

Discover Financial Services
Form 10-Q
October 06, 2010
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended August 31, 2010

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
(State or other jurisdiction of incorporation or organization)

36-2517428
(I.R.S. Employer Identification No.)

2500 Lake Cook Road,

Riverwoods, Illinois 60015
(Address of principal executive offices, including zip code)

(224) 405-0900
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that

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the registrant was required to submit and post such files). Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

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

As of September 30, 2010, there were 544,589,409 shares of the registrant's Common Stock, par value \$0.01 per share, outstanding.

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DISCOVER FINANCIAL SERVICES

Quarterly Report on Form 10-Q

for the quarterly period ended August 31, 2010

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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® More® Card, Discover® MotivaSM Card, Discover® Open Road® Card, Discover® Network and Diners Club International®. All other trademarks, trade names and service marks included in this quarterly report on Form 10-Q are the property of their respective owners.

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

| | August 31, 2010 | November 30, 2009 (unaudited) |
|---|---|-------------------------------------|
| | (dollars in thousands, except per share amounts) | |
| Assets | | |
| Cash and cash equivalents | \$ 7,916,091 | \$ 13,020,719 |
| Restricted cash - special dividend escrow | | 643,311 |
| Restricted cash - for securitization investors | 691,698 | |
| Other short-term investments | 375,000 | 1,350,000 |
| Investment securities: | | |
| Available-for-sale (amortized cost of \$1,134,898 and \$2,743,729 at August 31, 2010 and November 30, 2009, respectively) | 1,151,689 | 2,645,481 |
| Held-to-maturity (fair value of \$73,029 and \$1,953,990 at August 31, 2010 and November 30, 2009, respectively) | 74,058 | 2,389,816 |
| Total investment securities | 1,225,747 | 5,035,297 |
| Loan receivables: | | |
| Student loans held for sale | 1,437,592 | |
| Loan portfolio: | | |
| Credit card - restricted for securitization investors | 34,789,458 | |
| Other credit card | 10,458,708 | 20,230,302 |
| Total credit card loan receivables | 45,248,166 | 20,230,302 |
| Other | 3,444,906 | 3,394,782 |
| Total loan portfolio | 48,693,072 | 23,625,084 |
| Total loan receivables | 50,130,664 | 23,625,084 |
| Allowance for loan losses | (3,743,721) | (1,757,899) |
| Net loan receivables | 46,386,943 | 21,867,185 |
| Amounts due from asset securitization | | 1,692,051 |
| Premises and equipment, net | 456,943 | 499,303 |
| Goodwill | 255,421 | 255,421 |
| Intangible assets, net | 190,639 | 195,636 |
| Other assets | 2,559,071 | 1,462,064 |
| Total assets | \$ 60,057,553 | \$ 46,020,987 |
| Liabilities and Stockholders' Equity | | |
| Deposits: | | |
| Interest-bearing deposit accounts | \$ 34,148,932 | \$ 32,028,506 |
| Non-interest bearing deposit accounts | 97,872 | 64,506 |
| Total deposits | 34,246,804 | 32,093,012 |
| Long-term borrowings: | | |
| Long-term borrowings - owed to securitization investors | 14,869,265 | |

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| | | |
|---|----------------------|----------------------|
| Other long-term borrowings | 2,839,488 | 2,428,101 |
| Total long-term borrowings | 17,708,753 | 2,428,101 |
| Special dividend Morgan Stanley | | 808,757 |
| Accrued expenses and other liabilities | 1,990,699 | 2,255,570 |
| | | |
| Total liabilities | 53,946,256 | 37,585,440 |
| Commitments, contingencies and guarantees (Note 13) | | |
| Stockholders' Equity: | | |
| Preferred stock, par value \$.01 per share; 200,000,000 shares authorized, 0 and 1,224,558 shares issued and outstanding at August 31, 2010 and November 30, 2009, respectively | | 1,158,066 |
| Common stock, par value \$.01 per share; 2,000,000,000 shares authorized; 546,991,067 and 544,799,041 shares issued at August 31, 2010 and November 30, 2009, respectively | 5,470 | 5,448 |
| Additional paid-in capital | 3,428,089 | 3,573,231 |
| Retained earnings | 2,787,822 | 3,873,262 |
| Accumulated other comprehensive loss | (82,297) | (154,818) |
| Treasury stock, at cost; 2,440,632 and 1,876,795 shares at August 31, 2010 and November 30, 2009, respectively | (27,787) | (19,642) |
| | | |
| Total stockholders' equity | 6,111,297 | 8,435,547 |
| | | |
| Total liabilities and stockholders' equity | \$ 60,057,553 | \$ 46,020,987 |

See Notes to the Condensed Consolidated Financial Statements.

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

| | For the Three Months Ended August 31, 2010 | | For the Nine Months Ended August 31, 2010 | |
|--|---|-------------------|--|-------------------|
| | 2010 | 2009 | 2010 | 2009 |
| | (unaudited) | | | |
| | (dollars in thousands, except per share amounts) | | | |
| Interest income: | | | | |
| Credit card loans | \$ 1,455,907 | \$ 761,477 | \$ 4,423,654 | \$ 2,276,152 |
| Other loans | 67,588 | 43,397 | 183,150 | 119,271 |
| Investment securities | 5,574 | 18,062 | 15,966 | 51,606 |
| Other interest income | 6,870 | 10,281 | 24,101 | 59,965 |
| Total interest income | 1,535,939 | 833,217 | 4,646,871 | 2,506,994 |
| Interest expense: | | | | |
| Deposits | 279,137 | 289,518 | 882,921 | 894,767 |
| Short-term borrowings | | 10 | | 2,538 |
| Long-term borrowings | 110,000 | 14,873 | 324,561 | 39,821 |
| Total interest expense | 389,137 | 304,401 | 1,207,482 | 937,126 |
| Net interest income | 1,146,802 | 528,816 | 3,439,389 | 1,569,868 |
| Provision for loan losses | 712,565 | 380,999 | 2,824,035 | 1,962,673 |
| Net interest income after provision for loan losses | 434,237 | 147,817 | 615,354 | (392,805) |
| Other income: | | | | |
| Securitization income | | 567,288 | | 1,310,435 |
| Discount and interchange revenue | 273,932 | 51,641 | 805,209 | 208,802 |
| Fee products | 104,132 | 78,875 | 309,590 | 228,899 |
| Loan fee income | 92,465 | 75,528 | 267,483 | 195,843 |
| Transaction processing revenue | 40,184 | 31,839 | 109,570 | 93,309 |
| Merchant fees | 7,220 | 10,716 | 23,091 | 35,289 |
| Gain (loss) on investment securities | 18,951 | (7,422) | 19,131 | (9,239) |
| Antitrust litigation settlement | | 472,167 | | 1,419,783 |
| Other income | 27,260 | 35,328 | 88,790 | 103,915 |
| Total other income | 564,144 | 1,315,960 | 1,622,864 | 3,587,036 |
| Other expense: | | | | |
| Employee compensation and benefits | 204,210 | 208,528 | 602,510 | 636,167 |
| Marketing and business development | 130,532 | 77,814 | 313,175 | 292,169 |
| Information processing and communications | 62,357 | 67,679 | 190,862 | 217,017 |
| Professional fees | 85,289 | 83,746 | 239,169 | 228,419 |
| Premises and equipment | 17,722 | 18,437 | 53,273 | 54,732 |
| Other expense | 66,128 | 67,634 | 155,601 | 215,085 |
| Total other expense | 566,238 | 523,838 | 1,554,590 | 1,643,589 |
| Income before income tax expense | 432,143 | 939,939 | 683,628 | 1,550,642 |
| Income tax expense | 171,526 | 362,485 | 268,482 | 626,994 |
| Net income | \$ 260,617 | \$ 577,454 | \$ 415,146 | \$ 923,648 |
| Net income allocated to common stockholders | \$ 258,194 | \$ 552,928 | \$ 321,613 | \$ 876,506 |
| Basic earnings per share | \$ 0.47 | \$ 1.08 | \$ 0.59 | \$ 1.78 |

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|--|----|------|----|------|----|------|----|------|
| Diluted earnings per share | \$ | 0.47 | \$ | 1.07 | \$ | 0.58 | \$ | 1.78 |
| Dividends paid per share of common stock | \$ | 0.02 | \$ | 0.02 | \$ | 0.06 | \$ | 0.10 |

See Notes to the Condensed Consolidated Financial Statements.

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

| | Preferred Stock | | Common Stock | | | Additional Paid-in Capital (unaudited) | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Total Stockholders Equity |
|--|-----------------|--------------|--------------|----------|--------------|---|----------------------|---|-------------------|---------------------------------|
| | Shares | Amount | Shares | Amount | Amount | | | | | |
| (dollars and shares in thousands) | | | | | | | | | | |
| Balance at November 30, 2008 | | \$ | 480,517 | \$ 4,805 | \$ 2,938,657 | \$ 3,046,956 | \$ | (66,338) | \$ (8,257) | \$ 5,915,823 |
| Adoption of the measurement date provision of ASC 715 (FASB Statement No. 158), net of tax | | | | | | | (1,110) | | | (1,110) |
| Comprehensive income: | | | | | | | | | | |
| Net income | | | | | | | 923,648 | | | 923,648 |
| Adjustments related to investment securities, net of tax | | | | | | | | 41,605 | | |
| Adjustment related to pension and postretirement benefits, net of tax | | | | | | | | (239) | | |
| Other comprehensive income | | | | | | | | 41,366 | | 41,366 |
| Total comprehensive income | | | | | | | | | | 965,014 |
| Purchase of treasury stock | | | | | | | | | (10,348) | (10,348) |
| Common stock issued under employee benefit plans | | | 99 | 1 | 913 | | | | | 914 |
| Common stock issued and stock-based compensation expense | | | 3,885 | 40 | 33,803 | 120 | | | | 33,963 |
| Income tax deficiency on stock-based compensation plans | | | | | (18,494) | | | | | (18,494) |
| Issuance of common stock | | | 60,054 | 600 | 533,240 | | | | | 533,840 |
| Dividends paid common stock | | | | | | | (48,885) | | | (48,885) |
| Issuance of preferred stock | 1,225 | 1,148,691 | | | 75,867 | | | | | 1,224,558 |
| Accretion of preferred stock discount | | 6,048 | | | | | (6,048) | | | |
| Dividends preferred stock | | | | | | | (28,573) | | | (28,573) |
| Special dividend Morgan Stanley | | | | | | | (180,500) | | | (180,500) |
| Balance at August 31, 2009 | 1,225 | \$ 1,151,739 | 544,555 | \$ 5,446 | \$ 3,563,986 | \$ 3,705,608 | \$ | (24,972) | \$ (18,605) | \$ 8,386,202 |
| Balance at November 30, 2009 | 1,225 | \$ 1,158,066 | 544,799 | \$ 5,448 | \$ 3,573,231 | \$ 3,873,262 | \$ | (154,818) | \$ (19,642) | \$ 8,435,547 |
| Adoption of ASC 810 (FASB Statement No. 167), net of tax | | | | | | | (1,411,117) | 78,561 | | (1,332,556) |
| Comprehensive income: | | | | | | | | | | |
| Net income | | | | | | | 415,146 | | | 415,146 |
| Adjustments related to investment securities, net of tax | | | | | | | | (6,276) | | |
| Adjustments related to cash flow hedges, net of tax | | | | | | | | 158 | | |
| Adjustments related to pension and postretirement benefits, net of tax | | | | | | | | 78 | | |
| Other comprehensive loss | | | | | | | | (6,040) | | (6,040) |
| Total comprehensive income | | | | | | | | | | 409,106 |
| Purchase of treasury stock | | | | | | | | | (8,145) | (8,145) |
| Common stock issued under employee benefit plans | | | 67 | 1 | 867 | | | | | 868 |

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| | | | | |
|--|---------|-------------|--------------|--------------|
| Common stock issued and stock based compensation expense | 2,125 | 21 | 29,402 | 29,423 |
| Income tax deficiency on stock-based compensation plans | | | (3,411) | (3,411) |
| Dividends paid - common stock | | | (32,923) | (32,923) |
| Accretion of preferred stock discount | 66,492 | | (66,492) | |
| Dividends - preferred stock | | | (23,811) | (23,811) |
| Redemption of preferred stock | (1,225) | (1,224,558) | | (1,224,558) |
| Repurchase of stock warrant | | | (172,000) | (172,000) |
| Special dividend - Morgan Stanley | | | 33,757 | 33,757 |
| Balance at August 31, 2010 | \$ | 546,991 | \$ 5,470 | \$ 3,428,089 |
| | | | \$ 2,787,822 | \$ (82,297) |
| | | | | \$ (27,787) |
| | | | | \$ 6,111,297 |

See Notes to Condensed Consolidated Financial Statements.

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

| | For the Nine Months Ended August 31, | |
|---|---|-------------|
| | 2010 | 2009 |
| | (unaudited) | |
| | (dollars in thousands) | |
| Cash flows from operating activities | | |
| Net income | \$ 415,146 | \$ 923,648 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Net principal disbursed on loans originated for sale | (147,058) | |
| Proceeds from sale of loans originated for sale | 28,501 | |
| (Gain) loss on sale of student loans | (439) | |
| (Gain) loss on investment securities | (19,131) | 9,239 |
| Loss on disposal of equipment | 1,930 | 377 |
| Stock-based compensation expense | 29,554 | 34,877 |
| Income tax deficiency on stock-based compensation expense | (3,411) | (18,494) |
| Deferred income taxes | 63,131 | (124,460) |
| Depreciation and amortization on premises and equipment | 68,130 | 73,391 |
| Other depreciation and amortization | 57,947 | 94,199 |
| Amortization of deferred revenues | (137,492) | (109,761) |
| Provision for loan losses | 2,824,035 | 1,962,673 |
| Changes in assets and liabilities: | | |
| (Increase) decrease in amounts due from asset securitization | | 296,817 |
| (Increase) decrease in other assets | (230,385) | (90,970) |
| Increase (decrease) in accrued expenses and other liabilities | (243,696) | (455,387) |
| Net cash provided by operating activities | 2,706,762 | 2,596,149 |
| Cash flows from investing activities | | |
| Maturities of other short-term investments | 1,350,000 | |
| Purchases of other short-term investments | (375,000) | |
| Maturities of available-for-sale investment securities | 540,526 | 150,520 |
| Purchases of available-for-sale investment securities | (1,239,631) | (478,888) |
| Maturities of held-to-maturity investment securities | 19,779 | 59,056 |
| Purchases of held-to-maturity investment securities | (549) | (1,269) |
| Net principal disbursed on loans held for investment | (2,035,023) | (5,652,206) |
| Proceeds from securitization | | 2,246,100 |
| Decrease (increase) in restricted cash special dividend escrow | 643,311 | (502,292) |
| Decrease in restricted cash for securitization investors | 547,064 | |
| Proceeds from sale of equipment | 146 | 1,247 |
| Purchases of premises and equipment | (29,538) | (41,653) |
| Net cash used for investing activities | (578,915) | (4,219,385) |
| Cash flows from financing activities | | |
| Proceeds from issuance of preferred stock | | 1,148,691 |
| Redemption of preferred stock | (1,224,558) | |
| Proceeds from issuance of warrant | | 75,867 |
| Repurchase of warrant | (172,000) | |
| Proceeds from issuance of securitized debt | 1,000,000 | |
| Maturities of securitized debt | (8,560,528) | |
| Proceeds from issuance of other long-term borrowings | 1,003,427 | 400,000 |
| Net (decrease) in short-term borrowings | | (500,000) |
| Maturities of other long-term borrowings | (590,676) | (339,298) |
| Proceeds from issuance of common stock | | 533,840 |
| Purchase of treasury stock | (8,145) | (10,348) |
| Net increase in deposits | 1,177,096 | 1,046,320 |
| Proceeds from acquisition of deposits | 976,627 | |
| Dividend paid to Morgan Stanley | (775,000) | |

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|---|--------------|---------------|
| Dividends paid on common and preferred stock | (59,455) | (74,737) |
| Excess tax benefits related to stock-based compensation | 737 | |
| Net cash (used for) provided by financing activities | (7,232,475) | 2,280,335 |
| Net (decrease) increase in cash and cash equivalents | (5,104,628) | 657,099 |
| Cash and cash equivalents, at beginning of period | 13,020,719 | 10,171,143 |
| Cash and cash equivalents, at end of period | \$ 7,916,091 | \$ 10,828,242 |

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

| | | |
|---|--------------|--------------|
| Cash paid during the period for: | | |
| Interest expense | \$ 1,125,181 | \$ 929,542 |
| Income taxes, net of income tax refunds | \$ 112,027 | \$ 531,826 |
| Non-cash transactions: | | |
| Special dividend Morgan Stanley | \$ 33,757 | \$ (180,500) |
| Acquisition of certificated beneficial interests in DCENT and DCMT, net of maturities | \$ | \$ 1,647,783 |

See Notes to the Condensed Consolidated Financial Statements.

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

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

Basis of Presentation. The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the financial statements reflect all adjustments which are necessary for a fair presentation of the results for the quarter. All such adjustments are of a normal, recurring nature. The preparation of financial statements in conformity with GAAP requires the Company to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and related disclosures. These estimates are based on information available as of the date of the condensed consolidated financial statements. The Company believes that the estimates used in the preparation of the condensed consolidated financial statements are reasonable. Actual results could differ from these estimates. These interim condensed consolidated financial statements should be read in conjunction with the Company's 2009 audited consolidated financial statements filed with the Company's annual report on Form 10-K for the year ended November 30, 2009.

Recently Issued Accounting Pronouncements

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

In July 2010, the FASB issued ASU No. 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. ASU No. 2010-20 requires a greater level of disaggregation in disclosures relating to the credit quality of the Company's financing receivables and allowance for loan losses. Furthermore, ASU 2010-20 also requires enhanced disclosures around nonaccrual and past due financing receivables, impaired loans and loan modifications. The standard is effective for the first interim or annual reporting periods ending on or after December 15, 2010, and will apply beginning with the Company's Form 10-Q for the quarter ending February 28, 2011.

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In January 2010, the FASB issued ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. ASU 2010-06 revises two disclosure requirements concerning fair value measurements and clarifies two others. It requires separate presentation of significant transfers into and out of Levels 1 and 2 of the fair value hierarchy and disclosure of the reasons for such transfers. It will also require the presentation of purchases, sales, issuances and settlements within Level 3 on a gross basis rather than a net basis. The amendments also clarify that disclosures should be disaggregated by class of asset or liability and that disclosures about inputs and valuation techniques should be provided for both recurring and non-recurring fair value measurements. The Company's disclosures about fair value measurements, including the new disclosures which were applicable to the Company beginning in the second quarter 2010, are presented in Note 15: Fair Value Disclosures. The disclosures concerning gross presentation of Level 3 activity are effective for fiscal years beginning after December 15, 2010.

In December 2008, the FASB issued FASB Staff Position No. FAS 132(R)-1, *Employers' Disclosures about Postretirement Benefit Plan Assets* (codified within Accounting Standards Codification (ASC) Topic 715, *Compensation-Retirement Benefits*). This standard provides guidance on an employer's disclosures about plan assets of a defined benefit pension or other postretirement plan. Required disclosures include a description of how investment allocation decisions are made, the inputs and valuation techniques used to measure the fair value of plan assets and significant concentrations of risk. The standard is effective for fiscal years ending after December 15, 2009 and will first apply to the Company's Form 10-K for the year ending November 30, 2010.

2. Change in Accounting Principle

In June 2009, the FASB issued Statement of Financial Accounting Standards No. 166, *Accounting for Transfers of Financial Assets-an amendment of FASB Statement No. 140* (Statement No. 166, codified within ASC Topic 860, *Transfers and Servicing*) and Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)* (Statement No. 167, codified within ASC Topic 810, *Consolidation*).

Statement No. 166 amended the accounting for transfers of financial assets. Under Statement No. 166, the trusts used in the Company's securitization transactions are no longer exempt from consolidation. Statement No. 167 prescribes an ongoing assessment of the Company's involvement in the activities of the trusts and the Company's rights or obligations to receive benefits or absorb losses of the trusts that could be potentially significant in order to determine whether those variable interest entities (VIEs) will be required to be consolidated in the Company's financial statements. In accordance with Statement No. 167, the Company concluded it is the primary beneficiary of the Discover Card Master Trust I (DCMT) and the Discover Card Execution Note Trust (DCENT) (the trusts) and accordingly, the Company began consolidating the trusts on December 1, 2009. Using the carrying amounts of the trust assets and liabilities as prescribed by Statement No. 167, the Company recorded a \$21.1 billion increase in total assets, a \$22.4 billion increase in total liabilities and a \$1.3 billion decrease in stockholders' equity (comprised of a \$1.4 billion decrease in retained earnings offset by a \$0.1 billion increase in accumulated other comprehensive income). These amounts were comprised of the following transition adjustments, which were treated as noncash activities for purposes of preparing the condensed consolidated statement of cash flows:

Consolidation of \$22.3 billion of securitized loan receivables and the related debt issued from the trusts to third-party investors;

Consolidation of \$0.1 billion of cash collateral accounts and the associated debt issued from the trusts;

Reclassification of \$2.3 billion of held-to-maturity investment securities to loan receivables;

Reclassification of \$2.3 billion of available-for-sale investment securities to loan receivables and reversal of \$0.1 billion, net of tax, of related unrealized losses previously recorded in other comprehensive income;

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Recording of a \$2.1 billion allowance for loan losses, not previously required under GAAP, for the newly consolidated and reclassified credit card loan receivables;

Reversal of all amounts recorded in amounts due from asset securitization through (i) derecognition of the remaining \$0.1 billion value of the interest-only strip receivable, net of tax, (ii) reclassification of \$0.8 billion of cash collateral accounts and \$0.3 billion of accumulated collections to restricted cash, (iii) reclassification of \$0.2 billion to unbilled accrued interest receivable, and (iv) reclassification of \$0.3 billion of billed accrued interest receivable to loan receivables; and

Recording of net deferred tax assets of \$0.8 billion, largely related to establishing an allowance for loan losses on the newly consolidated and reclassified credit card loan receivables.

The assets of the consolidated VIEs include restricted cash and certain credit card loan receivables, which are restricted to settle the obligations of those entities and are not expected to be available to the Company or its creditors. Liabilities of the consolidated VIEs include secured borrowings for which creditors or beneficial interest holders do not have recourse to the general credit of the Company.

The Company's statements of income for the three months and nine months ended August 31, 2010 no longer reflect securitization income, but instead report interest income, net charge-offs and certain other income associated with all securitized loan receivables, and interest expense associated with debt issued from the trusts to third-party investors, in the same line items in the Company's statement of income as non-securitized credit card loan receivables and corporate debt. Additionally, the Company no longer records initial gains on new securitization activity since securitized credit card loans no longer receive sale accounting treatment. Also, there are no gains or losses recorded on the revaluation of the interest-only strip receivable as that asset is not recognizable in a transaction accounted for as a secured borrowing. Because the Company's securitization transactions are accounted for under the new accounting rules as secured borrowings rather than asset sales, the cash flows from these transactions are presented as cash flows from financing activities rather than as cash flows from operating or investing activities.

The Company's statement of income for the three and nine months ended August 31, 2009 and its statement of financial condition as of November 30, 2009 have not been retrospectively adjusted to reflect Statements No. 166 and 167. Therefore, current period results and balances will not be comparable to prior period amounts, particularly with regard to the following (and their related subtotals):

Investment securities;

Loan receivables (and the related delinquencies, charge-offs, and allowance and provision for loan losses);

Certain securitization assets recorded under prior GAAP;

Long-term borrowings;

Interest income;

Interest expense;

Other income; and

Earnings per share.

Table of Contents**3. Investment Securities**

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

| | August 31, 2010 | November 30, 2009 |
|--|--------------------|----------------------|
| U.S. Treasury securities | \$ 1,552 | \$ |
| U.S. government agency securities | 1,004 | |
| States and political subdivisions of states | 51,759 | 68,553 |
| Other securities: | | |
| Certificated retained interests in DCENT and DCMT ⁽¹⁾ | | 4,501,108 |
| Credit card asset-backed securities of other issuers | 1,149,666 | 381,705 |
| Asset-backed commercial paper notes | | 58,792 |
| Residential mortgage-backed securities | 10,630 | 12,929 |
| Other debt and equity securities | 11,136 | 12,210 |
| Total other securities | 1,171,432 | 4,966,744 |
| Total investment securities | \$ 1,225,747 | \$ 5,035,297 |

(1) Upon adoption of Statements No. 166 and 167 on December 1, 2009, the amount outstanding at November 30, 2009 was reclassified to loan receivables. See Note 2: Change in Accounting Principle for more information.

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

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|-------------------|------------------------------|-------------------------------|--------------|
| At August 31, 2010 | | | | |
| Available-for-Sale Investment Securities ⁽¹⁾ | | | | |
| Credit card asset-backed securities of other issuers | \$ 1,132,877 | \$ 16,807 | \$ (18) | \$ 1,149,666 |
| Equity securities | 15 | 2 | | 17 |
| U.S. government agency securities | 1,004 | | | 1,004 |
| U.S. Treasury securities | 1,002 | | | 1,002 |
| Total available-for-sale investment securities | \$ 1,134,898 | \$ 16,809 | \$ (18) | \$ 1,151,689 |
| Held-to-Maturity Investment Securities ⁽²⁾ | | | | |
| U.S. Treasury securities ⁽³⁾ | \$ 550 | \$ | \$ | \$ 550 |
| States and political subdivisions of states | 51,759 | 441 | (2,375) | 49,825 |
| Residential mortgage-backed securities | 10,630 | 905 | | 11,535 |
| Other debt securities ⁽⁴⁾ | 11,119 | | | 11,119 |
| Total held-to-maturity investment securities | \$ 74,058 | \$ 1,346 | \$ (2,375) | \$ 73,029 |
| At November 30, 2009 | | | | |
| Available-for-Sale Investment Securities ⁽¹⁾ | | | | |
| Certificated retained interests in DCENT | \$ 2,330,000 | \$ 978 | \$ (126,009) | \$ 2,204,969 |
| Credit card asset-backed securities of other issuers | 362,377 | 19,362 | (34) | 381,705 |
| Asset-backed commercial paper notes | 51,337 | 7,455 | | 58,792 |

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| | | | |
|---|--------------|-----------|---------------------------|
| Equity securities | 15 | | 15 |
| Total available-for-sale investment securities | \$ 2,743,729 | \$ 27,795 | \$ (126,043) \$ 2,645,481 |
| Held-to-Maturity Investment Securities⁽²⁾ | | | |
| Certificated retained interests in DCENT and DCMT | \$ 2,296,139 | \$ | \$ (430,655) \$ 1,865,484 |
| States and political subdivisions of states | 68,553 | 19 | (6,162) 62,410 |
| Residential mortgage-backed securities | 12,929 | 972 | 13,901 |
| Other debt securities ⁽⁴⁾ | 12,195 | | 12,195 |
| Total held-to-maturity investment securities | \$ 2,389,816 | \$ 991 | \$ (436,817) \$ 1,953,990 |

(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 U.S. Treasury securities pledged as collateral to a government-related merchant for which transaction settlement occurs beyond the normal 24-hour period.

(4) Included in other debt securities at August 31, 2010 and November 30, 2009 are commercial advances of \$8.3 million and \$9.4 million, respectively, related to the Company's Community Reinvestment Act strategies.

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At August 31, 2010, the Company had 13 investments in credit card asset-backed securities of other issuers and 3 investments in state and political subdivisions of states in an unrealized loss position. The following table provides information about investment securities with aggregate gross unrealized losses and the length of time that individual investment securities have been in a continuous unrealized loss position as of August 31, 2010 and November 30, 2009 (dollars in thousands):

| | Less than 12 months | | More than 12 months | |
|--|---------------------|-------------------|---------------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| At August 31, 2010 | | | | |
| Available-for-Sale Investment Securities | | | | |
| Credit card asset-backed securities of other issuers | \$ 117,404 | \$ (18) | \$ | \$ |
| Held-to-Maturity Investment Securities | | | | |
| State and political subdivisions of states | \$ | \$ | \$ 28,760 | \$ (2,375) |
| At November 30, 2009 | | | | |
| Available-for-Sale Investment Securities | | | | |
| Certificated retained interests in DCENT | \$ 1,149,143 | \$ (115,857) | \$ 889,848 | \$ (10,152) |
| Credit card asset-backed securities of other issuers | \$ 127,509 | \$ (34) | \$ | \$ |
| Held-to-Maturity Investment Securities | | | | |
| Certificated retained interests in DCENT and DCMT | \$ 1,865,484 | \$ (430,655) | \$ | \$ |
| State and political subdivisions of states | \$ | \$ | \$ 51,778 | \$ (6,162) |

During the nine months ended August 31, 2010 and 2009, the Company received \$560.3 million and \$209.6 million of proceeds related to maturities, redemptions or liquidation of investment securities, respectively. During the same periods, the Company had no sales of investment securities.

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. During the three and nine months ended August 31, 2010, the Company recorded losses of \$0.6 million and \$0.4 million, respectively, on other debt securities and a \$19.6 million pretax gain related to the liquidation of collateral supporting the asset-backed commercial paper notes of Golden Key U.S. LLC, which had invested in mortgage-backed securities. The investment was originally purchased in 2007 for \$120.1 million, subsequently written down to \$51.3 million and, in August 2010, liquidated for \$70.9 million. During the three and nine months ended August 31, 2009, the Company realized \$7.4 million and \$9.2 million of other than temporary impairment (OTTI), which was recorded entirely in earnings, the majority of which was related to Golden Key. As of August 31, 2010 and November 30, 2009, no OTTI had been recorded in other comprehensive income.

The Company records unrealized gains and losses on its available-for-sale investment securities in other comprehensive income. For the nine months ended August 31, 2010 and 2009, the Company recorded net unrealized losses of \$2.5 million (\$1.6 million after tax) and \$66.1 million (\$41.6 million after tax), respectively, in other comprehensive income. For the nine months ended August 31, 2010, the Company reversed an unrealized gain of \$7.5 million (\$4.7 million after tax) from other comprehensive income upon liquidation of the collateral supporting the Golden Key investment. Additionally, the Company eliminated a net unrealized loss of \$125.0 million (\$78.6 million after tax) upon consolidation of its securitization trusts in connection with the adoption of Statements No. 166 and 167 on December 1, 2009.

At August 31, 2010, the Company had \$2.4 million of gross unrealized losses on its held-to-maturity investment securities in states and political subdivisions of states, compared to \$6.2 million of gross unrealized losses at November 30, 2009. The Company believes the unrealized loss on these investments is the result of changes in interest rates subsequent to the Company's acquisitions of these securities and that the reduction in value is temporary. The Company does not intend to sell these investments nor does it expect to be required to sell these investments before recovery of their amortized cost bases, but rather expects to collect all amounts due according to the contractual terms of these securities.

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Maturities of available-for-sale debt securities and held-to-maturity debt securities at August 31, 2010 are provided in the table below (dollars in thousands):

| | One Year or Less | After One Year Through Five Years | After Five Years Through Ten Years | After Ten Years | Total |
|--|------------------------|--|---|--------------------|---------------------|
| Available-for-sale Amortized Cost⁽¹⁾ | | | | | |
| Credit card asset-backed securities of other issuers | \$ 833,951 | \$ 298,926 | \$ | \$ | \$ 1,132,877 |
| U.S. government agency securities | 1,004 | | | | 1,004 |
| U.S. Treasury securities | 1,002 | | | | 1,002 |
| Total available-for-sale investment securities | \$ 835,957 | \$ 298,926 | \$ | \$ | \$ 1,134,883 |
| Held-to-maturity Amortized Cost⁽²⁾ | | | | | |
| U.S. Treasury securities | \$ 550 | \$ | \$ | \$ | \$ 550 |
| State and political subdivisions of states | | 2,905 | 5,630 | 43,224 | 51,759 |
| Residential mortgage-backed securities | | | | 10,630 | 10,630 |
| Other debt securities | 964 | 4,211 | 2,140 | 3,804 | 11,119 |
| Total held-to-maturity investment securities | \$ 1,514 | \$ 7,116 | \$ 7,770 | \$ 57,658 | \$ 74,058 |
| Available-for-sale Fair Value⁽¹⁾ | | | | | |
| Credit card asset-backed securities of other issuers | \$ 837,293 | \$ 312,373 | \$ | \$ | \$ 1,149,666 |
| U.S. government agency securities | 1,004 | | | | 1,004 |
| U.S. Treasury securities | 1,002 | | | | 1,002 |
| Total available-for-sale investment securities | \$ 839,299 | \$ 312,373 | \$ | \$ | \$ 1,151,672 |
| Held-to-maturity Fair Value⁽²⁾ | | | | | |
| U.S. Treasury securities | \$ 550 | \$ | \$ | \$ | \$ 550 |
| State and political subdivisions of states | | 3,005 | 5,835 | 40,985 | 49,825 |
| Residential mortgage-backed securities | | | | 11,535 | 11,535 |
| Other debt securities | 964 | 4,211 | 2,140 | 3,804 | 11,119 |
| Total held-to-maturity investment securities | \$ 1,514 | \$ 7,216 | \$ 7,975 | \$ 56,324 | \$ 73,029 |

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

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

Table of Contents**4. Loan Receivables**

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

| | August 31, 2010 | November 30, 2009 |
|--|--------------------|----------------------|
| Student loans held for sale | \$ 1,437,592 | \$ |
| Loan portfolio: | | |
| Credit card loans: | | |
| Discover card ^{(1) (2)} | 44,930,267 | 19,826,153 |
| Discover business card | 317,899 | 404,149 |
| Total credit card loans | 45,248,166 | 20,230,302 |
| Other consumer loans: | | |
| Personal loans | 1,706,873 | 1,394,379 |
| Federal student loans ⁽³⁾⁽⁴⁾ | 809,055 | 1,352,587 |
| Private student loans ⁽⁴⁾ | 880,854 | 579,679 |
| Other | 48,124 | 68,137 |
| Total other consumer loans | 3,444,906 | 3,394,782 |
| Total loan portfolio | 48,693,072 | 23,625,084 |
| Total loan receivables | 50,130,664 | 23,625,084 |
| Allowance for loan losses ⁽²⁾ | (3,743,721) | (1,757,899) |
| Net loan receivables | \$ 46,386,943 | \$ 21,867,185 |

(1) Amounts include \$19.4 billion underlying investors' interests in trust debt at August 31, 2010, and \$15.4 billion and \$9.9 billion in seller's interest at August 31, 2010 and November 30, 2009, respectively. See Note 5: Credit Card Securitization Activities for more information.

(2) Upon adoption of Statements No. 166 and 167 on December 1, 2009, the Company consolidated \$22.3 billion of securitized loan receivables, reclassified \$4.6 billion from investment securities to loan receivables and recorded a \$2.1 billion allowance for loan losses. See Note 2: Change in Accounting Principle for more information.

(3) Amount at August 31, 2010 includes \$490.2 million of student loan receivables, which, along with accrued interest of \$27.3 million, are pledged as collateral against a long-term borrowing.

(4) Federal student loans are guaranteed by the U.S. Department of Education. Private student loans are made directly to the student with no government guarantees.

Student loans held for sale, which are carried at the lower of cost or market, represent certain federal student loans eligible for sale at August 31, 2010 to the U.S. Department of Education. See Note 18: Subsequent Events.

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The following table provides changes in the Company's allowance for loan losses for the three and nine months ended August 31, 2010 and 2009 (dollars in thousands):

| | For the Three Months Ended August 31, | | For the Nine Months Ended August 31, | |
|---|--|---------------------|---|---------------------|
| | 2010 | 2009 | 2010 | 2009 |
| Balance at beginning of period | \$ 3,930,624 | \$ 1,986,473 | \$ 1,757,899 | \$ 1,374,585 |
| Addition to allowance related to securitized receivables ⁽¹⁾ | | | 2,144,461 | |
| Additions: | | | | |
| Provision for loan losses | 712,565 | 380,999 | 2,824,035 | 1,962,673 |
| Deductions: | | | | |
| Charge-offs: | | | | |
| Discover card | (982,920) | (541,272) | (3,203,959) | (1,560,820) |
| Discover business card | (14,502) | (18,400) | (50,190) | (43,671) |
| Total credit card loans | (997,422) | (559,672) | (3,254,149) | (1,604,491) |
| Personal loans | (23,836) | (20,920) | (70,957) | (46,186) |
| Federal student loans | (11) | | (308) | |
| Private student loans | (660) | (259) | (1,264) | (355) |
| Other | (139) | | (858) | (18) |
| Total other consumer loans | (24,646) | (21,179) | (73,387) | (46,559) |
| Total charge-offs | (1,022,068) | (580,851) | (3,327,536) | (1,651,050) |
| Recoveries: | | | | |
| Discover card | 121,255 | 45,214 | 341,337 | 144,901 |
| Discover business card | 875 | 272 | 2,516 | 602 |
| Total credit card loans | 122,130 | 45,486 | 343,853 | 145,503 |
| Personal loans | 421 | 231 | 942 | 615 |
| Federal student loans | | | | |
| Private student loans | 14 | | 22 | |
| Other | 35 | 22 | 45 | 34 |
| Total other consumer loans | 470 | 253 | 1,009 | 649 |
| Total recoveries | 122,600 | 45,739 | 344,862 | 146,152 |
| Net charge-offs | (899,468) | (535,112) | (2,982,674) | (1,504,898) |
| Balance at end of period | \$ 3,743,721 | \$ 1,832,360 | \$ 3,743,721 | \$ 1,832,360 |

(1) Upon adoption of Statements No. 166 and 167 on December 1, 2009, the Company recorded a \$2.1 billion allowance for loan losses related to newly consolidated and reclassified credit card loan receivables. See Note 2: Change in Accounting Principle for more information.

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

| | For the Three Months Ended August 31, | | For the Nine Months Ended August 31, | |
|---|--|------------|---|------------|
| | 2010 ⁽¹⁾ | 2009 | 2010 ⁽¹⁾ | 2009 |
| Interest accrued subsequently charged off, net of recoveries (recorded as a reduction to interest income) | \$ 219,422 | \$ 114,828 | \$ 723,909 | \$ 363,769 |
| Fees accrued subsequently charged off, net of recoveries (recorded as a reduction to other income) | \$ 58,331 | \$ 43,730 | \$ 228,039 | \$ 134,578 |

(1) The amounts at August 31, 2010 include securitized loans as a result of the consolidation of the securitization trusts upon adoption of Statement No. 166 and 167 on December 1, 2009. See Note 2: Change in Accounting Principle for more information.

The Company calculates its allowance for loan losses by estimating probable losses separately for segments of the loan portfolio with similar risk characteristics, which generally results in segmenting the portfolio by loan product type.

For its credit card loan receivables, the Company uses a migration analysis to estimate the likelihood that a loan receivable will progress through various stages of delinquency and eventually charge off. In the first quarter 2010, the Company developed analytics which provide a better understanding of the likelihood that current accounts, or those that are not delinquent, will eventually charge off. The Company used this information in combination with the migration analysis to determine its allowance for credit card loan losses at August 31, 2010. The Company does not identify individual loans for impairment, but instead estimates its allowance for credit card loan losses on a pooled basis, which includes loans that are delinquent and/or no longer accruing interest.

Loan receivables that have been modified under troubled debt restructurings are evaluated separately from the pool of receivables that is subject to the above analysis. Credit card loan receivables modified in a troubled debt restructuring are recorded at their present values with impairment measured as the difference between the loan balance and the discounted present value of cash flows expected to be collected. Changes in the present value are recorded to the provision for loan losses.

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

Information regarding nonaccrual, past due and restructured loan receivables is as follows (dollars in thousands):

| | August 31, 2010 ⁽¹⁾ | November 30, 2009 |
|---|-----------------------------------|----------------------|
| Loans not accruing interest | \$ 374,836 | \$ 190,086 |
| Loans over 90 days delinquent and accruing interest | \$ 928,521 | \$ 522,190 |
| Restructured loans ⁽²⁾ | \$ 284,561 | \$ 72,924 |

(1) The amounts at August 31, 2010 include securitized loans as a result of the consolidation of the securitization trusts upon adoption of Statement No. 166 and 167 on December 1, 2009. See Note 2: Change in Accounting Principle for more information.

(2) Restructured loans include \$37.3 million and \$9.7 million for the periods ended August 31, 2010 and November 30, 2009, respectively, that are also included in loans over 90 days delinquent and accruing interest.

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As part of certain collection strategies, the Company may place a customer's account in a permanent workout program under which the loan may be restructured, at which time the customer's future borrowing privileges are suspended. Therefore, the Company has no commitments to lend additional funds to customers in a permanent workout program. Such modifications are accounted for in accordance with ASC 310-40, *Troubled Debt Restructuring by Creditors*, under which loan impairment is measured based on the discounted present value of cash flows expected to be collected. All of the Company's permanent workout loans, which are evaluated collectively on an aggregated basis, had a related allowance for loan losses.

At August 31, 2010 and November 30, 2009, the Company had included \$104.6 million and \$28.0 million, respectively, in its allowance for loan losses for loans in its permanent workout program. Interest income on these loans 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 loans in the Company's permanent workout program is shown below (dollars in thousands):

| | For the Three Months Ended August 31, | | For the Nine Months Ended August 31, | |
|--|--|-----------|---|-----------|
| | 2010 ⁽¹⁾ | 2009 | 2010 ⁽¹⁾ | 2009 |
| Average recorded investment in loans | \$ 271,114 | \$ 85,290 | \$ 248,686 | \$ 80,715 |
| Interest income recognized during the time within the period these loans were impaired ⁽²⁾ | \$ 765 | \$ 252 | \$ 2,107 | \$ 715 |
| Gross interest income that would have been recorded in accordance with the original terms ⁽³⁾ | \$ 10,462 | \$ 2,971 | \$ 28,707 | \$ 7,854 |

- (1) The amounts at August 31, 2010 include securitized loans as a result of the consolidation of the securitization trusts upon adoption of Statement No. 166 and 167 on December 1, 2009. See Note 2: Change in Accounting Principle for more information.
- (2) The Company does not separately track interest income on loans in its permanent workout program. Amounts shown are estimated by applying an average interest rate to the average loans in the permanent workout program.
- (3) The Company does not separately track the gross interest income that would have been recorded if the loans in its permanent workout 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 credit card accounts and the average interest rate earned on loans in the permanent workout program to the average loans in the permanent workout program.

5. Credit Card Securitization Activities

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

The DCMT debt structure consists of Class A, triple-A rated certificates and Class B, single-A rated certificates held by third parties. Credit enhancement is provided by the subordinated Class B certificates, cash collateral accounts, and more subordinated Series 2009-CE certificates that are held by a wholly-owned subsidiary of Discover Bank. The DCENT debt structure consists of four classes of securities (DiscoverSeries Class A, B, C and D notes), with the most senior class generally receiving a triple-A rating. In this structure, in order to issue senior, higher rated classes of notes, it is necessary to obtain the appropriate amount of credit enhancement, generally through the issuance of junior, lower rated or more highly subordinated classes of notes. The majority of these more highly subordinated classes of notes are held by subsidiaries of Discover Bank. In addition, there is another series of certificates (Series 2009-SD) issued by DCMT which provides increased excess spread levels to all other outstanding securities of the trusts. The Series 2009-SD certificates are held by a wholly-owned subsidiary of Discover Bank. In January 2010, the Company increased the size of the Class D (2009-1) note and Series 2009-CE certificate to further support the more senior securities of the trusts. The Company was not contractually required to provide this incremental level of credit enhancement but was permitted to do so pursuant to the trusts' governing documents.

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Subsequent to November 30, 2009, the Company's securitizations are accounted for as secured borrowings and the trusts are treated as consolidated subsidiaries of the Company under ASC 810 and ASC 860. Accordingly, beginning on December 1, 2009, all of the assets and liabilities of the trusts are included directly on the Company's consolidated statement of financial condition. Trust receivables underlying third-party investors' interests are recorded in credit card loan receivables restricted for securitization investors, and the related debt issued by the trusts is reported in long-term borrowings owed to securitization investors. Additionally, beginning on December 1, 2009, certain other of the Company's retained interests in the assets of the trusts, principally consisting of investments in DCMT certificates and DCENT notes held by subsidiaries of Discover Bank, now constitute intercompany positions, which are eliminated in the preparation of the Company's consolidated statement of financial condition. Trust receivables underlying the Company's various retained interests, including the seller's interest in trust receivables, are recorded in credit card loan receivables restricted for securitization investors.

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

| | August 31, 2010 |
|---|----------------------------|
| Cash collateral accounts | \$ 510,790 |
| Collections and interest funding accounts | 180,908 |
| Restricted cash for securitization investors | 691,698 |
| Investors' interests held by third-party investors | 14,871,057 |
| Investors' interests held by wholly owned subsidiaries of Discover Bank | 4,511,478 |
| Seller's interest | 15,406,923 |
| Loan receivables restricted for securitization investors ⁽¹⁾ | 34,789,458 |
| Allowance for loan losses ⁽¹⁾ | (2,756,199) |
| Net loan receivables | 32,033,259 |
| Other | 24,170 |
| Carrying value of assets of consolidated variable interest entities | \$ 32,749,127 |

(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 statement of financial condition in accordance with GAAP.

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

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

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

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

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

In addition to performance measures associated with the transferred credit card loan receivables, there are other events or conditions which could trigger an early amortization event. As of August 31, 2010, no economic or other early amortization events have occurred.

The tables below provide information concerning investors' interests and related excess spreads at August 31, 2010 (dollars in thousands):

| | Investors Interests ⁽¹⁾ | # of Series Outstanding |
|---|---------------------------------------|----------------------------|
| Discover Card Master Trust I | \$ 8,443,987 | 12 |
| Discover Card Execution Note Trust (DiscoverSeries notes) | 10,938,548 | 19 |
| Total investors' interests | \$ 19,382,535 | 31 |

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

| | 3-Month Rolling Average Excess Spread ⁽¹⁾⁽²⁾⁽³⁾ |
|---|--|
| Group excess spread percentage | 12.86% |
| DiscoverSeries excess spread percentage | 12.28% |

(1) DCMT certificates refer to the higher of the Group excess spread (as shown above) or their applicable series excess spread in assessing whether an economic early amortization has been triggered. DiscoverSeries notes refer to the higher of the Group or DiscoverSeries excess spread (both of which are shown above) in assessing whether an economic early amortization has occurred.

(2) Discount Series (DCMT 2009-SD), which was issued in September 2009, makes principal collections available for reallocation to other series to cover shortfalls in interest and servicing fees and to reimburse charge-offs. Three-month rolling average excess spread rates reflect the availability of these additional collections.

(3) Excess spread rates used in determining economic early amortization events and other triggers are reflective of the performance of all outstanding investors interests, including subordinated interests held by wholly-owned subsidiaries of Discover Bank.

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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.

The following disclosures apply to securitization activities of the Company prior to December 1, 2009, when transfers of receivables to the trusts were treated as sales in accordance with prior GAAP. At November 30, 2009, the Company's retained interests in credit card securitizations were accounted for as follows (dollars in thousands):

| | November 30, 2009 |
|--|------------------------------|
| Available-for-sale investment securities | \$ 2,204,969 |
| Held-to-maturity investment securities | 2,296,139 |
| Loan receivables (seller's interest) | 9,852,352 |
| Amounts due from asset securitization: | |
| Cash collateral accounts ⁽²⁾ | 822,585 |
| Accrued interest receivable | 519,275 |
| Interest-only strip receivable | 117,579 |
| Other subordinated retained interests | 220,288 |
| Other | 12,324 |
| Amounts due from asset securitization | 1,692,051 |
| Total retained interests | \$ 16,045,511 |

(1) Loan receivables net of allowance for loan losses were \$9.1 billion at November 30, 2009.

(2) \$0.8 billion was pledged as security against a long-term borrowing.

Retained interests classified as available-for-sale investment securities at November 30, 2009 were carried at amounts that approximated fair value with changes in the fair value estimates recorded in other comprehensive income, net of tax. Retained interests classified as held-to-maturity investment securities were carried at amortized cost. All other retained interests in credit card asset securitizations were recorded in amounts due from asset securitization at amounts that approximated fair value.

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Key estimates and sensitivities of fair values reported at November 30, 2009 of certain retained interests to immediate 10% and 20% adverse changes in those estimates were as follows (dollars in millions):

| | November 30, 2009 |
|---|------------------------------|
| Interest-only receivable strip (carrying amount/fair value) | \$ 118 |
| Weighted average life (in months) | 3.5 |
| Weighted average payment rate (rate per month) | 18.70% |
| Impact on fair value of 10% adverse change | \$ (4) |
| Impact on fair value of 20% adverse change | \$ (7) |
| Weighted average principal charge-offs (rate per annum) | 9.91% |
| Impact on fair value of 10% adverse change | \$ (46) |
| Impact on fair value of 20% adverse change | \$ (81) |
| Weighted average discount rate (rate per annum) | 16.50% |
| Impact on fair value of 10% adverse change | \$ |
| Impact on fair value of 20% adverse change | \$ (1) |
| Cash collateral accounts (carrying amount/fair value) | \$ 823 |
| Weighted average discount rate (rate per annum) | 1.99% |
| Impact on fair value of 10% adverse change | \$ (3) |
| Impact on fair value of 20% adverse change | \$ (7) |
| Certificated retained beneficial interests reported as available-for-sale investment securities (carrying amount/fair value) | \$ 2,205 |
| Weighted average discount rate (rate per annum) | 6.58% |
| Impact on fair value of 10% adverse change | \$ (14) |
| Impact on fair value of 20% adverse change | \$ (27) |

The sensitivity analyses of the interest-only strip receivable, cash collateral accounts and certificated retained beneficial interests are hypothetical and should be used with caution. Changes in fair value based on a 10% or 20% variation in an estimate generally cannot be extrapolated because the relationship of the change in the estimate to the change in fair value may not be linear. Also, the effect of a variation in a particular estimate on the fair value of the interest-only strip receivable, specifically, is calculated independent of changes in any other estimate; in practice, changes in one factor may result in changes in another (for example, increases in market interest rates may result in lower payments and increased charge-offs), which might magnify or counteract the sensitivities. In addition, the sensitivity analyses do not consider any action that the Company may take to mitigate the impact of any adverse changes in the key estimates.

During the three and nine months ended August 31, 2009, the Company recognized a net revaluation of its subordinated retained interests, principally the interest-only strip receivable, consisting of a \$68.9 million gain and a \$122.3 million loss, respectively, in securitization income in the condensed consolidated statements of income. For the three and nine months ended August 31, 2009, the Company securitized \$1.5 billion and \$2.2 billion of receivables, which resulted in an initial gain of \$7.9 and \$8.8 million for the respective periods.

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The following table summarizes certain cash flow information related to the securitized pool of loan receivables (dollars in millions):

| | For the Three Months Ended August 31, 2009 | For the Nine Months Ended August 31, 2009 |
|--|--|---|
| Proceeds from third-party investors in new credit card securitizations | \$ 1,496 | \$ 2,246 |
| Proceeds from collections reinvested in previous credit card securitizations | \$ 11,964 | \$ 33,569 |
| Contractual servicing fees received | \$ 121 | \$ 358 |
| Cash flows received from retained interests | \$ 352 | \$ 1,349 |
| Purchases of previously transferred credit card loan receivables (securitization maturities) | \$ 1,382 | \$ 4,371 |

Key estimates used in measuring the fair value of the interest-only strip receivable at the date of securitization that resulted from credit card securitizations completed during the nine months ended August 31, 2009 were as follows:

| | For the Nine Months Ended August 31, 2009 | |
|--|---|--------|
| Weighted average life (in months) | 1.8 | 4.8 |
| Payment rate (rate per month) | 17.18% | 17.66% |
| Principal charge-offs (rate per annum) | 9.66% | 9.81% |
| Discount rate (rate per annum) | 16.00% | |

The tables below present quantitative information about delinquencies and net principal charge-offs of securitized and non-securitized credit card loans for periods in which transfers of receivables to the securitization trusts were accounted for as sales (dollars in millions):

| | November 30, 2009 |
|---------------------------------------|----------------------|
| Loans Outstanding: | |
| Managed credit card loans | \$ 47,465 |
| Less: Securitized credit card loans | 27,235 |
| Owned credit card loans | \$ 20,230 |
| Loans Over 30 Days Delinquent: | |
| Managed credit card loans | \$ 2,657 |
| Less: Securitized credit card loans | 1,540 |
| Owned credit card loans | \$ 1,117 |

| | For the Three Months Ended August 31, 2009 | For the Nine Months Ended August 31, 2009 |
|-------------------------------------|--|---|
| Average Loans: | | |
| Managed credit card loans | \$ 48,642 | \$ 49,328 |
| Less: Securitized credit card loans | 24,591 | 23,868 |
| Owned credit card loans | \$ 24,051 | \$ 25,460 |

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| | | | | | |
|-------------------------------------|--|----|-------|----|-------|
| Net Principal Charge-offs: | | | | | |
| Managed credit card loans | | \$ | 1,058 | \$ | 2,866 |
| Less: Securitized credit card loans | | | 544 | | 1,407 |
| Owned credit card loans | | \$ | 514 | \$ | 1,459 |

Table of Contents**6. Deposits**

The Company offers its deposit products, including certificates of deposit, money market accounts, online savings accounts and Individual Retirement Account (IRA) certificates of deposit to customers through two channels: (i) through direct marketing, internet origination and affinity relationships (direct-to-consumer deposits); and (ii) indirectly through contractual arrangements with brokerage firms (brokered deposits). During the nine months ended August 31, 2010, the Company acquired approximately \$1 billion of direct-to-consumer deposit accounts from a third party. As of August 31, 2010 and November 30, 2009, the Company had approximately \$19.1 billion and \$12.6 billion, respectively, of direct-to-consumer deposits and approximately \$15.1 billion and \$19.5 billion, respectively, of brokered deposits.

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

| | August 31, 2010 | November 30, 2009 |
|--|----------------------|----------------------|
| Certificates of deposit in amounts less than \$100,000 ⁽¹⁾ | \$ 20,864,065 | \$ 22,587,898 |
| Certificates of deposit from amounts of \$100,000 ⁽¹⁾ to less than \$250,000 ⁽¹⁾ | 4,358,026 | 2,918,004 |
| Certificates of deposit in amounts of \$250,000 ⁽¹⁾ or greater | 1,163,140 | 1,129,945 |
| Savings deposits, including money market deposit accounts | 7,763,701 | 5,392,659 |
| Total interest-bearing deposits | \$ 34,148,932 | \$ 32,028,506 |
| Average annual interest rate | 3.18% | 3.94% |

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

At August 31, 2010, certificates of deposit maturing during the remainder of 2010, the next four years and thereafter were as follows (dollars in thousands):

| Year | Amount |
|------------|--------------|
| 2010 | \$ 2,794,711 |
| 2011 | \$ 9,029,215 |
| 2012 | \$ 5,972,694 |
| 2013 | \$ 4,553,847 |
| 2014 | \$ 1,985,343 |
| Thereafter | \$ 2,049,421 |

Table of Contents**7. Long-Term Borrowings**

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

| | August 31, 2010 | | November 30, 2009 | | Interest Rate Terms | Maturity |
|--|----------------------|---------------|---------------------|---------------|--|--------------------------------------|
| | Outstanding | Interest Rate | Outstanding | Interest Rate | | |
| Discover Card Master Trust I and Discover Card Execution Note Trust | | | | | | |
| Fixed rate asset-backed securities ⁽¹⁾ | \$ 2,598,208 | 5.47% | \$ | | 5.10% to | Various April 2011 September 2017 |
| Floating rate asset-backed securities ⁽¹⁾ | 10,771,057 | 0.75% | | | 5.65% fixed 1-month LIBOR ⁽²⁾ + 3 to 130 basis points | Various November 2010 July 2014 |
| Floating rate asset-backed securities ⁽¹⁾ | 1,250,000 | 0.88% | | | 3-month LIBOR ⁽²⁾ + 34 basis points | December 2012 |
| Floating rate asset-backed securities ⁽¹⁾ | 250,000 | 1.00% | | | Commercial Paper rate + 70 basis points | April 2013 |
| Total Long-Term Borrowings owed to securitization investors | 14,869,265 | | | | | |
| Discover Financial Services (Parent Company) | | | | | | |
| Floating rate senior notes | | | 400,000 | 0.83% | 3-month LIBOR ⁽²⁾ | June 2010 |
| | | | | | + 53 basis points | |
| Fixed rate senior notes due 2017 | 399,447 | 6.45% | 399,385 | 6.45% | 6.45% fixed | June 2017 |
| Fixed rate senior notes due 2019 | 400,000 | 10.25% | 400,000 | 10.25% | 10.25% fixed | July 2019 |
| Discover Bank | | | | | | |
| Subordinated bank notes due 2019 | 698,337 | 8.70% | 698,202 | 8.70% | 8.70% fixed | November 2019 |
| Subordinated bank notes due 2020 | 496,666 | 7.00% | | | 7.00% fixed | April 2020 |
| Floating rate secured borrowing ⁽³⁾ | 104,476 | 0.80% | 528,246 | 0.74% | Commercial Paper rate + 50 basis points | December 2010 ⁽³⁾ |
| Floating rate secured borrowing ⁽³⁾ | 236,050 | 0.73% | | | 1-month LIBOR ⁽²⁾ | December 2010 ⁽³⁾ |
| | | | | | + 45 basis points | |
| Floating rate secured borrowing ⁽⁴⁾ | 503,935 | 0.76% | | | Commercial Paper rate + 50 basis points | August 2013 ⁽⁴⁾ |
| Capital lease obligations | 577 | 6.26% | 2,268 | 6.26% | 6.26% fixed | Various |
| Total Other Long-Term Borrowings | 2,839,488 | | 2,428,101 | | | |
| Total long-term borrowings | \$ 17,708,753 | | \$ 2,428,101 | | | |

(1) Upon adoption of Statements No. 166 and 167 on December 1, 2009, the Company consolidated \$22.3 billion of securitized loan receivables and the related debt issued from the trusts to third-party investors. See Note 2: Change in Accounting Principle for more information. Asset-backed securities are collateralized by loan receivables as described in Footnote 5: Credit Card Securitization Activities.

(2) London Interbank Offered Rate (LIBOR).

(3) This loan facility was entered into to fund cash collateral account loans, which provide credit enhancement to certain DCMT certificates. Repayment is dependent upon the available balances of the cash collateral accounts at the various maturities of underlying securitization transactions, with final maturity in December 2010. The facility has two funding agents, one of which re-priced from commercial paper conduit costs to LIBOR-based pricing effective in July 2010.

(4) Under a program established by the U.S. Department of Education, this loan facility was entered into to fund certain federal student loans. Principal and interest payments on the underlying student loans will reduce the balance of the secured borrowing over time, with final maturity in August 2013.

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The Company has an unsecured credit agreement that is effective through May 2012. The agreement provides for a revolving credit commitment of up to \$2.4 billion (of which the Company may borrow up to 30% and Discover Bank may borrow up to 100% of the total commitment). As of August 31, 2010, the Company had no outstanding balances due under the facility. The credit agreement provides for a commitment fee on the unused portion of the facility, which can range from 0.07% to 0.175% depending on the index debt ratings. Loans outstanding under the credit facility bear interest at a margin above the Federal Funds rate, LIBOR, the Euro Interbank Offered Rate or the Euro Reference rate. The terms of the credit agreement include various affirmative and negative covenants, including financial covenants related to the maintenance of certain capitalization and tangible net worth levels, and certain double leverage, delinquency and Tier 1 capital to managed loans ratios. The credit agreement also includes customary events of default with corresponding grace periods, including, without limitation, payment defaults, cross-defaults to other agreements evidencing indebtedness for borrowed money and bankruptcy-related defaults. The commitment may be terminated upon an event of default.

The Company also has access to committed undrawn capacity through privately placed asset-backed conduits through bilateral agreements to support the funding of its credit card loan receivables. As of August 31, 2010, the total commitment of secured credit facilities through private providers was \$3.0 billion, of which \$0.3 billion had been used and was included in long-term borrowings owed to securitization investors at August 31, 2010. Access to the unused portions of the secured credit facilities expires in 2012 and 2013. Borrowings outstanding under each facility bear interest at a margin above asset-backed commercial paper costs of each individual conduit provider. The terms of each agreement provide for a commitment fee to be paid on the unused capacity, and include various affirmative and negative covenants, including performance metrics and legal requirements similar to those required to issue any term securitization transaction.

8. Preferred Stock

On April 21, 2010, the Company completed the repurchase of all the outstanding shares of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the Preferred Stock) issued to the U.S. Department of the Treasury under the Capital Purchase Program of the Troubled Asset Relief Program on March 13, 2009 for \$1.2 billion.

The Preferred Stock was issued at a discount to reflect the value of the warrant (the Warrant) to purchase 20,500,413 shares of common stock of the Company issued to the U.S. Treasury in connection with the initial sale of the Preferred Stock. As a result of the repurchase of the Preferred Stock, at the redemption date the Company accelerated the accretion of the remaining discount of \$61 million. On July 7, 2010, the Company repurchased the Warrant from the U.S Treasury for \$172 million.

Table of Contents**9. Employee Benefit Plans**

The Company sponsors defined benefit pension and other postretirement plans for its eligible U.S. employees. However, as of December 31, 2008, the pension plans no longer provide for the accrual of future benefits. For more information, see the Company's annual report on Form 10-K for the year ended November 30, 2009.

Net periodic benefit (income) cost expensed by the Company included the following components (dollars in thousands):

| | Pension | | | |
|---|--|-------------|---|-------------|
| | For the Three Months Ended August 31, | | For the Nine Months Ended August 31, | |
| | 2010 | 2009 | 2010 | 2009 |
| Service cost, benefits earned during the period | \$ | \$ 255 | \$ | \$ 765 |
| Interest cost on projected benefit obligation | 5,214 | 5,047 | 15,642 | 15,141 |
| Expected return on plan assets | (5,823) | (6,027) | (17,469) | (18,081) |
| Net amortization | 406 | (2) | 1,218 | (6) |
| Net settlements and curtailments | 68 | | 204 | |
| Net periodic benefit income | \$ (135) | \$ (727) | \$ (405) | \$ (2,181) |

| | Postretirement | | | |
|---|--|-------------|---|-------------|
| | For the Three Months Ended August 31, | | For the Nine Months Ended August 31, | |
| | 2010 | 2009 | 2010 | 2009 |
| Service cost, benefits earned during the period | \$ 264 | \$ 194 | \$ 792 | \$ 582 |
| Interest cost on projected benefit obligation | 347 | 394 | 1,041 | 1,182 |
| Net amortization | (1) | (38) | (3) | (114) |
| Net periodic benefit cost | \$ 610 | \$ 550 | \$ 1,830 | \$ 1,650 |

Table of Contents**10. Income Taxes**

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

| | For the Three Months Ended August 31, | | For the Nine Months Ended August 31, | |
|---------------------------|--|-------------------|---|-------------------|
| | 2010 | 2009 | 2010 | 2009 |
| Current: | | | | |
| U.S. federal | \$ 68,942 | \$ 201,615 | \$ 166,541 | \$ 653,888 |
| U.S. state and local | 24,451 | 41,736 | 38,512 | 95,083 |
| International | 53 | 665 | 298 | 2,483 |
| Total | 93,446 | 244,016 | 205,351 | 751,454 |
| Deferred: | | | | |
| U.S. federal | 73,149 | 109,028 | 61,301 | (111,923) |
| U.S. state and local | 4,931 | 9,441 | 1,830 | (12,537) |
| Total | 78,080 | 118,469 | 63,131 | (124,460) |
| Income tax expense | \$ 171,526 | \$ 362,485 | \$ 268,482 | \$ 626,994 |

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

| | For the Three Months Ended August 31, | | For the Nine Months Ended August 31, | |
|--|--|--------------|---|--------------|
| | 2010 | 2009 | 2010 | 2009 |
| U.S. federal statutory income tax rate | 35.0% | 35.0% | 35.0% | 35.0% |
| U.S. state and local income taxes and other, net of U.S. federal income tax benefits | 4.8 | 3.5 | 4.3 | 3.4 |
| Valuation allowance - capital loss | | | | 1.5 |
| Non-deductible compensation | 0.1 | 0.1 | 0.5 | 0.5 |
| Other | (0.2) | 0.2 | (0.5) | |
| Effective income tax rate | 39.7% | 38.6% | 39.3% | 40.4% |

The Company is under continuous examination by the IRS and the tax authorities for various states. The tax years under examination vary by jurisdiction; for example, the current IRS examination covers 1999 through 2005. The Company regularly assesses the likelihood of additional assessments in each of the taxing jurisdictions resulting from these and subsequent years' examinations.

As part of its audit of 1999-2005, the IRS has proposed additional tax assessments. The Company filed an appeal with the IRS to protest the proposed adjustments. The outcome of the appeal is not certain and the matter is in the preliminary stage. The Company believes that its reserve is sufficient to cover any penalties or interest that would result from an increase in federal taxes due.

Table of Contents**11. Earnings Per Share**

Effective December 1, 2009, the Company adopted new accounting guidance on earnings per share, which clarifies that unvested stock-based payment awards that contain nonforfeitable rights to dividends are participating securities and should be included in computing earnings per share (EPS) using the two-class method. The Company grants restricted stock units (RSUs) to certain employees under its stock-based compensation programs, which entitle the recipients to receive nonforfeitable dividend equivalents in the same amount and at the same time as dividends paid to all common stockholders; these unvested awards meet the definition of participating securities. Under the two-class method, all earnings (distributed and undistributed) are allocated to each class of common stock and participating securities, based on their respective rights to receive dividends. In accordance with the transition guidance, prior period EPS amounts have been restated to conform to current period presentation, although there was no material impact on the previously reported basic or diluted EPS.

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

| | For the Three Months Ended August 31, | | For the Nine Months Ended August 31, | |
|---|--|------------|---|------------|
| | 2010 | 2009 | 2010 | 2009 |
| Numerator: | | | | |
| Net income | \$ 260,617 | \$ 577,454 | \$ 415,146 | \$ 923,648 |
| Preferred stock dividends | | (15,307) | (23,811) | (28,573) |
| Preferred stock discount accretion | | (2,760) | (66,492) | (6,048) |
| Net income available to common stockholders | 260,617 | 559,387 | 324,843 | 889,027 |
| Income allocated to participating securities | (2,423) | (6,459) | (3,230) | (12,521) |
| Net income allocated to common stockholders | \$ 258,194 | \$ 552,928 | \$ 321,613 | \$ 876,506 |
| Denominator: | | | | |
| Weighted average common shares outstanding | 544,314 | 513,098 | 543,874 | 491,839 |
| Effect of dilutive common stock equivalents | 2,768 | 3,952 | 6,237 | 920 |
| Weighted average common shares outstanding and common stock equivalents | 547,082 | 517,050 | 550,111 | 492,759 |
| Basic earnings per share | \$ 0.47 | \$ 1.08 | \$ 0.59 | \$ 1.78 |
| Diluted earnings per share | \$ 0.47 | \$ 1.07 | \$ 0.58 | \$ 1.78 |

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

| | For the Three Months Ended August 31, | | For the Nine Months Ended August 31, | |
|---------------------------|---|-------|--|-------|
| | 2010 | 2009 | 2010 | 2009 |
| Unexercised stock options | 3,944 | 4,319 | 3,418 | 4,414 |

12. Capital Adequacy

The Company is subject to capital adequacy guidelines of the Federal Reserve, and Discover Bank (the Bank), the Company's main banking subsidiary, is subject to various regulatory capital requirements as administered by the Federal Deposit Insurance Corporation (the FDIC). Failure to meet minimum capital requirements can result in the initiation of certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the financial position and results of the Company and the Bank. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of

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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 August 31, 2010, 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 August 31, 2010, the Company and the Bank met the requirements for well-capitalized status and there have been no conditions or events that management believes have changed the Company's or the Bank's category.

The following table shows the actual capital amounts and ratios of the Company and the Bank as of August 31, 2010 and November 30, 2009 and comparisons of each to the regulatory minimum and well-capitalized requirements (dollars in thousands):

| | Actual | | Minimum Capital Requirements | | Capital Requirements To Be Classified as Well-Capitalized | |
|--|--------------|-------|------------------------------|-------------------|---|--------------------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| August 31, 2010⁽¹⁾ : | | | | | | |
| Total risk-based capital (to risk-weighted assets) | | | | | | |
| Discover Financial Services | \$ 7,595,473 | 15.5% | \$ 3,931,518 | ³ 8.0% | \$ 4,914,398 | ³ 10.0% |
| Discover Bank | \$ 7,601,827 | 15.7% | \$ 3,876,790 | ³ 8.0% | \$ 4,845,987 | ³ 10.0% |
| Tier 1 capital (to risk-weighted assets) | | | | | | |
| Discover Financial Services | \$ 5,747,535 | 11.7% | \$ 1,965,759 | ³ 4.0% | \$ 2,948,639 | ³ 6.0% |
| Discover Bank | \$ 5,762,334 | 11.9% | \$ 1,938,395 | ³ 4.0% | \$ 2,907,592 | ³ 6.0% |
| Tier 1 capital (to average assets) | | | | | | |
| Discover Financial Services | \$ 5,747,535 | 9.5% | \$ 2,417,397 | ³ 4.0% | \$ 3,021,746 | ³ 5.0% |
| Discover Bank | \$ 5,762,334 | 9.7% | \$ 2,385,823 | ³ 4.0% | \$ 2,982,279 | ³ 5.0% |
| November 30, 2009: | | | | | | |
| Total risk-based capital (to risk-weighted assets) | | | | | | |
| Discover Financial Services | \$ 9,516,965 | 17.9% | \$ 4,262,230 | ³ 8.0% | \$ 5,327,788 | ³ 10.0% |
| Discover Bank | \$ 8,210,450 | 15.8% | \$ 4,168,103 | ³ 8.0% | \$ 5,210,129 | ³ 10.0% |
| Tier 1 capital (to risk-weighted assets) | | | | | | |
| Discover Financial Services | \$ 8,139,309 | 15.3% | \$ 2,131,115 | ³ 4.0% | \$ 3,196,673 | ³ 6.0% |
| Discover Bank | \$ 6,572,320 | 12.6% | \$ 2,084,052 | ³ 4.0% | \$ 3,126,077 | ³ 6.0% |
| Tier 1 capital (to average assets) | | | | | | |
| Discover Financial Services | \$ 8,139,309 | 18.1% | \$ 1,798,937 | ³ 4.0% | \$ 2,248,672 | ³ 5.0% |
| Discover Bank | \$ 6,572,320 | 15.9% | \$ 1,657,397 | ³ 4.0% | \$ 2,071,746 | ³ 5.0% |

- (1) Upon adoption of Statements No. 166 and 167 on December 1, 2009, the Company recorded a \$1.4 billion reduction to retained earnings, which reduced total capital and Tier 1 capital by the same amount, and a \$21.1 billion increase to total assets, which impacted average assets. See Note 2: Change in Accounting Principle for more information. Risk-weighted assets were not significantly impacted by the adoption of Statements No. 166 and 167 as the Company began including securitized assets in its risk-weighted asset calculation beginning in the third quarter 2009 due to actions it took to adjust the credit enhancement structure of the securitization trusts.

Table of Contents**13. 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 2018. At August 31, 2010, future minimum payments on leases with original terms in excess of one year consist of the following (dollars in thousands):

| | Capitalized Leases | Operating Leases |
|--|-------------------------------|-----------------------------|
| 2010 | \$ 197 | \$ 1,526 |
| 2011 | 395 | 5,511 |
| 2012 | | 6,172 |
| 2013 | | 4,662 |
| 2014 | | 4,616 |
| Thereafter | | 16,342 |
| Total minimum lease payments | 592 | \$ 38,829 |
| Less: Amount representing interest | | 15 |
| Present value of net minimum lease payments | \$ 577 | |

Unused commitments to extend credit. At August 31, 2010, the Company had unused commitments to extend credit for consumer and commercial loans of approximately \$166 billion. Such commitments arise primarily from agreements with customers for unused lines of credit on certain credit cards and certain other consumer loan products, provided there is no violation of conditions in the related agreement. These commitments, substantially all of which the Company can terminate at any time and which do not necessarily represent future cash requirements, are periodically reviewed based on account usage, customer creditworthiness and loan qualification.

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

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

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

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

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

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

The maximum potential amount of future payments related to such contingent obligations is dependent upon the transaction volume processed between the time a counterparty defaults on its settlement and the time at which the Company disables the settlement of any further transactions for the defaulting party, which could be up to one month depending on the type of guarantee/counterparty. 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 contractual remedies to offset these counterparty settlement exposures, in the event that all licensees and/or issuers were to become unable to settle their transactions, the Company estimates its maximum potential counterparty exposures to these settlement guarantees, based on historical transaction volume of up to one month, would be as follows:

| | August 31, 2010 |
|----------------------------------|--------------------|
| Diners Club: | |
| Merchant guarantee (in millions) | \$ 224 |
| PULSE: | |
| ATM guarantee (in thousands) | \$ 833 |

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 August 31, 2010, 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 August 31, 2010, the Company had not recorded any contingent liability in the condensed consolidated financial statements related to this counterparty exposure, and management believes that the probability of any payments under this arrangement is low.

Merchant Chargeback Guarantees. The Company issues credit cards and owns and operates the Discover Network. The Company is contingently liable for certain transactions processed on the Discover Network in the event of a dispute between the credit 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 transaction to the merchant or merchant acquirer. If the Discover Network is unable to collect the amount from the merchant or merchant acquirer, it will bear the loss for the amount credited or refunded to the customer. In most instances, a payment obligation by the Discover Network is unlikely to arise because most

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products or services are delivered when purchased, and credits are issued by merchants on returned items in a timely fashion. However, where the product or service is not scheduled to be provided to the customer until some later date following the purchase, the likelihood of a contingent payment obligation by the Discover Network increases. The maximum potential amount of future payments related to 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. However, the Company believes that such amount is not representative of the Company's actual potential loss exposure based on the Company's historical experience. The actual amount of the potential exposure cannot be quantified as the Company cannot determine whether the current or cumulative transaction volumes may include or result in disputed transactions.

The table below summarizes certain information regarding merchant chargeback guarantees:

| | For the Three Months Ended August 31, | | For the Nine Months Ended August 31, | |
|---|--|-----------|---|-----------|
| | 2010 | 2009 | 2010 | 2009 |
| Losses related to merchant chargebacks (in thousands) | \$ 1,036 | \$ 1,717 | \$ 2,294 | \$ 5,049 |
| Aggregate transaction volume ⁽¹⁾ (in millions) | \$ 25,990 | \$ 24,258 | \$ 74,645 | \$ 69,768 |

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

The Company has not recorded any contingent liability in the condensed consolidated financial statements related to merchant chargeback guarantees at August 31, 2010 and November 30, 2009. The Company mitigates this risk by withholding settlement from merchants or obtaining escrow deposits 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 the settlement withholdings and escrow deposits, which are recorded in interest-bearing deposit accounts and accrued expenses and other liabilities on the Company's condensed consolidated statements of financial condition (in thousands):

| | August 31, 2010 | November 30, 2009 |
|---|--------------------|----------------------|
| Settlement withholdings and escrow deposits | \$ 31,702 | \$ 38,129 |

14. Litigation

The Company filed a lawsuit captioned Discover Financial Services, Inc. v. Visa USA Inc., MasterCard Inc. et al. in the U.S. District Court for the Southern District of New York on October 4, 2004. Through this lawsuit the Company sought to recover substantial damages and other appropriate relief in connection with Visa's and MasterCard's illegal anticompetitive practices that, among other things, foreclosed the Company from the credit and debit network services markets. The Company executed an agreement to settle the lawsuit with MasterCard and Visa for up to \$2.75 billion on October 27, 2008, which became effective on November 4, 2008 upon receipt of the approval of Visa's Class B shareholders. At the time of the Company's 2007 spin-off from Morgan Stanley, the Company entered into an agreement with Morgan Stanley regarding the manner in which the antitrust case against Visa and MasterCard was to be pursued and settled, and how proceeds of the litigation were to be shared (the Special Dividend Agreement).

On October 21, 2008, Morgan Stanley filed a lawsuit against the Company in New York Supreme Court for New York County seeking a declaration that Morgan Stanley did not breach the Special Dividend Agreement, did not interfere with any of the Company's existing or prospective agreements for resolution of the antitrust case against Visa and MasterCard, and that Morgan Stanley is entitled to receive a portion of the settlement proceeds as set forth in the Special Dividend Agreement. On November 18, 2008, the Company filed its response to

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Morgan Stanley's lawsuit, which included counterclaims against Morgan Stanley for interference with the Company's efforts to resolve the antitrust lawsuit against Visa and MasterCard and willful and material breach of the Special Dividend Agreement, which expressly provided that the Company would have sole control over the investigation, prosecution and resolution of the antitrust lawsuit.

Subsequent to a ruling by the New York State Court, the Company estimated that the amount that was probable it would owe to Morgan Stanley was \$837.7 million as of November 30, 2009. Of this amount, \$808.8 million was recorded as Special dividend Morgan Stanley in liabilities on the statement of financial condition with an offset to retained earnings and \$28.9 million of interest related to delayed payment was recorded in other expense. On February 11, 2010, the Company entered into a Settlement Agreement and Mutual Release with Morgan Stanley, in which each party released and discharged the other party from claims related to the sharing of proceeds from the antitrust suit against Visa and MasterCard. On the same day, the Company entered into a First Amendment to the Separation and Distribution Agreement dated as of June 29, 2007 (the First Amendment) with Morgan Stanley. The First Amendment provides that payments that Morgan Stanley receives from the Company in connection with the settlement of the antitrust litigation with Visa and MasterCard shall not exceed a total of \$775 million, inclusive of any accrued and unpaid interest and fees under the agreement. In addition, on the same day, the Company paid Morgan Stanley \$775 million from restricted cash held in an escrow account in complete satisfaction of its obligations under the Special Dividend Agreement.

Upon payment of the \$775 million on February 11, 2010, the Company reversed the \$28.9 million that had been recorded in other expense in the fourth quarter 2009 and recorded a reduction to the liability attributable to the special dividend from \$808.8 million to \$775 million with an offsetting increase to retained earnings.

15. Fair Value Disclosures

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

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

| | August 31, 2010 | | November 30, 2009 | |
|--|-----------------|----------------------|-------------------|----------------------|
| | Carrying Value | Estimated Fair Value | Carrying Value | Estimated Fair Value |
| Financial Assets | | | | |
| Cash and cash equivalents | \$ 7,916,091 | \$ 7,916,091 | \$ 13,020,719 | \$ 13,020,719 |
| Restricted cash - special dividend escrow | \$ | \$ | \$ 643,311 | \$ 643,311 |
| Restricted cash - for securitization investo ⁽¹⁾ | \$ 691,698 | \$ 691,698 | \$ | \$ |
| Other short-term investments | \$ 375,000 | \$ 375,000 | \$ 1,350,000 | \$ 1,350,000 |
| Investment securities: | | | | |
| Available-for-sale ⁽¹⁾ | \$ 1,151,689 | \$ 1,151,689 | \$ 2,645,481 | \$ 2,645,481 |
| Held-to-maturity ⁽¹⁾ | \$ 74,058 | \$ 73,029 | \$ 2,389,816 | \$ 1,953,990 |
| Net loan receivables ⁽¹⁾ | \$ 46,386,943 | \$ 46,482,449 | \$ 21,867,185 | \$ 21,984,317 |
| Amounts due from asset securitization ⁽¹⁾ | \$ | \$ | \$ 1,692,051 | \$ 1,692,051 |
| Derivative financial instruments | \$ 1,370 | \$ 1,370 | \$ 1,369 | \$ 1,369 |
| Financial Liabilities | | | | |
| Deposits | \$ 34,246,804 | \$ 35,404,706 | \$ 32,093,012 | \$ 33,139,823 |
| Long-term borrowings - owed to securitization investo ⁽¹⁾ | \$ 14,869,265 | \$ 15,217,056 | \$ | \$ |
| Other long-term borrowings | \$ 2,839,488 | \$ 3,156,018 | \$ 2,428,101 | \$ 2,524,320 |
| Derivative financial instruments | \$ 634 | \$ 634 | \$ | \$ |

(1) Upon adoption of Statements No. 166 and 167 on December 1, 2009, the Company consolidated the securitization trusts. Loan receivables increased by the amount of securitized loans and long-term borrowings increased by the amount of debt issued from the trusts to third-party investors. Furthermore, applicable amounts of held-to-maturity and available-for-sale investment securities were reclassified to loan receivables, while amounts recorded as due from asset securitization were either reclassified or reversed. See Note 2: Change in Accounting Principle for more information.

Fair Value of Assets and Liabilities Held at August 31, 2010. Below are descriptions of the techniques used to estimate the fair value of financial instruments on the Company's statement of financial condition as of August 31, 2010.

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 relatively liquid nature of these assets, particularly given the short maturities of the assets in which the restricted cash is invested.

Other short-term investments. The carrying value of other short-term investments 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 maturities of less than one year.

Available-for-sale investment securities. Investment securities classified as available-for-sale consist of credit card asset-backed securities issued by other institutions and, until August 2010, asset-backed commercial paper notes, the fair value estimate techniques of which are discussed below.

Held-to-maturity investment securities. Held-to-maturity investment securities are generally valued using the estimated fair values based on quoted market prices for the same or similar securities.

Net loan receivables. The Company's loan receivables include credit card and installment loans to consumers and credit card loans to businesses. To estimate the fair value of loan receivables, loans are

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aggregated into pools of similar loan types, characteristics and expected repayment terms. The fair values of the loans are estimated by discounting expected future cash flows using a rate at which similar loans could be made under current market conditions.

Deposits. The carrying values of money market deposits, non-interest bearing deposits, interest-bearing demand deposits and savings deposits approximate their fair values due to the 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.

Long-term borrowings owed to securitization investors. Fair values of long-term borrowings owed to securitization investors are determined utilizing quoted market prices of the same transactions.

Other long-term borrowings. Fair values of other long-term borrowings are determined utilizing current observable market prices for those transactions, if available. If there are no observable market transactions, then fair values are determined by discounting cash flows of future interest accruals at market rates currently offered for borrowings with credit risks, similar remaining maturities and repricing terms.

Derivative financial instruments. The Company's derivative activity consists of interest rate swaps and foreign currency forward contracts. The valuation of these instruments is determined using 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 uses observable market-based inputs, including interest rate curves and option volatility. The fair values of 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 (or receipts) are based on an expectation of future interest rates (forward curves) derived from observable market interest rate curves.

Fair Value of Assets Held at November 30, 2009. Below are descriptions of the techniques used to calculate the fair value of financial instruments on the Company's statements of financial condition as of November 30, 2009 which were subsequently derecognized, reclassified or eliminated in consolidation as a result of the adoption of Statements No. 166 and 167 on December 1, 2009.

Available-for-sale investment securities. Fair value of certain certificated subordinated interests issued by DCENT that were acquired by a wholly-owned subsidiary of the Company were estimated utilizing discounted cash flow analyses, where estimated contractual principal and interest cash flows were discounted at rates derived from indicative pricing observed in the most recent active market for such instruments, adjusted for changes reflective of incremental credit risk, liquidity risk, or both.

Held-to-maturity investment securities. The estimated fair values of certain certificated subordinated interests issued by DCENT and DCMT were derived utilizing a discounted cash flow analysis, where estimated contractual principal and interest cash flows were discounted at rates interpolated from recent pricing observed on similar asset classes, adjusted for incremental credit risk, liquidity risk, or both, to reflect, for example, the risk related to the lower rating on the instrument being valued than that which was observed. As a portion of these investment securities were zero coupon certificated retained interests, the aggregate carrying value, or amortized cost, significantly exceeded fair value.

Amounts due from asset securitization. Carrying values of the portion of amounts due from asset securitization that were short term in nature approximated their fair values. Fair values of the remaining assets recorded in amounts due from asset securitization reflected the present value of estimated future cash flows utilizing management's best estimate of key assumptions with regard to credit card loan receivable performance and interest rate environment projections.

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Assets and Liabilities Measured at Fair Value on a Recurring Basis. ASC 820 defines fair value, establishes a fair value hierarchy that distinguishes between valuations that are based on observable inputs from those based on unobservable inputs, and requires certain disclosures about those measurements. The table below presents information about the Company's assets and liabilities measured at fair value on a recurring basis at August 31, 2010, and indicates the level within the fair value hierarchy with which each of those items is associated. In general, 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. 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. 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's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

Disclosures concerning assets and liabilities measured at fair value on a recurring basis are as follows (dollars in thousands):

| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total |
|--|---|--|---|--------------|
| Balance at August 31, 2010 | | | | |
| Assets | | | | |
| Credit card asset-backed securities of other issuers | \$ | \$ 1,149,666 | \$ | \$ 1,149,666 |
| U.S. Treasury securities | 1,002 | | | 1,002 |
| U.S. government agency securities | | 1,004 | | 1,004 |
| Equity securities | | | 17 | 17 |
| Available-for-sale investment securities | \$ 1,002 | \$ 1,150,670 | \$ 17 | \$ 1,151,689 |
| Derivative financial instruments | \$ | \$ 1,370 | \$ | \$ 1,370 |
| Liabilities | | | | |
| Derivative financial instruments | \$ | \$ 634 | \$ | \$ 634 |
| Balance at November 30, 2009 | | | | |
| Assets | | | | |
| Available-for-sale investment securities | \$ 15 | \$ | \$ 2,645,466 | \$ 2,645,481 |
| Amounts due from asset securitization ⁽¹⁾ | \$ | \$ | \$ 940,164 | \$ 940,164 |
| Derivative financial instruments | \$ | \$ 1,369 | \$ | \$ 1,369 |

(1) Balances represent only the components of amounts due from asset securitization that are marked to fair value.

The Company considers relevant and observable market prices in its fair value calculations, evaluating 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. If relevant and observable prices are not available, other valuation techniques would be used and the fair values of the financial instruments would be classified as Level 3. The Company may utilize both observable and unobservable inputs in determining the fair values of financial instruments classified within the Level 3 category. The level to which an asset or liability is classified is based upon the lowest level of input that is

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significant to the fair value measurement. If the fair value of an asset or liability is measured based on observable inputs as well as unobservable inputs which contributed significantly to the determination of fair value, the asset or liability would be classified in Level 3 of the fair value hierarchy.

At August 31, 2010, amounts reported in credit card asset-backed securities issued by other institutions reflected senior-rated Class A securities having a par value of \$1,048 million and more junior-rated Class B and Class C securities with par values of \$50 million and \$42 million, respectively. The Class A securities had a weighted-average coupon of 2.56% and a weighted-average remaining maturity of 10.5 months, the Class B, 0.62% and 20.6 months, respectively, and the Class C, 0.74% and 15.6 months, respectively. The underlying loans for these securities are predominantly prime general-purpose credit card loan receivables. The Company utilizes an external pricing source for the reported fair value estimates of these securities. The expected cash flow models used by the pricing service utilize observable market data to the extent available and other valuation inputs such as benchmark yields, reported trades, broker quotes, issuer spreads, bids and offers, the priority of which may vary based on availability of information. We further assess the reasonableness of the price quotations received from the external pricing source by reference to indicative pricing from another independent, nationally recognized provider of capital markets information.

At November 30, 2009, the amount reported in asset-backed commercial paper notes included in available-for-sale investment securities was related to mortgage-backed commercial paper notes of Golden Key U.S. LLC. At that time, the estimated fair value reflected an estimate of the market value of those assets held by the issuer, which was primarily reliant upon unobservable data as the market for mortgage-backed securities had continued to experience significant disruption. The collateral supporting these notes was liquidated during the third quarter of 2010. See Note 3 Investment Securities for further discussion of this investment.

The following tables provide changes in the Company's Level 3 assets and liabilities measured at fair value on a recurring basis. Net transfers into and/or out of Level 3 are presented using beginning of the period fair values excluding purchases and other settlements. Excluding purchases and other settlements, the Company had no significant transfers between Levels 1, 2 or 3 during the second or third quarter of 2010, the effective periods for the new disclosure requirements prescribed by ASU No. 2010-06.

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis

(dollars in thousands)

| For the Three Months Ended | Balance at May 31, 2010 | Total Realized and Unrealized Gains (Losses) | Purchases, Sales, Other Settlements and Issuances, net | Net Transfers Into and/or Out of Level 3 | Balance at August 31, 2010 | Change in unrealized gains (losses) related to financial instruments held at August 31, 2010 |
|--|-------------------------------|---|---|--|----------------------------------|---|
| Assets | | | | | | |
| Asset-backed commercial paper notes | \$ 63,732 | \$ 7,161 | \$ (70,893) | \$ | \$ | \$ |
| Equity securities | 17 | | | | 17 | |
| Available-for-sale investment securities | \$ 63,749 | \$ 7,161 | \$ (70,893) | \$ | \$ 17 | \$ |

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| For the Nine Months Ended | Balance at November 30, 2009 | Derecognition of assets upon adoption of Statement No. 167 | Total Realized and Unrealized Gains (Losses) | Purchases, Sales, Other Settlements and Issuances, net | Net Transfers Into and/or Out of Level 3 | Balance at August 31, 2010 | Change in unrealized gains (losses) related to financial instruments held at August 31, 2010 |
|--|---|---|---|---|---|---|---|
| August 31, 2010 | | | | | | | |
| Assets | | | | | | | |
| Certificated retained interest in DCENT | \$ 2,204,969 | \$ (2,204,969) | \$ | \$ | \$ | \$ | \$ |
| Credit card asset-backed securities of other issuers | 381,705 | | | | (381,705) | | |
| Asset-backed commercial paper notes | 58,792 | | 12,101 | (70,893) | | | |
| Equity securities | | | | | 17 | 17 | |
| Available-for-sale investment securities | \$ 2,645,466 | \$ (2,204,969) | \$ 12,101 | \$ (70,893) | \$ (381,688) | \$ 17 | |
| Cash collateral accounts | \$ 822,585 | \$ (822,585) | \$ | \$ | \$ | \$ | \$ |
| Interest-only strip receivable | 117,579 | (117,579) | | | | | |
| Amounts due from asset securitization ⁽¹⁾ | \$ 940,164 | \$ (940,164) | \$ | \$ | \$ | \$ | \$ |
| For the Three Months Ended | | | | | | | |
| | Balance at May 31, 2009 | | Total Realized and Unrealized Gains (Losses) | Purchases, Sales, Other Settlements and Issuances, net | Net Transfers Into and/or Out of Level 3 | Balance at August 31, 2009 | |
| August 31, 2009 | | | | | | | |
| Assets | | | | | | | |
| Available-for-sale investment securities | \$ 1,429,723 | | \$ 40,922 | \$ 53,066 | \$ | \$ 1,523,711 | |
| Amounts due from asset securitization ⁽¹⁾ | \$ 1,053,792 | | \$ 68,880 | \$ (47,368) | \$ | \$ 1,075,304 | |
| For the Nine Months Ended | | | | | | | |
| | Balance at November 30, 2008 | | Total Realized and Unrealized Gains (Losses) | Purchases, Sales, Other Settlements and Issuances, net | Net Transfers Into and/or Out of Level 3 | Balance at August 31, 2009 | |
| August 31, 2009 | | | | | | | |
| Assets | | | | | | | |
| Available-for-sale investment securities | \$ 1,127,090 | | \$ 68,253 | \$ 328,368 | \$ | \$ 1,523,711 | |
| Amounts due from asset securitization ⁽¹⁾ | \$ 1,421,567 | | \$ (122,315) | \$ (223,948) | \$ | \$ 1,075,304 | |

(1) Balances represent only the components of amounts due from asset securitization that are marked to fair value.

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The following are the amounts recognized in earnings and other comprehensive income related to assets categorized as Level 3 during the respective periods (in thousands):

| | For the Three Months Ended August 31, | | For the Nine Months Ended August 31, | |
|---|--|------------|---|-------------|
| | 2010 | 2009 | 2010 | 2009 |
| Interest income interest accretion | \$ | \$ 4,878 | \$ | \$ 11,213 |
| Other income gain (loss) on investment securities | 19,556 | (7,422) | 19,556 | (8,249) |
| Securitization income net revaluation of retained interests | | 68,880 | | (122,315) |
| Amount recorded in earnings | 19,556 | 66,336 | 19,556 | (119,351) |
| Unrealized gains (losses) recorded in other comprehensive income, pre-tax | (12,395) | 43,467 | (7,455) | 65,289 |
| Total realized and unrealized gains (losses) | \$ 7,161 | \$ 109,803 | \$ 12,101 | \$ (54,062) |

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 their initial recognition is applicable if one or more is determined to be impaired. During the nine months ended August 31, 2010, the Company had no impairments related to these assets.

As of August 31, 2010, the Company had not made any fair value elections with respect to any of its eligible assets and liabilities as permitted under ASC 825-10-25.

16. Derivatives and Hedging Activities

The Company uses derivatives to manage its exposure to various financial risks. The Company entered into interest rate swap agreements as part of its interest rate risk management program. The Company also entered into foreign exchange forward contracts to manage the gains and losses that arise from certain foreign currency denominated receivables of one of its subsidiaries. The foreign exchange forward contracts are not designated as hedges, but provide a hedge of the volatility in earnings that arises from converting foreign denominated balance sheet items into the functional currency. The Company does not enter into derivatives for trading or speculative purposes. 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.

Derivatives may give rise to counterparty credit risk. 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 periodic basis by the Company to ensure compliance with the Company's risk policies and limits.

Derivatives Designated as Hedges

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

Cash Flow Hedges. The Company uses interest rate swaps to manage its exposure to changes in interest rates related to future cash flows resulting from credit card loan receivables. These transactions are hedged for a

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maximum period of three years. The derivatives are designated as a hedge of the risk of overall changes in cash flows on the Company's portfolios of prime-based interest receipts 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 is recognized directly in earnings. Amounts reported in accumulated other comprehensive income related to derivatives at August 31, 2010 will be reclassified to interest income as interest payments are received on certain of its floating rate credit card loan receivables. During the next 12 months, the Company estimates it will reclassify to earnings \$6.1 million of gains, pre-tax, related to its derivatives designated as cash flow hedges.

Fair Value Hedges. The Company is exposed to changes in fair value of certain of its fixed rate obligations due to changes in interest rates. As of August 31, 2010, the Company had no fair value hedges. During the nine months ended August 31, 2009, the Company used interest rate swaps from time to time to manage its exposure to changes in fair value of these obligations attributable to changes in LIBOR, a benchmark interest rate as defined by ASC 815. These interest rate swaps involved the receipt of fixed rate amounts from counterparties in exchange for the Company making payments of variable rate amounts over the life of the agreements without exchange of the underlying notional amount. Most of these agreements were designated to hedge interest-bearing deposits and qualify as fair value hedges in accordance with ASC 815. Changes in both the fair value of the derivatives and the hedged interest-bearing deposits relating to the risk being hedged were recorded in interest expense and provided offset to one another. Ineffectiveness related to these fair value hedges, if any, was recorded in interest expense.

Derivatives not Designated as Hedges

Foreign Exchange Forward Contracts. The Company has derivatives that are economic hedges and are not designated as hedges for accounting purposes. The Company enters into foreign exchange forward contracts to manage foreign currency risk. Foreign exchange forward contracts involve the purchase or sale of a designated currency at an agreed upon rate for settlement on a specified date. Changes in the fair value of these contracts are recorded in other income.

Interest Rate Swaps. The Company also may have from time to time interest rate swap agreements that are not designated as hedges. 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.

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The following table summarizes the fair value (including accrued interest) and related outstanding notional amounts of derivative instruments, as well as the location they are reported in the statement of financial condition as of August 31, 2010 and November 30, 2009 (dollars in thousands):

| | August 31, 2010 | | | | November 30, 2009 | | | | |
|---|-----------------|------------------------|-----------------------------|------------------------|-----------------------------|--------|-----------------|----------------------|----|
| | Notional Amount | Number of Transactions | Balance Sheet Location | | Balance Sheet Location | | Notional Amount | Accrued Expenses and | |
| Assets (At Fair Value) | | | Liabilities (At Fair Value) | Assets (At Fair Value) | Liabilities (At Fair Value) | Other | | Other | |
| Derivatives designated as hedges: | | | | | | | | | |
| Interest rate swaps Cash flow hedge | \$ 1,250,000 | 5 | \$ 1,327 | \$ 634 | \$ | \$ | \$ | \$ | \$ |
| Interest rate swaps Fair value hedge | \$ | | \$ | \$ | \$ 16,048 | \$ 400 | \$ | \$ | \$ |
| Derivatives not designated as hedges: | | | | | | | | | |
| Foreign exchange forward contracts ⁽¹⁾ | \$ 7,643 | 2 | \$ 43 | \$ | \$ | \$ | \$ | \$ | \$ |
| Interest rate swaps | \$ | | \$ | \$ | \$ 46,952 | \$ 969 | \$ | \$ | \$ |

(1) The foreign exchange forward contracts have notional amounts of EUR 4 million and GBP 1.7 million as of August 31, 2010.

The following table summarizes the impact of the derivative instruments on income, as well as the location they are reported in the financial statements for the three and nine months ended August 31, 2010 and 2009 (dollars in thousands):

| | Location | For the three months ended August 31 | | For the nine months ended August 31, | |
|--|----------------------------|--------------------------------------|----------|--------------------------------------|-----------|
| | | 2010 | 2009 | 2010 | 2009 |
| Derivatives designated as hedges: | | | | | |
| <i>Interest Rate Swaps-Cash Flow Hedges:</i> | | | | | |
| Gain (loss) recognized in other comprehensive income after amounts reclassified into earnings, pre-tax | Other Comprehensive Income | \$ 251 | \$ | \$ 251 | \$ |
| Total gains (losses) recognized in other comprehensive income | | \$ 251 | | \$ 251 | |
| Amounts reclassified from other comprehensive income into earnings | | | | | |
| Net hedge ineffectiveness | Interest Income | \$ 442 | \$ | \$ 442 | \$ |
| Gain (loss) excluded from assessment of hedge effectiveness | Interest Income | | | | |
| <i>Interest Rate Swaps-Fair Value Hedges:</i> | | | | | |
| Gain (loss) on interest rate swaps ⁽¹⁾ | Interest Expense | | 167 | 44 | 7,745 |
| Gain (loss) on hedged item ⁽²⁾ | Interest Expense | | 2,907 | | 8,425 |
| Total gains (losses) recognized in income | | \$ 442 | \$ 3,074 | \$ 486 | \$ 16,170 |
| Derivatives not designated as hedges: | | | | | |
| Gain (loss) on forward contract | Other Income | \$ (301) | \$ | \$ 458 | \$ |
| Gain (loss) on interest rate swaps | Other Income | | 166 | 6 | 1,767 |
| | | \$ (301) | \$ 166 | \$ 464 | \$ 1,767 |

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Total gains (losses) on derivatives not designated as hedges
recognized in income

- (1) For the three and nine months ended August 31, 2009, the gain (loss) on derivative includes ineffectiveness of \$105 thousand and \$1.2 million respectively.
- (2) For the three and nine months ended August 31, 2009, the gain (loss) on hedged item includes ineffectiveness of \$36 thousand and \$(2.2) million respectively.

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Collateral Requirements and Credit-Risk Related Contingency Features

For its interest rate swaps, the Company has master netting arrangements and minimum collateral posting thresholds with its counterparties. Collateral is required by either the Company or the counterparty depending on the net fair value position of all interest rate swaps held with that counterparty. Collateral amounts recorded in the consolidated statement of financial condition are based on the net collateral receivable or payable position for each counterparty. Collateral receivable or payable amounts are not offset against the fair value of the interest rate swap, but are recorded separately in other assets or deposits. As of August 31, 2010, the Company had swaps in a net liability position with one of its counterparties, the fair value of which was \$3 thousand, inclusive of accrued interest. As of August 31, 2010, the Company had a right to reclaim cash collateral of \$0.6 million based on these agreements and had no obligation to return cash collateral. If the Company had breached any provisions of the derivative agreements, it could have been required to settle its obligations under the agreements at their termination value, which was \$3 thousand at August 31, 2010.

The Company 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.

The Company also has agreements with certain of its derivative counterparties that contain provisions that require Discover Bank's debt to maintain an investment grade credit rating from specified major credit rating agencies. If Discover Bank's credit rating is reduced to below investment grade, the Company would be required to post additional collateral, which, as of August 31, 2010, would have been \$20 million.

17. 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 card-branded credit cards issued to individuals and small businesses on the Discover Network and other consumer products and services, including personal loans, student loans, prepaid cards and other consumer lending and deposit products offered through the Company's Discover Bank subsidiary.

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 third-party issuing business, which includes credit, debit and prepaid cards issued on the Discover Network by third parties.

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:

Prior to adoption of Statements No. 166 and 167, segment information was presented on a managed basis because management considered the performance of the entire managed loan portfolio in managing the business. A managed basis presentation, which is a non-GAAP presentation, involved reporting securitized loans with the Company's owned loans and reporting the earnings on securitized loans in the same manner as the owned loans instead of as securitization income. Although similar, a managed basis presentation is not the same as presenting a full consolidation of the trusts, and therefore, certain information may not be comparable between current and prior periods, particularly related to net interest income, provision for loan losses and other income. Subsequent to the consolidation of securitized assets and liabilities in connection with the adoption of Statements No. 166 and 167, there is no distinction between securitized and non-securitized assets on a GAAP basis. See Note 2: Change in Accounting Principle for more information.

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Other accounting policies applied to the operating segments are consistent with the accounting policies described in Note 2: Summary of Significant Accounting Policies to the audited consolidated financial statements included in the Company's annual report on Form 10-K for the year ended November 30, 2009.

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 operating 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.

Income taxes are not specifically allocated among the operating segments in the information reviewed by the Company's chief operating decision maker.

The following tables present segment data on a GAAP basis for the three and nine months ended August 31, 2010 and on a managed basis with a reconciliation to a GAAP presentation for the three and nine months ended August 31, 2009 (dollars in thousands):

| For the Three Months Ended | Direct | GAAP Basis | | | |
|-----------------------------------|----------------|-------------------|--------------|--|--|
| August 31, 2010 | Banking | Payment | Total | | |
| | | Services | | | |
| Interest income | \$ 1,535,934 | \$ 5 | \$ 1,535,939 | | |
| Interest expense | 389,059 | 78 | 389,137 | | |
| Net interest income | 1,146,875 | (73) | 1,146,802 | | |
| Provision for loan losses | 712,565 | | 712,565 | | |
| Other income | 495,771 | 68,373 | 564,144 | | |
| Other expense | 534,782 | 31,456 | 566,238 | | |
| Income before income tax expense | \$ 395,299 | \$ 36,844 | \$ 432,143 | | |

| August 31, 2009 | Direct | Managed Basis | Total | Securitization | GAAP |
|----------------------------------|----------------|----------------------|--------------|---------------------------------|--------------|
| | Banking | Payment | | Adjustment⁽¹⁾ | Basis |
| | | Services | | | Total |
| Interest income | \$ 1,663,886 | \$ 195 | \$ 1,664,081 | \$ (830,864) | \$ 833,217 |
| Interest expense | 392,592 | 50 | 392,642 | (88,241) | 304,401 |
| Net interest income | 1,271,294 | 145 | 1,271,439 | (742,623) | 528,816 |
| Provision for loan losses | 924,427 | | 924,427 | (543,428) | 380,999 |
| Other income ⁽²⁾ | 1,055,529 | 61,236 | 1,116,765 | 199,195 | 1,315,960 |
| Other expense | 489,596 | 34,242 | 523,838 | | 523,838 |
| Income before income tax expense | \$ 912,800 | \$ 27,139 | \$ 939,939 | \$ | \$ 939,939 |

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| For the Nine Months Ended | GAAP Basis | | Total |
|----------------------------------|----------------|------------------|--------------|
| | Direct Banking | Payment Services | |
| August 31, 2010 | | | |
| Interest income | \$ 4,646,856 | \$ 15 | \$ 4,646,871 |
| Interest expense | 1,207,322 | 160 | 1,207,482 |
| Net interest income | 3,439,534 | (145) | 3,439,389 |
| Provision for loan losses | 2,824,035 | | 2,824,035 |
| Other income | 1,423,823 | 199,041 | 1,622,864 |
| Other expense | 1,465,749 | 88,841 | 1,554,590 |
| Income before income tax expense | \$ 573,573 | \$ 110,055 | \$ 683,628 |

| For the Nine Months Ended | GAAP Basis | | | Securitization Adjustment ⁽¹⁾ | GAAP Basis Total |
|----------------------------------|----------------|--------------------------------|--------------|--|------------------|
| | Direct Banking | Managed Basis Payment Services | Total | | |
| August 31, 2009 | | | | | |
| Interest income | \$ 4,874,362 | \$ 1,020 | \$ 4,875,382 | \$ (2,368,388) | \$ 2,506,994 |
| Interest expense | 1,244,932 | 190 | 1,245,122 | (307,996) | 937,126 |
| Net interest income | 3,629,430 | 830 | 3,630,260 | (2,060,392) | 1,569,868 |
| Provision for loan losses | 3,369,332 | | 3,369,332 | (1,406,659) | 1,962,673 |
| Other income ⁽²⁾ | 2,753,382 | 179,921 | 2,933,303 | 653,733 | 3,587,036 |
| Other expense | 1,545,611 | 97,978 | 1,643,589 | | 1,643,589 |
| Income before income tax expense | \$ 1,467,869 | \$ 82,773 | \$ 1,550,642 | \$ | \$ 1,550,642 |

- (1) The Securitization Adjustment column presents the effect of loan securitizations by recharacterizing as securitization income the portions of the following items that relate to the securitized loans: interest income, interest expense, provision for loan losses, discount and interchange revenue and loan fee revenues. Securitization income is reported in other income.
- (2) The three and nine months ended August 31, 2009 includes \$472 million and \$1.4 billion, respectively, of income related to the Visa and MasterCard antitrust litigation settlement, which is included in the Direct Banking segment.

18. Subsequent Events

Subsequent to August 31, 2010, the Company had an increase in its investment securities resulting from the purchase of approximately \$4 billion of U.S. Treasury and U.S. government agency securities.

On September 23, 2010, the Company completed the sale of \$1.5 billion of federal student loans to the U.S. Department of Education, the majority of which were classified as held for sale as of August 31, 2010. The loans were sold pursuant to a Master Loan Sale Agreement for the 2009-10 Loan Purchase Program under the Ensuring Continued Access to Student Loans Act of 2008 (ECASLA). The impact of the sale on net income was not material.

On September 20, 2010, DCENT, one of the Company's securitization trusts, issued \$600 million of public asset-backed securities. On September 23, 2010, DCENT issued \$200 million of asset-backed securities through its private conduit providers. Related to these issuances, an additional \$111.8 million of subordinated interests were issued and retained by a wholly-owned subsidiary of the Company.

On September 17, 2010, the Company's wholly-owned subsidiary Discover Bank and The Student Loan Corporation (SLC) entered into an Agreement and Plan of Merger (the Merger Agreement), pursuant to which Discover Bank agreed to acquire SLC for \$600 million, or \$30 per share (the Merger Consideration), subject to an expected purchase price closing adjustment in the form of a cash payment of approximately \$150 million by Citibank, N.A. (Citibank), 80% owner of SLC, to Discover Bank. The acquisition will occur

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through the merger of a wholly-owned subsidiary of Discover Bank with and into SLC, with SLC surviving the merger as a wholly-owned subsidiary of Discover Bank. Immediately prior to the merger, SLC is expected to sell \$28 billion of assets to SLM Corporation (Sallie Mae) and \$8.7 billion of assets to Citibank. The transaction is expected to close after the end of the fiscal year but before the end of the calendar year, subject to closing conditions including, among others, the approval of the Merger Agreement by SLC's stockholders and the closing of SLC's asset sale transactions.

In the transaction, Discover Bank will acquire: (i) the beneficial interests in securitization trusts formed for the purpose of holding the private student loans associated with public securitization transactions issued out of the SLC Private Student Loan Trust 2006-A, and private securitization transactions issued out of the SLC Private Student Loan Trusts 2010-A and 2010-B (collectively, the Loans), which Loans had an estimated book value at June 30, 2010 of approximately \$4.2 billion, (ii) the cash reserves held in the securitization trusts associated with the Loans and (iii) certain fixed, tangible and intangible assets including, without limitation, SLC's student loan origination business. The Company estimates that approximately 70% of the Loans are covered by insurance, and approximately 65% of the Loans are in repayment. Discover Bank will also effectively assume securitization debt of approximately \$3.4 billion associated with the Loans.

Concurrently with the entry into the Merger Agreement, Discover Bank also entered into a Purchase Price Adjustment Agreement and an Indemnification Agreement with Citibank. Under the Purchase Price Adjustment Agreement, Citibank has agreed to pay Discover Bank the amount, if any, by which the aggregate Merger Consideration exceeds the closing purchase price of the securitization trust certificates, plus the absolute value of all reimbursable liabilities, less all cash or cash equivalents reflected on the closing balance sheet (excluding any cash and cash equivalents taken into account in determining the closing purchase price of the securitization trust certificates). If the aggregate Merger Consideration is less than such amount, Discover Bank would make a payment to Citibank. The Company expects that Citibank will be required to make a purchase price closing adjustment in the form of a cash payment to Discover Bank in the amount of approximately \$150 million. Under the terms of the Indemnification Agreement, Citibank has agreed to indemnify Discover Bank for liabilities and losses arising from and relating to (i) SLC's asset sales to Sallie Mae and Citibank, (ii) failure of the issuers of the insurance policies covering the Loans to perform their obligations, and (iii) certain other events.

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

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

The following factors, among others, could cause actual results to differ materially from those set forth in the forward-looking statements: changes in economic variables, such as the availability of consumer credit, the housing market, energy costs, the number and size of personal bankruptcy filings, the rate of unemployment and the levels of consumer confidence and consumer debt, and investor sentiment; the impact of current, pending and future legislation, regulation and regulatory and legal actions, including new laws and rules limiting or modifying certain credit card practices, new laws and rules affecting securitizations, funding and liquidity, new laws and rules related to financial regulatory reform, and bank holding company regulations and supervisory guidance; the restrictions on our operations resulting from financing transactions; the actions and initiatives of current and potential competitors; our ability to successfully achieve card acceptance across our networks and maintain relationships with network participants; our ability to manage our credit risk, market risk, liquidity risk, operational risk, legal and compliance risk, and strategic risk; the availability and cost of funding and capital; access to deposit, securitization, equity, debt and credit markets; the impact of rating agency actions; the level and volatility of equity prices, commodity prices and interest rates, currency values, investments, other market fluctuations and other market indices; losses in our investment portfolio; our ability to increase or sustain Discover card usage or attract new customers; our ability to attract new merchants and maintain relationships with current merchants; the effect of political, economic and market conditions, geopolitical events and unforeseen or catastrophic events; fraudulent activities or material security breaches of key systems; our ability to introduce new products and services; our ability to sustain our investment in new technology and manage our relationships with third-party vendors; our ability to collect amounts for disputed transactions from merchants and merchant acquirers; our ability to attract and retain employees; our ability to protect our reputation and our intellectual property; difficulty financing or integrating new businesses, products or technologies; and new lawsuits, investigations or similar matters or unanticipated developments related to current matters. In addition, we routinely evaluate and may pursue acquisitions of or investments in businesses, products, technologies, loan portfolios or deposits, which may involve payment in cash or our debt or equity securities, and which could cause actual results to differ materially from those set forth in the forward-looking statements.

Additional factors that could cause our results to differ materially from those described below can be found in this section in this quarterly report and in Risk Factors and Management's Discussion and Analysis of Financial Condition and Results of Operations in our annual report on Form 10-K for the year ended November 30, 2009 and in Risk Factors in our quarterly report on Form 10-Q for the quarter ended May 31, 2010, which were filed with the SEC and are available at the SEC's internet site (<http://www.sec.gov>).

Introduction and Overview

Discover Financial Services is a leading credit card issuer in the United States and an electronic payment services company. Through our Discover Bank subsidiary, we offer our customers credit cards, other consumer loans and deposit products. Through our DFS Services LLC subsidiary and its subsidiaries, we operate the Discover Network, the PULSE Network (PULSE) and Diners Club International (Diners Club). The Discover Network provides credit card transaction processing for Discover card-branded and third-party issued credit cards. PULSE operates an electronic funds transfer network, providing financial institutions issuing debit

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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 that grants rights to licensees, which are generally financial institutions, to issue Diners Club branded credit cards and/or to provide card acceptance services. Our Diners Club business also offers transaction processing and marketing services to licensees globally. Our fiscal year ends on November 30 of each year.

Our primary revenues consist of interest income earned on loan receivables and fees earned from customers, merchants and issuers. The primary expenses required to operate our business include funding costs (interest expense), loan loss provisions, customer rewards, and expenses incurred to grow, manage and service our loan receivables and networks. Our business activities are funded primarily through the raising of consumer deposits, securitization of loan receivables and the issuance of both secured and unsecured debt.

Change in Accounting Principle Related to Off-Balance Sheet Securitizations

Beginning with the first quarter 2010, we have included the trusts used in our securitization activities in our consolidated financial results in accordance with the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 166, *Accounting for Transfers of Financial Assets* an amendment of FASB Statement No. 140 (Statement No. 166) (codified under the FASB Accounting Standards Codification (ASC) Section 860, *Transfers and Servicing*) and Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretations No. 46(R)* (Statement No. 167) (codified under ASC Section 810, *Consolidation*), which were effective for us at the beginning of our current fiscal year, December 1, 2009.

Under Statement No. 166, the trusts used in our securitization transactions are no longer exempt from consolidation. Statement No. 167 prescribes an ongoing assessment of our involvement in the activities of the trusts and our rights or obligations to receive benefits or absorb losses of the trusts that could be potentially significant in order to determine whether those entities will be required to be consolidated on our financial statements. Based on our assessment, we concluded that we are the primary beneficiary of the Discover Card Master Trust I (DCMT) and the Discover Card Execution Note Trust (DCENT) (the trusts) and accordingly, we began consolidating the trusts on December 1, 2009. Using the carrying amounts of the trust assets and liabilities as prescribed by Statement No. 167, we recorded a \$21.1 billion increase in total assets, a \$22.4 billion increase in total liabilities and a \$1.3 billion decrease in stockholders' equity (comprised of a \$1.4 billion decrease in retained earnings offset by an increase of \$0.1 billion in accumulated other comprehensive income). The significant adjustments to our statement of financial condition upon adoption of Statements No. 166 and 167 are outlined below:

Consolidation of \$22.3 billion of securitized loan receivables and the related debt issued from the trusts to third-party investors;

Reclassification of \$4.6 billion of certificated retained interests classified as investment securities to loan receivables;

Recording of a \$2.1 billion allowance for loan losses, not previously required under GAAP, for the newly consolidated and reclassified credit card loan receivables;

Derecognition of the remaining \$0.1 billion value of the interest-only strip receivable, net of tax, recorded in amounts due from asset securitization and reclassification of the remaining \$1.6 billion of amounts due from asset securitization to restricted cash, loan receivables and other assets; and

Recording of net deferred tax assets of \$0.8 billion, largely related to establishing an allowance for loan losses on the newly consolidated and reclassified credit card loan receivables.

Beginning with the first quarter 2010, our results of operations no longer reflect securitization income, but instead report interest income, net charge-offs and certain other income associated with all securitized loan receivables and interest expense associated with debt issued from the trusts to third-party investors in the same line items in our results of operations as non-securitized credit card loan receivables and corporate debt. Additionally, we no longer record initial gains on new securitization activity since securitized credit card loans

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no longer receive sale accounting treatment. Also, there are no gains or losses on the revaluation of the interest-only strip receivable as that asset is not recognizable in a transaction accounted for as a secured borrowing. Because our securitization transactions are being accounted for under the new accounting rules as secured borrowings rather than asset sales, the cash flows from these transactions are presented as cash flows from financing activities rather than as cash flows from operating or investing activities. Notwithstanding this accounting treatment, our securitizations are structured to legally isolate the receivables from Discover Bank, and we would not expect to be able to access the assets of our securitization trusts, even in insolvency, receivership or conservatorship proceedings. We do, however, continue to have the rights associated with our retained interests in the assets of these trusts.

Reconciliations of GAAP to As Adjusted Data

We did not retrospectively adopt Statements No. 166 and 167 and, therefore, the condensed consolidated financial statements presented in this quarterly report as of and for the three and nine months ended August 31, 2010 reflect the new accounting requirements, but the historical statement of financial condition as of November 30, 2009 and statement of income and statement of cash flows for the three and nine months ended August 31, 2009 continue to reflect the accounting applicable prior to the adoption of the new accounting requirements.

To enable the reader to better understand our financial information by reflecting period-over-period data on a consistent basis, this Management Discussion and Analysis of Financial Condition and Results of Operations presents our financial information as of and for the three and nine months ended August 31, 2010 as compared to adjusted results of operations data for the three and nine months ended August 31, 2009 and adjusted credit card loan receivables data as of November 30, 2009. Management reviews the as adjusted financial information in its decision-making and in evaluating the business. Therefore, management believes the adjusted financial information is useful to investors as it aligns with management's view of the business. The as adjusted amounts:

show how our financial data would have been presented if the trusts used in our securitization activities were consolidated into our financial statements for such historical periods; and

remove the impact of income received in connection with the settlement of our antitrust litigation with Visa and MasterCard for such historical periods.

The impacts of Statements No. 166 and 167 on our earnings summary, detail of other income and Direct Banking segment information are reflected in two steps in the reconciliation of GAAP to as adjusted data in the tables below. First, we made securitization adjustments to reverse the effect of loan securitization by recharacterizing securitization income to report interest income, expense, provision for loan losses, discount and interchange revenue and loan fee income in the same line items as non-securitized loans. These adjustments result in a managed basis presentation, which we have historically included in our quarterly and annual reports to reflect the way in which our senior management evaluated our business performance and allocated resources.

Then, additional adjustments were made to reflect results as if the trusts used in our securitization activities had been fully consolidated in our historical results. These adjustments include:

Elimination of interest income and interest expense related to certificated retained interests classified as investment securities and associated intercompany debt;

An adjustment to the provision for loan losses for the change in securitized loan receivables;

Elimination of the revaluation gains or losses associated with the interest-only strip receivable, which was derecognized upon adoption; and

An adjustment to reflect the income tax effects related to these adjustments.

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The impacts of Statements No. 166 and 167 on our effective tax rate, loan receivables and average balance sheet information are reflected in one step, rather than two, in the reconciliation of GAAP to as adjusted data in the tables below as there is no meaningful difference between such information on a historical managed basis as compared to an as adjusted basis.

Earnings Summary and Reconciliation

| | As Reported | For the Three Months Ended August 31, 2009 | | | As Adjusted |
|---|----------------|--|-----------------------------------|---------------------------|--------------|
| | | Securitization Adjustments | Managed (dollars in thousands) | Additional Adjustments | |
| Interest income | \$ 833,217 | \$ 830,864 | \$ 1,664,081 | \$ (3,294) ^(A) | \$ 1,660,787 |
| Interest expense | 304,401 | 88,241 | 392,642 | (10,404) ^(B) | 382,238 |
| Net interest income | 528,816 | 742,623 | 1,271,439 | 7,110 | 1,278,549 |
| Provision for loan losses | 380,999 | 543,428 | 924,427 | 160,782 ^(C) | 1,085,209 |
| Net interest income after provision for loan losses | 147,817 | 199,195 | 347,012 | (153,672) | 193,340 |
| Antitrust litigation settlement | 472,167 | | 472,167 | (472,167) ^(D) | |
| Other income | 843,793 | (199,195) | 644,598 | (68,881) ^(E) | 575,717 |
| Total other income | 1,315,960 | (199,195) | 1,116,765 | (541,048) | 575,717 |
| Total other expense | 523,838 | | 523,838 | | 523,838 |
| Income (loss) before income tax expense | 939,939 | | 939,939 | (694,720) | 245,219 |
| Income tax expense (benefit) | 362,485 | | 362,485 | (267,830) ^(F) | 94,655 |
| Net income (loss) | \$ 577,454 | \$ | \$ 577,454 | \$ (426,890) | \$ 150,564 |

| | As Reported | For the Nine Months Ended August 31, 2009 | | | As Adjusted |
|---|----------------|---|-----------------------------------|----------------------------|--------------|
| | | Securitization Adjustments | Managed (dollars in thousands) | Additional Adjustments | |
| Interest income | \$ 2,506,994 | \$ 2,368,388 | \$ 4,875,382 | \$ (16,672) ^(A) | \$ 4,858,710 |
| Interest expense | 937,126 | 307,996 | 1,245,122 | (32,783) ^(B) | 1,212,339 |
| Net interest income | 1,569,868 | 2,060,392 | 3,630,260 | 16,111 | 3,646,371 |
| Provision for loan losses | 1,962,673 | 1,406,659 | 3,369,332 | 495,437 ^(C) | 3,864,769 |
| Net interest income after provision for loan losses | (392,805) | 653,733 | 260,928 | (479,326) | (218,398) |
| Antitrust litigation settlement | 1,419,783 | | 1,419,783 | (1,419,783) ^(D) | |
| Other income | 2,167,253 | (653,733) | 1,513,520 | 122,315 ^(E) | 1,635,835 |
| Total other income | 3,587,036 | (653,733) | 2,933,303 | (1,297,468) | 1,635,835 |
| Total other expense | 1,643,589 | | 1,643,589 | | 1,643,589 |
| Income (loss) before income tax expense | 1,550,642 | | 1,550,642 | (1,776,794) | (226,152) |
| Income tax expense (benefit) | 626,994 | | 626,994 | (675,082) ^(F) | (48,088) |
| Net income (loss) | \$ 923,648 | \$ | \$ 923,648 | \$ (1,101,712) | \$ (178,064) |

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- (A) Elimination of interest income on certificated retained interests previously classified as investment securities and balance transfer fee income previously included in gain/loss on interest-only strip asset.
- (B) Elimination of interest expense on certificated retained interests previously classified as investment securities and an interest expense adjustment related to the discount on securitized borrowings.
- (C) Provision for loan loss on the period to period change in securitized loans.
- (D) Exclusion of settlement proceeds related to the Visa and MasterCard antitrust litigation.
- (E) Elimination of gain/loss related to revaluation of interest-only strip receivable and cash collateral accounts.
- (F) Estimated income tax benefit on the pretax loss related to Statement No. 167 adjustments and exclusion of taxes on the Visa/MasterCard antitrust litigation settlement.

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(A) See Income Tax Expense for discussion.

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Table of Contents*Direct Banking Segment Summary and Reconciliation*

| | As Reported | For the Three Months Ended August 31, 2009 | | | As Adjusted |
|---|----------------|--|------------------------|-----------------------------|--------------|
| | | Securitization Adjustments | Managed | Additional Adjustments | |
| | | | | | |
| | | | (dollars in thousands) | | |
| Interest income | \$ 833,022 | \$ 830,864 | \$ 1,663,886 | \$ (3,294) ^(A) | \$ 1,660,592 |
| Interest expense | 304,351 | 88,241 | 392,592 | (10,404) ^(B) | 382,188 |
| Net interest income | 528,671 | 742,623 | 1,271,294 | 7,110 | 1,278,404 |
| Provision for loan losses | 380,999 | 543,428 | 924,427 | 160,782 ^(C) | 1,085,209 |
| Other income | 1,254,724 | (199,195) | 1,055,529 | (541,048) ^(D) | 514,481 |
| Other expense | 489,596 | | 489,596 | | 489,596 |
| Income (loss) before income tax expense | \$ 912,800 | \$ | \$ 912,800 | \$ (694,720) ^(E) | \$ 218,080 |

| | As Reported | For the Nine Months Ended August 31, 2009 | | | As Adjusted |
|---|----------------|---|------------------------|-------------------------------|--------------|
| | | Securitization Adjustments | Managed | Additional Adjustments | |
| | | | | | |
| | | | (dollars in thousands) | | |
| Interest income | \$ 2,505,974 | \$ 2,368,388 | \$ 4,874,362 | \$ (16,672) ^(A) | \$ 4,857,690 |
| Interest expense | 936,936 | 307,996 | 1,244,932 | (32,783) ^(B) | 1,212,149 |
| Net interest income | 1,569,038 | 2,060,392 | 3,629,430 | 16,111 | 3,645,541 |
| Provision for loan losses | 1,962,673 | 1,406,659 | 3,369,332 | 495,437 ^(C) | 3,864,769 |
| Other income | 3,407,115 | (653,733) | 2,753,382 | (1,297,468) ^(D) | 1,455,914 |
| Other expense | 1,545,611 | | 1,545,611 | | 1,545,611 |
| Income (loss) before income tax expense | \$ 1,467,869 | \$ | \$ 1,467,869 | \$ (1,776,794) ^(E) | \$ (308,925) |

- (A) Elimination of interest income on certificated retained interests previously classified as investment securities and balance transfer fee income previously included in gain/loss on interest-only strip asset.
- (B) Elimination of interest expense on certificated retained interests previously classified as investment securities and an interest expense adjustment related to the discount on securitized borrowings.
- (C) Provision for loan loss on the period-to-period change in securitized loans.
- (D) Exclusion of settlement proceeds related to Visa/MasterCard antitrust litigation and elimination of gain/loss related to revaluation of interest-only strip receivable and cash collateral accounts.
- (E) Estimated income tax on the pretax loss related to Statement No. 167 adjustments and exclusion of taxes on the Visa/MasterCard antitrust litigation settlement.

Table of Contents*Loan Receivables Data and Reconciliation*

| | As of and for the Three Months Ended August 31, 2009 | | As of and for the Nine Months Ended August 31, 2009 | |
|--|--|--|---|--|
| | Total Loan Receivables (dollars in thousands) | Total Credit Card Loans (dollars in thousands) | Total Loan Receivables (dollars in thousands) | Total Credit Card Loans (dollars in thousands) |
| Loan receivables | | | | |
| GAAP | \$ 25,489,809 | \$ 22,721,603 | \$ 25,489,809 | \$ 22,721,603 |
| Adjustments for Statement No. 167 | 25,406,787 | 25,406,787 | 25,406,787 | 25,406,787 |
| As Adjusted | \$ 50,896,596 | \$ 48,128,390 | \$ 50,896,596 | \$ 48,128,390 |
| Allowance for loan losses (beginning of period) | | | | |
| GAAP | \$ 1,986,473 | | \$ 1,374,585 | |
| Adjustments for Statement No. 167 | 1,714,428 | | 1,379,772 | |
| As Adjusted | \$ 3,700,901 | | \$ 2,754,357 | |
| Provision for loan losses | | | | |
| GAAP | \$ 380,999 | | \$ 1,962,673 | |
| Adjustments for Statement No. 167 | 704,210 | | 1,902,096 | |
| As Adjusted | \$ 1,085,209 | | \$ 3,864,769 | |
| Charge-offs | | | | |
| GAAP | \$ (580,851) | \$ (559,672) | \$ (1,651,050) | \$ (1,604,491) |
| Adjustments for Statement No. 167 | (598,066) | (598,066) | (1,556,363) | (1,556,363) |
| As Adjusted | \$ (1,178,917) | \$ (1,157,738) | \$ (3,207,413) | \$ (3,160,854) |
| Recoveries | | | | |
| GAAP | \$ 45,739 | \$ 45,486 | \$ 146,152 | \$ 145,503 |
| Adjustments for Statement No. 167 | 54,639 | 54,639 | 149,706 | 149,706 |
| As Adjusted | \$ 100,378 | \$ 100,125 | \$ 295,858 | \$ 295,209 |
| Net charge-offs | | | | |
| GAAP | \$ (535,112) | \$ (514,186) | \$ (1,504,898) | \$ (1,458,988) |
| Adjustments for Statement No. 167 | (543,427) | (543,427) | (1,406,657) | (1,406,657) |
| As Adjusted | \$ (1,078,539) | \$ (1,057,613) | \$ (2,911,555) | \$ (2,865,645) |
| Allowance for loan losses (end of period) | | | | |
| GAAP | \$ 1,832,360 | | \$ 1,832,360 | |
| Adjustments for Statement No. 167 | 1,875,211 | | 1,875,211 | |
| As Adjusted | \$ 3,707,571 | | \$ 3,707,571 | |
| Net charge-offs % | | | | |
| GAAP | 8.05% | 8.48% | 7.30% | 7.63% |
| Adjustments for Statement No. 167 | 0.35 | 0.15 | 0.26 | 0.11 |
| As Adjusted | 8.40% | 8.63% | 7.56% | 7.74% |

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| Delinquency rate (Over 30 Days) | | | | |
|--|-------|-------|-------|-------|
| GAAP | 4.86% | 5.27% | 4.86% | 5.27% |
| Adjustments for Statement No. 167 | 0.25 | 0.04 | 0.25 | 0.04 |
| As Adjusted | 5.11% | 5.31% | 5.11% | 5.31% |
| Delinquency rate (Over 90 Days) | | | | |
| GAAP | 2.46% | 2.70% | 2.46% | 2.70% |
| Adjustments for Statement No. 167 | 0.14 | 0.02 | 0.14 | 0.02 |
| As Adjusted | 2.60% | 2.72% | 2.60% | 2.72% |

| | For the Three Months Ended | For the Nine Months Ended |
|-----------------------------------|---------------------------------------|--------------------------------------|
| | August 31, 2009 | |
| | (dollars in thousands) | |
| Discover card | | |
| Charge-offs | | |
| GAAP | \$ (541,272) | \$ (1,560,820) |
| Adjustments for Statement No. 167 | (598,066) | (1,556,363) |
| As Adjusted | \$ (1,139,338) | \$ (3,117,183) |
| Recoveries | | |
| GAAP | \$ 45,214 | \$ 144,901 |
| Adjustments for Statement No. 167 | 54,639 | 149,706 |
| As Adjusted | \$ 99,853 | \$ 294,607 |

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| | As of November 30, 2009 (dollars in thousands) | |
|--|--|-------|
| Discover card | | |
| Total Discover card loans | | |
| GAAP | \$ 19,826,153 | |
| Adjustments for Statement No. 167 | 27,229,062 | |
| As Adjusted | \$ 47,055,215 | |
| Allowance for loan losses (end of period) | | |
| GAAP | \$ 1,587,107 | |
| Adjustments for Statement No. 167 | 2,144,461 | |
| As Adjusted | \$ 3,731,568 | |
| Credit Card Loans | | |
| Total credit card loans | | |
| GAAP | \$ 20,230,302 | |
| Adjustments for Statement No. 167 | 27,229,062 | |
| As Adjusted | \$ 47,459,364 | |
| Allowance for loan losses (end of period) | | |
| GAAP | \$ 1,647,086 | |
| Adjustments for Statement No. 167 | 2,144,461 | |
| As Adjusted | \$ 3,791,547 | |
| Total Loans | | |
| Total loans | | |
| GAAP | \$ 23,625,084 | |
| Adjustments for Statement No. 167 | 27,229,062 | |
| As Adjusted | \$ 50,854,146 | |
| Allowance for loan losses (end of period) | | |
| GAAP | \$ 1,757,899 | |
| Adjustments for Statement No. 167 | 2,144,461 | |
| As Adjusted | \$ 3,902,360 | |
| Net loans | | |
| GAAP | \$ 21,867,185 | |
| Adjustments for Statement No. 167 | 25,084,601 | |
| As Adjusted | \$ 46,951,786 | |
| Loans over 30 days delinquent | | |
| GAAP | \$ 1,161,497 | 4.92% |
| Adjustments for Statement No. 167 | 1,539,462 | 0.39 |
| As Adjusted | \$ 2,700,959 | 5.31% |
| Loans over 90 days delinquent and accruing interest | | |
| GAAP | \$ 522,190 | 2.21% |
| Adjustments for Statement No. 167 | 694,864 | 0.18 |
| As Adjusted | \$ 1,217,054 | 2.39% |

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Loans not accruing interest

| | | | |
|-----------------------------------|----|---------|-------|
| GAAP | \$ | 190,086 | 0.80% |
| Adjustments for Statement No. 167 | | 248,192 | 0.06 |
| As Adjusted | \$ | 438,278 | 0.86% |

Table of Contents*Average Balance Sheet Reconciliation*

| | For the Three Months Ended August 31, 2009 | | | For the Nine Months Ended August 31, 2009 | | |
|--|---|--|--------|--|--|--------|
| | Average Balances | Interest Income/Expense (dollars in thousands) | Yield | Average Balances | Interest Income/Expense (dollars in thousands) | Yield |
| Average restricted cash | | | | | | |
| GAAP | \$ | \$ | % | \$ | \$ | % |
| Adjustments for Statement No. 167 | 2,537,305 | 3,996 | 0.62 | 2,391,937 | 15,359 | 0.86 |
| As Adjusted | \$ 2,537,705 | \$ 3,996 | 0.62% | \$ 2,391,937 | \$ 15,359 | 0.86% |
| Average investment securities | | | | | | |
| GAAP | \$ 1,593,805 | \$ 18,062 | 4.50% | \$ 1,434,401 | \$ 51,606 | 4.79% |
| Adjustments for Statement No. 167 | (984,608) | (10,539) | 0.40 | (982,458) | (33,191) | 0.64 |
| As Adjusted | \$ 609,197 | \$ 7,523 | 4.90% | \$ 451,943 | \$ 18,415 | 5.43% |
| Average credit card loan receivables | | | | | | |
| GAAP | \$ 24,051,037 | \$ 761,477 | 12.56% | \$ 25,459,830 | \$ 2,276,152 | 11.91% |
| Adjustments for Statement No. 167 | 24,577,751 | 838,111 | 0.49 | 23,856,122 | 2,384,909 | 0.68 |
| As Adjusted | \$ 48,628,788 | \$ 1,599,588 | 13.05% | \$ 49,315,952 | \$ 4,661,061 | 12.59% |
| Average total loan receivables | | | | | | |
| GAAP | \$ 26,380,203 | \$ 804,874 | 12.10% | \$ 27,454,927 | \$ 2,395,423 | 11.62% |
| Adjustments for Statement No. 167 | 24,577,751 | 838,111 | 0.69 | 23,856,122 | 2,384,909 | 0.79 |
| As Adjusted | \$ 50,957,954 | \$ 1,642,985 | 12.79% | \$ 51,311,049 | \$ 4,780,332 | 12.41% |
| Average other interest-earning assets | | | | | | |
| GAAP | \$ 2,437,304 | \$ 3,998 | 0.65% | \$ 2,291,937 | \$ 15,361 | 0.89% |
| Adjustments for Statement No. 167 | (2,437,304) | (3,998) | (0.65) | (2,291,937) | (15,361) | (0.89) |
| As Adjusted | \$ | \$ | % | \$ | \$ | % |
| Average total interest-earning assets | | | | | | |
| GAAP | \$ 39,761,137 | \$ 833,217 | 8.31% | \$ 39,698,998 | \$ 2,506,994 | 8.41% |
| Adjustments for Statement No. 167 | 23,693,144 | 827,570 | 2.07 | 22,973,665 | 2,351,716 | 1.92 |
| As Adjusted | \$ 63,454,281 | \$ 1,660,787 | 10.38% | \$ 62,672,663 | \$ 4,858,710 | 10.33% |
| Average allowance for loan losses | | | | | | |
| GAAP | \$ (1,921,008) | | | \$ (1,824,834) | | |
| Adjustments for Statement No. 167 | (1,833,584) | | | (1,639,025) | | |
| As Adjusted | \$ (3,754,592) | | | \$ (3,463,859) | | |
| Average other assets (non-interest bearing) | | | | | | |
| GAAP | \$ 4,332,432 | | | \$ 3,580,461 | | |
| Adjustments for Statement No. 167 | (978,343) | | | (476,862) | | |

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| | | | | | | | |
|---|---------------|------------|--------|---------------|---------------|--------|--|
| As Adjusted | \$ 3,354,089 | | | | \$ 3,103,599 | | |
| Average total assets | | | | | | | |
| GAAP | \$ 42,172,561 | | | | \$ 41,454,625 | | |
| Adjustments for Statement No. 167 | 20,881,217 | | | | 20,857,778 | | |
| As Adjusted | \$ 63,053,778 | | | | \$ 62,312,403 | | |
| Average securitized borrowings | | | | | | | |
| GAAP | \$ | \$ | % | \$ | \$ | % | |
| Adjustments for Statement No. 167 | 22,713,709 | 77,837 | 1.36 | 22,585,331 | 275,211 | 1.62 | |
| As Adjusted | \$ 22,713,709 | \$ 77,837 | 1.36% | \$ 22,585,331 | \$ 275,211 | 1.62% | |
| Average total borrowings | | | | | | | |
| GAAP | \$ 1,636,950 | \$ 14,883 | 3.61% | \$ 2,685,340 | \$ 42,359 | 2.10% | |
| Adjustments for Statement No. 167 | 22,713,709 | 77,837 | (2.10) | 22,585,331 | 275,211 | (0.43) | |
| As Adjusted | \$ 24,350,659 | \$ 92,720 | 1.51% | \$ 25,270,671 | \$ 317,570 | 1.67% | |
| Average total interest-bearing liabilities | | | | | | | |
| GAAP | \$ 30,817,313 | \$ 304,401 | 3.92% | \$ 31,276,776 | \$ 937,126 | 3.99% | |
| Adjustments for Statement No. 167 | 22,713,709 | 77,837 | (1.09) | 22,585,331 | 275,211 | (0.99) | |
| As Adjusted | \$ 53,531,022 | \$ 382,238 | 2.83% | \$ 53,862,107 | \$ 1,212,337 | 3.00% | |

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| | For the Three Months Ended August 31, 2009 | For the Nine Months Ended August 31, 2009 |
|--|--|--|
| | Average Balances (dollars in thousands, except where noted) | |
| Average other liabilities and stockholders equity (non-interest earning) | | |
| GAAP | \$ 11,355,248 | \$ 10,177,849 |
| Adjustments for Statement No. 167 | (1,832,492) | (1,727,553) |
| As Adjusted | \$ 9,522,756 | \$ 8,450,296 |
| Average total liabilities and stockholders equity | | |
| GAAP | \$ 42,172,561 | \$ 41,454,625 |
| Adjustments for Statement No. 167 | 20,881,217 | 20,857,778 |
| As Adjusted | \$ 63,053,778 | \$ 62,312,403 |
| Ratios and Other Amounts | | |
| Net interest margin | | |
| GAAP | 7.95% | 7.62% |
| Adjustments for Statement No. 167 | 2.00 | 1.85 |
| As Adjusted | 9.95% | 9.47% |
| Net yield on interest-earning assets | | |
| GAAP | 5.28% | 5.27% |
| Adjustments for Statement No. 167 | 2.71 | 2.48 |
| As Adjusted | 7.99% | 7.75% |
| Interest rate spread | | |
| GAAP | 4.40% | 4.42% |
| Adjustments for Statement No. 167 | 3.15 | 2.91 |
| As Adjusted | 7.55% | 7.33% |
| Amortization of balance transfer fees in interest income on credit card loans | | |
| (dollars in millions) | | |
| GAAP | \$ 33 | \$ 105 |
| Adjustments for Statement No. 167 | 13 | 51 |
| As Adjusted | \$ 46 | \$ 156 |

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Highlights

Net income was \$261 million in the third quarter 2010 as compared to net income of \$151 million in the third quarter 2009 as adjusted.

Discover card sales volume increased 5% in the third quarter 2010 as compared to 2009, reflecting a continuation of the year-over-year growth seen throughout 2010, due to an increase in average spend per customer and broadened merchant acceptance. However, credit card loan receivables at August 31, 2010 were down 6%, to \$45.2 billion, from August 31, 2009 as adjusted due to a reduction in promotional rate balances and an increase in the payment rate. Total loan receivables were down only modestly as the decline in credit card loan receivables was partially offset by an increase in student loans.

Credit performance continued to improve during the third quarter 2010. Our net charge-off rate was 7.18% and our over 30 days delinquency rate was 4.16%, decreases of 79 and 36 basis points, respectively, as compared to the second quarter 2010. Additionally, improvement in our outlook for credit performance over the next twelve months led to a reduction in the loan loss reserve rate, which resulted in a \$187 million reduction of our allowance for loan losses during the third quarter 2010.

Transaction dollar volumes in our Payment Services segment increased to \$39 billion in the third quarter 2010, an increase of 8% as compared to the third quarter 2009, and the number of transactions processed on our PULSE network increased 17% during the same period. Pretax income for the segment rose to \$37 million in the third quarter 2010, an increase of 36% from the third quarter 2009, reflecting increased volumes from new and existing clients as well as higher margins from transactions on our PULSE network.

Direct-to-consumer deposits grew to \$19.1 billion at August 31, 2010, an increase of \$1.5 billion as compared to May 31, 2010.

Outlook

The third quarter 2010 continued to reflect growth in sales volumes as well as improvement in the credit performance of our loan portfolio on both a sequential and year-over-year basis. As we continue to invest in marketing and advertising, we expect that Discover card sales volumes will also continue to grow, although we anticipate it may be accompanied by higher payment rates. We believe that the level of credit card loan receivables, which has declined during 2010, has stabilized as of the end of the third quarter and expect that it will remain around that level for the fourth quarter.

We expect net charge-off dollars in the fourth quarter to remain in a reasonably tight range around the third quarter level. The net charge-off rate on total loans, however, could increase in the fourth quarter as a result of an anticipated decline in total loans due to the sale of federal student loan receivables as discussed in [Recent Developments](#) below.

Interest yield on credit card loan receivables declined slightly to 12.86% in the third quarter, down 7 basis points from the second quarter, reflecting the impact of the implementation of CARD Act provisions, partially offset by a decline in interest charge-offs. In the fourth quarter, we expect that interest yield on credit card loan receivables will decline further as the impact of implemented CARD Act changes is more fully reflected in our results, although the impact is expected to be partially offset by improvement in interest charge-offs.

At August 31, 2010, we had \$9.1 billion in our liquidity investment portfolio, which we expect will remain relatively stable through the end of 2010. As asset-backed securitized borrowings have matured, much of the funding they provided has been replaced by issuances of direct-to-consumer deposits and a planned reduction in our liquidity investment portfolio. In the fourth quarter 2010, we expect to continue to grow direct-to-consumer deposits. With respect to securitizations, in September 2010, we issued \$600 million of public asset-backed securities and utilized \$200 million of capacity under private asset-backed conduit funding facilities. Future

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asset-backed securities issuances will depend in part on the impact of legislative and regulatory developments on securitizations. See Legislative and Regulatory Developments Asset-Backed Securities Regulations for additional discussion.

Payment Services transaction volume is expected to continue to grow. We plan to continue making investments to build brand awareness and our global acceptance network for credit, debit and cash access transactions. We believe that our strategic network alliances with key card networks such as Korea's BC Card, Japan's JCB, China UnionPay and Serbia's DinaCard, along with continued development of merchant acquirer relationships, will be our foundation for driving global acceptance and volumes.

Recent Developments

On September 17, 2010, our wholly-owned subsidiary Discover Bank and The Student Loan Corporation (SLC) entered into an Agreement and Plan of Merger (the Merger Agreement), pursuant to which Discover Bank agreed to acquire SLC for \$600 million, or \$30 per share, subject to an expected purchase price closing adjustment in the form of a cash payment of approximately \$150 million by Citibank, N.A. (Citibank), 80% owner of SLC, to Discover Bank. The result is that Discover Bank expects to have a net cash outlay of approximately \$450 million for the acquisition of SLC. The acquisition will occur through the merger of a wholly-owned subsidiary of Discover Bank with and into SLC, with SLC surviving the merger as a wholly-owned subsidiary of Discover Bank. Immediately prior to the merger, SLC is expected to sell \$28 billion of assets to SLM Corporation (Sallie Mae) and \$8.7 billion of assets to Citibank. Discover Bank will acquire in the merger approximately \$4.2 billion of private student loans and related assets, along with assuming \$3.4 billion of SLC's existing asset-backed securitization debt funding for the loans. The transaction is expected to close after the end of the fiscal year but before the end of the calendar year, subject to closing conditions including, among others, the approval of the Merger Agreement by SLC's stockholders and the closing of SLC's asset sale transactions. There can be no assurance, however, that the acquisition will close by the end of the calendar year, if at all. For more information, see Note 18: Subsequent Events to our condensed consolidated financial statements.

On September 23, 2010, we completed the sale of \$1.5 billion of federal student loans to the U.S. Department of Education as part of the 2009-10 Loan Purchase Program under the Ensuring Continued Access to Student Loans Act of 2008 (ECASLA).

Legislative and Regulatory Developments

Legislation Addressing Credit Card Practices

In May 2009, the Credit Card Accountability Responsibility and Disclosure Act of 2009 (the CARD Act) was enacted. The CARD Act made numerous changes to the Truth in Lending Act, affecting the marketing, underwriting, pricing, billing and other aspects of the consumer credit card business. Several provisions of the CARD Act became effective in August 2009, but most of the requirements became effective in February 2010 and others became effective in August 2010.

A number of the CARD Act's requirements reflected our existing practices and have not required modifications of policies or procedures. Certain provisions of the CARD Act, however, have required and will require us to make additional fundamental changes to our business practices and systems. We are continuing to evaluate appropriate modifications to products, pricing, marketing strategies and other business practices that will be in compliance with the law, will be attractive to consumers and will provide a good return for our stockholders. The restrictions on late and other penalty fees will reduce loan fee revenues and may impact our ability to deter late payments. The requirement to review annual percentage rate increases since January 1, 2009 will reduce our interest income. The full impact of the CARD Act ultimately depends upon successful implementation of our strategies, consumer behavior, and the actions of our competitors, in addition to further Federal Reserve and Bureau of Consumer Financial Protection interpretation of the provisions.

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The CARD Act also requires the Federal Reserve and the Government Accountability Office to conduct various studies, including a review of interchange fees, reasons for credit limit reductions and rate increases, small business cards, and credit card terms and disclosures. Based on the results of these studies, new requirements that negatively impact us may be introduced as future legislation or regulation.

Financial Regulatory Reform

In July 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Reform Act), which contains a comprehensive set of provisions designed to govern the practices and oversight of financial institutions and other participants in the financial markets. The Reform Act, as well as other legislative and regulatory changes, could have a significant impact on us by, for example, requiring us to change our business practices, requiring us to meet more stringent capital, liquidity and leverage ratio requirements, limiting our ability to pursue business opportunities, imposing additional costs on us, limiting fees we can charge for services, impacting the value of our assets, or otherwise adversely affecting our businesses.

The Reform Act addresses risks to the economy and the payments system, especially those posed by large systemically significant financial firms, including bank holding companies with assets of at least \$50 billion, which would include us. It does so through a variety of measures, including increased capital and liquidity requirements, limits on leverage, enhanced supervisory authority (including authority to limit activities and growth), regulatory oversight of non-banking entities, broad new powers to seize and wind down failed systemically-important financial firms, including non-bank financial companies (and the establishment of a mechanism to recover such costs through assessments on large financial firms), enhanced regulation of derivatives, restrictions on and additional disclosure of executive compensation, additional corporate governance requirements, and oversight of credit rating agencies. Effective July 2011, the Reform Act requires a bank holding company that elects treatment as a financial holding company, including us, to be both well-capitalized and well-managed in addition to the existing requirement that a financial holding company's subsidiary banks be well-capitalized and well-managed.

Additionally, the Reform Act establishes the Bureau of Consumer Financial Protection (the BCFP) within the Federal Reserve, which will regulate consumer credit. On July 21, 2011, the consumer financial protection functions currently assigned to the federal banking and other designated agencies will shift to the BCFP. The BCFP will have broad rulemaking and enforcement authority over providers of credit, savings and payment services and products. The BCFP will be directed to prevent unfair, deceptive or abusive practices and ensure that all consumers have access to markets for consumer financial products and services, and that such markets are fair, transparent and competitive. The BCFP will have rulemaking and interpretive authority under existing and future consumer financial services laws and supervisory, examination and enforcement authority over institutions subject to its jurisdiction, which would include us. State officials will be authorized to enforce consumer protection rules issued by the BCFP.

In addition, the Reform Act requires, effective July 21, 2011, that interchange fees paid to or charged by payment card issuers on debit card transactions must be reasonable and proportional to the issuer's cost in connection with authorization, clearance or settlement of such transactions. The Reform Act directs the Federal Reserve to enact rules to implement this requirement, and also to enact rules to prohibit debit card networks and issuers from requiring transactions to be processed solely on a single payment network or two or more affiliated networks. Further, the Reform Act prohibits credit/debit network rules that restrict merchants from offering discounts to customers in order to encourage them to use a particular form of payment, or from setting minimum transaction amounts of \$10.00 or less for use of credit cards (or, with respect to government agencies and educational institutions, maximum transaction amounts), as long as such merchant practices do not differentiate on the basis of the issuer or network. The impact of these provisions on the debit card market and the PULSE network is uncertain at this time and will depend upon Federal Reserve implementing regulations, the actions of our competitors, and the behavior of other marketplace participants.

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In addition, the Reform Act contains several provisions that could increase the Federal Deposit Insurance Corporation (FDIC) deposit insurance premiums paid by Discover Bank, including a change in the assessment base for federal deposit insurance from the amount of insured deposits to consolidated assets less tangible equity and an increase in the minimum reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits (with the FDIC having until September 30, 2020 to meet the new minimum through assessments on insured depository institutions with assets of \$10 billion or more). Various assessments and fees are also authorized in the legislation and others could be authorized in the future.

As described below under Asset-Backed Securities Regulations, the Reform Act also imposes a number of significant changes relating to the asset-backed securities and structured finance markets, which may impact our ability and/or desire to utilize those markets to meet funding and liquidity needs.

Many provisions of the Reform Act require the adoption of rules to implement. In addition, the Reform Act mandates multiple studies, which could result in additional legislative or regulatory action. The effect of the Reform Act and its implementing regulations on our business and operations could be significant. In addition, we may be required to invest significant management time and resources to address the various provisions of the Reform Act and the numerous regulations that are required to be issued under it. The Reform Act, any related legislation and any implementing regulations could have a material adverse effect on our business, results of operations and financial condition.

Asset-Backed Securities Regulations

While we have capacity to issue new asset-backed securities from our securitization trusts, there has been uncertainty in the securitization market recently as a result of revised accounting standards and related guidance from the FDIC as well as proposed new Securities and Exchange Commission (SEC) rules governing the issuance of asset-backed securities and additional requirements contained in the Reform Act.

FDIC Rule

The ability of issuers of asset-backed securities to obtain necessary credit ratings for their issuances has been based, in part, on the FDIC's safe-harbor rule entitled *Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation*, which provides that the FDIC, as conservator or receiver, will not, using its power to disaffirm or repudiate contracts, seek to reclaim or recover assets transferred in connection with a securitization, or recharacterize them as assets of the insured depository institution, provided such transfer meets the conditions for sale accounting treatment under GAAP. Pursuant to FASB guidance for transfers of financial assets, effective for us on December 1, 2009, certain transfers of assets to special purpose entities (including Discover Bank's transfer of assets to the Discover Card Master Trust) no longer qualify for sale accounting treatment. Consequently, there has been uncertainty in the securitization market as to how the FDIC will treat assets transferred into securitization vehicles under the new FASB guidance.

In March 2010, the FDIC published a final rule that preserves the safe-harbor treatment applicable under the existing FDIC rule for beneficial interests in securitizations of revolving assets issued on or prior to September 30, 2010 so long as those securitizations would have complied with the original safe harbor under GAAP in effect prior to November 15, 2009. On September 27, 2010, the FDIC approved a final rule that preserves the safe-harbor treatment applicable to revolving trusts and master trusts, which we believe includes the trusts used in our credit card securitization program. Other legislative and regulatory developments, namely the proposed SEC Regulation AB 2, the securitization and rating agency provisions of the Reform Act and the federal banking agencies' notice regarding their consideration of replacement of the ratings-based approach for assessing capital charges against securitization exposures, may, however, impact our ability and/or desire to issue asset-backed securities in the future. See below for additional information.

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SEC Regulation AB 2

In April 2010, the SEC proposed revised rules for asset-backed securities offerings (SEC Regulation AB 2) that, if adopted, would substantially change the disclosure, reporting and offering process for public and private offerings of asset-backed securities, including those offered under our securitization program. The proposed rules, if adopted in their current form, would, among other things, impose as a condition for the shelf registration of asset-backed securities a requirement that the sponsor of the asset-backed securities offering hold a minimum of 5% of the nominal amount of each of the tranches sold or transferred to investors (or, in the case of revolving master trusts, an originator's interest of a minimum of 5% of the nominal amount of the securitization exposures) and not hedge those holdings. Issuers of publicly offered asset-backed securities would be required to disclose more information regarding the underlying assets and to file a computer program that demonstrates the effect of the transaction's waterfall of distributions. In addition, the proposals would alter the safe-harbor standards for the private placement of asset-backed securities to impose informational requirements similar to those that would apply to registered public offerings of such securities.

Reform Act

The Reform Act also imposes a number of significant changes relating to the asset-backed securities and structured finance markets, including a requirement that regulators jointly adopt regulations requiring the sponsor of a securitization to retain, subject to certain exemptions and exceptions, at least 5% unhedged credit risk on securitized exposures. The Reform Act also requires the SEC to impose asset-level registration statement disclosure requirements if the data is necessary for investors to independently perform due diligence.

Additionally, the Reform Act nullified Rule 436(g) of the Securities Act of 1933 (the Securities Act) effective immediately, which had provided that credit ratings assigned by a rating agency would not be considered part of a registration statement prepared or certified by an expert. This change requires registrants (including issuers of asset-backed securities) to obtain written consent of a credit rating agency in order to include the agency's rating in a registration statement and subjects the rating agencies to expert liability under Section 11 of the Securities Act for misstatements or omissions of material facts in connection with such credit rating disclosure. In response to this measure, the major credit rating agencies issued statements indicating that they would be unwilling to provide the required consent. In order to provide a transition period, the SEC subsequently issued a no-action letter in July 2010 allowing issuers to omit credit ratings from registration statements until January 24, 2011. Failure to resolve this issue after expiration of the no-action period could impact our ability to offer registered asset-backed securities.

Section 939A of the Reform Act requires each federal agency to review and to remove references to external credit ratings from their regulations that require the use of an assessment of creditworthiness of a security, and to substitute in their place other standards of creditworthiness that the agencies determine to be appropriate for such regulations. In response to such requirement, in August 2010, the federal banking agencies issued an advance notice of proposed rulemaking soliciting comment on alternatives to the use of credit ratings in their risk-based capital rules for banking organizations, including alternatives to the ratings-based approach in such rules for securitization exposures. It is not clear what alternatives will ultimately be adopted. Any such alternatives could, among other things, significantly affect the amount of capital that banking organizations are required to keep against such exposures.

It is uncertain at this time what the rules implementing the provisions of the Reform Act related to asset-backed securities will ultimately look like and what impact they will have on our ability and/or desire to issue asset-backed securities in the future. For instance, with respect to risk retention, we currently hold the seller's interest in our securitization trusts as well as certain subordinated tranches issued by these trusts, which collectively represent approximately 57% of the principal receivables balance in our trusts as of August 31, 2010. Although we believe it likely that any final regulations implementing the Reform Act risk retention requirements, which must be adopted on an interagency basis, will recognize these interests as satisfying the risk retention requirement, we will not have certainty until the proposed rules have been promulgated. The SEC recently

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published a timetable for the release of its rules implementing the provisions of the Reform Act including those impacting the issuance of asset-backed securities, which are scheduled to be released between October 2010 and July 2011. However, the SEC has provided no timetable for implementing the disclosure changes in proposed SEC Regulation AB 2, as the Reform Act does not mandate the timing for adoption of those changes.

Student Loan Legislation

The Health Care and Education Reconciliation Act of 2010 (HCERA). HCERA requires all federal student loans originated after July 2010 to be made directly by the federal government, rather than by private institutions through the Federal Family Education Loan Program. Because HCERA allows financial institutions to continue offering private student loans, we do not currently expect it to have a significant impact on our private student loan program. The Reform Act referenced above provides for a study of private education loans and lenders, and creates a private education loan Ombudsman within the Bureau of Consumer Financial Protection. The study could lead to additional legislation or regulation in the future. In addition, legislation has been introduced in Congress that would make it easier for borrowers to discharge private student loans in bankruptcy, as described further below.

Bankruptcy Legislation

A bill referred to the Senate Judiciary Committee would disallow claims in Chapter 7 bankruptcy based on high cost consumer debt and exclude consumers with such debt from the bankruptcy means test. The means test requires debtors who can afford to repay a portion of their debts through Chapter 13 repayment plan do so, rather than discharge all indebtedness under Chapter 7. The proposed legislation, if enacted, could increase the percentage of bankruptcy filers who obtain full debt discharges to the detriment of all unsecured lenders, and could result in increased charge-offs of our loan receivables. It is unclear whether this legislation will be considered by the next Congress.

Congress also considered legislation this year to allow bankruptcy courts to restructure first mortgage loans (e.g., by reducing the loan amount to the value of the collateral, a process referred to as cramdown). Such a change would likely increase the number of individuals who file for bankruptcy, which would adversely impact all creditors including us. While the House of Representatives approved a cramdown bill, the Senate did not. This or similar legislation could be reintroduced in the next Congress.

In addition, a bill has been introduced in Congress that would remove current limitations on the dischargeability of private student loan debts in bankruptcy. If enacted, the bill would make it easier for borrowers of private student loans to obtain a discharge of their student loan debts. The bill was recently approved by a subcommittee and forwarded to the House Committee on the Judiciary for consideration. The prospects for further advancement of this bill in the current Congressional session are unclear.

Compensation Developments

In June 2010, the Federal Reserve, together with the FDIC and the other banking agencies, issued final guidance designed to ensure that incentive compensation practices of financial organizations take into account risk and are consistent with safety and soundness. The Federal Reserve recently conducted a special horizontal review of compensation practices at more than twenty large complex banking organizations, including us, with the expectation that incentive compensation practices appropriately balance risk and financial results and avoid creating incentives for employees to take imprudent risks. The Reform Act described above under Financial Regulatory Reform imposes additional disclosures and restrictions on compensation.

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FDIC Initiatives Regarding Assessments

Market failures have significantly depleted the insurance fund of the FDIC and reduced the ratio of reserves to insured deposits. In January 2010, the FDIC issued an Advance Notice of Proposed Rulemaking seeking comment on ways that the FDIC's risk-based deposit insurance assessment system could be changed to account for the risks posed by certain employee incentive compensation programs. The proposed rulemaking was subject to a public comment period, which has expired, but no final rule has been issued. Additionally, in May 2010, the FDIC issued a Notice of Proposed Rulemaking proposing to revise the deposit assessment system applicable to large institutions, which would include Discover Bank, to better align assessment rates with the risks of such institutions. New initial and total base assessment rates would be effective January 1, 2011. The proposal includes a larger assessment on deposits that are treated under applicable banking regulations as brokered deposits to the extent that brokered deposits exceed 10% of the total deposits of a bank, which would adversely affect the assessment paid by Discover Bank, assuming its current deposit level and composition. The proposed rulemaking was subject to a public comment period, which expired in early July 2010, but no final rule has been issued. As discussed above under "Financial Regulatory Reform," the Reform Act will likely increase the amounts that we will have to pay to the FDIC for deposit insurance.

Initiatives Related to Capital and Liquidity

The Basel Committee on Banking Supervision released two consultative documents proposing significant changes to bank capital, leverage and liquidity requirements in December 2009, commonly referred to as Basel III. The Basel Committee considered public comments received on the December proposal, the results of a qualitative impact study and the economic impact over the transition period. In July 2010, the Committee issued statements that reflected, among other things, decisions reached on certain elements of the comprehensive proposals, including the overall design of the capital and liquidity reform package.

In September 2010, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee, announced minimum capital ratios and transition periods and endorsed the statements the Committee released in July 2010. The announcement provides that: (i) the minimum requirement for the Tier 1 common equity ratio will be increased from the current 2% level to 4.5%, to be phased in by January 1, 2015, and (ii) the minimum requirement for the Tier 1 capital ratio will be increased from 4% to 6%, to be phased in by January 1, 2015.

In addition, Basel III includes a capital conservation buffer that requires banking organizations to maintain an additional 2.5% of Tier 1 common equity to total risk weighted assets on top of the minimum requirement, which will be phased in between January 1, 2016 and January 1, 2019. The capital conservation buffer is designed to absorb losses in periods of financial and economic distress and, while banks are allowed to draw on the buffer during periods of stress, if a bank's regulatory capital ratios approach the minimum requirement, the bank will be subject to constraints on earnings distributions. In addition, Basel III includes a countercyclical buffer within a range of 0% to 2.5%, which would be implemented according to national circumstances.

These capital requirements are supplemented under Basel III by a non-risk-based leverage ratio. A minimum Tier 1 leverage ratio of 3% will be tested during the parallel run period starting January 1, 2013. Based on the results of the parallel run period, any final adjustments would be carried out in the first half of 2017.

The September 2010 Basel III announcement states that systemically important banks should have higher loss absorbing capacity than required by the Basel III standards. The announcement also reaffirms the Basel Committee's intention to introduce higher capital requirements on securitization and trading activities at the end of 2011.

The Basel III liquidity proposals have three main elements: (i) a liquidity coverage ratio designed to ensure that a bank maintains an adequate level of unencumbered high-quality assets sufficient to meet the bank's

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liquidity needs over a 30-day time horizon under an acute liquidity stress scenario, (ii) a net stable funding ratio designed to promote more medium and long-term funding of the assets and activities of banks over a one-year time horizon, and (iii) a set of monitoring tools that the Basel Committee indicates should be considered as the minimum types of information that banks should report to supervisors. After an observation period beginning in 2011, the liquidity coverage ratio will become effective on January 1, 2015. The revised net stable funding ratio will become effective January 1, 2018.

The U.S. federal banking agencies expressed support for the agreements reached by the Group of Governors and Heads of Supervision set forth in the announcement made in September 2010. While the announcement provided clarity on the minimum capital levels, many of the details of the new framework will remain unclear until the final release is issued. The Basel Committee is expected to release the final detailed requirements later this year. Implementation of any final provisions of Basel III in the U.S. will require implementing regulations and guidelines by U.S. banking regulators, which may differ in significant ways from the recommendations published by the Basel Committee. It is unclear how U.S. banking regulators will define well-capitalized in their implementation of Basel III.

The Reform Act also includes provisions related to increased capital and liquidity requirements. Such provisions would establish minimum leverage and risk-based capital requirements on a consolidated basis for all depository institution holding companies and insured depository institutions that cannot be less than the minimum currently in effect for depository institutions.

We are not able to predict at this time the content of capital and liquidity guidelines or regulations that may be adopted by regulatory agencies having authority over us and our subsidiaries or the impact that any changes in regulation would have on us. If new standards require us or our banking subsidiaries to maintain more capital, with common equity as a more predominant component, or manage the configuration of our assets and liabilities in order to comply with formulaic liquidity requirements, such regulation could significantly impact our return on equity, financial condition, operations, capital position and ability to pursue business opportunities.

* * *

The remaining discussion provides a summary of our results of operations for the three and nine months ended August 31, 2010 compared to our results of operations for the three and nine months ended August 31, 2009 as adjusted. It also provides information about our loan receivables as of August 31, 2010 as compared to November 30, 2009 as adjusted and August 31, 2009 as adjusted. For a reconciliation of GAAP to as adjusted financial data, see Reconciliation of GAAP to As Adjusted Data.

Segments

We manage our business activities in two segments: Direct Banking and Payment Services. In compiling the segment results that follow, our Direct Banking segment bears all overhead costs that are not specifically associated with a particular segment and all costs associated with Discover Network marketing, servicing and infrastructure, with the exception of an allocation of direct and incremental costs driven by our Payment Services segment.

Direct Banking. Our Direct Banking segment includes Discover card-branded credit cards issued to individuals and small businesses that are accepted on the Discover Network and other consumer products and services, including personal loans, student loans, prepaid cards and other consumer lending and deposit products offered through our Discover Bank subsidiary.

Payment Services. Our Payment Services segment includes the PULSE Network, an automated teller machine, debit and electronic funds transfer network; Diners Club, a global payments network; and our third-party issuing business, which includes credit, debit and prepaid cards issued on the Discover Network by third parties.

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

| | For the Three Months Ended August 31, | | For the Nine Months Ended August 31, | |
|--|--|-------------------|---|---------------------|
| | 2010 | 2009 | 2010 | 2009 |
| Direct Banking⁽¹⁾ | | | | |
| Interest income | \$ 1,535,934 | \$ 1,660,592 | \$ 4,646,856 | \$ 4,857,690 |
| Interest expense | 389,059 | 382,188 | 1,207,322 | 1,212,149 |
| Net interest income | 1,146,875 | 1,278,404 | 3,439,534 | 3,645,541 |
| Provision for loan losses | 712,565 | 1,085,209 | 2,824,035 | 3,864,769 |
| Other income | 495,771 | 514,481 | 1,423,823 | 1,455,914 |
| Other expense | 534,782 | 489,596 | 1,465,749 | 1,545,611 |
| Income (loss) before income tax expense | 395,299 | 218,080 | 573,573 | (308,925) |
| Payment Services | | | | |
| Interest income | 5 | 195 | 15 | 1,020 |
| Interest expense | 78 | 50 | 160 | 190 |
| Net interest income | (73) | 145 | (145) | 830 |
| Provision for loan losses | | | | |
| Other income | 68,373 | 61,236 | 199,041 | 179,921 |
| Other expense | 31,456 | 34,242 | 88,841 | 97,978 |
| Income before income tax expense | 36,844 | 27,139 | 110,055 | 82,773 |
| Total income (loss) before income tax expense | \$ 432,143 | \$ 245,219 | \$ 683,628 | \$ (226,153) |

(1) The 2009 Direct Banking segment information is presented on an as adjusted basis. No adjustments have been made to the Payment Services segment. See reconciliation in Reconciliation of GAAP to As Adjusted Data.

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

| | For the Three Months Ended August 31, | | For the Nine Months Ended August 31, | |
|---|--|---------------|---|----------------|
| | 2010 | 2009 | 2010 | 2009 |
| Network Transaction Volume | | | | |
| PULSE Network | \$ 30,581,850 | \$ 28,051,978 | \$ 86,845,109 | \$ 84,634,195 |
| Third-Party Issuers | 1,793,785 | 1,446,308 | 5,034,051 | 4,149,286 |
| Diners Club | 6,542,418 | 6,465,990 | 19,805,455 | 19,000,168 |
| Total Payment Services | 38,918,053 | 35,964,276 | 111,684,615 | 107,783,649 |
| Discover Network Proprietary ⁽¹⁾ | 24,880,163 | 23,579,434 | 71,684,416 | 67,976,397 |
| Total Volume | \$ 63,798,216 | \$ 59,543,710 | \$ 183,369,031 | \$ 175,760,046 |
| Transactions Processed on Networks | | | | |
| Discover Network | 418,423 | 390,643 | 1,192,556 | 1,126,605 |
| PULSE Network | 882,172 | 753,201 | 2,407,359 | 2,201,903 |

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| | | | | |
|---|---------------|---------------|---------------|---------------|
| Total | 1,300,595 | 1,143,844 | 3,599,915 | 3,328,508 |
| Credit Card Volume | | | | |
| Discover Card Volume ⁽²⁾ | \$ 25,552,568 | \$ 23,955,402 | \$ 73,644,406 | \$ 72,256,730 |
| Discover Card Sales Volume ⁽³⁾ | \$ 23,992,715 | \$ 22,768,927 | \$ 69,251,162 | \$ 65,556,858 |

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

(2) Represents Discover card activity related to net sales, balance transfers, cash advances and fee-based products.

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

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Direct Banking

Our Direct Banking segment reported pretax income of \$395 million and \$574 million for the three and nine months ended August 31, 2010, respectively, as compared to pretax income of \$218 million for the three months ended August 31, 2009 as adjusted and a pretax loss of \$309 million for the nine months ended August 31, 2009 as adjusted.

Discover card sales volume was up in both the quarter-to-date and year-to-date periods ending August 31, 2010 as compared to the prior year periods, reflecting higher average spend per customer, as well as a continued increase in merchant acceptance. Loan receivables totaled \$50.1 billion at August 31, 2010, which was down from \$50.9 billion at August 31, 2009 as adjusted, as a decline in credit card loans was partially offset by growth in student loans. The decline in credit card loans was driven by a reduction in promotional rate balances and an increase in the payment rate.

Net interest income declined during the three and nine months ended August 31, 2010 as compared to the three and nine months ended August 31, 2009 as adjusted, largely due to a lower net interest margin as well as a lower average level of loan receivables. The decline in net interest margin is reflective of an increase in lower rate student loan balances, the impact of legislative changes on credit card yield and higher funding costs. This was partially offset by a reduction in lower yielding promotional rate credit card balances, higher interest rates on standard balances and lower interest charge-offs.

At August 31, 2010, our over 30-days delinquency rate was 4.16% as compared to 5.11% at August 31, 2009 as adjusted, which is reflective of continued improvement in credit performance. At August 31, 2010, the net charge-off rate declined to 7.18% for the three months then ended, compared to 8.40% for the same period in 2009 as adjusted. For the nine months ended August 31, 2010, the net charge-off rate rose to 7.89% as compared to 7.56% for the same period in 2009 as adjusted. This increase for the nine month period was largely attributable to a peak in the level of charge-offs during the first quarter 2010.

The provision for loan losses declined in both the quarter-to-date and year-to-date periods ended August 31, 2010 as compared to August 31, 2009 as adjusted, which was primarily the result of a reduction in the loan loss reserve rate. Additionally, in the third quarter 2010, the decline in the provision for loan losses was also impacted by a decline in the level of net charge-offs. For a more detailed discussion on provision for loan losses, see [Loan Quality Provision and Allowance for Loan Losses](#).

Other income decreased in both periods as compared to the prior year as adjusted primarily due to the discontinuance of overlimit fees on consumer credit card loans beginning in February 2010 in connection with implementing the provisions of the CARD Act and lower late fees. This was partially offset by lower charge-offs of overlimit and late fees, a gain related to the liquidation of the collateral supporting our Golden Key investment (See Note 3: Investment Securities to our condensed consolidated financial statements) and higher discount and interchange revenue related to higher sales volume.

In the third quarter 2010, other expenses increased from the third quarter 2009 as we increased investments in account acquisition and promotional marketing while continuing to increase our investment in advertising. However, total other expense declined for the year-to-date period ending August 31, 2010 as compared to the comparable prior year period as the impact of the cost containment initiatives begun in 2009, particularly those related to employee compensation and benefits and information processing and communications, more than offset the impact of higher marketing expenses. Additionally, the first quarter of 2010 benefited from a \$29 million expense reversal related to the payment to Morgan Stanley under an amendment to the special dividend agreement, while the second quarter 2009 included a \$20 million restructuring charge related to a reduction in force.

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Payment Services

Our Payment Services segment reported pretax income of \$37 million and \$110 million for the three and nine months ended August 31, 2010, respectively, which was 36% and 33% higher than the three and nine months ended August 31, 2009, respectively, due to higher revenues and lower expenses. Higher revenues in both periods reflected increased volumes from new and existing clients, as well as higher margins from transactions on the PULSE network. Lower expenses in both periods were primarily due to transaction processing cost reduction initiatives as well as the inclusion of a number of significant Diners Club marketing initiatives in the third quarter 2009.

Transaction dollar volume for the three and nine months ended August 31, 2010 was \$39 billion and \$112 billion, respectively, an increase of 8% and 4% compared to the respective periods in 2009. The increase in transaction dollar volume was driven by higher volumes from all three contributors of our payments business. Additionally, the number of transactions processed on the PULSE Network from both new and existing clients increased by 17% and 9% for the three and nine months ended August 31, 2010, respectively, as compared to 2009.

Critical Accounting Estimates

In preparing our condensed consolidated financial statements in conformity with GAAP, management must make judgments and use estimates and assumptions about the effects of matters that are uncertain. For estimates that involve a high degree of judgment and subjectivity, it is possible that different estimates could reasonably be derived for the same period. For estimates that are particularly sensitive to changes in economic or market conditions, significant changes to the estimated amount from period to period are also possible. Management believes the current assumptions and other considerations used to estimate amounts reflected in our condensed consolidated financial statements are appropriate. However, if actual experience differs from the assumptions and other considerations used in estimating amounts in our consolidated financial statements, the resulting changes could have a material effect on our consolidated results of operations and, in certain cases, could have a material effect on our consolidated financial condition. Management has identified the estimates related to our allowance for loan losses, the accrual of credit card customer rewards cost, the evaluation of goodwill and other nonamortizable intangible assets for potential impairment and the accrual of income taxes as critical accounting estimates.

These critical accounting estimates are discussed in greater detail in our annual report on Form 10-K for the year ended November 30, 2009. That discussion can be found within Management's Discussion and Analysis of Financial Condition and Results of Operations under the heading Critical Accounting Estimates. In the first quarter 2010, management enhanced its ability to estimate loan loss emergence, which results in the allowance for loan losses having approximately 12 months loss coverage. For additional information, see Loan Quality Provision and Allowance for Loan Losses. Excluding the elimination of estimates related to assets that were derecognized or reclassified upon adoption of Statements No. 166 and 167 and the change in the estimate related to our allowance for loan losses, there have not been any material changes in our critical accounting estimates from those discussed in our annual report on Form 10-K for the year ended November 30, 2009.

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The following table outlines changes in our condensed consolidated statements of income for the periods presented (dollars in thousands):

| | For the Three Months Ended August 31, | | 2010 vs. 2009 increase (decrease) | | For the Nine Months Ended August 31, | | 2010 vs. 2009 increase (decrease) | |
|--|---|-------------------------------------|---|-------|--|-------------------------------------|---|-------|
| | 2010 | 2009 (As Adjusted ¹) | \$ | % | 2010 | 2009 (As Adjusted ¹) | \$ | % |
| Interest income | \$ 1,535,939 | \$ 1,660,787 | \$ (124,848) | (8%) | \$ 4,646,871 | \$ 4,858,710 | \$ (211,839) | (4%) |
| Interest expense | 389,137 | 382,238 | 6,899 | 2% | 1,207,482 | 1,212,339 | (4,857) | 0% |
| Net interest income | 1,146,802 | 1,278,549 | (131,747) | (10%) | 3,439,389 | 3,646,371 | (206,982) | (6%) |
| Provision for loan losses | 712,565 | 1,085,209 | (372,644) | (34%) | 2,824,035 | 3,864,769 | (1,040,734) | (27%) |
| Net interest income after provision for loan losses | 434,237 | 193,340 | 240,897 | 125% | 615,354 | (218,398) | 833,752 | NM |
| Other income | 564,144 | 575,717 | (11,573) | (2%) | 1,622,864 | 1,635,835 | (12,971) | (1%) |
| Other expense | 566,238 | 523,838 | 42,400 | 8% | 1,554,590 | 1,643,589 | (88,999) | (5%) |
| Income (loss) before income tax expense | 432,143 | 245,219 | 186,924 | 76% | 683,628 | (226,152) | 909,780 | NM |
| Income tax expense (benefit) | 171,526 | 94,655 | 76,871 | 81% | 268,482 | (48,088) | 316,570 | NM |
| Net income (loss) | \$ 260,617 | \$ 150,564 | \$ 110,053 | 73% | \$ 415,146 | \$ (178,064) | \$ 593,210 | NM |

(1) See Reconciliation of GAAP to As Adjusted Data.

Net Interest Income

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

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

The level and composition of loan receivables, including the proportion of credit card loans to other consumer loans, as well as the proportion of loan receivables bearing interest at promotional rates as compared to standard rates;

The credit performance of our loans, particularly with regard to charge-offs of finance charges, which reduce interest income;

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The terms of long-term borrowings and certificates of deposit upon initial offering, including maturity and interest rate;

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The level and composition of other interest-bearing assets and liabilities, including our liquidity investment portfolio;

Changes in the interest rate environment, including the levels of interest rates and the relationship between interest rate indices, such as the prime rate, the federal funds rate and LIBOR; and

The effectiveness of interest rate swaps in our interest rate risk management program.

For the Three Months Ended August 31, 2010 and 2009

Net interest income was \$1.1 billion for the three months ended August 31, 2010, a decline of 10% as compared to the three months ended August 31, 2009 as adjusted. The decline in net interest income was primarily driven by a decline in net interest margin, as well as a lower level of loan receivables.

Net interest margin was 9.16% for the third quarter 2010, down 79 basis points as compared to the third quarter 2009 as adjusted. This reflects the impact of legislative changes during 2010 related to restrictions on imposing default interest rates on existing balances, an increase in lower-rate student loan balances as a proportion of total loan receivables and higher funding costs. This was partially offset by a reduction in promotional rate credit card balances and lower interest charge-offs.

Average loan receivables declined 2% driven by a \$3.7 billion decline in average credit card loan receivables partially offset by an increase in student loan receivables. The decline in credit card loan receivables was driven by a reduction in promotional rate balances and an increase in the payment rate.

Funding costs increased in the third quarter 2010 as compared to the third quarter 2009 as adjusted. The increase is primarily due to a shift in our funding mix from securitized borrowings to higher-rate interest-bearing deposits and an increase in the funding cost of other long-term borrowings related to subordinated debt issuances in November 2009 and April 2010, partially offset by a year-over-year decline in the funding costs of interest-bearing deposits.

For the Nine Months Ended August 31, 2010 and 2009

Net interest income was \$3.4 billion for the nine months ended August 31, 2010, a decline of 6% as compared to the nine months ended August 31, 2009 as adjusted. The decline in net interest income was primarily due to a lower average level of loan receivables as well as a decline in net interest margin.

Net interest margin was 9.10% for the nine months ended August 31, 2010, down 37 basis points as compared to the nine months ended August 31, 2009 as adjusted. This reflects a higher mix of lower-rate student loans in our loan portfolio, lower rates earned on our liquidity investment portfolio and higher interest rates on long-term borrowings issued since August 31, 2009, partially offset by lower deposit funding costs and an improvement in credit card yield. Yield on credit card loan receivables improved as a result of lower promotional rate balances, higher interest rates earned on standard balances and lower interest charge-offs, partially offset by the impact of legislative changes related to restrictions on imposing default interest rates on existing balances beginning in February 2010.

The level of net interest income also declined during the nine months ended August 31, 2010, as compared to the same period ended August 31, 2009 as adjusted, largely due to a decline in the level of credit card loan receivables, which was driven by a reduction in promotional rate balances and an increase in the payment rate. This was partially offset by an increase in the level of student loans and a higher average level of liquidity.

Funding costs declined slightly in the year-to-date period ending August 31, 2010 as compared to the same period in 2009 largely as a result of a lower level of higher-rate securitized borrowings and lower deposit funding costs. This was partially offset by higher levels of deposits, which were used to replace a significant portion of the asset-backed securities maturities, and higher funding costs associated with subordinated debt issuances in November 2009 and April 2010.

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| | For the Three Months Ended August 31, | | | | | |
|---|---------------------------------------|--------|--------------|----------------------------------|--------|--------------|
| | 2010 | | | 2009 (As Adjusted ¹) | | |
| | Average Balance | Rate | Interest | Average Balance | Rate | Interest |
| (dollars in thousands) | | | | | | |
| Assets | | | | | | |
| Interest-earning assets: | | | | | | |
| Cash and cash equivalents | \$ 8,352,952 | 0.25% | \$ 5,326 | \$ 9,349,825 | 0.27% | \$ 6,283 |
| Restricted cash | 1,062,261 | 0.20% | 533 | 2,537,305 | 0.62% | 3,996 |
| Other short-term investments | 375,000 | 1.07% | 1,011 | | | |
| Investment securities | 1,196,306 | 1.85% | 5,574 | 609,197 | 4.90% | 7,523 |
| Loan receivables ⁽²⁾ : | | | | | | |
| Credit card ⁽³⁾ | 44,905,220 | 12.86% | 1,455,907 | 48,628,788 | 13.05% | 1,599,588 |
| Other ⁽⁴⁾ | 4,782,080 | 5.61% | 67,588 | 2,329,166 | 7.39% | 43,397 |
| Total loan receivables | 49,687,300 | 12.16% | 1,523,495 | 50,957,954 | 12.79% | 1,642,985 |
| Total interest-earning assets | 60,673,819 | 10.04% | 1,535,939 | 63,454,281 | 10.38% | 1,660,787 |
| Allowance for loan losses | (3,856,016) | | | (3,754,592) | | |
| Other assets | 3,973,848 | | | 3,354,089 | | |
| Total assets | \$ 60,791,651 | | | \$ 63,053,778 | | |
| Liabilities and Stockholders Equity | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing deposits: | | | | | | |
| Time deposits ⁽⁵⁾ | \$ 26,985,136 | 3.70% | 251,524 | \$ 25,094,285 | 4.32% | 273,510 |
| Money market deposits | 3,936,681 | 1.52% | 15,105 | 3,935,227 | 1.54% | 15,299 |
| Other interest-bearing deposits | 3,485,724 | 1.42% | 12,508 | 150,851 | 1.86% | 709 |
| Total interest-bearing deposits ⁽⁶⁾ | 34,407,541 | 3.22% | 279,137 | 29,180,363 | 3.94% | 289,518 |
| Borrowings: | | | | | | |
| Short-term borrowings | | | | 16,304 | 0.24% | 10 |
| Securitized borrowings | 14,964,828 | 1.77% | 66,677 | 22,713,709 | 1.36% | 77,837 |
| Other long-term borrowings | 2,884,933 | 5.96% | 43,323 | 1,620,646 | 3.64% | 14,873 |
| Total borrowings | 17,849,761 | 2.44% | 110,000 | 24,350,659 | 1.51% | 92,720 |
| Total interest-bearing liabilities | 52,257,302 | 2.95% | 389,137 | 53,531,022 | 2.83% | 382,238 |
| Other liabilities and stockholders equity | 8,534,349 | | | 9,522,756 | | |
| Total liabilities and stockholders equity | \$ 60,791,651 | | | \$ 63,053,778 | | |
| Net interest income | | | \$ 1,146,802 | | | \$ 1,278,549 |
| Net interest margin ⁽⁷⁾ | | 9.16% | | | 9.95% | |
| Net yield on interest-earning assets ⁽⁸⁾ | | 7.50% | | | 7.99% | |
| Interest rate spread ⁽⁹⁾ | | 7.09% | | | 7.55% | |

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| | For the Nine Months Ended August 31, | | | | | |
|---|--------------------------------------|--------|------------------------------------|----------------------------------|--------|--------------|
| | 2010 | | | 2009 (As Adjusted ¹) | | |
| | Average Balance | Rate | Interest (dollars in thousands) | Average Balance | Rate | Interest |
| Assets | | | | | | |
| Interest-earning assets: | | | | | | |
| Cash and cash equivalents | \$ 10,528,297 | 0.25% | \$ 20,018 | \$ 8,517,733 | 0.70% | \$ 44,604 |
| Restricted cash | 2,401,644 | 0.15% | 2,646 | 2,391,937 | 0.86% | 15,359 |
| Other short-term investments | 189,234 | 1.01% | 1,437 | | | |
| Investment securities | 910,722 | 2.34% | 15,966 | 451,943 | 5.43% | 18,415 |
| Loan receivables ⁽²⁾ : | | | | | | |
| Credit card ⁽³⁾ | 45,931,331 | 12.83% | 4,423,654 | 49,315,952 | 12.59% | 4,661,061 |
| Other ⁽⁴⁾ | 4,413,788 | 5.53% | 183,150 | 1,995,097 | 7.96% | 119,271 |
| Total loan receivables | 50,345,119 | 12.19% | 4,606,804 | 51,311,049 | 12.41% | 4,780,332 |
| Total interest-earning assets | 64,375,016 | 9.62% | 4,646,871 | 62,672,663 | 10.33% | 4,858,710 |
| Allowance for loan losses | (3,967,079) | | | (3,463,859) | | |
| Other assets | 4,004,750 | | | 3,103,599 | | |
| Total assets | \$ 64,412,687 | | | \$ 62,312,403 | | |
| Liabilities and Stockholders Equity | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing deposits: | | | | | | |
| Time deposits ⁽⁵⁾ | \$ 27,637,969 | 3.90% | 808,646 | \$ 24,409,522 | 4.60% | 842,592 |
| Money market deposits | 4,359,380 | 1.40% | 45,715 | 4,107,967 | 1.66% | 51,190 |
| Other interest-bearing deposits | 2,593,249 | 1.47% | 28,560 | 73,947 | 1.77% | 985 |
| Total interest-bearing deposits ⁽⁶⁾ | 34,590,598 | 3.40% | 882,921 | 28,591,436 | 4.17% | 894,767 |
| Borrowings: | | | | | | |
| Short-term borrowings | | | | 1,115,584 | 0.30% | 2,538 |
| Securitized borrowings | 17,872,540 | 1.55% | 207,580 | 22,585,331 | 1.62% | 275,211 |
| Other long-term borrowings | 2,705,586 | 5.76% | 116,981 | 1,569,756 | 3.38% | 39,821 |
| Total borrowings | 20,578,126 | 2.10% | 324,561 | 25,270,671 | 1.67% | 317,570 |
| Total interest-bearing liabilities | 55,168,724 | 2.92% | 1,207,482 | 53,862,107 | 3.00% | 1,212,337 |
| Other liabilities and stockholders equity | 9,243,963 | | | 8,450,296 | | |
| Total liabilities and stockholders equity | \$ 64,412,687 | | | \$ 62,312,403 | | |
| Net interest income | | | \$ 3,439,389 | | | \$ 3,646,373 |
| Net interest margin ⁽⁷⁾ | | 9.10% | | | 9.47% | |
| Net yield on interest-earning assets ⁽⁸⁾ | | 7.12% | | | 7.75% | |
| Interest rate spread ⁽⁹⁾ | | 6.70% | | | 7.33% | |

(1) Information related to restricted cash, investment securities, credit card loan receivables, allowance for loan losses, other assets, securitized borrowings, other long-term borrowings and other liabilities and stockholders equity are presented on an as adjusted basis. No adjustments have been made for cash and cash equivalents, other short-term investments, other loan receivables, interest-bearing deposits, short-term borrowings and other long-term borrowings. See Reconciliation of GAAP to As Adjusted Data.

(2)

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

- (3) Interest income on credit card loans includes \$41 million and \$124 million of amortization of balance transfer fees for the three and nine months ended August 31, 2010, respectively. Interest income on credit card loans includes \$46 million and \$156 million as adjusted of amortization of balance transfer fees for the three and nine months ended August 31, 2009, respectively.
- (4) Includes student loans held for sale.
- (5) Includes the impact of interest rate swap agreements used to change a portion of fixed-rate funding to floating-rate funding.
- (6) Includes the impact of FDIC insurance premiums and special assessments.
- (7) Net interest margin represents net interest income as a percentage of average total loan receivables.
- (8) Net yield on interest-earning assets represents net interest income as a percentage of total interest-earning assets.
- (9) Interest rate spread represents the difference between the rate on total interest-earning assets and the rate on total interest-bearing liabilities.

Table of Contents**Rate/Volume Variance Analysis⁽¹⁾**

| | For the Three Months Ended August 31, 2010 vs. August 31, 2009 | | | For the Nine Months Ended August 31, 2010 vs. August 31, 2009 | | |
|---|---|-------------|--------------|--|-------------|--------------|
| | Volume | Rate | Total | Volume | Rate | Total |
| (dollars in thousands) | | | | | | |
| Increase (decrease) due to changes in: | | | | | | |
| Interest-earning assets: | | | | | | |
| Cash and cash equivalents | \$ (647) | \$ (310) | \$ (957) | \$ 13,818 | \$ (38,404) | \$ (24,586) |
| Restricted cash | (1,594) | (1,869) | (3,463) | 103 | (12,816) | (12,713) |
| Other short-term investments | 1,011 | | 1,011 | 1,437 | | 1,437 |
| Investment securities | 21,397 | (23,346) | (1,949) | 16,335 | (18,784) | (2,449) |
| Loan receivables: | | | | | | |
| Credit cards | (121,002) | (22,679) | (143,681) | (370,729) | 133,322 | (237,407) |
| Other | 87,311 | (63,120) | 24,191 | 128,627 | (64,748) | 63,879 |
| Total loan receivables | (33,691) | (85,799) | (119,490) | (242,102) | 68,574 | (173,528) |
| Total interest income | (13,524) | (111,324) | (124,848) | (210,409) | (1,430) | (211,839) |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing deposits: | | | | | | |
| Time deposits | 100,039 | (122,025) | (21,986) | 143,181 | (177,127) | (33,946) |
| Money market deposits | 38 | (232) | (194) | 4,496 | (9,972) | (5,476) |
| Other interest-bearing deposits | 12,990 | (1,191) | 11,799 | 27,888 | (312) | 27,576 |
| Total interest-bearing deposits | 113,067 | (123,448) | (10,381) | 175,565 | (187,411) | (11,846) |
| Borrowings: | | | | | | |
| Short-term borrowings | (10) | | (10) | (2,538) | | (2,538) |
| Securitized borrowings | (104,559) | 93,399 | (11,160) | (55,230) | (12,401) | (67,631) |
| Other long-term borrowings | 15,669 | 12,781 | 28,450 | 39,096 | 38,064 | 77,160 |
| Total borrowings | (88,900) | 106,180 | 17,280 | (18,672) | 25,663 | 6,991 |
| Total interest expense | 24,167 | (17,268) | 6,899 | 156,893 | (161,748) | (4,855) |
| Net interest income | \$ (37,691) | \$ (94,056) | \$ (131,747) | \$ (367,302) | \$ 160,318 | \$ (206,984) |

(1) The rate/volume variance for each category has been allocated on a consistent basis between rate and volume variances between August 31, 2010 and August 31, 2009 as adjusted based on the percentage of the rate or volume variance to the sum of the two absolute variances. Calculation of rate/volume variance is based on August 31, 2009 amounts as adjusted.

Loan Quality

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

| | August 31, 2010 | November 30, 2009 (As Adjusted ¹) |
|-----------------------------|--------------------|---|
| Student loans held for sale | \$ 1,437,592 | \$ |
| Loan portfolio: | | |
| Credit card loans: | | |

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| | | |
|----------------------------|---------------|---------------|
| Discover card | 44,930,267 | 47,055,215 |
| Discover business card | 317,899 | 404,149 |
| | | |
| Total credit card loans | 45,248,166 | 47,459,364 |
| Other consumer loans: | | |
| Personal loans | 1,706,873 | 1,394,379 |
| Federal student loans | 809,055 | 1,352,587 |
| Private student loans | 880,854 | 579,679 |
| Other | 48,124 | 68,137 |
| | | |
| Total other consumer loans | 3,444,906 | 3,394,782 |
| | | |
| Total loan portfolio | 48,693,072 | 50,854,146 |
| | | |
| Total loan receivables | 50,130,664 | 50,854,146 |
| Allowance for loan losses | (3,743,721) | (3,902,360) |
| | | |
| Net loan receivables | \$ 46,386,943 | \$ 46,951,786 |

- (1) Discover card loan balances and the allowance for loan losses are presented on an as adjusted basis. No adjustments have been made to student loans held for sale, Discover business card, personal loans, federal or private student loans or other loans. See reconciliation in Reconciliation of GAAP to As Adjusted Data.

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Provision and Allowance for Loan Losses

Provision for loan losses is the expense related to maintaining the allowance for loan losses at a level management believes is adequate to absorb the estimated probable losses in the loan portfolio at each period end date. Factors that influence the provision for loan losses include:

The impact of general economic conditions on the consumer, including unemployment levels, bankruptcy trends and interest rate movements;

Changes in consumer spending and payment behaviors;

Changes in our loan portfolio, including the overall mix of accounts, products and loan balances within the portfolio;

The level and direction of historical and anticipated loan delinquencies and charge-offs;

The credit quality of the loan portfolio, which reflects, among other factors, our credit granting practices and the effectiveness of our collection efforts; and

Regulatory changes or new regulatory guidance.

In calculating the allowance for loan losses, we estimate probable losses separately for segments of the loan portfolio that have similar risk characteristics, such as credit card and other consumer loans. For our credit card loans, we use a migration analysis to determine the likelihood that a loan receivable will progress through various stages of delinquency and eventually charge-off. In the first quarter 2010, we developed analytics which provide us with a better understanding of the likelihood that non-delinquent accounts will eventually charge-off, thus broadening the identification of loss emergence. We use this in combination with the migration analysis to determine our allowance for loan losses.

For the three and nine months ended August 31, 2010, the provision for loan losses decreased \$373 million and \$1.0 billion, or 34% and 27% respectively, as compared to the three and nine months ended August 31, 2009 as adjusted. This decrease is attributable to improved credit performance, reflecting the decline in the level of net charge-offs in the second and third quarters of 2010 subsequent to a peak in the level of net charge-offs in the first quarter of 2010. Improvements in credit performance were also evidenced by a decline in the delinquency rate in each quarter of 2010 as compared to November 30, 2009, as adjusted, which was the primary driver of the reduction in the allowance for loan losses during both the three and nine months ended August 31, 2010.

For our other consumer loans, we consider historical and forecasted losses in estimating the related allowance for loan losses. At August 31, 2010, the level of the allowance related to other consumer loans decreased \$14 million as compared to November 30, 2009 largely due to a decline in the personal loan reserve rate related to credit improvement in that portfolio.

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The following table provides changes in our allowance for loan losses (dollars in thousands):

| | For the Three Months Ended August 31, | | For the Nine Months Ended August 31, | |
|---|--|-------------------------------------|---|-------------------------------------|
| | 2010 | 2009 (As Adjusted ¹) | 2010 | 2009 (As Adjusted ¹) |
| Balance at beginning of period, as adjusted | \$ 3,930,624 | \$ 3,700,901 | \$ 3,902,360 | \$ 2,754,357 |
| Additions: | | | | |
| Provision for loan losses | 712,565 | 1,085,209 | 2,824,035 | 3,864,769 |
| Deductions: | | | | |
| Charge-offs: | | | | |
| Discover card | (982,920) | (1,139,338) | (3,203,959) | (3,117,183) |
| Discover business card | (14,502) | (18,400) | (50,190) | (43,671) |
| Total credit card loans | (997,422) | (1,157,738) | (3,254,149) | (3,160,854) |
| Personal loans | (23,836) | (20,920) | (70,957) | (46,186) |
| Federal student loans | (11) | | (308) | |
| Private student loans | (660) | (259) | (1,264) | (355) |
| Other | (139) | | (858) | (18) |
| Total other consumer loans | (24,646) | (21,179) | (73,387) | (46,559) |
| Total charge-offs | (1,022,068) | (1,178,917) | (3,327,536) | (3,207,413) |
| Recoveries: | | | | |
| Discover card | 121,255 | 99,853 | 341,337 | 294,607 |
| Discover business card | 875 | 272 | 2,516 | 602 |
| Total credit card loans | 122,130 | 100,125 | 343,853 | 295,209 |
| Personal loans | 421 | 231 | 942 | 615 |
| Federal student loans | | | | |
| Private student loans | 14 | | 22 | |
| Other | 35 | 22 | 45 | 34 |
| Total other consumer loans | 470 | 253 | 1,009 | 649 |
| Total recoveries | 122,600 | 100,378 | 344,862 | 295,858 |
| Net charge-offs | (899,468) | (1,078,539) | (2,982,674) | (2,911,555) |
| Balance at end of period | \$ 3,743,721 | \$ 3,707,571 | \$ 3,743,721 | \$ 3,707,571 |

(1) Information related to Discover card and total loans is presented on an as adjusted basis. No adjustments have been made for Discover business card, personal loans, federal or private student loans or other loans. See reconciliation in Reconciliation of GAAP to As Adjusted Data.

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The following table presents a breakdown of the allowance for loan losses (dollars in thousands):

| | August 31, 2010 | November 30, 2009 (As Adjusted ¹) |
|--|---------------------|--|
| Discover card | \$ 3,598,685 | \$ 3,731,568 |
| Discover business card | 48,285 | 59,979 |
| Total credit card loans | 3,646,970 | 3,791,547 |
| Personal loans | 80,171 | 95,056 |
| Federal student loans | 1,054 | 968 |
| Private student loans | 14,699 | 13,734 |
| Other | 827 | 1,055 |
| Total other consumer loans | 96,751 | 110,813 |
| Total allowance for loan losses | \$ 3,743,721 | \$ 3,902,360 |

(1) Information related to Discover card, credit card and total loan receivables is presented on an as adjusted basis. No adjustments have been made for Discover business card, personal loans, federal or private student loans or other loans. See reconciliation in Reconciliation of GAAP to As Adjusted Data.

Net Charge-offs

Our net charge-offs include the principal amount of losses 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 and loan fee income for loan receivables 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. Closed-end consumer loan receivables are charged-off at the end of the month during which an account becomes 120 days contractually past due, except for student loans that are guaranteed by the federal government. 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.

The following table presents amounts and rates of net charge-offs of loan receivables (dollars in thousands):

| | For the Three Months Ended August 31, | | | | For the Nine Months Ended August 31, | | | |
|------------------------------|--|--------------|-------------------------------------|--------------|---|--------------|-------------------------------------|--------------|
| | 2010 | | 2009 (As Adjusted ¹) | | 2010 | | 2009 (As Adjusted ¹) | |
| | \$ | % | \$ | % | \$ | % | \$ | % |
| Credit card loans | \$ 875,292 | 7.73% | \$ 1,057,613 | 8.63% | \$ 2,910,296 | 8.44% | \$ 2,865,645 | 7.74% |
| Other consumer loans | 24,176 | 2.01% | 20,926 | 3.56% | 72,378 | 2.18% | 45,910 | 3.07% |
| Total net charge-offs | \$ 899,468 | 7.18% | \$ 1,078,539 | 8.40% | \$ 2,982,674 | 7.89% | \$ 2,911,555 | 7.56% |

(1) Information related to credit card loan receivables and total loan receivables is presented on an as adjusted basis. No adjustments have been made for other consumer loan receivables. See reconciliation in Reconciliation of GAAP to As Adjusted Data.

The amount and rate of net charge-offs declined in the third quarter 2010 as compared to the third quarter 2009 as adjusted as the credit performance of our portfolio continued to improve. However, the amount and rate of net charge-offs increased for the nine months ended August 31, 2010 as compared to the nine months ended August 31, 2009 as adjusted, largely due to a peak in the level of charge-offs in the first quarter 2010.

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The charge-off rate for other consumer loans declined during the three and nine months ended 2010 as compared to the same periods in 2009 due to an increase in the level of student loans, which have not yet entered into repayment and, thus, have minimal levels of net charge-offs. This was partially offset by the seasoning of our personal loan products which has led to a higher level of net charge-offs for those loans.

Table of Contents**Delinquencies**

Delinquencies are an indicator of credit quality at a point in time. Loan balances are considered delinquent when contractual payments on the loan become 30 days past due. Credit card and closed-end consumer loan receivables are placed on nonaccrual status upon receipt of notification of the bankruptcy or death of a customer, suspected fraudulent activity on an account, as part of certain collection management processes, and other instances in which management feels collectability is not assured. In some cases of suspected fraudulent activity, loan receivables may resume accruing interest upon completion of the fraud investigation.

The following table presents the amounts and delinquency rates of loan receivables over 30 days past due, loan receivables over 90 days delinquent and accruing interest and loan receivables that are not accruing interest, regardless of delinquency (dollars in thousands):

| | August 31, 2010 | | November 30, 2009 (As Adjusted ¹) | |
|---|--------------------|-------|---|-------|
| | \$ | % | \$ | % |
| Loans over 30 days delinquent | \$ 2,083,128 | 4.16% | \$ 2,700,959 | 5.31% |
| Loans over 90 days delinquent and accruing interest | \$ 928,521 | 1.85% | \$ 1,217,054 | 2.39% |
| Loans not accruing interest | \$ 374,836 | 0.75% | \$ 438,278 | 0.86% |

(1) See Reconciliation of GAAP to As Adjusted Data.

Delinquency rates as of August 31, 2010 have declined as compared to November 30, 2009 as adjusted due to better credit trends that led to an improvement in early delinquency balances as well as enhanced collection management and underwriting processes.

Modified and Restructured Loans

We hold various credit card loans for which the terms have been modified, including some that are accounted for as troubled debt restructurings. Our modified credit card loans include loans for which temporary hardship concessions have been granted and loans in permanent workout programs. Eligibility, frequency, duration and offer type for both of these programs are offered in compliance with stated regulatory guidelines.

Temporary hardship concessions primarily consist of a reduced minimum payment and an interest rate reduction, both lasting for a period no longer than twelve months. These short term concessions do not include the forgiveness of unpaid principal, but may involve the reversal of certain unpaid interest or fee assessments. At the end of the concession period, loan terms revert to standard rates. These arrangements are automatically terminated if the customer makes two consecutive late payments, at which time their account reverts back to its original terms. In assessing the appropriate allowance for loan loss, these loans are included in the general pool of credit cards with the allowance determined under the contingent loss model of ASC 450-20, *Loss Contingencies* (guidance formerly contained in FASB Statement No. 5). We do not consider these loans in the troubled debt restructuring (TDR) pool. If we applied accounting under ASC 310-40, *Troubled Debt Restructurings by Creditors* (guidance formerly contained in FASB Statement No. 114), to loans in this program, there would not be a material difference in the allowance. Loans for which temporary hardship concessions were granted comprised less than 1% of our total credit card loans at August 31, 2010 and November 30, 2009.

In contrast to temporary hardship concessions, our permanent workout programs entail more significant and permanent concessions including changing the structure of the loan to a fixed payment loan with a maturity no longer than 60 months. The concessions associated with a permanent workout also include a significant reduction in interest rate and possible waivers of unpaid interest and fees. We account for permanent workout loans as TDRs and, as a result, we measure impairment of these loans based on the discounted present value of cash flows expected to be received on them. Loans in permanent workout programs comprised less than 1% of our total credit card loans at August 31, 2010 and November 30, 2009.

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We also participate with consumer credit counseling agency (CCCA) programs in an effort to assist customers to proactively manage their credit card balances. The vast majority of loans entering CCCA programs are not delinquent at the time of enrollment, and our charge-off rate on these loans is comparable or less than the rate on our overall credit card receivables portfolio. These loans continue to meet original minimum payment terms and do not normally include waiver of unpaid principal, interest or fees. In assessing the appropriate allowance for loan loss, these loans are included in the general pool of credit card loans with the allowance determined under the contingent loss model. We do not consider these loans in the TDR pool. If we applied TDR accounting to loans in this program, there would not be a material difference in the allowance. Credit card loans modified under CCCA programs comprised approximately 1.7% of our total credit card loans at August 31, 2010 and November 30, 2009.

Other Income

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

| | For the Three Months Ended August 31, 2009 | | 2010 vs. 2009 increase (decrease) | | For the Nine Months Ended August 31, 2009 | | 2010 vs. 2009 increase (decrease) | |
|---|--|-----------------------------|-----------------------------------|-------|---|-----------------------------|-----------------------------------|-------|
| | 2010 | (As Adjusted ¹) | \$ | % | 2010 | (As Adjusted ¹) | \$ | % |
| Discount and interchange revenue ⁽²⁾ | \$ 273,932 | \$ 259,524 | \$ 14,408 | 6% | \$ 805,209 | \$ 737,386 | \$ 67,823 | 9% |
| Fee products | 104,132 | 105,399 | (1,267) | (1%) | 309,590 | 305,701 | 3,889 | 1% |
| Loan fee income | 92,465 | 140,333 | (47,868) | (34%) | 267,483 | 369,474 | (101,991) | (28%) |
| Transaction processing revenue | 40,184 | 31,839 | 8,345 | 26% | 109,570 | 93,309 | 16,261 | 17% |
| Merchant fees | 7,220 | 10,716 | (3,496) | (33%) | 23,091 | 35,289 | (12,198) | (35%) |
| Gain (loss) on investments | 18,951 | (7,422) | 26,373 | NM | 19,131 | (9,239) | 28,370 | NM |
| Other income | 27,260 | 35,328 | (8,068) | (23%) | 88,790 | 103,915 | (15,125) | (15%) |
| Total other income | \$ 564,144 | \$ 575,717 | \$ (11,573) | (2%) | \$ 1,622,864 | \$ 1,635,835 | \$ (12,971) | (1%) |

(1) See Reconciliation of GAAP to As Adjusted Data.

(2) Net of rewards, including *Cashback Bonus* rewards, of \$194 million and \$174 million for the three months ended August 31, 2010 and 2009, respectively, and \$535 million and \$499 million for the nine months ended August 31, 2010 and 2009, respectively.

Total other income decreased in the three and nine months ended August 31, 2010 compared to the three and nine months ended August 31, 2009 as adjusted as lower loan fees and lower other income were largely offset by higher revenues from discount and interchange, transaction processing revenues and a \$19.6 million gain relating to the liquidation of collateral supporting the asset-backed commercial paper notes of Golden Key. The investment was originally purchased in 2007 for \$120.1 million, subsequently written down to \$51.3 million and, in August 2010, liquidated for \$70.9 million. In contrast, during the third quarter 2009, we recorded a \$7.4 million other than temporary impairment on the Golden Key investment.

Loan fee income consists primarily of fees on credit card loans and includes late, overlimit, cash advance, pay-by-phone and other miscellaneous fees. However, effective February 2010, as a result of legislative changes, we no longer charge overlimit or pay-by-phone fees on consumer credit card loans. Furthermore, the legislative changes also resulted in changes to our late fee policy, which resulted in lower late fees. These factors contributed to the decline in loan fee income in 2010 as compared to 2009 as adjusted. Additionally, lower gains on sales of merchant portfolios resulted in a decrease in other income for both the three and nine months ended August 31, 2010, as compared to the three and nine months ended August 31, 2009 as adjusted.

Discount and interchange revenue includes discount revenue and acquirer interchange net of interchange paid to third-party issuers and is further reduced by the cost of rewards programs offered to our customers. We had higher sales volume in each of the quarters of 2010 as compared to the same periods in 2009 which

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contributed to the increase in discount and interchange revenue. We also had higher dollar and transaction volumes in our Payments Services segment which, along with higher margins at PULSE, resulted in an increase in transaction processing revenue.

Other Expense

The following table represents the components of other expense for the periods presented (dollars in thousands):

| | For the Three Months Ended | | 2010 vs. 2009 | | For the Nine Months Ended | | 2010 vs. 2009 | |
|---|----------------------------|-------------------|------------------|-----------|---------------------------|---------------------|--------------------|-------------|
| | August 31, | | increase | | August 31, | | increase | |
| | 2010 | 2009 | \$ | % | 2010 | 2009 | \$ | % |
| Employee compensation and benefits | \$ 204,210 | \$ 208,528 | \$ (4,318) | (2%) | \$ 602,510 | \$ 636,167 | \$ (33,657) | (5%) |
| Marketing and business development | 130,532 | 77,814 | 52,718 | 68% | 313,175 | 292,169 | 21,006 | 7% |
| Information processing and communications | 62,357 | 67,679 | (5,322) | (8%) | 190,862 | 217,017 | (26,155) | (12%) |
| Professional fees | 85,289 | 83,746 | 1,543 | 2% | 239,169 | 228,419 | 10,750 | 5% |
| Premises and equipment | 17,722 | 18,437 | (715) | (4%) | 53,273 | 54,732 | (1,459) | (3%) |
| Other expense | 66,128 | 67,634 | (1,506) | (2%) | 155,601 | 215,085 | (59,484) | (28%) |
| Total other expense | \$ 566,238 | \$ 523,838 | \$ 42,400 | 8% | \$ 1,554,590 | \$ 1,643,589 | \$ (88,999) | (5%) |

For the three months ended August 31, 2010, total other expense was higher than the same prior year period largely due to an increase in marketing expenses, primarily attributable to increased investment in account acquisition, advertising and promotional marketing expenses during the third quarter of 2010. This increase was partially offset by lower employee compensation and benefits due to cost containment initiatives undertaken in 2009, and decreased information processing and communications expenses due to our efforts to reduce costs associated with ongoing contracts.

For the nine months ended August 31, 2010, total other expense was lower than the same prior year period. This is attributable to lower employee compensation and benefit expense, information processing and communication expense and other expense, partially offset by a continued increase in marketing expense over the course of 2010. Employee compensation and benefits expense decreased as we continued to benefit from cost containment initiatives undertaken in 2009, which included lowering headcount. Information processing and communications expense was lower in 2010 than in 2009 due to our efforts to reduce costs associated with ongoing contracts, which most significantly impacted the first half of 2010. Also contributing to the decline in other expense in the nine months ended August 31, 2010 was: (i) a \$20 million restructuring charge recorded during the second quarter 2009 as a result of the reduction in headcount discussed above and (ii) a \$29 million nonrecurring benefit related to the reversal expense that had been recorded in the fourth quarter 2009 related to the payment to Morgan Stanley under an amendment to the special dividend agreement (see Note 14: Litigation to our condensed consolidated financial statements).

Income Tax Expense

For the three and nine months ended August 31, 2010, our effective tax rate was 39.7% and 39.3%, respectively, as compared to an effective tax rate of 38.6% and 21.3% for the three and nine months ended August 31, 2009, respectively. The increase in the effective tax rate, including the effective state tax rate, for the nine months ended August 31, 2010 as compared to 2009 was the result of shifting from an as adjusted pretax loss position in 2009, where state gross receipt taxes have a disproportionate effect on the expected year-end tax rate, to a pretax income position in 2010, where state gross receipt taxes had a smaller impact on the expected

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year-end tax rate. The nine months ended August 31, 2009 also included the impact of recording a valuation allowance on a tax benefit arising from the sale of the Goldfish business in 2008 that we no longer believed was realizable, as well as non-deductible stock-based compensation expense recorded in March 2009.

Liquidity and Capital Resources

We seek to maintain diversified funding sources and a strong liquidity profile in order to fund our business and service our maturing obligations. In addition, we seek to achieve an appropriate maturity profile, utilize a cost-effective mix of both long-term and short-term funding sources and ensure that the composition of our funding sources provides appropriate diversification. Our primary funding sources include deposits, sourced directly from consumers or through brokers, term asset-backed securitizations, asset-backed conduit financing and long-term borrowings.

Funding Sources

Deposits. Since 2009, deposits have become our largest source of funding. We offer deposit products, including certificates of deposit, money market accounts, online savings accounts and Individual Retirement Account (IRA) certificates of deposit, to customers through two channels: (i) through direct marketing, internet origination and affinity relationships (direct-to-consumer deposits); and (ii) indirectly through contractual arrangements with brokerage firms (brokered deposits).

Since November 30, 2009, direct-to-consumer deposits have grown \$6.5 billion, or 52%, which includes approximately \$1 billion of deposit accounts acquired in March 2010. At August 31, 2010, we had \$15.1 billion of brokered deposits, which decreased \$4.4 billion, or 23%, since November 30, 2009 as a result of growing our direct-to-consumer deposit program. Maturities of our certificates of deposit range from one month to ten years, with a weighted average maturity of 22 months at August 31, 2010.

The following table summarizes deposits by maturity as of August 31, 2010 (dollars in thousands):

| | Total | Three Months or Less | Over Three Months Through Six Months | Over Six Months Through Twelve Months | Over Twelve Months |
|--|----------------------|-------------------------|---|---|-----------------------|
| Certificates of deposit in amounts less than \$100,000 ⁽¹⁾ | \$ 20,864,065 | \$ 1,979,764 | \$ 1,355,137 | \$ 4,002,978 | \$ 13,526,186 |
| Certificates of deposit from amounts of \$100,000 ⁽¹⁾ to less than \$250,000 ⁽¹⁾ | 4,358,026 | 589,648 | 546,870 | 1,068,569 | 2,152,939 |
| Certificates of deposit in amounts of \$250,000 ⁽¹⁾ or greater | 1,163,140 | 225,298 | 175,685 | 306,624 | 455,533 |
| Savings deposits, including money market deposit accounts | 7,763,701 | 7,763,701 | | | |
| Total interest-bearing deposits | \$ 34,148,932 | \$ 10,558,411 | \$ 2,077,692 | \$ 5,378,171 | \$ 16,134,658 |

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

Securitization Financing. We use the securitization of credit card receivables as an additional source of funding. We access the asset-backed securitization market using the Discover Card Master Trust I (DCMT) and the Discover Card Execution Note Trust (DCENT), through which we issue asset-backed securities both publicly and through privately placed asset-backed conduit facilities, which may be fully or partially undrawn at closing.

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The DCMT structure utilizes Class A and Class B certificates held by third parties, with credit enhancement provided by the subordinated Class B certificates, cash collateral account loans and the more subordinated Series 2009-CE. DCENT consists of four classes of securities (Class A, B, C and D), with credit enhancement provided by the subordinated classes of notes. Both DCMT and DCENT are further enhanced by Series 2009-SD through its provisions to reallocate principal cash flows, thereby enhancing the excess spread, discussed below, of both trusts.

The securitization structures include certain features designed to protect investors. The primary feature relates to the availability and adequacy of cash flows in the securitized pool of receivables to meet contractual requirements, the insufficiency of which triggers early repayment of the securities. We refer to this as economic early amortization, which is based on excess spread levels. Excess spread is the amount by which income received by a trust during a collection period, including interest collections, fees and interchange, as well as the amount of certain principal collections available to be reallocated from Series 2009-SD exceeds the fees and expenses of the trust during such collection period, including interest expense, servicing fees and charged-off receivables. In the event of an economic early amortization, which would occur if the excess spread falls below 0% for a contractually specified period, generally a three-month rolling average, we would be required to repay the affected outstanding securitized borrowings over a period of a few months using all available collections received by the trust. An early amortization event would negatively impact our liquidity, and require us to rely on alternative funding sources, which may or may not be available at the time. As of August 31, 2010, no economic early amortization events have occurred.

Another feature of our securitization structure, which is applicable only to the notes issued from DCENT, is a reserve account funding requirement in which excess cash flows generated by the transferred loan receivables are held at the trust. This funding requirement is triggered when DCENT's three-month average excess spread rate decreases to below 4.50%, with increasing funding requirements as excess spread levels decline below preset levels to 0%. The reserve account funding requirement has been triggered only once, in August 2009, and the amount was released from the trust to us in the following month. See Note 5: Credit Card Securitization Activities to our condensed consolidated financial statements for additional information regarding the structures of DCMT and DCENT, and for tables providing information concerning investors interests and related excess spreads at August 31, 2010.

At August 31, 2010, we had \$14.6 billion of outstanding public asset-backed securities, \$0.3 billion of outstanding private asset-backed conduit financings and \$4.5 billion of outstanding asset-backed securities that had been issued to our wholly-owned subsidiaries. The following table summarizes expected maturities of the investors' interests in securitizations excluding those that have been issued to our wholly-owned subsidiaries at August 31, 2010 (dollars in thousands):

| | Total | Less Than One Year | One Year Through Three Years | Four Years Through Five Years | After Five Years |
|---|---------------|-------------------------------|---|--|-----------------------------|
| Scheduled maturities of long-term borrowings owed to securitization investors | \$ 14,869,265 | \$ 4,849,549 | \$ 8,030,964 | \$ 989,113 | \$ 999,639 |

On September 20, 2010, an additional \$600 million of public asset-backed securities were issued that are scheduled to mature in September 2015. On September 23, 2010, an additional \$200 million of private asset backed conduit funding was utilized. Related to both the public issuance and the conduit utilization, an additional \$111.8 million of subordinated interests were issued and retained by a wholly-owned subsidiary.

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The cash collateral account loans that provide credit enhancement to certain DCMT certificates were \$511 million at August 31, 2010 and were recorded in restricted cash for securitization investors in our condensed consolidated statement of financial condition. These cash collateral accounts were funded through a loan facility entered into between a consolidated special purpose subsidiary, DRFC Funding LLC, and third-party lenders. At August 31, 2010, \$341 million of the DRFC Funding LLC facility was outstanding and was recorded in long-term borrowings in our condensed consolidated statement of financial condition. Repayment of this loan facility is secured by the cash collateral account loans, which were sold to DRFC Funding LLC and are not expected to be available to our creditors.

The following table summarizes estimated maturities of the cash collateral accounts at August 31, 2010 (dollars in thousands):

| | Total | Less Than One Year | One Year Through Three Years | Four Years Through Five Years | After Five Years |
|--|------------|-----------------------|------------------------------------|-------------------------------------|---------------------|
| Scheduled maturities of cash collateral accounts | \$ 510,790 | \$ 284,211 | \$ 167,369 | \$ 59,210 | \$ |

At August 31, 2010, we had capacity to issue up to \$5.5 billion in triple-A rated asset-backed securities from DCENT without the issuance of additional Class B or Class C notes as subordination, which could include \$2.75 billion in undrawn asset-backed conduit capacity. The triple-A rating of DCENT Class A Notes issued to date has been based, in part, on an FDIC rule which creates a safe harbor that provides that the FDIC, as conservator or receiver, will not, using its power to disaffirm or repudiate contracts, seek to reclaim or recover assets transferred in connection with a securitization, or recharacterize them as assets of the insured depository institution, provided such transfer meets the conditions for sale accounting treatment under GAAP. There has been uncertainty in both the public and private securitization markets as to whether the safe harbor rule will continue to apply to securitized receivables that are treated as secured borrowings rather than as sales in accordance with GAAP as amended by Statements No. 166 and 167. On September 27, 2010, the FDIC approved a final rule that preserves the safe-harbor treatment applicable to revolving trusts and master trusts, which we believe includes the trusts used in our credit card securitization program. Other legislative and regulatory developments, namely the proposed SEC Regulation AB 2, the securitization and rating agency provisions of the Reform Act and the federal banking agencies' notice regarding their consideration of replacement of the ratings-based approach for assessing capital charges against securitization exposures, may, however, impact our ability and/or desire to issue asset-backed securities in the future. See Legislative and Regulatory Developments Asset-Backed Securities Regulations for additional information.

Short-Term Borrowings. In the past, we have accessed short-term borrowings through overnight Federal Funds purchased, and other short-term borrowings with original maturities of less than one year. However, we had no outstanding short-term borrowings at August 31, 2010.

Long-Term Borrowings and Subordinated Notes. At August 31, 2010, we had \$0.8 billion senior unsecured notes outstanding, reflecting two separate issuances of \$400 million each of fixed rate senior unsecured notes, one maturing in June 2017 and the other maturing in July 2019. As of August 31, 2010, Discover Bank had a total of \$1.2 billion in principal amount of subordinated notes outstanding, which included \$700 million due in November 2019 and \$500 million due in April 2020.

ECASLA. The Ensuring Continued Access to Student Loans Act of 2008 (as amended, ECASLA) provides originators of Federal Family Education Loan Program (FFELP) loans with a cost-effective source of funding and liquidity with respect to qualifying FFELP loans. On April 12, 2010, Discover Bank financed \$0.5 billion of eligible FFELP loans through an agreement with Straight-A Funding, LLC, an asset-backed commercial paper conduit sponsored by the U.S. Department of Education (DOE) under ECASLA, which matures August 2013. On September 23, 2010, Discover Bank sold \$1.5 billion of federal student loans, the majority of which were classified as held for sale as of August 31, 2010, to the DOE. The impact of the sale on net income was not material. During the third quarter 2010, we earned an interest yield of approximately 1.4% on our federal student loan portfolio, which is based on rates published by the U.S. Department of Education.

Table of Contents**Additional Funding Sources**

Asset-Backed Conduit Funding Facilities. We have access to committed undrawn capacity through privately placed asset-backed conduits to support the funding of our credit card loan receivables. Under these conduits, we had used \$0.3 billion of capacity at August 31, 2010 and, in September 2010, we used an additional \$0.2 billion of capacity. As of September 30, 2010, we had undrawn capacity of \$2.6 billion. The FDIC final rule approved on September 27, 2010 grandfathered these conduit commitments such that they may be utilized through their scheduled maturity with the benefit of the safe harbor. See Legislative and Regulatory Developments Asset-Backed Securities Regulations for more information regarding the FDIC final rule.

Unsecured Committed Credit Facility. Our unsecured committed credit facility of \$2.4 billion is available through May 2012. This facility serves to diversify our funding sources and enhance our liquidity. This facility is provided by a group of major global banks, and is available to both Discover Financial Services and Discover Bank (Discover Financial Services may borrow up to 30% and Discover Bank may borrow up to 100% of the total commitment). The facility is available to support general liquidity needs and may be drawn to meet short-term funding needs from time to time. We have no outstanding balances due under the facility.

Federal Reserve. Discover Bank has access to the Federal Reserve Bank of Philadelphia's discount window. As of August 31, 2010, Discover Bank had \$7.5 billion of available capacity through the discount window. We have no borrowings outstanding under the discount window.

Credit Ratings

Our borrowing costs and capacity in certain funding markets, including securitizations and senior and subordinated debt, may be affected by the credit ratings for Discover Financial Services, Discover Bank and the securitization trusts. Downgrades in these credit ratings could result in higher interest expense on our unsecured debt and asset securitizations, as well as potentially higher fees related to borrowings under our lines of credit. In addition to increased funding costs, declines in credit ratings could reduce our borrowing capacity in the unsecured debt and asset securitization capital markets. We also have agreements with certain of our derivative counterparties that contain provisions that require Discover Bank's debt to maintain an investment grade credit rating from specified major credit rating agencies. If Discover Bank's credit rating is reduced to below investment grade, we would be required to post additional collateral, which, as of August 31, 2010, would have been \$20 million.

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

| | Discover Financial Services Senior Unsecured Debt | Discover Bank Senior Unsecured Debt | Outlook for Senior Unsecured Debt | Discover Bank Subordinated Debt | Discover Card Master Trust I | | Discover Card Execution Note Trust | | |
|---------------------------|--|---|--|--|---------------------------------|---------|---------------------------------------|---------|----------|
| | | | | | Class A ⁽¹⁾ | Class B | Class A ⁽¹⁾ | Class B | Class C |
| Moody's Investors Service | Ba1 | Baa3 | Negative | Ba1 | Aaa(sf) | A1(sf) | Aaa(sf) | A1(sf) | Baa1(sf) |
| Standard & Poor's | BBB- | BBB | Stable | BBB- | AAA(SF) | AA+(SF) | AAA(SF) | AA+(SF) | A+(SF) |
| Fitch Ratings | BBB | BBB | Stable | BBB- | AAAsf | AAsf | AAAsf | AA-sf | A-sf |

(1) An 'sf' in the rating denotes an identification for structured finance product ratings that was implemented for these products as of September 2010. Several rating agencies have announced that they will be evaluating the effects of the Reform Act that was enacted in July 2010 in order to determine the extent, if any, to which financial institutions, including us, may be negatively impacted. While we are currently unaware of any negative actions, there is no assurance that our credit ratings could not be downgraded in the future as a result of any such reviews. See Legislative and Regulatory Developments for information regarding the Reform Act.

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We seek to ensure that we have adequate liquidity to sustain business operations, fund asset growth and satisfy debt obligations. In the assessment of our liquidity needs, we also evaluate a range of stress events that would impact our access to normal funding sources, cash needs and/or liquidity. We maintain contingent funding sources, including our liquidity investment portfolio, asset-backed conduit capacity, committed credit facility capacity and Federal Reserve discount window capacity, which we could seek to utilize to satisfy liquidity needs during such stress events. We expect to be able to satisfy all maturing obligations and fund business operations during the next 12 months by utilizing our deposit channels and our contingent funding sources.

At August 31, 2010, our liquidity investment portfolio was comprised of cash and cash equivalents and high quality, liquid, unencumbered investments. Cash and cash equivalents are invested primarily in deposits with the Federal Reserve, certificates of deposit with highly-rated banks which had maturities of 90 days or less when purchased, and AAA rated government money market mutual funds. Investments included certificates of deposit with maturities greater than 90 days and credit card asset-backed securities of other issuers. The level of our liquidity investment portfolio may fluctuate based upon the level of expected maturities of our funding sources as well as operational requirements and market conditions.

At August 31, 2010, our liquidity investment portfolio was \$9.1 billion, which was \$5.4 billion lower than the balance at November 30, 2009 due to funding of maturities of primarily asset-backed securities in the first half 2010. Our undrawn credit facilities have increased since November 30, 2009 by \$3.0 billion, primarily due to the net addition of \$1.3 billion of asset backed conduit funding facilities and through a \$1.7 billion increase in pledged collateral, including the credit for pledged collateral, to the Federal Reserve discount window.

| | August 31, 2010 | November 30, 2009 |
|---|-----------------------|----------------------|
| | (dollars in billions) | |
| Liquidity investment portfolio | | |
| Cash and cash equivalents ⁽¹⁾ | \$ 7.6 | \$ 12.7 |
| Other investments | 1.5 | 1.8 |
| Total liquidity investment portfolio | 9.1 | 14.5 |
| Undrawn credit facilities | | |
| Asset-backed conduit funding facilities | 2.8 | 1.5 |
| Committed unsecured credit facility | 2.4 | 2.4 |
| Federal Reserve discount window ⁽²⁾ | 6.5 | 4.8 |
| Total undrawn credit facilities | 11.7 | 8.7 |
| Total liquidity investment portfolio and undrawn credit facilities | \$ 20.8 | \$ 23.2 |

(1) Cash-in-process is excluded from cash and cash equivalents for liquidity purposes.

(2) Excludes \$1.1 billion of investments pledged to the Federal Reserve, which is included within the liquidity investment portfolio.

Subsequent to August 31, 2010, we moved a portion of our liquidity investment portfolio into approximately \$4 billion of U.S. Treasury and U.S. government agency securities, both of which we expect to be readily convertible to cash. This investment strategy is expected to result in a higher return for our liquidity investment portfolio. This investment strategy is not expected to have a material impact on our risk based capital ratios. See Capital section below for further information on our capital ratios.

Capital

Our primary sources of capital are from the earnings generated by the business and issuance in the capital markets. We seek to manage capital to a level and composition sufficient to support the risks of the business, meet regulatory requirements, adhere to rating agency guidelines and support future business growth. Within

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these constraints, we are focused on deploying capital in a manner that provides attractive returns to our stockholders. The level, composition and utilization of capital are influenced by changes in the economic environment in addition to legislative and regulatory developments. See

Legislative and Regulatory Developments Initiatives Related to Capital and Liquidity for a discussion of recent initiatives related to capital matters.

Under regulatory capital requirements adopted by the FDIC, the Federal Reserve and other bank regulatory agencies, we, along with Discover Bank, must maintain minimum levels of capital. Failure to meet minimum capital requirements can result in the initiation of certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could limit our business activities and have a direct material effect on our financial position and results. We must meet specific capital 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.

Our capital adequacy assessment also includes tax and accounting considerations in accordance with regulatory guidance. We maintain a substantial deferred tax asset on our balance sheet, and we include this asset when calculating our regulatory capital levels. However, for regulatory capital purposes, deferred tax assets that are dependent on future taxable income are limited to the lesser of: (i) the amount of deferred tax assets we expect to realize within one year of the calendar quarter-end date, based on our projected future taxable income for that year; or (ii) 10% of the amount of our Tier 1 capital. At August 31, 2010, no portion of our deferred tax asset was disallowed for regulatory capital purposes.

At August 31, 2010, Discover Financial Services and Discover Bank met the requirements for well-capitalized status, exceeding the regulatory minimums to which they were subject. See Note 12: Capital Adequacy to our condensed consolidated financial statements for quantitative disclosures of our capital ratios and levels. Recent regulatory initiatives may subject us to increased capital requirements in the future. See Legislative and Regulatory Developments Initiatives Related to Capital and Liquidity.

Equity Capital. At August 31, 2010, equity was \$6.1 billion as compared to \$8.4 billion at November 30, 2009. The decline in equity is the result of adopting Statements No. 166 and 167 in the first quarter 2010, which reduced equity by \$1.3 billion, and redeeming all outstanding shares of the preferred stock that had previously been issued to the U.S. Treasury under the Capital Purchase Program in the second quarter 2010, which reduced equity by \$1.2 billion. On July 7, 2010, we repurchased the warrant to purchase 20,500,413 shares of our common stock that we issued to the U.S. Treasury in connection with the issuance of our preferred stock. We repurchased the warrant from the U.S. Treasury for \$172 million.

Dividends. Our board of directors declared a common stock cash dividend of \$.02 per share in September 2010, payable on October 21, 2010, to holders of record on October 7, 2010. The declaration and payment of future dividends, as well as the amount thereof, are subject to the discretion of our board of directors and will depend upon our results of operations, financial condition, capital levels, cash requirements, future prospects and other factors deemed relevant by our board of directors. Accordingly, there can be no assurance that we will declare and pay any dividends in the future. In addition, as a result of applicable banking law, regulations and guidance and provisions that may be contained in our borrowing agreements or the borrowing agreements of our subsidiaries, our ability to pay dividends to our stockholders may be further limited.

Stock Repurchase Program. On December 3, 2007, we announced that our board of directors authorized the repurchase of up to \$1 billion of our outstanding shares of common stock. This share repurchase program expires on November 30, 2010, and may be terminated at any time. At August 31, 2010, we had not repurchased any stock under this program.

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Guarantees

Guarantees are contracts or indemnification agreements that contingently require us to make payments to a guaranteed party based on changes in an underlying asset, liability, or equity security of a guaranteed party, rate or index. Also included in guarantees are contracts that contingently require the guarantor to make payments to a guaranteed party based on another entity's failure to perform under an agreement. Our guarantees relate to transactions processed on the Discover Network and certain transactions processed by PULSE and Diners Club. See Note 13: Commitments, Contingencies and Guarantees to our condensed consolidated financial statements for further discussion regarding our guarantees.

Contractual Obligations and Contingent Liabilities and Commitments

In the normal course of business, we enter into various contractual obligations that may require future cash payments. Contractual obligations at August 31, 2010, which include deposits, securitized debt, long-term borrowings, operating and capital lease obligations and purchase obligations were \$54 billion. Contractual obligations grew \$18 billion from November 30, 2009, largely as a result of the consolidation of the liabilities of the variable interest entities used in our securitization activities and also due to the growth in our deposit funding. For more information, see *Change in Accounting Principle Related to Off-Balance Sheet Securitizations*. For a description of our contractual obligations as of November 30, 2009, see our annual report on Form 10-K for the year ended November 30, 2009 under *Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources - Contractual Obligations and Contingent Liabilities and Commitments*.

At August 31, 2010, we had extended credit for consumer and commercial loans of approximately \$166 billion, primarily arising from agreements with customers for unused lines of credit on credit cards, subject to the customer's compliance with the related cardmember agreement. These commitments, substantially all of which we can terminate at any time and which do not necessarily represent future cash requirements, are periodically reviewed based on account usage and customer creditworthiness. In addition, in the ordinary course of business, we guarantee payment on behalf of subsidiaries relating to contractual obligations with external parties. The activities of the subsidiaries covered by any such guarantees are included in our condensed consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

Interest Rate Risk. Changes in interest rates impact interest-earning assets, principally loan receivables. Changes in interest rates also impact interest sensitive liabilities that finance these assets, including asset-backed securitizations, deposits, and short-term and long-term borrowings.

Our interest rate risk management policies are designed to measure and manage the potential volatility of earnings that may arise from changes in interest rates by having a financing portfolio that reflects the mix of variable and fixed rate assets. To the extent that asset and related financing repricing characteristics of a particular portfolio are not matched effectively, we may utilize interest rate derivative contracts, such as swap agreements, to achieve our objectives. Interest rate swap agreements effectively convert the underlying asset or financing from fixed to floating rate or from floating to fixed rate. See Note 16: Derivatives and Hedging Activities to our condensed consolidated financial statements for information on our derivatives activity.

We use an interest rate sensitivity simulation to assess our interest rate risk exposure. For purposes of presenting the possible earnings effect of a hypothetical, adverse change in interest rates over the 12-month

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period from our reporting date, we assume that all interest rate sensitive assets and liabilities will be impacted by a hypothetical, immediate 100 basis point increase in interest rates as of the beginning of the period. The sensitivity is based upon the hypothetical assumption that all relevant types of interest rates that affect our results would increase instantaneously, simultaneously and to the same degree.

Our interest rate sensitive assets include our variable rate loan receivables and the assets that make up our liquidity investment portfolio. Due to recently enacted credit card legislation, we now have restrictions on our ability to mitigate interest rate risk by adjusting rates on existing balances. At August 31, 2010, the majority of our credit card loans were at variable rates. Beginning in the third quarter 2010, we began using interest rate derivatives to reduce the asset sensitivity that resulted from having a larger percentage of our loan portfolio at variable rates. Assets with rates that are fixed at period end but which will mature, or otherwise contractually reset to a market-based indexed rate or other fixed rate prior to the end of the 12-month period, are considered to be rate sensitive. The latter category includes certain credit card loans that may be offered at below-market rates for an introductory period, such as balance transfers and special promotional programs, after which the loans will contractually reprice in accordance with our normal market-based pricing structure. For purposes of measuring rate sensitivity for such loans, only the effect of the hypothetical 100 basis point change in the underlying market-based indexed rate or other fixed rate has been considered rather than the full change in the rate to which the loan would contractually reprice. For assets that have a fixed interest rate at the fiscal period end but which contractually will, or are assumed to, reset to a market-based indexed rate or other fixed rate during the next 12 months, earnings sensitivity is measured from the expected repricing date. In addition, for all interest rate sensitive assets, earnings sensitivity is calculated net of expected loan losses.

Interest rate sensitive liabilities are assumed to be those for which the stated interest rate is not contractually fixed for the next 12-month period. Thus, liabilities that vary with changes in a market-based index, such as Federal Funds or LIBOR, which will reset before the end of the 12-month period, or liabilities whose rates are fixed at the fiscal period end but which will mature and are assumed to be replaced with a market-based indexed rate prior to the end of the 12-month period, also are considered to be rate sensitive. For these fixed rate liabilities, earnings sensitivity is measured from the expected repricing date. Assuming an immediate 100 basis point increase in the interest rates affecting all interest rate sensitive assets and liabilities at August 31, 2010, we estimate that net interest income over the following 12-month period would increase by approximately \$56 million. Assuming an immediate 100 basis point increase in the interest rates affecting all interest rate sensitive assets and liabilities at November 30, 2009, we estimated that net interest income over the following 12-month period would increase by approximately \$84 million. The decline in the estimated impact of an immediate 100 basis point increase in interest rates at August 31, 2010 as compared to November 30, 2009, was primarily driven by reducing the asset sensitivity of our balance sheet through the use of interest rate derivatives. Specifically, beginning in the third quarter 2010, we entered into interest rate derivative agreements under which we receive a fixed interest rate on forecasted cash flows related to variable rate credit card receivables. We anticipate that the asset sensitivity of the balance sheet will be reduced further with continued management of our balance sheet sensitivity and through the use of derivatives. We have not provided an estimate of any impact on net interest income of a decrease in interest rates as many of our interest rate sensitive assets and liabilities are tied to interest rates that are already at or near their minimum levels and, therefore, could not materially decrease further.

Item 4. Controls and Procedures*Evaluation of Disclosure Controls and Procedures*

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the Exchange Act)), which are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or

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submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting (as such term is defined in Exchange Act Rule 13a-15(f)) that occurred during the quarter ended August 31, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In the normal course of business, from time to time, we have been named as a defendant in various legal actions, including arbitrations, class actions, and other litigation, arising in connection with our 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. We have historically relied on the arbitration clause in our cardmember agreements, which has in some instances limited the costs of, and our exposure to, litigation, but there can be no assurance that we will continue to be successful in enforcing our arbitration clause in the future. Legal challenges to the enforceability of these clauses have led most card issuers and may cause us to discontinue their use, and there are bills pending in Congress to directly or indirectly prohibit the use of pre-dispute arbitration clauses. Further, we are involved in pending legal actions challenging our arbitration clause. We are also involved, from time to time, in other reviews, investigations and proceedings (both formal and informal) by governmental agencies regarding our business, including, among other matters, accounting, tax and operational matters, some of which may result in adverse judgments, settlements, fines, penalties, injunctions, or other relief. For example, we have received a notice of proposed assessment from the IRS related to its audit of our 1999-2005 tax years as further discussed in Note 10: Income Taxes to the condensed consolidated financial statements. Litigation and regulatory actions could also adversely affect our reputation.

We contest liability and/or the amount of damages as appropriate in each pending matter. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases where claimants seek substantial or indeterminate damages or where investigations and proceedings are in the early stages, we cannot predict with certainty the loss or range of loss, if any, related to such matters, how such matters will be resolved, when they will ultimately be resolved, or what the eventual settlement, fine, penalty or other relief, if any, might be. Subject to the foregoing, we believe, based on current knowledge and after consultation with counsel, that the outcome of the pending matters will not have a material adverse effect on our financial condition, although the outcome of such matters could be material to our operating results and cash flows for a particular future period, depending on, among other things, our level of income for such period.

Item 1A. Risk Factors

There have been no material changes to the risk factors previously disclosed in our quarterly report on Form 10-Q for the quarter ended May 31, 2010 and our annual report on Form 10-K for the year ended November 30, 2009.

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Issuer Purchases of Equity Securities

The table below sets forth the information with respect to purchases of our common stock made by us or on our behalf during the three months ended August 31, 2010:

| Period | Total Number of Shares Purchased ⁽²⁾ | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs ⁽¹⁾ | Maximum Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs |
|--------------------------------------|---|------------------------------|---|--|
| June 1 30, 2010 | | | | |
| Repurchase program ⁽¹⁾ | | \$ | | \$ 1 billion |
| Employee transactions ⁽²⁾ | 1,937 | \$ 14.37 | N/A | N/A |
| July 1 31, 2010 | | | | |
| Repurchase program ⁽¹⁾ | | \$ | | \$ 1 billion |
| Employee transactions ⁽²⁾ | 175,145 | \$ 13.84 | N/A | N/A |
| August 1 31, 2010 | | | | |
| Repurchase program ⁽¹⁾ | | \$ | | \$ 1 billion |
| Employee transactions ⁽²⁾ | 13,728 | \$ 15.11 | N/A | N/A |
| Total | | | | |
| Repurchase program ⁽¹⁾ | | \$ | | \$ 1 billion |
| Employee transactions ⁽²⁾ | 190,810 | \$ 13.93 | N/A | N/A |

(1) On December 3, 2007, we announced that our board of directors authorized the repurchase of up to \$1 billion of our outstanding stock under a new share repurchase program. This share repurchase program expires on November 30, 2010, and may be terminated at any time. At August 31, 2010, we had not repurchased any stock under this program.

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

Item 3. Defaults Upon Senior Securities

None

Item 4. (Removed and Reserved)**Item 5. Other Information**

None

Item 6. Exhibits

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

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Signature

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Discover Financial Services

(Registrant)

By: **/s/ ROY A. GUTHRIE**
Roy A. Guthrie

Executive Vice President and

Chief Financial Officer

Date: October 6, 2010

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| Exhibit Number | Description |
|-----------------------|--|
| 10.1 | Second Amended and Restated Pooling and Servicing Agreement, between Discover Bank as Master Servicer, Servicer and Seller and U.S. Bank National Association, as Trustee, dated as of June 4, 2010 (filed as Exhibit 4.1 to Discover Bank's Current Report on Form 8-K filed on June 4, 2010 and incorporated herein by reference thereto). |
| 10.2 | Amendment to Specified Series Supplements, between Discover Bank, as Master Servicer, Servicer and Seller and U.S. Bank National Association, as Trustee, dated as of June 4, 2010 (filed as Exhibit 4.2 to Discover Bank's Current Report on Form 8-K filed on June 4, 2010 and incorporated herein by reference thereto). |
| 10.3 | First Amendment to Trust Agreement, between Discover Bank, as Beneficiary and Wilmington Trust Company, as Owner Trustee, dated as of June 4, 2010 (filed as Exhibit 4.3 to Discover Bank's Current Report on Form 8-K filed on June 4, 2010 and incorporated herein by reference thereto). |
| 10.4 | First Amendment to Indenture, between Discover Card Execution Note Trust, as Issuer, and U.S. Bank National Association, as Indenture Trustee, dated as of June 4, 2010 (filed as Exhibit 4.4 to Discover Bank's Current Report on Form 8-K filed on June 4, 2010 and incorporated herein by reference thereto). |
| 10.5 | Amended and Restated Indenture Supplement for the DiscoverSeries Notes, between Discover Card Execution Note Trust, as Issuer, and U.S. Bank National Association, as Indenture Trustee, dated as of June 4, 2010 (filed as Exhibit 4.5 to Discover Bank's Current Report on Form 8-K filed on June 4, 2010 and incorporated herein by reference thereto). |
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934. |
| 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934. |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 1350 of Chapter 63 of Title 18 of the United States Code. |
| 101.INS | XBRL Instance Document. |
| 101.SCH | XBRL Taxonomy Extension Schema Document. |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document. |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document. |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document. |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document. |