatives as of December 31, 2018, therefore, no collateral was required.

### **Credit Risk Mitigation**

As part of its risk management activities, Discover uses various risk mitigants to manage portions of the credit risk in its portfolios. Credit risk mitigation is important to the Company in the effective management of its credit risk exposures. A majority of the Company's assets are comprised of credit card receivables, with unfunded commitments that are unconditionally cancelable.

The sole asset category of the Company that benefits from collateral in order to reduce capital requirements are loans, secured by 1-4 family residential properties. As of December 31, 2018, the decrease in RWA as a result of collateral held against those loans was \$59 million, which represents only 0.06% of total RWA and has no impact on Discover's capital ratios.

As of December 31, 2018, Discover does not utilize credit derivatives as a risk mitigation tool.

### **Securitization**

#### **Securitization Activities**

The Company engages in credit card and student loan securitization activities. The Company's securitizations are accounted for as secured borrowings and the trusts are treated as consolidated subsidiaries of the Company. The assets of the Company's consolidated variable interest entities ("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 trusts. The related debt issued by all securitization trusts is reported in long-term borrowings.

The Company accesses the term asset securitization market through the Discover Card Master Trust I ("DCMT") and the Discover Card Execution Note Trust ("DCENT"). Credit card loan receivables are transferred into DCMT and beneficial interests in DCMT are transferred into DCENT. Interests in DCENT are issued to investors in the form of debt securities. Student loan trust receivables underlying third-party investors' interests are recorded in PCI loans. See Note 5: Credit Card and Student Loan Securitization Activities in the 2018 Form 10-K for more information on the Company's credit card and student loan securitization activities.

The total outstanding principal amount of assets securitized by Discover does not meet operational criteria as defined in the Basel III rules. The underlying assets are reconsolidated in the balance sheet and accordingly risk weighted based on their balance sheet classification for Basel III purposes. In addition, Discover did not hold investments in asset-backed securities subject to Basel III securitization disclosure requirements as of December 31, 2018. As a result, Table 8 of disclosure requirements under section 217.63 is not applicable to Discover at this time.

## Equities Not Subject to Market Risk Rule

### Overview

Discover makes investments in equities with objectives of: (i) generating capital gains; (ii) fostering strategic relationships; and (iii) fulfilling Community Reinvestment Act requirements. None of the Company's equity investments are publicly traded or are included in tier 1 or tier 2 capital.

The following table presents the carrying value and fair value of the Company's equity investments (dollars in millions):

	Carrying Value	Fair Value
<b>At December 31, 2018</b>		
Equity investments	\$ 444	\$ 444

### Risk Weighting

The Company utilizes different approaches in calculating RWA for equity exposures not subject to market risk capital rules. Simplified Risk-Weight Approach ("SRWA") is used to risk weight community development and non-significant equity exposures. Under SRWA, adjusted carrying value for each type of equity exposure is multiplied by the prescribed risk weight. The adjusted carrying value for an on-balance sheet exposure is the carrying value of the exposure. Equity investments are considered non-significant if the aggregate adjusted carrying value of the exposures does not exceed 10 percent of a banking organization's total capital.

Alternative Modified Look-Through Approach is used to calculate RWA amounts for equity exposures to investment funds. Using the Alternative Approach, the adjusted carrying value of an equity exposure to an investment fund is assigned on a pro-rata basis to the different risk weight categories based on the investment limits in the fund's prospectus, partnership agreement, or similar contract that defines the fund's permissible investments. It is assumed the fund invests to the maximum extent permitted under its investment limits in the exposure type with the highest applicable risk weight and continues to make investments in order of the exposure type with the next highest applicable risk weight, until the maximum total investment is reached. The assignment of the pro-rata investment limits risk weights for all exposure types within the fund will not exceed 100 percent.

The following table presents the Company's equity exposures not subject to the Basel III market risk capital rule, using the Simplified Risk-Weight Approach and the Alternative Modified Look-Through Approach (dollars in millions):

	Risk Weight %	Exposure	RWA
<b>At December 31, 2018</b>			
Community development equity exposure	100%	\$ 295	\$ 295
Non-significant equity exposure	100%	44	44
Modified look-through		105	22
Total equity exposure not subject to the Basel III market risk capital rule		<u>\$ 444</u>	<u>\$ 361</u>

### Interest Rate Risk for Non-Trading Activities

For information on the Company's interest rate risk related to non-trading activities, see "Quantitative and Qualitative Disclosures About Market Risk" in the 2018 Form 10-K.