

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549  
**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2019

**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)

DE

(State or other jurisdiction of incorporation or organization)

36-2517428

(I.R.S. Employer Identification No.)

2500 Lake Cook Road , Riverwoods , Illinois 60015

(Address of principal executive offices, including zip code)

( 224 ) 405-0900

(Registrant's telephone number, including area code)

**Securities registered pursuant to Section 12(b) of the Act**

| <u>Title of each class</u>               | <u>Trading symbol(s)</u> | <u>Name of each exchange on which registered</u> |
|--|--------------------------|--|
| Common Stock, par value \$0.01 per share | DFS                      | New York Stock Exchange                          |

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  No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes  No

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

|                         |                                     |                           |                          |
|-------------------------|-------------------------------------|---------------------------|--------------------------|
| Large Accelerated Filer | <input checked="" type="checkbox"/> | Accelerated Filer         | <input type="checkbox"/> |
| Non-accelerated Filer   | <input type="checkbox"/>            | Smaller Reporting Company | <input type="checkbox"/> |
|                         |                                     | Emerging Growth Company   | <input type="checkbox"/> |

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

As of July 26, 2019, there were 318,241,033 shares of the registrant's Common Stock, par value \$0.01 per share, outstanding.

**DISCOVER FINANCIAL SERVICES**  
**Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2019**

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Except as otherwise indicated or unless the context otherwise requires, "Discover Financial Services," "Discover," "DFS," "we," "us," "our," and "the Company" refer to Discover Financial Services and its subsidiaries. See Glossary of Acronyms, located after Part I — Item 4, for terms and abbreviations used throughout the quarterly report.

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<sup>®</sup>, PULSE<sup>®</sup>, Cashback Bonus<sup>®</sup>, Discover Cashback Checking<sup>®</sup>, Discover it<sup>®</sup>, Freeze it<sup>®</sup>, College Covered<sup>®</sup>, and Diners Club International<sup>®</sup>. All other trademarks, trade names and service marks included in this quarterly report on Form 10-Q are the property of their respective owners.

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**Part I. FINANCIAL INFORMATION**  
**Item 1. Financial Statements**

**DISCOVER FINANCIAL SERVICES**  
**Condensed Consolidated Statements of Financial Condition**

|  | June 30,<br>2019  | December 31,<br>2018 |
|--|---|----------------------|
|  | (unaudited)<br>(dollars in millions,<br>except share amounts) |                      |
| <b>Assets</b>  |   |                      |
| Cash and cash equivalents  | \$ 10,313   | \$ 13,299            |
| Restricted cash  | 1,040   | 1,846                |
| Other short-term investments   | 1,000   | —                    |
| Investment securities (includes \$7,323 and \$3,133 at fair value at June 30, 2019 and December 31, 2018, respectively)  | 7,581   | 3,370                |
| Loan receivables   |   |                      |
| Loan receivables   | 90,229  | 90,512               |
| Allowance for loan losses  | (3,202)   | (3,041)              |
| Net loan receivables   | 87,027  | 87,471               |
| Premises and equipment, net  | 1,008   | 936                  |
| Goodwill   | 255   | 255                  |
| Intangible assets, net   | 160   | 161                  |
| Other assets   | 2,323   | 2,215                |
| Total assets   | <u>\$ 110,707</u>   | <u>\$ 109,553</u>    |
| <b>Liabilities and Stockholders' Equity</b>  |   |                      |
| <b>Liabilities</b>   |   |                      |
| Deposits   |   |                      |
| Interest-bearing deposit accounts  | \$ 69,064   | \$ 67,084            |
| Non-interest bearing deposit accounts  | 670   | 675                  |
| Total deposits   | 69,734  | 67,759               |
| Long-term borrowings   | 25,163  | 27,228               |
| Accrued expenses and other liabilities   | 4,317   | 3,436                |
| Total liabilities  | 99,214  | 98,423               |
| Commitments, contingencies and guarantees (Notes 8, 11 and 12)   |   |                      |
| <b>Stockholders' Equity</b>  |   |                      |
| Common stock, par value \$0.01 per share; 2,000,000,000 shares authorized; 566,018,680 and 564,851,848 shares issued at June 30, 2019 and December 31, 2018, respectively                            | 6   | 6                    |
| Preferred stock, par value \$0.01 per share; 200,000,000 shares authorized; 5,700 shares issued and outstanding and aggregate liquidation preference of \$570 at June 30, 2019 and December 31, 2018 | 563   | 563                  |
| Additional paid-in capital   | 4,167   | 4,130                |
| Retained earnings  | 20,107  | 18,906               |
| Accumulated other comprehensive loss   | (83)  | (156)                |
| Treasury stock, at cost; 246,543,201 and 233,406,005 shares at June 30, 2019 and December 31, 2018, respectively   | (13,267)  | (12,319)             |
| Total stockholders' equity   | 11,493  | 11,130               |
| Total liabilities and stockholders' equity   | <u>\$ 110,707</u>   | <u>\$ 109,553</u>    |

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 those assets that can only 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 Discover Financial Services.

|   | June 30,<br>2019                     | December 31,<br>2018 |
|---|--------------------------------------|----------------------|
|   | (unaudited)<br>(dollars in millions) |                      |
| <b>Assets</b>   |                                      |                      |
| Restricted cash   | \$ 1,040                             | \$ 1,846             |
| Loan receivables  | \$ 31,564                            | \$ 33,424            |
| Allowance for loan losses allocated to securitized loan receivables | \$ (1,161)                           | \$ (1,150)           |
| Other assets  | \$ 8                                 | \$ 7                 |

**Liabilities**

|  |    |        |    |        |
|--|----|--------|----|--------|
| Long-term borrowings                   | \$ | 14,214 | \$ | 16,917 |
| Accrued expenses and other liabilities | \$ | 15     | \$ | 18     |

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See Notes to the Condensed Consolidated Financial Statements.

**DISCOVER FINANCIAL SERVICES**  
**Condensed Consolidated Statements of Income**

|   | For the Three Months Ended June 30,             |          | For the Six Months Ended June 30, |          |
|---|---|----------|-----------------------------------|----------|
|   | 2019  | 2018     | 2019                              | 2018     |
|   | (unaudited)                                     |          |                                   |          |
|   | (dollars in millions, except per share amounts) |          |                                   |          |
| <b>Interest income</b>                              |   |          |                                   |          |
| Credit card loans                                   | \$ 2,396  | \$ 2,139 | \$ 4,758                          | \$ 4,229 |
| Other loans   | 460   | 421      | 917                               | 838      |
| Investment securities                               | 39  | 6        | 67                                | 13       |
| Other interest income                               | 82  | 70       | 172                               | 125      |
| Total interest income                               | 2,977   | 2,636    | 5,914                             | 5,205    |
| <b>Interest expense</b>                             |   |          |                                   |          |
| Deposits  | 401   | 287      | 787                               | 549      |
| Long-term borrowings                                | 244   | 220      | 490                               | 427      |
| Total interest expense                              | 645   | 507      | 1,277                             | 976      |
| Net interest income                                 | 2,332   | 2,129    | 4,637                             | 4,229    |
| Provision for loan losses                           | 787   | 742      | 1,596                             | 1,493    |
| Net interest income after provision for loan losses | 1,545   | 1,387    | 3,041                             | 2,736    |
| <b>Other income</b>                                 |   |          |                                   |          |
| Discount and interchange revenue, net               | 299   | 263      | 530                               | 517      |
| Protection products revenue                         | 49  | 50       | 98                                | 103      |
| Loan fee income                                     | 102   | 95       | 206                               | 191      |
| Transaction processing revenue                      | 48  | 42       | 94                                | 85       |
| Other income  | 22  | 24       | 50                                | 53       |
| Total other income                                  | 520   | 474      | 978                               | 949      |
| <b>Other expense</b>                                |   |          |                                   |          |
| Employee compensation and benefits                  | 427   | 400      | 852                               | 805      |
| Marketing and business development                  | 224   | 224      | 419                               | 409      |
| Information processing and communications           | 101   | 86       | 200                               | 168      |
| Professional fees                                   | 183   | 161      | 350                               | 316      |
| Premises and equipment                              | 26  | 24       | 54                                | 50       |
| Other expense                                       | 117   | 89       | 227                               | 204      |
| Total other expense                                 | 1,078   | 984      | 2,102                             | 1,952    |
| Income before income tax expense                    | 987   | 877      | 1,917                             | 1,733    |
| Income tax expense                                  | 234   | 208      | 438                               | 398      |
| Net income  | \$ 753  | \$ 669   | \$ 1,479                          | \$ 1,335 |
| Net income allocated to common stockholders         | \$ 747  | \$ 663   | \$ 1,452                          | \$ 1,309 |
| Basic earnings per common share                     | \$ 2.32   | \$ 1.91  | \$ 4.46                           | \$ 3.73  |
| Diluted earnings per common share                   | \$ 2.32   | \$ 1.91  | \$ 4.46                           | \$ 3.72  |

See Notes to the Condensed Consolidated Financial Statements.

**DISCOVER FINANCIAL SERVICES**  
**Condensed Consolidated Statements of Comprehensive Income**

|   | For the Three Months Ended June 30,                |        | For the Six Months Ended June 30, |          |
|---|--|--------|-----------------------------------|----------|
|   | 2019   | 2018   | 2019                              | 2018     |
|   | <b>(unaudited)</b><br><b>(dollars in millions)</b> |        |                                   |          |
| Net income  | \$ 753   | \$ 669 | \$ 1,479                          | \$ 1,335 |
| Other comprehensive income, net of tax  |  |        |                                   |          |
| Unrealized gains (losses) on available-for-sale investment securities, net of tax | 71   | (1)    | 102                               | (8)      |
| Unrealized (losses) gains on cash flow hedges, net of tax                         | (18)   | 7      | (30)                              | 26       |
| Unrealized pension and post-retirement plan gains, net of tax                     | —  | —      | 1                                 | 1        |
| Other comprehensive income  | 53   | 6      | 73                                | 19       |
| Comprehensive income  | \$ 806   | \$ 675 | \$ 1,552                          | \$ 1,354 |

See Notes to the Condensed Consolidated Financial Statements.

**DISCOVER FINANCIAL SERVICES**  
**Condensed Consolidated Statements of Changes in Stockholders' Equity**

|   | Preferred Stock |               | Common Stock   |             | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated Other<br>Comprehensive Loss | Treasury<br>Stock  | Total<br>Stockholders'<br>Equity |
|---|-----------------|---------------|----------------|-------------|----------------------------------|----------------------|---|--------------------|----------------------------------|
|   | Shares          | Amount        | Shares         | Amount      |                                  |                      |   |                    |                                  |
| (unaudited)<br>(dollars in millions, shares in thousands) |                 |               |                |             |                                  |                      |   |                    |                                  |
| <b>For the Three Months Ended June 30, 2018</b>           |                 |               |                |             |                                  |                      |   |                    |                                  |
| <b>Balance at March 31, 2018</b>                          | 6               | \$ 563        | 564,510        | \$ 6        | \$ 4,068                         | \$ 17,211            | \$ (139)                                | \$ (10,838)        | \$ 10,871                        |
| Cumulative effect of ASU No. 2018-02 adoption             | —               | —             | —              | —           | —                                | 29                   | (29)                                    | —                  | —                                |
| Net income  | —               | —             | —              | —           | —                                | 669                  | —                                       | —                  | 669                              |
| Other comprehensive income                                | —               | —             | —              | —           | —                                | —                    | 6                                       | —                  | 6                                |
| Purchases of treasury stock                               | —               | —             | —              | —           | —                                | —                    | —                                       | (556)              | (556)                            |
| Common stock issued under employee benefit plans          | —               | —             | 22             | —           | 1                                | —                    | —                                       | —                  | 1                                |
| Common stock issued and stock-based compensation expense  | —               | —             | 26             | —           | 20                               | —                    | —                                       | —                  | 20                               |
| Dividends — common stock (\$0.35 per share)               | —               | —             | —              | —           | —                                | (122)                | —                                       | —                  | (122)                            |
| <b>Balance at June 30, 2018</b>                           | <b>6</b>        | <b>\$ 563</b> | <b>564,558</b> | <b>\$ 6</b> | <b>\$ 4,089</b>                  | <b>\$ 17,787</b>     | <b>\$ (162)</b>                         | <b>\$ (11,394)</b> | <b>\$ 10,889</b>                 |
| <b>For the Three Months Ended June 30, 2019</b>           |                 |               |                |             |                                  |                      |   |                    |                                  |
| <b>Balance at March 31, 2019</b>                          | 6               | \$ 563        | 565,973        | \$ 6        | \$ 4,148                         | \$ 19,484            | \$ (136)                                | \$ (12,806)        | \$ 11,259                        |
| Net income  | —               | —             | —              | —           | —                                | 753                  | —                                       | —                  | 753                              |
| Other comprehensive income                                | —               | —             | —              | —           | —                                | —                    | 53                                      | —                  | 53                               |
| Purchases of treasury stock                               | —               | —             | —              | —           | —                                | —                    | —                                       | (461)              | (461)                            |
| Common stock issued under employee benefit plans          | —               | —             | 24             | —           | 1                                | —                    | —                                       | —                  | 1                                |
| Common stock issued and stock-based compensation expense  | —               | —             | 22             | —           | 18                               | —                    | —                                       | —                  | 18                               |
| Dividends — common stock (\$0.40 per share)               | —               | —             | —              | —           | —                                | (130)                | —                                       | —                  | (130)                            |
| <b>Balance at June 30, 2019</b>                           | <b>6</b>        | <b>\$ 563</b> | <b>566,019</b> | <b>\$ 6</b> | <b>\$ 4,167</b>                  | <b>\$ 20,107</b>     | <b>\$ (83)</b>                          | <b>\$ (13,267)</b> | <b>\$ 11,493</b>                 |
| <b>For the Six Months Ended June 30, 2018</b>             |                 |               |                |             |                                  |                      |   |                    |                                  |
| <b>Balance at December 31, 2017</b>                       | 6               | \$ 563        | 563,498        | \$ 6        | \$ 4,042                         | \$ 16,687            | \$ (152)                                | \$ (10,254)        | \$ 10,892                        |
| Cumulative effect of ASU No. 2018-02 adoption             | —               | —             | —              | —           | —                                | 29                   | (29)                                    | —                  | —                                |
| Net income  | —               | —             | —              | —           | —                                | 1,335                | —                                       | —                  | 1,335                            |
| Other comprehensive income                                | —               | —             | —              | —           | —                                | —                    | 19                                      | —                  | 19                               |
| Purchases of treasury stock                               | —               | —             | —              | —           | —                                | —                    | —                                       | (1,140)            | (1,140)                          |
| Common stock issued under employee benefit plans          | —               | —             | 45             | —           | 3                                | —                    | —                                       | —                  | 3                                |
| Common stock issued and stock-based compensation expense  | —               | —             | 1,015          | —           | 44                               | —                    | —                                       | —                  | 44                               |
| Dividends — common stock (\$0.70 per share)               | —               | —             | —              | —           | —                                | (248)                | —                                       | —                  | (248)                            |
| Dividends — preferred stock (\$2,750 per share)           | —               | —             | —              | —           | —                                | (16)                 | —                                       | —                  | (16)                             |
| <b>Balance at June 30, 2018</b>                           | <b>6</b>        | <b>\$ 563</b> | <b>564,558</b> | <b>\$ 6</b> | <b>\$ 4,089</b>                  | <b>\$ 17,787</b>     | <b>\$ (162)</b>                         | <b>\$ (11,394)</b> | <b>\$ 10,889</b>                 |
| <b>For the Six Months Ended June 30, 2019</b>             |                 |               |                |             |                                  |                      |   |                    |                                  |
| <b>Balance at December 31, 2018</b>                       | 6               | \$ 563        | 564,852        | \$ 6        | \$ 4,130                         | \$ 18,906            | \$ (156)                                | \$ (12,319)        | \$ 11,130                        |
| Net income  | —               | —             | —              | —           | —                                | 1,479                | —                                       | —                  | 1,479                            |
| Other comprehensive income                                | —               | —             | —              | —           | —                                | —                    | 73                                      | —                  | 73                               |
| Purchases of treasury stock                               | —               | —             | —              | —           | —                                | —                    | —                                       | (948)              | (948)                            |
| Common stock issued under employee benefit plans          | —               | —             | 51             | —           | 3                                | —                    | —                                       | —                  | 3                                |
| Common stock issued and stock-based compensation expense  | —               | —             | 1,116          | —           | 34                               | —                    | —                                       | —                  | 34                               |
| Dividends — common stock (\$0.80 per share)               | —               | —             | —              | —           | —                                | (262)                | —                                       | —                  | (262)                            |
| Dividends — preferred stock (\$2,750 per share)           | —               | —             | —              | —           | —                                | (16)                 | —                                       | —                  | (16)                             |
| <b>Balance at June 30, 2019</b>                           | <b>6</b>        | <b>\$ 563</b> | <b>566,019</b> | <b>\$ 6</b> | <b>\$ 4,167</b>                  | <b>\$ 20,107</b>     | <b>\$ (83)</b>                          | <b>\$ (13,267)</b> | <b>\$ 11,493</b>                 |

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See Notes to the Condensed Consolidated Financial Statements.



**DISCOVER FINANCIAL SERVICES**  
**Condensed Consolidated Statements of Cash Flows**

|   | For the Six Months Ended June 30,    |           |
|---|--------------------------------------|-----------|
|   | 2019                                 | 2018      |
|   | (unaudited)<br>(dollars in millions) |           |
| <b>Cash flows from operating activities</b>   |                                      |           |
| Net income  | \$ 1,479                             | \$ 1,335  |
| Adjustments to reconcile net income to net cash provided by operating activities      |                                      |           |
| Provision for loan losses   | 1,596                                | 1,493     |
| Depreciation and amortization   | 202                                  | 216       |
| Amortization of deferred revenues and accretion of accretable yield on acquired loans | (201)                                | (198)     |
| Net loss on investments and other assets  | 21                                   | 22        |
| Other, net  | (11)                                 | (93)      |
| Changes in assets and liabilities   |                                      |           |
| (Increase) decrease in other assets   | (23)                                 | 190       |
| Increase (decrease) in accrued expenses and other liabilities                         | 850                                  | (141)     |
| Net cash provided by operating activities   | 3,913                                | 2,824     |
| <b>Cash flows from investing activities</b>   |                                      |           |
| Purchases of other short-term investments   | (1,000)                              | —         |
| Maturities of available-for-sale investment securities                                | 70                                   | 86        |
| Purchases of available-for-sale investment securities                                 | (4,115)                              | —         |
| Maturities of held-to-maturity investment securities                                  | 12                                   | 9         |
| Purchases of held-to-maturity investment securities                                   | (34)                                 | (62)      |
| Net principal disbursed on loans originated for investment                            | (950)                                | (1,639)   |
| Purchases of other investments  | (21)                                 | (5)       |
| Purchases of premises and equipment   | (151)                                | (118)     |
| Net cash used for investing activities  | (6,189)                              | (1,729)   |
| <b>Cash flows from financing activities</b>   |                                      |           |
| Proceeds from issuance of securitized debt  | 1,234                                | 2,184     |
| Maturities and repayment of securitized debt  | (4,070)                              | (2,337)   |
| Proceeds from issuance of other long-term borrowings                                  | 595                                  | 844       |
| Maturities and repayment of other long-term borrowings                                | (7)                                  | (753)     |
| Proceeds from issuance of common stock  | 4                                    | 3         |
| Purchases of treasury stock   | (948)                                | (1,140)   |
| Net increase in deposits  | 1,955                                | 2,900     |
| Dividends paid on common and preferred stock  | (279)                                | (264)     |
| Net cash (used for) provided by financing activities                                  | (1,516)                              | 1,437     |
| Net (decrease) increase in cash, cash equivalents and restricted cash                 | (3,792)                              | 2,532     |
| Cash, cash equivalents and restricted cash, at beginning of period                    | 15,145                               | 13,387    |
| Cash, cash equivalents and restricted cash, at end of period                          | \$ 11,353                            | \$ 15,919 |
| <b>Reconciliation of cash, cash equivalents and restricted cash</b>                   |                                      |           |
| Cash and cash equivalents   | \$ 10,313                            | \$ 15,289 |
| Restricted cash   | 1,040                                | 630       |
| Cash, cash equivalents and restricted cash, at end of period                          | \$ 11,353                            | \$ 15,919 |

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 as well as a financial holding company under the Gramm-Leach-Bliley Act and therefore is subject to oversight, regulation and examination by the Board of Governors of the Federal Reserve System (the "Federal Reserve"). The Company provides direct banking products and services and payment services through its subsidiaries. The Company offers its customers credit card loans, private student loans, personal loans, home equity loans and deposit products. The Company also operates the Discover Network, the PULSE network ("PULSE") and Diners Club International ("Diners Club"). The Discover Network processes transactions for Discover-branded credit and debit cards and provides payment transaction processing and settlement services. PULSE operates an electronic funds transfer network, providing financial institutions issuing debit cards on the PULSE network with access to ATMs domestically and internationally, as well as merchant acceptance throughout the U.S. for debit card transactions. Diners Club is a global payments network of licensees, which are generally financial institutions, that issue Diners Club branded charge cards and/or provide card acceptance services.

The Company's business activities are managed in two segments, Direct Banking and Payment Services, based on the products and services provided. For a detailed description of the operations of each segment, as well as the allocation conventions used in business segment reporting, see Note 15: Segment Disclosures.

***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 interim period. 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 2018 audited consolidated financial statements filed with the Company's annual report on Form 10-K for the year ended December 31, 2018 .

***Recently Issued Accounting Pronouncements***

In June 2016, the Financial Accounting Standards Board issued Accounting Standards Update ("ASU") No. 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. This ASU replaces the incurred loss model with the current expected credit loss ("CECL") approach. For loans carried at amortized cost, the allowance for loan losses will be based on management's current estimate of all expected credit losses over the remaining contractual term of the loans. Upon the origination of a loan, the Company will have to record its estimate of all expected credit losses on that loan through an immediate charge to earnings. Updates to that estimate each period will be recorded through provision expense. The CECL estimate is to be based on historical experience, current conditions and reasonable and supportable forecasts.

The CECL approach is expected to increase the Company's allowance for loan losses as a result of: (1) recording reserves for expected losses, not simply those deemed to be already incurred, (2) extending the loss estimate period over the entire life of the loan and (3) reclassification of the credit loss component of the purchased credit-impaired ("PCI") loan portfolio out of loan carrying value and into the allowance for loan losses. The allowance for loan losses on all loans carried at amortized cost, including PCI loans and loans modified in a troubled debt restructuring ("TDR") will be measured under the CECL approach. Existing specialized measurement guidance for PCI loans, which the ASU refers to as purchased credit-deteriorated ("PCD"), and TDRs will be eliminated, although certain separate disclosure guidance will be retained. Measurement of credit impairment of available-for-sale debt securities will generally remain unchanged under the new rules, but any such impairment will be recorded through an allowance, rather than a direct write-down of the security.

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The ASU is effective for the Company on January 1, 2020. A cross-functional governance structure is in place to oversee the implementation of the standard. The Company continues to refine loss forecasting models and technological solutions, and advance processes and controls in support of the new standard. Management is also finalizing key accounting interpretations, the time period over which losses can be reasonably estimated and the reversion method for periods beyond the reasonable and supportable forecast period. Upon adoption, the allowance for loan losses is expected to increase with an offsetting adjustment, net of taxes, to retained earnings. Additionally, there will be an immaterial increase to the carrying value of PCD loans. Adoption of the standard will materially impact stockholders' equity, regulatory capital and the Company's consolidated financial condition. In addition, the Company's results of operations may be subject to more volatility. The extent of the impact upon adoption will depend on the characteristics of the Company's loan portfolio and economic conditions at that date, as well as forecasted conditions thereafter.

**2. Investments**

The Company's other short-term investments and investment securities consist of the following (dollars in millions):

|  | June 30,<br>2019 | December 31,<br>2018 |
|--|------------------|----------------------|
| Certificates of deposit <sup>(1)</sup>                         | \$ 1,000         | \$ —                 |
| Total other short-term investments                             | \$ 1,000         | \$ —                 |
| U.S. Treasury securities <sup>(2)</sup>                        | \$ 6,835         | \$ 2,586             |
| Residential mortgage-backed securities - Agency <sup>(3)</sup> | 746              | 784                  |
| Total investment securities                                    | \$ 7,581         | \$ 3,370             |

(1) Includes certificates of deposit with maturity dates greater than 90 days but less than one year at the time of acquisition.

(2) Includes \$53 million and \$42 million of U.S. Treasury securities pledged as swap collateral as of June 30, 2019 and December 31, 2018, respectively.

(3) Consists of residential mortgage-backed securities issued by Fannie Mae, Freddie Mac and Ginnie Mae.

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 millions):

|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value |
|--|-------------------|------------------------------|-------------------------------|------------|
| <b>At June 30, 2019</b>  |                   |                              |                               |            |
| <b>Available-for-Sale Investment Securities <sup>(1)</sup></b> |                   |                              |                               |            |
| U.S. Treasury securities                                       | \$ 6,686          | \$ 149                       | \$ —                          | \$ 6,835   |
| Residential mortgage-backed securities - Agency                | 488               | 2                            | (2)                           | 488        |
| Total available-for-sale investment securities                 | \$ 7,174          | \$ 151                       | \$ (2)                        | \$ 7,323   |
| <b>Held-to-Maturity Investment Securities <sup>(2)</sup></b>   |                   |                              |                               |            |
| Residential mortgage-backed securities - Agency <sup>(3)</sup> | \$ 258            | \$ 3                         | \$ (1)                        | \$ 260     |
| Total held-to-maturity investment securities                   | \$ 258            | \$ 3                         | \$ (1)                        | \$ 260     |
| <b>At December 31, 2018</b>                                    |                   |                              |                               |            |
| <b>Available-for-Sale Investment Securities <sup>(1)</sup></b> |                   |                              |                               |            |
| U.S. Treasury securities                                       | \$ 2,559          | \$ 27                        | \$ —                          | \$ 2,586   |
| Residential mortgage-backed securities - Agency                | 559               | —                            | (12)                          | 547        |
| Total available-for-sale investment securities                 | \$ 3,118          | \$ 27                        | \$ (12)                       | \$ 3,133   |
| <b>Held-to-Maturity Investment Securities <sup>(2)</sup></b>   |                   |                              |                               |            |
| Residential mortgage-backed securities - Agency <sup>(3)</sup> | \$ 237            | \$ —                         | \$ (4)                        | \$ 233     |

|  |    |     |    |   |    |     |    |     |
|--|----|-----|----|---|----|-----|----|-----|
| Total held-to-maturity investment securities | \$ | 237 | \$ | — | \$ | (4) | \$ | 233 |
|--|----|-----|----|---|----|-----|----|-----|

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- (1) Available-for-sale investment securities are reported at fair value.
  - (2) Held-to-maturity investment securities are reported at amortized cost.
  - (3) Amounts represent residential mortgage-backed securities that were classified as held-to-maturity as they were entered into as a part of the Company's community reinvestment initiatives.

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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 (dollars in millions):

|   | Number of Securities in a Loss Position | Less than 12 months |                   | More than 12 months |                   |
|---|---|---------------------|-------------------|---------------------|-------------------|
|   |   | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses |
| <b>At June 30, 2019</b>                         |   |                     |                   |                     |                   |
| <b>Available-for-Sale Investment Securities</b> |   |                     |                   |                     |                   |
| Residential mortgage-backed securities - Agency | 13                                      | \$ 39               | \$ —              | \$ 176              | \$ (2)            |
| <b>Held-to-Maturity Investment Securities</b>   |   |                     |                   |                     |                   |
| Residential mortgage-backed securities - Agency | 51                                      | \$ 4                | \$ —              | \$ 78               | \$ (1)            |
| <b>At December 31, 2018</b>                     |   |                     |                   |                     |                   |
| <b>Available-for-Sale Investment Securities</b> |   |                     |                   |                     |                   |
| Residential mortgage-backed securities - Agency | 31                                      | \$ 110              | \$ (1)            | \$ 437              | \$ (11)           |
| <b>Held-to-Maturity Investment Securities</b>   |   |                     |                   |                     |                   |
| Residential mortgage-backed securities - Agency | 90                                      | \$ 101              | \$ (1)            | \$ 83               | \$ (3)            |

There were no losses related to other-than-temporary impairments and no proceeds from sales or recognized gains and losses on available-for-sale securities during the three and six months ended June 30, 2019 and 2018. See Note 7: Accumulated Other Comprehensive Income for unrealized gains and losses on available-for-sale securities during the three and six months ended June 30, 2019 and 2018.

Maturities of available-for-sale debt securities and held-to-maturity debt securities are provided in the following table (dollars in millions):

|  | One Year or Less | After One Year Through Five Years | After Five Years Through Ten Years | After Ten Years | Total    |
|--|------------------|-----------------------------------|------------------------------------|-----------------|----------|
| <b>At June 30, 2019</b>  |                  |                                   |                                    |                 |          |
| <b>Available-for-Sale Investment Securities—Amortized Cost</b> |                  |                                   |                                    |                 |          |
| U.S. Treasury securities                                       | \$ 372           | \$ 5,563                          | \$ 751                             | \$ —            | \$ 6,686 |
| Residential mortgage-backed securities - Agency <sup>(1)</sup> | —                | 110                               | 378                                | —               | 488      |
| Total available-for-sale investment securities                 | \$ 372           | \$ 5,673                          | \$ 1,129                           | \$ —            | \$ 7,174 |
| <b>Held-to-Maturity Investment Securities—Amortized Cost</b>   |                  |                                   |                                    |                 |          |
| Residential mortgage-backed securities - Agency <sup>(1)</sup> | \$ —             | \$ —                              | \$ —                               | \$ 258          | \$ 258   |
| Total held-to-maturity investment securities                   | \$ —             | \$ —                              | \$ —                               | \$ 258          | \$ 258   |
| <b>Available-for-Sale Investment Securities—Fair Values</b>    |                  |                                   |                                    |                 |          |
| U.S. Treasury securities                                       | \$ 374           | \$ 5,694                          | \$ 767                             | \$ —            | \$ 6,835 |
| Residential mortgage-backed securities - Agency <sup>(1)</sup> | —                | 110                               | 378                                | —               | 488      |
| Total available-for-sale investment securities                 | \$ 374           | \$ 5,804                          | \$ 1,145                           | \$ —            | \$ 7,323 |
| <b>Held-to-Maturity Investment Securities—Fair Values</b>      |                  |                                   |                                    |                 |          |
| Residential mortgage-backed securities - Agency <sup>(1)</sup> | \$ —             | \$ —                              | \$ —                               | \$ 260          | \$ 260   |

Total held-to-maturity investment securities

\$ — \$ — \$ — \$ 260 \$ 260

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(1) Maturities of residential mortgage-backed securities are reflective of the contractual maturities of the investment.

***Other Investments***

As a part of the Company's community reinvestment initiatives, the Company has made equity investments in certain limited partnerships and limited liability companies that finance the construction and rehabilitation of affordable rental housing, as well as stimulate economic development in low to moderate income communities. These investments are accounted for using the equity method of accounting and are recorded within other assets. The related commitment for future investments is recorded in accrued expenses and other liabilities within the condensed consolidated statements of financial condition. The portion of each investment's operating results allocable to the Company reduces the carrying value of the investments and is recorded in other expense within the condensed consolidated statements of income. The Company further

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reduces the carrying value of the investments by recognizing any amounts that are in excess of future net tax benefits in other expense. The Company earns a return primarily through the receipt of tax credits allocated to the affordable housing projects and the community revitalization projects. These investments are not consolidated as the Company does not have a controlling financial interest in the entities. As of June 30, 2019 and December 31, 2018, the Company had outstanding investments in these entities of \$310 million and \$295 million, respectively, and related contingent liabilities of \$65 million and \$49 million, respectively. Of the above outstanding equity investments, the Company had \$290 million and \$271 million of investments related to affordable housing projects as of June 30, 2019 and December 31, 2018, respectively, which had \$59 million and \$30 million related contingent liabilities, respectively.

### 3. Loan Receivables

The Company has three loan portfolio segments: credit card loans, other loans and PCI loans.

The Company's classes of receivables within the three portfolio segments are depicted in the following table (dollars in millions):

|                                  | June 30,<br>2019 | December 31,<br>2018 |
|----------------------------------|------------------|----------------------|
| Credit card loans <sup>(1)</sup> | \$ 72,393        | \$ 72,876            |
| Other loans                      |                  |                      |
| Personal loans                   | 7,414            | 7,454                |
| Private student loans            | 7,943            | 7,728                |
| Other                            | 1,047            | 817                  |
| Total other loans                | 16,404           | 15,999               |
| PCI loans <sup>(2)</sup>         | 1,432            | 1,637                |
| Total loan receivables           | 90,229           | 90,512               |
| Allowance for loan losses        | (3,202)          | (3,041)              |
| Net loan receivables             | \$ 87,027        | \$ 87,471            |

(1) Amounts include carrying values of \$19.0 billion and \$22.0 billion in underlying investors' interest in trust debt at June 30, 2019 and December 31, 2018, respectively, and \$12.3 billion and \$11.1 billion in seller's interest at June 30, 2019 and December 31, 2018, respectively. See Note 4: Credit Card and Student Loan Securitization Activities for additional information.

(2) Amounts include carrying values of \$326 million and \$363 million in loans pledged as collateral against the note issued from The Student Loan Corporation ("SLC") securitization trust at June 30, 2019 and December 31, 2018, respectively. See Note 4: Credit Card and Student Loan Securitization Activities for additional information.

### Credit Quality Indicators

The Company regularly reviews its collection experience (including delinquencies and net charge-offs) in determining its allowance for loan losses.

Information related to the delinquent and non-accruing loans in the Company's loan portfolio is shown below by each class of loan receivables except for PCI student loans, which is shown under the heading "— Purchased Credit-Impaired Loans" (dollars in millions):

|  | 30-89 Days<br>Delinquent | 90 or<br>More Days<br>Delinquent | Total Past<br>Due | 90 or<br>More Days<br>Delinquent<br>and<br>Accruing | Total<br>Non-accruing <sup>(1)</sup> |
|--|--------------------------|----------------------------------|-------------------|---|--------------------------------------|
| <b>At June 30, 2019</b>                              |                          |                                  |                   |   |                                      |
| Credit card loans <sup>(2)</sup>                     | \$ 835                   | \$ 857                           | \$ 1,692          | \$ 772  | \$ 246                               |
| Other loans  |                          |                                  |                   |   |                                      |
| Personal loans <sup>(3)</sup>                        | 79                       | 31                               | 110               | 29  | 11                                   |
| Private student loans (excluding PCI) <sup>(4)</sup> | 100                      | 33                               | 133               | 33  | 8                                    |
| Other  | 3                        | 1                                | 4                 | —   | 14                                   |
| Total other loans (excluding PCI)                    | 182                      | 65                               | 247               | 62  | 33                                   |
| Total loan receivables (excluding PCI)               | <u>\$ 1,017</u>          | <u>\$ 922</u>                    | <u>\$ 1,939</u>   | <u>\$ 834</u>                                       | <u>\$ 279</u>                        |
| <b>At December 31, 2018</b>                          |                          |                                  |                   |   |                                      |
| Credit card loans <sup>(2)</sup>                     | \$ 885                   | \$ 887                           | \$ 1,772          | \$ 781  | \$ 266                               |
| Other loans  |                          |                                  |                   |   |                                      |
| Personal loans <sup>(3)</sup>                        | 84                       | 35                               | 119               | 33  | 11                                   |
| Private student loans (excluding PCI) <sup>(4)</sup> | 117                      | 38                               | 155               | 37  | 8                                    |
| Other  | 2                        | 1                                | 3                 | —   | 17                                   |
| Total other loans (excluding PCI)                    | 203                      | 74                               | 277               | 70  | 36                                   |
| Total loan receivables (excluding PCI)               | <u>\$ 1,088</u>          | <u>\$ 961</u>                    | <u>\$ 2,049</u>   | <u>\$ 851</u>                                       | <u>\$ 302</u>                        |

(1) The Company estimates that the gross interest income that would have been recorded in accordance with the original terms of non-accruing credit card loans was \$11 million and \$10 million for the three months ended June 30, 2019 and 2018, respectively, and \$23 million and \$19 million for the six months ended June 30, 2019 and 2018, respectively. The Company does not separately track the amount of gross interest income that would have been recorded in accordance with the original terms of loans. This amount was estimated based on customers' current balances and most recent interest rates.

(2) Credit card loans that are 90 or more days delinquent and accruing interest include \$135 million and \$116 million of loans accounted for as TDRs at June 30, 2019 and December 31, 2018, respectively.

(3) Personal loans that are 90 or more days delinquent and accruing interest include \$6 million and \$5 million of loans accounted for as TDRs at June 30, 2019 and December 31, 2018, respectively.

(4) Private student loans that are 90 or more days delinquent and accruing interest include \$7 million of loans accounted for as TDRs at June 30, 2019 and December 31, 2018.



Information related to the net charge-offs in the Company's loan portfolio is shown below by each class of loan receivables except for PCI student loans, which is shown under the heading "— Purchased Credit-Impaired Loans" (dollars in millions):

|                                       | For the Three Months Ended June 30, |                                    |                 |                                    |
|---------------------------------------|-------------------------------------|------------------------------------|-----------------|------------------------------------|
|                                       | 2019                                |                                    | 2018            |                                    |
|                                       | Net Charge-offs                     | Net Charge-off Rate <sup>(1)</sup> | Net Charge-offs | Net Charge-off Rate <sup>(1)</sup> |
| Credit card loans                     | \$ 623                              | 3.49%                              | \$ 555          | 3.34%                              |
| Other loans                           |                                     |                                    |                 |                                    |
| Personal loans                        | 80                                  | 4.33%                              | 72              | 3.97%                              |
| Private student loans (excluding PCI) | 15                                  | 0.73%                              | 21              | 1.16%                              |
| Other                                 | —                                   | —%                                 | 1               | 0.34%                              |
| Total other loans                     | 95                                  | 2.31%                              | 94              | 2.48%                              |
| Net charge-offs (excluding PCI)       | \$ 718                              | 3.27%                              | \$ 649          | 3.18%                              |
| Net charge-offs (including PCI)       | \$ 718                              | 3.22%                              | \$ 649          | 3.11%                              |

  

|                                       | For the Six Months Ended June 30, |                                    |                 |                                    |
|---------------------------------------|-----------------------------------|------------------------------------|-----------------|------------------------------------|
|                                       | 2019                              |                                    | 2018            |                                    |
|                                       | Net Charge-offs                   | Net Charge-off Rate <sup>(1)</sup> | Net Charge-offs | Net Charge-off Rate <sup>(1)</sup> |
| Credit card loans                     | \$ 1,239                          | 3.50%                              | \$ 1,095        | 3.33%                              |
| Other loans                           |                                   |                                    |                 |                                    |
| Personal loans                        | 164                               | 4.43%                              | 145             | 4.00%                              |
| Private student loans (excluding PCI) | 30                                | 0.76%                              | 43              | 1.17%                              |
| Other                                 | —                                 | —%                                 | 1               | 0.23%                              |
| Total other loans                     | 194                               | 2.38%                              | 189             | 2.50%                              |
| Net charge-offs (excluding PCI)       | \$ 1,433                          | 3.29%                              | \$ 1,284        | 3.18%                              |
| Net charge-offs (including PCI)       | \$ 1,433                          | 3.23%                              | \$ 1,284        | 3.10%                              |

(1) Net charge-off rate represents net charge-off dollars (annualized) divided by average loans for the reporting period.

As part of credit risk management activities, on an ongoing basis, the Company reviews information related to the performance of a customer's account with the Company as well as information from credit bureaus, such as FICO or other credit scores, relating to the customer's broader credit performance. FICO scores are generally obtained at origination of the account and are refreshed monthly or quarterly thereafter to assist in predicting customer behavior. Historically, the Company has noted that a significant portion of delinquent accounts have FICO scores below 660.

The following table provides the most recent FICO scores available for the Company's customers as a percentage of each class of loan receivables:

|  | Credit Risk Profile<br>by FICO Score |                           |
|--|--------------------------------------|---------------------------|
|  | 660 and Above                        | Less than 660 or No Score |
| <b>At June 30, 2019</b>                              |                                      |                           |
| Credit card loans                                    | 81%                                  | 19%                       |
| Personal loans                                       | 94%                                  | 6%                        |
| Private student loans (excluding PCI) <sup>(1)</sup> | 94%                                  | 6%                        |
| <b>At December 31, 2018</b>                          |                                      |                           |
| Credit card loans                                    | 81%                                  | 19%                       |
| Personal loans                                       | 94%                                  | 6%                        |
| Private student loans (excluding PCI) <sup>(1)</sup> | 94%                                  | 6%                        |

(1) PCI loans are discussed under the heading "— Purchased Credit-Impaired Loans."

For private student loans, additional credit risk management activities include monitoring the amount of loans in forbearance. Forbearance allows borrowers experiencing temporary financial difficulties and willing to make payments, the ability to temporarily suspend payments. Eligible borrowers have a lifetime cap on forbearance of 12 months. At June 30, 2019 and December 31, 2018, there were \$41 million and \$37 million, respectively, of private student loans, including those classified as PCI, in forbearance, representing 0.7% of total student loans in repayment and forbearance.

### Allowance for Loan Losses

The following tables provide changes in the Company's allowance for loan losses (dollars in millions):

|                                       | For the Three Months Ended June 30, 2019 |                |                              |             |                 |
|---------------------------------------|--|----------------|------------------------------|-------------|-----------------|
|                                       | Credit Card                              | Personal Loans | Student Loans <sup>(1)</sup> | Other       | Total           |
| <b>Balance at beginning of period</b> | \$ 2,622                                 | \$ 338         | \$ 168                       | \$ 6        | \$ 3,134        |
| Additions                             |  |                |                              |             |                 |
| Provision for loan losses             | 692                                      | 80             | 15                           | —           | 787             |
| Deductions                            |  |                |                              |             |                 |
| Charge-offs                           | (789)                                    | (91)           | (18)                         | —           | (898)           |
| Recoveries                            | 166                                      | 11             | 3                            | —           | 180             |
| Net charge-offs                       | (623)                                    | (80)           | (15)                         | —           | (718)           |
| Other <sup>(2)</sup>                  | —  | —              | (1)                          | —           | (1)             |
| <b>Balance at end of period</b>       | <u>\$ 2,691</u>                          | <u>\$ 338</u>  | <u>\$ 167</u>                | <u>\$ 6</u> | <u>\$ 3,202</u> |

|                                       | For the Three Months Ended June 30, 2018 |                |                              |              |                 |
|---------------------------------------|--|----------------|------------------------------|--------------|-----------------|
|                                       | Credit Card                              | Personal Loans | Student Loans <sup>(1)</sup> | Other        | Total           |
| <b>Balance at beginning of period</b> | \$ 2,252                                 | \$ 301         | \$ 170                       | \$ 13        | \$ 2,736        |
| Additions                             |  |                |                              |              |                 |
| Provision for loan losses             | 637                                      | 84             | 22                           | (1)          | 742             |
| Deductions                            |  |                |                              |              |                 |
| Charge-offs                           | (684)                                    | (80)           | (24)                         | (1)          | (789)           |
| Recoveries                            | 129                                      | 8              | 3                            | —            | 140             |
| Net charge-offs                       | (555)                                    | (72)           | (21)                         | (1)          | (649)           |
| Other <sup>(2)</sup>                  | —  | —              | (1)                          | —            | (1)             |
| <b>Balance at end of period</b>       | <u>\$ 2,334</u>                          | <u>\$ 313</u>  | <u>\$ 170</u>                | <u>\$ 11</u> | <u>\$ 2,828</u> |

(1) Includes both PCI and non-PCI private student loans.

(2) Net change in reserves on PCI pools having no remaining non-accretable difference.

The following tables provide changes in the Company's allowance for loan losses (dollars in millions):

|                                       | For the Six Months Ended June 30, 2019 |                |                              |             |                 |
|---------------------------------------|--|----------------|------------------------------|-------------|-----------------|
|                                       | Credit Card                            | Personal Loans | Student Loans <sup>(1)</sup> | Other       | Total           |
| <b>Balance at beginning of period</b> | \$ 2,528                               | \$ 338         | \$ 169                       | \$ 6        | \$ 3,041        |
| <b>Additions</b>                      |  |                |                              |             |                 |
| Provision for loan losses             | 1,402                                  | 164            | 30                           | —           | 1,596           |
| <b>Deductions</b>                     |  |                |                              |             |                 |
| Charge-offs                           | (1,563)                                | (185)          | (37)                         | —           | (1,785)         |
| Recoveries                            | 324                                    | 21             | 7                            | —           | 352             |
| Net charge-offs                       | (1,239)                                | (164)          | (30)                         | —           | (1,433)         |
| Other <sup>(2)</sup>                  | —                                      | —              | (2)                          | —           | (2)             |
| <b>Balance at end of period</b>       | <u>\$ 2,691</u>                        | <u>\$ 338</u>  | <u>\$ 167</u>                | <u>\$ 6</u> | <u>\$ 3,202</u> |

|                                       | For the Six Months Ended June 30, 2018 |                |                              |              |                 |
|---------------------------------------|--|----------------|------------------------------|--------------|-----------------|
|                                       | Credit Card                            | Personal Loans | Student Loans <sup>(1)</sup> | Other        | Total           |
| <b>Balance at beginning of period</b> | \$ 2,147                               | \$ 301         | \$ 162                       | \$ 11        | \$ 2,621        |
| <b>Additions</b>                      |  |                |                              |              |                 |
| Provision for loan losses             | 1,282                                  | 157            | 53                           | 1            | 1,493           |
| <b>Deductions</b>                     |  |                |                              |              |                 |
| Charge-offs                           | (1,347)                                | (161)          | (49)                         | (1)          | (1,558)         |
| Recoveries                            | 252                                    | 16             | 6                            | —            | 274             |
| Net charge-offs                       | (1,095)                                | (145)          | (43)                         | (1)          | (1,284)         |
| Other <sup>(2)</sup>                  | —                                      | —              | (2)                          | —            | (2)             |
| <b>Balance at end of period</b>       | <u>\$ 2,334</u>                        | <u>\$ 313</u>  | <u>\$ 170</u>                | <u>\$ 11</u> | <u>\$ 2,828</u> |

(1) Includes both PCI and non-PCI private student loans.

(2) Net change in reserves on PCI pools having no remaining non-accretable difference.

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

|  | For the Three Months Ended June 30, |        | For the Six Months Ended June 30, |        |
|--|-------------------------------------|--------|-----------------------------------|--------|
|  | 2019                                | 2018   | 2019                              | 2018   |
| Interest and fees accrued subsequently charged off, net of recoveries (recorded as a reduction of interest income) | \$ 128                              | \$ 110 | \$ 255                            | \$ 219 |
| Fees accrued subsequently charged off, net of recoveries (recorded as a reduction to other income)                 | \$ 30                               | \$ 28  | \$ 61                             | \$ 55  |

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The following tables provide additional detail of the Company's allowance for loan losses and recorded investment in its loan portfolio by impairment methodology (dollars in millions):

|  | Credit Card      | Personal Loans  | Student Loans <sup>(1)</sup> | Other Loans     | Total            |
|--|------------------|-----------------|------------------------------|-----------------|------------------|
| <b>At June 30, 2019</b>  |                  |                 |                              |                 |                  |
| <b>Allowance for loans evaluated for impairment as</b>                             |                  |                 |                              |                 |                  |
| Collectively evaluated for impairment in accordance with ASC 450-20                | \$ 2,265         | \$ 282          | \$ 116                       | \$ 4            | \$ 2,667         |
| Evaluated for impairment in accordance with ASC 310-10-35 <sup>(2)(3)</sup>        | 426              | 56              | 28                           | 2               | 512              |
| Acquired with deteriorated credit quality, evaluated in accordance with ASC 310-30 | —                | —               | 23                           | —               | 23               |
| <b>Total allowance for loan losses</b>   | <b>\$ 2,691</b>  | <b>\$ 338</b>   | <b>\$ 167</b>                | <b>\$ 6</b>     | <b>\$ 3,202</b>  |
| <b>Recorded investment in loans evaluated for impairment as</b>                    |                  |                 |                              |                 |                  |
| Collectively evaluated for impairment in accordance with ASC 450-20                | \$ 69,583        | \$ 7,233        | \$ 7,715                     | \$ 994          | \$ 85,525        |
| Evaluated for impairment in accordance with ASC 310-10-35 <sup>(2)(3)</sup>        | 2,810            | 181             | 228                          | 53              | 3,272            |
| Acquired with deteriorated credit quality, evaluated in accordance with ASC 310-30 | —                | —               | 1,432                        | —               | 1,432            |
| <b>Total recorded investment</b>   | <b>\$ 72,393</b> | <b>\$ 7,414</b> | <b>\$ 9,375</b>              | <b>\$ 1,047</b> | <b>\$ 90,229</b> |
| <b>At December 31, 2018</b>  |                  |                 |                              |                 |                  |
| <b>Allowance for loans evaluated for impairment as</b>                             |                  |                 |                              |                 |                  |
| Collectively evaluated for impairment in accordance with ASC 450-20                | \$ 2,229         | \$ 292          | \$ 121                       | \$ 4            | \$ 2,646         |
| Evaluated for impairment in accordance with ASC 310-10-35 <sup>(2)(3)</sup>        | 299              | 46              | 23                           | 2               | 370              |
| Acquired with deteriorated credit quality, evaluated in accordance with ASC 310-30 | —                | —               | 25                           | —               | 25               |
| <b>Total allowance for loan losses</b>   | <b>\$ 2,528</b>  | <b>\$ 338</b>   | <b>\$ 169</b>                | <b>\$ 6</b>     | <b>\$ 3,041</b>  |
| <b>Recorded investment in loans evaluated for impairment as</b>                    |                  |                 |                              |                 |                  |
| Collectively evaluated for impairment in accordance with ASC 450-20                | \$ 70,628        | \$ 7,302        | \$ 7,546                     | \$ 761          | \$ 86,237        |
| Evaluated for impairment in accordance with ASC 310-10-35 <sup>(2)(3)</sup>        | 2,248            | 152             | 182                          | 56              | 2,638            |
| Acquired with deteriorated credit quality, evaluated in accordance with ASC 310-30 | —                | —               | 1,637                        | —               | 1,637            |
| <b>Total recorded investment</b>   | <b>\$ 72,876</b> | <b>\$ 7,454</b> | <b>\$ 9,365</b>              | <b>\$ 817</b>   | <b>\$ 90,512</b> |

(1) Includes both PCI and non-PCI private student loans.

(2) Loan receivables evaluated for impairment in accordance with Accounting Standards Codification ("ASC") 310-10-35 include credit card loans, personal loans and student loans collectively evaluated for impairment in accordance with ASC Subtopic 310-40, *Receivables*, which consists of modified loans accounted for as TDRs. Other loans are individually evaluated for impairment and generally do not represent TDRs.

(3) The unpaid principal balance of credit card loans was \$2.5 billion and \$2.0 billion at June 30, 2019 and December 31, 2018, respectively. All loans accounted for as TDRs have a related allowance for loan losses.

### ***Troubled Debt Restructurings***

The Company has internal loan modification programs that provide relief to credit card, personal loan and student loan borrowers who may be experiencing financial hardship. The Company continually evaluates new programs to determine which of them meet the definition of a TDR. The internal loan modification programs include both temporary and permanent programs, which vary by product. External loan modification programs are also available for credit card and personal loans. Temporary and permanent modifications on credit card and personal loans, as well as temporary modifications on student loans and certain grants of student loan forbearance, result in the loans being considered individually impaired. In addition, loans that defaulted or graduated from modification programs or forbearance are considered to be individually impaired.

For credit card customers, the Company offers temporary hardship programs consisting of an interest rate reduction and in some cases a reduced minimum payment, both lasting for a period no longer than 12 months. The permanent modification 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. The permanent modification program does 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 permanent loan modifications for customers who request financial assistance through external sources, such as a consumer credit counseling agency program. 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. Modified credit card loans that are deemed to meet the definition of TDRs include loans in both temporary and permanent programs.

For personal loan customers, in certain situations the Company offers various payment programs, including temporary and permanent programs. The temporary programs normally consist of a reduction of the minimum payment for a period of no longer than 12 months with the option of a final balloon payment required at the end of the loan term or an extension of the maturity date with the total term not exceeding nine years. Further, in certain circumstances the interest rate on the loan is reduced. The permanent programs involve changing the terms of the loan in order to pay off the outstanding balance over a longer term and also in certain circumstances reducing the interest rate on the loan. Similar to the temporary programs, the total term may not exceed nine years. The Company also allows permanent loan modifications for customers who request financial assistance through external sources, similar to the credit card customers discussed above. Payments are modified based on the new terms agreed upon with the credit counseling agency. Personal loans included in temporary and permanent programs are accounted for as TDRs.

At June 30, 2019, there was \$5.5 billion of private student loans in repayment, which includes both PCI and non-PCI loans. To assist student loan borrowers who are experiencing temporary financial difficulties but are willing to resume making payments, the Company may offer hardship forbearance or programs that include payment deferral, temporary payment reduction, temporary interest rate reduction or extended terms. A non-PCI modified loan typically meets the definition of a TDR based on the cumulative length of the concession period and an evaluation of the credit quality of the borrower based on FICO scores.

Borrower performance after using payment programs or forbearance is monitored and the Company believes the programs help to prevent defaults and are useful in assisting customers experiencing financial difficulties. The Company plans to continue to use payment programs and forbearance and, as a result, expects to have additional loans classified as TDRs in the future.

Additional information about modified loans classified as TDRs is shown below (dollars in millions):

|   | Average recorded investment in loans | Interest income recognized during period loans were impaired <sup>(1)</sup> | Gross interest income that would have been recorded with original terms <sup>(2)</sup> |
|---|--------------------------------------|---|--|
| <b>For the Three Months Ended June 30, 2019</b> |                                      |   |  |
| Credit card loans <sup>(3)</sup>                | \$ 2,680                             | \$ 82   | \$ 50  |
| Personal loans                                  | \$ 173                               | \$ 4  | \$ 2   |
| Private student loans                           | \$ 215                               | \$ 4  | \$ —   |
| <b>For the Three Months Ended June 30, 2018</b> |                                      |   |  |
| Credit card loans <sup>(3)</sup>                | \$ 1,604                             | \$ 41   | \$ 32  |
| Personal loans                                  | \$ 125                               | \$ 3  | \$ 2   |
| Private student loans                           | \$ 153                               | \$ 3  | \$ —   |
| <b>For the Six Months Ended June 30, 2019</b>   |                                      |   |  |
| Credit card loans <sup>(3)</sup>                | \$ 2,541                             | \$ 152  | \$ 95  |
| Personal loans                                  | \$ 166                               | \$ 8  | \$ 4   |
| Private student loans                           | \$ 204                               | \$ 8  | \$ —   |
| <b>For the Six Months Ended June 30, 2018</b>   |                                      |   |  |
| Credit card loans <sup>(3)</sup>                | \$ 1,507                             | \$ 75   | \$ 58  |
| Personal loans                                  | \$ 120                               | \$ 6  | \$ 3   |
| Private student loans                           | \$ 147                               | \$ 6  | \$ —   |

- (1) 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.
- (2) The Company does not separately track the amount of additional 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 loans and the average interest rate earned on loans in the modification programs to the average loans in the modification programs.
- (3) Includes credit card loans that were modified in TDRs, but are no longer enrolled in a TDR program due to noncompliance with the terms of the modification or due to successful completion of a program after which charging privileges may be reinstated based on customer-level evaluation. The average balance of credit card loans that were no longer enrolled in a TDR program was \$834 million and \$397 million for the three months ended June 30, 2019 and 2018, respectively, and \$756 million and \$391 million for the six months ended June 30, 2019 and 2018, respectively.

In order to evaluate the primary financial effects that resulted from credit card loans entering into a loan modification program during the three and six months ended June 30, 2019 and 2018, the Company quantified the amount by which interest and fees were reduced during the periods. During the three months ended June 30, 2019 and 2018, the Company forgave approximately \$17 million and \$11 million, respectively, of interest and fees as a result of accounts entering into a credit card loan modification program. During the six months ended June 30, 2019 and 2018, the Company forgave approximately \$34 million and \$23 million, respectively, of interest and fees as a result of accounts entering into a credit card loan modification program.

The following table provides information on loans that entered a loan modification program during the period (dollars in millions):

|  | For the Three Months Ended June 30, |          |                    |          |
|--|-------------------------------------|----------|--------------------|----------|
|  | 2019                                |          | 2018               |          |
|  | Number of Accounts                  | Balances | Number of Accounts | Balances |
| <b>Accounts that entered a loan modification program during the period</b> |                                     |          |                    |          |
| Credit card loans  | 84,568                              | \$ 551   | 56,003             | \$ 363   |
| Personal loans   | 2,670                               | \$ 36    | 1,836              | \$ 23    |
| Private student loans  | 1,710                               | \$ 30    | 1,046              | \$ 21    |
|  | For the Six Months Ended June 30,   |          |                    |          |
|  | 2019                                |          | 2018               |          |
|  | Number of Accounts                  | Balances | Number of Accounts | Balances |
| <b>Accounts that entered a loan modification program during the period</b> |                                     |          |                    |          |
| Credit card loans  | 176,924                             | \$ 1,143 | 116,058            | \$ 743   |
| Personal loans   | 5,270                               | \$ 71    | 3,964              | \$ 52    |
| Private student loans  | 3,286                               | \$ 61    | 1,952              | \$ 37    |

The following table presents the carrying value of loans that experienced a payment default during the period that had been modified in a TDR during the 15 months preceding the end of each period (dollars in millions):

|   | For the Three Months Ended June 30, |  |                    |  |
|---|-------------------------------------|--|--------------------|--|
|   | 2019                                |  | 2018               |  |
|   | Number of Accounts                  | Aggregated Outstanding Balances Upon Default | Number of Accounts | Aggregated Outstanding Balances Upon Default |
| <b>Troubled debt restructurings that subsequently defaulted</b> |                                     |  |                    |  |
| Credit card loans <sup>(1)(2)</sup>                             | 16,220                              | \$ 95  | 8,970              | \$ 49  |
| Personal loans <sup>(2)</sup>                                   | 946                                 | \$ 14  | 637                | \$ 8   |
| Private student loans <sup>(3)</sup>                            | 290                                 | \$ 6   | 204                | \$ 3   |
|   | For the Six Months Ended June 30,   |  |                    |  |
|   | 2019                                |  | 2018               |  |
|   | Number of Accounts                  | Aggregated Outstanding Balances Upon Default | Number of Accounts | Aggregated Outstanding Balances Upon Default |
| <b>Troubled debt restructurings that subsequently defaulted</b> |                                     |  |                    |  |
| Credit card loans <sup>(1)(2)</sup>                             | 31,872                              | \$ 185                                       | 17,784             | \$ 96  |
| Personal loans <sup>(2)</sup>                                   | 1,794                               | \$ 27  | 1,212              | \$ 16  |
| Private student loans <sup>(3)</sup>                            | 570                                 | \$ 11  | 475                | \$ 8   |

(1) Terms revert back to the pre-modification terms for customers who default from a temporary program and charging privileges remain revoked in most cases.

(2) For credit card loans and personal loans, a customer defaults from a modification program after two consecutive missed payments. The outstanding balance upon default is generally the loan balance at the end of the month prior to default.

(3) For student loans, defaults have been defined as loans that are 60 or more days delinquent. The outstanding balance upon default is generally the loan balance at the end of the month prior to default.

Of the account balances that defaulted as shown above for the three months ended June 30, 2019 and 2018, approximately 39% and 34%, respectively, of the total balances were charged off at the end of the month in which they defaulted from a loan modification program. Of the account balances that defaulted as shown above for the six months ended June 30, 2019 and 2018, approximately 39% and 36%, respectively, of the total balances were charged off at the end of

the month in which they defaulted from a loan modification program. For accounts that have defaulted from a loan modification



program and have not been subsequently charged off, the balances are included in the allowance for loan loss analysis discussed above under "— Allowance for Loan Losses."

***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 SLC transaction, as well as the additional acquired private student loan portfolio comprise the Company's only PCI loans at June 30, 2019 and December 31, 2018 . Total PCI student loans had an outstanding balance of \$1.5 billion and \$1.7 billion , including accrued interest, and a related carrying amount of \$1.4 billion and \$1.6 billion as of June 30, 2019 and December 31, 2018 , respectively.

The following table provides changes in accretable yield for the acquired loans during each period (dollars in millions):

|                                       | For the Three Months Ended June 30, |        | For the Six Months Ended June 30, |        |
|---------------------------------------|-------------------------------------|--------|-----------------------------------|--------|
|                                       | 2019                                | 2018   | 2019                              | 2018   |
| <b>Balance at beginning of period</b> | \$ 538                              | \$ 633 | \$ 548                            | \$ 669 |
| Accretion into interest income        | (31)                                | (36)   | (63)                              | (72)   |
| Other changes in expected cash flows  | 1                                   | 11     | 23                                | 11     |
| <b>Balance at end of period</b>       | \$ 508                              | \$ 608 | \$ 508                            | \$ 608 |

Periodically, the Company updates the estimate of cash flows expected to be collected based on management's latest expectations of future net credit losses, borrower prepayments and certain other assumptions that affect cash flows. No provision expense was recorded during the three or six months ended June 30, 2019 and 2018 . The allowance for PCI loan losses at June 30, 2019 and December 31, 2018 was \$23 million and \$25 million , respectively. For the three and six months ended June 30, 2019 and 2018 , the increase in accretable yield was primarily driven by changes in rates on variable rate loans. Changes to accretable yield are recognized prospectively as an adjustment to yield over the remaining life of the pools.

At June 30, 2019 , the 30 or more days delinquency and 90 or more days delinquency rates on PCI student loans (which include loans not yet in repayment) were 2.64% and 0.58% , respectively. At December 31, 2018 , the 30 or more days delinquency and 90 or more days delinquency rates on PCI student loans (which include loans not yet in repayment) were 2.93% and 0.78% , respectively. These rates include private student loans that are greater than 120 days delinquent that are covered by an indemnification agreement or insurance arrangements through which the Company expects to recover a substantial portion of the loan. The net charge-off rate on PCI student loans was 0.43% and 0.31% for the three months ended June 30, 2019 and 2018 , respectively, and 0.34% and 0.66% for the six months ended June 30, 2019 and 2018 , respectively.

**4. Credit Card and Student Loan Securitization Activities**

The Company's securitizations are accounted for as secured borrowings and the related trusts are treated as consolidated subsidiaries of the Company. For a description of the Company's principles of consolidation with respect to VIEs, see Note 1: Background and Basis of Presentation to the consolidated financial statements of the Company's annual report on Form 10-K for the year ended December 31, 2018 .

***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"). Credit card loan receivables are transferred into DCMT and beneficial interests in DCMT are transferred into DCENT. DCENT issues debt securities to investors that are reported in long-term borrowings.

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 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 subordinated classes are held by wholly-owned subsidiaries of Discover Bank. The Company is exposed to credit-related risk of loss associated with trust assets as of the balance sheet date through the retention of these subordinated interests. The estimated probable incurred loss is included in the allowance for loan losses estimate.

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The Company's retained interests in the assets of the trusts, consisting of investments in DCENT notes held by subsidiaries of Discover Bank, constitute intercompany positions, which are eliminated in the preparation of the Company's condensed consolidated statements 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. Further, the transferred credit card loan receivables are owned by the trust and are not available to third-party creditors of the Company. The trusts have ownership of cash balances, the amounts of which are reported in restricted cash. 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. 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 the Company's general credit for a shortage in cash flows.

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

|  | June 30,<br>2019 | December 31,<br>2018 |
|--|------------------|----------------------|
| Restricted cash  | \$ 1,029         | \$ 1,834             |
| Investors' interests held by third-party investors                                 | 14,000           | 16,800               |
| Investors' interests held by wholly-owned subsidiaries of Discover Bank            | 4,951            | 5,211                |
| Seller's interest  | 12,287           | 11,050               |
| Loan receivables <sup>(1)</sup>  | 31,238           | 33,061               |
| Allowance for loan losses allocated to securitized loan receivables <sup>(1)</sup> | (1,161)          | (1,150)              |
| Net loan receivables   | 30,077           | 31,911               |
| Other  | 8                | 7                    |
| Carrying value of assets of consolidated variable interest entities                | <u>\$ 31,114</u> | <u>\$ 33,752</u>     |

(1) 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 trusts are subject to credit, payment and interest rate risks on the transferred credit card loan receivables. To protect investors in the securities, there are certain features or triggering events that could cause an early amortization of the debt securities, including triggers related to the impact of the performance of the trust receivables on the availability and adequacy of cash flows to meet contractual requirements. As of June 30, 2019, no economic or other early amortization events have occurred.

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, net of related expenses.

### ***Student Loan Securitization Activities***

Student loan trust receivables underlying third-party investors' interests are recorded in PCI loans and the related debt issued by the trusts is reported in long-term borrowings. The assets of the trusts are restricted from being sold or pledged as collateral for other borrowings and the cash flows from these restricted assets may be used only to pay obligations of the trusts. With the exception of the trusts' restricted assets, the trusts and investors have no recourse to the Company's other assets or the Company's general credit for a shortage in cash flows.

Currently there is one trust from which issued securities remain outstanding to investors. Principal payments on the long-term secured borrowings are made as cash is collected on the underlying loans that are used as collateral on the secured borrowings. The Company does not have access to cash collected by the securitization trust until cash is released in accordance with the trust indenture agreement. Similar to the credit card securitizations, the Company continues to own and service the accounts that generate the student loan receivables held by the trust and receives servicing fees from the trust based on a percentage of the principal balance outstanding. Although the servicing fee income offsets the fee expense related

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to the trust 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, net of related expenses.

Under terms of the trust arrangement, the Company has the option, but not the obligation, to provide financial support to the trust, but has never provided such support. A substantial portion of the credit risk associated with the securitized loans has been transferred to a third party under an indemnification arrangement.

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

|   | June 30,<br>2019 | December 31,<br>2018 |
|---|------------------|----------------------|
| Restricted cash   | \$ 11            | \$ 12                |
| Student loan receivables  | 326              | 363                  |
| Carrying value of assets of consolidated variable interest entities | <u>\$ 337</u>    | <u>\$ 375</u>        |

## 5. Deposits

The Company offers its deposit products 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"). Direct-to-consumer deposits include online savings accounts, certificates of deposit, money market accounts, IRA certificates of deposit and checking accounts, while brokered deposits include certificates of deposit and sweep accounts.

The following table provides a summary of interest-bearing deposit accounts (dollars in millions):

|  | June 30,<br>2019 | December 31,<br>2018 |
|--|------------------|----------------------|
| Certificates of deposit in amounts less than \$100,000                 | \$ 25,909        | \$ 27,947            |
| Certificates of deposit in amounts \$100,000 or greater <sup>(1)</sup> | 7,789            | 6,841                |
| Savings deposits, including money market deposit accounts              | 35,366           | 32,296               |
| Total interest-bearing deposits  | <u>\$ 69,064</u> | <u>\$ 67,084</u>     |

(1) Includes \$2.0 billion and \$1.7 billion in certificates of deposit equal to or greater than \$250,000, the Federal Deposit Insurance Corporation ("FDIC") insurance limit, as of June 30, 2019 and December 31, 2018, respectively.

The following table summarizes certificates of deposit in amounts of \$100,000 or greater by contractual maturity (dollars in millions):

|                                       | June 30, 2019   |
|---------------------------------------|-----------------|
| Three months or less                  | \$ 1,285        |
| Over three months through six months  | 1,293           |
| Over six months through twelve months | 2,921           |
| Over twelve months                    | 2,290           |
| Total                                 | <u>\$ 7,789</u> |

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The following table summarizes certificates of deposit maturing over the remainder of this year, over each of the next four years, and thereafter (dollars in millions):

|              | June 30, 2019    |
|--------------|------------------|
| 2019         | \$ 8,037         |
| 2020         | 12,269           |
| 2021         | 5,678            |
| 2022         | 3,002            |
| 2023         | 1,860            |
| Thereafter   | 2,852            |
| <b>Total</b> | <b>\$ 33,698</b> |

## 6. Long-Term Borrowings

Long-term borrowings consist of borrowings 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 outstanding balances (dollars in millions):

|   | June 30, 2019 |               |                                | December 31, 2018  |                    |
|---|---------------|---------------|--------------------------------|--------------------|--------------------|
|   | Maturity      | Interest Rate | Weighted-Average Interest Rate | Outstanding Amount | Outstanding Amount |
| <b>Securitized Debt</b>   |               |               |                                |                    |                    |
| Fixed-rate asset-backed securities <sup>(1)</sup>                         | 2019-2024     | 1.39%-3.32%   | 2.34%                          | \$ 9,821           | \$ 10,657          |
| Floating-rate asset-backed securities <sup>(2)(3)</sup>                   | 2020-2024     | 2.62%-2.99%   | 2.80%                          | 4,215              | 6,063              |
| Total Discover Card Master Trust I and Discover Card Execution Note Trust |               |               |                                | 14,036             | 16,720             |
| Floating-rate asset-backed security <sup>(4)(5)</sup>                     | 2031          | 6.50%         | 6.50%                          | 178                | 197                |
| Total SLC Private Student Loan Trust                                      |               |               |                                | 178                | 197                |
| Total long-term borrowings - owed to securitization investors             |               |               |                                | 14,214             | 16,917             |
| <b>Discover Financial Services (Parent Company)</b>                       |               |               |                                |                    |                    |
| Fixed-rate senior notes   | 2019-2027     | 3.75%-10.25%  | 4.30%                          | 3,356              | 2,743              |
| Fixed-rate retail notes   | 2019-2031     | 2.85%-4.60%   | 3.73%                          | 339                | 346                |
| <b>Discover Bank</b>  |               |               |                                |                    |                    |
| Fixed-rate senior bank notes <sup>(1)</sup>                               | 2020-2028     | 3.10%-4.65%   | 3.69%                          | 6,058              | 6,027              |
| Fixed-rate subordinated bank notes  | 2019-2028     | 4.68%-8.70%   | 6.32%                          | 1,196              | 1,195              |
| <b>Total long-term borrowings</b>   |               |               |                                | <b>\$ 25,163</b>   | <b>\$ 27,228</b>   |

(1) The Company uses interest rate swaps to hedge portions of these long-term borrowings against changes in fair value attributable to changes in London Interbank Offered Rate ("LIBOR") or Overnight Index Swap ("OIS") Rate. Use of these interest rate swaps impacts carrying value of the debt. See Note 14: Derivatives and Hedging Activities.

(2) Discover Card Execution Note Trust floating-rate asset-backed securities include issuances with the following interest rate terms: 1-month LIBOR + 23 to 60 basis points as of June 30, 2019.

(3) The Company uses interest rate swaps to manage its exposure to changes in interest rates related to future cash flows resulting from interest payments on a portion of these long-term borrowings. There is no impact on debt carrying value from use of these interest rate swaps. See Note 14: Derivatives and Hedging Activities.

(4) SLC Private Student Loan Trust floating-rate asset-backed security includes an issuance with the following interest rate term: Prime rate + 100 basis points as of June 30, 2019.

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

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The following table summarizes long-term borrowings maturing over the remainder of this year, over each of the next four years, and thereafter (dollars in millions):

|              | <b>June 30, 2019</b> |
|--------------|----------------------|
| 2019         | \$ 2,475             |
| 2020         | 4,739                |
| 2021         | 3,417                |
| 2022         | 4,110                |
| 2023         | 3,329                |
| Thereafter   | 7,093                |
| <b>Total</b> | <b>\$ 25,163</b>     |

The Company has access to committed borrowing capacity through private securitizations to support the funding of its credit card loan receivables. As of June 30, 2019, the total commitment of secured credit facilities through private providers was \$6.0 billion, none of which was drawn as of June 30, 2019. Access to the unused portions of the secured credit facilities is subject to the terms of the agreements with each of the providers, which have various expirations in calendar years 2020 through 2022. 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.

**7. Accumulated Other Comprehensive Income**

Changes in each component of accumulated other comprehensive income (loss) ("AOCI") were as follows (dollars in millions):

|  | <b>Unrealized Gains<br/>(Losses) on<br/>Available-for-Sale<br/>Investment<br/>Securities, Net of<br/>Tax</b> | <b>Gains (Losses) on<br/>Cash Flow Hedges,<br/>Net of Tax</b> | <b>Losses on Pension<br/>Plan, Net of Tax</b> | <b>AOCI</b>     |
|--|--|---|---|-----------------|
| <b>For the Three Months Ended June 30, 2019</b>              |  |   |   |                 |
| <b>Balance at March 31, 2019</b>                             | \$ 41  | \$ 10   | \$ (187)                                      | \$ (136)        |
| Net change   | 71   | (18)  | —   | 53              |
| <b>Balance at June 30, 2019</b>                              | <b>\$ 112</b>  | <b>\$ (8)</b>   | <b>\$ (187)</b>                               | <b>\$ (83)</b>  |
| <b>For the Three Months Ended June 30, 2018</b>              |  |   |   |                 |
| <b>Balance at March 31, 2018</b>                             | \$ (12)  | \$ 29   | \$ (156)                                      | \$ (139)        |
| Cumulative effect of ASU No. 2018-02 adoption <sup>(1)</sup> | (1)  | 3   | (31)  | (29)            |
| Net change   | (1)  | 7   | —   | 6               |
| <b>Balance at June 30, 2018</b>                              | <b>\$ (14)</b>   | <b>\$ 39</b>  | <b>\$ (187)</b>                               | <b>\$ (162)</b> |
| <b>For the Six Months Ended June 30, 2019</b>                |  |   |   |                 |
| <b>Balance at December 31, 2018</b>                          | \$ 10  | \$ 22   | \$ (188)                                      | \$ (156)        |
| Net change   | 102  | (30)  | 1   | 73              |
| <b>Balance at June 30, 2019</b>                              | <b>\$ 112</b>  | <b>\$ (8)</b>   | <b>\$ (187)</b>                               | <b>\$ (83)</b>  |
| <b>For the Six Months Ended June 30, 2018</b>                |  |   |   |                 |
| <b>Balance at December 31, 2017</b>                          | \$ (5)   | \$ 10   | \$ (157)                                      | \$ (152)        |
| Cumulative effect of ASU No. 2018-02 adoption <sup>(1)</sup> | (1)  | 3   | (31)  | (29)            |
| Net change   | (8)  | 26  | 1   | 19              |
| <b>Balance at June 30, 2018</b>                              | <b>\$ (14)</b>   | <b>\$ 39</b>  | <b>\$ (187)</b>                               | <b>\$ (162)</b> |

(1) Represents the adjustment to AOCI as a result of adoption of ASU No. 2018-02, Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income, in the second quarter of 2018.

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The following table presents each component of other comprehensive income (loss) ("OCI") before reclassifications and amounts reclassified from AOCI for each component of OCI before- and after-tax (dollars in millions):

|   | Before Tax     | Tax (Expense)<br>Benefit | Net of Tax     |
|---|----------------|--------------------------|----------------|
| <b>For the Three Months Ended June 30, 2019</b>         |                |                          |                |
| <b>Available-for-Sale Investment Securities</b>         |                |                          |                |
| Net unrealized holding gains arising during the period  | \$ 94          | \$ (23)                  | \$ 71          |
| Net change  | <u>\$ 94</u>   | <u>\$ (23)</u>           | <u>\$ 71</u>   |
| <b>Cash Flow Hedges</b>                                 |                |                          |                |
| Net unrealized losses arising during the period         | \$ (22)        | \$ 6                     | \$ (16)        |
| Amounts reclassified from AOCI                          | (2)            | —                        | (2)            |
| Net change  | <u>\$ (24)</u> | <u>\$ 6</u>              | <u>\$ (18)</u> |
| <b>For the Three Months Ended June 30, 2018</b>         |                |                          |                |
| <b>Available-for-Sale Investment Securities</b>         |                |                          |                |
| Net unrealized holding losses arising during the period | \$ (1)         | \$ —                     | \$ (1)         |
| Net change  | <u>\$ (1)</u>  | <u>\$ —</u>              | <u>\$ (1)</u>  |
| <b>Cash Flow Hedges</b>                                 |                |                          |                |
| Net unrealized gains arising during the period          | \$ 10          | \$ (2)                   | \$ 8           |
| Amounts reclassified from AOCI                          | (1)            | —                        | (1)            |
| Net change  | <u>\$ 9</u>    | <u>\$ (2)</u>            | <u>\$ 7</u>    |
| <b>For the Six Months Ended June 30, 2019</b>           |                |                          |                |
| <b>Available-for-Sale Investment Securities</b>         |                |                          |                |
| Net unrealized holding gains arising during the period  | \$ 134         | \$ (32)                  | \$ 102         |
| Net change  | <u>\$ 134</u>  | <u>\$ (32)</u>           | <u>\$ 102</u>  |
| <b>Cash Flow Hedges</b>                                 |                |                          |                |
| Net unrealized losses arising during the period         | \$ (35)        | \$ 9                     | \$ (26)        |
| Amounts reclassified from AOCI                          | (5)            | 1                        | (4)            |
| Net change  | <u>\$ (40)</u> | <u>\$ 10</u>             | <u>\$ (30)</u> |
| <b>Pension Plan</b>                                     |                |                          |                |
| Unrealized gains arising during the period              | \$ 1           | \$ —                     | \$ 1           |
| Net change  | <u>\$ 1</u>    | <u>\$ —</u>              | <u>\$ 1</u>    |
| <b>For the Six Months Ended June 30, 2018</b>           |                |                          |                |
| <b>Available-for-Sale Investment Securities</b>         |                |                          |                |
| Net unrealized holding losses arising during the period | \$ (10)        | \$ 2                     | \$ (8)         |
| Net change  | <u>\$ (10)</u> | <u>\$ 2</u>              | <u>\$ (8)</u>  |
| <b>Cash Flow Hedges</b>                                 |                |                          |                |
| Net unrealized gains arising during the period          | \$ 34          | \$ (8)                   | \$ 26          |
| Net change  | <u>\$ 34</u>   | <u>\$ (8)</u>            | <u>\$ 26</u>   |
| <b>Pension Plan</b>                                     |                |                          |                |
| Unrealized gains arising during the period              | \$ 1           | \$ —                     | \$ 1           |
| Net change  | <u>\$ 1</u>    | <u>\$ —</u>              | <u>\$ 1</u>    |

## 8. Income Taxes

The following table presents the calculation of the Company's effective income tax rate (dollars in millions, except effective income tax rate):

|                                  | For the Three Months Ended June 30, |        | For the Six Months Ended June 30, |          |
|----------------------------------|-------------------------------------|--------|-----------------------------------|----------|
|                                  | 2019                                | 2018   | 2019                              | 2018     |
| Income before income tax expense | \$ 987                              | \$ 877 | \$ 1,917                          | \$ 1,733 |
| Income tax expense               | \$ 234                              | \$ 208 | \$ 438                            | \$ 398   |
| Effective income tax rate        | 23.8%                               | 23.7%  | 22.9%                             | 23.0%    |

Income tax expense increased \$26 million and \$40 million for the three and six months ended June 30, 2019, respectively, as compared to the same periods in 2018. The effective tax rate was flat for the three and six months ended June 30, 2019 as compared to the same periods in 2018.

The Company is subject to examination by the Internal Revenue Service ("IRS") and tax authorities in various state, local and foreign tax jurisdictions. The Company regularly assesses the likelihood of additional assessments or settlements in each of the taxing jurisdictions resulting from these and subsequent years' examinations. The IRS is currently examining the years 2011-2015. At this time, the potential change in unrecognized tax benefits is not expected to be significant over the next 12 months. The Company believes that its reserves are sufficient to cover any tax, penalties and interest that would result from such examinations.

## 9. Earnings Per Share

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

|  | For the Three Months Ended June 30, |         | For the Six Months Ended June 30, |          |
|--|-------------------------------------|---------|-----------------------------------|----------|
|  | 2019                                | 2018    | 2019                              | 2018     |
| <b>Numerator</b>   |                                     |         |                                   |          |
| Net income   | \$ 753                              | \$ 669  | \$ 1,479                          | \$ 1,335 |
| Preferred stock dividends  | —                                   | —       | (16)                              | (16)     |
| Net income available to common stockholders                                      | 753                                 | 669     | 1,463                             | 1,319    |
| Income allocated to participating securities                                     | (6)                                 | (6)     | (11)                              | (10)     |
| Net income allocated to common stockholders                                      | \$ 747                              | \$ 663  | \$ 1,452                          | \$ 1,309 |
| <b>Denominator</b>   |                                     |         |                                   |          |
| Weighted-average shares of common stock outstanding                              | 322                                 | 348     | 325                               | 351      |
| Effect of dilutive common stock equivalents                                      | 1                                   | —       | 1                                 | —        |
| Weighted-average shares of common stock outstanding and common stock equivalents | 323                                 | 348     | 326                               | 351      |
| Basic earnings per common share  | \$ 2.32                             | \$ 1.91 | \$ 4.46                           | \$ 3.73  |
| Diluted earnings per common share  | \$ 2.32                             | \$ 1.91 | \$ 4.46                           | \$ 3.72  |

There were no anti-dilutive securities on the computation of diluted EPS for the three or six months ended June 30, 2019 and 2018.

## 10. Capital Adequacy

The Company is subject to the capital adequacy guidelines of the Federal Reserve, and Discover Bank, the Company's main banking subsidiary, is subject to various regulatory capital requirements as administered by 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 Discover Bank. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company

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and Discover Bank must meet specific capital guidelines that involve quantitative measures of assets, liabilities and certain off-balance sheet items, as calculated under regulatory guidelines. Capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

The Company and Discover Bank are subject to regulatory and capital rules issued by the Federal Reserve and FDIC, respectively, under the Basel Committee's December 2010 framework ("Basel III rules"). The Basel III rules, which became effective for the Company January 2015, were subject to phase-in periods through the end of 2018, based on the Company being classified as a "Standardized Approach" entity. As of January 1, 2019, the Basel III rules subject to transition have all been fully phased in with the exception of certain transition provisions that were frozen pursuant to regulation issued in November 2017.

As of June 30, 2019, the Company and Discover Bank met all Basel III minimum capital ratio requirements to which they were subject. The Company and Discover Bank also met the requirements to be considered "well-capitalized" under Regulation Y and prompt corrective action regulations, respectively, and there have been no conditions or events that management believes have changed the Company's or Discover Bank's category. To be categorized as "well-capitalized," the Company and Discover Bank must maintain minimum capital ratios as set forth in the table below.

The following table shows the actual capital amounts and ratios of the Company and Discover Bank and comparisons of each to the regulatory minimum and "well-capitalized" requirements (dollars in millions):

|   | Actual    |                      | Minimum Capital Requirements |       | Capital Requirements To Be Classified as Well-Capitalized |                      |
|---|-----------|----------------------|------------------------------|-------|---|----------------------|
|   | Amount    | Ratio <sup>(1)</sup> | Amount                       | Ratio | Amount <sup>(2)</sup>                                     | Ratio <sup>(2)</sup> |
| <b>June 30, 2019</b>                                  |           |                      |                              |       |   |                      |
| <b>Total capital (to risk-weighted assets)</b>        |           |                      |                              |       |   |                      |
| Discover Financial Services                           | \$ 12,765 | 13.7%                | \$ 7,436                     | ≥8.0% | \$ 9,295  | ≥10.0%               |
| Discover Bank   | \$ 13,218 | 14.4%                | \$ 7,351                     | ≥8.0% | \$ 9,188  | ≥10.0%               |
| <b>Tier 1 capital (to risk-weighted assets)</b>       |           |                      |                              |       |   |                      |
| Discover Financial Services                           | \$ 11,188 | 12.0%                | \$ 5,577                     | ≥6.0% | \$ 5,577  | ≥6.0%                |
| Discover Bank   | \$ 11,047 | 12.0%                | \$ 5,513                     | ≥6.0% | \$ 7,351  | ≥8.0%                |
| <b>Tier 1 capital (to average assets)</b>             |           |                      |                              |       |   |                      |
| Discover Financial Services                           | \$ 11,188 | 10.2%                | \$ 4,404                     | ≥4.0% | N/A   | N/A                  |
| Discover Bank   | \$ 11,047 | 10.1%                | \$ 4,355                     | ≥4.0% | \$ 5,444  | ≥5.0%                |
| <b>Common Equity Tier 1 (to risk-weighted assets)</b> |           |                      |                              |       |   |                      |
| Discover Financial Services                           | \$ 10,625 | 11.4%                | \$ 4,183                     | ≥4.5% | N/A   | N/A                  |
| Discover Bank   | \$ 11,047 | 12.0%                | \$ 4,135                     | ≥4.5% | \$ 5,972  | ≥6.5%                |
| <b>December 31, 2018</b>                              |           |                      |                              |       |   |                      |
| <b>Total capital (to risk-weighted assets)</b>        |           |                      |                              |       |   |                      |
| Discover Financial Services                           | \$ 12,532 | 13.5%                | \$ 7,450                     | ≥8.0% | \$ 9,312  | ≥10.0%               |
| Discover Bank   | \$ 13,106 | 14.2%                | \$ 7,372                     | ≥8.0% | \$ 9,215  | ≥10.0%               |
| <b>Tier 1 capital (to risk-weighted assets)</b>       |           |                      |                              |       |   |                      |
| Discover Financial Services                           | \$ 10,895 | 11.7%                | \$ 5,587                     | ≥6.0% | \$ 5,587  | ≥6.0%                |
| Discover Bank   | \$ 10,834 | 11.8%                | \$ 5,529                     | ≥6.0% | \$ 7,372  | ≥8.0%                |
| <b>Tier 1 capital (to average assets)</b>             |           |                      |                              |       |   |                      |
| Discover Financial Services                           | \$ 10,895 | 10.1%                | \$ 4,308                     | ≥4.0% | N/A   | N/A                  |
| Discover Bank   | \$ 10,834 | 10.2%                | \$ 4,265                     | ≥4.0% | \$ 5,332  | ≥5.0%                |
| <b>Common Equity Tier 1 (to risk-weighted assets)</b> |           |                      |                              |       |   |                      |
| Discover Financial Services                           | \$ 10,332 | 11.1%                | \$ 4,191                     | ≥4.5% | N/A   | N/A                  |
| Discover Bank   | \$ 10,834 | 11.8%                | \$ 4,147                     | ≥4.5% | \$ 5,990  | ≥6.5%                |

(1) Capital ratios are calculated based on the Basel III Standardized Approach rules, subject to applicable transition provisions.

(2) The Basel III rules do not establish well-capitalized thresholds for these measures for bank holding companies. Existing well-capitalized thresholds established in the Federal Reserve's Regulation Y have been included where available.



## 11. Commitments, Contingencies and Guarantees

In the normal course of business, the Company enters into a number of off-balance sheet commitments, transactions and obligations under guarantee arrangements that expose the Company to varying degrees of risk. The Company's commitments, contingencies and guarantee relationships are described below.

### **Commitments**

#### *Unused Credit Arrangements*

At June 30, 2019, the Company had unused credit arrangements for loans of approximately \$204.0 billion. Such arrangements arise primarily from agreements with customers for unused lines of credit on certain credit cards and certain other loan products, provided there is no violation of conditions in the related agreements. These arrangements, 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.

### **Contingencies**

See Note 12: Litigation and Regulatory Matters for a description of potential liability arising from pending litigation or regulatory proceedings involving the Company.

### **Guarantees**

The Company has obligations under certain guarantee arrangements, including contracts, indemnification agreements, and representations and warranties, 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.

#### *Securitized 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 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, and the principal amount of any student loan secured borrowings, plus any unpaid interest for the corresponding secured borrowings. The Company has recorded substantially all of the maximum potential amount of future payments in long-term borrowings on the Company's condensed consolidated statements 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.

#### *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.
- *Network Alliance Guarantee.* Discover Network, Diners Club and PULSE have entered into contractual relationships with certain international payment networks in which DFS Services LLC retains the counterparty exposure if a network 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 potential counterparty defaults on its settlement and the time at which the Company disables the settlement of any further transactions for the defaulting party. The Company has some contractual remedies to offset these counterparty settlement exposures (such as letters of credit or pledged deposits), 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. 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 would be approximately \$170 million as of June 30, 2019.

The Company believes that the estimated amounts of maximum potential future payments are not representative of the Company's actual potential loss exposure given Diners Club's and PULSE's insignificant historical losses from these counterparty exposures. As of June 30, 2019, 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.

#### *Discover Network Merchant Chargeback Guarantees*

The Company operates the Discover Network, issues payment cards and permits third parties to issue payment cards. 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. Losses related to merchant chargebacks were not material for the three and six months ended June 30, 2019 and 2018.

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 following table summarizes certain information regarding merchant chargeback guarantees (in millions):

|   | For the Three Months Ended June 30, |           | For the Six Months Ended June 30, |           |
|---|-------------------------------------|-----------|-----------------------------------|-----------|
|   | 2019                                | 2018      | 2019                              | 2018      |
| Aggregate sales transaction volume <sup>(1)</sup> | \$ 42,831                           | \$ 39,977 | \$ 81,590                         | \$ 75,994 |

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

The Company did not record any contingent liability in the condensed consolidated financial statements for merchant chargeback guarantees as of June 30, 2019 or December 31, 2018 . 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. As of June 30, 2019 and December 31, 2018 , the Company had escrow deposits and settlement withholdings of \$11 million and \$10 million , respectively, which are recorded in interest-bearing deposit accounts and accrued expenses and other liabilities on the Company's condensed consolidated statements of financial condition.

## **12. Litigation and Regulatory Matters**

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 litigation process is not predictable and can lead to unexpected results. The Company contests liability and/or the amount of damages as appropriate in each pending matter.

The Company has historically offered its customers an arbitration clause in its customer agreements. The arbitration clause allows the Company and its customers to quickly and economically resolve disputes. Additionally, the arbitration clause has in some instances limited the costs of, and the Company's exposure to, litigation. Future legal and regulatory challenges and prohibitions may cause the Company to discontinue its offering and use of such clauses. From time to time, the Company is involved in legal actions challenging its arbitration clause. Bills may be periodically introduced in Congress to directly or indirectly prohibit the use of pre-dispute arbitration clauses.

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, consumer regulatory, accounting, tax and other operational matters, some of which may result in significant adverse judgments, settlements, fines, penalties, injunctions, decreases in regulatory ratings, customer restitution or other relief, which could materially impact the Company's condensed consolidated financial statements, increase its cost of operations, or limit its ability to execute its business strategies and engage in certain business activities. For example, the Company is currently the subject of an action by the Federal Reserve with respect to anti-money laundering and related compliance programs as referred to below. In addition, certain subsidiaries of the Company are subject to a consent order with the Consumer Financial Protection Bureau (the "CFPB") regarding certain student loan servicing practices, as described below. Pursuant to powers granted under federal banking laws, regulatory agencies have broad and sweeping discretion, and may assess civil money penalties, require changes to certain business practices or require customer restitution at any time. The existing supervisory action related to anti-money laundering and related laws and regulations will limit for a period of time the Company's ability to enter into certain types of acquisitions and make certain types of investments.

In accordance with applicable accounting guidance, the Company establishes an accrued liability for legal and regulatory matters when those matters present loss contingencies that are both probable and estimable. Litigation and regulatory settlement related expense was not material for the three and six months ended June 30, 2019 and 2018 .

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 amounts that the Company has accrued for legal and regulatory proceedings is up to \$100 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. Various aspects of 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 condensed 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.

On May 26, 2015, the Company entered into a written agreement with the Federal Reserve Bank of Chicago where the Company agreed to enhance the Company's enterprise-wide anti-money laundering and related compliance programs. The agreement does not include civil money penalties.

On July 22, 2015, the Company announced that its subsidiaries, Discover Bank, SLC and Discover Products Inc. (the "Discover Subsidiaries"), agreed to a consent order with the CFPB resolving the agency's investigation with respect to certain student loan servicing practices. The CFPB's investigation into these practices has been previously disclosed by the Company, initially in February 2014. The order required the Discover Subsidiaries to provide redress of approximately \$16 million to consumers who may have been affected by the activities described in the order related to certain collection calls, overstatements of minimum payment due amounts in billing statements, and provision of interest paid information to consumers, and provide regulatory disclosures with respect to loans acquired in default. In addition, the Discover Subsidiaries were required to pay a \$2.5 million civil money penalty to the CFPB. As required by the consent order, on October 19, 2015, the Discover Subsidiaries submitted to the CFPB a redress plan and a compliance plan designed to ensure that the Discover Subsidiaries provide redress and otherwise comply with the terms of the order.

On March 8, 2016, a class action lawsuit was filed against the Company, other credit card networks, other issuing banks, and EMVCo in the U.S. District Court for the Northern District of California (B&R Supermarket, Inc., d/b/a Milam's Market, et al. v. Visa, Inc. et al.) alleging violations of the Sherman Antitrust Act, California's Cartwright Act, and unjust enrichment. Plaintiffs allege a conspiracy by defendants to shift fraud liability to merchants with the migration to the EMV security standard and chip technology. Plaintiffs assert joint and several liability among the defendants and seek unspecified damages, including treble damages, attorneys' fees, costs and injunctive relief. On July 15, 2016, plaintiffs filed an amended complaint that includes additional named plaintiffs, reasserts the original claims, and includes additional state law causes of action. On September 30, 2016, the court granted the motions to dismiss for certain issuing banks and EMVCo but denied the motions to dismiss filed by the networks, including the Company. In May 2017, the Court entered an order transferring the entire action to a federal court in New York that is presiding over certain related claims that are pending in the actions consolidated as MDL 1720. On March 11, 2018, the Court entered an order denying the plaintiffs' motion for class certification without prejudice to filing a renewed motion. Plaintiffs filed a renewed motion for class certification on July 16, 2018 and opening merits expert reports on October 5, 2018. Defendants filed their Opposition to Class Certification on March 15, 2019. Briefing and expert discovery related to class certification will close in July 2019 with a hearing date on class certification to be scheduled. 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, but will seek to vigorously defend against all claims asserted by the plaintiffs.

### 13. Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC Topic 820, *Fair Value Measurement*, provides a three-level hierarchy for classifying financial instruments, which is based on whether the inputs to the valuation techniques used to measure the fair value of each financial instrument are observable or unobservable. It also requires certain disclosures about those measurements. The three-level valuation hierarchy is as follows:

- *Level 1* : Fair values determined by Level 1 inputs are defined as those that utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access.
- *Level 2* : Fair values determined by Level 2 inputs are those that utilize inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and liabilities in active or inactive markets, quoted prices for the identical assets in an inactive market, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals. The Company evaluates factors such as the frequency of transactions, the size of the bid-ask spread and the significance of adjustments made when considering transactions involving similar assets or liabilities to assess the relevance of those observed prices. If relevant and observable prices are available, the fair values of the related assets or liabilities would be classified as Level 2.
- *Level 3* : Fair values determined by Level 3 inputs are those based on unobservable inputs and include situations where there is little, if any, market activity for the asset or liability being valued. In instances in which the inputs used to measure fair value may fall into different levels of the fair value hierarchy, the level in the fair value hierarchy within which the fair value measurement in its entirety is classified is based on the lowest level input that is significant to the fair value measurement in its entirety. The Company may utilize both observable and unobservable inputs in determining the fair values of financial instruments classified within the Level 3 category.

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The determination of classification of its financial instruments within the fair value hierarchy is performed at least quarterly by the Company. For transfers in and out of the levels of the fair value hierarchy, the Company discloses the fair value measurement based on the value immediately preceding the transfer.

The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and involves consideration of factors specific to the asset or liability. Furthermore, certain techniques used to measure fair value 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.

**Assets and Liabilities Measured at Fair Value on a Recurring Basis**

Assets and liabilities measured at fair value on a recurring basis are as follows (dollars in millions):

|   | Quoted Price in<br>Active Markets<br>for Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total    |
|---|---|---|--|----------|
| <b>Balance at June 30, 2019</b>                                     |   |   |  |          |
| <b>Assets</b>   |   |   |  |          |
| <b>Fair value - OCI</b>   |   |   |  |          |
| U.S. Treasury securities  | \$ 6,835  | \$ —  | \$ —   | \$ 6,835 |
| Residential mortgage-backed securities - Agency                     | —   | 488   | —  | 488      |
| Available-for-sale investment securities                            | \$ 6,835  | \$ 488  | \$ —   | \$ 7,323 |
| <b>Liabilities</b>  |   |   |  |          |
| <b>Fair value - OCI</b>   |   |   |  |          |
| Derivative financial instruments - cash flow hedges <sup>(1)</sup>  | \$ —  | \$ 2  | \$ —   | \$ 2     |
| <b>Fair value - Net income</b>                                      |   |   |  |          |
| Derivative financial instruments - fair value hedges <sup>(1)</sup> | \$ —  | \$ 2  | \$ —   | \$ 2     |
| <b>Balance at December 31, 2018</b>                                 |   |   |  |          |
| <b>Assets</b>   |   |   |  |          |
| <b>Fair value - OCI</b>   |   |   |  |          |
| U.S. Treasury securities  | \$ 2,586  | \$ —  | \$ —   | \$ 2,586 |
| Residential mortgage-backed securities - Agency                     | —   | 547   | —  | 547      |
| Available-for-sale investment securities                            | \$ 2,586  | \$ 547  | \$ —   | \$ 3,133 |
| Derivative financial instruments - cash flow hedges <sup>(1)</sup>  | \$ —  | \$ 8  | \$ —   | \$ 8     |
| <b>Fair value - Net income</b>                                      |   |   |  |          |
| Derivative financial instruments - fair value hedges <sup>(1)</sup> | \$ —  | \$ 5  | \$ —   | \$ 5     |
| <b>Liabilities</b>  |   |   |  |          |
| <b>Fair value - OCI</b>   |   |   |  |          |
| Derivative financial instruments - cash flow hedges <sup>(1)</sup>  | \$ —  | \$ 2  | \$ —   | \$ 2     |

(1) Derivative instrument carrying values in an asset or liability position are presented as part of other assets or accrued expenses and other liabilities, respectively, in the Company's condensed consolidated statements of financial condition.

There were no transfers between Levels 1 and 2 within the fair value hierarchy for the three or six months ended June 30, 2019 and 2018 .

*Available-for-Sale Investment Securities*

Investment securities classified as available-for-sale consist of U.S. Treasury securities and residential mortgage-backed securities. The fair value estimates of investment securities classified as Level 1, consisting of U.S. Treasury securities, are determined based on quoted market prices for the same securities. The Company classifies residential mortgage-backed securities as Level 2, the fair value estimates of which are based on the best information available. This data may consist of observed market prices, broker quotes or discounted cash flow models that incorporate assumptions such as benchmark yields, issuer spreads, prepayment speeds, credit ratings and losses, the priority of which may vary based on availability of information.

The Company validates the fair value estimates provided by pricing services primarily by comparison to valuations obtained through other pricing sources. The Company evaluates pricing variances amongst different pricing sources to ensure that the valuations utilized are reasonable. The Company also corroborates the reasonableness of the fair value estimates with analysis of trends of significant inputs, such as market interest rate curves. The Company further performs due diligence in understanding the procedures and techniques performed by the pricing services to derive fair value estimates.

At June 30, 2019, amounts reported in residential mortgage-backed securities reflect government-rated obligations issued by Fannie Mae, Freddie Mac and Ginnie Mae with a par value of \$479 million, a weighted-average coupon of 2.81% and a weighted-average remaining maturity of three years.

*Derivative Financial Instruments*

The Company's derivative financial instruments consist of interest rate swaps and foreign exchange forward contracts. These instruments are classified as Level 2 as their fair values are estimated using proprietary pricing models, containing certain assumptions based on readily observable market-based inputs, including interest rate curves, option volatility and foreign currency forward and spot rates. In determining fair values, the pricing models use widely accepted valuation techniques including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity and the observable market-based inputs. The fair values of the interest rate swaps are determined using the market standard methodology of netting the discounted future fixed cash receipts (or payments) and the discounted expected variable cash payments (or receipts). The variable cash payments are based on an expectation of future interest rates derived from the observable market interest rate curves. The Company considers collateral and master netting agreements that mitigate credit exposure to counterparties in determining the counterparty credit risk valuation adjustment. The fair values of the currency instruments are valued comparing the contracted forward exchange rate pertaining to the specific contract maturities to the current market exchange rate.

The Company validates the fair value estimates of interest rate swaps primarily through comparison to the fair value estimates computed by the counterparties to each of the derivative transactions. The Company evaluates pricing variances amongst different pricing sources to ensure that the valuations utilized are reasonable. The Company also corroborates the reasonableness of the fair value estimates with analysis of trends of significant inputs, such as market interest rate curves. The Company performs due diligence in understanding the impact to any changes to the valuation techniques performed by proprietary pricing models prior to implementation, working closely with the third-party valuation service, and reviews the control objectives of the service at least annually. The Company corroborates the fair value of foreign exchange forward contracts through independent calculation of the fair value estimates.

*Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis*

The Company also has assets that under certain conditions are subject to measurement at fair value on a non-recurring basis. These assets include those associated with acquired businesses, including goodwill and other intangible assets. For these assets, measurement at fair value in periods subsequent to the initial recognition of the assets is applicable if one or more of the assets is determined to be impaired. The Company had no impairments related to these assets during the three or six months ended June 30, 2019 and 2018.

**Financial Instruments Measured at Other Than Fair Value**

The following tables disclose the estimated fair value of the Company's financial assets and financial liabilities that are not required to be carried at fair value (dollars in millions):

| Balance at June 30, 2019                                     | Quoted Prices in<br>Active Markets<br>for Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs (Level 2) | Significant<br>Unobservable<br>Inputs (Level 3) | Total     | Carrying<br>Value |
|--|--|--|---|-----------|-------------------|
| <b>Assets</b>  |  |  |   |           |                   |
| <i>Amortized cost</i>  |  |  |   |           |                   |
| Residential mortgage-backed securities - Agency              | \$ —   | \$ 260   | \$ —  | \$ 260    | \$ 258            |
| Held-to-maturity investment securities                       | \$ —   | \$ 260   | \$ —  | \$ 260    | \$ 258            |
| Net loan receivables   | \$ —   | \$ —   | \$ 90,586                                       | \$ 90,586 | \$ 87,027         |
| <i>Carrying value approximates fair value <sup>(1)</sup></i> |  |  |   |           |                   |
| Cash and cash equivalents                                    | \$ 10,313  | \$ —   | \$ —  | \$ 10,313 | \$ 10,313         |
| Restricted cash  | \$ 1,040   | \$ —   | \$ —  | \$ 1,040  | \$ 1,040          |
| Other short-term investments                                 | \$ 1,000   | \$ —   | \$ —  | \$ 1,000  | \$ 1,000          |
| Accrued interest receivables <sup>(2)</sup>                  | \$ —   | \$ 990   | \$ —  | \$ 990    | \$ 990            |
| <b>Liabilities</b>   |  |  |   |           |                   |
| <i>Amortized cost</i>  |  |  |   |           |                   |
| Time deposits <sup>(3)</sup>                                 | \$ —   | \$ 33,969  | \$ —  | \$ 33,969 | \$ 33,698         |
| Long-term borrowings - owed to securitization investors      | \$ —   | \$ 14,101  | \$ 194  | \$ 14,295 | \$ 14,214         |
| Other long-term borrowings                                   | \$ —   | \$ 11,589  | \$ —  | \$ 11,589 | \$ 10,949         |
| Long-term borrowings   | \$ —   | \$ 25,690  | \$ 194  | \$ 25,884 | \$ 25,163         |
| <i>Carrying value approximates fair value <sup>(1)</sup></i> |  |  |   |           |                   |
| Accrued interest payables <sup>(2)</sup>                     | \$ —   | \$ 302   | \$ —  | \$ 302    | \$ 302            |

(1) The carrying values of these assets and liabilities approximate fair value due to the nature of their liquidity (i.e., due or payable in less than one year).

(2) Accrued interest receivable and payable carrying values are presented as part of other assets or accrued expenses and other liabilities, respectively, in the Company's condensed consolidated statements of financial condition.

(3) Excludes deposits without contractually defined maturities for all periods presented.

The following tables disclose the estimated fair value of the Company's financial assets and financial liabilities that are not required to be carried at fair value (dollars in millions):

| <b>Balance at December 31, 2018</b>                          | <b>Quoted Prices in<br/>Active Markets<br/>for Identical<br/>Assets<br/>(Level 1)</b> | <b>Significant<br/>Other<br/>Observable<br/>Inputs (Level 2)</b> | <b>Significant<br/>Unobservable<br/>Inputs (Level 3)</b> | <b>Total</b> | <b>Carrying<br/>Value</b> |
|--|---|--|--|--------------|---------------------------|
| <b>Assets</b>  |   |  |  |              |                           |
| <i>Amortized cost</i>  |   |  |  |              |                           |
| Residential mortgage-backed securities - Agency              | \$ —  | \$ 233   | \$ —   | \$ 233       | \$ 237                    |
| Held-to-maturity investment securities                       | \$ —  | \$ 233   | \$ —   | \$ 233       | \$ 237                    |
| Net loan receivables   | \$ —  | \$ —   | \$ 90,787  | \$ 90,787    | \$ 87,471                 |
| <i>Carrying value approximates fair value <sup>(1)</sup></i> |   |  |  |              |                           |
| Cash and cash equivalents                                    | \$ 13,299   | \$ —   | \$ —   | \$ 13,299    | \$ 13,299                 |
| Restricted cash  | \$ 1,846  | \$ —   | \$ —   | \$ 1,846     | \$ 1,846                  |
| Accrued interest receivables <sup>(2)</sup>                  | \$ —  | \$ 951   | \$ —   | \$ 951       | \$ 951                    |
| <b>Liabilities</b>   |   |  |  |              |                           |
| <i>Amortized cost</i>  |   |  |  |              |                           |
| Time deposits <sup>(3)</sup>                                 | \$ —  | \$ 34,635  | \$ —   | \$ 34,635    | \$ 34,788                 |
| Long-term borrowings - owed to securitization investors      | \$ —  | \$ 16,701  | \$ 217   | \$ 16,918    | \$ 16,917                 |
| Other long-term borrowings                                   | \$ —  | \$ 10,325  | \$ —   | \$ 10,325    | \$ 10,311                 |
| Long-term borrowings   | \$ —  | \$ 27,026  | \$ 217   | \$ 27,243    | \$ 27,228                 |
| <i>Carrying value approximates fair value <sup>(1)</sup></i> |   |  |  |              |                           |
| Accrued interest payables <sup>(2)</sup>                     | \$ —  | \$ 292   | \$ —   | \$ 292       | \$ 292                    |

(1) The carrying values of these assets and liabilities approximate fair value due to the nature of their liquidity (i.e., due or payable in less than one year).

(2) Accrued interest receivable and payable carrying values are presented as part of other assets or accrued expenses and other liabilities, respectively, in the Company's condensed consolidated statements of financial condition.

(3) Excludes deposits without contractually defined maturities for all periods presented.

#### 14. Derivatives and Hedging Activities

The Company uses derivatives to manage its exposure to various financial risks. The Company does not enter into derivatives for trading or speculative purposes. Certain derivatives used to manage the Company's exposure to foreign currency are not designated as hedges and do not qualify for hedge accounting.

Derivatives may give rise to counterparty credit risk, which generally is addressed through collateral arrangements as described under the sub-heading "— Collateral Requirements and Credit-Risk Related Contingency Features." The Company enters into derivative transactions with established dealers that meet minimum credit criteria established by the Company. All counterparties must be pre-approved prior to engaging in any transaction with the Company. Counterparties are monitored on a regular basis by the Company to ensure compliance with the Company's risk policies and limits. In determining the counterparty credit risk valuation adjustment for the fair values of derivatives, the Company considers collateral and legally enforceable master netting agreements that mitigate credit exposure to related counterparties.

All derivatives are recorded in other assets at their gross positive fair values and in accrued expenses and other liabilities at their gross negative fair values. See Note 13: Fair Value Measurements for a description of the valuation methodologies of derivatives. Cash collateral amounts associated with derivative positions that are cleared through an exchange are legally characterized as settlement of the derivative positions. Such collateral amounts are reflected as offsets to the associated derivatives balances recorded in other assets or in accrued expenses and other liabilities. Other cash collateral posted and held balances are recorded in other assets and deposits, respectively, in the condensed consolidated statements of



financial condition. Collateral amounts recorded in the condensed consolidated statements of financial condition are based on the net collateral posted or held position for each applicable legal entity's master netting arrangement with each counterparty.

### ***Derivatives Designated as Hedges***

Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows arising from changes in interest rates, or other types of forecasted transactions, are considered cash flow hedges. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges.

#### *Cash Flow Hedges*

The Company uses interest rate swaps to manage its exposure to changes in interest rates related to future cash flows resulting from interest payments on credit card securitized debt and deposits. The Company's outstanding cash flow hedges are for an initial maximum period of seven years for securitized debt and deposits. The derivatives are designated as hedges of the risk of changes in cash flows on the Company's LIBOR or Federal Funds rate-based interest payments, and qualify for hedge accounting in accordance with ASC Topic 815, *Derivatives and Hedging* ("ASC 815").

The change in the fair value of derivatives designated as cash flow hedges is recorded in OCI and is subsequently reclassified into earnings in the period that the hedged forecasted cash flows affect earnings. Amounts reported in AOCI related to derivatives at June 30, 2019 will be reclassified to interest expense as interest payments are accrued on certain of the Company's floating-rate securitized debt and deposits. During the next 12 months, the Company estimates it will reclassify an immaterial amount of pretax expense to interest expense related to its derivatives designated as cash flow hedges.

#### *Fair Value Hedges*

The Company is exposed to changes in fair value of its fixed-rate debt obligations due to changes in interest rates. The Company uses interest rate swaps to manage its exposure to changes in fair value of certain fixed-rate long-term borrowings, including securitized debt and bank or other senior notes, and deposits attributable to changes in LIBOR or OIS rate, benchmark interest rates as defined by ASC 815. These interest rate swaps qualify as fair value hedges in accordance with ASC 815. Changes in both (i) the fair values of the derivatives and (ii) the hedged long-term borrowings and deposits relating to the risk being hedged are recorded in interest expense. The changes generally provide substantial offset to one another, with any difference in interest expense.

### ***Derivatives Not Designated as Hedges***

#### *Foreign Exchange Forward Contracts*

The Company has foreign exchange forward contracts that are economic hedges and are not designated as accounting hedges. The Company enters into foreign exchange forward contracts to manage foreign currency risk. Changes in the fair value of these contracts are recorded in other income.

### ***Derivatives Cleared Through an Exchange***

The legal characterization of cash variation margin payments on derivatives cleared through an exchange are legally considered settlement payments and are accounted for with corresponding derivative positions as one unit of account and not separately as collateral. With settlement payments on derivative positions cleared through this exchange reflected as offsets to the associated derivative asset and liability balances, the fair values of derivative instruments and collateral balances shown are generally reduced.

**Derivatives Activity**

The following table summarizes the fair value (including accrued interest) and outstanding notional amounts of derivative instruments and related collateral balances (dollars in millions):

|  | June 30, 2019   |  |                   |                        | December 31, 2018 |                   |                        |  |
|--|-----------------|--|-------------------|------------------------|-------------------|-------------------|------------------------|--|
|  | Notional Amount | Number of Outstanding Derivative Contracts | Derivative Assets | Derivative Liabilities | Notional Amount   | Derivative Assets | Derivative Liabilities |  |
| <b>Derivatives designated as hedges</b>                  |                 |  |                   |                        |                   |                   |                        |  |
| Interest rate swaps—cash flow hedge                      | \$ 1,650        | 4  | \$ —              | \$ 2                   | \$ 2,450          | \$ 8              | \$ 2                   |  |
| Interest rate swaps—fair value hedge                     | \$ 8,250        | 10   | —                 | 2                      | \$ 8,000          | 5                 | —                      |  |
| <b>Derivatives not designated as hedges</b>              |                 |  |                   |                        |                   |                   |                        |  |
| Foreign exchange forward contracts <sup>(1)</sup>        | \$ 35           | 7  | —                 | —                      | \$ 33             | —                 | —                      |  |
| Total gross derivative assets/liabilities <sup>(2)</sup> |                 |  | —                 | 4                      |                   | 13                | 2                      |  |
| Less: collateral held/posted <sup>(3)</sup>              |                 |  | —                 | (4)                    |                   | (8)               | (2)                    |  |
| Total net derivative assets/liabilities                  |                 |  | \$ —              | \$ —                   | \$ 5              | \$ —              |                        |  |

(1) The foreign exchange forward contracts have notional amounts of EUR 9 million, GBP 12 million, SGD 1 million and INR 596 million as of June 30, 2019 and notional amounts of EUR 9 million, GBP 12 million, SGD 1 million and INR 464 million as of December 31, 2018.

(2) In addition to the derivatives disclosed in the table, the Company enters into forward contracts to purchase when-issued mortgage-backed securities as part of its community reinvestment initiatives. At June 30, 2019, the Company had one outstanding contract with a notional amount of \$46 million and immaterial fair value. At December 31, 2018, the Company had one outstanding contract with a notional amount of \$79 million and immaterial fair value.

(3) Collateral amounts, which consist of both cash and investment securities, are limited to the related derivative asset/liability balance and do not include excess collateral received/pledged.

The following amounts were recorded on the statements of financial condition related to cumulative basis adjustment for fair value hedges (dollars in millions):

|                      | June 30, 2019                                |   | December 31, 2018                            |   |
|----------------------|--|---|--|---|
|                      | Carrying Amount of Hedged Assets/Liabilities | Cumulative Amount of Fair Value Hedging Adjustment Increasing (Decreasing) the Carrying Amount of Hedged Assets/Liabilities | Carrying Amount of Hedged Assets/Liabilities | Cumulative Amount of Fair Value Hedging Adjustment Increasing (Decreasing) the Carrying Amount of Hedged Assets/Liabilities |
| Long-term borrowings | \$ 7,800                                     | \$ 49   | \$ 7,893                                     | \$ (91)   |

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The following table summarizes the impact of the derivative instruments on income and indicates where within the condensed consolidated financial statements such impact is reported (dollars in millions):

|  | Location and Amount of (Losses) Gains Recognized in Income |                      |              |
|--|--|----------------------|--------------|
|  | Interest (Expense)   |                      |              |
|  | Deposits   | Long-Term Borrowings | Other Income |
| <b>For the Three Months Ended June 30, 2019</b>  |  |                      |              |
| Total amounts of income and expense line items presented in the statements of income in which the effects of fair value or cash flow hedges are recorded | \$ (401)   | \$ (244)             | \$ 22        |
| <b>The effects of cash flow and fair value hedging</b>   |  |                      |              |
| <b>Gains on cash flow hedging relationship</b>   |  |                      |              |
| Amounts reclassified from OCI into earnings  | \$ 1   | \$ 1                 | \$ —         |
| <b>Gains (losses) on fair value hedging relationship</b>   |  |                      |              |
| Gains (losses) on hedged items   | \$ —   | \$ (85)              | \$ —         |
| Gains on interest rate swaps   | —  | 74                   | —            |
| Total gains (losses) on fair value hedges  | \$ —   | \$ (11)              | \$ —         |
| <b>For the Three Months Ended June 30, 2018</b>  |  |                      |              |
| Total amounts of income and expense line items presented in the statements of income in which the effects of fair value or cash flow hedges are recorded | \$ (287)   | \$ (220)             | \$ 24        |
| <b>The effects of cash flow and fair value hedging</b>   |  |                      |              |
| <b>Gains on cash flow hedging relationship</b>   |  |                      |              |
| Amounts reclassified from OCI into earnings  | \$ —   | \$ 1                 | \$ —         |
| <b>Gains (losses) on fair value hedging relationship</b>   |  |                      |              |
| Gains on hedged items  | \$ —   | \$ 11                | \$ —         |
| Gains (losses) on interest rate swaps  | —  | (22)                 | —            |
| Total gains (losses) on fair value hedges  | \$ —   | \$ (11)              | \$ —         |
| <b>The effects of derivatives not designated in hedging relationships</b>  |  |                      |              |
| Gains on derivatives not designated as hedges  | \$ —   | \$ —                 | \$ 2         |

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The following table summarizes the impact of the derivative instruments on income and indicates where within the condensed consolidated financial statements such impact is reported (dollars in millions):

|  | Location and Amount of (Losses) Gains Recognized in Income |                      |              |
|--|--|----------------------|--------------|
|  | Interest (Expense)   |                      |              |
|  | Deposits   | Long-Term Borrowings | Other Income |
| <b>For the Six Months Ended June 30, 2019</b>  |  |                      |              |
| Total amounts of income and expense line items presented in the statements of income in which the effects of fair value or cash flow hedges are recorded | \$ (787)   | \$ (490)             | \$ 50        |
| <b>The effects of cash flow and fair value hedging</b>   |  |                      |              |
| <b>Gains on cash flow hedging relationship</b>   |  |                      |              |
| Amounts reclassified from OCI into earnings  | \$ 2   | \$ 3                 | \$ —         |
| <b>Gains (losses) on fair value hedging relationship</b>   |  |                      |              |
| Gains (losses) on hedged items   | \$ —   | \$ (140)             | \$ —         |
| Gains on interest rate swaps   | —  | 116                  | —            |
| Total gains (losses) on fair value hedges  | \$ —   | \$ (24)              | \$ —         |
| <b>For the Six Months Ended June 30, 2018</b>  |  |                      |              |
| Total amounts of income and expense line items presented in the statements of income in which the effects of fair value or cash flow hedges are recorded | \$ (549)   | \$ (427)             | \$ 53        |
| <b>The effects of cash flow and fair value hedging</b>   |  |                      |              |
| <b>(Losses) gains on cash flow hedging relationship</b>  |  |                      |              |
| Amounts reclassified from OCI into earnings  | \$ (1)   | \$ 1                 | \$ —         |
| <b>Gains (losses) on fair value hedging relationship</b>   |  |                      |              |
| Gains on hedged items  | \$ —   | \$ 59                | \$ —         |
| Gains (losses) on interest rate swaps  | —  | (74)                 | —            |
| Total gains (losses) on fair value hedges  | \$ —   | \$ (15)              | \$ —         |
| <b>The effects of derivatives not designated in hedging relationships</b>  |  |                      |              |
| Gains on derivatives not designated as hedges  | \$ —   | \$ —                 | \$ 1         |

For the impact of the derivative instruments on OCI, see Note 7: Accumulated Other Comprehensive Income.

**Collateral Requirements and Credit-Risk Related Contingency Features**

The Company has master netting arrangements and minimum collateral posting thresholds with its counterparties for its fair value and cash flow hedge interest rate swaps and foreign exchange forward contracts. The Company has not sought a legal opinion in relation to the enforceability of its master netting arrangements and, as such, does not report any of these positions on a net basis. Collateral is required by either the Company or its subsidiaries or the counterparty depending on the net fair value position of these derivatives held with that counterparty. The Company may also be required to post collateral with a counterparty for its fair value and cash flow hedge interest rate swaps depending on the credit rating it or Discover Bank receives from specified major credit rating agencies. Collateral receivable or payable amounts are generally not offset against the fair value of these derivatives, but are recorded separately in other assets or deposits.

However, certain cash collateral amounts related to positions cleared through an exchange are reflected as offsets to the associated derivatives balances recorded in other assets and accrued expenses and other liabilities.

At June 30, 2019 , Discover Bank's credit rating met specified thresholds set by its counterparties. However, if its credit rating is reduced below investment grade, Discover Bank would be required to post additional collateral. The amount of

additional collateral as of June 30, 2019 would have been \$20 million . DFS (Parent Company) had no outstanding derivatives as of June 30, 2019 , and therefore, no collateral was required.

The Company also has agreements with certain of its derivative counterparties that contain a provision where if the Company defaults on any of its indebtedness, including default where repayment of the indebtedness has not been accelerated by the lender, then the Company could also be declared in default on its derivative obligations.

## 15. Segment Disclosures

The Company's business activities are managed in two segments: Direct Banking and Payment Services.

- *Direct Banking:* The Direct Banking segment includes Discover-branded credit cards issued to individuals on the Discover Network and other consumer products and services, including private student loans, personal loans, home equity loans, and other consumer lending and deposit products. The majority of Direct Banking revenues relate to interest income earned on the segment's loan products. Additionally, the Company's credit card products generate substantially all revenues related to discount and interchange, protection products and loan fee income.
- *Payment Services:* The Payment Services segment includes PULSE, an automated teller machine, debit and electronic funds transfer network; Diners Club, a global payments network; and the Company's Network Partners business, which provides payment transaction processing and settlement services on the Discover Network. The majority of Payment Services revenues relate to transaction processing revenue from PULSE and royalty and licensee revenue from Diners Club.

The business segment reporting provided to and used by the Company's chief operating decision maker is prepared using the following principles and allocation conventions:

- The Company aggregates operating segments when determining reportable segments.
- Corporate overhead is not allocated between segments; all corporate overhead is included in the Direct Banking segment.
- Through its operation of the Discover Network, the Direct Banking segment incurs fixed marketing, servicing and infrastructure costs that are not specifically allocated among the segments, with the exception of an allocation of direct and incremental costs driven by the Company's Payment Services segment.
- The assets of the Company are not allocated among the operating segments in the information reviewed by the Company's chief operating decision maker.
- The revenues of each segment are derived from external sources. The segments do not earn revenue from intercompany sources.
- Income taxes are not specifically allocated between the operating segments in the information reviewed by the Company's chief operating decision maker.

The following table presents segment data (dollars in millions):

|   | <b>Direct<br/>Banking</b> | <b>Payment<br/>Services</b> | <b>Total</b>  |
|---|---------------------------|-----------------------------|---------------|
| <b>For the Three Months Ended June 30, 2019</b> |                           |                             |               |
| Interest income                                 |                           |                             |               |
| Credit card loans                               | \$ 2,396                  | \$ —                        | \$ 2,396      |
| Private student loans                           | 172                       | —                           | 172           |
| PCI student loans                               | 31                        | —                           | 31            |
| Personal loans                                  | 241                       | —                           | 241           |
| Other   | 136                       | 1                           | 137           |
| Total interest income                           | 2,976                     | 1                           | 2,977         |
| Interest expense                                | 645                       | —                           | 645           |
| Net interest income                             | 2,331                     | 1                           | 2,332         |
| Provision for loan losses                       | 787                       | —                           | 787           |
| Other income                                    | 436                       | 84                          | 520           |
| Other expense                                   | 1,039                     | 39                          | 1,078         |
| Income before income tax expense                | <u>\$ 941</u>             | <u>\$ 46</u>                | <u>\$ 987</u> |
| <b>For the Three Months Ended June 30, 2018</b> |                           |                             |               |
| Interest income                                 |                           |                             |               |
| Credit card loans                               | \$ 2,139                  | \$ —                        | \$ 2,139      |
| Private student loans                           | 150                       | —                           | 150           |
| PCI student loans                               | 35                        | —                           | 35            |
| Personal loans                                  | 229                       | —                           | 229           |
| Other   | 83                        | —                           | 83            |
| Total interest income                           | 2,636                     | —                           | 2,636         |
| Interest expense                                | 507                       | —                           | 507           |
| Net interest income                             | 2,129                     | —                           | 2,129         |
| Provision for loan losses                       | 742                       | —                           | 742           |
| Other income                                    | 398                       | 76                          | 474           |
| Other expense                                   | 948                       | 36                          | 984           |
| Income before income tax expense                | <u>\$ 837</u>             | <u>\$ 40</u>                | <u>\$ 877</u> |

The following table presents segment data (dollars in millions):

|   | <b>Direct<br/>Banking</b> | <b>Payment<br/>Services</b> | <b>Total</b>    |
|---|---------------------------|-----------------------------|-----------------|
| <b>For the Six Months Ended June 30, 2019</b> |                           |                             |                 |
| Interest income                               |                           |                             |                 |
| Credit card loans                             | \$ 4,758                  | \$ —                        | \$ 4,758        |
| Private student loans                         | 345                       | —                           | 345             |
| PCI student loans                             | 63                        | —                           | 63              |
| Personal loans                                | 478                       | —                           | 478             |
| Other   | 269                       | 1                           | 270             |
| Total interest income                         | 5,913                     | 1                           | 5,914           |
| Interest expense                              | 1,277                     | —                           | 1,277           |
| Net interest income                           | 4,636                     | 1                           | 4,637           |
| Provision for loan losses                     | 1,596                     | —                           | 1,596           |
| Other income                                  | 808                       | 170                         | 978             |
| Other expense                                 | 2,028                     | 74                          | 2,102           |
| Income before income tax expense              | <u>\$ 1,820</u>           | <u>\$ 97</u>                | <u>\$ 1,917</u> |
| <b>For the Six Months Ended June 30, 2018</b> |                           |                             |                 |
| Interest income                               |                           |                             |                 |
| Credit card loans                             | \$ 4,229                  | \$ —                        | \$ 4,229        |
| Private student loans                         | 297                       | —                           | 297             |
| PCI student loans                             | 72                        | —                           | 72              |
| Personal loans                                | 455                       | —                           | 455             |
| Other   | 152                       | —                           | 152             |
| Total interest income                         | 5,205                     | —                           | 5,205           |
| Interest expense                              | 976                       | —                           | 976             |
| Net interest income                           | 4,229                     | —                           | 4,229           |
| Provision for loan losses                     | 1,493                     | —                           | 1,493           |
| Other income                                  | 792                       | 157                         | 949             |
| Other expense                                 | 1,880                     | 72                          | 1,952           |
| Income before income tax expense              | <u>\$ 1,648</u>           | <u>\$ 85</u>                | <u>\$ 1,733</u> |



## 16. Revenue from Contracts with Customers

ASC Topic 606, *Revenue from Contracts with Customers* ("ASC 606"), generally applies to the sales of any good or service for which no other specific accounting guidance is provided. ASC 606 defines a principles-based model under which revenue from a contract is allocated to the distinct performance obligations within the contract and recognized in income as each performance obligation is satisfied. The Company's revenue that is subject to this model includes discount and interchange, protection products fees, transaction processing revenue, and amounts classified as other income.

The following table presents revenue from contracts with customers disaggregated by business segment and reconciles revenue from contracts with customers to total other income (dollars in millions):

|  | <u>Direct Banking</u> | <u>Payment Services</u> | <u>Total</u>  |
|--|-----------------------|-------------------------|---------------|
| <b>For the Three Months Ended June 30, 2019</b>      |                       |                         |               |
| <b>Other income subject to ASC 606</b>               |                       |                         |               |
| Discount and interchange revenue, net <sup>(1)</sup> | \$ 283                | \$ 16                   | \$ 299        |
| Protection products revenue                          | 49                    | —                       | 49            |
| Transaction processing revenue                       | —                     | 48                      | 48            |
| Other income   | 2                     | 20                      | 22            |
| Total other income subject to ASC 606 <sup>(2)</sup> | <u>334</u>            | <u>84</u>               | <u>418</u>    |
| <b>Other income not subject to ASC 606</b>           |                       |                         |               |
| Loan fee income                                      | 102                   | —                       | 102           |
| Total other income not subject to ASC 606            | <u>102</u>            | <u>—</u>                | <u>102</u>    |
| Total other income by operating segment              | <u>\$ 436</u>         | <u>\$ 84</u>            | <u>\$ 520</u> |
| <b>For the Three Months Ended June 30, 2018</b>      |                       |                         |               |
| <b>Other income subject to ASC 606</b>               |                       |                         |               |
| Discount and interchange revenue, net <sup>(1)</sup> | \$ 250                | \$ 13                   | \$ 263        |
| Protection products revenue                          | 50                    | —                       | 50            |
| Transaction processing revenue                       | —                     | 42                      | 42            |
| Other income   | 3                     | 21                      | 24            |
| Total other income subject to ASC 606 <sup>(2)</sup> | <u>303</u>            | <u>76</u>               | <u>379</u>    |
| <b>Other income not subject to ASC 606</b>           |                       |                         |               |
| Loan fee income                                      | 95                    | —                       | 95            |
| Total other income not subject to ASC 606            | <u>95</u>             | <u>—</u>                | <u>95</u>     |
| Total other income by operating segment              | <u>\$ 398</u>         | <u>\$ 76</u>            | <u>\$ 474</u> |

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The following table presents revenue from contracts with customers disaggregated by business segment and reconciles revenue from contracts with customers to total other income (dollars in millions):

|  | Direct Banking | Payment Services | Total  |
|--|----------------|------------------|--------|
| <b>For the Six Months Ended June 30, 2019</b>        |                |                  |        |
| <b>Other income subject to ASC 606</b>               |                |                  |        |
| Discount and interchange revenue, net <sup>(1)</sup> | \$ 500         | \$ 30            | \$ 530 |
| Protection products revenue                          | 98             | —                | 98     |
| Transaction processing revenue                       | —              | 94               | 94     |
| Other income   | 4              | 46               | 50     |
| Total other income subject to ASC 606 <sup>(2)</sup> | 602            | 170              | 772    |
| <b>Other income not subject to ASC 606</b>           |                |                  |        |
| Loan fee income                                      | 206            | —                | 206    |
| Total other income not subject to ASC 606            | 206            | —                | 206    |
| Total other income by operating segment              | \$ 808         | \$ 170           | \$ 978 |
| <b>For the Six Months Ended June 30, 2018</b>        |                |                  |        |
| <b>Other income subject to ASC 606</b>               |                |                  |        |
| Discount and interchange revenue, net <sup>(1)</sup> | \$ 492         | \$ 25            | \$ 517 |
| Protection products revenue                          | 103            | —                | 103    |
| Transaction processing revenue                       | —              | 85               | 85     |
| Other income   | 6              | 47               | 53     |
| Total other income subject to ASC 606 <sup>(2)</sup> | 601            | 157              | 758    |
| <b>Other income not subject to ASC 606</b>           |                |                  |        |
| Loan fee income                                      | 191            | —                | 191    |
| Total other income not subject to ASC 606            | 191            | —                | 191    |
| Total other income by operating segment              | \$ 792         | \$ 157           | \$ 949 |

(1) Net of rewards, including Cashback Bonus rewards, of \$460 million and \$461 million for the three months ended June 30, 2019 and 2018, respectively, and \$906 million and \$853 million for the six months ended June 30, 2019 and 2018, respectively.

(2) Excludes \$1 million and \$2 million of deposit product fees that are reported within net interest income for the three and six months ended June 30, 2019, respectively, and \$1 million for the three and six months ended June 30, 2018.

For a detailed description of the Company's significant revenue recognition accounting policies, see Note 2: Summary of Significant Accounting Policies to the consolidated financial statements of the Company's annual report on Form 10-K for the year ended December 31, 2018.

## 17. Subsequent Events

The Company has evaluated events and transactions that have occurred subsequent to June 30, 2019 and determined that there were no subsequent events that would require recognition or disclosure in the condensed consolidated financial statements.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and related notes included elsewhere in this quarterly report. This quarterly report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements, which speak to our expected business and financial performance, among other matters, contain words such as "believe," "expect," "anticipate," "intend," "plan," "aim," "will," "may," "should," "could," "would," "likely," and similar expressions. Such statements are based upon the current beliefs and expectations of our management and are subject to significant risks and uncertainties. Actual results may differ materially from those set forth in the forward-looking statements. These forward-looking statements speak only as of the date of this quarterly report, and there is no undertaking to update or revise them as more information becomes available.*

*The following factors, among others, could cause actual results to differ materially from those set forth in the forward-looking statements: changes in economic variables, such as the availability of consumer credit, the housing market, energy costs, the number and size of personal bankruptcy filings, the rate of unemployment, the levels of consumer confidence and consumer debt and investor sentiment; the impact of current, pending and future legislation, regulation, supervisory guidance and regulatory and legal actions, including, but not limited to, those related to financial regulatory reform, consumer financial services practices, anti-corruption and funding, capital and liquidity; the actions and initiatives of current and potential competitors; our ability to manage our expenses; our ability to successfully achieve card acceptance across our networks and maintain relationships with network participants; our ability to sustain and grow our private student loan, personal loan and home equity loan products; difficulty obtaining regulatory approval for, financing, transitioning, integrating or managing the expenses of acquisitions of or investments in new businesses, products or technologies; our ability to manage our credit risk, market risk, liquidity risk, operational risk, legal and compliance risk and strategic risk; the availability and cost of funding and capital; access to deposit, securitization, equity, debt and credit markets; the impact of rating agency actions; the level and volatility of equity prices, commodity prices and interest rates, currency values, investments, other market fluctuations and other market indices; losses in our investment portfolio; limits on our ability to pay dividends and repurchase our common stock; limits on our ability to receive payments from our subsidiaries; fraudulent activities or material security breaches of key systems; our ability to remain organizationally effective; our ability to increase or sustain Discover card usage or attract new customers; our ability to maintain relationships with merchants; the effect of political, economic and market conditions, geopolitical events and unforeseen or catastrophic events; our ability to introduce new products and services; our ability to manage our relationships with third-party vendors; our ability to maintain current technology and integrate new and acquired systems; our ability to collect amounts for disputed transactions from merchants and merchant acquirers; our ability to attract and retain employees; our ability to protect our reputation and our intellectual property; and new lawsuits, investigations or similar matters or unanticipated developments related to current matters. We routinely evaluate and may pursue acquisitions of or investments in businesses, products, technologies, loan portfolios or deposits, which may involve payment in cash or our debt or equity securities.*

*Additional factors that could cause our results to differ materially from those described below can be found in this section in this quarterly report and in "Risk Factors," "Business — Competition," "Business — Supervision and Regulation" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our annual report on Form 10-K for the year ended December 31, 2018, which is filed with the SEC and available at the SEC's internet site (<https://www.sec.gov>).*

### **Introduction and Overview**

Discover Financial Services ("DFS") is a direct banking and payment services company. We provide direct banking products and services and payment services through our subsidiaries. We offer our customers credit card loans, private student loans, personal loans, home equity loans and deposit products. We also operate the Discover Network, the PULSE network ("PULSE") and Diners Club International ("Diners Club"). The Discover Network processes transactions for Discover-branded credit and debit cards and provides payment transaction processing and settlement services. PULSE operates an electronic funds transfer network, providing financial institutions issuing debit cards on the PULSE network with access to ATMs domestically and internationally, as well as merchant acceptance throughout the U.S. for debit card transactions. Diners Club is a global payments network of licensees, which are generally financial institutions, that issue Diners Club branded charge cards and/or provide card acceptance services.

Our primary revenues consist of interest income earned on loan receivables and fees earned from customers, financial institutions, merchants and issuers. The primary expenses required to operate our business include funding costs (interest expense), loan loss provisions, customer rewards and expenses incurred to grow, manage and service our loan receivables and

networks. Our business activities are funded primarily through consumer deposits, securitization of loan receivables and the issuance of unsecured debt.

### Quarter Highlights

The highlights below compare results as of and for the three months ended June 30, 2019 against results for the same period in prior year.

- Net income was \$753 million , or \$2.32 per diluted share, compared to \$669 million , or \$1.91 per diluted share, for the prior year.
- Total loans grew \$5.4 billion , or 6% , to \$90.2 billion .
- Credit card loans grew \$4.6 billion , or 7% , to \$72.4 billion .
- The total net charge-off rate increased 11 basis points to 3.22% .
- The net charge-off rate for credit card loans increased 15 basis points to 3.49% and the delinquency rate for credit card loans over 30 days past due increased 18 basis points to 2.34% .
- Direct-to-consumer deposits grew \$7.4 billion , or 17% , to \$49.7 billion .
- Payment Services transaction volume for the segment was \$61.8 billion , up 8% .

### Outlook

We continue to focus on disciplined capital deployment through profitable organic loan growth and execution of our capital plan, which includes our share repurchase program and recently increased common stock dividend. Our marketing strategy remains focused on expanding wallet share with existing customers and adding new accounts to achieve continued loan growth.

Total expenses are expected to increase as we continue to invest in business growth and technology, including the deployment of advanced analytics and automation. We continue to expect a modest increase in the full-year rewards rate year over year.

The total net charge-off rate is expected to increase in comparison to the prior year; however, we anticipate the deceleration in the pace of the year-over-year increase to continue. We expect to add to the loan loss reserve due to the seasoning of continued loan growth and supply-driven credit normalization. While net interest margin is expected to compress during the remainder of the year, we continue to anticipate a modest increase for the full year compared to the prior year.

In our payments segment, we will continue to pursue new ways to drive volume growth in a competitive environment. We continue to leverage our network to support our card-issuing business.

### Regulatory Environment and Developments

Policymakers continue to develop, implement and execute on regulatory, supervisory and enforcement priorities. The impact of the evolving regulatory environment on our business and operations depends upon a number of factors, including the actions of policymakers at the federal and state levels, our competitors, and consumers. For more information on how the regulatory and supervisory environment, enforcement actions and findings, and changes to laws and regulations could impact our strategies, the value of our assets, or otherwise adversely affect our business see "Risk Factors — Current Economic and Regulatory Environment" in our annual report on Form 10-K year ended December 31, 2018 . For more information on recent matters affecting us, see Note 12: Litigation and Regulatory Matters to our condensed consolidated financial statements.

Federal banking regulators continue to propose and implement new regulations and supervisory guidance, and modify their examination and enforcement priorities. In May 2018, the President signed into law the Economic Growth, Regulatory Relief, and Consumer Protection Act, which is intended to promote economic growth, provide tailored regulatory relief for smaller and less complex financial institutions, and enhance consumer protections. Among other provisions, the new law raised the asset threshold for automatically designating a bank holding company as "systemically important" from \$50 billion to \$250 billion, so that bank holding companies with assets below \$250 billion are no longer automatically subject to enhanced prudential standards pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-

Frank Act"), which created a framework for regulation of large financial firms, including Discover. However, the extent of relief afforded to Discover under the law will depend on how it is implemented.

In October 2018, the federal banking regulators issued proposals to tailor the existing regulatory requirements related to capital, liquidity and enhanced prudential standards to an institution's risk and complexity profile for banking institutions with total assets of \$100 billion or more. On February 5, 2019, the Federal Reserve announced that certain less complex firms subject to Comprehensive Capital Analysis and Review ("CCAR"), generally those with total consolidated assets between \$100 billion and \$250 billion, have been provided relief from certain components of the Federal Reserve's capital planning and stress testing framework for the 2019 stress test cycle. The Federal Reserve issued a temporary order granting Discover relief from the regulatory requirements related to supervisory stress testing and company-run stress testing for the 2019 stress test cycle and provided Discover a one-year extension of the requirement to submit a capital plan to the Federal Reserve until April 5, 2020.

Policymakers at the federal and state levels are increasingly focused on measures to enhance data security and data breach incident response requirements as a result of growing cybersecurity threats and the number of incidents involving unauthorized access to consumer information. Furthermore, regulations and legislation at various levels of government have been proposed and enacted to augment data privacy standards. For example, the California Consumer Privacy Act ("CCPA") creates a broad set of privacy rights and remedies modeled in part on the European Union's General Data Protection Regulation. The CCPA goes into effect on January 1, 2020 and regulations still need to be promulgated. While it is too early to know the requirements' full impact, these developments may ultimately result in the imposition of requirements on Discover and other providers of consumer financial services or networks that could increase costs or otherwise adversely affect our businesses.

## **Banking**

### *Current Expected Credit Loss*

In June 2016, the Financial Accounting Standards Board issued Accounting Standards Update No. 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, which is effective for us on January 1, 2020. The standard alters accounting principles generally accepted in the United States by replacing the incurred loss model with the current expected credit loss ("CECL") approach. The CECL approach requires our allowance for loan losses to be based on an estimate of all expected credit losses over the remaining contractual term of all of the loans, as opposed to an estimate of incurred losses as of the balance sheet date. We are continuing to refine loss forecasting models and technological solutions, and advance processes and controls in support of the new standard.

To enhance investors' understanding of the potential impact of CECL, we are providing our current preliminary estimate of the impact on the allowance for loan losses assuming the standard had become effective for us on June 30, 2019. That estimate, which remains subject to further refinement, would have resulted in an increase in the allowance for loan losses of approximately 55% to 65%. Additionally, our results of operations may be subject to more volatility under CECL. The ultimate extent of the impact upon adoption will depend on the characteristics of our loan portfolio and economic conditions at that date, as well as forecasted conditions thereafter.

In December 2018, federal banking agencies adopted a joint final rule that will, among other things, give bank holding companies and banks, including Discover and its bank subsidiaries, the option to phase in the regulatory capital impacts of implementing CECL over a three-year transition period. Additionally, notwithstanding the January 1, 2020 effective date, the Federal Reserve announced that it will not incorporate CECL into its supervisory stress tests until at least 2022 to reduce uncertainty, allow for better capital planning at affected firms and allow the Federal Reserve to gather additional information on the impact of CECL; however, banking institutions subject to Dodd-Frank Act company-run stress test requirements are required to incorporate CECL into their internal stress testing processes beginning in 2020. We anticipate that DFS and Discover Bank will continue to meet requirements to be "well-capitalized" upon adoption of the standard. For more information on CECL, see Note 1: Background and Basis of Presentation to our condensed consolidated financial statements.

## *Capital*

Discover Financial Services and Discover Bank are subject to regulatory capital requirements that became effective January 2015 under final rules issued by the Federal Reserve and the Federal Deposit Insurance Corporation ("FDIC") to implement the provisions under the Basel Committee's December 2010 framework ("Basel III rules"). The Basel III rules require Discover Financial Services and Discover Bank to maintain minimum risk-based capital and leverage ratios and define what constitutes capital for purposes of calculating those ratios. In addition, the Basel III rules establish a capital

conservation buffer ("CCB") above the regulatory minimum capital requirements, which must consist entirely of Common Equity Tier 1 ("CET1") capital and result in higher required minimum ratios by at least 2.5%. The CCB requirement became effective January 2016; however, the buffer threshold amounts were subject to a gradual phase-in period that ended on December 31, 2018. The full 2.5% buffer requirement was fully phased in as of January 1, 2019. A banking organization is subject to limitations on paying dividends, engaging in share repurchases and paying discretionary bonuses if its capital level falls below any of the minimum capital requirements, taking into account the applicable CCB thresholds. Based on our current capital composition and levels and business plans, we are and expect to continue to be in compliance with the requirements for the foreseeable future. For additional information, see "— Liquidity and Capital Resources — Capital."

In April 2018, the Federal Reserve issued a notice of proposed rulemaking that would significantly revise the regulatory capital and stress testing frameworks for mid-sized bank holding companies such as Discover Financial Services by, among other things, imposing new "stress buffer" requirements and revising certain assumptions used in supervisory stress tests. The proposal is intended to make regulatory capital requirements more forward-looking, risk-sensitive and firm-specific by linking them to the annual CCAR stress testing and capital plan review process. The timing and substance of any final rulemaking is uncertain at this time.

### *Liquidity*

We are currently subject to the U.S. liquidity coverage ratio rule issued by federal banking regulators. This quantitative requirement is designed to promote the short-term resilience of the liquidity risk profile of large and internationally active banking organizations in the United States. The rule requires covered banks to maintain an amount of high-quality liquid assets sufficient to cover projected net cash outflows during a prospective 30-day calendar period under an acute, hypothetical liquidity stress scenario. Given our current asset size, we are subject to a modified liquidity coverage ratio requirement, which requires a lower level of high-quality liquid assets to meet the minimum ratio requirement due to adjustments to the net cash outflow amount. The Federal Reserve issued a proposal on October 31, 2018 that would exempt bank holding companies with less than \$250 billion in assets and less than \$75 billion in certain other exposures from the liquidity coverage ratio rule. The timing and substance of any final rulemaking is unknown.

### *LIBOR*

On July 27, 2017, the UK Financial Conduct Authority announced that it would no longer encourage or compel banks to continue to contribute quotes and maintain the London Interbank Offered Rate ("LIBOR") after 2021. LIBOR is commonly used as a benchmark to determine interest rates for financial instruments, such as floating-rate asset-backed securities issued by Discover Card Execution Note Trust, and certain financial products, including some of our floating-rate student loans. We have a cross-functional team in place to oversee and manage our transition away from the use of LIBOR. This team monitors developments associated with LIBOR alternatives and evolving industry and marketplace norms and conventions for LIBOR indexed instruments, evaluates the impact that the inability to determine LIBOR after 2021 will have on us, and facilitates the operational changes associated with the use of alternative benchmark rates.

### *Consumer Financial Services*

The Consumer Financial Protection Bureau (the "CFPB") regulates consumer financial products and services, and examines certain service providers, including Discover. The CFPB's authority to prevent "unfair, deceptive or abusive acts or practices" and ensuring that consumer have access to fair, transparent and competitive financial products and services. The CFPB has rulemaking, supervision and enforcement powers with respect to federal consumer protection laws. Historically, the CFPB's policy priorities focused on several financial products of the type we offer (e.g. credit cards and student loans). In addition, the CFPB is required by statute to undertake certain actions including its bi-annual review of the consumer credit card market.

The current CFPB Director has indicated that the CFPB will focus on the prevention of harm, establishing valid metrics for success, and creating a level playing field for all financial institutions. Additionally, with regards to the CFPB's rulemaking and enforcement activities, the Director has outlined a framework that seeks to foster a more transparent rulemaking process that incorporates a robust cost benefit analysis, applies supervisory practices consistently, and ensures due process is a critical component of enforcement activity.

### Payment Networks

The Dodd-Frank Act contains several provisions impacting the debit card market, including network participation requirements and interchange fee limitations. The changing debit card environment, including competitor actions related to merchant and acquirer pricing and transaction routing strategies, has adversely affected, and is expected to continue to adversely affect, our PULSE network's business practices, network transaction volume, revenue and prospects for future growth. We continue to closely monitor competitor pricing and technology development strategies in order to assess their impact on our business and on competition in the marketplace. Following an inquiry by the U.S. Department of Justice into some of these competitor pricing strategies, PULSE filed a lawsuit against Visa in late 2014 with respect to these competitive concerns. The Court granted summary judgment in favor of Visa in August 2018. PULSE filed an appeal on January 17, 2019 and Visa filed their response to the appeal on April 5, 2019. Visa also faces ongoing merchant litigation as it relates to the underlying anticompetitive behavior that is the subject of PULSE's case against Visa. In addition, the Dodd-Frank Act's network participation requirements impact PULSE's ability to enter into exclusivity arrangements, which affects PULSE's current business practices and may materially adversely affect its network transaction volume and revenue.

### Segments

We manage our business activities in two segments, Direct Banking and Payment Services, based on the products and services provided. For a detailed description of the operations of each segment, as well as the allocation conventions used in our business segment reporting, see Note 15: Segment Disclosures to our condensed consolidated financial statements.

The following table presents segment data (dollars in millions):

|  | For the Three Months Ended June 30, |          | For the Six Months Ended June 30, |          |
|--|-------------------------------------|----------|-----------------------------------|----------|
|  | 2019                                | 2018     | 2019                              | 2018     |
| <b>Direct Banking</b>                  |                                     |          |                                   |          |
| Interest income                        |                                     |          |                                   |          |
| Credit card                            | \$ 2,396                            | \$ 2,139 | \$ 4,758                          | \$ 4,229 |
| Private student loans                  | 172                                 | 150      | 345                               | 297      |
| PCI student loans                      | 31                                  | 35       | 63                                | 72       |
| Personal loans                         | 241                                 | 229      | 478                               | 455      |
| Other                                  | 136                                 | 83       | 269                               | 152      |
| Total interest income                  | 2,976                               | 2,636    | 5,913                             | 5,205    |
| Interest expense                       | 645                                 | 507      | 1,277                             | 976      |
| Net interest income                    | 2,331                               | 2,129    | 4,636                             | 4,229    |
| Provision for loan losses              | 787                                 | 742      | 1,596                             | 1,493    |
| Other income                           | 436                                 | 398      | 808                               | 792      |
| Other expense                          | 1,039                               | 948      | 2,028                             | 1,880    |
| Income before income tax expense       | 941                                 | 837      | 1,820                             | 1,648    |
| <b>Payment Services</b>                |                                     |          |                                   |          |
| Net interest income                    | 1                                   | —        | 1                                 | —        |
| Other income                           | 84                                  | 76       | 170                               | 157      |
| Other expense                          | 39                                  | 36       | 74                                | 72       |
| Income before income tax expense       | 46                                  | 40       | 97                                | 85       |
| Total income before income tax expense | \$ 987                              | \$ 877   | \$ 1,917                          | \$ 1,733 |

The following table presents information on transaction volume (in millions):

|   | For the Three Months Ended June 30, |           | For the Six Months Ended June 30, |            |
|---|-------------------------------------|-----------|-----------------------------------|------------|
|   | 2019                                | 2018      | 2019                              | 2018       |
| <b>Network Transaction Volume</b>           |                                     |           |                                   |            |
| PULSE Network                               | \$ 47,389                           | \$ 44,308 | \$ 94,495                         | \$ 87,466  |
| Network Partners                            | 5,950                               | 4,602     | 11,613                            | 9,155      |
| Diners Club <sup>(1)</sup>                  | 8,472                               | 8,417     | 16,750                            | 16,807     |
| Total Payment Services                      | 61,811                              | 57,327    | 122,858                           | 113,428    |
| Discover Network—Proprietary <sup>(2)</sup> | 37,891                              | 36,339    | 71,942                            | 68,721     |
| Total Volume                                | \$ 99,702                           | \$ 93,666 | \$ 194,800                        | \$ 182,149 |
| <b>Transactions Processed on Networks</b>   |                                     |           |                                   |            |
| Discover Network                            | 671                                 | 614       | 1,276                             | 1,164      |
| PULSE Network                               | 1,183                               | 1,055     | 2,315                             | 2,044      |
| Total                                       | 1,854                               | 1,669     | 3,591                             | 3,208      |
| <b>Credit Card Volume</b>                   |                                     |           |                                   |            |
| Discover Card Volume <sup>(3)</sup>         | \$ 39,935                           | \$ 38,430 | \$ 76,321                         | \$ 72,757  |
| Discover Card Sales Volume <sup>(4)</sup>   | \$ 36,664                           | \$ 35,077 | \$ 69,563                         | \$ 65,927  |

(1) Diners Club volume is derived from data provided by licensees for Diners Club branded cards issued outside North America and is subject to subsequent revision or amendment.

(2) Represents gross proprietary sales volume on the Discover Network.

(3) Represents Discover card activity related to net sales, balance transfers, cash advances and other activity.

(4) Represents Discover card activity related to net sales.

### Direct Banking

Our Direct Banking segment reported pretax income of \$941 million and \$1.8 billion, respectively, for the three and six months ended June 30, 2019 as compared to pretax income of \$837 million and \$1.6 billion, respectively, for the three and six months ended June 30, 2018.

Net interest margin increased for the three and six months ended June 30, 2019 as compared to the same periods in 2018. This was primarily driven by higher yields on credit card loans, partially offset by higher funding costs, both of which were the result of higher market rates. The increase in net interest margin for the three months ended June 30, 2019 was also favorably impacted by portfolio mix. Interest income increased during the three and six months ended June 30, 2019 as compared to the same periods in 2018 due to continued loan growth and yield expansion resulting from prime rate increases. Interest expense increased during the three and six months ended June 30, 2019 as compared to the same periods in 2018 primarily due to a larger funding base and higher market rates.

For the three and six months ended June 30, 2019, the provision for loan losses increased as compared to the same periods in 2018 primarily due to higher levels of net charge-offs, partially offset by lower reserve builds. For a detailed discussion on provision for loan losses, see "— Loan Quality — Provision and Allowance for Loan Losses."

Total other income increased for the three months ended June 30, 2019 as compared to the same period in 2018, which was primarily due to higher discount and interchange revenue as a result of higher sales volume, while rewards remained flat due to lower promotional rewards. While total other income for the six months ended June 30, 2019 was relatively flat compared to the same period in 2018, there was an increase in discount and interchange revenue that was partially offset by an increase in rewards costs, both of which were the result of higher sales volume.

Total other expense increased in the three and six months ended June 30, 2019 as compared to the same periods in 2018. The increase was primarily driven by higher employee compensation and benefits, professional fees, information processing and communications, and other expense. Employee compensation and benefits increased as a result of higher average salaries. The increase in professional fees was primarily driven by higher collection fees, due to higher recoveries, and investments in technological capabilities. Information processing and communications increased because of investments in infrastructure and analytic capabilities while the increase in other expense was the result of higher incentives supporting global merchant acceptance.



Discover card sales volume was \$36.7 billion and \$69.6 billion, respectively, for the three and six months ended June 30, 2019, which was an increase of 4.5% and 5.5%, respectively, as compared to the same periods in 2018. This volume growth was primarily driven by higher consumer spending.

### Payment Services

Our Payment Services segment reported pretax income of \$46 million and \$97 million, respectively, for the three and six months ended June 30, 2019 as compared to pretax income of \$40 million and \$85 million, respectively, for the same periods in 2018. The increase in segment pretax income was primarily due to higher transaction volume across multiple channels.

Downturns in the global economy or negative impacts in foreign currency may adversely affect our financial condition or results of operations in our Payment Services segment. We continue to work with our Diners Club licensees with regard to their ability to maintain financing sufficient to support business operations. We may continue to provide additional support in the future, including loans, facilitating transfer of ownership, or acquiring assets or licensees, which may cause us to incur losses. The licensees that we currently consider to be of concern accounted for approximately 4% of Diners Club revenues during the three and six months ended June 30, 2019.

### Critical Accounting Estimates

In preparing our condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States ("GAAP"), management must make judgments and use estimates and assumptions about the effects of matters that are uncertain. For estimates that involve a high degree of judgment and subjectivity, it is possible that different estimates could reasonably be derived for the same period. For estimates that are particularly sensitive to changes in economic or market conditions, significant changes to the estimated amount from period to period are also possible. Management believes the current assumptions and other considerations used to estimate amounts reflected in our condensed consolidated financial statements are appropriate. However, if actual experience differs from the assumptions and other considerations used in estimating amounts in our condensed consolidated financial statements, the resulting changes could have a material effect on our consolidated results of operations and, in certain cases, could have a material effect on our consolidated financial condition. Management has identified the estimates related to our allowance for loan losses, the evaluation of goodwill for potential impairment and the accrual of income taxes as critical accounting estimates. These critical accounting estimates are discussed in greater detail in our annual report on Form 10-K for the year ended December 31, 2018. That discussion can be found within "Management's Discussion and Analysis of Financial Condition and Results of Operations — Critical Accounting Estimates." There have not been any material changes in the methods used to formulate these critical accounting estimates from those discussed in our annual report on Form 10-K for the year ended December 31, 2018.

### Earnings Summary

The following table outlines changes in our condensed consolidated statements of income (dollars in millions):

|   | For the Three Months Ended<br>June 30, |          | 2019 vs. 2018<br>Increase |     | For the Six Months Ended<br>June 30, |          | 2019 vs. 2018<br>Increase |     |
|---|--|----------|---------------------------|-----|--------------------------------------|----------|---------------------------|-----|
|   | 2019                                   | 2018     | \$                        | %   | 2019                                 | 2018     | \$                        | %   |
| Interest income                                     | \$ 2,977                               | \$ 2,636 | \$ 341                    | 13% | \$ 5,914                             | \$ 5,205 | \$ 709                    | 14% |
| Interest expense                                    | 645                                    | 507      | 138                       | 27% | 1,277                                | 976      | 301                       | 31% |
| Net interest income                                 | 2,332                                  | 2,129    | 203                       | 10% | 4,637                                | 4,229    | 408                       | 10% |
| Provision for loan losses                           | 787                                    | 742      | 45                        | 6%  | 1,596                                | 1,493    | 103                       | 7%  |
| Net interest income after provision for loan losses | 1,545                                  | 1,387    | 158                       | 11% | 3,041                                | 2,736    | 305                       | 11% |
| Other income  | 520                                    | 474      | 46                        | 10% | 978                                  | 949      | 29                        | 3%  |
| Other expense                                       | 1,078                                  | 984      | 94                        | 10% | 2,102                                | 1,952    | 150                       | 8%  |
| Income before income tax expense                    | 987                                    | 877      | 110                       | 13% | 1,917                                | 1,733    | 184                       | 11% |
| Income tax expense                                  | 234                                    | 208      | 26                        | 13% | 438                                  | 398      | 40                        | 10% |
| Net income  | \$ 753                                 | \$ 669   | \$ 84                     | 13% | \$ 1,479                             | \$ 1,335 | \$ 144                    | 11% |

## Net Interest Income

The table that follows this section has been provided to supplement the discussion below and provide further analysis of net interest income and net interest margin. Net interest income represents the difference between interest income earned on our interest-earning assets and the interest expense incurred to finance those assets. We analyze net interest income in total by calculating net interest margin (net interest income as a percentage of average total loan receivables) and net yield on interest-earning assets (net interest income as a percentage of average total interest-earning assets). We also separately consider the impact of the level of loan receivables and the related interest yield and the impact of the cost of funds related to each of our funding sources, along with the income generated by our liquidity portfolio, on net interest income.

Our interest-earning assets consist of: (i) cash and cash equivalents primarily related to amounts on deposit with the Federal Reserve Bank of Philadelphia, (ii) restricted cash, (iii) other short-term investments, (iv) investment securities and (v) loan receivables. Our interest-bearing liabilities consist primarily of deposits, both direct-to-consumer and brokered, and long-term borrowings, including amounts owed to securitization investors. Net interest income is influenced by the following:

- The level and composition of loan receivables, including the proportion of credit card loans to other loans, as well as the proportion of loan receivables bearing interest at promotional rates as compared to standard rates;
- The credit performance of our loans, particularly with regard to charge-offs of finance charges, which reduce interest income;
- The terms of long-term borrowings and certificates of deposit upon initial offering, including maturity and interest rate;
- The interest rates necessary to attract and maintain direct-to-consumer deposits;
- The level and composition of other interest-earning assets, including our liquidity portfolio and interest-bearing liabilities;
- Changes in the interest rate environment, including the levels of interest rates and the relationships among interest rate indices, such as the prime rate, the Federal Funds rate, interest rate on excess reserves and London Interbank Offered Rate;
- The effectiveness of interest rate swaps in our interest rate risk management program; and
- The difference between the carrying amount and future cash flows expected to be collected on purchased credit-impaired ("PCI") loans.

Net interest margin increased for the three and six months ended June 30, 2019 as compared to the same periods in 2018. This was primarily driven by higher yields on credit card loans, partially offset by higher funding costs, both of which were the result of higher market rates. The increase in net interest margin for the three months ended June 30, 2019 was also favorably impacted by portfolio mix. Interest income increased during the three and six months ended June 30, 2019 as compared to the same periods in 2018 due to continued loan growth and yield expansion resulting from prime rate increases. Interest expense increased during the three and six months ended June 30, 2019 as compared to the same periods in 2018 primarily due to a larger funding base and higher market rates.

**Average Balance Sheet Analysis**  
(dollars in millions)

|   | For the Three Months Ended June 30, |        |          |                 |        |          |
|---|-------------------------------------|--------|----------|-----------------|--------|----------|
|   | 2019                                |        |          | 2018            |        |          |
|   | Average Balance                     | Rate   | Interest | Average Balance | Rate   | Interest |
| <b>Assets</b>                                       |                                     |        |          |                 |        |          |
| Interest-earning assets                             |                                     |        |          |                 |        |          |
| Cash and cash equivalents                           | \$ 11,641                           | 2.41%  | \$ 70    | \$ 14,870       | 1.82%  | \$ 68    |
| Restricted cash                                     | 888                                 | 2.32%  | 5        | 466             | 1.85%  | 2        |
| Other short-term investments                        | 1,000                               | 2.66%  | 7        | —               | —%     | —        |
| Investment securities                               | 6,265                               | 2.52%  | 39       | 1,525           | 1.67%  | 6        |
| Loan receivables <sup>(1)</sup>                     |                                     |        |          |                 |        |          |
| Credit card <sup>(2)</sup>                          | 71,492                              | 13.44% | 2,396    | 66,594          | 12.88% | 2,139    |
| Personal loans                                      | 7,419                               | 13.02% | 241      | 7,304           | 12.55% | 228      |
| Private student loans                               | 7,985                               | 8.64%  | 172      | 7,321           | 8.21%  | 150      |
| PCI student loans                                   | 1,479                               | 8.35%  | 31       | 1,898           | 7.45%  | 35       |
| Other   | 983                                 | 6.83%  | 16       | 531             | 6.02%  | 8        |
| Total loan receivables                              | 89,358                              | 12.82% | 2,856    | 83,648          | 12.28% | 2,560    |
| Total interest-earning assets                       | 109,152                             | 10.94% | 2,977    | 100,509         | 10.52% | 2,636    |
| Allowance for loan losses                           | (3,133)                             |        |          | (2,731)         |        |          |
| Other assets  | 4,539                               |        |          | 4,170           |        |          |
| Total assets  | \$ 110,558                          |        |          | \$ 101,948      |        |          |
| <b>Liabilities and Stockholders' Equity</b>         |                                     |        |          |                 |        |          |
| Interest-bearing liabilities                        |                                     |        |          |                 |        |          |
| Interest-bearing deposits                           |                                     |        |          |                 |        |          |
| Time deposits <sup>(3)</sup>                        | \$ 33,576                           | 2.56%  | 214      | \$ 29,829       | 2.14%  | 159      |
| Money market deposits <sup>(4)</sup>                | 7,047                               | 2.20%  | 39       | 6,938           | 1.73%  | 30       |
| Other interest-bearing savings deposits             | 27,801                              | 2.14%  | 148      | 23,858          | 1.65%  | 98       |
| Total interest-bearing deposits <sup>(5)</sup>      | 68,424                              | 2.35%  | 401      | 60,625          | 1.90%  | 287      |
| Borrowings  |                                     |        |          |                 |        |          |
| Short-term borrowings                               | —                                   | 2.59%  | —        | 1               | 1.89%  | —        |
| Securitized borrowings <sup>(3)(4)</sup>            | 15,179                              | 3.01%  | 114      | 16,121          | 2.67%  | 108      |
| Other long-term borrowings <sup>(3)</sup>           | 10,932                              | 4.75%  | 130      | 9,866           | 4.57%  | 112      |
| Total borrowings                                    | 26,111                              | 3.74%  | 244      | 25,988          | 3.39%  | 220      |
| Total interest-bearing liabilities                  | 94,535                              | 2.73%  | 645      | 86,613          | 2.35%  | 507      |
| Other liabilities and stockholders' equity          | 16,023                              |        |          | 15,335          |        |          |
| Total liabilities and stockholders' equity          | \$ 110,558                          |        |          | \$ 101,948      |        |          |
| Net interest income                                 |                                     |        | \$ 2,332 |                 |        | \$ 2,129 |
| Net interest margin <sup>(6)</sup>                  |                                     | 10.47% |          |                 | 10.21% |          |
| Net yield on interest-earning assets <sup>(7)</sup> |                                     | 8.57%  |          |                 | 8.50%  |          |
| Interest rate spread <sup>(8)</sup>                 |                                     | 8.21%  |          |                 | 8.17%  |          |

**Average Balance Sheet Analysis**  
(dollars in millions)

|   | For the Six Months Ended June 30, |        |          |                 |        |          |
|---|-----------------------------------|--------|----------|-----------------|--------|----------|
|   | 2019                              |        |          | 2018            |        |          |
|   | Average Balance                   | Rate   | Interest | Average Balance | Rate   | Interest |
| <b>Assets</b>                                       |                                   |        |          |                 |        |          |
| Interest-earning assets                             |                                   |        |          |                 |        |          |
| Cash and cash equivalents                           | \$ 12,843                         | 2.44%  | \$ 155   | \$ 14,193       | 1.70%  | \$ 120   |
| Restricted cash                                     | 846                               | 2.33%  | 10       | 643             | 1.61%  | 5        |
| Other short-term investments                        | 558                               | 2.66%  | 7        | —               | —%     | —        |
| Investment securities                               | 5,261                             | 2.57%  | 67       | 1,537           | 1.71%  | 13       |
| Loan receivables <sup>(1)</sup>                     |                                   |        |          |                 |        |          |
| Credit card <sup>(2)</sup>                          | 71,428                            | 13.43% | 4,758    | 66,290          | 12.87% | 4,229    |
| Personal loans                                      | 7,444                             | 12.94% | 478      | 7,345           | 12.49% | 455      |
| Private student loans                               | 8,028                             | 8.67%  | 345      | 7,367           | 8.12%  | 296      |
| PCI student loans                                   | 1,531                             | 8.30%  | 63       | 1,958           | 7.41%  | 72       |
| Other   | 925                               | 6.84%  | 31       | 492             | 6.00%  | 15       |
| Total loan receivables                              | 89,356                            | 12.81% | 5,675    | 83,452          | 12.24% | 5,067    |
| Total interest-earning assets                       | 108,864                           | 10.96% | 5,914    | 99,825          | 10.52% | 5,205    |
| Allowance for loan losses                           | (3,086)                           |        |          | (2,674)         |        |          |
| Other assets  | 4,497                             |        |          | 4,196           |        |          |
| Total assets  | \$ 110,275                        |        |          | \$ 101,347      |        |          |
| <b>Liabilities and Stockholders' Equity</b>         |                                   |        |          |                 |        |          |
| Interest-bearing liabilities                        |                                   |        |          |                 |        |          |
| Interest-bearing deposits                           |                                   |        |          |                 |        |          |
| Time deposits <sup>(3)</sup>                        | \$ 33,901                         | 2.52%  | 424      | \$ 30,023       | 2.09%  | 311      |
| Money market deposits <sup>(4)</sup>                | 7,058                             | 2.20%  | 77       | 6,856           | 1.66%  | 56       |
| Other interest-bearing savings deposits             | 27,075                            | 2.13%  | 286      | 23,168          | 1.59%  | 182      |
| Total interest-bearing deposits <sup>(5)</sup>      | 68,034                            | 2.33%  | 787      | 60,047          | 1.85%  | 549      |
| Borrowings  |                                   |        |          |                 |        |          |
| Short-term borrowings                               | 1                                 | 2.59%  | —        | 1               | 1.82%  | —        |
| Securitized borrowings <sup>(3)(4)</sup>            | 15,520                            | 3.03%  | 233      | 16,150          | 2.55%  | 204      |
| Other long-term borrowings <sup>(3)</sup>           | 10,822                            | 4.78%  | 257      | 9,906           | 4.53%  | 223      |
| Total borrowings                                    | 26,343                            | 3.75%  | 490      | 26,057          | 3.30%  | 427      |
| Total interest-bearing liabilities                  | 94,377                            | 2.73%  | 1,277    | 86,104          | 2.29%  | 976      |
| Other liabilities and stockholders' equity          | 15,898                            |        |          | 15,243          |        |          |
| Total liabilities and stockholders' equity          | \$ 110,275                        |        |          | \$ 101,347      |        |          |
| Net interest income                                 |                                   |        | \$ 4,637 |                 |        | \$ 4,229 |
| Net interest margin <sup>(6)</sup>                  |                                   | 10.47% |          |                 | 10.22% |          |
| Net yield on interest-earning assets <sup>(7)</sup> |                                   | 8.59%  |          |                 | 8.54%  |          |
| Interest rate spread <sup>(8)</sup>                 |                                   | 8.23%  |          |                 | 8.23%  |          |

(1) Average balances of loan receivables include non-accruing loans, which are included in the yield calculations. If the non-accruing loan balances were excluded, there would not be a material impact on the amounts reported above.

(2) Interest income on credit card loans includes \$66 million and \$60 million of amortization of balance transfer fees for the three months ended June 30, 2019 and 2018, respectively, and \$130 million and \$119 million for the six months ended June 30, 2019 and 2018, respectively.

(3) Includes the impact of interest rate swap agreements used to change a portion of fixed-rate funding to floating-rate funding.

(4) Includes the impact of interest rate swap agreements used to change a portion of floating-rate funding to fixed-rate funding.

(5) Includes the impact of FDIC insurance premiums and Large Institution Surcharge. As of October 2018, the FDIC no longer assesses a Large Institution Surcharge.

(6) Net interest margin represents net interest income as a percentage of average total loan receivables.

(7) Net yield on interest-earning assets represents net interest income as a percentage of average total interest-earning assets.

(8) Interest rate spread represents the difference between the rate on total interest-earning assets and the rate on total interest-bearing liabilities.

**Loan Quality**

Loan receivables consist of the following (dollars in millions):

|                           | June 30,<br>2019 | December 31, 2018 |
|---------------------------|------------------|-------------------|
| Credit card loans         | \$ 72,393        | \$ 72,876         |
| Other loans               |                  |                   |
| Personal loans            | 7,414            | 7,454             |
| Private student loans     | 7,943            | 7,728             |
| Other                     | 1,047            | 817               |
| Total other loans         | 16,404           | 15,999            |
| PCI loans <sup>(1)</sup>  | 1,432            | 1,637             |
| Total loan receivables    | 90,229           | 90,512            |
| Allowance for loan losses | (3,202)          | (3,041)           |
| Net loan receivables      | \$ 87,027        | \$ 87,471         |

(1) Represents PCI private student loans. See Note 3: Loan Receivables to our condensed consolidated financial statements for more information regarding PCI loans.

**Provision and Allowance for Loan Losses**

Provision for loan losses is the expense related to maintaining the allowance for loan losses at an appropriate level to absorb the estimated probable losses in the loan portfolio at each period end date. While establishing the estimate for probable losses requires significant management judgment, the factors that influence the provision for loan losses include:

- The impact of general economic conditions on the consumer, including national and regional conditions, unemployment levels, bankruptcy trends and interest rate movements;
- Changes in consumer spending, payment and credit utilization behaviors;
- Changes in our loan portfolio, including the overall mix of accounts, products and loan balances within the portfolio and maturation of the loan portfolio;
- The level and direction of historical and anticipated loan delinquencies and charge-offs;
- The credit quality of the loan portfolio, which reflects, among other factors, our credit granting practices and effectiveness of collection efforts; and
- Regulatory changes or new regulatory guidance.

In determining the allowance for loan losses, we estimate probable losses separately for segments of the loan portfolio that have similar risk characteristics. We use a migration analysis to estimate the likelihood that a loan will progress through the various stages of delinquency. We use other analyses to estimate losses incurred from non-delinquent accounts, which adds to the identification of loss emergence. We use these analyses together as a basis for determining our allowance for loan losses.

The provision for loan losses is the amount of expense realized after considering the level of net charge-offs in the period and the required amount of allowance for loan losses at the balance sheet date. For the three and six months ended June 30, 2019, the provision for loan losses increased by \$45 million or 6%, and \$103 million or 7%, respectively, as compared to the same periods in 2018 primarily due to higher levels of net charge-offs, partially offset by lower reserve builds.

The allowance for loan losses was \$3.2 billion at June 30, 2019, which reflects a \$161 million reserve build over the amount of the allowance for loan losses at December 31, 2018. The reserve build, which related to credit card loans, was because of seasoning of continued loan growth and supply-driven credit normalization, due to increasing consumer debt levels.

The following tables provide changes in our allowance for loan losses (dollars in millions):

|                                       | For the Three Months Ended June 30, 2019 |                |                              |             |                 |
|---------------------------------------|--|----------------|------------------------------|-------------|-----------------|
|                                       | Credit Card                              | Personal Loans | Student Loans <sup>(1)</sup> | Other       | Total           |
| <b>Balance at beginning of period</b> | \$ 2,622                                 | \$ 338         | \$ 168                       | \$ 6        | \$ 3,134        |
| Additions                             |  |                |                              |             |                 |
| Provision for loan losses             | 692                                      | 80             | 15                           | —           | 787             |
| Deductions                            |  |                |                              |             |                 |
| Charge-offs                           | (789)                                    | (91)           | (18)                         | —           | (898)           |
| Recoveries                            | 166                                      | 11             | 3                            | —           | 180             |
| Net charge-offs                       | (623)                                    | (80)           | (15)                         | —           | (718)           |
| Other <sup>(2)</sup>                  | —  | —              | (1)                          | —           | (1)             |
| <b>Balance at end of period</b>       | <b>\$ 2,691</b>                          | <b>\$ 338</b>  | <b>\$ 167</b>                | <b>\$ 6</b> | <b>\$ 3,202</b> |

|                                       | For the Three Months Ended June 30, 2018 |                |                              |              |                 |
|---------------------------------------|--|----------------|------------------------------|--------------|-----------------|
|                                       | Credit Card                              | Personal Loans | Student Loans <sup>(1)</sup> | Other        | Total           |
| <b>Balance at beginning of period</b> | \$ 2,252                                 | \$ 301         | \$ 170                       | \$ 13        | \$ 2,736        |
| Additions                             |  |                |                              |              |                 |
| Provision for loan losses             | 637                                      | 84             | 22                           | (1)          | 742             |
| Deductions                            |  |                |                              |              |                 |
| Charge-offs                           | (684)                                    | (80)           | (24)                         | (1)          | (789)           |
| Recoveries                            | 129                                      | 8              | 3                            | —            | 140             |
| Net charge-offs                       | (555)                                    | (72)           | (21)                         | (1)          | (649)           |
| Other <sup>(2)</sup>                  | —  | —              | (1)                          | —            | (1)             |
| <b>Balance at end of period</b>       | <b>\$ 2,334</b>                          | <b>\$ 313</b>  | <b>\$ 170</b>                | <b>\$ 11</b> | <b>\$ 2,828</b> |

|                                       | For the Six Months Ended June 30, 2019 |                |                              |             |                 |
|---------------------------------------|--|----------------|------------------------------|-------------|-----------------|
|                                       | Credit Card                            | Personal Loans | Student Loans <sup>(1)</sup> | Other       | Total           |
| <b>Balance at beginning of period</b> | \$ 2,528                               | \$ 338         | \$ 169                       | \$ 6        | \$ 3,041        |
| Additions                             |  |                |                              |             |                 |
| Provision for loan losses             | 1,402                                  | 164            | 30                           | —           | 1,596           |
| Deductions                            |  |                |                              |             |                 |
| Charge-offs                           | (1,563)                                | (185)          | (37)                         | —           | (1,785)         |
| Recoveries                            | 324                                    | 21             | 7                            | —           | 352             |
| Net charge-offs                       | (1,239)                                | (164)          | (30)                         | —           | (1,433)         |
| Other <sup>(2)</sup>                  | —                                      | —              | (2)                          | —           | (2)             |
| <b>Balance at end of period</b>       | <b>\$ 2,691</b>                        | <b>\$ 338</b>  | <b>\$ 167</b>                | <b>\$ 6</b> | <b>\$ 3,202</b> |

|                                       | For the Six Months Ended June 30, 2018 |                |                              |              |                 |
|---------------------------------------|--|----------------|------------------------------|--------------|-----------------|
|                                       | Credit Card                            | Personal Loans | Student Loans <sup>(1)</sup> | Other        | Total           |
| <b>Balance at beginning of period</b> | \$ 2,147                               | \$ 301         | \$ 162                       | \$ 11        | \$ 2,621        |
| Additions                             |  |                |                              |              |                 |
| Provision for loan losses             | 1,282                                  | 157            | 53                           | 1            | 1,493           |
| Deductions                            |  |                |                              |              |                 |
| Charge-offs                           | (1,347)                                | (161)          | (49)                         | (1)          | (1,558)         |
| Recoveries                            | 252                                    | 16             | 6                            | —            | 274             |
| Net charge-offs                       | (1,095)                                | (145)          | (43)                         | (1)          | (1,284)         |
| Other <sup>(2)</sup>                  | —                                      | —              | (2)                          | —            | (2)             |
| <b>Balance at end of period</b>       | <b>\$ 2,334</b>                        | <b>\$ 313</b>  | <b>\$ 170</b>                | <b>\$ 11</b> | <b>\$ 2,828</b> |

(1) Includes both PCI and non-PCI private student loans.

(2) Net change in reserves on PCI pools having no remaining non-accretable difference.

### Net Charge-offs

Our net charge-offs include the principal amount of losses charged off less principal recoveries and exclude charged-off and recovered interest and fees and fraud losses. Charged-off and recovered interest and fees are recorded in interest income and loan fee income, respectively, which is effectively a reclassification of the provision for loan losses, while fraud losses are recorded in other expense.

The following table presents amounts and rates of net charge-offs of key loan products (dollars in millions):

|   | For the Three Months Ended June 30, |       |        |       | For the Six Months Ended June 30, |       |          |       |
|---|-------------------------------------|-------|--------|-------|-----------------------------------|-------|----------|-------|
|   | 2019                                |       | 2018   |       | 2019                              |       | 2018     |       |
|   | \$                                  | %     | \$     | %     | \$                                | %     | \$       | %     |
| Credit card loans                                     | \$ 623                              | 3.49% | \$ 555 | 3.34% | \$ 1,239                          | 3.50% | \$ 1,095 | 3.33% |
| Personal loans  | \$ 80                               | 4.33% | \$ 72  | 3.97% | \$ 164                            | 4.43% | \$ 145   | 4.00% |
| Private student loans (excluding PCI <sup>(1)</sup> ) | \$ 15                               | 0.73% | \$ 21  | 1.16% | \$ 30                             | 0.76% | \$ 43    | 1.17% |

(1) See Note 3: Loan Receivables to our condensed consolidated financial statements for information regarding the accounting for charge-offs on PCI loans.

The net charge-off rates on our credit card and personal loans increased 15 and 36 basis points, respectively, for the three months ended June 30, 2019 and 17 and 43 basis points, respectively, for the six months ended June 30, 2019 when compared to the same periods in 2018. The net charge-off rate on our private student loans decreased 43 basis points for the three months ended June 30, 2019 and 41 basis points for the six months ended June 30, 2019 when compared to the same periods in 2018. Net charge-off rates were generally higher due to seasoning of continued loan growth and supply-driven credit normalization.

### Delinquencies

Delinquencies are an indicator of credit quality at a point in time. A loan balance is considered delinquent when contractual payments on the loan become 30 days past due.

The following table presents the amounts and delinquency rates of key loan products that are 30 and 90 days or more delinquent, loan receivables that are not accruing interest regardless of delinquency, and restructured loans (dollars in millions):

|  | June 30, 2019 |       | December 31, 2018 |       |
|--|---------------|-------|-------------------|-------|
|  | \$            | %     | \$                | %     |
| <b>Loans 30 or more days delinquent</b>                                    |               |       |                   |       |
| Credit card loans  | \$ 1,692      | 2.34% | \$ 1,772          | 2.43% |
| Personal loans   | \$ 110        | 1.49% | \$ 119            | 1.60% |
| Private student loans (excluding PCI loans <sup>(1)</sup> )                | \$ 133        | 1.67% | \$ 155            | 2.00% |
| <b>Loans 90 or more days delinquent</b>                                    |               |       |                   |       |
| Credit card loans  | \$ 857        | 1.18% | \$ 887            | 1.22% |
| Personal loans   | \$ 31         | 0.42% | \$ 35             | 0.47% |
| Private student loans (excluding PCI loans <sup>(1)</sup> )                | \$ 33         | 0.42% | \$ 38             | 0.49% |
| Loans not accruing interest  | \$ 279        | 0.31% | \$ 302            | 0.34% |
| <b>Restructured loans</b>  |               |       |                   |       |
| Credit card loans <sup>(2)</sup>   | \$ 2,810      | 3.88% | \$ 2,248          | 3.08% |
| Personal loans <sup>(3)</sup>  | \$ 181        | 2.44% | \$ 152            | 2.04% |
| Private student loans (excluding PCI loans <sup>(1)</sup> ) <sup>(4)</sup> | \$ 228        | 2.87% | \$ 182            | 2.36% |

(1) Excludes PCI loans, which are accounted for on a pooled basis. Since a pool is accounted for as a single asset with a single composite interest rate and aggregate expectation of cash flows, the past-due status of a pool, or that of the individual loans within a pool, is not meaningful. Because we are recognizing interest income on a pool of loans, it is all considered to be performing.

(2) Restructured credit card loans include \$143 million and \$124 million at June 30, 2019 and December 31, 2018, respectively, which are also included in loans 90 or more days delinquent.

(3) Restructured personal loans include \$7 million and \$6 million at June 30, 2019 and December 31, 2018, which are also included in loans 90 or more days delinquent.

(4) Restructured private student loans include \$7 million at June 30, 2019 and December 31, 2018, which are also included in loans 90 or more days delinquent.

The 30-day delinquency rates for credit card, personal and private student loans at June 30, 2019 decreased compared to December 31, 2018 primarily due to seasonality. Loans 90 or more days delinquent were relatively flat compared to December 31, 2018.

The restructured loan balances at June 30, 2019 increased as compared to December 31, 2018 due to seasoning of continued loan growth and greater utilization of programs available to assist borrowers having difficulties meeting payment obligations.

### Modified and Restructured Loans

For information regarding modified and restructured loans, see Note 3: Loan Receivables to our condensed consolidated financial statements.

### Other Income

The following table presents the components of other income (dollars in millions):

|  | For the Three Months Ended<br>June 30, |               | 2019 vs 2018<br>Increase (Decrease) |      | For the Six Months Ended<br>June 30, |               | 2019 vs. 2018<br>Increase (Decrease) |      |
|--|--|---------------|-------------------------------------|------|--------------------------------------|---------------|--------------------------------------|------|
|  | 2019                                   | 2018          | \$                                  | %    | 2019                                 | 2018          | \$                                   | %    |
| Discount and interchange revenue, net <sup>(1)</sup> | \$ 299                                 | \$ 263        | \$ 36                               | 14 % | \$ 530                               | \$ 517        | \$ 13                                | 3 %  |
| Protection products revenue                          | 49                                     | 50            | (1)                                 | (2)% | 98                                   | 103           | (5)                                  | (5)% |
| Loan fee income                                      | 102                                    | 95            | 7                                   | 7 %  | 206                                  | 191           | 15                                   | 8 %  |
| Transaction processing revenue                       | 48                                     | 42            | 6                                   | 14 % | 94                                   | 85            | 9                                    | 11 % |
| Other income   | 22                                     | 24            | (2)                                 | (8)% | 50                                   | 53            | (3)                                  | (6)% |
| Total other income                                   | <u>\$ 520</u>                          | <u>\$ 474</u> | <u>\$ 46</u>                        | 10 % | <u>\$ 978</u>                        | <u>\$ 949</u> | <u>\$ 29</u>                         | 3 %  |

(1) Net of rewards, including *Cashback Bonus* rewards, of \$460 million and \$461 million for the three months ended June 30, 2019 and 2018, respectively and \$906 million and \$853 million for the six months ended June 30, 2019.

Total other income increased for the three months ended June 30, 2019 as compared to the same period in 2018, which was primarily due to higher discount and interchange revenue as a result of higher sales volume, while rewards remained flat due to lower promotional rewards. While total other income for the six months ended June 30, 2019 was relatively flat compared to the same period in 2018, there was an increase in discount and interchange revenue that was partially offset by an increase in rewards costs, both of which were the result of higher sales volume.

### Other Expense

The following table represents the components of other expense (dollars in millions):

|   | For the Three Months Ended<br>June 30, |               | 2019 vs. 2018<br>Increase |     | For the Six Months Ended<br>June 30, |                 | 2019 vs. 2018<br>Increase |     |
|---|--|---------------|---------------------------|-----|--------------------------------------|-----------------|---------------------------|-----|
|   | 2019                                   | 2018          | \$                        | %   | 2019                                 | 2018            | \$                        | %   |
| Employee compensation and benefits        | \$ 427                                 | \$ 400        | \$ 27                     | 7%  | \$ 852                               | \$ 805          | \$ 47                     | 6%  |
| Marketing and business development        | 224                                    | 224           | —                         | —%  | 419                                  | 409             | 10                        | 2%  |
| Information processing and communications | 101                                    | 86            | 15                        | 17% | 200                                  | 168             | 32                        | 19% |
| Professional fees                         | 183                                    | 161           | 22                        | 14% | 350                                  | 316             | 34                        | 11% |
| Premises and equipment                    | 26                                     | 24            | 2                         | 8%  | 54                                   | 50              | 4                         | 8%  |
| Other expense                             | 117                                    | 89            | 28                        | 31% | 227                                  | 204             | 23                        | 11% |
| Total other expense                       | <u>\$ 1,078</u>                        | <u>\$ 984</u> | <u>\$ 94</u>              | 10% | <u>\$ 2,102</u>                      | <u>\$ 1,952</u> | <u>\$ 150</u>             | 8%  |

Total other expense increased in the three and six months ended June 30, 2019 as compared to the same periods in 2018. The increase was primarily driven by higher employee compensation and benefits, professional fees, information processing and communications, and other expense. Employee compensation and benefits increased as a result of higher average salaries. The increase in professional fees was primarily driven by higher collection fees, due to higher recoveries, and investments in technological capabilities. Information processing and communications increased because of investments



in infrastructure and analytic capabilities while the increase in other expense was the result of higher incentives supporting global merchant acceptance.

## Income Tax Expense

The following table presents the calculation of the effective income tax rate (dollars in millions, except effective income tax rate):

|                                  | For the Three Months Ended June 30, |        | For the Six Months Ended June 30, |          |
|----------------------------------|-------------------------------------|--------|-----------------------------------|----------|
|                                  | 2019                                | 2018   | 2019                              | 2018     |
| Income before income tax expense | \$ 987                              | \$ 877 | \$ 1,917                          | \$ 1,733 |
| Income tax expense               | \$ 234                              | \$ 208 | \$ 438                            | \$ 398   |
| Effective income tax rate        | 23.8%                               | 23.7%  | 22.9%                             | 23.0%    |

Income tax expense increased \$26 million and \$40 million for the three and six months ended June 30, 2019, respectively, as compared to the same periods in 2018. The effective tax rate was flat for the three and six months ended June 30, 2019 as compared to the same periods in 2018.

## Liquidity and Capital Resources

### Funding and Liquidity

We seek to maintain stable, diversified and cost-effective funding sources and a strong liquidity profile in order to fund our business and repay or refinance our maturing obligations under both normal operating conditions and periods of economic or financial stress. In managing our liquidity risk, we seek to maintain a prudent liability maturity profile and ready access to an ample store of primary and contingent liquidity sources. Our primary funding sources include direct-to-consumer and brokered deposits, public term asset-backed securitizations and other short-term and long-term borrowings. Our primary liquidity sources include a liquidity portfolio comprised of highly liquid, unencumbered assets, including cash and cash equivalents and investment securities, and borrowing capacity through private term asset-backed securitizations. In addition, we have unused borrowing capacity with the Federal Reserve discount window, which provides another source of contingent liquidity.

### Funding Sources

#### Deposits

We offer deposit products 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"). Direct-to-consumer deposits include online savings accounts, certificates of deposit, money market accounts, IRA certificates of deposit and checking accounts, while brokered deposits include certificates of deposit and sweep accounts. At June 30, 2019, we had \$49.7 billion of direct-to-consumer deposits and \$20.0 billion of brokered and other deposits.

#### Credit Card Securitization Financing

We securitize credit card receivables as a source of funding. We access the asset-backed securitization market using the Discover Card Master Trust I ("DCMT") and the Discover Card Execution Note Trust ("DCENT"), through which we issue DCENT DiscoverSeries notes in both public and private transactions. From time to time, we may add credit card receivables to these trusts to create sufficient funding capacity for future securitizations while managing seller's interest. We retain significant exposure to the performance of trust assets through holdings of the seller's interest and subordinated security classes of DCENT.

The securitization structures include certain features designed to protect investors. The primary feature relates to the availability and adequacy of cash flows in the securitized pool of receivables to meet contractual requirements, the insufficiency of which triggers early repayment of the securities. We refer to this as "economic early amortization", which is based on excess spread levels. Excess spread is the amount by which income received by a trust during a collection period, including interest collections, fees and interchange, exceeds the fees and expenses of the trust during such collection period, including interest expense, servicing fees and charged-off receivables. In the event of an economic early amortization, which

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would occur if the excess spread fell below 0% on a three-month rolling average basis, we would be required to repay the affected outstanding securitized borrowings using available collections received by the trust; the period of ultimate repayment would be determined by the amount and timing of collections received. An early amortization event would impair our liquidity, and may require us to utilize our available non-securitization related contingent liquidity or rely on alternative funding sources, which may or may not be available at the time. As of June 30, 2019, the DiscoverSeries three-month rolling average excess spread was 12.97%.

We may elect to add receivables to the restricted pool of receivables, subject to certain requirements. Through our wholly-owned indirect subsidiary, Discover Funding LLC, we are 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. 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 interests held by us). If the level of receivables in the trust were to fall below the required minimum, we 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. Seller's interest is impacted by seasonality as higher balance repayments tend to occur in the first calendar year quarter. If we could not add enough receivables to satisfy the minimum seller's interest requirement, an early amortization (or repayment) of investors' interests would be triggered. No accounts were added to those restricted for securitization investors for the three or six months ended June 30, 2019.

At June 30, 2019, we had \$14.0 billion of outstanding public asset-backed securities and \$5.0 billion of outstanding subordinated asset-backed securities that had been issued to our wholly-owned subsidiaries.

The following table summarizes expected contractual maturities of the investors' interests in credit card securitizations, excluding those that have been issued to our wholly-owned subsidiaries (dollars in millions):

| <b>At June 30, 2019</b>   | <b>Total</b> | <b>Less Than<br/>One Year</b> | <b>One Year<br/>Through<br/>Three Years</b> | <b>Four Years<br/>Through<br/>Five Years</b> | <b>After Five<br/>Years</b> |
|---|--------------|-------------------------------|---|--|-----------------------------|
| Scheduled maturities of long-term borrowings - owed to credit card securitization investors | \$ 14,036    | \$ 3,344                      | \$ 7,078                                    | \$ 3,614                                     | \$ —                        |

The triple-A rating of DCENT Class A Notes issued to date has been based, in part, on an FDIC rule, which created a safe harbor that provides that the FDIC, as conservator or receiver, will not, using its power to disaffirm or repudiate contracts, seek to reclaim or recover assets transferred in connection with a securitization, or recharacterize them as assets of the insured depository institution, provided such transfer satisfies the conditions for sale accounting treatment under previous GAAP. Although the implementation of the Financial Accounting Standards Board Accounting Standards Codification Topic 860, Transfers and Servicing, no longer qualified certain transfers of assets for sale accounting treatment, the FDIC approved a final rule that preserved the safe-harbor treatment applicable to revolving trusts and master trusts, including DCMT, so long as those trusts would have satisfied the original FDIC safe harbor if evaluated under GAAP pertaining to transfers of financial assets in effect prior to December 2009. Other legislative and regulatory developments may, however, impact our ability and/or desire to issue asset-backed securities in the future.

#### *Other Long-Term Borrowings—Student Loans*

At June 30, 2019, \$178 million of remaining principal balance was outstanding on securitized debt assumed as part of our acquisition of The Student Loan Corporation. Principal and interest payments on the underlying student loans will reduce the balance of these secured borrowings over time.

### *Other Long-Term Borrowings — Corporate and Bank Debt*

The following table provides a summary of Discover Financial Services (Parent Company) and Discover Bank outstanding fixed-rate debt (dollars in millions):

| <b>At June 30, 2019</b>  |    | <b>Principal Amount<br/>Outstanding</b> |
|--|----|---|
| Discover Financial Services (Parent Company) fixed-rate senior notes, maturing 2019-2027 | \$ | 3,500                                   |
| Discover Financial Services (Parent Company) fixed-rate retail notes, maturing 2019-2031 | \$ | 345                                     |
| Discover Bank fixed-rate senior bank notes, maturing 2020-2028                           | \$ | 6,100                                   |
| Discover Bank fixed-rate subordinated bank notes, maturing 2019-2028                     | \$ | 1,200                                   |

Certain Discover Financial Services senior notes require us to offer to repurchase the notes at a price equal to 101% of their aggregate principal amount plus accrued and unpaid interest in the event of a change of control involving us and a corresponding ratings downgrade to below investment grade.

### *Short-Term Borrowings*

As part of our regular funding strategy, we may from time to time borrow short-term funds in the federal funds market or the repurchase ("repo") market through repurchase agreements. Federal funds are short-term, unsecured loans between banks or other financial entities with a Federal Reserve account. Funds borrowed in the repo market are short-term, collateralized loans, usually secured with highly-rated investment securities such as U.S. Treasury bills or notes, or federal agency mortgage bonds or debentures. At June 30, 2019, there were no outstanding balances in the federal funds market or repurchase agreements.

### *Additional Funding Sources*

#### *Private Asset-Backed Securitizations*

We have access to committed borrowing capacity through privately placed asset-backed securitizations. At June 30, 2019, we had total committed capacity of \$6.0 billion, none of which was drawn. While we may utilize funding from these private securitizations from time to time for normal business operations, their committed nature also makes them a reliable contingency funding source. Therefore, we reserve some undrawn capacity, informed by our liquidity stress test results, for potential contingency funding needs. We also seek to ensure the stability and reliability of these securitizations by staggering their maturity dates, renewing them approximately one year prior to their scheduled maturity dates and periodically drawing them for operational testing purposes and seasonal funding needs.

#### *Federal Reserve*

Discover Bank has access to the Federal Reserve Bank of Philadelphia's discount window. As of June 30, 2019, Discover Bank had \$32.5 billion of available borrowing capacity through the discount window based on the amount and type of assets pledged, primarily consumer loans. We have no borrowings outstanding under the discount window and reserve this capacity as a source of contingent liquidity.

### *Funding Uses*

Our primary uses of funds include the extensions of loans and credit, primarily through Discover Bank; the purchase of investment securities for our liquidity portfolio; working capital; and debt and capital service. We assess funding uses and liquidity needs under stressed and normal operating conditions, considering primary uses of funding, such as on-balance sheet loans, and contingent uses of funding, such as the need to post additional collateral for derivatives positions. In order to anticipate funding needs under stress, we conduct liquidity stress tests to assess the impact of idiosyncratic, systemic and hybrid (idiosyncratic and systemic) scenarios with varying levels of liquidity risk reflecting a range of stress severity.

### *Credit Ratings*

Our borrowing costs and capacity in certain funding markets, including those for securitizations and unsecured senior and subordinated debt, may be affected by the credit ratings of DFS, Discover Bank and the securitization trusts. Downgrades in these credit ratings could result in higher interest expense on our unsecured debt and asset securitizations, as well as higher

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collateral enhancement requirements for both our public and private asset securitizations. In addition to increased funding costs, deterioration in credit ratings could reduce our borrowing capacity in the unsecured debt and asset securitization capital markets.

We also maintain agreements with certain of our derivative counterparties that contain provisions that require DFS and Discover Bank to maintain an investment grade credit rating from specified major credit rating agencies. At June 30, 2019, Discover Bank's credit rating met specified thresholds set by its counterparties. However, if its credit ratings were to fall below investment grade, Discover Bank would be required to post additional collateral, which, as of June 30, 2019, would have been \$20 million. DFS (Parent Company) had no outstanding derivatives as of June 30, 2019, and therefore, no collateral was required.

The table below reflects our current credit ratings and outlooks:

|   | Moody's Investors Service | Standard & Poor's | Fitch Ratings |
|---|---------------------------|-------------------|---------------|
| <b>Discover Financial Services</b>                            |                           |                   |               |
| Senior unsecured debt   | Baa3                      | BBB-              | BBB+          |
| Outlook for Discover Financial Services senior unsecured debt | Stable                    | Stable            | Stable        |
| <b>Discover Bank</b>  |                           |                   |               |
| Senior unsecured debt   | Baa2                      | BBB               | BBB+          |
| Outlook for Discover Bank senior unsecured debt               | Stable                    | Stable            | Stable        |
| Subordinated debt   | Baa3                      | BBB-              | BBB           |
| <b>Discover Card Execution Note Trust</b>                     |                           |                   |               |
| Class A <sup>(1)</sup>  | Aaa(sf)                   | AAA(sf)           | AAA(sf)       |

(1) An "sf" in the rating denotes rating agency identification for structured finance product ratings.

A credit rating is not a recommendation to buy, sell or hold securities, may be subject to revision or withdrawal at any time by the assigning rating organization, and each rating should be evaluated independently of any other rating.

### Liquidity

We seek to ensure that we have adequate liquidity to sustain business operations, fund asset growth and satisfy debt obligations under stressed and normal operating conditions. In addition to the funding sources discussed in the previous section, we also maintain highly liquid, unencumbered assets in our liquidity portfolio that we expect to be able to convert to cash quickly and with little loss of value using either the repo market or outright sales.

We maintain a liquidity risk and funding management policy, which outlines the overall framework and general principles we follow in managing liquidity risk across our business. The policy is approved by the Board of Directors with implementation responsibilities delegated to the Asset and Liability Management Committee (the "ALCO"). Additionally, we maintain a liquidity management framework document, which outlines the general strategies, objectives and principles we utilize to manage our liquidity position and the various liquidity risks inherent in our business model. We seek to balance the trade-offs between maintaining too much liquidity, which may be costly, with having too little liquidity, which could cause financial distress. Liquidity risk is centrally managed by the ALCO, which is chaired by our Treasurer and has cross-functional membership. The ALCO monitors the liquidity risk profiles of DFS and Discover Bank and oversees any actions Corporate Treasury may take to ensure that we maintain ready access to our funding sources and sufficient liquidity to meet current and projected needs. In addition, the ALCO and our Board of Directors regularly review our compliance with our liquidity limits at DFS and Discover Bank, which are established in accordance with the liquidity risk appetite set by our Board of Directors.

We employ a variety of metrics to monitor and manage liquidity. We utilize early warning indicators ("EWIs") to detect the initial phases of liquidity stress events and a reporting and escalation process that is designed to be consistent with regulatory guidance. The EWIs include both idiosyncratic and systemic measures, and are monitored on a daily basis and reported to the ALCO regularly. A warning from one or more of these indicators triggers prompt review and decision-making by our senior management team, and in certain instances may lead to the convening of a senior-level response team and activation of our contingency funding plan.

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In addition, we conduct liquidity stress tests regularly and ensure contingency funding is in place to address potential liquidity shortfalls. We evaluate a range of stress scenarios that are designed in accordance with regulatory requirements, including idiosyncratic, systemic and a combination of such events that could impact funding sources and our ability to meet liquidity needs. These scenarios measure the projected liquidity position at DFS and Discover Bank across a range of time horizons by comparing estimated contingency funding needs to available contingent liquidity.

Our primary contingent liquidity sources include our liquidity portfolio and private securitizations with unused borrowing capacity. In addition, we have unused borrowing capacity with the Federal Reserve discount window, which provides an additional source of contingent liquidity. We seek to maintain sufficient liquidity to be able to satisfy all maturing obligations and fund business operations for at least 12 months in a severe stress environment. In such an environment, we may also take actions to curtail the size of our balance sheet, which would reduce the need for funding and liquidity.

At June 30, 2019, our liquidity portfolio is comprised of highly liquid, unencumbered assets, including cash and cash equivalents and investment securities. Cash and cash equivalents were primarily in the form of deposits with the Federal Reserve. Investment securities primarily included debt obligations of the U.S. Treasury and residential mortgage-backed securities issued by U.S. government housing agencies or government-sponsored enterprises. These investments are considered highly liquid, and we expect to have the ability to raise cash by selling them, utilizing repurchase agreements or pledging certain of these investments to access secured funding. The size and composition of our liquidity portfolio may fluctuate based upon the size of our balance sheet as well as operational requirements, market conditions and interest rate risk management policies. For example, we have altered the composition of our liquidity portfolio to manage the potential volatility of earnings that may arise from changes in interest rates.

At June 30, 2019, our liquidity portfolio and undrawn credit facilities were \$55.7 billion, which was \$2.8 billion higher than the balance at December 31, 2018. During the three and six months ended June 30, 2019, the average balance of our liquidity portfolio was \$18.9 billion and \$18.7 billion, respectively.

|   | June 30,<br>2019      | December 31,<br>2018 |
|---|-----------------------|----------------------|
|   | (dollars in millions) |                      |
| Liquidity portfolio                                     |                       |                      |
| Cash and cash equivalents <sup>(1)</sup>                | \$ 9,013              | \$ 12,832            |
| Other short-term investments                            | 1,000                 | —                    |
| Investment securities <sup>(2)</sup>                    | 7,270                 | 3,091                |
| Total liquidity portfolio                               | 17,283                | 15,923               |
| Private asset-backed securitizations <sup>(3)</sup>     | 6,000                 | 5,500                |
| Primary liquidity sources                               | 23,283                | 21,423               |
| Federal Reserve discount window <sup>(3)</sup>          | 32,466                | 31,486               |
| Total liquidity portfolio and undrawn credit facilities | \$ 55,749             | \$ 52,909            |

(1) Cash in the process of settlement and restricted cash are excluded from cash and cash equivalents for liquidity purposes.

(2) Excludes \$53 million and \$42 million of U.S. Treasury securities that have been pledged as swap collateral in lieu of cash as of June 30, 2019 and December 31, 2018, respectively.

(3) See "— Additional Funding Sources" for additional information.

*Bank Holding Company Liquidity*

The primary uses of funds at the unconsolidated DFS level include debt service obligations (interest payments and return of principal) and capital service and management activities, which include dividend payments on capital instruments and the periodic repurchase of shares of our common stock. Our primary sources of funds at the bank holding company level include the proceeds from the issuance of unsecured debt and capital securities, as well as dividends from our subsidiaries, particularly Discover Bank. Under periods of idiosyncratic or systemic stress, the bank holding company could lose or experience impaired access to the capital markets. In addition, our regulators have the discretion to restrict dividend payments from Discover Bank to the bank holding company.

We utilize a measure referred to as Number of Months of Pre-Funding to determine the length of time Discover Financial Services can meet upcoming funding obligations including common and preferred stock dividend payments and debt service obligations using existing cash resources. At June 30, 2019, Discover Financial Services had sufficient cash resources to fund the dividend and debt service payments for more than 18 months.

We structure our debt maturity schedule to minimize the amount of debt maturing within a short period of time. See Note 6: Long-Term Borrowings to our condensed consolidated financial statements for further information regarding our debt.

### **Capital**

Our primary sources of capital are the earnings generated by our businesses and the proceeds from issuances of capital securities. We seek to manage capital to a level and composition sufficient to support the growth and risks of our businesses and to meet regulatory requirements, rating agency targets and debt investor expectations. Within these constraints, we are focused on deploying capital in a manner that provides attractive returns to our stockholders. The level, composition and utilization of capital are influenced by changes in the economic environment, strategic initiatives, and legislative and regulatory developments.

Under regulatory capital requirements adopted by the Federal Reserve and the FDIC, DFS, along with Discover Bank, must maintain minimum levels of capital. 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 limit our business activities and have a direct material effect on our financial position and results. We must meet specific capital requirements that involve quantitative measures of assets, liabilities and certain off-balance sheet items, as calculated under regulatory guidance and regulations. Current or future legislative or regulatory reforms, such as the future implementation of CECL, may require us to hold more capital or adversely impact our capital level. We consider the potential impacts of these reforms in managing our capital position.

Under Basel III rules for regulatory capital, DFS and Discover Bank are classified as "Standardized Approach" entities, defined as U.S. banking organizations with consolidated total assets over \$50 billion but not exceeding \$250 billion and consolidated total on-balance sheet foreign exposures less than \$10 billion. The Basel III rules revised minimum and "well-capitalized" risk-based capital and leverage ratios, effective January 2015, and refined the definition of what constitutes capital for purposes of calculating those ratios, of which certain requirements were subject to phase-in periods through the end of 2018; as of January 1, 2019, thresholds within the Basel III rules are fully phased in with the exception of certain transition provisions that were frozen pursuant to regulation issued in November 2017. For additional information regarding the risk-based capital and leverage ratios, see Note 10: Capital Adequacy to our condensed consolidated financial statements.

The Basel III rules also introduced a CCB on top of the minimum risk-weighted asset ratios. The buffer is designed to absorb losses during periods of economic stress. The application of the buffer was subject to phase-in periods that ended beginning January 1, 2019. The CCB effectively results in minimum regulatory capital ratios (including the CCB) of (i) CET1 to risk-weighted assets of at least 7.0%, (ii) Tier 1 capital to risk-weighted assets of at least 8.5% and (iii) Total capital to risk-weighted assets of at least 10.5%. Banking institutions with a capital ratio below the required threshold will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall. There is a proposal under regulatory review by the Federal Reserve that would effectively replace the CCB with a new buffer requirement for DFS that is linked to supervisory stress testing results (i.e., the Stress Capital Buffer), see "— Regulatory Environment and Developments — Banking — Capital ."

Another main component of the Basel III rules is a prescribed "Standardized Approach" for calculating risk-weighted assets that expands the risk-weight range from 0% to 1,250%. The new range is intended to be more risk-sensitive and the risk weight assigned depends on the nature of the asset in question.

The Basel III rules provide for certain threshold-based deductions from and adjustments to CET1, to the extent that any one such category exceeds 10% of CET1 or all such categories in the aggregate exceed 15%. In September 2017, federal banking regulators issued a notice of proposed rulemaking that would, among other things, revise certain capital requirements for Standardized Approach banks by raising the 10% of CET1 deduction threshold for certain items to 25% and eliminating the 15% combined deduction threshold applying to these items. These proposed changes have not yet been implemented. The federal banking agencies approved the final rule with an effective date in April 2020.

Basel III rules also require disclosures relating to market discipline. This series of disclosures is commonly referred to as "Pillar 3." The objective is to increase transparency of capital requirements for banking organizations. We are required to make prescribed regulatory disclosures on a quarterly basis regarding our capital structure, capital adequacy, risk exposures and risk-weighted assets. The Pillar 3 disclosures are made publicly available on our website in a report called "Basel III Regulatory Capital Disclosures."

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At June 30, 2019, DFS and Discover Bank met the requirements for "well-capitalized" status under Regulation Y and the prompt corrective action rules, respectively, exceeding the regulatory minimums to which they were subject under the applicable rules.

We disclose tangible common equity, which represents common equity less goodwill and intangibles. Management believes that common stockholders' equity excluding goodwill and intangibles is a more meaningful measure to investors of our true net asset value. As of June 30, 2019, tangible common equity is not formally defined by U.S. GAAP or codified in the federal banking regulations and, as such, is considered to be a non-GAAP financial measure. Other financial services companies may also disclose this metric and definitions may vary, so we advise users of this information to exercise caution in comparing this metric for different companies.

The following table provides a reconciliation of total common stockholders' equity (a U.S. GAAP financial measure) to tangible common equity (dollars in millions):

|  | June 30,<br>2019 | December 31,<br>2018 |
|--|------------------|----------------------|
| Total common stockholders' equity <sup>(1)</sup> | \$ 10,930        | \$ 10,567            |
| Less: goodwill                                   | (255)            | (255)                |
| Less: intangible assets, net                     | (160)            | (161)                |
| Tangible common equity                           | <u>\$ 10,515</u> | <u>\$ 10,151</u>     |

(1) Total common stockholders' equity is calculated as total stockholders' equity less preferred stock.

Additionally, we are subject to regulatory requirements imposed by the Federal Reserve as part of its stress testing framework and CCAR program. On February 5, 2019, the Federal Reserve announced that certain less complex firms subject to CCAR, generally those with total consolidated assets between \$100 billion and \$250 billion, have been provided relief from certain components of the Federal Reserve's capital planning and stress testing framework for the 2019 stress test cycle. The Federal Reserve issued a temporary order granting Discover relief from the regulatory requirements related to supervisory stress testing and company-run stress testing for the 2019 stress test cycle and provided Discover a one-year extension of the requirement to submit a capital plan to the Federal Reserve until April 5, 2020. The Federal Reserve also pre-approved Discover's capital distributions for the period between July 1, 2019 and June 30, 2020 up to an amount based on results from the 2018 supervisory stress test.

Notwithstanding the regulatory relief and the pre-approval of capital distributions, Discover was still required to prepare a capital plan to be approved by its Board of Directors, containing planned capital distributions for the period from July 1, 2019 to June 30, 2020. In April 2019, we submitted our planned capital actions for the period between July 1, 2019 and June 30, 2020 to the Federal Reserve. The contemplated capital actions were within the Federal Reserve's pre-approved amount, and include share repurchases of up to \$1.6 billion and an increase in our quarterly common stock dividend from \$0.40 to \$0.44 per share.

We recently declared a quarterly cash dividend on our common stock of \$0.44 per share, payable on September 5, 2019 to holders of record on August 22, 2019. We also recently declared a semi-annual cash dividend on our preferred stock of \$2,750 per share, equal to \$27.50 per depositary share, payable on October 30, 2019 to holders of record on October 15, 2019, which is consistent with the amount paid in the second quarter of 2019.

On July 18, 2019, our Board of Directors approved a share repurchase program authorizing the repurchase of up to \$2.2 billion of our outstanding shares of common stock. The program expires on September 30, 2020 and may be terminated at any time. This program replaced the prior \$3.0 billion share repurchase program, which had \$1.2 billion of remaining authorization. During the three months ended June 30, 2019, we repurchased approximately 6 million shares, or 2% of our outstanding common stock for \$460 million. We expect to continue to repurchase shares under our program from time to time based on market conditions and other factors, subject to legal and regulatory requirements and restrictions, including limitations from the Federal Reserve as described above. Share repurchases under the program may be made through a variety of methods, including open market purchases, privately negotiated transactions or other purchases, including block trades, accelerated share repurchase transactions, or any combination of such methods.

The amount and size of any future dividends and share repurchases will depend upon our results of operations, financial condition, capital levels, cash requirements, future prospects and other factors, such as the future implementation of CECL. The declaration and payment of future dividends, as well as the amount thereof, are subject to the discretion of our Board of Directors. Holders of our shares of common stock are subject to the prior dividend rights of holders of our preferred

stock or the depositary shares representing such preferred stock outstanding, and if full dividends have not been declared and paid on all outstanding shares of preferred stock in any dividend period, no dividend may be declared or paid or set aside for payment on our common stock. In addition, as noted above, banking laws and regulations and our banking regulators may limit our ability to pay dividends and make share repurchases, including limitations on the extent to which our banking subsidiaries can provide funds to us through dividends, loans or otherwise. Further, current or future regulatory reforms may require us to hold more capital or adversely impact our capital level. There can be no assurance that we will declare and pay any dividends or repurchase any shares of our common stock in the future.

### **Certain Off-Balance Sheet Arrangements**

#### ***Guarantees***

Guarantees are contracts or indemnification agreements that contingently require us to make payments to a guaranteed party based on changes in an underlying asset, liability, or equity security of a guaranteed party, rate or index. Also included in guarantees are contracts that contingently require the guarantor to make payments to a guaranteed party based on another entity's failure to perform under an agreement. Our guarantees relate to transactions processed on the Discover Network and certain transactions processed by PULSE and Diners Club. See Note 11: Commitments, Contingencies and Guarantees to our condensed consolidated financial statements for further discussion regarding our guarantees.

### **Contractual Obligations and Contingent Liabilities and Commitments**

In the normal course of business, we enter into various contractual obligations that may require future cash payments. Contractual obligations at June 30, 2019, which include deposits, long-term borrowings, operating lease obligations, interest payments on fixed-rate debt, purchase obligations and other liabilities were \$99.1 billion. For a description of our contractual obligations, see our annual report on Form 10-K for the year ended December 31, 2018 under "Management's Discussion and Analysis of Financial Condition and Results of Operations — Contractual Obligations and Contingent Liabilities and Commitments."

We extend credit for consumer loans, primarily arising from agreements with customers for unused lines of credit on certain credit cards and certain other loan products, provided there is no violation of conditions established in the related agreement. At June 30, 2019, our unused credit arrangements were approximately \$204.0 billion. These arrangements, substantially all of which we 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. In addition, in the ordinary course of business, we guarantee payment on behalf of subsidiaries relating to contractual obligations with external parties. The activities of the subsidiaries covered by any such guarantees are included in our condensed consolidated financial statements.



**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Market risk refers to the risk that a change in the level of one or more market prices, rates, indices, correlations or other market factors will result in losses for an investment position or portfolio. We are exposed to market risk primarily from changes in interest rates.

***Interest Rate Risk***

We borrow money from a variety of depositors and institutions in order to provide loans to our customers, as well as invest in other assets and our business. These loans and other assets earn interest, which we use to pay interest on the money borrowed. Our net interest income and, therefore, earnings, will be reduced if the interest rate earned on assets increases at a slower pace than the interest rate paid on our borrowings. Changes in interest rates and our competitors' responses to those changes may influence customer payment rates, loan balances or deposit account activity. As a result, we may incur higher funding costs, which may decrease earnings.

Our interest rate risk management policies are designed to measure and manage the potential volatility of earnings that may arise from changes in interest rates by having a financing portfolio that reflects our mix of variable- and fixed-rate assets. To the extent that the repricing characteristics of the assets and liabilities in a particular portfolio are not sufficiently matched, we may utilize interest rate derivative contracts, such as swap agreements, to achieve our objectives. Interest rate swap agreements effectively convert the underlying asset or liability from fixed- to floating-rate or from floating- to fixed-rate. See Note 14: Derivatives and Hedging Activities to our condensed consolidated financial statements for information on our derivatives activity.

We use an interest rate sensitivity simulation to assess our interest rate risk exposure. For purposes of presenting the possible earnings effect of a hypothetical, adverse change in interest rates over the 12-month period from our reporting date, we assume that all interest rate sensitive assets and liabilities will be impacted by a hypothetical, immediate 100 basis point change in interest rates relative to market consensus expectations as of the beginning of the period. The sensitivity is based upon the hypothetical assumption that all relevant types of interest rates would change instantaneously, simultaneously and to the same degree.

Our interest rate sensitive assets include our variable-rate loan receivables and the assets that make up our liquidity portfolio. We have limitations on our ability to mitigate interest rate risk by adjusting rates on existing balances and competitive actions may limit our ability to increase the rates that we charge to customers for new loans. At June 30, 2019, the majority of our credit card and student loans charge variable rates. Assets with rates that are fixed at period end but which will mature, or otherwise contractually reset to a market-based indexed rate or other fixed rate prior to the end of the 12-month period, are considered to be rate sensitive. The latter category includes certain revolving credit card loans that may be offered at below-market rates for an introductory period, such as balance transfers and special promotional programs, after which the loans will contractually reprice in accordance with our normal market-based pricing structure. For assets that have a fixed interest rate but contractually will, or are assumed to, reset to a market-based indexed rate or other fixed rate during the next 12 months, earnings sensitivity is measured from the expected repricing date. In addition, for all interest rate sensitive assets, earnings sensitivity is calculated net of expected loan losses, which for purposes of this analysis are assumed to remain unchanged relative to our baseline expectations over the analysis horizon.

Interest rate sensitive liabilities are assumed to be those for which the stated interest rate is not contractually fixed for the next 12-month period. Thus, liabilities that vary with changes in a market-based index, such as the federal funds rate or London Interbank Offered Rate, which will reset before the end of the 12-month period, or liabilities whose rates are fixed at the fiscal period end but will mature and are assumed to be replaced with a market-based indexed rate prior to the end of the 12-month period, are also considered to be rate sensitive. For these fixed-rate liabilities, earnings sensitivity is measured from the expected maturity date.

Net interest income sensitivity requires assumptions to be made regarding market conditions, consumer behavior, and the overall growth and composition of the balance sheet. These assumptions are inherently uncertain and, as a result, actual earnings may differ from the simulated earnings presented below. Our actual earnings depend on multiple factors including, but not limited to, the direction and timing of changes in interest rates, the movement of short-term versus long-term rates, balance sheet composition, competitor actions affecting pricing decisions in our loans and deposits, and strategic actions undertaken by management.

The following table shows the impacts to net interest income over the following 12-month period that we estimate would result from an immediate and parallel change in interest rates affecting all interest rate sensitive assets and liabilities (dollars in millions):

| <b>Basis point change</b> | <b>At June 30, 2019</b> |          | <b>At December 31, 2018</b> |          |
|---------------------------|-------------------------|----------|-----------------------------|----------|
|                           | <b>\$</b>               | <b>%</b> | <b>\$</b>                   | <b>%</b> |
| +100                      | \$ 126                  | 1.30 %   | \$ 192                      | 2.01 %   |
| -100                      | \$ (134)                | (1.38)%  | \$ (194)                    | (2.03)%  |

#### **Item 4. Controls and Procedures**

##### ***Evaluation of Disclosure Controls and Procedures***

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")), which are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

##### ***Changes in Internal Control over Financial Reporting***

There have been no changes in our internal control over financial reporting (as such term is defined in Exchange Act Rule 13a-15(f) and 15d-15(f)) that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Glossary of Acronyms**

- **ALCO** : Asset and Liability Management Committee
- **AOCI** : Accumulated Other Comprehensive Income
- **ASC** : Accounting Standards Codification
- **ASU** : Accounting Standards Update
- **CCAR** : Comprehensive Capital Analysis and Review
- **CCB** : Capital Conservation Buffer
- **CCPA** : California Consumer Privacy Act
- **CECL** : Current Expected Credit Loss
- **CET1** : Common Equity Tier 1
- **CFPB** : Consumer Financial Protection Bureau
- **DCENT** : Discover Card Execution Note Trust
- **DCMT** : Discover Card Master Trust
- **DFS** : Discover Financial Services
- **EPS** : Earnings Per Share
- **EWIs** : Early Warning Indicators
- **FDIC** : Federal Deposit Insurance Corporation
- **GAAP** : Generally Accepted Accounting Principles
- **IRS** : Internal Revenue Service
- **LIBOR** : London Interbank Offered Rate
- **OCI** : Other Comprehensive Income
- **OIS** : Overnight Index Swap
- **PCD** : Purchased Credit-Deteriorated
- **PCI** : Purchased Credit-Impaired
- **SLC** : The Student Loan Corporation
- **TDR** : Troubled Debt Restructuring
- **VIEs** : Variable Interest Entities

**Part II. OTHER INFORMATION****Item 1. Legal Proceedings**

For a description of legal proceedings, see Note 12: Litigation and Regulatory Matters to our condensed consolidated financial statements.

**Item 1A. Risk Factors**

There have been no material changes to the risk factors disclosed in our annual report on Form 10-K for the year ended December 31, 2018 .

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds****Issuer Purchases of Equity Securities**

The following table sets forth information regarding purchases of our common stock related to our share repurchase program and employee transactions that were made by us or on our behalf during the most recent quarter.

| <b>Period</b>                        | <b>Total Number of Shares Purchased</b> | <b>Average Price Paid Per Share</b> | <b>Total Number of Shares Purchased as Part of Publicly Announced Plan or Program <sup>(1)</sup></b> | <b>Maximum Dollar Value of Shares that may yet be purchased under the Plans or Programs <sup>(1)</sup></b> |
|--------------------------------------|---|-------------------------------------|--|--|
| <b>April 1 - 30, 2019</b>            |   |                                     |  |  |
| Repurchase program <sup>(1)</sup>    | 1,859,629                               | \$ 75.28                            | 1,859,629  | \$ 1,540,479,353   |
| Employee transactions <sup>(2)</sup> | 1,750                                   | \$ 74.12                            | N/A  | N/A  |
| <b>May 1 - 31, 2019</b>              |   |                                     |  |  |
| Repurchase program <sup>(1)</sup>    | 2,230,279                               | \$ 78.91                            | 2,230,279  | \$ 1,364,480,310   |
| Employee transactions <sup>(2)</sup> | 1,405                                   | \$ 79.45                            | N/A  | N/A  |
| <b>June 1 - 30, 2019</b>             |   |                                     |  |  |
| Repurchase program <sup>(1)</sup>    | 1,860,869                               | \$ 77.38                            | 1,860,869  | \$ 1,220,480,007   |
| Employee transactions <sup>(2)</sup> | 1,379                                   | \$ 77.82                            | N/A  | N/A  |
| <b>Total</b>                         |   |                                     |  |  |
| Repurchase program <sup>(1)</sup>    | 5,950,777                               | \$ 77.30                            | 5,950,777  | \$ 1,220,480,007   |
| Employee transactions <sup>(2)</sup> | 4,534                                   | \$ 76.90                            | N/A  | N/A  |

(1) On July 18, 2019 , our Board of Directors approved a share repurchase program authorizing the purchase of up to \$2.2 billion of our outstanding shares of common stock. This share repurchase program expires on September 30, 2020 and may be terminated at any time.

(2) Reflects shares withheld (under the terms of grants under employee stock compensation plans) to offset tax withholding obligations that occur upon the delivery of outstanding shares underlying restricted stock units or upon the exercise of stock options.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

See "Exhibit Index" for documents filed herewith and incorporated herein by reference.

**Exhibit Index**

| <b>Exhibit Number</b> | <b>Description</b>  |
|-----------------------|---|
| <a href="#">31.1</a>  | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.  |
| <a href="#">31.2</a>  | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.  |
| <a href="#">32.1</a>  | Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code.              |
| 101.INS               | XBRL Instance Document — the instance document does not appear in the interactive data file because its XBRL tags are embedded within the inline XBRL document. |
| 101.SCH               | XBRL Taxonomy Extension Schema Document.  |
| 101.CAL               | XBRL Taxonomy Extension Calculation Linkbase Document.  |
| 101.DEF               | XBRL Taxonomy Extension Definition Linkbase Document.   |
| 101.LAB               | XBRL Taxonomy Extension Label Linkbase Document.  |
| 101.PRE               | XBRL Taxonomy Extension Presentation Linkbase Document.   |

**Signature**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Discover Financial Services  
(Registrant)

By:

*/s/ R. M ARK G RAF*

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**R. Mark Graf**  
**Executive Vice President, Chief Financial Officer**

Date: August 1, 2019

## CERTIFICATION

I, Roger C. Hochschild, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Discover Financial Services (the "registrant");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 1, 2019

/s/ R OGER C. H OCHSCHILD

Roger C. Hochschild

Chief Executive Officer and President

## CERTIFICATION

I, R. Mark Graf, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Discover Financial Services (the "registrant");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 1, 2019

/s/ R. M ARK G RAF

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R. Mark Graf

Executive Vice President, Chief Financial Officer



**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Discover Financial Services (the "Company") on Form 10-Q for the period ended June 30, 2019, as filed with the Securities and Exchange Commission (the "Report"), each of Roger C. Hochschild, Chief Executive Officer and President of the Company, and R. Mark Graf, Executive Vice President and Chief Financial Officer of the Company, certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 1, 2019

/s/ R OGER C. H OCHSCHILD

Roger C. Hochschild  
Chief Executive Officer and President

Date: August 1, 2019

/s/ R. M ARK G RAF

R. Mark Graf  
Executive Vice President, Chief Financial Officer