DISCOVER FINANCIAL SERVICES

Dodd-Frank Act Stress Test Disclosures

July 23, 2015

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DFAST 2015 Mid-cycle Public Disclosure of Stress Test Results

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

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 Regulation YY (12 CFR Part 252, Board of Governors, Federal Reserve System, Enhanced Prudential Standards), 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 as 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, 2014, and other reports filed with the Securities and Exchange Commission, which are available at www.sec.gov.

Summary of Internal Severely Adverse Scenario

Under the Dodd-Frank Act Stress Testing (DFAST) rules for the mid-cycle company-run stress tests, Discover is required to use internally developed baseline and stress scenarios and publicly disclose a summary of the results of the internally developed stress scenario. For the DFAST annual stress test disclosure, Discover is required to use the Supervisory Severely Adverse scenario as released by the Regulators.

Since the Internal Severely Adverse scenario is designed to stress Discover's own risk profile, this scenario is more severe than the Supervisory Severely Adverse scenario that was used for the DFAST annual stress test disclosure. In particular, the unemployment rate is increased by 5% in the Internal Severely Adverse scenario as compared to an increase of 4% in the Supervisory Severely Adverse scenario used in the annual stress tests.

The Internal Severely Adverse scenario forecasts a deep recession followed by a slow economic recovery. This downside 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. The US banking system is strained as a result of its ties to the European banks, leading credit availability to shrink significantly. The value of the dollar rises as the United States is once again perceived as a safe haven, and the stock market drops sharply.

The drop-off in US exports and business investment precipitates a deep and long recession beginning in the second quarter of 2015 as the labor market and financial sector quickly deteriorate. The Federal Reserve maintains an accommodative monetary policy by keeping short-term interest rates low, but the impasse among US policy makers prevents a fiscal policy response to stem the downturn, and, instead, the rising US federal deficit in the presence of an already high national debt causes a new round of US fiscal austerity. 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 to 2009 recession. The result is another cycle of house price declines. The unemployment rate increases by 5% and reaches a high of 10.7% by mid-2016, remaining in double digits through 2016. 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 counterparty 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, compliance and legal 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. Compliance risk is the risk of legal or regulatory sanctions, financial loss, or damage to reputation resulting from failure to comply with laws, regulations, rules, other regulatory requirements, or codes of conduct and other standards applicable to the company. Legal risk arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of the company. 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.

Stress Test 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.

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 cost of 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.

A variety of approaches are used to forecast each component of non-interest expense. For instance, volume-driven expenses are driven by macroeconomic variables; fixed expenses or expenses that vary in response to factors other than business volume are forecasted using current expense levels, expense trends, and 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 vintage-based framework and 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 for risk categories that include external fraud, damage to physical assets, business disruptions and systems failures, employment practices and workplace safety, and losses related to development, marketing, execution, and delivery of products and services. Further, idiosyncratic operational risk losses, which are potentially severe losses driven by low probability operational risk events identified through the company's operational risk scenario analysis framework, are also included under stress conditions in total operational risk loss estimates as either an increase in non-interest expense or a reduction of non-interest income.

Company-run Stress Test Results

The results of the company-run stress test on Discover'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, including:

- For second quarter 2015, actual capital actions taken throughout the quarter, including dividends and share repurchases, are reflected in the results.
- For third quarter 2015 through the second quarter 2017, 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 2015 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.

Regulatory Capital Ratios

The following table presents hypothetical Discover Capital Ratios in the Internal Severely Adverse DFAST scenario:

	DFS Consolidated		
	Actual	Stress Scenario	
	1Q15[1]	2Q17[1]	Minimum[2]
Tier 1 Common Capital Ratio	14.7%	12.7%	12.3%
Common Equity Tier 1 Capital	14.8%	12.6%	12.1%
Tier 1 Capital Ratio	15.6%	13.4%	12.9%
Total Risk-based Capital Ratio	17.6%	14.9%	14.6%
Tier 1 Leverage Ratio	13.3%	11.7%	11.4%

Risk-weighted Assets

The following table presents actual 1Q15 and hypothetical 2Q17 risk-weighted assets in the Internal Severely Adverse DFAST scenario:

	DFS Consolidated	
	Actual 1Q15	Projected 2Q17
	Basel III Standardized Approach[3]	Basel III Standardized Approach[3]
Risk-weighted Assets ($ in billions)	70.9	67.3

[1] Represents Basel III Capital Ratios reflecting transition provisions, except for Tier1 common capital, which is calculated based on Basel I rule
[2] Represents the projected minimum quarter-end ratio at any point during the forecast horizon
[3] Basel III standardized approach risk-weighted assets reflect transition provisions

Pro Forma Nine-quarter Income Statement

The following table presents hypothetical nine-quarter (2Q15 to 2Q17) losses, revenue, and net income before taxes under the Internal Severely Adverse scenario:

	($ in Billions)	% of Average Assets[4]
Pre-provision Net Revenue[5]	7.8	9.7%
Other Revenue[6]	-	-
Provisions	(8.9)	(11.1%)
Realized (losses)/gains on Securities (AFS/HTM)	-	-
Trading and Counterparty Losses[7]	-	-
Other (losses)/gains[8]	(0.2)	(0.2%)
Net Income Before Tax	(1.2)	(1.5%)
Memo Items		
Other Comprehensive Income	-	-
Other Effects on Capital		
AOCI Included in Capital (billions of dollars)[9]	-	-

Loan Losses

The following table presents hypothetical nine-quarter (2Q15 to 2Q17) loan losses, by type of loan, under the Internal Severely Adverse scenario:

	($ in Billions)	Portfolio Loss Rates[10]
Loan Losses	7.8	11.7%
First-lien Mortgages, Domestic	-	-
Junior Liens and HELOCs, Domestic	-	-
Commercial and Industrial	-	-
Commercial Real Estate, Domestic	-	-
Credit Cards	7.0	13.2%
Other Consumer	0.8	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,

[4] Expressed on a nine-quarter cumulative basis as a percentage of average total 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 scenario component applied to derivatives, securities lending, and repurchase agreement activities
[8] Other (losses)/gains includes goodwill impairment losses
[9] As a non-advanced approaches Banking organization, Discover chose to "opt out" of including AOCI in the regulatory capital calculations
[10] Nine-quarter cumulative losses as a percentage of average balances over the same time period

driven by higher expected net charge-offs early in the scenario horizon, and as the economy begins to improve, there is an offset from reserve 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.