Discover Financial Services
Form 10-Q
April 09, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended February 28, 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	**36-2517428**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
2500 Lake Cook Road, **Riverwoods, Illinois 60015**	**(224) 405-0900**
(Address of principal executive offices, including zip code)	**(Registrant s telephone number, including area code)**

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

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

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

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

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

As of March 31, 2010, there were 543,823,818 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 February 28, 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® Motiva℠ Card, Discover® Open Road® Card, Discover® Network and Diners Club International®. All other trademarks, trade names and service marks included in this quarterly report on Form 10-Q are the property of their respective owners.

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Part I. FINANCIAL INFORMATION

Item 1. Financial Statements

DISCOVER FINANCIAL SERVICES

Condensed Consolidated Statements of Financial Condition

	February 28, 2010 (unaudited)	November 30, 2009
	(dollars in thousands, except per share amounts)	
Assets		
Cash and cash equivalents	$ 12,728,321	$ 13,020,719
Restricted cash special dividend escrow		643,311
Restricted cash for securitization investors	3,676,000	
Other short-term investments	175,000	1,350,000
Investment securities:		
Available-for-sale (amortized cost of $617,921 and $2,743,729 at February 28, 2010 and November 30, 2009, respectively)	648,144	2,645,481
Held-to-maturity (fair value of $85,446 and $1,953,990 at February 28, 2010 and November 30, 2009, respectively)	89,437	2,389,816
Total investments securities	737,581	5,035,297
Loan receivables:		
Credit card restricted for securitization investors	35,377,123	
Other credit card	10,384,116	20,230,302
Total credit card loan receivables	45,761,239	20,230,302
Other	4,332,277	3,394,782
Total loan receivables	50,093,516	23,625,084
Allowance for loan losses	(4,207,360)	(1,757,899)
Net loan receivables	45,886,156	21,867,185
Amounts due from asset securitization		1,692,051
Premises and equipment, net	482,833	499,303
Goodwill	255,421	255,421
Intangible assets, net	193,970	195,636
Other assets	2,683,669	1,462,064
Total assets	$ 66,818,951	$ 46,020,987
Liabilities and Stockholders Equity		
Deposits:		
Interest-bearing deposit accounts	$ 34,954,443	$ 32,028,506
Non-interest bearing deposit accounts	97,223	64,506
Total deposits	35,051,666	32,093,012
Long-term borrowings:		
Long-term borrowings owed to securitization investors	20,036,538	
Other long-term borrowings	2,355,662	2,428,101
Total long-term borrowings	22,392,200	2,428,101
Special dividend Morgan Stanley		808,757
Accrued expenses and other liabilities	2,360,037	2,255,570

Total liabilities	59,803,903	37,585,440
Commitments, contingencies and guarantees (Note 12)		
Stockholders Equity:		
Preferred stock, par value $.01 per share; 200,000,000 shares authorized, 1,224,558 issued and outstanding at February 28, 2010 and November 30, 2009	1,161,454	1,158,066
Common stock, par value $.01 per share; 2,000,000,000 shares authorized; 546,021,858 and 544,799,041 shares issued at February 28, 2010 and November 30, 2009, respectively	5,460	5,448
Additional paid-in capital	3,584,512	3,573,231
Retained earnings	2,362,685	3,873,262
Accumulated other comprehensive (loss) income	(74,038)	(154,818)
Treasury stock, at cost; 2,245,092 and 1,876,795 shares at February 28, 2010 and November 30, 2009, respectively	(25,025)	(19,642)
Total stockholders equity	7,015,048	8,435,547
Total liabilities and stockholders equity	$ 66,818,951	$ 46,020,987

See Notes to the Condensed Consolidated Financial Statements.

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DISCOVER FINANCIAL SERVICES

Condensed Consolidated Statements of Income

	For the Three Months Ended February 28, 2010	2009
	(unaudited)	
	(dollars in thousands, except per share amounts)	
Interest income:		
Credit card loans	$ 1,491,887	$ 733,499
Other loans	52,668	35,233
Investment securities	5,328	15,584
Other interest income	9,267	31,477
Total interest income	1,559,150	815,793
Interest expense:		
Deposits	305,449	297,126
Short-term borrowings		1,183
Long-term borrowings	108,275	14,411
Total interest expense	413,724	312,720
Net interest income	1,145,426	503,073
Provision for loan losses	1,387,206	937,813
Net interest income after provision for loan losses	(241,780)	(434,740)
Other income:		
Securitization income		417,883
Discount and interchange revenue	261,991	75,267
Fee products	104,095	74,776
Loan fee income	105,285	68,022
Transaction processing revenue	32,918	28,866
Merchant fees	8,445	12,837
Gain (loss) on investment securities	180	(805)
Antitrust litigation settlement		474,841
Other income	32,962	38,269
Total other income	545,876	1,189,956
Other expense:		
Employee compensation and benefits	195,764	219,488
Marketing and business development	84,673	111,433
Information processing and communications	65,418	74,897
Professional fees	75,813	70,123
Premises and equipment	17,860	18,072
Other expense	35,276	65,110
Total other expense	474,804	559,123
(Loss) income before income tax expense	(170,708)	196,093
Income tax (benefit) expense	(67,170)	75,699
Net (loss) income	(103,538)	120,394
Net (loss) income allocated to common stockholders	$ (122,233)	$ 118,380

Basic earnings per share	$	(0.22)	$	0.25
Diluted earnings per share	$	(0.22)	$	0.25
Dividends paid per share	$	0.02	$	0.06

See Notes to the Condensed Consolidated Financial Statements.

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DISCOVER FINANCIAL SERVICES

Condensed Consolidated Statements of Changes in Stockholders Equity

	Preferred Stock		Common Stock						
	Shares	Amount	Shares	Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stockholders Equity
					(unaudited)				
					(dollars and shares in thousands)				
Balance at November 30, 2008		$	480,517	$ 4,805	$ 2,938,657	$ 3,046,956	$ (66,338)	$ (8,257)	$ 5,915,823
Adoption of the measurement provisions of ASC 715 (FASB Statement No. 158), net of tax						(1,110)			(1,110)
Comprehensive income:									
Net income						120,394			120,394
Adjustments related to investment securities, net of tax							498		
Adjustments related to pension and postretirement benefits, net of tax							(239)		
Other comprehensive income							259		259
Total comprehensive income									120,653
Purchases of treasury stock								(6,161)	(6,161)
Common stock issued and stock-based compensation expense			2,320	23	11,060				11,083
Income tax deficiency on stock-based compensation plans					(11,674)				(11,674)
Dividends paid common stock						(29,263)			(29,263)
Balance at February 28, 2009		$	482,837	$ 4,828	$ 2,938,043	$ 3,136,977	$ (66,079)	$ (14,418)	$ 5,999,351
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 loss						(103,538)			(103,538)
Adjustments related to investment securities, net of tax							2,160		
Adjustments related to pension and postretirement benefits, net of tax							59		
Other comprehensive income							2,219		2,219
Total comprehensive loss									(101,319)
Purchases of treasury stock								(5,383)	(5,383)
Common stock issued under employee benefit plans			22		285				285
Common stock issued and stock-based compensation expense			1,201	12	10,996				11,008
Dividends paid common stock						(10,984)			(10,984)
Accretion of preferred stock discount		3,388				(3,388)			
Dividends preferred stock						(15,307)			(15,307)
Special dividend Morgan Stanley						33,757			33,757

Balance at February 28, 2010	1,225	$	1,161,454	546,022	$	5,460	$	3,584,512	$	2,362,685	$	(74,038)	$	(25,025)	$ 7,015,048

See Notes to the Condensed Consolidated Financial Statements.

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DISCOVER FINANCIAL SERVICES

Condensed Consolidated Statements of Cash Flows

	For the Three Months Ended February 28, 2010	2009
	(unaudited) (dollars in thousands)	
Cash flows from operating activities		
Net (loss) income	$ (103,538)	$ 120,394
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
(Gain) loss on investment securities	(180)	805
Loss (gain) on equipment	33	(14)
Stock-based compensation expense	11,293	11,083
Income tax deficiency on stock-based compensation expense		(11,674)
Deferred income taxes	(100,918)	(196,763)
Depreciation and amortization on premises and equipment	23,689	24,945
Other depreciation and amortization	18,737	34,678
Provision for loan losses	1,387,206	937,813
Amortization of deferred revenues	(42,065)	(35,405)
Changes in assets and liabilities:		
(Increase) decrease in amounts due from asset securitization		386,408
(Increase) decrease in other assets	(170,051)	9,469
Increase (decrease) in accrued expenses and other liabilities	110,896	(753,360)
Net cash provided by operating activities	1,135,102	528,379
Cash flows from investing activities		
Maturities of other short-term investments	1,175,000	
Maturities and sales of available-for-sale investment securities	68,214	
Purchases of available-for-sale investment securities	(269,310)	(98)
Maturities of held-to-maturity investment securities	4,433	906
Purchases of held-to-maturity investment securities		(73,799)
Net principal disbursed on loans held for investment	(291,098)	(3,229,840)
Decrease in restricted cash special dividend escrow	643,311	
(Increase) in restricted cash for securitization investors	(2,437,239)	
Proceeds from sale of equipment		1,139
Purchases of premises and equipment	(7,826)	(18,126)
Net cash used for investing activities	(1,114,515)	(3,319,818)
Cash flows from financing activities		
Net (decrease) increase in short-term borrowings		1,875,000
Proceeds from securitized debt	750,000	
Maturities of securitized debt	(3,142,983)	
Maturities of other long-term borrowings	(71,930)	(302,456)
Purchases of treasury stock	(5,383)	(6,161)
Net increase (decrease) in deposits	2,958,602	(192,616)
Dividends paid to Morgan Stanley	(775,000)	
Dividends paid on common and preferred stock	(26,291)	(29,263)
Net cash (used for) provided by financing activities	(312,985)	1,344,504
Net decrease in cash and cash equivalents	(292,398)	(1,446,935)
Cash and cash equivalents, at beginning of period	13,020,719	10,171,143
Cash and cash equivalents, at end of period	$ 12,728,321	$ 8,724,208

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Cash paid during the year for:				
Interest expense	$	369,924	$	327,345
Income taxes, net of income tax refunds	$	14,141	$	(208)
Non-cash transactions:				
Special dividend Morgan Stanley	$	33,757	$	

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. In March 2009, the Company became a bank holding company under the Bank Holding Company Act of 1956 and a financial holding company under the Gramm-Leach-Bliley Act. Therefore, the Company is now 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 of licensees, which are generally financial institutions, that issue Diners Club branded credit cards and/or provide card acceptance services.

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

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

In February 2010, the Financial Accounting Standards Board (the FASB) issued Accounting Standards Update (ASU) No. 2010-09, *Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*. The amendments remove the requirement for an SEC registrant to disclose the date through which subsequent events were evaluated as this requirement would have potentially conflicted with SEC reporting requirements. Removal of the disclosure requirement is not expected to affect the nature or timing of subsequent events evaluations performed by the Company. This ASU became effective upon issuance.

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

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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 are presented in Note 14: Fair Value Disclosures. These new disclosure requirements will first apply to the Company in its financial statements for the period ending May 31, 2010, except for the requirement concerning gross presentation of Level 3 activity, which is 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 FSP is effective for fiscal years ending after December 15, 2009 and will first apply to the Company s Form 10-K for the period ending November 30, 2010. The application of this guidance will only affect disclosures and therefore will not impact the Company s financial condition, results of operations or cash flows.

In June 2008, the FASB issued FASB Staff Position No. EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (codified within ASC Topic 260, *Earnings per Share*), which addresses whether certain unvested equity-based awards constitute participating securities and, therefore, need to be included in the earnings allocation in computing earnings per share under the two-class method described in FASB Statement No. 128, *Earnings per Share*. This guidance became effective for the Company on December 1, 2009. Beginning with this report, all earnings per share data is computed pursuant to this new standard. All comparative prior period earnings per share amounts presented have been adjusted retrospectively to conform to the new guidance. The adoption of this standard has not impacted the Company s financial condition, results of operations or cash flows.

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). Included in these amounts were the following transition adjustments:

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

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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;

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 cons