

**DISCOVER FINANCIAL SERVICES**

**Basel III Regulatory Capital Disclosures**

**For the Quarterly Period Ended December 31, 2015**

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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 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 the current Basel I regulatory capital calculations for banking organizations in July 2013. The effective date of the Basel III rules, for the Company, was January 1, 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 1, 2016.

The Basel III rules substantially revise 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 18: Capital Adequacy of the 2015 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 begin publicly disclosing 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 Company's Annual Report on Form 10-K for the year ended December 31, 2015 ("2015 Form 10-K"), Federal Reserve FRY-9C form for the year-to-date period ended December 31, 2015 and Discover Bank's Call Report ("Call Report") for the year-to-date period ended December 31, 2015, 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 2015 Form 10-K for details on the Company's principles of consolidation.

## Capital in Subsidiaries

At December 31, 2015, 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 annual 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 2015 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, 2015, 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 2015 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, 2015, 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 2015 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, 2015
Common stock	\$ 5
Additional paid-in capital	3,885
Retained earnings	13,250
Accumulated other comprehensive (loss) income	(160)
Treasury stock	(6,265)
Common shareholder's equity	10,715
Less: Deductions for goodwill and intangible assets, net of deferred tax liabilities	309
Less: Deductions for AOCI related adjustments	(160)
Common equity tier 1	10,566
Perpetual non-cumulative preferred stock	560
Tier 1 capital	11,126
Qualifying subordinated debt	415
Other elements of tier 2 capital	959
Tier 2 capital	1,374
Total capital	\$ 12,500

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 December 1, 2017 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 13: Common and Preferred Stock of the 2015 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, 2015</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

Both tranches of the 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, 2015, see Note 18: Capital Adequacy in the 2015 Form 10-K and Schedule HC-R in the 4Q15 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 under the Comprehensive Capital Analysis and Review ("CCAR") process. A component of that regulation is submitting an annual capital plan to the Federal Reserve that includes an assessment of the Company's expected uses and sources of capital over the nine quarter planning horizon and the Dodd-Frank Act Stress Test ("DFAST"). The intent of the CCAR process is to ensure that BHCs have thorough and forward-looking capital planning processes that account for their unique set of risks. In addition, the purpose is to ensure these institutions have sufficient capital levels to operate under periods of economic and financial stress.

CCAR and the Federal Reserve's capital planning rules apply to BHCs with \$50 billion or more in total consolidated assets, including Discover Financial Services. Our ability to make capital distributions, including our ability to pay dividends or repurchase shares of our common stock, will be subject to the Federal Reserve's review and non-objection of the actions that we proposed in our annual capital plan.

The DFAST requirements are very similar to those of the CCAR process. The stress test includes multiple scenarios; in this case: (i) baseline, (ii) adverse and (iii) severely adverse. DFAST regulations require BHCs to publish a company-run stress test twice a year. Results from our annual company-run stress tests are reported to the appropriate regulators and published on the Company's website. Our most recent company-run stress test results were published on July 23, 2015. For more information on assessment of the Company's capital adequacy, see Note 18: Capital Adequacy in the 2015 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, 2015
On-balance sheet:	
Exposure to depository institutions and foreign banks	\$ 216
Exposures to GSE <sup>(1)</sup> and PSE <sup>(2)</sup>	300
Credit card receivable	57,113
Personal and student loans receivable	14,182
Residential mortgage exposure	162
Retail exposure	71,457
Past due exposure <sup>(3)</sup>	1,065
Equity exposures	484
Other exposures <sup>(4)</sup>	3,079
Off-balance sheet:	
Off-balance sheet derivatives	9
Off-balance sheet commitments	87
Allowance for loan losses excluded from RWA	(910)
Total standardized risk-weighted assets	<u>\$ 75,787</u>

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

(2) Public sector entity ("PSE")

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

(4) Includes \$163 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, 2015, as calculated under the Basel III Standardized Approach framework for Discover Financial Services and Discover Bank, see Note 18: Capital Adequacy in the 2015 Form 10-K.

### 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 2015 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 5: Loan Receivables in the 2015 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 2015 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, 2015	QTD Average
Cash and cash equivalents <sup>(1)</sup>	\$ 1,065	\$ 1,085
Loans held for investment ("LHFI") <sup>(2)</sup>	\$ 72,385	\$ 70,503
Unused commitments <sup>(3)</sup>	\$ 178,740	\$ 179,961
Debt securities	\$ 3,084	\$ 3,161

(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, 2015</b>		
California	\$ 6,259	\$ 17,627
New York	5,804	11,984
Texas	5,585	14,012
Pennsylvania	4,130	9,855
Illinois	4,035	10,116
Florida	4,041	11,349
Ohio	3,095	8,001
New Jersey	2,900	6,781
Michigan	2,185	5,460
Massachusetts	2,043	4,884
Other States	32,308	78,671
<b>Total United States</b>	<b>\$ 72,385</b>	<b>\$ 178,740</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 \$94 million as of December 31, 2015.

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, 2015</b>				
Cash and cash equivalents <sup>(1)</sup>	\$ —	\$ —	\$ 1,065	\$ —
LHFI	\$ 72,162	\$ —	\$ —	\$ 223
Unused commitments	\$ 177,672	\$ —	\$ —	\$ 1,068
Debt securities	\$ —	\$ 3,084	\$ —	\$ —
Loans past due 90 days and non-accruing	\$ 70	\$ —	\$ —	\$ —
Loans past due 90 days and still accruing <sup>(2)</sup>	\$ 486	\$ —	\$ —	\$ 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, 2015
One year or less	\$ 50,420
Over one year through five years	\$ 12,366
Over five years	\$ 9,376

(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 2015 Form 10-K for quantitative information regarding credit risk exposures, which are presented in accordance with U.S. GAAP.

#### *Loan Receivables*

- See Note 5: 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 5: 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**

Counterparty credit risk is the risk that the counterparty to a transaction could default before final settlement of the transaction's cash flows. For derivatives, counterparty credit risk of the Company arises primarily from interest rate swap transactions and forward transactions. The Company has master netting arrangements and minimum collateral posting thresholds with its counterparties for its fair value and cash flow hedge interest rate swaps and foreign exchange forward contracts. For more information on the Company's counterparty credit risk-related exposures, see Note 22: Derivatives and Hedging Activities in the 2015 Form 10-K.

#### **Methodology Used to Assign 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 counterparty

credit risk products, including derivative contracts and repo transactions. The process includes the determination of maximum potential exposure after recognition of netting agreements and collateral 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 management and strategy, as well as the business profile and regulatory environment facing the counterparty. These factors are taken into consideration in setting counterparty limits and approval levels. Exposure to credit risk on derivatives is also impacted by market volatility, which may impair the ability of clients to satisfy their obligations to the Company or its affiliates. Credit risk analysts conduct daily monitoring versus limits and any resulting issues are escalated to credit officers and business management as appropriate. Usage against the credit limits may reflect netting agreements and collateral.

### **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 credit risk. Specifically, businesses are required to establish standard eligibility criteria for collateral usage. Industry standard legal agreements combined with internal reviews for legal enforceability are used to achieve a perfected security interest in the collateral. Additionally, risk management establishes guidelines on appropriate collateral haircuts. A haircut is the percentage of reduction in current market value applicable to each type of collateral and is largely based on liquidity and price volatility of the underlying security.

The current market value of collateral is monitored on a regular basis. Margin procedures are established for managing margin calls in order to maintain an appropriate level of collateral coverage reflecting market value fluctuations. Trades are reconciled on a regular basis that is consistent with regulatory or industry guidelines and margin dispute processes are in place. Counterparty credit risk arising on derivative transactions is managed through the margining process and regular monitoring of exposures.

### **Primary Types of Collateral**

Cash collateral and U.S. Treasury securities are used to secure the net open exposure of derivative transactions.

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

The Company's agreements with certain derivative counterparties contain provisions that require DFS and Discover Bank to maintain an investment grade credit rating from specified major credit rating agencies. Because the credit rating of DFS did not meet some specified thresholds, we had posted \$4 million of collateral with our counterparties at December 31, 2015. Discover Bank's credit rating met specified thresholds set by its counterparties. However, if Discover Bank's credit rating were reduced by one ratings notch, Discover Bank would be required to post additional collateral, which, as of December 31, 2015, would have been \$73 million.

### **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, 2015, the decrease in RWA as a result of collateral held against those loans was \$16 million which represents only 0.02% of total RWA and has no impact on Discover's capital ratios.

As of December 31, 2015, 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 credit card 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 DCENT issues notes to investors. Student loan trust receivables underlying third-party investors' interests are recorded in PCI loans. See Note 6: Credit Card and Student Loan Securitization Activities in the 2015 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, 2015. 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, 2015</b>		
Equity investments	\$ 485	\$ 485

#### 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, 2015</b>			
Community development equity exposure	100%	\$ 327	\$ 327
Non-significant equity exposure	100%	57	57
Modified look-through		101	100
Total equity exposure not subject to the Basel III market risk capital rule		<u>\$ 485</u>	<u>\$ 484</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 2015 Form 10-K.