



THE FEDERAL RESERVE BANK OF RICHMOND

RICHMOND ■ BALTIMORE ■ CHARLOTTE

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September 27, 2024

Richard Kim, Esq.
Wachtell, Lipton, Rosen & Katz
51 West 52nd Street
New York, NY 10019
Sent via EZFile

Dear Mr. Kim:

The following additional information request relates to (1) the application filed by Capital One Financial Corporation (“Capital One”), the parent of Capital One, National Association (“CONA”), both of McLean, Virginia, to acquire 100 percent of Discover Financial Services (“Discover”), Riverwoods, Illinois, and thereby indirectly acquire Discover Bank, Greenwood, Delaware, pursuant to section 3 of the Bank Holding Company Act of 1956¹ (“BHC Act”) (“Section 3 Application”), and (2) the notice filed by Capital One to indirectly acquire DFS Services LLC (“DFS Services”), Riverwoods, Illinois; Discover Financial Services (Canada), Inc., Vancouver, British Columbia, Canada; PULSE Network LLC, Houston, Texas; and Diners Club International Ltd., Riverwoods, Illinois, pursuant to sections 4(c)(8) and 4(j) of the BHC Act.² Please provide responses to each of the following questions, including in the Confidential Annex. Supporting documentation should be provided, as appropriate.

To the extent the information requested below is not yet available, provide a date by which the requested information is expected to be made available to the Board of Governors of the Federal Reserve System (“Board”).

1. Discuss what changes Capital One would make to its controls for monitoring the resulting institution’s compliance with sections 23A and 23B of the Federal Reserve Act and the Board’s Regulation W.
2. Discuss what changes Capital One would make to its Transactions with Affiliates policies and procedures for Regulation W compliance of the resulting institution. In your response, include any identified, or expected to be identified, covered transactions under section 23A of the Federal Reserve Act and the Board’s Regulation W involving DFS Services LLC and/or other nonbank entities of Discover.
3. Discuss how the proposed transaction would impact liquidity and liquidity risk management practices of Capital One, particularly with respect to the payment service operations of the target organization.

¹ 12 U.S.C. § 1842.

² 12 U.S.C. § 1843(c)(8) and (j).

4. Discuss what changes Capital One would make, if any, to how the performance of functions related to the operation of Discover card payment network is divided between Discover Bank, on the one hand, and Discover's nonbank subsidiaries, on the other hand. In your response, provide the following items:
 - a. With reference to Chart A and Chart B from Discover's Annual Report for the year ended December 31, 2023, included in the Appendix, provide the following:
 - i. For each activity or action described, identify the Discover legal entity currently responsible for such activity or action.
 - ii. Describe further the specific activities involved in each step outlined in Chart A and Chart B.
 - iii. Describe in detail all interactions between Discover's nonbank subsidiaries and Discover Bank.
 - iv. Provide the above information for Capital One and CONA following consummation of the proposal as currently contemplated.
 - b. To the extent not already described, in reference to the bottom-left box of Chart A, describe in detail the interaction between the Discover card payment network and Discover Bank for a card transaction. Your response should clearly explain or illustrate the flow of funds at each step of this stage, parties involved including any Federal Reserve payment service systems, payment time periods or intervals, debits and credits, and any other key aspects in the payment, clearance, and settlement process. In addition, explain whether such processes can result in extensions of credit, or other covered transactions, under sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W. Clarify how, if at all, your responses would differ if the Merchant (top-right box) is a Capital One Shopping entity.
5. With respect to Capital One's resolution planning:
 - a. Elaborate on the legal entity and business line structure of Capital One post-merger and how the structure would support the firm's preferred resolution strategy, minimize risk to U.S. financial stability in the event of the firm's failure, and promote separability. In addition, discuss what legal entity rationalization and separability principles would drive corporate entity and business line structuring decisions.
 - b. To the extent not already provided, clarify whether Capital One intends to operate Discover's card payment network through nonbank subsidiaries of Capital One (rather than operated solely through CONA). If so, explain the business rationale for this intended structure and discuss the impact of this structure on the resolvability of the resulting organization.

6. Discuss credit performance of domestic credit card receivables by vintage in terms of delinquencies and net charge offs for CONA and Discover Bank as of August 31, 2024, and for the combined bank on a pro forma basis. Your discussion should include aspects of performance that are unfavorable relative to historical averages or management expectations. In addition, discuss projected credit performance post-merger for year-end 2025, 2026, and 2027, and expected impact to net income and regulatory capital. Your discussion should include credit risk mitigants as well as any expected significant increases in allowance for credit losses relative to historical experience.
7. Broadly discuss any credit performance deterioration associated with Capital One's auto lending business and management expectations over the next three years.
8. Provide current and pro forma asset and liability concentrations for CONA relative to tier 1 capital plus allowance for credit losses, as of June 30, 2024.
 - a. Provide further breakdown of current and pro forma concentrations by subprime/non-subprime across domestic credit card and auto loan portfolios.
 - b. Discuss key processes that are currently employed and/or whether any enhancements are needed to effectively monitor and manage any asset or liability concentrations following the proposed bank merger. This may include any de-risking initiatives or recalibration of lending thresholds or risk tolerance limits.
 - c. Provide current and pro forma asset (major loan products) and liability (major funding/deposit products) composition mix for CONA and discuss any meaningful change relative to the bank's current balance sheet, as of June 30, 2024.
9. Provide asset quality ratios (with relevant calculations) for Capital One and CONA on a consolidated and bank-only basis, using current and pro forma balance sheets as of June 30, 2024. The asset quality analysis should include the following:
 - a. Focus on two separate elements: (i) internally classified assets comprised of the separate categories of substandard, doubtful, and loss (with relevant components of other real estate owned ("OREO") separately identified in each category), and (ii) nonperforming assets, comprised of nonaccrual loans, all restructured and modified loans, and OREO.
 - b. For the classified assets ratio, the level of classified assets should be compared to the total amount of tier 1 capital and allowance for credit losses.
 - c. For the nonperforming assets ratio, the level of nonperforming assets should be compared to the total equity capital and the allowance for credit losses.
10. Provide loan loss reserve coverage ratios (with relevant calculations) for Capital One and CONA on a consolidated and bank-only basis, using current and pro forma balance sheets as of June 30, 2024. The coverage ratios should include the following:

- a. For Capital One, for the numerator use the total allowance for credit losses and for the denominator use nonaccrual loans and loans past due more than 90 days.
 - b. For CONA, for the numerator use the total allowance for credit losses and for the denominator use nonaccrual loans.
11. Provide balance sheets and income statements for DFS Services and DFS Corporate Services, LLC, Riverwoods, Illinois, as of June 30, 2024.
12. Describe how Capital One and Discover each identify a credit card account as a post-secondary student credit card account. Indicate which, if any, account attributes (e.g., credit card product, accountholder FICO score, age, location, enrollment status) Capital One or Discover each use to identify whether an account is a post-secondary student credit card account.
13. For purchase volumes, outstandings, and number of accounts, recompute the volume of commerce, market shares, change in HHI, post-merger HHI and combined share from Confidential Annex 4 to Confidential Exhibit J³ of the Section 3 Application (using the same data or a comparable source), now conditional on post-secondary student credit card accounts. Provide the data underlying these calculations.
14. Describe how Capital One and Discover each identify credit card accounts as ones with little to no credit history (sometimes referred to as “thin file” customers) or as ones with invalid FICO scores. Indicate which, if any, account attributes (e.g., credit card product, accountholder FICO score, age, location, age of oldest account) Capital One or Discover each use to identify a credit card account with little to no credit history or with an invalid FICO score.
15. For purchase volumes, outstandings, and number of accounts, recompute the volume of commerce, market shares, change in HHI, post-merger HHI and combined share from Confidential Annex 4 to Confidential Exhibit J of the Section 3 Application (using the same data or a comparable source), now conditional on credit card accounts with little to no credit history or invalid FICO scores. Provide the data underlying these calculations.
16. Provide a summary discussion as to how the proposed transaction would increase consolidated profitability for the three years following consummation of the proposed transaction. Identify the primary factors that would drive or enable profits and any underlying assumptions.

³ In response to a request under the Freedom of Information Act, Capital One confirmed that Confidential Annex 4 could be disclosed in full and submitted a revised version of Public Exhibit 21, which included Confidential Annex 4.

Provide your response via EZ-File #111944 within eight business days. Any information for which confidential treatment is desired should be so labeled and separately bound in accordance with section 261.17 of the Board's Rules Regarding Availability of Information. The public portion of any response should be so designated. The Board will make the public portion of this request and the public portion of any response available on the Board's website, so that it is readily accessible to the commenters and to other interested parties.⁴ Please also send a copy of your response to the Office of the Comptroller of the Currency Senior Licensing Analyst Patricia Roberts at patricia.roberts@occ.treas.gov, the Federal Deposit Insurance Corporation Senior Case Manager Jeffrey Ralston at jralston@fdic.gov, and the Delaware Office of the State Bank Commissioner Senior Deputy Commissioner Lisa Collison at lisa.collison@delaware.gov.

If you have any questions, please contact Katherine Eike of this Reserve Bank, via email at kathy.eike@rich.frb.org.

Sincerely,

E-SIGNED by Brent Hassell
on 2024-09-27 19:54:00 GMT

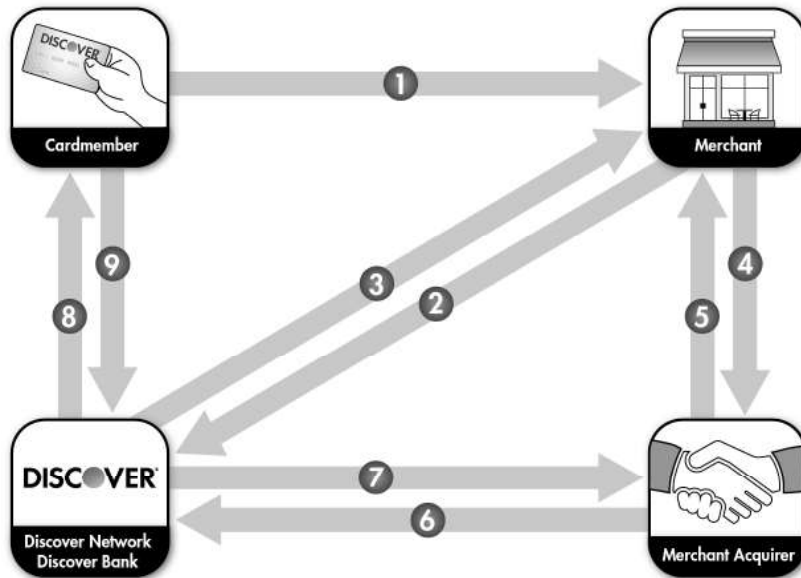
Brent Hassell
Assistant Vice President

cc: Board of Governors of the Federal Reserve System
Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Delaware Office of the State Bank Commissioner

⁴ See <https://www.federalreserve.gov/foia/capital-one-discover-application-materials.htm>.

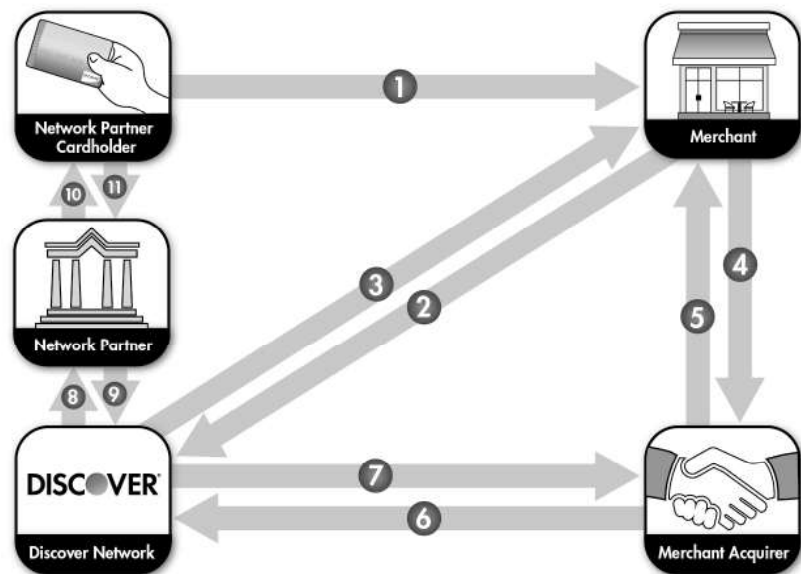
Appendix

Chart A



*This is a simplified illustration of a typical credit card transaction. It does not reflect certain operations and assessment fees, cash or balance transfer transactions, authorizations, disputes or other specifics.

Chart B



*This is a simplified illustration of a typical credit card transaction. It does not reflect certain operations and assessment fees, cash or balance transfer transactions, authorizations, disputes or other specifics.