Discover Financial Services

Dodd-Frank Act Stress Test Disclosures

September 16, 2014

Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank Act") and the Federal Reserve Regulation YY require certain bank holding companies, including Discover Financial Services ("Discover" or the "company") to perform stress tests to assess the potential impact of hypothetical economic scenarios on the company's operations and capital over a defined planning horizon. As required in the Capital Planning Regulation (12 CFR Part 225, Board of Governors, Federal Reserve System, Capital Planning), Discover has conducted mid-cycle company-run stress tests. These tests reflect the company's assessment of capital adequacy on a forward-looking basis under different economic scenarios and within the framework of the Discover Capital Adequacy Process (CAP). The scenario portrays a hypothetical, severely adverse macroeconomic environment, which includes a substantial weakening in economic activity and a significant reversal of recent improvements to the US housing market.

This disclosure contains forward-looking statements, including projections of the company's results of operations and financial condition, under a hypothetical scenario incorporating a set of assumed economic and financial conditions that are more adverse than the company expects. The projections do not represent forecasts of expected results of operations or financial condition, but rather reflect possible results under a hypothetical scenario developed by the company. The company's future results of operations and financial condition will be influenced by actual economic and financial conditions and various other factors as described in the company's annual report on Form 10-K for the year ended December 31, 2013, and other reports filed with the Securities and Exchange Commission, which are available at www.sec.gov.

Summary of Internal Severely Adverse Scenario

The Internal Severely Adverse Scenario is caused by multiple factors that set off a deep recession. The euro zone drops back into recession as the burden of fiscal austerity stresses the economy and squeezes the financial systems of other heavily indebted nations, threatening the existence of the single-currency area. Emerging markets experience capital flight, and the US banking system is strained as a result of its ties to the European banks, leading credit availability to shrink significantly.

The drop-off in US exports and business investment precipitates a deep recession in 2014 as the labor market and financial sector quickly deteriorate. The Federal Reserve maintains an accommodative monetary policy by keeping short-term interest rates near zero, but the impasse among policymakers prevents a fiscal policy response to stem the downturn. Consumer sentiment and spending decrease much more sharply than expected. Reduced household wealth and high unemployment cause consumers to pull back further on their spending. Corporate bond spreads rise significantly above baseline levels, causing business investment to retrench significantly.

Foreclosures rise again, and federal support to housing is more limited than in the 2008–2009 recession.

The result is another cycle of housing price declines. The overall price drop during the second dip is 21%.

Housing starts slow to two-thirds of the current pace and take years to recover their 2013 pace.

In this deep slump, real GDP declines a cumulative 5% peak to trough. The unemployment rate reaches a high of 11.7% in mid-2015 and remains in double digits through 2017. To prevent the economy from sliding further, the Federal Reserve keeps interest rates near 0% through at least 2017.

Discover added idiosyncratic risk events to capture firm-specific risks and to account for risks that are more difficult to quantify or model. Idiosyncratic risks include operational, strategic, and credit risk.

Risk Types

When conducting the company-run stress test under the Internal Severely Adverse Scenario, the company intended to capture the principal risks to which the company is exposed, including credit risk, market risk, operational risk, regulatory risk, liquidity risk, and strategic risk. Credit risk is primarily incurred through the company's consumer lending activities. Operational risk refers to the risk of loss that can arise from a number of events, such as inadequate or failed internal processes or systems, breaches of technology and information systems, fraud, potential legal or regulatory actions, or external events. Market risk is incurred due to adverse movements in market rates or prices, such as interest rates, foreign exchange rates, credit spreads, or equity prices. Regulatory risk arises from changes in laws or regulations or the interpretation thereof. Liquidity risk arises from events that could impact the company's ability to meet its day-to-day operating expenses, extend credit to consumers, or repay principal and interest on borrowings. Strategic risk is associated with a highly competitive marketplace, macroeconomic factors, and the uncertainty associated with new and acquired businesses.

Methodology

Discover used both quantitative and qualitative methods to measure and assess risks, including proprietary models that forecast receivables, revenues, expenses, and losses under the Internal Severely Adverse Scenario. The company's capital position was projected by aggregating revenue and loss estimates as well as capital actions over the nine-quarter capital planning horizon. The models used in the 2014 mid-cycle stress test were independently reviewed and validated by the Model Risk Management Team (MRM) under Discover's Model Risk Policy. MRM provides independent management of model risk, including activities like identification, quantification, monitoring, and mitigation of model risk across the company through model validation and performance-monitoring activities.

Pre-provision Net Revenue ("PPNR")

PPNR is estimated as total revenues (interest and non-interest revenues), net of interest expense and non-interest expense.

Interest income is generated from the company's lending products, while non-interest income is generated by both the payments businesses and the lending products. Interest income is estimated across the company's lending products using the forecasted performing receivables balance and projected yield. The receivables balance is forecasted based on projected originations, payments, charge-offs, and other product-specific inputs. The projected yield is forecasted based on the yield on the loan, pricing strategies, and historical pricing information. Non-interest income is generally estimated by forecasting the volume of transactions and the rate for those transactions.

Interest expense is forecasted for both retail and wholesale funding channels. The total cost of funding is estimated by multiplying the expected interest rates with the projected funding balance across those channels.

Non-interest expense is forecasted in several components based on whether they are fixed expenses, volume-driven expenses, expenses that vary in response to factors other than business volume, or expenses due to known initiatives that are expected to impact expense trends.

Net interest income and non-interest income components are forecasted at a business line level and then aggregated with non-interest expenses to determine total PPNR.

Loan Losses

Net loan losses are calculated as gross loan losses less recoveries. Discover forecasts its gross loan losses by using regression analyses based on macroeconomic, internal portfolio, and other data.

Reserves are estimated based on the 12-month forward forecast of loan losses, adjusted for an estimate of activity included in the loss forecast related to loans that do not exist on the balance sheet at the reporting date.

Operational Risk Losses

Operational risk loss estimates include forecasted operational risk expenses, such as credit card fraud, for which the company maintains reserves; and idiosyncratic operational risk losses, which are potentially severe losses driven by low probability operational risk events identified through the company's operational risk management framework. Losses from idiosyncratic operational risk events are included as non-interest expense and also impact revenues and net charge-offs.

Company-Run Stress Test Results

The results of the company-run stress test on the company's capital ratios and certain financial metrics are set forth in the following tables. The results include capital action assumptions provided within the Dodd-Frank Act Stress Testing ("DFAST") rules:

- For second quarter 2014, actual capital actions taken throughout the quarter, including dividends and share repurchases, are reflected in the results.
- For third quarter 2014 through the second quarter 2016, common stock dividends equal to the quarterly average dollar amount of common stock dividends that the company paid in the previous year (this includes the second quarter 2014 and the preceding three calendar quarters), as well as preferred dividends, were included. Consistent with the Federal Reserve instructions, common stock issuances associated with expensed employee compensation were also included.

These capital actions are defined in the DFAST rule in order to allow the Federal Reserve to conduct the required stress tests and may not represent the actual capital actions that Discover would take in a similar economic environment.

Hypothetical Discover Capital Ratios in the Internal Severely Adverse Scenario

	DFS Consolidated		
	Actual	Stress Scenario	
	1Q 2014	2Q 2016	Minimum[1]
Tier 1 Common Capital Ratio	14.9%	14.8%	13.6%
Common Equity Tier 1 Capital[2]	n/a	14.5%	n/a
Tier 1 Capital Ratio	15.8%	15.7%	14.4%
Total Risk-based Capital Ratio	18.1%	17.6%	16.7%
Tier 1 Leverage Ratio	13.4%	13.6%	12.8%

Actual 1Q 2014 and Hypothetical 2Q 2016 Risk-weighted Assets

	Actual 1Q 2014	Projected 2Q 2016	
		Current General Approach	Basel III Standardized Approach
Risk-weighted Assets[3] ($ in billions)	67.4	63.1	64.7

[1] Represents the projected minimum quarter-end ratio at any point during the nine-quarter planning horizon of the Internal Severely Adverse Scenario

[2] Common Equity Tier 1 Capital reflects the transition schedule provided in the Federal Reserve's revised capital framework

[3] For each quarter in 2014, risk-weighted assets are calculated using the current general risk-based capital approach; for each quarter in 2015, risk-weighted assets are calculated under the Basel III standardized capital risk-based approach, except for the tier 1 common ratio, which uses the general risk-based capital approach for all quarters

Hypothetical 9-quarter (2Q 2014 to 2Q 2016) Losses, Revenue, and Net Income before Taxes under the Internal Severely Adverse Scenario

	($ in Billions)	**% of Average Assets**[4]
Pre-provision Net Revenue[5]	$ 8.7	11.7%
Other Revenue[6]	-	-
Less		
Provisions	8.2	11.0%
Realized losses/gains on securities (AFS/HTM)	-	-
Trading and counterparty losses[7]	-	-
Other losses/gains[8]	-	-
Equals		
Net Income Before Tax	$ 0.5	0.7%
Memo Items		
Other comprehensive income[9]	-	-
Other effects on capital		
AOCI included in capital (billions of dollars) [10]	-	-

[4] Expressed on a nine-quarter cumulative basis as a percentage of average assets over the same time period

[5] Pre-provision Net Revenue includes losses from operational risk events, credit card fraud losses, and mortgage put-back expenses

[6] Other revenue includes one-time income and (expense) items not included in pre-provision net revenue

[7] Trading and counterparty losses include mark-to-market and credit valuation adjustments (CVA) losses and losses arising from the counterparty default component applied to derivatives, securities lending, and repurchase agreement activities

[8] Other losses/gains include projected change in fair value of loans held for sale and loans held for investment measured under the fair-value option

[9] Other comprehensive income is only calculated for advanced approaches BHCs, as only those BHCs include accumulated other comprehensive income (AOCI) in calculations of regulatory capital; other comprehensive income includes incremental unrealized losses/gains on AFS securities and on any HTM securities that have experienced other than temporary impairment

[10] Non-advanced approaches BHCs are assumed to opt-out of including AOCI in their capital calculations

Hypothetical 9-quarter (2Q 2014 to 2Q 2016) Loan Losses, by Type of Loan, under the Internal Severely Adverse Scenario

	($ in Billions)	Portfolio Loss Rates[11]
Loan Losses	7.1	11.3%
First-lien mortgages domestic	-	-
Junior liens and HELOCs, domestic	-	-
Commercial and Industrial	-	-
Commercial real estate, domestic	-	-
Credit cards	6.3	12.7%
Other consumer	0.7	5.9%
Other loans	-	-

Description of Stress Scenario Results For the Company

While capital ratios decline over the scenario horizon for the company, both ending and minimum capital ratios are significantly above regulatory requirements. The decrease in capital ratios is due to a reduction in earnings in the stress scenario, offset in part by lower risk-weighted assets.

The decline in earnings under the stress scenario is primarily the result of an increase in the provision for loan losses. Net charge-offs rise significantly over the period, driven largely by credit cards due to a significant increase in both contractual and bankruptcy charge-offs. Net income is further impacted by a significant increase in loan loss provisions, driven by higher expected net charge-offs early in the scenario horizon partially offset by releases in the second half of the scenario.

In the scenario, PPNR declines because of a decrease in net interest income due to lower receivables, higher non-principal charge-offs, and higher operating expenses. Non-interest income also declines, driven by lower discount and interchange revenue due to lower credit card sales volume. Idiosyncratic operational and strategic risk scenarios also impact PPNR through higher non-interest expenses and lower revenues.

Assets decline over the period, driven primarily by credit card receivables, due to an increase in credit losses, lower credit card balance growth from existing customers, and a reduction in marketing activities across all lending products. Total funding falls due to lower borrowing needs while maintaining funding diversification throughout the forecast period.

[11] Nine-quarter cumulative losses as a percentage of average balances over the same time period