Discover Financial Services
Form 10-Q
April 08, 2011
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended February 28, 2011

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission File Number 001-33378

DISCOVER FINANCIAL SERVICES

(Exact name of registrant as specified in its charter)

Delaware	**36-2517428**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
2500 Lake Cook Road, Riverwoods, Illinois 60015	**(224) 405-0900**
(Address of principal executive offices, including zip code)	**(Registrant s telephone number, including area code)**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ¨ No x

As of March 25, 2011, there were 545,485,833 shares of the registrant s Common Stock, par value $0.01 per share, outstanding.

Table of Contents

DISCOVER FINANCIAL SERVICES

Quarterly Report on Form 10-Q

for the quarterly period ended February 28, 2011

TABLE OF CONTENTS

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

We own or have rights to use the trademarks, trade names and service marks that we use in conjunction with the operation of our business, including, but not limited to: Discover®, PULSE®, Cashback Bonus®, Discover® More® Card, Discover® Motiva℠ Card, Discover® Open Road® Card, Discover® Network and Diners Club International®. All other trademarks, trade names and service marks included in this quarterly report on Form 10-Q are the property of their respective owners.

Table of Contents

Part I. FINANCIAL INFORMATION

Item 1. Financial Statements

DISCOVER FINANCIAL SERVICES

Condensed Consolidated Statements of Financial Condition

	February 28, 2011 (unaudited)	November 30, 2010
	(dollars in thousands, except share amounts)	
Assets		
Cash and cash equivalents	$ 5,171,425	$ 5,098,733
Restricted cash	676,074	1,363,758
Other short-term investments	375,000	375,000
Investment securities:		
Available-for-sale (amortized cost of $5,188,830 and $4,989,958 at February 28, 2011 and November 30, 2010, respectively)	5,177,116	5,002,579
Held-to-maturity (fair value of $59,991 and $70,195 at February 28, 2011 and November 30, 2010, respectively)	63,765	72,816
Total investments securities	5,240,881	5,075,395
Loan receivables:		
Loans held for sale	766,661	788,101
Loan portfolio:		
Credit card	44,317,247	45,156,994
Other	3,567,936	2,891,318
Purchased credit-impaired loans	3,011,384	0
Total loan portfolio	50,896,567	48,048,312
Total loan receivables	51,663,228	48,836,413
Allowance for loan losses	(3,033,459)	(3,304,118)
Net loan receivables	48,629,769	45,532,295
Premises and equipment, net	458,950	460,732
Goodwill	255,421	255,421
Intangible assets, net	193,293	188,973
Other assets	2,505,796	2,434,661
Total assets	$ 63,506,609	$ 60,784,968
Liabilities and Stockholders Equity		
Deposits:		
Interest-bearing deposit accounts	$ 34,728,329	$ 34,309,839
Non-interest bearing deposit accounts	130,665	103,544
Total deposits	34,858,994	34,413,383
Short-term borrowings	100,000	0
Long-term borrowings	18,990,170	17,705,728
Accrued expenses and other liabilities	2,658,280	2,209,011
Total liabilities	56,607,444	54,328,122
Commitments, contingencies and guarantees (Note 11)		
Stockholders Equity:		
Common stock, par value $.01 per share; 2,000,000,000 shares authorized; 547,985,670 and 547,128,270 shares issued at February 28, 2011 and November 30, 2010, respectively	5,480	5,471
Additional paid-in capital	3,452,513	3,435,318
Retained earnings	3,580,338	3,126,488

Accumulated other comprehensive loss	(106,279)	(82,548)
Treasury stock, at cost; 2,716,532 and 2,446,506 shares at February 28, 2011 and November 30, 2010, respectively	(32,887)	(27,883)
Total stockholders equity	6,899,165	6,456,846
Total liabilities and stockholders equity	$ 63,506,609	$ 60,784,968

The table below presents the carrying amounts of certain assets and liabilities of Discover Financial Services consolidated variable interest entities (VIEs) which are included in the condensed consolidated statements of financial condition above. The assets in the table below include only those assets that can be used to settle obligations of the consolidated VIEs. The liabilities in the table below include third party liabilities of consolidated VIEs only, and exclude intercompany balances that eliminate in consolidation. The liabilities also exclude amounts for which creditors have recourse to the general credit of the Company.

	February 28, 2011 (unaudited)	**November 30, 2010**
	(dollars in thousands)	
Assets		
Restricted cash	$ 676,074	$ 1,363,758
Credit card loan receivables	33,400,781	34,452,989
Other loan receivables	3,006,809	0
Allowance for loan losses allocated to securitized loan receivables	(2,207,480)	(2,431,399)
Other assets	34,421	24,083
Liabilities		
Long-term borrowings	$ 16,531,018	$ 14,919,400

See Notes to the Condensed Consolidated Financial Statements.

1

Table of Contents

DISCOVER FINANCIAL SERVICES

Condensed Consolidated Statements of Income

	For the Three Months Ended February 28, 2011 (unaudited) (dollars in thousands, except per share amounts)	2010
Interest income:		
Credit card loans	$ 1,417,116	$ 1,491,887
Other loans	119,536	52,668
Investment securities	12,215	5,328
Other interest income	4,097	9,267
Total interest income	1,552,964	1,559,150
Interest expense:		
Deposits	256,695	305,449
Short-term borrowings	46	0
Long-term borrowings	125,987	108,275
Total interest expense	382,728	413,724
Net interest income	1,170,236	1,145,426
Provision for loan losses	417,709	1,387,206
Net interest income (loss) after provision for loan losses	752,527	(241,780)
Other income:		
Discount and interchange revenue	260,916	261,991
Fee products	108,553	104,095
Loan fee income	85,600	105,285
Transaction processing revenue	42,551	32,918
Merchant fees	4,655	8,445
Gain (loss) on investment securities	141	180
Other income	60,208	32,962
Total other income	562,624	545,876
Other expense:		
Employee compensation and benefits	213,075	195,764
Marketing and business development	135,665	84,673
Information processing and communications	64,717	65,418
Professional fees	90,331	75,813
Premises and equipment	17,248	17,860
Other expense	74,112	35,276
Total other expense	595,148	474,804
Income (loss) before income tax expense	720,003	(170,708)
Income tax expense (benefit)	255,111	(67,170)
Net income (loss)	$ 464,892	$ (103,538)

Net income allocated to common stockholders	$	459,428	$	(122,233)
Basic earnings per share	$	0.84	$	(0.22)
Diluted earnings per share	$	0.84	$	(0.22)
Dividends paid per share	$	0.02	$	0.02

See Notes to the Condensed Consolidated Financial Statements.

Table of Contents

DISCOVER FINANCIAL SERVICES

Condensed Consolidated Statements of Changes in Stockholders Equity

	Preferred Stock		Common Stock						
	Shares	**Amount**	**Shares**	**Amount**	**Additional Paid-in Capital**	**Retained Earnings**	**Accumulated Other Comprehensive Income (Loss)**	**Treasury Stock**	**Total Stockholders Equity**
					(unaudited)				
					(dollars and shares in thousands)				
Balance at November 30, 2009	1,225	$ 1,158,066	544,799	$ 5,448	$ 3,573,231	$ 3,873,262	$ (154,818)	$ (19,642)	$ 8,435,547
Adoption of ASC 810 (FASB Statement No. 167), net of tax	0	0	0	0	0	(1,411,117)	78,561	0	(1,332,556)
Comprehensive income:									
Net loss	0	0	0	0	0	(103,538)	0	0	(103,538)
Adjustments related to investment securities, net of tax	0	0	0	0	0	0	2,160	0	
Adjustments related to pension and postretirement benefits, net of tax	0	0	0	0	0	0	59	0	
Other comprehensive income	0	0	0	0	0	0	2,219	0	2,219
Total comprehensive loss	0	0	0	0	0	0	0	0	(101,319)
Purchases of treasury stock	0	0	0	0	0	0	0	(5,383)	(5,383)
Common stock issued under employee benefit plans	0	0	22	0	285	0	0	0	285
Common stock issued and stock-based compensation expense	0	0	1,201	12	10,996	0	0	0	11,008
Dividends paid common stock	0	0	0	0	0	(10,984)	0	0	(10,984)
Accretion of preferred stock discount	0	3,388	0	0	0	(3,388)	0	0	0
Dividends preferred stock	0	0	0	0	0	(15,307)	0	0	(15,307)
Special dividend Morgan Stanley	0	0	0	0	0	33,757	0	0	33,757
Balance at February 28, 2010	1,225	$ 1,161,454	546,022	$ 5,460	$ 3,584,512	$ 2,362,685	$ (74,038)	$ (25,025)	$ 7,015,048
Balance at November 30, 2010	0	$ 0	547,128	$ 5,471	$ 3,435,318	$ 3,126,488	$ (82,548)	$ (27,883)	$ 6,456,846
Comprehensive income:									
Net income	0	0	0	0	0	464,892	0	0	464,892
Adjustments related to investment securities, net of tax	0	0	0	0	0	0	(15,247)	0	
Adjustments related to cash flow hedges, net of tax	0	0	0	0	0	0	(8,826)	0	
Adjustments related to pension and postretirement benefits, net of tax	0	0	0	0	0	0	342	0	
Other comprehensive loss	0	0	0	0	0	0	(23,731)	0	(23,731)
Total comprehensive income	0	0	0	0	0	0	0	0	441,161
Purchases of treasury stock	0	0	0	0	0	0	0	(5,004)	(5,004)
Common stock issued under employee benefit plans	0	0	13	0	271	0	0	0	271
Common stock issued and stock-based compensation expense	0	0	845	9	16,924	0	0	0	16,933
Dividends paid common stock	0	0	0	0	0	(11,042)	0	0	(11,042)
Balance at February 28, 2011	0	$ 0	547,986	$ 5,480	$ 3,452,513	$ 3,580,338	$ (106,279)	$ (32,887)	$ 6,899,165

See Notes to the Condensed Consolidated Financial Statements.

Table of Contents

DISCOVER FINANCIAL SERVICES

Condensed Consolidated Statements of Cash Flows

	For the Three Months Ended February 28, 2011	2010
	(unaudited)	
	(dollars in thousands)	
Cash flows from operating activities		
Net income (loss)	$ 464,892	$ (103,538)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for loan losses	417,709	1,387,206
Deferred income taxes	112,511	(100,918)
Depreciation and amortization on premises and equipment	22,042	23,689
Amortization of deferred revenues	(60,351)	(42,065)
Other depreciation and amortization	(21,036)	18,737
(Gain) loss on investment securities	(141)	(180)
Loss (gain) on equipment	123	33
Stock-based compensation expense	11,875	11,293
Gain on purchase of business	(15,917)	0
Net change in loans originated for sale	21,440	0
Changes in assets and liabilities:		
(Increase) decrease in other assets	(43,733)	(170,051)
Increase (decrease) in accrued expenses and other liabilities	369,669	110,896
Net cash provided by operating activities	1,279,083	1,135,102
Cash flows from investing activities		
Maturities of other short-term investments	0	1,175,000
Maturities and sales of available-for-sale investment securities	332,954	68,214
Purchases of available-for-sale investment securities	(542,025)	(269,310)
Maturities of held-to-maturity investment securities	9,072	4,433
Net principal disbursed on loans held for investment	(7,185)	(291,098)
Purchase of loan receivables	(395,658)	0
Purchase of business, net of cash acquired	(366,049)	0
Decrease in restricted cash special dividend escrow	0	643,311
Decrease (increase) in restricted cash for securitization investors	884,950	(2,437,239)
Proceeds from sale of equipment	13	0
Purchases of premises and equipment	(15,586)	(7,826)
Net cash used for investing activities	(99,514)	(1,114,515)
Cash flows from financing activities		
Net increase (decrease) in short-term borrowings	100,000	0
Proceeds from issuance of securitized debt	500,000	750,000
Maturities of securitized debt	(1,819,185)	(3,142,983)
Maturities of other long-term borrowings	(315,028)	(71,930)
Proceeds from issuance of common stock	931	0
Purchases of treasury stock	(5,004)	(5,383)
Net increase (decrease) in deposits	442,435	2,958,602
Dividend paid to Morgan Stanley	0	(775,000)
Dividends paid on common and preferred stock	(11,026)	(26,291)
Net cash used for financing activities	(1,106,877)	(312,985)
Net increase (decrease) in cash and cash equivalents	72,692	(292,398)
Cash and cash equivalents, at beginning of period	5,098,733	13,020,719
Cash and cash equivalents, at end of period	$ 5,171,425	$ 12,728,321

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid during the year for:		
Interest expense	$ 383,757	$ 369,924
Income taxes, net of income tax refunds	$ 38,209	$ 14,141
Non-cash transactions:		
Post-closing adjustment payable SLC acquisition	$ 35,108	$ 0
Assumption of SLC debt	$ 2,921,372	$ 0
Special dividend Morgan Stanley	$ 0	$ 33,757

See Notes to the Condensed Consolidated Financial Statements.

Notes to the Condensed Consolidated Financial Statements

(unaudited)

1. Background and Basis of Presentation

Description of Business. Discover Financial Services (DFS or the Company) is a direct banking and payment services company. The Company is a bank holding company under the Bank Holding Company Act of 1956 and a financial holding company under the Gramm-Leach-Bliley Act. The Company is subject to oversight, regulation and examination by the Board of Governors of the Federal Reserve System (the Federal Reserve). Through its Discover Bank subsidiary, a Delaware state-chartered bank, the Company offers its customers credit cards, student loans, personal loans and deposit products. Through its DFS Services LLC subsidiary and its subsidiaries, the Company operates the Discover Network, the PULSE Network (PULSE) and Diners Club International (Diners Club). The Discover Network is a payment card transaction processing network for Discover card-branded and third-party issued credit, debit and prepaid cards. PULSE operates an electronic funds transfer network, providing financial institutions issuing debit cards on the PULSE network with access to ATMs domestically and internationally, as well as point of sale terminals at retail locations throughout the U.S. for debit card transactions. Diners Club is a global payments network of licensees, which are generally financial institutions, that issue Diners Club branded credit cards and/or provide card acceptance services.

The Company s business segments are Direct Banking and Payment Services. The Direct Banking segment includes Discover card-branded credit cards issued to individuals and small businesses on the Discover Network and other consumer products and services, including personal loans, student loans, prepaid cards and other consumer lending and deposit products offered through the Company s Discover Bank subsidiary. The Payment Services segment includes PULSE, Diners Club and the Company s third-party issuing business, which includes credit, debit and prepaid cards issued on the Discover Network by third parties.

Basis of Presentation. The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the financial statements reflect all adjustments which are necessary for a fair presentation of the results for the quarter. All such adjustments are of a normal, recurring nature. The preparation of financial statements in conformity with GAAP requires the Company to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and related disclosures. These estimates are based on information available as of the date of the condensed consolidated financial statements. The Company believes that the estimates used in the preparation of the condensed consolidated financial statements are reasonable. Actual results could differ from these estimates. These interim condensed consolidated financial statements should be read in conjunction with the Company s 2010 audited consolidated financial statements filed with the Company s annual report on Form 10-K for the year ended November 30, 2010.

Recently Issued Accounting Pronouncements

The application of the following guidance will only affect disclosures and therefore will not impact the Company s financial condition, results of operations or cash flows.

In July 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. ASU No. 2010-20 requires a greater level of disaggregation in disclosures relating to the credit quality of the Company s financing receivables and allowance for loan losses. ASU 2010-20 also requires enhanced disclosures around nonaccrual and past due financing receivables and impaired loans. The Company has included the new required disclosures in Note 4: Loan Receivables. ASU 2010-20 also requires enhanced disclosures around troubled debt restructurings. However, the FASB announced that the effective date related to those disclosures would be deferred and would instead have an effective date concurrent with that of the proposed ASU, *Receivables* (Topic 310): Clarifications to Accounting for Troubled Debt Restructurings by Creditors. Currently, that guidance is anticipated to be effective for interim and annual periods ending after June 15, 2011.

2. Business Combinations

On December 31, 2010, the Company acquired The Student Loan Corporation (SLC), which is now a wholly-owned subsidiary of Discover Bank and included in the Company s Direct Banking segment. The Company acquired SLC s ongoing private student loan business, which includes certain private student loans held in three securitization trusts and other assets, and assumed SLC s asset-backed securitization debt incurred by those trusts and other liabilities. The acquired loans are considered to be purchased credit-impaired loans for accounting purposes, the details of which are discussed further in Note 4: Loan Receivables. The acquisition significantly increased the size of the Company s private student loan portfolio. In addition, the acquisition has provided the Company with a developed student loan business platform, additional school relationships and SLC s website. Since the acquisition date, the results of operations and cash flows of SLC have been included in the Company s condensed consolidated results of operations and cash flows. Pro forma data is not provided as the impact of the SLC acquisition was not significant to the Company s condensed consolidated results of operations or cash flows.

Net cash consideration paid. The following table provides a calculation of the amount paid by the Company for the net assets of the SLC securitization trusts acquired after applying an 8.5% discount to the trust assets (the Trust Certificate Purchase Price) (dollars in millions):

	Actual February 28, 2011	Estimate at Closing December 31, 2010
Gross trust assets	$ 3,977	$ 3,993
Less: 8.5% discount	(338)	(339)
Net trust assets	3,639	3,654
Less: Principal amount of and accrued interest on trust debt	(3,193)	(3,215)
Trust Certificate Purchase Price	$ 446	$ 439

Although the Company paid SLC shareholders $600 million for the acquisition of SLC (Aggregate Merger Consideration), the Company received a purchase price adjustment from Citibank, N.A. (Citibank) equivalent to the amount by which the Aggregate Merger Consideration exceeded the value of the Trust Certificate Purchase Price. In addition, Citibank agreed to adjust the cash consideration paid by the Company to compensate it for (i) agreeing to commute certain insurance policies covering certain of the loans acquired and (ii) for the value of non-trust related liabilities assumed by the Company. The following table provides a summary of total consideration paid by Discover at the closing of the acquisition on December 31, 2010 and a summary of the consideration revised for post-closing adjustments (dollars in millions):

	Actual February 28, 2011	Estimate at Closing December 31, 2010
Aggregate Merger Consideration	$ 600	$ 600
Less: Purchase price adjustment[1]	(154)	(161)
Trust Certificate Purchase Price	446	439
Less: Further adjustments provided for by Citibank		
Cash received for consent to insurance commutation	(16)	(16)
Cash received related to reimbursable liabilities[1]	(29)	(57)
Net cash consideration paid[1]	$ 401	$ 366

(1) Based on the actual audited SLC closing balance sheet, the Company accrued a $35 million liability payable to Citibank for post-closing adjustments arising from a $7 million increase in the Trust Certificate Purchase Price and a $28 million reduction in reimbursable liabilities, which together resulted in the difference between the actual and estimated numbers shown.

6

Table of Contents

Net assets acquired. The Company acquired net assets (including $155 million of cash) with an aggregate fair value of $572 million in exchange for cash consideration of $556 million, resulting in the recognition of a bargain purchase gain of approximately $16 million. The bargain purchase gain primarily resulted from Citibank s adjustment of the cash consideration to be paid by the Company in exchange for the Company s consent to permit SLC to commute, immediately prior to the acquisition, certain student loan insurance policies covering loans in one of the three trusts. The bargain purchase gain is recorded in other income on the Company s condensed consolidated statement of income.

The following table summarizes the fair values of the assets acquired and liabilities assumed at the date of the SLC acquisition. Adjustments to these amounts may occur during the remainder of 2011 as the Company completes its final valuation analysis of assets acquired and liabilities assumed (dollars in thousands):

	At December 31, 2010
Student loan receivables	$ 3,050,784
Cash	155,347
Indemnification asset	101,127
Student relationships intangible	2,400
Trade name intangible	3,800
Total intangible assets	6,200
Other assets	218,514
Total assets acquired	3,531,972
Securitized debt	2,921,372
Other liabilities	38,178
Total liabilities assumed	2,959,550
Net assets acquired	$ 572,422

The Company acquired $6.2 million in identifiable intangible assets. These intangible assets consist of student relationships and trade name intangibles. Acquired student relationships consist of those relationships in existence between SLC and the numerous students that carry student loan balances. This intangible asset is deemed to have a finite useful life of five years and will be amortized over this period. Trade name intangibles relate to trademarks, trade names and internet domains and content. This intangible asset is deemed to have an indefinite useful life and is therefore not subject to amortization.

The Company also recorded a $101 million indemnification asset. This asset reflects the discounted present value of payments expected to be received under Citibank s indemnification of student loan credit losses that would have been recoverable under certain student loan insurance policies which, as noted above, were commuted pursuant to an agreement entered into by SLC with the Company s consent immediately prior to the acquisition. The indemnification pertains only to loans in one of the three trusts. The initial value of the indemnification asset is based on the insured portion of expected credit losses reflected in the initial carrying value of the related loans. Indemnification payments related to student loan credit losses are subject to an overall cap of $166.8 million, consistent with the terms of the insurance policies which the indemnification serves to replace. As changes occur in the expected losses on the trust loans, the value of the remaining indemnification asset will be adjusted accordingly.

Table of Contents

3. Investment Securities

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

	February 28, 2011	November 30, 2010
U.S. Treasury securities	$ 1,807,964	$ 1,575,403
U.S. government agency securities	2,120,627	1,888,701
States and political subdivisions of states	43,616	51,774
Other securities:		
Credit card asset-backed securities of other issuers	743,475	1,031,112
Corporate debt securities[(1)]	505,600	507,896
Residential mortgage-backed securities	9,002	9,800
Other debt and equity securities	10,597	10,709
Total other securities	1,268,674	1,559,517
Total investment securities	$ 5,240,881	$ 5,075,395

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

The amortized cost, gross unrealized gains and losses, and fair value of available-for-sale and held-to-maturity investment securities are as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
At February 28, 2011				
Available-for-Sale Investment Securities[(1)]				
U.S Treasury securities	$ 1,823,524	$ 183	$ (16,293)	$ 1,807,414
U.S government agency securities	2,128,854	15	(8,242)	2,120,627
Credit card asset-backed securities of other issuers	731,042	12,434	(1)	743,475
Corporate debt securities	505,410	268	(78)	505,600
Total available-for-sale investment securities	$ 5,188,830	$ 12,900	$ (24,614)	$ 5,177,116
Held-to-Maturity Investment Securities[(2)]				
U.S. Treasury securities[(3)]	$ 550	$ 0	$ 0	$ 550
States and political subdivisions of states	43,616	130	(4,676)	39,070
Residential mortgage-backed securities	9,002	772	0	9,774
Other debt securities[(4)]	10,597	0	0	10,597
Total held-to-maturity investment securities	$ 63,765	$ 902	$ (4,676)	$ 59,991
At November 30, 2010				
Available-for-Sale Investment Securities[(1)]				
U.S Treasury securities	$ 1,576,094	$ 344	$ (1,585)	$ 1,574,853
U.S government agency securities	1,888,909	1,090	(1,298)	1,888,701
Credit card asset-backed securities of other issuers	1,017,183	13,983	(54)	1,031,112
Corporate debt securities	507,757	241	(102)	507,896
Equity securities	15	2	0	17

Total available-for-sale investment securities	$ 4,989,958	$ 15,660	$ (3,039)	$ 5,002,579
Held-to-Maturity Investment Securities(2)				
U.S. Treasury securities(3)	$ 550	$ 0	$ 0	$ 550
States and political subdivisions of states	51,774	281	(3,771)	48,284
Residential mortgage-backed securities	9,800	869	0	10,669
Other debt securities(4)	10,692	0	0	10,692
Total held-to-maturity investment securities	$ 72,816	$ 1,150	$ (3,771)	$ 70,195

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

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

(3) Amount represents securities pledged as collateral to a government-related merchant for which transaction settlement occurs beyond the normal 24-hour period.

(4) Included in other debt securities at February 28, 2011 and November 30, 2010 are commercial advances of $7.9 million for both periods related to the Company s Community Reinvestment Act strategies.

Table of Contents

The following table provides information about investment securities with aggregate gross unrealized losses and the length of time that individual investment securities have been in a continuous unrealized loss position as of February 28, 2011 and November 30, 2010 (dollars in thousands):

	Number of Securities in a Loss Position	Less than 12 months		More than 12 months	
		Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
At February 28, 2011					
Available-for-Sale Investment Securities					
U.S. Treasury securities	19	$ 1,364,442	$ 16,293	$ 0	$ 0
U.S. government agency securities	32	1,969,674	8,242	$ 0	$ 0
Credit card asset-backed securities of other issuers	5	40,931	1	$ 0	$ 0
Corporate debt securities	2	76,946	78	$ 0	$ 0
Held-to-Maturity Investment Securities					
State and political subdivisions of states	5	$ 9,016	$ 190	$ 22,084	$ 4,486
At November 30, 2010					
Available-for-Sale Investment Securities					
U.S. Treasury securities	17	$ 1,262,670	$ 1,585	$ 0	$ 0
U.S. government agency securities	18	$ 1,181,148	$ 1,298	$ 0	$ 0
Credit card asset-backed securities of other issuers	23	$ 238,646	$ 54	$ 0	$ 0
Corporate debt securities	5	$ 230,441	$ 102	$ 0	$ 0
Held-to-Maturity Investment Securities					
State and political subdivisions of states	4	$ 7,731	$ 239	$ 27,603	$ 3,532

During the three months ended February 28, 2011 and 2010, the Company received $342 million and $72.6 million, respectively, of proceeds related to maturities or redemptions of investment securities. In 2011, approximately $333 million of these proceeds related to maturities of credit card asset-backed securities of other issuers.

The Company records gains and losses on investment securities in other income when investments are sold or liquidated, when the Company believes an investment is other than temporarily impaired prior to the disposal of the investment, or in certain other circumstances. In the first quarter of 2011, the Company recorded a $141 thousand gain relating primarily to the sale of equity securities.

The Company records unrealized gains and losses on its available-for-sale investment securities in other comprehensive income. For the three months ended February 28, 2011 and 2010, the Company recorded net unrealized losses of $24.3 million ($15.2 million after tax) and net unrealized gains of $3.4 million ($2.2 million after tax), respectively, in other comprehensive income.

At February 28, 2011, the Company had $4.5 million of gross unrealized losses in a continuous loss position for more than 12 months on its held-to-maturity investment securities in states and political subdivisions of states, compared to $3.5 million of gross unrealized losses at November 30, 2010. The Company believes the unrealized loss on these investments is the result of changes in interest rates subsequent to the Company s acquisitions of these securities and that the reduction in value is temporary. The Company does not intend to sell these investments nor does it expect to be required to sell these investments before recovery of their amortized cost bases, but rather expects to collect all amounts due according to the contractual terms of these securities.

Table of Contents

Maturities of available-for-sale debt securities and held-to-maturity debt securities at February 28, 2011 are provided in the table below (dollars in thousands):

	One Year or Less	After One Year Through Five Years	After Five Years Through Ten Years	After Ten Years	Total
Available-for-sale Amortized Cost[1]					
U.S Treasury securities	$ 402,064	$ 1,421,460	$ 0	$ 0	$ 1,823,524
U.S government agency securities	430,657	1,698,197	0	0	2,128,854
Credit card asset-backed securities of other issuers	456,594	274,448	0	0	731,042
Corporate debt securities	153,064	352,346	0	0	505,410
Total available-for-sale investment securities	$ 1,442,379	$ 3,746,451	$ 0	$ 0	$ 5,188,830
Held-to-maturity Amortized Cost[2]					
U.S. Treasury securities	$ 550	$ 0	$ 0	$ 0	$ 550
State and political subdivisions of states	0	2,535	4,175	36,906	43,616
Residential mortgage-backed securities	0	0	0	9,002	9,002
Other debt securities	619	4,210	1,991	3,777	10,597
Total held-to-maturity investment securities	$ 1,169	$ 6,745	$ 6,166	$ 49,685	$ 63,765
Available-for-sale Fair Values[1]					
U.S Treasury securities	$ 402,223	$ 1,405,191	$ 0	$ 0	$ 1,807,414
U.S government agency securities	430,608	1,690,019	0	0	2,120,627
Credit card asset-backed securities of other issuers	458,445	285,030	0	0	743,475
Corporate debt securities	153,145	352,455	0	0	505,600
Total available-for-sale investment securities	$ 1,444,421	$ 3,732,695	$ 0	$ 0	$ 5,177,116
Held-to-maturity Fair Values[2]					
U.S. Treasury securities	$ 550	$ 0	$ 0	$ 0	$ 550
State and political subdivisions of states	0	2,549	4,291	32,230	39,070
Residential mortgage-backed securities	0	0	0	9,774	9,774
Other debt securities	619	4,210	1,991	3,777	10,597
Total held-to-maturity investment securities	$ 1,169	$ 6,759	$ 6,282	$ 45,781	$ 59,991

(1) Available-for-sale investment securities are reported at fair value.
(2) Held-to-maturity investment securities are reported at amortized cost.

Table of Contents

4. Loan Receivables

The Company has three portfolio segments: credit card loans, other consumer loans and purchased credit-impaired (PCI) student loans acquired in the SLC transaction (See Note 2: Business Combinations). Within these portfolio segments, the Company has classes of receivables which are depicted in the table below (dollars in thousands):

	February 28, 2011	November 30, 2010
Loans held for sale[(1)]	$ 766,661	$ 788,101
Loan portfolio:		
Credit card loans:		
Discover Card[(2)]	44,081,251	44,904,267
Discover business card	235,996	252,727
Total credit card loans	44,317,247	45,156,994
Other consumer loans:		
Personal loans	2,019,749	1,877,633
Private student loans	1,534,104	999,322
Other	14,083	14,363
Total other consumer loans	3,567,936	2,891,318
PCI student loans[(3)]	3,011,384	0
Total loan portfolio	50,896,567	48,048,312
Total loan receivables	51,663,228	48,836,413
Allowance for loan losses	(3,033,459)	(3,304,118)
Net loan receivables	$ 48,629,769	$ 45,532,295

(1) Amount represents federal student loans. At February 28, 2011 and November 30, 2010, $491.0 million and $500.2 million of federal student loan receivables, respectively, were pledged as collateral against a long-term borrowing.

(2) Amounts include $18.3 billion and $19.5 billion of underlying investors interest in trust debt at February 28, 2011 and November 30, 2010, respectively, and $15.1 billion and $14.9 billion in seller s interest at February 28, 2011 and November 30, 2010, respectively. See Note 5: Credit Card and Student Loan Securitization Activities for further information.

(3) Amount includes $3,007 million of loans pledged as collateral against the notes issued from the SLC securitization trusts. See Note 5: Credit Card and Student Loan Securitization Activities. The remaining $4.6 million not pledged as collateral represents loans eligible for reimbursement through an indemnification claim. SLC must purchase such loans from the trust before a claim may be filed.

Credit Quality Indicators. The Company regularly reviews its collection experience (including delinquencies and net charge-offs) in determining its allowance for loan losses. Credit card and closed-end consumer loan receivables are placed on nonaccrual status upon receipt of notification of the bankruptcy or death of a customer or suspected fraudulent activity on an account. In some cases of suspected fraudulent activity, loan receivables may resume accruing interest upon completion of the fraud investigation.

Table of Contents

Information related to the delinquencies and net charge-offs in the Company s loan portfolio, which excludes loans held for sale, is shown below by each class of loan receivables except for PCI student loans, which is shown later under the heading Purchased Credit-Impaired Loans (dollars in thousands):

Delinquent and Non-Accruing Loans:

	30-89 Days Delinquent	90 or More Days Delinquent	Total Past Due	90 or More Days Delinquent and Accruing	Total Non-accruing
At February 28, 2011					
Credit card loans:					
Discover card(1)	$ 703,504	$ 875,406	$ 1,578,910	$ 764,968	$ 250,827
Discover business card	3,997	6,984	10,981	6,423	1,107
Total credit card loans	707,501	882,390	1,589,891	771,391	251,934
Other consumer loans:					
Personal loans	15,661	8,643	24,304	7,880	2,633
Private student loans (excluding PCI)	9,384	1,697	11,081	1,697	95
Other	199	3,472	3,671	0	3,556
Total other consumer loans (excluding PCI)	25,244	13,812	39,056	9,577	6,284
Total loan receivables (excluding PCI)	$ 732,745	$ 896,202	$ 1,628,947	$ 780,968	$ 258,218
At November 30, 2010					
Total loan receivables(1)	$ 908,306	$ 993,618	$ 1,901,924	$ 853,757	$ 325,900

(1) Consumer credit card loans that are 90 or more days delinquent and accruing interest include $77.0 million and $35.0 million of loans accounted for as troubled debt restructurings at February 28, 2011 and November 30, 2010, respectively.

Net Charge-Offs:

	Net Charge-offs	Net Charge-off Rate
For the Three Months Ended February 28, 2011		
Credit card loans:		
Discover card	$ 661,243	5.93%
Discover business card	6,533	10.38%
Total credit card loans	667,776	5.96%
Other consumer loans:		
Personal loans	19,634	4.10%
Private student loans (excluding PCI)	924	0.29%
Other	34	0.97%
Total other consumer loans (excluding PCI)	20,592	1.38%
Net charge-offs as a percentage of total loans (excluding PCI)	$ 688,368	5.64%
Net charge-offs as a percentage of total loans (including PCI)	$ 688,368	5.42%

Table of Contents

Additionally, the Company reviews information related to the performance of the customer s account with the Company as well as information from credit bureaus, such as a FICO score, relating to the customer s broader credit performance. FICO scores are generally obtained at origination of the account and monthly or quarterly thereafter. The following table provides the most recent FICO scores available for the Company s customers as of February 28, 2011, as a percentage of each class of loan receivables:

	Credit Risk Profile by FICO Score	
	660 and Above	**Less than 660 or No Score**
Discover card	76%	24%
Discover business card	84%	16%
Private student loans (excluding PCI)	93%	7%
Personal loans	89%	11%

Allowance for Loan Losses. The Company maintains an allowance for loan losses at a level that is adequate to absorb probable losses inherent in the loan portfolio. The Company considers the collectibility of all amounts contractually due on its loan receivables, including those components representing interest and fees. Accordingly, the allowance for loan losses represents the estimated uncollectible principal, interest and fee components of loan receivables. The allowance is evaluated monthly for adequacy and is maintained through an adjustment to the provision for loan losses. Charge-offs of principal amounts of loans outstanding are deducted from the allowance and subsequent recoveries of such amounts increase the allowance. Charge-offs of loan balances representing unpaid interest and fees result in a reversal of interest and fee income, respectively.

For its credit card loan receivables, the Company bases its allowance for loan losses on several analyses that help estimate incurred losses as of the balance sheet date. While the Company s estimation process includes historical data and analysis, there is a significant amount of judgment applied in selecting inputs and analyzing the results produced by the models to determine the allowance. The Company uses a migration analysis to estimate the likelihood that a loan will progress through the various stages of delinquency. The loan balances used in the migration analysis represent all amounts contractually due and, as a result, the migration analysis captures principal, interest and fee components in estimating uncollectible accounts. The Company uses other analyses to estimate losses incurred on non-delinquent accounts. The considerations in these analyses include past performance, risk management techniques applied to various accounts, historical behavior of different account vintages, current economic conditions, recent trends in delinquencies, bankruptcy filings, account collection management, policy changes, account seasoning, loan volume and amounts, payment rates, and forecasting uncertainties. The Company does not identify individual loans for impairment, but instead estimates its allowance for credit card loan losses on a pooled basis, which includes loans that are delinquent and/or no longer accruing interest.

For its other consumer loans, the Company considers historical and forecasted estimates of incurred losses in estimating the related allowance for loan losses. The Company may also consider other factors, such as current economic conditions, recent trends in delinquencies and bankruptcy filings, account collection management, policy changes, account seasoning, loan volume and amounts, payment rates and forecasting uncertainties.

Table of Contents

The following table provides changes in the Company s allowance for loan losses for the three months ended February 28, 2011 and 2010 (dollars in thousands):

	For the Three Months Ended February 28, 2011	2010
Balance at beginning of period	$ 3,304,118	$ 1,757,899
Additions:		
Addition to allowance related to securitized receivables(1)	0	2,144,461
Provision for loan losses	417,709	1,387,206
Deductions:		
Charge-offs:		
Discover card	(792,632)	(1,140,485)
Discover business card	(7,386)	(19,286)
Total credit card loans	(800,018)	(1,159,771)
Personal loans	(20,050)	(24,080)
Federal student loans	0	(49)
Private student loans	(939)	(344)
Other	(35)	(8)
Total other consumer loans	(21,024)	(24,481)
Total charge-offs	(821,042)	(1,184,252)
Recoveries:		
Discover card	131,389	101,121
Discover business card	853	730
Total credit card loans	132,242	101,851
Personal loans	416	191
Private student loans	15	2
Other	1	2
Total other consumer loans	432	195
Total recoveries	132,674	102,046
Net charge-offs	(688,368)	(1,082,206)
Balance at end of period	$ 3,033,459	$ 4,207,360

(1) On December 1, 2009, upon adoption of FASB Statements No. 166 and 167, the Company recorded $2.1 billion allowance for loan losses related to newly consolidated and reclassified credit card loan receivables.

Net charge-offs of principal are recorded against the allowance for loan losses, as shown in the table above. Information regarding net charge-offs of interest and fee revenues on credit card and other consumer loans is as follows (dollars in thousands):

	For the Three Months Ended February 28, 2011	2010

Interest and fees accrued subsequently charged off, net of recoveries (recorded as a reduction of interest income)[(1)]	$ 188,221	$ 267,707
Fees accrued subsequently charged off, net of recoveries (recorded as a reduction to other income)[(1)]	$ 35,370	$ 92,088

(1) Beginning in 2011, net charge-offs of interest and fees include amounts related to other consumer loans. Prior to 2011 such amounts were not material.

14

Table of Contents

The following table provides additional detail of the Company s allowance for loan losses and recorded investment in its loan portfolio (which excludes loans held for sale) by impairment methodology (dollars in thousands):

	Credit Card	Personal Loans	Student Loans	Other Loans	Total
At February 28, 2011					
Allowance for loans evaluated for impairment as:					
Collectively impaired[1]	$ 2,733,992	$ 74,379	$ 19,153	$ 1,081	$ 2,828,605
Troubled debt restructurings[2]	204,854	0	0	0	204,854
Purchased credit-impaired[3]	0	0	0	0	0
Total allowance for loan losses	$ 2,938,846	$ 74,379	$ 19,153	$ 1,081	$ 3,033,459
Recorded investment in loans evaluated for impairment as:					
Collectively impaired[1]	$ 43,047,675	$ 2,019,749	$ 1,534,104	$ 14,083	$ 46,615,611
Troubled debt restructurings[2]	1,269,572	0	0	0	1,269,572
Purchased credit-impaired[3]	0	0	3,011,384	0	3,011,384
Total recorded investment	$ 44,317,247	$ 2,019,749	$ 4,545,488	$ 14,083	$ 50,896,567
At November 30, 2010					
Allowance for loans evaluated for impairment as:					
Collectively impaired[1]	$ 3,095,046	$ 76,087	$ 18,569	$ 574	$ 3,190,276
Troubled debt restructurings[2]	113,842	0	0	0	113,842
Purchased credit-impaired[3]	0	0	0	0	0
Total allowance for loan losses	$ 3,208,888	$ 76,087	$ 18,569	$ 574	$ 3,304,118
Recorded investment in loans evaluated for impairment as:					
Collectively impaired[1]	$ 44,851,650	$ 1,877,633	$ 999,322	$ 14,363	$ 47,742,968
Troubled debt restructurings[2]	305,344	0	0	0	305,344
Purchased credit-impaired[3]	0	0	0	0	0
Total recorded investment	$ 45,156,994	$ 1,877,633	$ 999,322	$ 14,363	$ 48,048,312

(1) Represents loans evaluated for impairment in accordance with ASC 450-20, *Loss Contingencies.*
(2) Represents loans evaluated for impairment in accordance with ASC 310-10, *Receivables,* which consists of modified loans accounted for as troubled debt restructurings. The unpaid principal balance of such loans was $1.1 billion at February 28, 2011. In the first quarter 2011, the Company began accounting for credit card loans modified through temporary hardship and external programs as troubled debt restructurings. The impact on the allowance for loan losses as a result of this change was not material. All loans accounted for as troubled debt restructurings have a related allowance for loan losses.
(3) Represents loans evaluated for impairment in accordance with ASC 310-30, *Receivables-Loans and Debt Securities Acquired with Deteriorated Credit Quality.*

Impaired Loans and Troubled Debt Restructurings. The Company has loan modification programs that provide for temporary or permanent hardship relief for credit card loans to borrowers experiencing financial hardship. The temporary hardship program primarily consists of a reduced minimum payment and an interest rate reduction, both lasting for a period no longer than twelve months. The permanent workout program involves changing the structure of the loan to a fixed payment loan with a maturity no longer than 60 months and reducing the interest rate on the loan. These programs do not normally provide for the forgiveness of unpaid principal, but may allow for the reversal of certain unpaid interest or fee assessments.

The Company also makes loan modifications for customers who request financial assistance through external sources, such as a consumer credit counseling agency (CCCA) program (referred to below as external programs). These loans typically receive a reduced interest rate but continue to be subject to the original minimum payment terms and do not normally include waiver of unpaid principal, interest or fees.

Table of Contents

Credit card loan receivables modified in a troubled debt restructuring are recorded at their present value with impairment measured as the difference between the loan balance and the discounted present value of cash flows expected to be collected. Consistent with the Company s measurement of impairment of modified loans on a pooled basis, the Company uses as its discount rate the average current annual percentage rate it applies to non-impaired credit card loans, similar to what would have applied to the pool of modified loans prior to impairment.

Interest income from loans accounted for as troubled debt restructurings is accounted for in the same manner as other accruing loans. Cash collections on these loans are allocated according to the same payment hierarchy methodology applied to loans that are not in such programs. Additional information about modified loans in the Company s credit card portfolio is shown below (dollars in thousands):

For the Three Months Ended February 28, 2011(1)	**Temporary and Permanent Programs**	**External Programs**
Average recorded investment in loans	$ 545,030	$ 741,654
Interest income recognized during the time within the period these loans were impaired(2)	$ 6,490	$ 15,740
Gross interest income that would have been recorded in accordance with the original terms(3)	$ 15,523	$ 2,529

For the Three Months Ended February 28, 2010	**Permanent Programs**
Average recorded investment in loans	$ 226,506
Interest income recognized during the time within the period these loans were impaired(2)	$ 642
Gross interest income that would have been recorded in accordance with the original terms(3)	$ 8,618

(1) In addition to loans modified through permanent workout programs, in the first quarter 2011, the Company began accounting for credit card loans modified through temporary hardship and external programs as troubled debt restructurings. The impact on the allowance for loan losses as a result of this change was not material.

(2) The Company does not separately track interest income on loans in modification programs. Amounts shown are estimated by applying an average interest rate to the average loans in the various modification programs.

(3) The Company does not separately track the amount of gross interest income that would have been recorded if the loans in modification programs had not been restructured and interest had instead been recorded in accordance with the original terms. Amounts shown are estimated by applying the difference between the average interest rate earned on non-impaired credit card loans and the average interest rate earned on loans in the modification programs to the average loans in the modification programs.

Purchased Credit-Impaired Loans. Purchased loans with evidence of credit deterioration since origination for which it is probable that not all contractually required payments will be collected are considered impaired at acquisition and are reported as PCI loans. The private student loans acquired in The Student Loan Corporation transaction comprise the Company s only PCI loans at February 28, 2011.

PCI loans are subject to interest income recognition on the basis of expected cash flows rather than contractual cash flows, pursuant to ASC Subtopic 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*. The Company accounts for the entire portfolio of acquired private student loans on the basis of expected cash flows. As the loan portfolio was acquired at a discount related, at least in part, to a decline in the credit quality of the loans since their origination, management has concluded it is probable that it will be unable to collect all contractually required payments due. However, the Company is unable to specifically identify which loans it will be unable to collect.

The PCI student loans were aggregated into pools based on common risk characteristics. Loans were grouped primarily on the basis of origination date as loans originated in a particular year generally reflect the application of common origination strategies and/or underwriting criteria. Because student loan payments are

Table of Contents

deferred while the student is in school and all loans in deferment are considered performing, the segmentation between performing and non-performing loans is not considered an accurate risk indicator and was therefore not used as a basis for segmentation. The loan pools match the composition of the securitization trusts in which the acquired loans are held. Each pool is accounted for as a single asset and each has a single composite interest rate, total contractual cash flows and total expected cash flows.

As of the December 31, 2010 acquisition date, the PCI student loans had an aggregate outstanding balance of approximately $3.8 billion, including accrued interest, and a fair value (initial carrying value) of approximately $3.1 billion. Of the $3.8 billion aggregate outstanding balance of loans acquired, loans with an aggregate outstanding balance of approximately $31 million were non-performing as of the acquisition date. PCI student loans had an unpaid principal balance of $3.6 billion and a related carrying amount of $3.0 billion as of February 28, 2011.

At the time of acquisition, these loans were recorded at fair value. The Company estimated the initial fair value of the acquired loans based on the cash flows expected to be collected, discounted at a market rate of interest. Expected cash flows used in the initial fair value measurement reflect the effect of expected losses and prepayments as well as anticipated changes in the interest rate indices applicable to these variable rate loans.

Interest income is recognized on each pool of PCI student loans through accretion on a level-yield basis over the life of the loan pool of the difference between the carrying amount of the loan pool and the expected cash flows (accretable yield). The initial estimate of the fair value of the PCI student loans includes the impact of expected credit losses, and therefore, no allowance for loan losses was recorded at the purchase date. The difference between contractually required cash flows and cash flows expected to be collected, as measured at the acquisition date and considering the impact of expected prepayments, is referred to as the non-accretable difference. Charge-offs are absorbed by the non-accretable difference and do not result in a charge to earnings. Consistent prepayment assumptions, which are based on management s consideration of loan pool characteristics, are applied to both the contractual cash flow and expected cash flow estimates.

The initial estimate of cash flows expected to be collected is updated each reporting period to reflect management s latest assumptions about expected credit losses and borrower prepayments, and interest rates in effect in the current period. To the extent expected credit losses increase after the date of acquisition, the Company must record an allowance for loan losses through a charge against earnings. There has not been any significant credit deterioration since the acquisition date, and therefore no allowance has been established for the PCI student loans at February 28, 2011. Changes in expected cash flows related to changes in prepayments or interest rate indices for variable rate loans generally are recorded prospectively as adjustments to interest income.

To the extent that a significant increase in cash flows due to lower expected losses is deemed probable, the Company will first reverse any previously established allowance for loan loss and then increase the amount of remaining accretable yield. The increase to yield would be recognized prospectively over the remaining life of the loan pool. An increase in the accretable yield would reduce the remaining non-accretable difference available to absorb subsequent charge-offs.

Certain PCI student loans contained in the pool are covered by an indemnification from Citibank for credit losses. The indemnified loans are presented along with all other PCI student loans and the related indemnification asset is recognized as a separate asset on the Company s condensed consolidated statement of financial condition. See Note 2: Business Combinations for a description of the indemnification asset.

Table of Contents

The following are contractually required payments receivable, cash flows expected to be collected and fair value as of the acquisition date (dollars in millions):

	At December 31, 2010
Contractually required payments receivable[1]	$ 5,673
Less: Non-accretable difference[2]	(846)
Cash flows expected to be collected	4,827
Less: Accretable yield[3]	(1,776)
Fair value of loans acquired	$ 3,051

(1) Amount represents principal and interest payments, both currently due and due in the future, adjusted for the effect of estimated prepayments.
(2) Charge-offs on acquired loans will be written off against non-accretable difference.
(3) Amount accreted into interest income over the estimated lives of the acquired loans.

The following table provides changes in accretable yield for the acquired loans for the period ended February 28, 2011 (dollars in millions):

	For the Three Months Ended February 28, 2011
Balance at beginning of period	$ 0
Acquisition of The Student Loan Corporation	1,776
Accretion into interest income	(39)
Balance at end of period	$ 1,737

Information related to the credit quality indicators of the PCI student loans in total (which includes loans not yet in repayment) is shown in the table below:

	At February 28, 2011
30 or more days delinquent	2.65%
90 or more days delinquent	0.85%
Net charge-off rate	1.06%

5. Credit Card and Student Loan Securitization Activities

Credit Card Securitization Activities

The Company accesses the term asset securitization market through the Discover Card Master Trust I (DCMT) and the Discover Card Execution Note Trust (DCENT), which are trusts into which credit card loan receivables are transferred (or, in the case of DCENT, into which beneficial interests in DCMT are transferred) and from which beneficial interests are issued to investors.

The DCMT structure consists of Class A, triple-A rated certificates and Class B, single-A rated certificates held by third parties. Credit enhancement is provided by the subordinated Class B certificates, cash collateral accounts, and more subordinated Series 2009-CE certificates that are held by a wholly-owned subsidiary of Discover Bank. The DCENT debt structure consists of four classes of securities (DiscoverSeries

Class A, B, C and D notes), with the most senior class generally receiving a triple-A rating. In this structure, in order to issue senior, higher rated classes of notes, it is necessary to obtain the appropriate amount of credit enhancement, generally through the issuance of junior, lower rated or more highly subordinated classes of notes. The majority of these more highly subordinated classes of notes are held by subsidiaries of Discover Bank. In addition, there is another series of certificates (Series 2009-SD) issued by DCMT which provides increased excess spread levels to

Table of Contents

all other outstanding securities of the trusts. The Series 2009-SD certificates are held by a wholly-owned subsidiary of Discover Bank. In January 2010, the Company increased the size of the Class D (2009-1) note and Series 2009-CE certificate to further support the more senior securities of the trusts. The Company was not contractually required to provide this incremental level of credit enhancement but did so pursuant to the trusts governing documents in order to maintain the credit ratings of the securities issued by the trusts and to preserve the Company s viability as a participant in the credit card asset-backed securitization markets. The credit-related risk of loss associated with trust assets as of the balance sheet date to which the Company is exposed through the retention of these subordinated interests is fully captured in the allowance for loan losses recorded by the Company.

The Company s credit card securitizations are accounted for as secured borrowings and the trusts are treated as consolidated subsidiaries of the Company. The Company s retained interests in the assets of the trusts, principally consisting of investments in DCMT certificates and DCENT notes held by subsidiaries of Discover Bank, constitute intercompany positions which are eliminated in the preparation of the Company s condensed consolidated statement of financial condition.

Upon transfer of credit card loan receivables to the trust, the receivables and certain cash flows derived from them become restricted for use in meeting obligations to the trusts creditors. The trusts have ownership of cash balances that also have restrictions, the amounts of which are reported in restricted cash for securitization investors. Investment of trust cash balances is limited to investments that are permitted under the governing documents of the trusts and which have maturities no later than the related date on which funds must be made available for distribution to trust investors. With the exception of the seller s interest in trust receivables, the Company s interests in trust assets are generally subordinate to the interests of third-party investors and, as such, may not be realized by the Company if needed to absorb deficiencies in cash flows that are allocated to the investors in the trusts debt. The carrying values of these restricted assets, which are presented on the Company s condensed consolidated statement of financial condition as relating to securitization activities, are shown in the table below (dollars in thousands):

	February 28, 2011	November 30, 2010
Cash collateral accounts[(1)]	$ 345,000	$ 459,474
Collections and interest funding accounts	169,921	904,284
Restricted cash for securitization investors	514,921	1,363,758
Investors interests held by third-party investors	13,694,740	14,921,057
Investors interests held by wholly owned subsidiaries of Discover Bank	4,595,532	4,608,210
Seller s interest	15,110,509	14,923,722
Loan receivables restricted for securitization investors[(2)]	33,400,781	34,452,989
Allowance for loan losses allocated to securitized loan receivables[(2)]	2,207,480	2,431,399
Net loan receivables	31,193,301	32,021,590
Other	23,872	24,083
Carrying value of assets of consolidated variable interest entities	$ 31,732,094	$ 33,409,431

(1) Amount pledged as collateral against a long-term borrowing.

(2) The Company maintains its allowance for loan losses at an amount sufficient to absorb probable losses inherent in all loan receivables, which includes all loan receivables in the trusts. Therefore, credit risk associated with the transferred receivables is fully reflected on the Company s balance sheet in accordance with GAAP.

The debt securities issued by the consolidated VIEs are subject to credit, payment and interest rate risks on the transferred credit card loan receivables. To protect investors, the securitization structures include certain features that could result in earlier-than-expected repayment of the securities. The primary investor protection feature relates to the availability and adequacy of cash flows in the securitized pool of receivables to meet contractual requirements. Insufficient cash flows would trigger the early repayment of the securities. This is referred to as the economic early amortization feature.

19

Table of Contents

Investors are allocated cash flows derived from activities related to the accounts comprising the securitized pool of receivables, the amounts of which reflect finance charges billed, certain fee assessments, allocations of merchant discount and interchange, and recoveries on charged-off accounts. From these cash flows, investors are reimbursed for charge-offs occurring within the securitized pool of receivables and receive a contractual rate of return and Discover Bank is paid a servicing fee as servicer. Any cash flows remaining in excess of these requirements are reported to investors as excess spread. An excess spread rate of less than 0% for a contractually specified period, generally a three-month average, would trigger an economic early amortization event. In such an event, the Company would be required to seek immediate sources of replacement funding. Apart from the restricted assets related to securitization activities, the investors and the securitization trusts have no recourse to the Company s other assets or credit for a shortage in cash flows.

The Company is required to maintain a contractual minimum level of receivables in the trust in excess of the face value of outstanding investors interests. This excess is referred to as the minimum seller s interest requirement. The required minimum seller s interest in the pool of trust receivables, which is included in credit card loan receivables restricted for securitization investors, is set at approximately 7% in excess of the total investors interests (which includes interests held by third parties as well as those certificated interests held by the Company). If the level of receivables in the trust was to fall below the required minimum, the Company would be required to add receivables from the unrestricted pool of receivables, which would increase the amount of credit card loan receivables restricted for securitization investors. A decline in the amount of the excess seller s interest could occur if balance repayments and charge-offs exceeded new lending on the securitized accounts or as a result of changes in total outstanding investors interests. If the Company could not add enough receivables to satisfy the requirement, an early amortization (or repayment) of investors interests would be triggered.

Another feature of the Company s securitization structure that is designed to protect investors interests from loss, which is applicable only to the notes issued from DCENT, is a reserve account funding requirement in which excess cash flows generated by the transferred loan receivables are held at the trust. This funding requirement is triggered when DCENT s three-month average excess spread rate decreases to below 4.50%, with increasing funding requirements as excess spread levels decline below preset levels to 0%.

In addition to performance measures associated with the transferred credit card loan receivables, there are other events or conditions which could trigger an early amortization event. As of February 28, 2011, no economic or other early amortization events have occurred.

The tables below provide information concerning investors interests and related excess spreads at February 28, 2011 (dollars in thousands):

	Investors Interests(1)	**# of Series Outstanding**
Discover Card Master Trust I	$ 5,938,317	10
Discover Card Execution Note Trust (DiscoverSeries notes)	12,351,955	26
Total investors interests	$ 18,290,272	36

(1) Investors interests include third-party interests and subordinated interests held by wholly-owned subsidiaries of Discover Bank.

	3-Month Rolling Average Excess Spread(1)(2)
Group excess spread percentage	14.40%
DiscoverSeries excess spread percentage	14.01%

(1) DCMT certificates refer to the higher of the Group excess spread or their applicable series excess spread (not shown) and DiscoverSeries notes refer to the higher of the Group or DiscoverSeries excess spread in assessing whether an economic early amortization has been triggered.
(2) Discount Series (DCMT 2009-SD) makes principal collections available for reallocation to other series to cover shortfalls in interest and servicing fees and to reimburse charge-offs. Three-month rolling average excess spread rates reflected the availability of these additional collections.

20

Table of Contents

The Company continues to own and service the accounts that generate the loan receivables held by the trusts. Discover Bank receives servicing fees from the trusts based on a percentage of the monthly investor principal balance outstanding. Although the fee income to Discover Bank offsets the fee expense to the trusts and thus is eliminated in consolidation, failure to service the transferred loan receivables in accordance with contractual requirements could lead to a termination of the servicing rights and the loss of future servicing income.

Student Loan Securitization Activities

The Company s student loan securitizations are accounted for as secured borrowings and the trusts are treated as consolidated subsidiaries of the Company. Trust receivables underlying third-party investors interests are recorded in other loan receivables, and the related debt issued by the trusts is reported in long-term borrowings. The assets of the Company s consolidated VIEs are restricted from being sold or pledged as collateral for other borrowings and the cash flows from these restricted assets may be used only to pay obligations of the trust.

Under terms of all the trust arrangements, the Company has the option, but not the obligation, to provide financial support, but has never provided such support. A substantial portion of the credit risk associated with the securitized loans has been transferred to third parties under private credit insurance or indemnification. See Note 2: Business Combinations.

The carrying values of these restricted assets, which are presented on the Company s condensed consolidated statement of financial condition as relating to securitization activities, are shown in the table below (dollars in thousands):

	February 28, 2011
Restricted cash for securitization investors	$ 161,153
Student loan receivables at fair value	$ 3,006,809
Other assets	$ 10,549

6. Deposits

The Company offers its deposit products, including certificates of deposit, money market accounts, online savings accounts and Individual Retirement Account (IRA) certificates of deposit to customers through two channels: (i) through direct marketing, internet origination and affinity relationships (direct-to-consumer deposits); and (ii) indirectly through contractual arrangements with securities brokerage firms (brokered deposits). As of February 28, 2011 and November 30, 2010, the Company had approximately $21.8 billion and $20.6 billion, respectively, of direct-to-consumer deposits and approximately $12.9 billion and $13.7 billion, respectively, of brokered deposits.

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

	February 28, 2011	November 30, 2010
Certificates of deposit in amounts less than $100,000(1)	$ 19,329,927	$ 19,797,420
Certificates of deposit from amounts of $100,000(1) to less than $250,000(1)	4,765,285	4,626,792
Certificates of deposit in amounts of $250,000(1) or greater	1,152,040	1,146,843
Savings deposits, including money market deposit accounts	9,481,077	8,738,784
Total interest-bearing deposits	$ 34,728,329	$ 34,309,839
Average annual interest rate	2.81%	3.12%

(1) $100,000 represents the basic insurance amount previously covered by the FDIC. Effective July 21, 2010, the basic insurance per depositor was permanently increased to $250,000.

21

Table of Contents

At February 28, 2011, certificates of deposit maturing during the remainder of 2011, over the next four years and thereafter were as follows (dollars in thousands):

Year	Amount
2011	$ 8,136,884
2012	$ 7,570,052
2013	$ 4,878,707
2014	$ 2,036,652
2015	$ 1,804,175
Thereafter	$ 820,782

7. Long-Term Borrowings

Long-term borrowings consist of borrowings and capital leases having original maturities of one year or more. The following table provides a summary of the Company s long-term borrowings and weighted average interest rates on balances outstanding at period end (dollars in thousands):

	February 28, 2011		November 30, 2010			
	Outstanding	Interest Rate	Outstanding	Interest Rate	Interest Rate Terms	Maturity
Securitized Debt						
Fixed rate asset-backed securities (including discount of $1,521)	$ 2,598,479	5.47%	$ 2,598,343	5.47%	5.10% to 5.65% fixed	Various April 2011 September 2017
Floating rate asset-backed securities	9,094,740	0.84%	10,621,057	0.75%	1-month LIBOR(1) + 3 to 130 basis points	Various March 2011 September 2015
Floating rate asset-backed securities	1,250,000	0.64%	1,250,000	0.63%	3-month LIBOR(1) + 34 basis points	December 2012
Floating rate asset-backed securities and other borrowings	750,000	0.95%	450,000	0.98%	Commercial Paper rate + 70 basis points	Various June 2011 April 2013
Total Discover Card Master Trust I and Discover Card Execution Note Trust	13,693,219		14,919,400			
Floating rate asset-backed securities (including discount of $264,312)	1,542,120	0.49%	0		3-month LIBOR(1) + 7 to 45 basis points	Various April 2018 July 2036(2)
Floating rate asset-backed securities (including discount of $4,303)	693,883	4.25%	0		Prime rate +100 basis points	June 2031(2)
Floating rate asset-backed securities (including premium of $3,314)	183,841	4.00%	0		Prime rate + 75 basis points	July 2042(2)
Floating rate asset-backed securities (including premium of $7,535)	417,955	3.77%	0		1-month LIBOR(1) + 350 basis points	July 2042(2)
Total SLC Private Student Loan Trusts	2,837,799		0			
Total Long-Term Borrowings owed to securitization investors	16,531,018		14,919,400			
Discover Financial Services (Parent Company)						
Fixed rate senior notes due 2017						
Principal value (including discount of $512)	399,488	6.45%	399,467	6.45%	6.45% fixed	June 2017
Fair value adjustment(3)	(19,995)		(7,888)			
Net book value	379,493		391,579			

Fixed rate senior notes due 2019	400,000	10.25%	400,000	10.25%	10.25% fixed	July 2019
Discover Bank						
Subordinated bank notes due 2019 (including discount of $1,573)	698,427	8.70%	698,382	8.70%	8.70% fixed	November 2019
Subordinated bank notes due 2020 (including discount of $3,161)	496,839	7.00%	496,753	7.00%	7.00% fixed	April 2020
Floating rate secured borrowings	0	0.00%	93,980	0.79%	Commercial Paper rate + 50 basis points	December 2010
Floating rate secured borrowings	0	0.00%	212,336	0.70%	1-month LIBOR(1) + 45 basis points	December 2010
Floating rate secured borrowings(4)	484,198	0.74%	492,910	0.66%	Commercial Paper rate + 50 basis points	August 2013(4)
Capital lease obligations	195	6.26%	388	6.26%	6.26% fixed	Various
Total long-term borrowings	$ 18,990,170		$ 17,705,728			

(1) London Interbank Offered Rate (LIBOR).

(2) Repayment of this debt is dependent upon the timing of principal and interest payments on the underlying student loans. The dates shown represent final maturity dates.

(3) The Company uses interest rate swaps to hedge this long-term borrowing against changes in fair value attributable to changes in LIBOR. See Note 14: Derivatives and Hedging Activities.

(4) Under a program established by the U.S. Department of Education, this loan facility was entered into to fund certain federal student loans, which were held for sale at February 28, 2011 and November 30, 2010. Principal and interest payments on the underlying student loans will reduce the balance of the secured borrowing over time, with final maturity in August 2013. However, upon sale of the loans, this loan facility will be repaid.

Table of Contents

The Company has an unsecured credit agreement that is effective through May 2012. The agreement provides for a revolving credit commitment of up to $2.4 billion (of which the Company may borrow up to 30% and Discover Bank may borrow up to 100% of the total commitment). As of February 28, 2011, the Company had no outstanding balances due under the facility. The credit agreement provides for a commitment fee on the unused portion of the facility, which can range from 0.07% to 0.175% depending on the index debt ratings. Loans outstanding under the credit facility bear interest at a margin above the Federal Funds rate, LIBOR, the EURIBOR or the Euro Reference rate. The terms of the credit agreement include various affirmative and negative covenants, including financial covenants related to the maintenance of certain capitalization and tangible net worth levels, and certain double leverage, delinquency and Tier 1 capital to managed loans ratios. The credit agreement also includes customary events of default with corresponding grace periods, including, without limitation, payment defaults, cross-defaults to other agreements evidencing indebtedness for borrowed money and bankruptcy-related defaults. The commitment may be terminated upon an event of default.

The Company also has access to committed undrawn capacity through private securitizations to support the funding of its credit card loan receivables. As of February 28, 2011, the total commitment of secured credit facilities through private providers was $5.5 billion, of which $0.8 billion had been used and was included in long-term borrowings at February 28, 2011. Access to the unused portions of the secured credit facilities expires in 2012 and 2013. Borrowings outstanding under each facility bear interest at a margin above LIBOR or the asset-backed commercial paper costs of each individual conduit provider. The terms of each agreement provide for a commitment fee to be paid on the unused capacity, and include various affirmative and negative covenants, including performance metrics and legal requirements similar to those required to issue any term securitization transaction.

8. Income Taxes

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

	For the Three Months Ended February 28,	
	2011	2010
Current:		
U.S. federal	$ 138,848	$ 37,247
U.S. state and local	2,407	(3,970)
International	1,345	471
Total	142,600	33,748
Deferred:		
U.S. federal	108,629	(92,799)
U.S. state and local	3,891	(8,119)
International	(9)	0
Total	112,511	(100,918)
Income tax expense (benefit)	$ 255,111	$ (67,170)

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

	For the Three Months Ended February 28,	
	2011	2010
U.S. federal statutory income tax rate	35.0%	35.0%
U.S. state and local income taxes, net of U.S. federal income tax benefits	0.9	5.8
Other	(0.5)	(1.5)
Effective income tax rate	35.4%	39.3%

Table of Contents

During the first quarter 2011, the Company decreased the amount of unrecognized tax benefits by $17.6 million as a result of the settlement of certain state examination issues and receiving confirmation of a state s treatment on a position that was uncertain. The Company is under continuous examination by the IRS and the tax authorities for various states. The tax years under examination vary by jurisdiction; for example, the current IRS examination covers 2006 through June 30, 2007. The Company regularly assesses the likelihood of additional assessments in each of the taxing jurisdictions resulting from these and subsequent years examinations. As part of its audit of 1999 through 2005, the IRS has proposed additional tax assessments. In August 2010, the Company filed an appeal with the IRS to protest the proposed adjustments. The Company does not anticipate that resolution of this matter will occur within the next twelve months as it is in the preliminary stage. Due to the uncertainty of the outcome of the appeal, the Company is unable to determine if the total amount of unrecognized tax benefits will significantly increase or decrease within the next twelve months. However, the Company believes that its reserve is sufficient to cover any penalties and interest that would result in an increase in federal taxes due.

9. Earnings Per Share

The following table presents the calculation of basic and diluted EPS (dollars in thousands, except per share amounts):

	For the Three Months Ended February 28,	
	2011	**2010**
Numerator:		
Net income (loss)	$ 464,892	$ (103,538)
Preferred stock dividends	0	(15,307)
Preferred stock accretion	0	(3,388)
Net income (loss) available to common stockholders	464,892	(122,233)
Income allocated to participating securities[(1)]	(5,464)	0
Net income (loss) allocated to common stockholders	$ 459,428	$ (122,233)
Denominator:		
Weighted average shares of common stock outstanding	545,052	543,422
Effect of dilutive common stock equivalents	489	0
Weighted average shares of common stock outstanding and common stock equivalents	545,541	543,422
Basic earnings per share	$ 0.84	$ (0.22)
Diluted earnings per share	$ 0.84	$ (0.22)

(1) For the three months ended February 28, 2010, no portion of the net loss incurred by the Company was allocated to participating securities as they do not participate in net losses incurred by the Company.

The following securities were considered anti-dilutive and therefore were excluded from the denominator in the computation of diluted EPS (shares in thousands):

	For the Three Months Ended February 28,	
	2011	**2010**
Unexercised stock options	554	4,081
Warrant issued to the U.S. Treasury	0	7,736

Table of Contents

10. Capital Adequacy

The Company is subject to capital adequacy guidelines of the Federal Reserve, and Discover Bank (the Bank), the Company s main banking subsidiary, is subject to various regulatory capital requirements as administered by the Federal Deposit Insurance Corporation (the FDIC). Failure to meet minimum capital requirements can result in the initiation of certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the financial position and results of the Company and the Bank. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance sheet items, as calculated under regulatory accounting practices. Capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (as defined in the regulations) of total risk-based capital and Tier 1 capital to risk-weighted assets, and of Tier 1 capital to average assets. As of February 28, 2011, the Company and the Bank met all capital adequacy requirements to which they were subject.

Under regulatory capital requirements, the Company and the Bank must maintain minimum levels of capital that are dependent upon the risk-weighted amount or average level of the financial institution s assets, specifically (a) 8% to 10% of total risk-based capital to risk-weighted assets (total risk-based capital ratio), (b) 4% to 6% of Tier 1 capital to risk-weighted assets (Tier 1 risk-based capital ratio) and (c) 4% to 5% of Tier 1 capital to average assets (Tier 1 leverage ratio). To be categorized as well-capitalized, the Company and the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table below. As of February 28, 2011, the Company and the Bank met the requirements for well-capitalized status and there have been no conditions or events that management believes have changed the Company s or the Bank s category.

The following table shows the actual capital amounts and ratios of the Company and the Bank as of February 28, 2011 and November 30, 2010 and comparisons of each to the regulatory minimum and well-capitalized requirements (dollars in thousands):

	Actual		Minimum Capital Requirements		Capital Requirements To Be Classified as Well-Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
February 28, 2011:						
Total capital (to risk-weighted assets)						
Discover Financial Services	$ 8,442,146	16.0%	$ 4,229,495	≥8.0%	$ 5,286,869	≥10.0%
Discover Bank	$ 8,143,844	15.7%	$ 4,161,583	≥8.0%	$ 5,201,978	≥10.0%
Tier 1 capital (to risk-weighted assets)						
Discover Financial Services	$ 6,556,730	12.4%	$ 2,114,747	≥4.0%	$ 3,172,121	≥6.0%
Discover Bank	$ 6,268,908	12.1%	$ 2,080,791	≥4.0%	$ 3,121,187	≥6.0%
Tier 1 capital (to average assets)						
Discover Financial Services	$ 6,556,730	10.2%	$ 2,559,973	≥4.0%	$ 3,199,967	≥5.0%
Discover Bank	$ 6,268,908	9.9%	$ 2,522,435	≥4.0%	$ 3,153,044	≥5.0%
November 30, 2010:						
Total capital (to risk-weighted assets)						
Discover Financial Services	$ 7,946,619	15.9%	$ 3,989,689	≥8.0%	$ 4,987,111	≥10.0%
Discover Bank	$ 7,817,205	15.9%	$ 3,923,344	≥8.0%	$ 4,904,180	≥10.0%
Tier 1 capital (to risk-weighted assets)						
Discover Financial Services	$ 6,095,000	12.2%	$ 1,994,844	≥4.0%	$ 2,992,266	≥6.0%
Discover Bank	$ 5,975,824	12.2%	$ 1,961,672	≥4.0%	$ 2,942,508	≥6.0%
Tier 1 capital (to average assets)						
Discover Financial Services	$ 6,095,000	9.9%	$ 2,464,324	≥4.0%	$ 3,080,406	≥5.0%
Discover Bank	$ 5,975,824	9.8%	$ 2,431,610	≥4.0%	$ 3,039,512	≥5.0%

Table of Contents

11. Commitments, Contingencies and Guarantees

Lease commitments. The Company leases various office space and equipment under capital and non-cancelable operating leases which expire at various dates through 2021. At February 28, 2011, future minimum payments on leases with original terms in excess of one year consist of the following (dollars in thousands):

	Capitalized Leases	Operating Leases
2011	$ 197	$ 6,323
2012	0	9,906
2013	0	8,299
2014	0	6,986
2015	0	6,133
Thereafter	0	14,460
Total minimum lease payments	197	$ 52,107
Less: Amount representing interest	2	
Present value of net minimum lease payments	$ 195	

Unused commitments to extend credit. At February 28, 2011, the Company had unused commitments to extend credit for consumer loans and commercial loans of approximately $165 billion. Such commitments arise primarily from agreements with customers for unused lines of credit on certain credit cards and certain other consumer loan products, provided there is no violation of conditions in the related agreement. These commitments, substantially all of which the Company can terminate at any time and which do not necessarily represent future cash requirements, are periodically reviewed based on account usage, customer creditworthiness and loan qualification.

Commitments to purchase private student loans. Prior to its acquisition by the Company on December 31, 2010, SLC had an agreement with Citibank providing for the origination and servicing of private student loans. Citibank would originate and fund such loans and, after final disbursement, SLC would purchase the loans from Citibank. This agreement between SLC and Citibank was terminated on December 31, 2010, at which time the Company entered into an agreement with Citibank to purchase (i) eligible private student loans originated by Citibank prior to December 31, 2010 and (ii) any private student loans originated by Citibank on or after December 31, 2010 under a new loan origination agreement entered into between Citibank and SLC on December 31, 2010. The Company has agreed to purchase the loans at the funded amount (plus accrued interest and less any capitalized fees for any loans first funded prior to December 31, 2010) and, for any loans first funded by Citibank on December 31, 2010 or later, pay a premium equal to 0.125%. The Company completed the first purchase of loan participations under this agreement on January 3, 2011. The agreement expires on December 31, 2011, although the Company is permitted to extend the agreement for up to two additional six-month terms, or through December 31, 2012. Although the agreement does not set forth a minimum or maximum amount of loans to be purchased, the Company must purchase all eligible loans originated by Citibank, which the Company estimates to be $0.5 billion to $1 billion through the end of the first term, or December 31, 2011. As of February 28, 2011, the Company had committed to purchase $14 million of loans under this agreement.

Secured Borrowing Representations and Warranties. As part of the Company s financing activities, the Company provides representations and warranties that certain assets pledged as collateral in secured borrowing arrangements conform to specified guidelines. Due diligence is performed by the Company which is intended to ensure that asset guideline qualifications are met. If the assets pledged as collateral do not meet certain conforming guidelines, the Company may be required to replace, repurchase or sell such assets. In its credit card securitization activities, the Company would replace nonconforming receivables through the allocation of excess seller s interest or from additional transfers from the unrestricted pool of receivables. If the Company could not

Table of Contents

add enough receivables to satisfy the requirement, an early amortization (or repayment) of investors interests would be triggered. In its student loan securitizations, the Company would generally repurchase the loans from the trust at the outstanding principal amount plus interest.

The maximum potential amount of future payments the Company could be required to make would be equal to the current outstanding balances of third-party investor interests in credit card asset-backed securities plus the principal amount of any other outstanding secured borrowings. The Company has recorded substantially all of the maximum potential amount of future payments in long-term borrowings on the Company s statement of financial condition. The Company has not recorded any incremental contingent liability associated with its secured borrowing representations and warranties. Management believes that the probability of having to replace, repurchase or sell assets pledged as collateral under secured borrowing arrangements, including an early amortization event, is low.

Guarantees. The Company has obligations under certain guarantee arrangements, including contracts and indemnification agreements, which contingently require the Company to make payments to the guaranteed party based on changes in an underlying asset, liability or equity security of a guaranteed party, rate or index. Also included as guarantees are contracts that contingently require the Company to make payments to a guaranteed party based on another entity s failure to perform under an agreement. The Company s use of guarantees is disclosed below by type of guarantee.

Counterparty Settlement Guarantees. Diners Club and DFS Services LLC, on behalf of PULSE, have various counterparty exposures, which are listed below.

Merchant Guarantee. Diners Club has entered into contractual relationships with certain international merchants, which generally include travel-related businesses, for the benefit of all Diners Club licensees. The licensees hold the primary liability to settle the transactions of their customers with these merchants. However, Diners Club retains a counterparty exposure if a licensee fails to meet its financial payment obligation to one of these merchants.

ATM Guarantee. PULSE entered into contractual relationships with certain international ATM acquirers in which DFS Services LLC retains counterparty exposure if an issuer fails to fulfill its settlement obligation.

The maximum potential amount of future payments related to such contingent obligations is dependent upon the transaction volume processed between the time a counterparty defaults on its settlement and the time at which the Company disables the settlement of any further transactions for the defaulting party, which could be up to one month depending on the type of guarantee/counterparty. However, there is no limitation on the maximum amount the Company may be liable to pay. The actual amount of the potential exposure cannot be quantified as the Company cannot determine whether particular counterparties will fail to meet their settlement obligations. While the Company has some contractual remedies to offset these counterparty settlement exposures (such as letters of credit or pledged deposits), in the event that all licensees and/or issuers were to become unable to settle their transactions, the Company estimates its maximum potential counterparty exposures to these settlement guarantees, based on historical transaction volume of up to one month, would be as follows:

	February 28, 2011
Diners Club:	
Merchant guarantee (in millions)	$ 261
PULSE:	
ATM guarantee (in thousands)	$ 910

With regard to the counterparty settlement guarantees discussed above, the Company believes that the estimated amounts of maximum potential future payments are not representative of the Company s actual

Table of Contents

potential loss exposure given Diners Club s and PULSE s insignificant historical losses from these counterparty exposures. As of February 28, 2011, the Company had not recorded any contingent liability in the condensed consolidated financial statements for these counterparty exposures, and management believes that the probability of any payments under these arrangements is low.

The Company also retains counterparty exposure for the obligations of Diners Club licensees that participate in the Citishare network, an electronic funds processing network. Through the Citishare network, Diners Club customers are able to access certain ATMs directly connected to the Citishare network. The Company s maximum potential future payment under this counterparty exposure is limited to $15 million, subject to annual adjustment based on actual transaction experience. However, as of February 28, 2011, the Company had not recorded any contingent liability in the condensed consolidated financial statements related to this counterparty exposure, and management believes that the probability of any payments under this arrangement is low.

Merchant Chargeback Guarantees. The Company issues and permits third parties to issue payment cards and owns and operates the Discover Network. The Company is contingently liable for certain transactions processed on the Discover Network in the event of a dispute between the payment card customer and a merchant. The contingent liability arises if the disputed transaction involves a merchant or merchant acquirer with whom the Discover Network has a direct relationship. If a dispute is resolved in the customer s favor, the Discover Network will credit or refund the disputed amount to the Discover Network card issuer, who in turn credits its customer s account. The Discover Network will then charge back the disputed amount of the payment card transaction to the merchant or merchant acquirer, where permitted by the applicable agreement, to seek recovery of amounts already paid to the merchant for payment card transactions. If the Discover Network is unable to collect the amount subject to dispute from the merchant or merchant acquirer (e.g., in the event of merchant default or dissolution) or after expiration of the time period for chargebacks in the applicable agreement, the Discover Network will bear the loss for the amount credited or refunded to the customer. In most instances, a loss by the Discover Network is unlikely to arise in connection with payments on card transactions because most products or services are delivered when purchased, and credits are issued by merchants on returned items in a timely fashion, thus minimizing the likelihood of cardholder disputes with respect to amounts paid by the Discover Network. However, where the product or service is not scheduled to be provided to the customer until a later date following the purchase, the likelihood of a contingent payment obligation by the Discover Network increases.

The maximum potential amount of obligations of the Discover Network arising as a result of such contingent obligations is estimated to be the portion of the total Discover Network transaction volume processed to date for which timely and valid disputes may be raised under applicable law and relevant issuer and customer agreements. There is no limitation on the maximum amount the Company may be liable to pay to issuers. However, the Company believes that such amount is not representative of the Company s actual potential loss exposure based on the Company s historical experience. The actual amount of the potential exposure cannot be quantified as the Company cannot determine whether the current or cumulative transaction volumes may include or result in disputed transactions.

The table below summarizes certain information regarding merchant chargeback guarantees:

	For the Three Months Ended February 28, 2011	2010
Losses related to merchant chargebacks (in thousands)	$ 921	$ 757
Aggregate sales transaction volume (in millions)(1)	$ 25,787	$ 23,996

(1) Represents period transactions processed on the Discover Network to which a potential liability exists which, in aggregate, can differ from credit card sales volume.

Table of Contents

The Company has not recorded any contingent liability in the condensed consolidated financial statements for merchant chargeback guarantees on February 28, 2011 and November 30, 2010. The Company mitigates the risk of potential loss exposure by withholding settlement from merchants, obtaining third party guarantees, or obtaining escrow deposits or letters of credit from certain merchant acquirers or merchants that are considered higher risk due to various factors such as time delays in the delivery of products or services. The table below provides information regarding settlement withholdings and escrow deposits, which are recorded in interest-bearing deposit accounts, and accrued expenses and other liabilities on the Company s condensed consolidated statements of financial condition (in thousands):

	February 28, 2011	November 30, 2010
Settlement withholdings and escrow deposits	$ 37,022	$ 30,483

12. Litigation

In the normal course of business, from time to time, the Company has been named as a defendant in various legal actions, including arbitrations, class actions, and other litigation, arising in connection with its activities. Certain of the actual or threatened legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. The Company contests liability and/or the amount of damages as appropriate in each pending matter. In accordance with applicable accounting guidance, the Company establishes an accrued liability for legal and regulatory matters when those matters present loss contingencies which are both probable and estimable. In such cases, there may be an exposure to loss in excess of any amounts accrued. The Company believes the estimate of the aggregate range of reasonably possible losses (meaning those losses the likelihood of which is more than remote but less than likely) in excess of the reserves that the Company has established for legal proceedings is from $0 to $40 million. This estimated range of reasonably possible losses is based upon currently available information for those proceedings in which the Company is involved, takes into account the Company s best estimate of such losses for those matters for which an estimate can be made, and does not represent the Company s maximum potential loss exposure. The legal proceedings underlying the estimated range will change from time to time and actual results may vary significantly from the estimate.

The Company s estimated range above involves significant judgment, given the varying stages of the proceedings, the existence of numerous yet to be resolved issues, the breadth of the claims (often spanning multiple years and, in some cases, a wide range of business activities), unspecified damages and/or the novelty of the legal issues presented. The outcome of pending matters could be material to the Company s consolidated financial condition, operating results and cash flows for a particular future period, depending on, among other things, the level of the Company s income for such period, and could adversely affect the Company s reputation.

The Company has historically relied on the arbitration clause in its cardmember agreements, which has in some instances limited the costs of, and the Company s exposure to, litigation, but there can be no assurance that the Company will continue to be successful in enforcing its arbitration clause in the future. Legal challenges to the enforceability of these clauses have led most card issuers and may cause the Company to discontinue their use, and there are bills pending in Congress to directly or indirectly prohibit the use of pre-dispute arbitration clauses. Further, the Company is involved in pending legal actions challenging its arbitration clause.

The Company is also involved, from time to time, in other reviews, investigations and proceedings (both formal and informal) by governmental agencies regarding the Company s business including, among other matters, accounting, tax and operational matters, some of which may result in adverse judgments, settlements, fines, penalties, injunctions, or other relief. For example, the Company received a notice of proposed assessment from the IRS related to its audit of the Company s 1999-2005 tax years as further discussed in Note 8: Income Taxes.

On November 16, 2010, a putative class action lawsuit was filed against the Company by a cardmember in the U.S. District Court for the Southern District of California (Michele Bennett et al. v. Discover Card, a/k/a DFS Services LLC). The plaintiff alleges that the Company contacted her, and members of the putative class, on their cellular telephones without their express consent in violation of the Telephone Consumer Protection Act (TCPA). The TCPA provides for statutory damages of $500 for each violation ($1,500 for willful violations). Plaintiff seeks statutory damages for alleged negligent and willful violations of the TCPA, attorneys fees, costs and injunctive relief. The Company will seek to vigorously defend all claims asserted against it. The Company is not in a position at this time to assess the likely outcome or its exposure, if any, with respect to this matter.

On December 6, 2010, the Attorney General for the State of Minnesota filed a lawsuit against the Company in the District Court for Hennepin County, Minnesota (Minnesota v. Discover Financial Services, Discover Bank and DFS Services LLC). The lawsuit challenges the Company s enrollment of Discover cardmembers in various fee based products under Minnesota law. The remedies sought in the lawsuit include an injunction prohibiting the Company from engaging in the alleged violations, restitution for all persons allegedly injured by the complained of practices, civil penalties and costs. The Company will seek to vigorously defend all claims asserted against it. The Company is not in a position at this time to assess the likely outcome or its exposure, if any, with respect to this matter.

There are eight putative class action cases pending in relation to the sale of the Company s payment protection fee product. The cases were filed (all in United States District Courts) on July 8, 2010 in the Northern District of California (Walker, et al. v. DFS, Inc. and Discover Bank; subsequently transferred to the Northern District of Illinois); July 16, 2010 in the Central District of California (Conroy v. Discover Financial Services and Discover Bank); October 22, 2010 in the District of South Carolina (Alexander v. Discover Financial Services, Inc.; DFS Services LLC; Discover Bank; and Morgan Stanley); November 5, 2010 in the Northern District of Illinois (Callahan v. Discover Financial Services, Inc. and Discover Bank); December 17, 2010 in the Western District of Tennessee (Sack v. DFS Services LLC; Discover Financial Services, Inc.; and Discover Bank); January 14, 2011 in the Eastern District of Pennsylvania (Boyce v. DFS Services LLC; Discover Financial Services Inc.; Discover Bank); February 15, 2011 in the Southern District of Florida (Triplett v. Discover Financial Services, Inc., DFS Financial Services LLC, Discover Bank and Morgan Stanley); and March 7, 2011 in the Eastern District of Pennsylvania (Discover Financial Services, Inc., DFS Financial Services LLC, Discover Bank, Morgan Stanley et al.). On February 7, 2011, six of the cases (Alexander, Conroy, Walker, Callahan, Sack and Boyce) were transferred to the U.S. District Court for the Northern District of Illinois pursuant to a multi-district litigation order issued by the Joint Panel on Multidistrict Litigation.

These class actions challenge the Company s marketing practices with respect to its payment protection fee product to cardmembers under various state laws and the Truth in Lending Act. The plaintiffs seek monetary remedies including unspecified damages and restitution, attorneys fees and costs, and various forms of injunctive relief including an order rescinding the payment protection fee product enrollments of all class members. The Company will seek to vigorously defend all claims asserted against it. The Company is not in a position at this time to assess the likely outcomes or its exposure, if any, with respect to these matters.

13. Fair Value Disclosures

The Company is required to disclose the fair value of financial instruments for which it is practical to estimate fair value. To obtain fair values, observable market prices are used if available. In some instances, observable market prices are not readily available and fair value is determined using present value or other techniques appropriate for a particular financial instrument. These techniques involve some degree of judgment and, as a result, are not necessarily indicative of the amounts the Company would realize in a current market exchange. The use of different assumptions or estimation techniques may have a material effect on the estimated fair value amounts.

Table of Contents

The following table provides the estimated fair values of financial instruments (dollars in thousands):

	February 28, 2011		November 30, 2010	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Financial Assets				
Cash and cash equivalents	$ 5,171,425	$ 5,171,425	$ 5,098,733	$ 5,098,733
Restricted cash	$ 676,074	$ 676,074	$ 1,363,758	$ 1,363,758
Other short-term investments	$ 375,000	$ 375,000	$ 375,000	$ 375,000
Investment securities:				
Available-for-sale	$ 5,177,116	$ 5,177,116	$ 5,002,579	$ 5,002,579
Held-to-maturity	$ 63,765	$ 59,991	$ 72,816	$ 70,195
Net loan receivables	$ 48,629,769	$ 48,930,530	$ 45,532,295	$ 45,835,543
Derivative financial instruments	$ 10,552	$ 10,552		