Discover Financial Services
Form 10-Q
October 28, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2014

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission File Number 001-33378
DISCOVER FINANCIAL SERVICES
(Exact name of registrant as specified in its charter)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

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

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

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

As of October 24, 2014, there were 453,479,765 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 September 30, 2014
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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.

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

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Part I. FINANCIAL INFORMATION
Item 1. Financial Statements
DISCOVER FINANCIAL SERVICES
Condensed Consolidated Statements of Financial Condition

	September 30, 2014 (unaudited)	December 31, 2013
	(dollars in millions, except share amounts)	
Assets		
Cash and cash equivalents	$7,382	$ 6,554
Restricted cash	103	182
Investment securities:		
Available-for-sale (amortized cost of $3,881 and $4,900 at September 30, 2014 and December 31, 2013, respectively)	3,913	4,931
Held-to-maturity (fair value of $82 and $58 at September 30, 2014 and December 31, 2013, respectively)	82	60
Total investment securities	3,995	4,991
Loan receivables:		
Mortgage loans held for sale, measured at fair value	148	148
Loan portfolio:		
Credit card	53,699	53,150
Other	9,731	8,295
Purchased credit-impaired loans	3,788	4,178
Total loan portfolio	67,218	65,623
Total loan receivables	67,366	65,771
Allowance for loan losses	(1,644)	(1,648)
Net loan receivables	65,722	64,123
Premises and equipment, net	661	654
Goodwill	284	284
Intangible assets, net	177	185
Other assets	2,272	2,367
Total assets	$80,596	$ 79,340
Liabilities and Stockholders' Equity		
Deposits:		
Interest-bearing deposit accounts	$45,177	$ 44,766
Non-interest bearing deposit accounts	205	193
Total deposits	45,382	44,959
Short-term borrowings	139	140
Long-term borrowings	20,918	20,474
Accrued expenses and other liabilities	2,856	2,958
Total liabilities	69,295	68,531
Commitments, contingencies and guarantees (Notes 8, 11 and 12)		
Stockholders' Equity:		
Common stock, par value $0.01 per share; 2,000,000,000 shares authorized; 558,160,815 and 555,349,629 shares issued at September 30, 2014 and December 31, 2013, respectively	5	5
Preferred stock, par value $0.01 per share; 200,000,000 shares authorized; 575,000 shares issued or outstanding and aggregate liquidation preference of $575 at September 30, 2014	560	560

and December 31, 2013		
Additional paid-in capital	3,775	3,687
Retained earnings	11,182	9,611
Accumulated other comprehensive loss	(70)	(68)
Treasury stock, at cost; 102,763,441 and 83,105,578 shares at September 30, 2014 and December 31, 2013, respectively	(4,151)	(2,986)
Total stockholders' equity	11,301	10,809
Total liabilities and stockholders' equity	$80,596	$79,340

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.

	September 30, 2014 (unaudited)	December 31, 2013
	(dollars in millions)	
Assets		
Restricted cash	$100	$179
Credit card loan receivables	$29,505	$31,112
Purchased credit-impaired loans	$2,038	$2,248
Allowance for loan losses allocated to securitized loan receivables	$(800)	$(861)
Other assets	$37	$34
Liabilities		
Long-term borrowings	$16,276	$16,986
Accrued interest payable	$10	$9

See Notes to the Condensed Consolidated Financial Statements.

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DISCOVER FINANCIAL SERVICES

Condensed Consolidated Statements of Income

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
	(unaudited)			
	(dollars in millions, except per share amounts)			
Interest income:				
Credit card loans	$1,613	$1,513	$4,710	$4,427
Other loans	291	255	848	730
Investment securities	17	16	50	55
Other interest income	5	3	14	10
Total interest income	1,926	1,787	5,622	5,222
Interest expense:				
Deposits	153	169	457	539
Short-term borrowings	—	1	1	3
Long-term borrowings	135	108	374	331
Total interest expense	288	278	832	873
Net interest income	1,638	1,509	4,790	4,349
Provision for loan losses	354	333	986	732
Net interest income after provision for loan losses	1,284	1,176	3,804	3,617
Other income:				
Discount and interchange revenue, net	295	276	876	847
Protection products revenue	78	90	239	266
Loan fee income	85	78	248	235
Transaction processing revenue	46	46	136	146
Gain on investments	—	—	4	3
Gain on origination and sale of mortgage loans	19	25	57	127
Other income	29	38	90	122
Total other income	552	553	1,650	1,746
Other expense:				
Employee compensation and benefits	320	292	928	867
Marketing and business development	182	174	519	528
Information processing and communications	87	81	258	244
Professional fees	111	97	322	302
Premises and equipment	23	21	68	60
Other expense	104	118	313	355
Total other expense	827	783	2,408	2,356
Income before income tax expense	1,009	946	3,046	3,007
Income tax expense	365	353	1,127	1,139
Net income	$644	$593	$1,919	$1,868
Net income allocated to common stockholders	$630	$579	$1,878	$1,826
Basic earnings per common share	$1.37	$1.20	$4.03	$3.73
Diluted earnings per common share	$1.37	$1.20	$4.02	$3.72
Dividends declared per common share	$0.24	$0.20	$0.68	$0.40

See Notes to the Condensed Consolidated Financial Statements.

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DISCOVER FINANCIAL SERVICES

Condensed Consolidated Statements of Comprehensive Income

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
	(unaudited)			
	(dollars in millions)			
Net income	$644	$593	$1,919	$1,868
Other comprehensive income (loss), net of taxes				
Unrealized (loss) gain on securities available for sale, net of tax	(9)	4	1	(38)
Unrealized gain (loss) on cash flow hedges, net of tax	12	(7)	(2)	—
Foreign currency translation adjustments, net of tax	(1)	1	(1)	1
Other comprehensive income (loss)	2	(2)	(2)	(37)
Comprehensive income	$646	$591	$1,917	$1,831

See Notes to the Condensed Consolidated Financial Statements.

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

	Preferred Stock		Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Stockholders' Equity
	Shares	Amount	Shares	Amount					
	(unaudited) (dollars in millions, shares in thousands)								
Balance at December 31, 2012	575	$560	553,351	$5	$ 3,598	$7,472	$ (72)	$(1,690)	$ 9,873
Net income	—	—	—	—	—	1,868	—	—	1,868
Other comprehensive loss	—	—	—	—	—	—	(37)	—	(37)
Purchases of treasury stock	—	—	—	—	—	—	—	(950)	(950)
Common stock issued under employee benefit plans	—	—	51	—	2	—	—	—	2
Common stock issued and stock-based compensation expense	—	—	1,875	—	71	—	—	—	71
Dividends — common stock	—	—	—	—	—	(197)	—	—	(197)
Dividends — preferred stock	—	—	—	—	—	(28)	—	—	(28)
Balance at September 30, 2013	575	$560	555,277	$5	$ 3,671	$9,115	$ (109)	$(2,640)	$ 10,602
Balance at December 31, 2013	575	$560	555,350	$5	$ 3,687	$9,611	$ (68)	$(2,986)	$ 10,809
Net income	—	—	—	—	—	1,919	—	—	1,919
Other comprehensive loss	—	—	—	—	—	—	(2)	—	(2)
Purchases of treasury stock	—	—	—	—	—	—	—	(1,165)	(1,165)
Common stock issued under employee benefit plans	—	—	45	—	3	—	—	—	3
Common stock issued and stock-based compensation expense	—	—	2,766	—	85	—	—	—	85
Dividends — common stock	—	—	—	—	—	(320)	—	—	(320)

Dividends — preferred stock	—	—	—	—	—	(28)	—	—	(28)
Balance at September 30, 2014	575	$560	558,161	$5	$ 3,775	$11,182	$ (70)	$(4,151)	$ 11,301

See Notes to the Condensed Consolidated Financial Statements.
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DISCOVER FINANCIAL SERVICES
Condensed Consolidated Statements of Cash Flows

	For the Nine Months Ended September 30,	
	2014	2013
	(unaudited) (dollars in millions)	
Cash flows from operating activities		
Net income	$1,919	$1,868
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	986	732
Deferred income taxes	76	154
Depreciation and amortization on premises and equipment	93	83
Amortization of deferred revenues	(160)	(143)
Other depreciation and amortization	181	164
Accretion of accretable yield on acquired loans	(198)	(205)
Gain on investments	(4)	(3)
Loss on equity method and other investments	19	13
Gain on origination and sale of loans	(57)	(127)
Stock-based compensation expense	46	45
Proceeds from sale of mortgage loans originated for sale	1,962	3,553
Net principal disbursed on mortgage loans originated for sale	(1,903)	(3,201)
Changes in assets and liabilities:		
Increase in other assets	(94)	(112)
Decrease in accrued expenses and other liabilities	(40)	(286)
Net cash provided by operating activities	2,826	2,535
Cash flows from investing activities		
Maturities and sales of available-for-sale investment securities	1,395	1,364
Purchases of available-for-sale investment securities	(390)	(258)
Maturities of held-to-maturity investment securities	9	27
Purchases of held-to-maturity investment securities	(31)	(1)
Net principal disbursed on loans originated for investment	(2,243)	(752)
Purchases of loan receivables	—	(136)
Purchases of other investments	(42)	(76)
Decrease in restricted cash	79	107
Purchases of premises and equipment	(102)	(177)
Net cash (used for) provided by investing activities	(1,325)	98
Cash flows from financing activities		
Net decrease in short-term borrowings	(1)	(246)
Proceeds from issuance of securitized debt	3,849	3,250
Maturities and repayment of securitized debt	(4,590)	(3,537)
Proceeds from issuance of other long-term borrowings	1,147	1,248
Payment of contingent consideration for purchase of net assets of a business, at fair value	—	(9)
Proceeds from issuance of common stock	4	12
Purchases of treasury stock	(1,165)	(950)
Net increase in deposits	431	932
Dividends paid on common and preferred stock	(348)	(294)

Net cash (used for) provided by financing activities	(673)	406
Net increase in cash and cash equivalents	828	3,039
Cash and cash equivalents, at beginning of period	6,554	2,584
Cash and cash equivalents, at end of period	$7,382	$5,623

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"). Through its Discover Bank subsidiary, a Delaware state-chartered bank, the Company offers its customers credit card loans, private student loans, personal loans, home equity loans and deposit products. Through its Discover Home Loans, Inc. subsidiary, the Company offers its customers home loans. Through its DFS Services LLC subsidiary and its subsidiaries, the Company operates the Discover Network, the PULSE network ("PULSE") and Diners Club International ("Diners Club"). The Discover Network is a payment transaction processing network for Discover branded credit cards and credit, debit and prepaid cards, issued by third parties, which the Company refers to as network partners. PULSE operates an electronic funds transfer network, providing financial institutions issuing debit cards on the PULSE network with access to ATMs domestically and internationally, as well as point-of-sale terminals at retail locations throughout the U.S. for debit card transactions. Diners Club is a global payments network of licensees that issue Diners Club branded charge cards and/or provide card acceptance services.

The Company's business segments are Direct Banking and Payment Services. The Direct Banking segment includes consumer banking and lending products, specifically Discover branded credit cards issued to individuals and small businesses on the Discover Network and other consumer products and services, including private student loans, personal loans, home loans, home equity loans, prepaid cards 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.

The Payment Services segment includes PULSE, Diners Club and the Company's network partners business, which includes credit, debit and prepaid cards issued on the Discover Network by third parties. This segment also includes the business operations of Diners Club Italy, which primarily consist of issuing Diners Club charge cards. The majority of Payment Services revenues relate to transaction processing revenue from PULSE and royalty and licensee revenue (included in other income) from Diners Club.

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 2013 audited consolidated financial statements filed with the Company's annual report on Form 10-K for the calendar year ended December 31, 2013.

Recently Issued Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (Topic 606). The guidance in this update supersedes existing revenue recognition requirements in Topic 605, Revenue Recognition, including an assortment of transaction-specific and industry-specific rules. The ASU establishes 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. ASU Topic 606 does not apply to rights or obligations associated with financial instruments (for example, interest income from loans or investments, or interest expense on debt), and therefore the Company's net interest income should not be affected. The Company's revenue from discount and interchange, protection products, transaction processing and certain fees are within the scope of these rules. Management has not yet completed its evaluation of the impact, if any, of the new guidance on these revenues. The new revenue recognition model will become effective for the Company on January 1, 2017. Upon adoption in 2017, the Company will record an adjustment to retained earnings as of the beginning of the year of initial application, which can be either the earliest comparative period presented, with all periods presented under the new rules, or January 1, 2017, without restating prior periods presented. Management has not yet determined which transition reporting option it will apply.

In January 2014, the FASB issued ASU No. 2014-01, Investments-Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects. This standard will permit a reporting entity to make an accounting policy election to account for investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under this new method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). This treatment will replace the effective yield method currently permitted for certain investments of this kind. The Company has not historically utilized the effective yield method, and as a result, implementation of this ASU will not impact the Company's accounting for its investments in qualified affordable housing projects unless a subsequent election is made to apply it. In addition to establishing the conditions under which the proportional amortization method can be used, the ASU calls for additional disclosures that will enable the reader to understand the nature of the investment and the effect of its measurement and related tax credits on the company's financial position and results of operations. The new guidance is effective for annual reporting periods beginning after December 15, 2014 and interim periods within those periods, with early adoption permitted. The standard will require additional disclosure about the nature of the Company's affordable housing investments, but unless the Company subsequently elects to apply the proportional amortization model, the new guidance will have no effect on the Company's financial condition, results of operations or cash flows.

2. Investments

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

	September 30, 2014	December 31, 2013
U.S. Treasury securities[(1)]	$ 1,335	$ 2,058
U.S. government agency securities	1,038	1,561
States and political subdivisions of states	10	15
Other securities:		
Credit card asset-backed securities of other issuers	—	6
Residential mortgage-backed securities - Agency[(2)]	1,612	1,351
Total other securities	1,612	1,357
Total investment securities	$ 3,995	$ 4,991

(1) Includes $15 million and $9 million of U.S. Treasury securities that have been pledged as swap collateral in lieu of cash as of September 30, 2014 and December 31, 2013, respectively.

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

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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 Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
At September 30, 2014				
Available-for-Sale Investment Securities[1]				
U.S. Treasury securities	$1,318	$16	$—	$1,334
U.S. government agency securities	1,022	16	—	1,038
Residential mortgage-backed securities - Agency	1,541	6	(6)	1,541
Total available-for-sale investment securities	$3,881	$38	$(6)	$3,913
Held-to-Maturity Investment Securities[2]				
U.S. Treasury securities[3]	$1	$—	$—	$1
States and political subdivisions of states	10	—	—	10
Residential mortgage-backed securities - Agency[4]	71	—	—	71
Total held-to-maturity investment securities	$82	$—	$—	$82
At December 31, 2013				
Available-for-Sale Investment Securities[1]				
U.S. Treasury securities	$2,030	$27	$—	$2,057
U.S. government agency securities	1,535	26	—	1,561
Credit card asset-backed securities of other issuers	6	—	—	6
Residential mortgage-backed securities - Agency	1,329	—	(22)	1,307
Total available-for-sale investment securities	$4,900	$53	$(22)	$4,931
Held-to-Maturity Investment Securities[2]				
U.S. Treasury securities[3]	$1	$—	$—	$1
States and political subdivisions of states	15	—	(1)	14
Residential mortgage-backed securities - Agency[4]	44	—	(1)	43
Total held-to-maturity investment securities	$60	$—	$(2)	$58

(1) Available-for-sale investment securities are reported at fair value.
(2) Held-to-maturity investment securities are reported at amortized cost.
(3) Amount represents securities pledged as collateral to a government-related merchant for which transaction settlement occurs beyond the normal 24-hour period.
(4) 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.

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
At September 30, 2014					
Available-for-Sale Investment Securities					
Residential mortgage-backed securities - Agency	16	$370	$(1)	$480	$(5)
At December 31, 2013					

Available-for-Sale Investment Securities					
Residential mortgage-backed securities - Agency	23	$1,097	$(20)	$48	$(2)
Held-to-Maturity Investment Securities					
State and political subdivisions of states	4	$8	$(1)	$3	$—
Residential mortgage-backed securities - Agency	2	$40	$(1)	$—	$—

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The Company records gains and losses on investment securities in other income when investments are sold or liquidated, when the Company believes an investment is other than temporarily impaired prior to the disposal of the investment, or in certain other circumstances. Gains and losses on sales of available-for-sale investment securities are calculated using the specific identification method and are recorded entirely in earnings. The Company records unrealized gains and losses on its available-for-sale investment securities in other comprehensive income. Other-than-temporary impairment for investments is calculated using the specific identification method. No gains or losses related to other-than-temporary impairments were recorded during the three and nine months ended September 30, 2014 and 2013.

The following table provides information about proceeds related to maturities and redemptions of investment securities and proceeds from sales, recognized gains and losses and net unrealized gains and losses on available-for-sale securities (dollars in millions):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
Proceeds related to maturities or redemptions of investment securities	$65	$94	$184	$672
Proceeds from the sales of available-for-sale investment securities, comprised of U.S. Treasury securities and U.S. government agency securities	$—	$—	$1,220	$719
Gains on sales of available-for-sale investment securities	$—	$—	$4	$2
Net unrealized (losses) gains recorded in other comprehensive income, before-tax	$(15)	$6	$1	$(61)
Net unrealized (losses) gains recorded in other comprehensive income, after-tax	$(9)	$4	$1	$(38)

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

	One Year or Less	After One Year Through Five Years	After Five Years Through Ten Years	After Ten Years	Total
At September 30, 2014					
Available-for-Sale—Amortized Cost[1]					
U.S. Treasury securities	$567	$751	$—	$—	$1,318
U.S. government agency securities	401	621	—	—	1,022
Residential mortgage-backed securities - Agency	—	—	520	1,021	1,541
Total available-for-sale investment securities	$968	$1,372	$520	$1,021	$3,881
Held-to-Maturity—Amortized Cost[2]					
U.S. Treasury securities	$1	$—	$—	$—	$1
State and political subdivisions of states	—	—	—	10	10
Residential mortgage-backed securities - Agency	—	—	—	71	71
Total held-to-maturity investment securities	$1	$—	$—	$81	$82
Available-for-Sale—Fair Values[1]					
U.S. Treasury securities	$571	$763	$—	$—	$1,334
U.S. government agency securities	406	632	—	—	1,038
Residential mortgage-backed securities - Agency	—	—	519	1,022	1,541

Total available-for-sale investment securities	$977	$1,395	$519	$1,022	$3,913
Held-to-Maturity—Fair Values[2]					
U.S. Treasury securities	$1	$—	$—	$—	$1
State and political subdivisions of states	—	—	—	10	10
Residential mortgage-backed securities - Agency	—	—	—	71	71
Total held-to-maturity investment securities	$1	$—	$—	$81	$82

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

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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, and the related commitment for future investments is recorded in accrued expenses and other liabilities within the statement of financial condition. The portion of each investment's operating results allocable to the Company is recorded in other expense within the condensed consolidated statement of income. 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 September 30, 2014 and December 31, 2013, the Company had outstanding investments in these entities of $317 million and $308 million, respectively, and related contingent liabilities of $44 million and $52 million, respectively.

3. Loan Receivables

The Company has three loan portfolio segments: credit card loans, other loans and purchased credit-impaired ("PCI") student loans, as well as mortgage loans held for sale.

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

	September 30, 2014	December 31, 2013
Mortgage loans held for sale[(1)]	$ 148	$ 148
Loan portfolio:		
Credit card loans:		
Discover card[(2)]	53,503	52,952
Discover business card	196	198
Total credit card loans	53,699	53,150
Other loans:		
Personal loans	4,830	4,191
Private student loans	4,706	3,969
Other	195	135
Total other loans	9,731	8,295
Purchased credit-impaired loans[(3)]	3,788	4,178
Total loan portfolio	67,218	65,623
Total loan receivables	67,366	65,771
Allowance for loan losses	(1,644)	(1,648)
Net loan receivables	$ 65,722	$ 64,123

(1) Substantially all mortgage loans held for sale are pledged as collateral against the warehouse line of credit used to fund consumer residential loans.

(2) Amounts include $20.2 billion underlying investors' interest in trust debt at September 30, 2014 and December 31, 2013, and $9.3 billion and $10.9 billion in seller's interest at September 30, 2014 and December 31, 2013, respectively. See Note 4: Credit Card and Student Loan Securitization Activities for further information.

(3) Amounts include $2.0 billion and $2.2 billion of loans pledged as collateral against the notes issued from the Student Loan Corporation ("SLC") securitization trusts at September 30, 2014 and December 31, 2013. See Note 4: Credit Card and Student Loan Securitization Activities. Of the remaining $1.8 billion and $2.0 billion at September 30, 2014 and December 31, 2013, respectively, that were not pledged as collateral, approximately $23 million and $22 million, respectively, represents loans eligible for reimbursement through an indemnification claim. Discover Bank must purchase such loans from the trust before a claim may be filed.

Credit Quality Indicators

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

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

	30-89 Days Delinquent	90 or More Days Delinquent	Total Past Due	90 or More Days Delinquent and Accruing	Total Non-accruing[1]
At September 30, 2014					
Credit card loans:					
Discover card[2]	$479	$439	$918	$401	$ 164
Discover business card	1	1	2	1	1
Total credit card loans	480	440	920	402	165
Other loans:					
Personal loans[3]	26	10	36	9	5
Private student loans (excluding PCI)[4]	61	24	85	24	—
Other	—	2	2	—	24
Total other loans (excluding PCI)	87	36	123	33	29
Total loan receivables (excluding PCI)	$567	$476	$1,043	$435	$ 194
At December 31, 2013					
Credit card loans:					
Discover card[2]	$464	$445	$909	$406	$ 154
Discover business card	1	2	3	2	1
Total credit card loans	465	447	912	408	155
Other loans:					
Personal loans[3]	21	8	29	8	5
Private student loans (excluding PCI)[4]	48	18	66	18	—
Other	1	2	3	—	40
Total other loans (excluding PCI)	70	28	98	26	45
Total loan receivables (excluding PCI)	$535	$475	$1,010	$434	$ 200

(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 $7 million for the three months ended September 30, 2014 and 2013 and was $20 million and $22 million for the nine months ended September 30, 2014 and 2013, respectively. The Company does not separately systematically compute 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' quarterly average balances and rates prior to non-accrual status.

(2) Consumer credit card loans that are 90 or more days delinquent and accruing interest include $40 million and $41 million of loans accounted for as troubled debt restructurings at September 30, 2014 and December 31, 2013, respectively.

(3) Personal loans that are 90 or more days delinquent and accruing interest include $2 million of loans accounted for as troubled debt restructurings at September 30, 2014 and December 31, 2013.

(4) Private student loans that are 90 or more days delinquent and accruing interest include $4 million and $3 million of loans accounted for as troubled debt restructurings at September 30, 2014 and December 31, 2013, respectively.

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Net Charge-offs

The Company's net charge-offs include the principal amount of loans charged off less principal recoveries and exclude charged-off interest and fees, recoveries of 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 loan loss provision, while fraud losses are recorded in other expense. Credit card loan receivables are charged off at the end of the month during which an account becomes 180 days contractually past due. Personal loans and private student loans, which are closed-end consumer loan receivables, are generally charged off at the end of the month during which an account becomes 120 days contractually past due. Generally, customer bankruptcies and probate accounts are charged off at the end of the month 60 days following the receipt of notification of the bankruptcy or death but not later than the 180-day or 120-day contractual time frame.

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

	For the Three Months Ended September 30,			
	2014		2013	
	Net Charge-offs	Net Charge-off Rate	Net Charge-offs	Net Charge-off Rate
Credit card loans:				
Discover card	$288	2.16 %	$257	2.05 %
Discover business card	1	1.82 %	1	2.12 %
Total credit card loans	289	2.16 %	258	2.05 %
Other loans:				
Personal loans	23	1.92 %	20	2.01 %
Private student loans (excluding PCI)	12	1.14 %	12	1.33 %
Other	—	0.60 %	1	2.35 %
Total other loans (excluding PCI)	35	1.50 %	33	1.65 %
Net charge-offs as a percentage of total loans (excluding PCI)	$324	2.06 %	$291	2.00 %
Net charge-offs as a percentage of total loans (including PCI)	$324	1.94 %	$291	1.86 %

	For the Nine Months Ended September 30,			
	2014		2013	
	Net Charge-offs	Net Charge-off Rate	Net Charge-offs	Net Charge-off Rate
Credit card loans:				
Discover card	$880	2.27 %	$827	2.25 %
Discover business card	3	1.75 %	4	2.31 %
Total credit card loans	883	2.27 %	831	2.25 %
Other loans:				
Personal loans	66	1.98 %	58	2.18 %
Private student loans (excluding PCI)	40	1.25 %	32	1.25 %
Other	1	0.88 %	1	1.72 %
Total other loans (excluding PCI)	107	1.58 %	91	1.66 %
Net charge-offs as a percentage of total loans (excluding PCI)	$990	2.16 %	$922	2.17 %
	$990	2.03 %	$922	2.01 %

Net charge-offs as a percentage of total loans (including PCI)

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 proportion of delinquent accounts have FICO scores below 660.

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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 by FICO Score	
	660 and Above	Less than 660 or No Score
At September 30, 2014		
Discover card	83 %	17 %
Discover business card	92 %	8 %
Personal loans	97 %	3 %
Private student loans (excluding PCI)[1]	95 %	5 %
At December 31, 2013		
Discover card	83 %	17 %
Discover business card	92 %	8 %
Personal loans	97 %	3 %
Private student loans (excluding PCI)[1]	95 %	5 %

(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, but still willing to make payments, the ability to temporarily suspend payments. Eligible borrowers have a lifetime cap on forbearance of 12 months. At September 30, 2014 and December 31, 2013, there were $44 million and $110 million of private student loans, including PCI, in forbearance, respectively. In addition, at September 30, 2014 and December 31, 2013, there were 0.8% and 1.9% of private student loans in forbearance as a percentage of student loans in repayment and forbearance, respectively. At September 30, 2014, the dollar amount of loans in forbearance and loans in forbearance as a percentage of private student loans in repayment and forbearance were lower when compared to December 31, 2013 due to the implementation of temporary reduced payment programs, which normally consist of a reduction of the minimum payment for a period of no longer than 12 months at a time. Loans in these programs are not considered to be in forbearance.

Allowance for Loan Losses

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

The Company bases its allowance for loan losses on several analyses that help estimate incurred losses as of the balance sheet date. While the Company’s estimation process includes historical data and analysis, there is a significant amount of judgment applied in selecting inputs and analyzing the results produced by the models to determine the allowance. The Company uses a migration analysis to estimate the likelihood that a loan will progress through the various stages of delinquency. The Company uses other analyses to estimate losses incurred on non-delinquent accounts. The considerations in these analyses include past performance, risk management techniques applied to various accounts, historical behavior of different account vintages, economic conditions, recent trends in delinquencies, bankruptcy filings, account collection management, policy changes, account seasoning, loan volume and amounts, payment rates and forecasting uncertainties. The Company primarily estimates its allowance for loan losses on a pooled basis, which includes loans that are delinquent and/or no longer accruing interest and/or certain

loans that have defaulted from a loan modification program, as discussed below under the section entitled "— Troubled Debt Restructurings." Certain other loans, including non-performing Diners Club licensee loans, are individually evaluated for impairment.

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

	For the Three Months Ended September 30, 2014				
	Credit Card	Personal Loans	Student Loans	Other	Total
Balance at beginning of period	$1,359	$109	$128	$18	$1,614
Additions:					
Provision for loan losses	318	22	16	(2)	354
Deductions:					
Charge-offs	(400)	(26)	(14)	—	(440)
Recoveries	111	3	2	—	116
Net charge-offs	(289)	(23)	(12)	—	(324)
Balance at end of period	$1,388	$108	$132	$16	$1,644

	For the Three Months Ended September 30, 2013				
	Credit Card	Personal Loans	Student Loans	Other	Total
Balance at beginning of period	$1,360	$98	$82	$16	$1,556
Additions:					
Provision for loan losses	291	28	14	—	333
Deductions:					
Charge-offs	(381)	(21)	(13)	(1)	(416)
Recoveries	123	1	1	—	125
Net charge-offs	(258)	(20)	(12)	(1)	(291)
Balance at end of period	$1,393	$106	$84	$15	$1,598

	For the Nine Months Ended September 30, 2014				
	Credit Card	Personal Loans	Student Loans	Other	Total
Balance at beginning of period	$1,406	$112	$113	$17	$1,648
Additions:					
Provision for loan losses	865	62	59	—	986
Deductions:					
Charge-offs	(1,223)	(74)	(44)	(1)	(1,342)
Recoveries	340	8	4	—	352
Net charge-offs	(883)	(66)	(40)	(1)	(990)
Balance at end of period	$1,388	$108	$132	$16	$1,644

	For the Nine Months Ended September 30, 2013				
	Credit Card	Personal Loans	Student Loans	Other	Total
Balance at beginning of period	$1,613	$99	$75	$1	$1,788
Additions:					
Provision for loan losses	611	65	41	15	732
Deductions:					
Charge-offs	(1,220)	(63)	(34)	(1)	(1,318)
Recoveries	389	5	2	—	396
Net charge-offs	(831)	(58)	(32)	(1)	(922)
Balance at end of period	$1,393	$106	$84	$15	$1,598

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
Interest and fees accrued subsequently charged off, net of recoveries (recorded as a reduction of interest income)	$69	$66	$211	$213
Fees accrued subsequently charged off, net of recoveries (recorded as a reduction to other income)	$16	$14	$50	$44

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

	Credit Card	Personal Loans	Student Loans	Other Loans	Total
At September 30, 2014					
Allowance for loans evaluated for impairment as:					
Collectively evaluated for impairment in accordance with ASC 450-20	$1,228	$103	$94	$2	$1,427
Evaluated for impairment in accordance with ASC 310-10-35[(1)(2)]	160	5	10	14	189
Acquired with deteriorated credit quality, evaluated in accordance with ASC 310-30	—	—	28	—	28
Total allowance for loan losses	$1,388	$108	$132	$16	$1,644
Recorded investment in loans evaluated for impairment as:					
Collectively evaluated for impairment in accordance with ASC 450-20	$52,654	$4,779	$4,672	$133	$62,238
Evaluated for impairment in accordance with ASC 310-10-35[(1)(2)]	1,045	51	34	62	1,192
Acquired with deteriorated credit quality, evaluated in accordance with ASC 310-30	—	—	3,788	—	3,788
Total recorded investment	$53,699	$4,830	$8,494	$195	$67,218
At December 31, 2013					
Allowance for loans evaluated for impairment as:					
Collectively evaluated for impairment in accordance with ASC 450-20	$1,218	$109	$76	$1	$1,404
Evaluated for impairment in accordance with ASC 310-10-35[(1)(2)]	188	3	9	16	216
Acquired with deteriorated credit quality, evaluated in accordance with ASC 310-30	—	—	28	—	28
Total allowance for loan losses	$1,406	$112	$113	$17	$1,648
Recorded investment in loans evaluated for impairment as:					
Collectively evaluated for impairment in accordance with ASC 450-20	$52,027	$4,160	$3,941	$56	$60,184

Evaluated for impairment in accordance with ASC 310-10-35[1][2]	1,123	31	28	79	1,261
Acquired with deteriorated credit quality, evaluated in accordance with ASC 310-30	—	—	4,178	—	4,178
Total recorded investment	$53,150	$4,191	$8,147	$135	$65,623

(1) Loan receivables evaluated for impairment in accordance with 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 troubled debt restructurings. Other loans are individually evaluated for impairment and generally do not represent troubled debt restructurings.

(2) The unpaid principal balance of credit card loans was $883 million and $900 million at September 30, 2014 and December 31, 2013, respectively. The unpaid principal balance of personal loans was $51 million and $31 million at September 30, 2014 and December 31, 2013, respectively. The unpaid principal balance of student loans was $33 million and $26 million at September 30, 2014 and December 31, 2013, respectively. All loans accounted for as troubled debt restructurings have a related allowance for loan losses.

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Troubled Debt Restructurings

The Company has internal loan modification programs that provide relief to credit card, personal loan and student loan borrowers who are experiencing financial hardship. 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. Credit card, personal and student loans that have permanent, and certain temporary, modifications, as well as certain grants of student loan forbearance, are considered to be individually impaired. In addition, loans that defaulted or graduated from modification programs or forbearance are considered to be individually impaired. As a result, the above mentioned loans are considered troubled debt restructurings and are accounted for in accordance with ASC Subtopic 310-40, Troubled Debt Restructurings by Creditors.

For credit card customers, the temporary hardship program primarily consists of a reduced minimum payment and an interest rate reduction, both lasting for a period no longer than 12 months. The permanent workout program involves changing the structure of the loan to a fixed payment loan with a maturity no longer than 60 months and reducing the interest rate on the loan. 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 loan modifications for customers who request financial assistance through external sources, such as a consumer credit counseling agency program (referred to here as external programs). These loans typically receive a reduced interest rate but continue to be subject to the original minimum payment terms and do not normally include waiver of unpaid principal, interest or fees.

To assist student loan borrowers who are experiencing temporary financial difficulties but are willing to resume making payments, the Company may offer hardship forbearance periods of up to 12 months over the life of the loan. The Company does not anticipate significant shortfalls in the contractual amount due for borrowers using a first hardship forbearance period as the historical performance of these borrowers is not significantly different from the overall portfolio. However, when a borrower is 30 or more days delinquent and granted a second hardship forbearance period, the forbearance is considered a troubled debt restructuring. In addition, the Company offers temporary reduced payment programs, which normally consist of a reduction of the minimum payment for a period of no longer than 12 months at a time. When a student loan borrower is enrolled in the temporary reduced payment program for 12 months or fewer over the life of the loan, the modification is not considered a troubled debt restructuring. However, when a borrower is enrolled in the temporary reduced payment program for more than 12 months over the life of the loan, the modification is considered a troubled debt restructuring.

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 program involves 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 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 troubled debt restructurings. Beginning in first quarter of 2014, loan modifications through external sources are accounted for as troubled debt restructurings.

The Company monitors borrower performance after using payment programs or forbearance 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 troubled debt restructurings in the future.

Loans classified as troubled debt restructurings are recorded at their present value with impairment measured as the difference between the loan balance and the discounted present value of cash flows expected to be collected. Consistent with the Company's measurement of impairment of modified loans on a pooled basis, the discount rate used for credit card loans in internal programs is the average current annual percentage rate applied to non-impaired credit

card loans, which approximates what would have applied to the pool of modified loans prior to impairment. The discount rate used for credit card loans in external programs reflects a rate that is consistent with rates offered to cardmembers not in a program that have similar risk characteristics. For student and personal loans, the discount rate used is the average contractual rate prior to modification.

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Interest income from loans accounted for as troubled debt restructurings is accounted for in the same manner as other accruing loans. Cash collections on these loans are allocated according to the same payment hierarchy methodology applied to loans that are not in such programs.

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

	Average recorded investment in loans	Interest income recognized during period loans were impaired[1]	Gross interest income that would have been recorded with original terms[2]
For the Three Months Ended September 30, 2014			
Credit card loans			
Modified credit card loans[3]	$248	$11	$1
Internal programs	$449	$3	$15
External programs	$353	$7	$4
Personal loans	$49	$2	$—
Student loans[4]	$33	$1	N/A
For the Three Months Ended September 30, 2013			
Credit card loans			
Modified credit card loans[3]	$263	$12	$—
Internal programs	$457	$2	$17
External programs	$447	$9	$3
Personal loans	$27	$1	$1
Student loans[4]	$22	$—	N/A
For the Nine Months Ended September 30, 2014			
Credit card loans			
Modified credit card loans[3]	$251	$34	$3
Internal programs	$452	$9	$46
External programs	$374	$21	$10
Personal loans	$46	$4	$1
Student loans[4]	$31	$2	N/A
For the Nine Months Ended September 30, 2013			
Credit card loans			
Modified credit card loans[3]	$271	$37	$2
Internal programs	$473	$7	$50
External programs	$477	$28	$8
Personal loans	$24	$2	$1
Student loans[4]	$20	$1	N/A

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

programs to the average loans in the modification programs.

(3) This balance is considered impaired, but is excluded from the internal and external program amounts reflected in this table. Represents credit card loans that were modified in troubled debt restructurings, but are no longer enrolled in troubled debt restructuring program due to noncompliance with the terms of the modification or successful completion of a program.

(4) Student loan customers who have been granted a forbearance are not given interest rate reductions.

In order to evaluate the primary financial effects that resulted from credit card loans entering into a loan modification program during the three and nine months ended September 30, 2014 and 2013, the Company quantified the amount by which interest and fees were reduced during the periods. During the three months ended September 30, 2014 and 2013, the Company forgave approximately $11 million and $10 million, respectively, of interest and fees as a result of accounts

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entering into a credit card loan modification program. During the nine months ended September 30, 2014 and 2013, the Company forgave approximately $30 million 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 each period (dollars in millions):

	For the Three Months Ended September 30,			
	2014		2013	
	Number of Accounts	Balances	Number of Accounts	Balances
Accounts that entered a loan modification program during the period:				
Credit card:				
Internal programs	12,115	$80	10,671	$67
External programs	8,203	$42	8,665	$47
Personal loans	980	$12	665	$8
Student loans	393	$6	292	$5

	For the Nine Months Ended September 30,			
	2014		2013	
	Number of Accounts	Balances	Number of Accounts	Balances
Accounts that entered a loan modification program during the period:				
Credit card:				
Internal programs	35,199	$232	30,149	$190
External programs	24,458	$128	26,652	$144
Personal loans	2,512	$30	1,618	$20
Student loans	1,045	$15	590	$12

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

	For the Three Months Ended September 30,			
	2014		2013	
	Number of Accounts	Aggregated Outstanding Balances Upon Default	Number of Accounts	Aggregated Outstanding Balances Upon Default
Troubled debt restructurings that subsequently defaulted:				
Credit card:				
Internal programs[(1)(2)]	2,488	$15	1,778	$11
External programs[(1)(2)]	1,874	$8	2,178	$9
Personal loans[(2)]	118	$2	74	$1
Student loans[(3)]	286	$4	214	$4

	For the Nine Months Ended September 30,			
	2014		2013	
	Number of Accounts	Aggregated Outstanding Balances Upon Default	Number of Accounts	Aggregated Outstanding Balances Upon Default
Troubled debt restructurings that subsequently defaulted:				
Credit card:				
Internal programs[(1)(2)]	7,282	$44	7,170	$45
External programs[(1)(2)]	5,440	$23	6,399	$27
Personal loans[(2)]	321	$4	159	$2
Student loans[(3)]	820	$12	405	$9

(1) The outstanding balance upon default is the loan balance at the end of the month prior to default. 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) A customer defaults from a modification program after two consecutive missed payments.
(3) Student loan defaults have been defined as loans that are 60 or more days delinquent.

Of the account balances that defaulted as shown above for the three months ended September 30, 2014 and 2013, approximately 34% and 33%, respectively, of the total balances charged off at the end of the month in which they defaulted. Of the account balances that defaulted as shown above for the nine months ended September 30, 2014 and 2013, approximately 36% and 42%, respectively, of the total balances charged off at the end of the month in which they defaulted. For accounts that have defaulted from a loan modification program and have not 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 private student loan portfolio acquired from Citibank, comprise the Company’s only PCI loans at September 30, 2014 and December 31, 2013. Total PCI student loans had an outstanding balance of $4.1 billion and $4.6 billion, including accrued interest, and a related

carrying amount of $3.8 billion and $4.2 billion as of September 30, 2014 and December 31, 2013, respectively.

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
Balance at beginning of period	$1,450	$1,952	$1,580	$2,072
Accretion into interest income	(64)	(66)	(198)	(205)
Other changes in expected cash flows	—	(1)	4	18
Balance at end of period	$1,386	$1,885	$1,386	$1,885

Periodically, the Company updates the estimate of cash flows expected to be collected based on management's latest expectations of future credit losses, borrower prepayments and certain other assumptions that affect cash flows. The Company recorded no provision expense during the three and nine months ended September 30, 2014 and 2013. The allowance for PCI loan losses at September 30, 2014 and December 31, 2013 was $28 million. For the three months ended September 30, 2014, there were no changes in other cash flow assumptions. For the nine months ended September 30, 2014, changes in other cash flow assumptions resulted in an increase in accretable yield primarily related to change in borrower prepayments. While there were no changes to overall credit loss assumptions during the nine months ended September 30, 2013, changes to other cash flow expectations during nine months ended September 30, 2013 resulted in the changes to accretable yield reflected in the table above. Changes to accretable yield are recognized prospectively as an adjustment to yield over the remaining life of the pools.

At September 30, 2014, the 30 or more days delinquency and 90 or more days delinquency rates on PCI student loans (which includes loans not yet in repayment) were 2.36% and 0.78%, respectively. At December 31, 2013, the 30 or more days delinquency and 90 or more days delinquency rates on PCI student loans (which includes loans not yet in repayment) were 2.33% and 0.80%, 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 0.63% and 1.09% for the three months ended September 30, 2014 and 2013, respectively, and 0.63% and 1.33% for the nine months ended September 30, 2014 and 2013, respectively. The decrease in net charge-off rate on PCI student loans is primarily due to seasoning of the portfolio and introduction of the temporary interest-only programs, which reduce the borrower's minimum payment for a period of no longer than 12 months at a time.

Mortgage Loans Held For Sale

The Company originates all of its residential real estate loans, except for home equity loans, with the intent to sell them in the secondary market. Loans held for sale consist primarily of residential first mortgage loans that are secured by residential real estate throughout the United States. Mortgage loans are funded through a warehouse line of credit and are recorded at fair value. Changes in the fair value of mortgage loans are recorded through other income prior to the sale of the loans to investors. The gain or loss on the sale of loans is recognized on the date the loans are sold and is based on the difference between the sale proceeds received and the carrying value of the loans, adjusted for the impact of the related hedges. See Note 14: Derivatives and Hedging Activities for further discussion of the mortgage loan related hedging activities. The Company sells its loans on a servicing released basis in which the Company gives up the right to service the loans.

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The following table provides a summary of the initial unpaid principal balance of mortgage loans sold during each period, by type of loan (dollars in millions):

	For the Three Months Ended September 30,					
	2014			2013		
	Amount	%		Amount	%	
Conforming[1]	$704	90.03	%	$705	77.64	%
FHA[2]	64	8.18		202	22.25	
Jumbo[3]	11	1.41		1	0.11	
VA[4]	3	0.38		—	—	
Total	$782	100.00	%	$908	100.00	%

	For the Nine Months Ended September 30,					
	2014			2013		
	Amount	%		Amount	%	
Conforming[1]	$1,723	90.16	%	$2,208	64.50	%
FHA[2]	161	8.42		1,214	35.47	
Jumbo[3]	24	1.26		1	0.03	
VA[4]	3	0.16		—	—	
Total	$1,911	100.00	%	$3,423	100.00	%

(1) Conforming loans are loans that conform to Government Sponsored Enterprises guidelines.
(2) FHA loans are loans that are insured by the Federal Housing Administration and are typically made to borrowers with low down payments. The initial loan amount must be within certain limits.
(3) Jumbo loans are loans with an initial amount larger than the limits set by a Government Sponsored Enterprise.
(4) VA loans are loans that are insured by and conform to the Department of Veteran Affairs guidelines.

The following table represents the loans held for sale by type of loan (dollars in millions):

	September 30, 2014			December 31, 2013		
	Amount	%		Amount	%	
Conforming[1]	$129	87.16	%	$136	91.89	%
FHA[2]	15	10.14		11	7.43	
Jumbo[3]	2	1.35		1	0.68	
VA[4]	2	1.35		—	—	
Total	$148	100.00	%	$148	100.00	%

(1) Conforming loans are loans that conform to Government Sponsored Enterprises guidelines.
(2) FHA loans are loans that are insured by the Federal Housing Administration and are typically made to borrowers with low down payments. The initial loan amount must be within certain limits.
(3) Jumbo loans are loans with an initial loan amount larger than the limits set by a Government Sponsored Enterprise.
(4) VA loans are loans that are insured by and conform to the Department of Veteran Affairs guidelines.

4. Credit Card and Student Loan Securitization Activities

Credit Card Securitization Activities

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

The DCENT debt structure consists of four classes of securities (DiscoverSeries Class A, B, C and D notes), with the most senior class generally receiving a triple-A rating. In this structure, in order to issue senior, higher rated classes of

notes, it is necessary to obtain the appropriate amount of credit enhancement, generally through the issuance of junior, lower rated or more highly subordinated classes of notes, the majority of which are held by wholly-owned subsidiaries of Discover Bank. The previous DCMT structure consisted of Class A, triple-A rated certificates and Class B, single-A rated certificates held by third parties. Credit enhancement was provided by the subordinated Class B certificates, cash collateral accounts and more subordinated Series 2009-CE certificates held by a wholly-owned subsidiary of Discover Bank. The credit-related risk of loss

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associated with trust assets as of the balance sheet date to which the Company is exposed through the retention of these subordinated interests is fully captured in the allowance for loan losses recorded by the Company.

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

Upon transfer of credit card loan receivables to the trust, the receivables and certain cash flows derived from them become restricted for use in meeting obligations to the trusts’ creditors. 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 that also have restrictions, the amounts of which are reported in restricted cash. Investment of trust cash balances is limited to investments that are permitted under the governing documents of the trusts and which have maturities no later than the related date on which funds must be made available for distribution to trust investors. With the exception of the seller’s interest in trust receivables, the Company’s interests in trust assets are generally subordinate to the interests of third-party investors and, as such, may not be realized by the Company if needed to absorb deficiencies in cash flows that are allocated to the investors in the trusts’ debt.

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

	September 30, 2014	December 31, 2013
Cash collateral accounts	$ —	$ 59
Collections and interest funding accounts	15	31
Restricted cash	15	90
Investors’ interests held by third-party investors	14,750	15,190
Investors’ interests held by wholly-owned subsidiaries of Discover Bank	5,466	5,024
Seller’s interest	9,289	10,898
Loan receivables[1]	29,505	31,112
Allowance for loan losses allocated to securitized loan receivables[1]	(772)	(833)
Net loan receivables	28,733	30,279
Other	37	34
Carrying value of assets of consolidated variable interest entities	$ 28,785	$ 30,403

(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, the securitization structures include certain features that could result in earlier-than-expected repayment of the securities. The primary investor protection feature relates to the availability and adequacy of cash flows in the securitized pool of receivables to meet contractual requirements. Insufficient cash flows would trigger the early repayment of the securities. This is referred to as the “economic early amortization” feature.

Investors are allocated cash flows derived from activities related to the accounts comprising the securitized pool of receivables, the amounts of which reflect finance charges billed, certain fee assessments, allocations of merchant discount and interchange, and recoveries on charged-off accounts. From these cash flows, investors are reimbursed for charge-offs occurring within the securitized pool of receivables and receive a contractual rate of return and Discover Bank is paid a servicing fee as servicer. Any cash flows remaining in excess of these requirements are reported to investors as excess spread. An excess spread rate of less than 0% for a contractually specified period, generally a three-month average, would trigger an economic early amortization event. In such an event, the Company would be required to seek immediate sources of replacement funding. Apart from the restricted assets related to securitization

activities, the investors and the securitization trusts have no recourse to the Company’s other assets or the Company's general credit for a shortage in cash flows.

The Company is required to maintain a contractual minimum level of receivables in the trust in excess of the face value of outstanding investors’ interests. This excess is referred to as the minimum seller’s interest requirement. The required minimum seller’s interest in the pool of trust receivables, which is included in credit card loan receivables restricted for

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securitization investors, is set at approximately 7% in excess of the total investors' interests (which includes interests held by third parties as well as those certificated interests held by the Company). If the level of receivables in the trust was to fall below the required minimum, the Company would be required to add receivables from the unrestricted pool of receivables, which would increase the amount of credit card loan receivables restricted for securitization investors. A decline in the amount of the excess seller's interest could occur if balance repayments and charge-offs exceeded new lending on the securitized accounts or as a result of changes in total outstanding investors' interests. Seller's interest is impacted by seasonality as higher balance repayments tend to occur in the first calendar year quarter. If the Company could not add enough receivables to satisfy the requirement, an early amortization (or repayment) of investors' interests would be triggered. The Company retains significant exposure to the performance of trust assets through holdings of the seller's interest and subordinated security classes of DCENT and previously DCMT. In addition, the Company has the right to remove a random selection of accounts, which would serve to decrease the amount of credit card loan receivables restricted for securitization investors, subject to certain requirements including that the minimum seller's interest is still met.

Another feature of the Company's credit card securitization structure that is designed to protect investors' interests from loss, which is applicable to the notes issued from DCENT, is a reserve account funding requirement in which excess cash flows generated by the transferred loan receivables are held at the trust. This funding requirement is triggered when DCENT's three-month average excess spread rate decreases to below 4.5%, with increasing funding requirements as excess spread levels decline below preset levels to 0%.

In addition to performance measures associated with the transferred credit card loan receivables or the inability to add receivables to satisfy the seller's interest requirement, there are other events or conditions which could trigger an early amortization event, such as non-payment of principal at expected maturity. As of September 30, 2014, no economic or other early amortization events have occurred.

The table below provides information concerning investors' interests and related excess spread at the end of the current period (dollars in millions):

At September 30, 2014	Investors' Interests[(1)]	# of Series Outstanding	3-Month Rolling Average Excess Spread	
Discover Card Execution Note Trust (DiscoverSeries notes)	$20,216	37	13.63	%

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

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

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

Currently there are three trusts from which securities were issued 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 trusts until cash is released in accordance with the trust indenture agreements and, for certain securitizations, no cash will be released to the Company until all outstanding trust borrowings have been repaid. Similar to the credit card securitizations, the Company continues to own and service the accounts that generate the student loan receivables held by the trusts and receives servicing fees from the trusts based on either a percentage of the principal balance outstanding or a flat fee

per borrower. Although the servicing fee income offsets the fee expense related to the trusts, failure to service the transferred loan receivables in accordance with contractual requirements could lead to a termination of the servicing rights.

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Under terms of all the trust arrangements, the Company has the option, but not the obligation, to provide financial support to the trusts, but has never provided such support. A substantial portion of the credit risk associated with the securitized loans has been transferred to third parties under private credit insurance or indemnification arrangements. The carrying values of these restricted assets, which are presented on the Company's condensed consolidated statement of financial condition as relating to securitization activities, are shown in the table below (dollars in millions):

	September 30, 2014	December 31, 2013
Restricted cash	$ 85	$ 89
Student loan receivables[1]	2,038	2,248
Allowance for loan losses allocated to securitized loan receivables[1]	(28)	(28)
Net student loan receivables	2,010	2,220
Carrying value of assets of consolidated variable interest entities	$ 2,095	$ 2,309

(1) The Company maintains its allowance for loan losses on purchased credit-impaired loans sufficient to absorb probable decreases in cash flows that were previously expected. Therefore, credit risk associated with the transferred receivables is fully reflected on the Company's balance sheet in accordance with GAAP.

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 certificates of deposit, money market accounts, online savings and checking accounts and IRA certificates of deposit, while brokered deposits include certificates of deposit and sweep accounts.

As of September 30, 2014 and December 31, 2013, the Company had approximately $28.8 billion and $28.4 billion, respectively, of direct-to-consumer deposits. As of September 30, 2014 and December 31, 2013, the Company had approximately $16.6 billion and $16.4 billion, respectively, of brokered and other deposits.

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

	September 30, 2014	December 31, 2013
Certificates of deposit in amounts less than $100,000[1]	$20,908	$21,211
Certificates of deposit from amounts of $100,000[1] to less than $250,000[1]	4,605	4,860
Certificates of deposit in amounts of $250,000[1] or greater	1,174	1,180
Savings deposits, including money market deposit accounts	18,490	17,515
Total interest-bearing deposits	$45,177	$44,766
Average annual interest rate	1.30 %	1.57 %

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

At the end of the current period, certificates of deposit maturing over the remainder of this year, over each of the next four years, and thereafter were as follows (dollars in millions):

Year	Amount
2014	$3,110
2015	$10,714
2016	$5,068
2017	$3,110
2018	$1,958
Thereafter	$2,727

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6. Long-Term Borrowings

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

	September 30, 2014			December 31, 2013				
	Outstanding	Interest Rate		Outstanding	Interest Rate		Interest Rate Terms	Maturity
Securitized Debt								
Fixed rate asset-backed securities								
Principal value (including discount of $1 at September 30, 2014 and December 31, 2013)	$7,749	1.82	%	$5,549	1.86	%	Various fixed rates	Various February 2015 - July 2019
Fair value adjustment[1]	3			5				
Book value	7,752			5,554				
Floating rate asset-backed securities	6,150	0.51	%	9,140	0.46	%	1-month LIBOR(2) + 18 to 58 basis points	Various July 2015 - January 2019
Floating rate asset-backed securities	850	0.43	%	—	—	%	3-month LIBOR(2) + 20 basis points	February 2017
Floating rate asset-backed securities	—	—	%	500	0.44	%	Commercial Paper rate + 30 basis points	March 2014
Total Discover Card Master Trust I and Discover Card Execution Note Trust	14,752			15,194				
Floating rate asset-backed securities (including discount of $97 and $129 at September 30, 2014 and December 31, 2013)	869	0.48	%	1,005	0.48	%	3-month LIBOR(2) + 12 to 45 basis points	Various January 2019 - July 2036 (3)
Floating rate asset-backed securities (including discount of $2 and $3 at September 30, 2014 and December 31, 2013)	364	4.25	%	434	4.25	%	Prime rate + 100 basis points	June 2031 (3)
Floating rate asset-backed securities (including premium of $1 at September 30, 2014 and December 31, 2013)	89	4.00	%	105	4.00	%	Prime rate + 75 basis points	July 2042 (3)
Floating rate asset-backed securities (including premium of $2 and $3 at September 30, 2014 and December 31, 2013)	202	3.65	%	248	3.66	%	1-month LIBOR(2) + 350 basis points	July 2042 (3)
	1,524			1,792				

Total SLC Private Student Loan Trusts								
Total Long-Term Borrowings—owed to securitization investors	16,276			16,986				
Discover Financial Services (Parent Company)								
Fixed rate senior notes due 2017								
Principal value	400	6.45	%	400	6.45	%	Fixed	June 2017
Fair value adjustment[1]	6			13				
Book value	406			413				
Fixed rate senior notes due 2019	78	10.25	%	78	10.25	%	Fixed	July 2019
Fixed rate senior notes due 2022 (including discount of $98 and $103 at September 30, 2014 and December 31, 2013)[4]	224	5.20	%	219	5.20	%	Fixed	April 2022
Fixed rate senior notes due 2022 (including discount of $157 and $165 at September 30, 2014 and December 31, 2013)[5]	343	3.85	%	335	3.85	%	Fixed	November 2022
Discover Bank								
Senior bank notes due 2018	750	2.00	%	750	2.00	%	Fixed	February 2018
Senior bank notes due 2021 (including discount of $2 at September 30, 2014)	748	3.20	%	—	—	%	Fixed	August 2021
Senior bank notes due 2023 (including discount of $5 and $6 at September 30, 2014 and December 31, 2013)	995	4.20	%	994	4.20	%	Fixed	August 2023
Senior bank notes due 2026 (including discount of $1 at September 30, 2014)	399	4.25	%	—	—	%	Fixed	March 2026
Subordinated bank notes due 2019	200	8.70	%	200	8.70	%	Fixed	November 2019
Subordinated bank notes due 2020 (including discount of $2 at September 30, 2014 and December 31, 2013)	498	7.00	%	498	7.00	%	Fixed	April 2020
Capital lease obligations	1	4.51	%	1	4.51	%	Fixed	April 2016
Total long-term borrowings	$20,918			$20,474				

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(1) The Company uses interest rate swaps to hedge portions of these long-term borrowings against changes in fair value attributable to changes in LIBOR. See Note 14: Derivatives and Hedging Activities.

(2) London Interbank Offered Rate ("LIBOR").

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

(4) Discount primarily relates to $115 million cash premium paid at issuance as part of 2012 private exchange offer to replace higher rate borrowings with borrowings bearing lower interest rates. During each of the three months ended September 30, 2014 and 2013, $2 million of the premium paid was amortized and included in interest expense in the condensed consolidated statements of income. During the nine months ended September 30, 2014 and 2013, respectively, $6 million and $5 million of the premium paid was amortized and included in interest expense in the condensed consolidated statements of income.

(5) Discount primarily relates to $176 million cash premium paid at issuance as part of 2012 private exchange offer to replace higher rate borrowings with borrowings bearing lower interest rates. During the three months ended September 30, 2014 and 2013, respectively, $3 million and $2 million of the premium paid was amortized and included in interest expense in the condensed consolidated statements of income. During the nine months ended September 30, 2014 and 2013. respectively, $9 million and $8 million of the premium paid was amortized and included in interest expense in the condensed consolidated statements of income.

Maturities

Long-term borrowings had the following maturities at the end of the current period (dollars in millions):

Year	Amount
Due in 2014	$—
Due in 2015	3,303
Due in 2016	3,050
Due in 2017	3,905
Due in 2018	2,650
Thereafter	8,010
Total	$20,918

The Company has access to committed undrawn capacity through private securitizations to support the funding of its credit card loan receivables. As of September 30, 2014, the total commitment of secured credit facilities through private providers was $7.5 billion, none of which had been used at September 30, 2014. 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 2015 and 2016. 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.

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7. Accumulated Other Comprehensive (Loss) Income

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

	Unrealized Gain (Loss) on Available-for-Sale Investment Securities, Net of Tax	Gain (Loss) on Cash Flow Hedges, Net of Tax	Foreign Currency Translation Adjustments, Net of Tax[1]	Pension and Post Retirement Plan Loss, Net of Tax	AOCI
For the Three Months Ended September 30, 2014					
Balance at June 30, 2014	$ 29	$(1)	$ 1	$(101)	$(72)
Net change	(9)	12	(1)	—	2
Balance at September 30, 2014	$ 20	$11	$—	$(101)	$(70)
For the Three Months Ended September 30, 2013					
Balance at June 30, 2013	$ 29	$10	$—	$(146)	$(107)
Net change	4	(7)	1	—	(2)
Balance at September 30, 2013	$ 33	$3	$ 1	$(146)	$(109)
For the Nine Months Ended September 30, 2014					
Balance at December 31, 2013	$ 19	$13	$ 1	$(101)	$(68)
Net change	1	(2)	(1)	—	(2)
Balance at September 30, 2014	$ 20	$11	$—	$(101)	$(70)
For the Nine Months Ended September 30, 2013					
Balance at December 31, 2012	$ 71	$3	$—	$(146)	$(72)
Net change	(38)	—	1	—	(37)
Balance at September 30, 2013	$ 33	$3	$ 1	$(146)	$(109)

(1) Includes unrealized gains/losses on hedge of net investment in foreign subsidiary, net of tax expense/benefit and net gains/losses on foreign currency translation adjustments.

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The table below 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 Benefit (Expense)	Net of Tax
For the Three Months Ended September 30, 2014			
Available-for-Sale Investment Securities:			
Net unrealized holding losses arising during the period	$(15)	$6	$(9)
Net change	$(15)	$6	$(9)
Cash Flow Hedges:			
Net unrealized gains arising during the period	$10	$(4)	$6
Amounts reclassified from AOCI	11	(5)	6
Net change	$21	$(9)	$12
Foreign Currency Translation Adjustments:			
Net unrealized losses arising during the period	$(1)	$—	$(1)
Net change	$(1)	$—	$(1)
For the Three Months Ended September 30, 2013			
Available-for-Sale Investment Securities:			
Net unrealized holding gains arising during the period	$7	$(3)	$4
Amounts reclassified from AOCI	(1)	1	—
Net change	$6	$(2)	$4
Cash Flow Hedges:			
Net unrealized losses arising during the period	$(17)	$6	$(11)
Amounts reclassified from AOCI	6	(2)	4
Net change	$(11)	$4	$(7)
Foreign Currency Translation Adjustments:			
Net unrealized gains arising during the period	$1	$—	$1
Net change	$1	$—	$1

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The table below presents each component of OCI before reclassifications and amounts reclassified from AOCI for each component of OCI before- and after-tax (dollars in millions):

	Before Tax	Tax (Expense) Benefit	Net of Tax
For the Nine Months Ended September 30, 2014			
Available-for-Sale Investment Securities:			
Net unrealized holding gains arising during the period	$5	$(2)	$3
Amounts reclassified from AOCI	(4)	2	(2)
Net change	$1	$—	$1
Cash Flow Hedges:			
Net unrealized losses arising during the period	$(28)	$10	$(18)
Amounts reclassified from AOCI	26	(10)	16
Net change	$(2)	$—	$(2)
Foreign Currency Translation Adjustments:			
Net unrealized losses arising during the period	$(1)	$—	$(1)
Net change	$(1)	$—	$(1)
For the Nine Months Ended September 30, 2013			
Available-for-Sale Investment Securities:			
Net unrealized holding losses arising during the period	$(58)	$22	$(36)
Amounts reclassified from AOCI	(3)	1	(2)
Net change	$(61)	$23	$(38)
Cash Flow Hedges:			
Net unrealized losses arising during the period	$(1)	$—	$(1)
Amounts reclassified from AOCI	2	(1)	1
Net change	$1	$(1)	$—
Foreign Currency Translation Adjustments:			
Net unrealized gains arising during the period	$1	$—	$1
Net change	$1	$—	$1

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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 September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
Income before income tax expense	$1,009	$946	$3,046	$3,007
Income tax expense	$365	$353	$1,127	$1,139
Effective income tax rate	36.2 %	37.3 %	37.0 %	37.9 %

Income tax expense increased $12 million for the three months ended September 30, 2014, as compared to the same period in 2013 due to an increase in pretax income. The effective tax rate decreased from 37.3% for the three months ended September 30, 2013 to 36.2% for the three months ended September 30, 2014 due to recognition of tax benefits attributable to prior year tax adjustments. The 2013 prior period included a one-time increase to unrecognized tax benefits.

Income tax expense decreased $12 million for the nine months ended September 30, 2014, as compared to the same period in 2013. The effective tax rate decreased from 37.9% for the nine months ended September 30, 2013 to 37.0% for the nine months ended September 30, 2014 due to a favorable adjustments to unrecognized tax benefits and decreases in state income tax rates as a result of the changes in state apportionment factors.

The Company is subject to examination by the Internal Revenue Service (“IRS”), various state and foreign tax jurisdictions. The tax years under examination vary by jurisdiction. The IRS is currently examining 2011 through 2012.

The Company is pursuing an administrative appeal of the IRS’s proposed assessment for the years 1999 through 2005. It is reasonably possible that a settlement of the IRS appeal for the years 1999 through 2005 and certain state audits may be made within 12 months of the reporting date. In the second quarter of 2014, the IRS issued a Notice of Proposed Adjustment for the years 2006 through June 30, 2007, which was accepted by the Company, resulting in the recognition of previously unrecognized tax benefits for those years. At this time, as a result of such settlements, the Company believes it is reasonably possible that a reduction of unrecognized tax benefits in the range of $90 million to $340 million could be recognized. The Company is also pursuing an administrative appeal of the IRS's proposed assessment for the years 2008 through 2010.

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 Company believes that its reserves are sufficient to cover any tax, penalties and interest that could result from such examinations.

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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 September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
Numerator:				
Net income	$644	$593	$1,919	$1,868
Preferred stock dividends	(9)	(9)	(28)	(28)
Net income available to common stockholders	635	584	1,891	1,840
Income allocated to participating securities	(5)	(5)	(13)	(14)
Net income allocated to common stockholders	$630	$579	$1,878	$1,826
Denominator:				
Weighted average shares of common stock outstanding	460	482	466	489
Effect of dilutive common stock equivalents	1	2	1	2
Weighted average shares of common stock outstanding and common stock equivalents	461	484	467	491
Basic earnings per common share	$1.37	$1.20	$4.03	$3.73
Diluted earnings per common share	$1.37	$1.20	$4.02	$3.72

Anti-dilutive securities were not material and had no impact on the computation of diluted EPS for the three and nine months ended September 30, 2014 and 2013, respectively.

10. Capital Adequacy

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

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (as defined in the regulations) of total risk-based capital and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets. As of September 30, 2014, the Company and the Bank met all capital adequacy requirements to which they were subject. Under regulatory capital requirements, the Company and the Bank must maintain minimum levels of capital that are dependent upon the risk-weighted amount or average level of the financial institution’s assets, specifically (a) 8% to 10% of total risk-based capital to risk-weighted assets (“total risk-based capital ratio”), (b) 4% to 6% of Tier 1 capital to risk-weighted assets (“Tier 1 risk-based capital ratio”) and (c) 4% to 5% of Tier 1 capital to average assets (“Tier 1 leverage ratio”). To be categorized as “well-capitalized,” the Company and the Bank must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the table below. As of September 30, 2014, the Company and the Bank met the requirements for well-capitalized status and there have been no conditions or events that management believes have changed the Company’s or the Bank’s category.

The following table shows the actual capital amounts and ratios of the Company and the Bank 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		Amount	Ratio	Amount	Ratio
At September 30, 2014							
Total capital (to risk-weighted assets)							
Discover Financial Services	$12,494	17.8	%	$5,611	≥8.0%	$7,013	≥10.0%
Discover Bank	$11,044	15.9	%	$5,549	≥8.0%	$6,937	≥10.0%
Tier 1 capital (to risk-weighted assets)							
Discover Financial Services	$10,910	15.6	%	$2,805	≥4.0%	$4,208	≥6.0%
Discover Bank	$9,470	13.7	%	$2,775	≥4.0%	$4,162	≥6.0%
Tier 1 capital (to average assets)							
Discover Financial Services	$10,910	13.7	%	$3,195	≥4.0%	$3,994	≥5.0%
Discover Bank	$9,470	12.0	%	$3,156	≥4.0%	$3,945	≥5.0%
At December 31, 2013							
Total capital (to risk-weighted assets)							
Discover Financial Services	$11,975	17.4	%	$5,492	≥8.0%	$6,865	≥10.0%
Discover Bank	$10,496	15.5	%	$5,428	≥8.0%	$6,785	≥10.0%
Tier 1 capital (to risk-weighted assets)							
Discover Financial Services	$10,409	15.2	%	$2,746	≥4.0%	$4,119	≥6.0%
Discover Bank	$8,941	13.2	%	$2,714	≥4.0%	$4,071	≥6.0%
Tier 1 capital (to average assets)							
Discover Financial Services	$10,409	13.4	%	$3,116	≥4.0%	$3,895	≥5.0%
Discover Bank	$8,941	11.6	%	$3,077	≥4.0%	$3,847	≥5.0%

11. Commitments, Contingencies and Guarantees

Lease Commitments

The Company leases various office space and equipment under capital and non-cancelable operating leases, which expire at various dates through 2024. At the end of the current period, future minimum payments on leases with original terms in excess of one year consist of the following (dollars in millions):

	Capitalized Leases	Operating Leases
2014	$—	$4
2015	1	16
2016	—	16
2017	—	13
2018	—	12
Thereafter	—	52
Total minimum lease payments	1	$113
Less: Amount representing interest	—	
Present value of net minimum lease payments	$1	

Unused Commitments to Extend Credit

At September 30, 2014, the Company had unused commitments to extend credit for loans of approximately $169.1 billion. Such commitments 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 commitments,

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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.

Securitizations 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 plus the principal amount of any other outstanding secured borrowings. The Company has recorded substantially all of the maximum potential amount of future payments in long-term borrowings on the Company's statement of financial condition. The Company has not recorded any incremental contingent liability associated with its secured borrowing representations and warranties. Management believes that the probability of having to replace, repurchase or sell assets pledged as collateral under secured borrowing arrangements, including an early amortization event, is low.

Mortgage Loans Representations and Warranties

The Company sells loans it originates to investors on a servicing released basis and the risk of loss or default by the borrower is generally transferred to the investor. However, the Company is required by these investors to make certain representations and warranties relating to credit information, loan documentation and collateral. These representations and warranties may extend through the contractual life of the mortgage loan. Subsequent to the sale, if underwriting deficiencies, borrower fraud or documentation defects are discovered in individual mortgage loans, the Company may be obligated to repurchase the respective mortgage loan or indemnify the investors for any losses from borrower defaults if such deficiency or defect cannot be cured within the specified period following discovery. The Company has established a repurchase reserve based on expected losses. At September 30, 2014, this amount was not material and was included in accrued expenses and other liabilities on the condensed consolidated statements of financial condition. The related provision was included in other income on the condensed consolidated statements of income.

Guarantees

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

Counterparty Settlement Guarantees

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

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

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The maximum potential amount of future payments related to such contingent obligations is dependent upon the transaction volume processed between the time a counterparty defaults on its settlement and the time at which the Company disables the settlement of any further transactions for the defaulting party, which could be one month depending on the type of guarantee/counterparty. However, there is no limitation on the maximum amount the Company may be liable to pay. The actual amount of the potential exposure cannot be quantified as the Company cannot determine whether particular counterparties will fail to meet their settlement obligations.

While the Company has some contractual remedies to offset these counterparty settlement exposures (such as letters of credit or pledged deposits), in the event that all licensees and/or issuers were to become unable to settle their transactions, the Company estimates its maximum potential counterparty exposures to these settlement guarantees, based on historical transaction volume, would be as follows (dollars in millions):

	September 30, 2014
Diners Club:	
Merchant guarantee	$ 124
PULSE:	
ATM guarantee	$ 1

With regard to the counterparty settlement guarantees discussed above, the Company believes that the estimated amounts of maximum potential future payments are not representative of the Company's actual potential loss exposure given Diners Club's and PULSE's insignificant historical losses from these counterparty exposures. As of September 30, 2014, the Company had not recorded any contingent liability in the condensed consolidated financial statements for these counterparty exposures, and management believes that the probability of any payments under these arrangements is low.

The Company also retains counterparty exposure for the obligations of Diners Club licensees that participate in the Citishare network, an electronic funds processing network. Through the Citishare network, Diners Club customers are able to access certain ATMs directly connected to the Citishare network. The Company's maximum potential future payment under this counterparty exposure is limited to $15 million subject to annual adjustment based on actual transaction experience. However, as of September 30, 2014, the Company had not recorded any contingent liability in the condensed consolidated financial statements related to this counterparty exposure, and management believes that the probability of any payments under this arrangement is low.

Merchant Chargeback Guarantees

The Company 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 nine months ended September 30, 2014 or 2013.

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

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amount is not representative of the Company’s actual potential loss exposure based on the Company’s historical experience. The actual amount of the potential exposure cannot be quantified as the Company cannot determine whether the current or cumulative transaction volumes may include or result in disputed transactions.

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
Aggregate sales transaction volume[(1)]	$31,963	$30,633	$92,262	$88,073

(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 September 30, 2014 or December 31, 2013. The Company mitigates the risk of potential loss exposure by withholding settlement from merchants, obtaining third-party guarantees, or obtaining escrow deposits or letters of credit from certain merchant acquirers or merchants that are considered higher risk due to various factors such as time delays in the delivery of products or services.

The table below provides information regarding settlement withholdings and escrow deposits, which are recorded in interest-bearing deposit accounts and accrued expenses and other liabilities on the Company’s condensed consolidated statements of financial condition (dollars in millions):

	September 30, 2014	December 31, 2013
Settlement withholdings and escrow deposits	$ 19	$ 17

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 Company contests liability and/or the amount of damages as appropriate in each pending matter.

The Company has historically relied on the arbitration clause in its cardmember agreements, which has in some instances limited the costs of, and the Company’s exposure to litigation, but there can be no assurance that the Company will continue to be successful in enforcing its arbitration clause in the future. Legal challenges to the enforceability of these clauses have led most card issuers, and may cause the Company, to discontinue their use. In addition, bills are periodically introduced in Congress to directly or indirectly prohibit the use of pre-dispute arbitration clauses, and the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Reform Act") authorized the Consumer Financial Protection Bureau (the "CFPB") to conduct a study on pre-dispute arbitration clauses and, based on the study, potentially limit or ban arbitration clauses. A preliminary report on arbitration agreements issued by the CFPB expressed concerns about these agreements that may signal the CFPB is contemplating taking such steps. Further, the Company is involved in pending legal actions challenging its arbitration clause.

The Company is also involved, from time to time, in other reviews, investigations and proceedings (both formal and informal) by governmental agencies regarding the Company’s business including, among other matters, 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 financial statements, increase its cost of operations, or limit its ability to execute its business strategies and engage in certain business activities. For example, Discover Bank entered into a Consent Order with the FDIC as described more fully below. Also, the Federal Reserve notified the Company of its intention to enter into a supervisory action with the Company to require enhancements to the Company's enterprise-wide anti-money laundering and related compliance programs. In addition, as previously disclosed, the

CFPB issued a Civil Investigative Demand to Discover Bank seeking documents and information regarding certain of Discover Bank's student loan servicing practices, which could lead to a supervisory action. The Company and Discover Bank are cooperating with the Federal Reserve and the CFPB, respectively, on these matters. Supervisory actions generally can include demands for civil money penalties, changes to certain business practices and customer restitution. Supervisory actions 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 which are both probable and estimable. Litigation expense was not material for the three and nine months ended September 30, 2014 and 2013.

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 $165 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 July 5, 2012, the Antitrust Division of the United States Department of Justice (the "Division") issued a Civil Investigative Demand ("CID") to the Company seeking information regarding an investigation related to potential violations of Sections 1 and 2 of the Sherman Act, 15 U.S.C. §§1-2, by an unidentified party other than Discover. The CID seeks documents, data and narrative responses to several interrogatories and document requests, related to the debit card market. A CID is a request for information in the course of a civil investigation and does not constitute the commencement of legal proceedings. The Division is permitted by statute to issue a CID to anyone whom it believes may have information relevant to an investigation. The receipt of a CID does not presuppose that there is probable cause to believe that a violation of the antitrust laws has occurred or that a formal complaint ultimately will be filed. The Company is cooperating with the Division in connection with the CID.

On August 14, 2012, a purported shareholder, James Groen, filed a shareholder derivative action in the U.S. District Court for the Northern District of Illinois (Groen v. Nelms et al.) against the Company's board of directors, certain current and former officers and directors and the Company as nominal defendant. On August 27, 2012, a second purported shareholder, the Charter Township of Clinton Police and Fire Retirement System, filed a substantially identical shareholder derivative action in the same court against the same parties (Charter Township of Clinton Police and Fire Retirement System v. Nelms et al.). On September 25, 2012, the actions were consolidated, and on February 19, 2013, the plaintiffs filed an amended consolidated complaint. The consolidated complaint asserts claims against the board of directors and certain current and former officers and directors for alleged breach of fiduciary duty, corporate waste and unjust enrichment arising out of the Company's alleged violations of the law in connection with the marketing and sale of its protection products. The relief sought in the consolidated complaint includes changes to the Company's corporate governance procedures; unspecified damages, injunctive relief, restitution and disgorgement from the individual defendants; and attorneys' fees. On April 5, 2013, the defendants filed a motion to dismiss the amended consolidated complaint, and on June 5, 2013, briefing on the motion to dismiss was completed. The motion to dismiss is currently pending.

On June 13, 2014, Discover Bank entered into a Consent Order with the FDIC to resolve previously disclosed matters related to the FDIC's examination of Discover Bank's anti-money laundering and related compliance programs. In the Consent Order, Discover Bank agreed to, among other things, enhance its anti-money laundering and related compliance programs. The order does not include civil money penalties.

On September 2, 2014, a purported shareholder, Steamfitters Local 449 Pension Fund, filed a shareholder derivative action in the Circuit Court of the Nineteenth Judicial Circuit, Lake County, Illinois (Steamfitters Local 449 Pension Fund, derivatively on behalf of Discover Financial Services v. David W. Nelms, et al.) against the Company's board of directors and certain current and former officers and directors of the Company. The complaint asserts claims for alleged breach of fiduciary duty, corporate waste and unjust enrichment arising out of the Company's alleged violations of the law in connection with the marketing and sale of protection products. The relief sought in the consolidated complaint includes changes to the Company's corporate governance procedures, unspecified damages, restitution and disgorgement from the individual defendants, and attorneys' fees. On September 25, 2014, the court entered an order staying the case until 30 days after the U.S. District Court for the Northern District of Illinois enters an order on defendants' motion to dismiss the amended consolidated complaint in Groen v. Nelms et al. and Charter Township of Clinton Police and Fire Retirement System v. Nelms et al. (as consolidated, the Groen and Charter Township cases are now captioned: In re Discover Financial Services Derivative Litigation).

On September 3, 2014, a collective action lawsuit was filed against the Company by a former employee in the U.S. District Court for the Northern District of Illinois (Pawel Holda, et al. v. Discover Financial Services). The plaintiff alleges that the Company misclassified employees as being exempt from the Fair Labor Standards Act. The plaintiff seeks to recover overtime pay on behalf of himself and other allegedly similarly situated employees together with penalties, interest and attorney's fees. The Company will seek to vigorously defend against the claims asserted in this matter.

13. Fair Value Measurements and Disclosures

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.

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.

During the nine months ended September 30, 2014, there were no changes to the Company's valuation techniques that had, or are expected to have, a material impact on the Company's condensed consolidated financial position or results of operations.

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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 Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Balance at September 30, 2014				
Assets				
U.S Treasury securities	$ 1,334	$—	$—	$1,334
U.S government agency securities	1,038	—	—	1,038
Residential mortgage-backed securities - Agency	—	1,541	—	1,541
Available-for-sale investment securities	$ 2,372	$1,541	$—	$3,913
Mortgage loans held for sale	$ —	$147	$1	$148
Interest rate lock commitments	$ —	$—	$6	$6
Forward delivery contracts	—	1	—	1
Other derivative financial instruments	—	55	—	55
Derivative financial instruments	$ —	$56	$6	$62
Liabilities				
Forward delivery contracts	$ —	$2	$—	$2
Other derivative financial instruments	—	8	—	8
Derivative financial instruments	$ —	$10	$—	$10
Balance at December 31, 2013				
Assets				
U.S Treasury securities	$ 2,057	$—	$—	$2,057
U.S government agency securities	1,561	—	—	1,561
Credit card asset-backed securities of other issuers	—	6	—	6
Residential mortgage-backed securities - Agency	—	1,307	—	1,307
Available-for-sale investment securities	$ 3,618	$1,313	$—	$4,931
Mortgage loans held for sale	$ —	$148	$—	$148
Interest rate lock commitments	$ —	$—	$4	$4
Forward delivery contracts	—	5	—	5
Other derivative financial instruments	—	70	—	70
Derivative financial instruments	$ —	$75	$4	$79
Liabilities				
Forward delivery contracts	$ —	$1	$—	$1
Other derivative financial instruments	—	6	—	6
Derivative financial instruments	$ —	$7	$—	$7

There were no transfers between Levels 1 and 2 within the fair value hierarchy for the three or nine months ended September 30, 2014 and 2013.

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Available-for-Sale Investment Securities

Investment securities classified as available-for-sale consist of U.S. Treasury and government agency securities, residential mortgage-backed securities and credit card asset-backed securities issued by other financial institutions. The fair value estimates of investment securities classified as Level 1, consisting of U.S. Treasury and government agency securities, are determined based on quoted market prices for the same or similar securities. The Company classifies all other available-for-sale investment securities as Level 2, the fair value estimates of which are primarily obtained from pricing services, where fair values are estimated using pricing models based on observable market inputs or recent trades of similar securities. The fair value estimates of mortgage-backed and credit card asset-backed securities 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 the 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 September 30, 2014, 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 $1.5 billion, a weighted-average coupon of 2.81% and a weighted-average remaining maturity of 4 years.

Mortgage Loans Held for Sale and Related Derivative Instruments

The Company enters into commitments with consumers to originate mortgage loans at a specified interest rate, known as interest rate lock commitments (“IRLCs”). The Company reports IRLCs as derivative instruments at fair value with changes in fair value being recorded in other income. IRLCs and mortgage loans held for sale under certain loan programs are hedged in aggregate using “to be announced mortgage-backed securities” (“TBA MBS”). IRLCs and mortgage loans held for sale under loan programs that generally have lower volume are hedged on an individual loan level using best-efforts forward delivery contracts.

Fair values for each of these instruments are determined using quantitative risk models. The Company has various monitoring processes in place to validate these valuations, including valuations of Level 3 assets. Valuation results are reviewed in comparison to expected results, recent activity and historical trends. Any significant or unusual fluctuations in value are analyzed.

- Mortgage loans held for sale. Valuations of mortgage loans held for sale are based on the loan amount, note rate, loan program, expected sale date of the loan and, most significantly, investor pricing tables stratified by product, note rate and term, adjusted for current market conditions. Mortgage loans held for sale are classified as Level 2 as the investor pricing tables used to value them are an observable input. Impaired mortgage loans held for sale are classified as Level 3 as loss severity is an unobservable input used in valuation. The Company recognizes interest income separately from changes in fair value.
- Interest rate lock commitments. IRLCs for loans to be sold to investors using a mandatory or assignment of trade method derive their base value from an underlying loan type with similar characteristics using the TBA MBS market, which is actively quoted and easily validated through external sources. The data inputs used in this valuation include, but are not limited to, loan type, underlying loan amount, note rate, loan program and commitment term. IRLCs for loans to be sold to investors on a best-efforts basis derive their base value from the value of the underlying loans using investor pricing tables stratified by product, note rate and term, adjusted for current market conditions. These valuations are adjusted at the loan level to consider the servicing release premium and loan pricing adjustments specific to each loan. For all IRLCs, this base value is then adjusted for the anticipated loan funding probability, or pull through rate. The anticipated loan funding probability is an unobservable input based on historical experience, which results in classification of IRLCs as Level 3.
- Forward delivery contracts. Under the Company's risk management policy, the Company economically hedges the changes in fair value of IRLCs and mortgage loans held for sale caused by changes in interest rates by using TBA

MBS and entering into best-efforts forward delivery contracts. These hedging instruments are recorded at fair value with changes in fair value recorded in other income. TBA MBS used to hedge both IRLCs and loans

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held for sale are valued based primarily on observable inputs related to characteristics of the underlying MBS stratified by product, coupon and settlement date. Therefore, these derivatives are classified as Level 2. Best-efforts forward delivery contracts are valued based on investor pricing tables, which are observable inputs, stratified by product, note rate and term, adjusted for current market conditions. An anticipated loan funding probability is applied to value best-efforts contracts hedging IRLCs, which results in the classification of these contracts as Level 3. The current base loan price and, for best-efforts contracts hedging IRLCs, the anticipated loan funding probability, are the most significant assumptions affecting the value of the best-efforts contracts. The best-efforts forward delivery contracts hedging loans held for sale are classified as Level 2, so such contracts are transferred from Level 3 to Level 2 at the time the underlying loan is originated. For the purposes of the tables below, TBA MBS and best-efforts forward delivery contracts are referred to as forward delivery contracts.

Other Derivative Financial Instruments

The Company's other 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 under the Fair Value Option

The Company has elected to account for mortgage loans held for sale at fair value. Electing the fair value option allows a better offset of the changes in fair values of the loans and the forward delivery contracts used to economically hedge them without the burden of complying with the requirements for hedge accounting. At September 30, 2014 and December 31, 2013, the aggregate unpaid principal balance of loans held for sale for which the fair value option had been elected was $144 million and $146 million, respectively. At September 30, 2014 and December 31, 2013, the same loans both had a fair value of $148 million. For the three and nine months ended September 30, 2014, respectively, $10 million and $13 million of losses from fair value adjustments on mortgage loans held for sale were recorded in other income on the condensed consolidated statements of income. For the three and nine months ended September 30, 2013, respectively, $6 million and $30 million of losses from fair value adjustments on mortgage loans held for sale were recorded in other income on the condensed consolidated statements of income.

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Level 3 Financial Instruments Only
Changes in Level 3 Assets and Liabilities Measure at Fair Value on a Recurring Basis
The following tables provide changes in the Company's Level 3 assets and liabilities measured at fair value on a recurring basis (dollars in millions):

For the Three Months Ended September 30, 2014

	Balance at June 30, 2014	Transfers into Level 3	Transfers out of Level 3	Total Net Gains included in Earnings	Purchases	Sales	Settlements	Transfers of IRLCs to Closed Loans	Balance at September 30, 2014
Interest rate lock commitments	$8	—	—	18	—	—	2	(22)	$6
Mortgage loans held for sale	$—	1	—	—	1	(1)	—	—	$1

For the Three Months Ended September 30, 2013

	Balance at June 30, 2013	Transfers into Level 3	Transfers out of Level 3	Total Net Gains included in Earnings	Purchases	Sales	Settlements	Transfers of IRLCs to Closed Loans	Balance at September 30, 2013
Interest rate lock commitments	$8	—	—	24	—	—	(2)	(22)	$8
Forward delivery contracts	$1	—	(1)	—	—	—	—	—	$—
Mortgage loans held for sale	$—	1	—	—	—	—	—	—	$1

For the Nine Months Ended September 30, 2014

	Balance at December 31, 2013	Transfers into Level 3	Transfers out of Level 3	Total Net Gains included in Earnings	Purchases	Sales	Settlements	Transfers of IRLCs to Closed Loans	Balance at September 30, 2014
Interest rate lock commitments	$4	—	—	61	—	—	4	(63)	$6
	$—	—	(1)	1	—	—	—	—	$—

Forward delivery contracts									
Mortgage loans held for sale	$—	2	—	—	1	(2)	—	—	$1

For the Nine Months Ended September 30, 2013

	Balance at December 31, 2012	Transfers into Level 3	Transfers out of Level 3	Total Net Gains included in Earnings	Purchases	Sales	Settlements	Transfers of IRLCs to Closed Loans	Balance at September 30, 2013
Interest rate lock commitments	$12	—	—	105	—	—	3	(112)	$8
Forward delivery contracts	$—	—	(2)	2	—	—	—	—	$—
Mortgage loans held for sale	$—	3	—	—	1	(2)	(1)	—	$1

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Unobservable Inputs and Sensitivities

The following table presents information about significant unobservable inputs related to the Company's Level 3 financial assets and liabilities measured at fair value on a recurring and non-recurring basis at the end of the current period (dollars in millions):

At September 30, 2014	Fair Value	Valuation Technique	Significant Unobservable Input	Ranges of Inputs				Weighted Average[(1)]	
				Low		High			
Interest rate lock commitments	$6	Quantitative risk models	Loan funding probability	13	%	99	%	57	%
Mortgage loans held for sale	$1	Market comparables	Loss severity	17	%	20	%	19	%

(1) Weighted averages are calculated using notional amounts for derivative instruments.

The anticipated loan funding probability represents the Company's expectation regarding the percentage of IRLCs that will ultimately be funded. Generally, an increase in the anticipated loan funding probability would result in an increase in the magnitude of fair value measurements.

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. During the three and nine months ended September 30, 2014 and 2013, the Company had no material impairments related to these assets.

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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):

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	Carrying Value
Balance at September 30, 2014					
Assets					
U.S Treasury securities	$ 1	$—	$—	$1	$1
States and political subdivisions of states	—	10	—	10	10
Residential mortgage-backed securities - Agency	—	71	—	71	71
Held-to-maturity investment securities	$ 1	$81	$—	$82	$82
Cash and cash equivalents	$ 7,382	$—	$—	$7,382	$7,382
Restricted cash	$ 103	$—	$—	$103	$103
Net loan receivables[1]	$ —	$—	$66,744	$66,744	$65,574
Accrued interest receivables	$ —	$602	$—	$602	$602
Liabilities					
Deposits	$ —	$45,527	$—	$45,527	$45,382
Short-term borrowings	$ —	$139	$—	$139	$139
Long-term borrowings - owed to securitization investors	$ —	$14,894	$1,660	$16,554	$16,276
Other long-term borrowings	$ —	$5,181	$1	$5,182	$4,642
Accrued interest payables	$ —	$126	$—	$126	$126
Balance at December 31, 2013					
Assets					
U.S Treasury securities	$ 1	$—	$—	$1	$1
States and political subdivisions of states	—	14	—	14	15
Residential mortgage-backed securities - Agency	—	43	—	43	44
Held-to-maturity investment securities	$ 1	$57	$—	$58	$60
Cash and cash equivalents	$ 6,554	$—	$—	$6,554	$6,554
Restricted cash	$ 182	$—	$—	$182	$182
Net loan receivables[1]	$ —	$—	$64,968	$64,968	$63,975
Accrued interest receivables	$ —	$556	$—	$556	$556
Liabilities					
Deposits	$ —	$45,231	$—	$45,231	$44,959
Short-term borrowings	$ —	$140	$—	$140	$140
Long-term borrowings - owed to securitization investors	$ —	$15,312	$1,971	$17,283	$16,986
Other long-term borrowings	$ —	$3,934	$1	$3,935	$3,488
Accrued interest payables	$ —	$117	$—	$117	$117

(1) Net loan receivables exclude mortgage loans held for sale that are measured at fair value on a recurring basis.

The fair values of these financial assets and liabilities, which are not carried at fair value on the condensed consolidated statements of financial condition, were determined by applying the fair value provisions discussed herein. The use of different assumptions or estimation techniques may have a material effect on these estimated fair value amounts. The following describes the valuation techniques of these financial instruments measured at other than fair value.

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Cash and Cash Equivalents

The carrying value of cash and cash equivalents approximates fair value due to the low level of risk these assets present to the Company as well as the relatively liquid nature of these assets, particularly given their short maturities.

Restricted Cash

The carrying value of restricted cash approximates fair value due to the low level of risk these assets present to the Company as well as the relatively liquid nature of these assets, particularly given their short maturities.

Held-to-Maturity Investment Securities

Held-to-maturity investment securities consist of residential mortgage-backed securities issued by agencies and municipal bonds. The fair value of residential mortgage-backed securities included in the held-to-maturity portfolio is estimated similarly to residential mortgage-backed securities carried at fair value on a recurring basis discussed herein. Municipal bonds are valued based on quoted market prices for the same or similar securities.

Net Loan Receivables

The Company's loan receivables are comprised of credit card and installment loans, including the PCI student loans. Fair value estimates are derived utilizing discounted cash flow analyses, the calculations of which are performed on groupings of loan receivables that are similar in terms of loan type and characteristics. Inputs to the cash flow analysis of each grouping consider recent pre-payment and interest accrual trends and leverage forecasted loss estimates. The expected future cash flows, derived through the cash flow analysis, of each grouping are discounted at rates at which similar loans within each grouping could be originated under current market conditions. Significant inputs to the fair value measurement of the loan portfolio are unobservable, and as such are classified as Level 3.

Accrued Interest Receivables

The carrying value of accrued interest receivable, which is included in other assets on the statement of financial condition, approximates fair value as it is short term in nature and is due in less than one year.

Deposits

The carrying values of money market deposits, savings deposits and demand deposits approximate fair value due to the potentially liquid nature of these deposits. For time deposits for which readily available market rates do not exist, fair values are estimated by discounting expected future cash flows using market rates currently offered for deposits with similar remaining maturities.

Short-Term Borrowings

The carrying values of short-term borrowings approximate fair value as they are short term in nature and have maturities of less than one year.

Long-Term Borrowings - Owed to Securitization Investors

Fair values of long-term borrowings owed to credit card securitization investors are determined utilizing quoted market prices of the same transactions and, as such, are classified as Level 2. Fair values of long-term borrowings owed to student loan securitization investors are calculated by discounting cash flows using estimated assumptions including, among other things, maturity and market discount rates. A portion of the difference between the carrying value and the fair value of the long-term borrowings owed to student loan securitization investors relates to purchase accounting adjustments recorded in connection with the December 2010 purchase of SLC. Significant inputs to these fair value measurements are unobservable and, as such, are classified as Level 3.

Other Long-Term Borrowings

Fair values of other long-term borrowings, consisting of subordinated debt and unsecured debt, are determined utilizing current observable market prices for those transactions and, as such, are classified as Level 2. A portion of the difference between the carrying value and the fair value of the subordinated debt relates to the cash premiums paid in connection with the second and fourth quarter of the 2012 fiscal year debt exchanges as discussed in further detail in Note 6:

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Long-Term Borrowings. Fair values of other long-term borrowing for which there are no observable market transactions, namely capitalized leases, are determined by discounting cash flows of future interest accruals at market rates currently offered for borrowings with similar credit risks, remaining maturities and repricing terms. As the significant inputs to these fair value measurements are unobservable, they are classified as Level 3.

Accrued Interest Payables

The carrying value of the Company's accrued interest payable, which is included in other liabilities on the statement of financial condition, approximates fair value as it is short term in nature and is payable in less than one year.

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 interest rate movements and other identified risks 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 related to 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 and Disclosures for a description of the valuation methodologies of derivatives. Cash collateral posted and held balances are recorded in other assets and deposits, respectively, in the condensed consolidated statement of financial condition. Collateral amounts recorded in the condensed consolidated statement 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 fluctuations in foreign exchange rates on investments in foreign entities are referred to as net investment 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, and previously from interest receipts on credit card loan receivables. The Company's outstanding cash flow hedges are for an initial maximum period of five years for securitized debt and seven years for deposits. The Company's cash flow hedges related to credit card loan receivables were for an initial maximum period of three years, with none outstanding as of September 30, 2014. 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 effective portion of the change in the fair value of derivatives designated as cash flow hedges is recorded in other comprehensive income and is subsequently reclassified into earnings in the period that the hedged forecasted cash flows affect earnings. The ineffective portion of the change in fair value of the derivative, if any, is recognized directly in earnings. Amounts reported in accumulated other comprehensive income related to derivatives at September 30, 2014 will be reclassified to interest expense as interest payments are made on certain of the Company's floating rate securitized debt or deposits. During the next 12 months, the Company estimates it will reclassify $43 million of pretax losses to interest expense related to its derivatives designated as cash flow hedges.

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Net Investment Hedges

The Company is exposed to fluctuations in foreign exchange rates on investments it holds in foreign entities with a functional currency other than the U.S. dollar. The Company uses foreign exchange forward contracts to hedge its exposure to changes in foreign exchange rates on its net investment in Diners Club Italy. Foreign exchange forward contracts utilized by the Company involve fixing the U.S. dollar-euro exchange rate for delivery of a specified amount of foreign currency on a specified date. These derivatives are designated as net investment hedges, with the effective portion of changes in the fair value of the derivatives reported in other comprehensive income as part of the cumulative translation adjustment. The ineffective portion of the change in fair value of the derivatives, if any, is recognized directly in earnings. Amounts are reclassified out of accumulated other comprehensive income into earnings when the hedged net investment is either sold or substantially liquidated.

Fair Value Hedges

The Company is exposed to changes in fair value of certain 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 senior notes, securitized debt and interest-bearing brokered deposits attributable to changes in LIBOR, a benchmark interest rate 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 fixed rate senior notes, securitized debt and interest-bearing brokered deposits relating to the risk being hedged are recorded in interest expense. The changes generally provide substantial offset to one another, with any difference, or ineffectiveness, recorded in interest expense. Any basis differences between the fair value and the carrying amount of the hedged item at the inception of the hedging relationship are amortized to interest expense.

Derivatives Not Designated as Hedges

Interest Rate Swaps

The Company may have, from time to time, interest rate swap agreements that are not designated as hedges. As part of its acquisition of SLC, the Company also acquired an interest rate swap related to the securitized debt assumed in the transaction. Such agreements are not speculative and are also used to manage interest rate risk but are not designated for hedge accounting. Changes in the fair value of these contracts are recorded in other income.

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.

Forward Delivery Contracts

The Company economically hedges the changes in fair value of IRLCs and mortgage loans held for sale caused by changes in interest rates by using TBA MBS and entering into best-efforts forward delivery commitments. These derivative instruments are recorded at fair value with changes in fair value recorded in other income.

Interest Rate Lock Commitments

The Company enters into commitments with consumers to originate residential mortgage loans at a specified interest rate. The Company reports IRLCs that relate to the origination of mortgage loans that will be held for sale as derivative instruments at fair value with changes in fair value recorded in other income.

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

	September 30, 2014				December 31, 2013		
	Notional Amount	Number of Outstanding Derivative Contracts	Derivative Assets	Derivative Liabilities	Notional Amount	Derivative Assets	Derivative Liabilities
Derivatives designated as hedges:							
Interest rate swaps—cash flow hedge	$4,100	8	$16	$2	$2,650	$18	$—
Interest rate swaps—fair value hedge	$5,507	175	39	6	$7,138	52	6
Foreign exchange forward contract - net investment hedge(1)	$29	1	—	—	$35	—	—
Derivatives not designated as hedges:							
Foreign exchange forward contracts(2)	$49	8	—	—	$44	—	—
Interest rate swap(3)	$387	1	—	—	$796	—	—
Forward delivery contracts	$1,084	433	1	2	$693	5	1
Interest rate lock commitments(3)	$407	1,742	6	—	$235	4	—
Total gross derivative assets / liabilities(4)			62	10		79	7
Less: Collateral held/posted(5)			(49)	(10)		(61)	(7)
Total net derivative assets / liabilities			$13	$—		$18	$—

(1) The foreign exchange forward contract has a notional amount of EUR 23 million and EUR 26 million as of September 30, 2014 and December 31, 2013, respectively.

(2) The foreign exchange forward contracts have notional amounts of EUR 23 million, GBP 6 million, SGD 1 million and CHF 8 million as of September 30, 2014, and EUR 20 million, GBP 6 million, SGD 1 million and CHF 5 million as of December 31, 2013.

(3) Interest rate swaps not designated as hedges and interest rate lock commitments do not have associated master netting arrangements.

(4) In addition to the derivatives disclosed in the table, the Company had one outstanding forward contract to purchase when-issued mortgage-backed securities as part of the community reinvestment initiatives. This forward contract had a notional amount of $11 million and $40 million and immaterial fair values as of September 30, 2014 and December 31, 2013, respectively.

(5) 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.

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The following tables summarize the impact of the derivative instruments on income and other comprehensive income, and indicates where within the consolidated financial statements such impact is reported for the period (dollars in millions):

	Location	Amount of Gain (Loss) Recognized in Other Comprehensive Income			
		For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
		2014	2013	2014	2013
Derivatives designated as hedges:					
Interest rate swaps—cash flow/net investment hedges:					
Total gains (losses) recognized in other comprehensive income after amounts reclassified into earnings, pre-tax	Other Comprehensive Income	$23	$(13)	$—	$(1)
Total gains (losses) recognized in other comprehensive income		$23	$(13)	$—	$(1)

	Location	Amount of Gain (Loss) Recognized in Income			
		For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
		2014	2013	2014	2013
Derivatives designated as hedges:					
Interest rate swaps—cash flow hedges:					
Amount reclassified from other comprehensive income into income	Interest Income	$—	$—	$—	$4
Amount reclassified from other comprehensive income into income	Interest Expense	(11)	(5)	(26)	(6)
Total amount reclassified from other comprehensive income into income		(11)	(5)	(26)	(2)
Interest rate swaps—fair value hedges:					
Interest expense—ineffectiveness		(14)	12	(13)	(38)
Interest expense—other		9	10	29	30
(Loss) gain on interest rate swaps	Interest Expense	(5)	22	16	(8)
Interest expense—ineffectiveness		16	(10)	18	42
Interest expense—other		(2)	(1)	(1)	(4)
Gain (loss) on hedged item	Interest Expense	14	(11)	17	38
Total (losses) gains on derivatives designated as hedges recognized in income		$(2)	$6	$7	$28
Derivatives not designated as hedges:					
Gain (loss) on forward contracts	Other Income	$4	$(2)	$4	$(1)
Loss on interest rate swaps	Other Income	—	—	(1)	—
Gain (loss) on forward delivery contracts	Other Income	3	(18)	(4)	(3)
Gain on interest rate lock commitments	Other Income	18	24	61	105
		$25	$4	$60	$101

Total gains on derivatives not designated as
hedges recognized in 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, foreign exchange forward contracts and forward delivery 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

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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 not offset against the fair value of these derivatives, but are recorded separately in other assets or deposits.

As of September 30, 2014, DFS had a right to reclaim $4 million of cash collateral that had been posted (net of amounts required to be posted by the counterparty) because the credit rating of the Company did not meet specified thresholds. At September 30, 2014, Discover Bank's credit rating met specified thresholds set by its counterparties. However, if Discover Bank's credit rating is reduced by one ratings notch, Discover Bank would be required to post additional collateral, which would have been $97 million as of September 30, 2014.

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 and small businesses on the Discover Network and other consumer products and services, including private student loans, personal loans, home loans, home equity loans, prepaid cards 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 includes credit, debit and prepaid cards issued on the Discover Network by third parties. This segment also includes the business operations of Diners Club Italy, which primarily consist of issuing Diners Club charge cards. The majority of Payment Services revenues relate to transaction processing revenue from PULSE and royalty and licensee revenue (included in other income) 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 reporting 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.
- 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.

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

	Direct Banking	Payment Services	Total
For the Three Months Ended September 30, 2014			
Interest income			
Credit card	$1,613	$—	$1,613
Private student loans	80	—	