TheStreet Transcript

DISCOVER FINANCIAL SVCS INC (DFS) Earnings Report: Q4 2014 Conference Call Transcript

The following DISCOVER FINANCIAL SVCS INC conference call took place on January 21, 2015, 05:00 PM ET. This is a transcript of that earnings call:

Company Participants

- Bill Franklin; Discover Financial Services; VP - IR
- David Nelms; Discover Financial Services; Chairman, CEO
- Mark Graf; Discover Financial Services; CFO

Other Participants

- Sanjay Sakhrani; Keefe, Bruyette and Woods; Analyst
- Mark DeVries; Barclays Capital; Analyst
- Bob Napoli; William Blair and Company; Analyst
- Jamie Friedman; Susquehanna Financial Group; Analyst
- Ryan Nash; Goldman Sachs; Analyst
- Matthew Howlett; UBS; Analyst
- Jason Arnold; RBC Capital Markets; Analyst
- Moshe Orenbuch; Credit Suisse; Analyst
- Vincent Caintic; Macquarie Capital; Analyst
- Chris Donat; Sandler O'Neill and Partners; Analyst
- John Hecht; Jefferies Capital; Analyst
- Betsy Graseck; Morgan Stanley; Analyst
- Rick Shane; JPMorgan; Analyst
- Owen Lau; Janney Capital Markets; Analyst

MANAGEMENT DISCUSSION SECTION

Operator:

Welcome to the fourth quarter 2014 Discover Financial Services earnings conference call.

(Operator Instructions)

Please note that this conference is being recorded.

I'll now turn the call over to Mr. Bill Franklin. Mr. Franklin, you may begin.

Bill Franklin (VP - IR):

Thank you. Good afternoon, everyone. We appreciate all of you joining us.

Let me begin, as always, with slide 2 of our earnings presentation, which is on the Investor Relations section of discover.com. Our discussion today contains certain forward-looking statements about the Company's future financial performance and business prospects, which are subject to risks and uncertainties, and speak only as of today.

Factors that could cause actual results to differ materially from these forward-looking statements are set forth within today's earnings press release, which was furnished to the SEC in an 8-K report, and in our 10-K and 10-Qs, which are on our Web site and on file with the SEC.

In the fourth-quarter 2014 earnings materials, we have provided information that compares and reconciles the Company's non-GAAP financial measures with the GAAP financial information, and we explain why these presentations are useful to management and investors. We urge you to review that information in conjunction with today's discussion.

Our call this afternoon will include formal remarks from David Nelms, our Chairman and Chief Executive Officer, and Mark Graf, our Chief Financial Officer. After Mark completes his comments, there will be time for a question-and-answer session. During the Q&A period, it would be very helpful if you limit yourself to one question and one related follow-up, so we can make sure that everyone is accommodated.

So now it is my pleasure to turn the call over to David.

David Nelms (Chairman, CEO):

Good afternoon, everyone, and thank you for joining us today. Starting on slide 3 of the earnings presentation, we reported fourth-quarter net income of $404 million, and diluted earnings per share of $0.87, after some one-time charges in the quarter. Excluding these charges, adjusted net income was $553 million, or $1.19 of adjusted diluted earnings per share.

Mark will cover the details of the charges later, but the largest was the previously announced $178-million elimination of our credit card rewards forfeiture reserve. We think the changes that we decided to make in our rewards program that resulted in this charge will be beneficial to our Business, and we are receiving favorable feedback from our card members. Our business model continues to deliver solid results.

Turning to slide 4, Discover achieved total loan growth of 6% over the prior year. This was driven by strong growth in card and personal loans.

Card receivables grew 6% this quarter. This growth is the result of the continuing success of Discover it driving new accounts and an increasing wallet share with existing customers. Our focus on the prime revolver segment is working, as evidenced by relative yield stability and profitable loan growth.

Card sales for the quarter increased 5% from the prior year. Lower gas prices brought down the sales growth by roughly 1%.

Private student loans grew 4%. And when you look at the organic growth, excluding the acquired portfolios, we achieved 22% growth year over year. Personal loans surpassed $5 billion in receivables, up 19% from the prior year.

On the right side of slide 4, payments volume in total was up 2%. PULSE volume increased 4% from the prior year. Network partners' volume declined 13%, due to the previously announced loss of volume from a third-party issuer. This runoff in network partners' volume was partially offset by growing AribaPay volume; however, this volume is at a substantially lower margin.

Diners volume increased 2%, but was up high-single digits year over year on a real basis, excluding FX. This was driven by strong volume growth in Asia-Pacific and Latin America.

Turning to slide 5, as we look back on 2014, our first priority was to grow Discover card loan share, while maintaining leading credit performance. We grew card receivables by 6%, a pace that was meaningfully faster than the industry. The new accounts we originated are more active, which speaks to the features and benefits of Discover it.

We have made investments in customer experience and rewards, and across all channels a card member may choose to access their account, whether it is on a desktop, a tablet, or a mobile phone. In 2014, Discover received the highest rating in the area of customer interaction, and tied for highest total customer satisfaction with credit card companies, according to JD Power.

In addition, we launched a new rewards site, Discover Deals, which provides card members with valuable offers, and provides retailers with a low-cost, highly targeted marketing platform. I'm also very proud that our 2.3% card net charge-off rate is one of the lowest in the industry.

We grew our non-card loans by originating $1.2 billion of private student loans, and almost $3 billion of personal loans. Private student and personal loans combined drove non-card receivables growth of approximately 10%, at the top end of our long-term target of 5% to 10%.

In payments, we lost some third-party volume in network partners, and the competitive landscape in debit remains challenging. However, our global acceptance and reach of the Discover network is larger than it has ever been. Also, the Discover network continues to provide significant benefits to our card-issuing business. In emerging payments, we are very pleased with the early results at the launch of AribaPay, which generated $1.5 billion in volume in the fourth quarter.

In terms of progress against optimizing our funding costs, we have continued to extend the duration of our funding by issuing longer-term, fixed-rate debt, and we took actions which we believe will make our deposits stickier when rates rise. In regards to optimizing our capital position, we repurchased 5% of our shares, while also increasing our dividend.

Lastly, we continue to enhance our operating model with our successful implementation of the deposit component of our core banking platform. Additionally, we continue to strengthen our compliance and controls infrastructure, which will remain a focus in 2015. We will discuss our other 2015 priorities later this year at our financial community briefing; but one preview I'll give you is that we plan on launching a new card product early this year.

As we look back on 2014, we feel very good about how we executed on these priorities. We delivered net income for the year of $2.3 billion, or $2.5 billion adjusted for the non-recurring charges in the fourth quarter, and we achieved an ROE of over 20%.

Now I'll turn the call over to Mark to discuss the details of our fourth-quarter results.

Mark Graf (CFO):

Thanks, David. Good evening, everyone. I'll start with the revenue detail on slide 6 of our presentation. Net interest income increased $103 million, or 7%, over the prior year, due to continued strong loan growth. Total non-interest income was down $195 million, due largely to the previously announced $178-million one-time charge related to the elimination of the rewards forfeiture reserve.

Research we conducted showed that rewards that are easier to redeem, and never expire, are as valuable to a customer as a higher earn rate. Our adjusted rewards rate, excluding the charge, was 10 basis points higher than last year, primarily due to a broader 5% cash back program in the quarter, which included both online and department store sales.

Protection product revenue continues to decline, down $9 million year over year, given our suspension of sales in late 2012. Other revenue decreased $11 million, primarily due to the reclassification of some merchant fees that we previously discussed several quarters ago. This is the last quarter where this reclassification will impact year-over-year comparisons.

Continuing on slide 6, payment services' revenue was down $6 million for the quarter, primarily due to the loss of the Sam's and Walmart co-brand volume in network partners. The transition is now largely completed, but will impact comparisons next year. This, combined with the continuing competitive challenges at PULSE, and the cost of a lawsuit filed by PULSE against a competitor to address these issues, will result in a decrease in profits for our payment segment in 2015.

Turning to slide 7, total loan yield of 11.4% was up 2 basis points over the prior year. The slightly higher loan yield was more than offset by higher funding costs, which drove a 5-basis-point decline in net interest margin over the prior year to 9.76%.

Our cost of funds has increased, as we've issued more long-term, fixed-rate debt over the last year. In addition, we're no longer seeing the same level of benefit from the maturity of CDs priced at rates considerably above those in the market today. These had been creating a meaningful funding cost tailwind in the last few years, but this opportunity has now largely played out.

Turning to slide 8, total operating expense increased by $94 million, or 11%, over the prior year, including $48 million in non-recurring items. One of the non-recurring items was the $27-million impairment of goodwill realized with the Discover Home Loans acquisition. We have not diversified beyond refinance volume into purchase money originations in a meaningful way, and, therefore, we aren't driving a level of originations that we expected. Going forward, we'll continue to evaluate our home loan strategy.

The other non-recurring item in other expense was the $21-million mark to fair value related to Diners Club Italy. We acquired DC Italy to support acceptance in the region in June of 2013. But as we've consistently said, it's not part of our strategy to own this franchise long term. We're now actively engaged in a sales process, which is why it has been classified as held for sale.

The three other key drivers of the increase in expenses year over year were additional marketing this quarter, particularly in card and personal loans to drive new accounts; higher professional fees related to investments in web and mobile; and higher employee compensation.

Turning to provision for loan losses and credit on slide 9, provision for loan losses was higher by $103 million, including a $52-million higher reserve build compared to the prior year. Net charge-offs increased by $51 million, driven primarily by loan growth, and, to a lesser degree, lower dollar recoveries on aged charge-offs. The credit card net charge-off rate was 2.26%, up 17 basis points year over year, and up 10 basis points sequentially. The 30-plus day delinquency rate was relatively flat, at 1.73%.

The private student loan net charge-off rate, excluding purchased credit impaired loans, was relatively flat year over year, at 1.4%. The 30-plus day delinquency rate increased by 14 basis points over the prior year, to 1.8%, as the organic book continues to enter repayment.

Switching to personal loans, the net charge-off rate was up 20 basis points year over year to 2.2%, due to the seasoning of growth. And the over 30-day delinquency rate was up 9 basis points, to 79 basis points. Across all of our portfolios, we remain pleased with our strong credit results.

Next, I'll touch on our capital position on slide 10. Our tier 1 common equity ratio was 14.1%. The sequential decrease in our capital ratios was driven by seasonal loan growth, as well as continued capital deployment. We repurchased $400 million of stock in the quarter. To complete the $1.6 billion of repurchases we submitted as part of last year's CCAR capital actions, we plan to buy back approximately $400 million worth of stock in the first quarter as well.

Moving to 2015 guidance on slide 11, since our annual financial community briefing will be somewhat later this year, we felt it appropriate to provide some select guidance for 2015. We expect revenue margin to decline modestly from 12.9% this year.

There are four main drivers of this compression. First, we expect modest NIM compression, driven by increasing funding costs, as well as a small decline in asset yields. Second, we anticipate protection product revenue will continue to decline. Third, we anticipate a rewards rate of approximately 105 basis points in 2015. And the fourth driver is the lower payments revenue I discussed earlier.

Moving down the list to provisions, we expect the provision for loan loss rate to increase from 2.2% for 2014, to approximately 2.5% for 2015. As we've been telegraphing, this expectation is primarily driven by the seasoning of several years of consistent loan growth, as opposed to a fundamental deterioration in credit.

With respect to operating expenses, we previously stated that we expect our efficiency ratio to be modestly above our 38% long-term target next year. The increase in operating expenses will be driven by higher marketing investments; higher regulatory and compliance costs, including those related to remediation of our AML/BSA program consent order; and the impact of increased technology investments.

In conclusion, our outlook for 2015 reflects an end to the declining credit and funding costs that we've enjoyed in recent years, as well as some increased regulatory and compliance expenditures. However, most of the fundamental operating trends of the Business remain very solid.

That concludes our formal remarks, so now I'll turn the call back to our operator, Leslie, to begin the Q&A session.

QUESTIONS & ANSWERS

Operator:

Thank you.

(Operator Instructions)

Bill Carcache, Nomura.

Mark Graf (CFO):

Bill? No Bill. Why don't we move along, Leslie.

Operator:

Sanjay Sakhrani, KBW.

Sanjay Sakhrani (Analyst - Keefe, Bruyette and Woods):

Two questions. First, I was wondering, Mark, if you could just dimensionalize how much of a decline you're talking about in the revenue margin when you say modest? Maybe you could just give us some rough sense of that. And then secondly, one for David, maybe you could talk about the competitive environment and what you're seeing in terms of yields? Thanks.

Mark Graf (CFO):

Yes. So, Sanjay, we finished the year with a revenue margin of about 12.9%. We don't give specific EPS oriented guidance, so I'm going to be a little bit probably less specific than you'd like me to be, but I can help you at least qualitatively dimension this a little bit. The biggest component of it's going to be a little bit of NIM compression.

Again, I think we've consistently been describing that as modest NIM compression. And we purposely chose to include the phrase modest in the release again this year. So I wouldn't think about this as a 50 basis point decline in NIM or something on the order of that. We certainly stay well above the long-term targets we've talked about.

Second component that's going into that dimensionalization is obviously going to be your payments revenue. I think we talked, during the course of the discussion, about the fact that there's going to be some expense related to the PULSE litigation against VISA that will be creeping in. And also, while we're growing volumes in the space, a lot of the volume we're growing is B2B volume in our Ariba partnership and it's coming on at a lower margin.

The higher Rewards rate, I think we've said about 105 basis points for next year is the right way to think about it. And then just the continued attrition of the protection products revenue. So I would say there's nothing I would describe as cataclysmic in terms of those components.

David Nelms (Chairman, CEO):

Sanjay, in terms of the competitive environment, I think it's been fairly stable on the yield side. As Mark mentioned, most of the pressure will come more on the cost of funds side. And from a competitive perspective, I feel like things are fairly stable overall, but if anything, I think there's probably more action in the rewards earn rate from some competitors, as opposed to probably on the APR side.

Operator:

Mark DeVries, Barclays.

Mark DeVries (Analyst - Barclays Capital):

My question is around, Mark, your comments around the provision, the guidance there. I understand you're looking for that to be up year-over-year, due to expected seasoning. But what I'm wondering is, is that assuming some deterioration in the delinquency rates that we're not seeing?

Because when I look at the data, charge-offs, gross charge-offs are basically still flat year-over-year, net up modestly, due to lower recoveries, and delinquencies are also pretty flat and stable. And your customer just effectively got a raise with lower gas prices. So I'm wondering, what's embedded in your assumptions there?

Mark Graf (CFO):

I think there's a couple things embedded in the assumptions there, Mark. And it's a great question. Number one, I would say, is I think we really hit the bottom for this cycle, I would say, with respect to credit, this last year.

So if you look at our reserve to our total loans trending over the course of the last couple years, I think you see, if you're looking at ending total loans, I think it was 3.8%, 3.9% at the end of 2011. It declined to 2.51% at the end of 2013, and we're looking at 2.5% again, roughly, at the end of last year. So it feels like we've found the bottom there. So that's the starting point.

Then on top of that, you look at three years of consistent loan growth that we've put up, whereas most of our peers have returned to loan growth really only like the last six months. And if you think the way a loan seasons, a card loan seasons, it tends to have peak charge-offs between months 18 and 30.

So you really have -- that vintage from three years ago is still under the high part of that curve. The vintage from two years is right under the peak part of that curve. The advantage from last year is climbing that slope. And you don't have the benefit of the backdrop of the improving credit environment to help mitigate and offset some of the impacts of that growth.

So I think it's just an inevitability of the fact we've been growing. It doesn't feel like there's a problem. It doesn't feel like there's a fundamental turn in credit. It's just a function of growth.

Mark DeVries (Analyst - Barclays Capital):

Okay. Got it. Thanks.

Operator:

Bob Napoli, William Blair.

Bob Napoli (Analyst - William Blair and Company):

I was just wondering if you had any updated thoughts on loan growth, as we look into 2015. The loan growth that we saw this quarter in credit card and we've seen relatively stable, would you expect to continue to grow around that rate? And then, there's been a little bit of a slowdown in the personal loan business. So some thoughts around loan growth would be helpful.

David Nelms (Chairman, CEO):

Sure. I think we'll probably have more to say about long-term targets at our investor day. But generally, I continue to be very pleased with how strong our loan growth has been, both in this quarter, as well as the last few quarters. High end of the industry, above our range, and coming in with very high quality, to boot.

In terms of personal loans, I think the dollars of loan growth have continued to be very strong. And what I would expect generally is that the percentage growth rate will tend to start declining a bit, just because of the large numbers. That's becoming a large, sizable loan book, but continues to be the fastest growing part of our portfolio and one of the fastest growth loan books in the industry.

Bob Napoli (Analyst - William Blair and Company):

And then just on AribaPay, $1.5 billion in volume this quarter. Can you give a feel for the revenue yield you're getting on that and what kind of -- is that $1.5 billion -- how many customers does AribaPay have and how quickly is that going to grow? It's pretty quickly -- $1.5 billion is a pretty big number to hit in a short period of time.

David Nelms (Chairman, CEO):

It is. But remember, this is B2B. So even one customer can be very, very sizable. And so you look at the size of that market. In total, it's a larger market than consumer credit cards and it's a new market for us.

But it's also, to some degree, we're substituting for checks and other lower cost methods of payment than traditional credit cards. So it's a business that we think can produce, over time, very significant volumes, but at much lower than the typical network fees that we might expect on the consumer side.

Bob Napoli (Analyst - William Blair and Company):

All right. Thank you.

Operator:

James Friedman, Susquehanna.

Jamie Friedman (Analyst - Susquehanna Financial Group):

Thanks. It's Jamie Friedman. I had two questions, one for Mark and one for David. Mark, on slide 8, you were calling out, I thought, three one-time events. I got the Discover Home Loans. I got the Diners Club Italy. I thought that there was a third one maybe I missed. And then, if I could, a follow-up afterwards.

Mark Graf (CFO):

Yes. So there are three one-time items in total, Jamie. The first is the $178 million Rewards charge for elimination of the forfeiture reserve. That's actually a contra revenue; it was covered on another slide.

And then there's two that are specific on the expense side of the equation, and that's going to be about $0.04, $21 million, roughly, for the Diners, fair market valuation and the move to held for sale, or the classification of held for sale. And then about $27 million or so, roughly, another $0.04 related to the Home Loans business.

Jamie Friedman (Analyst - Susquehanna Financial Group):

Thank you. And then, David, with regard to student loans, I just wanted to get your response. In the instance that some of the proposals on Capitol Hill go through, with regard to community college, I realize you don't extend loans to community college, but how should we think about that as a competitive dynamic?

David Nelms (Chairman, CEO):

I think, as you say, because we aren't in the community student loan market, I really wouldn't expect that to have a significant impact on our business, should it go through.

Jamie Friedman (Analyst - Susquehanna Financial Group):

Okay. Thank you.

Operator:

Ryan Nash, Goldman Sachs.

Ryan Nash (Analyst - Goldman Sachs):

Good evening. Just a question on the outlook for operating expenses, the $3.5 billion. When I think about some of the one-time costs that you outlined for BSA/ML and EMV, it gets the core expense growth rate closer to 3%.

So I guess, I know we're still far away from 2016, but would you expect any of these expenses to stay in the run rate? And if not, do you think we could resume, beyond 2015, closer to a 3% to 4% expense growth rate?

Mark Graf (CFO):

I think there's definitely, Ryan, some one-time impacts associated with next year. I think back in December, actually at your conference, we made mention of the fact the AML/BSA cost we saw was in the $70 million, $75 million range, something like that. So that's clearly a piece of this puzzle. We would not expect that to be all recurring expense.

The other big components of the increase really are marketing spend. David alluded to the launch of a new product. And we've also spoken pretty openly about the fact we're getting great new accounts, in terms of both of numbers, as well as the level of activity we're seeing out of those customers.

So it doesn't feel like the time when credit's stable, we're getting the right kind of results from the marketing. The costs per account acquired are in line. It doesn't feel the right time to pull back on that, either.

And those are the two big drivers. The other pieces are really some technology spend, big chunk of which is amortization of money that's already been spent. And then there's the litigation that we talked about earlier that PULSE has filed, as well.

So those are -- there's some of the components there that are clearly have levers that can be dialed back when the time feels right. It just feels when the fundamental business is running well, it's not the time to dial some of them back.

Ryan Nash (Analyst - Goldman Sachs):

Got it. And one other financial question for you. When I think about the guidance for net interest margin compression, are there any assumptions for changes in the rate environment embedded in your guidance? And if so, what happens if interest rates don't rise? Does that change the trajectory of the net interest margin?

Mark Graf (CFO):

So the assumptions we use, as we build off the forward curve, which you guys can just always work off the same things. You're going to be looking at the same info we are that way. We have essentially focused our positioning on the multi-year impact of rising rates. Because if you think about it in the one-year time frame, a card loan and a ten-year student loan react the same way; when in reality, that's not what will happen.

So we're asset sensitive in a one-year profile. We're essentially neutralized to the impact of rates through the cycle on the long tier basis, as well, based on the actions we've done. And our actions going forward would be trying to protect that positioning in that multi-year look. It's really kind of where we're spending our attention, how we're focused.

The toughest scenario for us is a steepener in 2s to 5s. And we are flat, essentially, in that today. I think we might lose $9 million or $10 million. It's not a lot. We're essentially flat. And a flattener, which people are starting to talk about, actually would be a slight benefit to us, if it occurred on the front end of the curve.

Ryan Nash (Analyst - Goldman Sachs):

Got it. Thanks for taking my questions.

Bill Franklin (VP - IR):

You bet.

Operator:

Matthew Howlett, UBS.

Matthew Howlett (Analyst - UBS):

The loan growth was strong. Obviously, December numbers look really good. I guess I just wanted a comment on the lower gas prices. Obviously, retail sales were weak in December, and I think just one of your peers just said that that was a disappointment in December. Can you touch on anything in terms of if gas keeps on going lower, what that does potentially to spend or growth, loan growth?

David Nelms (Chairman, CEO):

Well, generally, I think lower gas prices is great for consumers. So I wouldn't express that as it being disappointed. It certainly does have some negative impact on our sales growth. And so our sales growth would have been, with stable gas prices, approximately 1% faster year-over-year. We have -- I've seen various theories out there as to whether customers, what do they do with that extra money? Does it help them make their payments and therefore, does it help credit?

Does it -- do they spend it on other things? Do they save it? So far -- maybe because it's been such a short term and such a significant drop -- we haven't noticeably seen it being spent in other places. And so that's why we've called it out as some drag on sales, but good for consumers.

Matthew Howlett (Analyst - UBS):

Is it as simple as if it was 10% of your volume, like it is for the industry, that gas prices fall 50% year-over-year, do we look at that taking that, we just don't know what the difference is going to be if they decide to spend it in other areas? Is that sort of how to think about it?

David Nelms (Chairman, CEO):

I think that's the reasonable way to think about it. And historically, it has been about 10% of our sales. Right now, it's something less than 10% of our sales.

Matthew Howlett (Analyst - UBS):

Right. Great. And then just on the personal lending side, phenomenal growth. I noticed a slight uptick on delinquencies. Is that just seasonality? Clearly, there's a lot of competition entering the space. Do you still feel really good about pricing today in that market?

Mark Graf (CFO):

I would say it's really more as opposed to seasonality, seasoning. Much like in the card business, there's been a lot of growth over the course of the last couple years there. And you're starting to see the impact of that growth just naturally show up. So don't feel like there's any fundamental credit issue there to call out at all. In terms of the performance of the business, continues to feel very good to us. It's a great asset.

The other thing I would call out around it is, because I'm presuming your next question is the modest amount of yield compression we've had around that asset. And the bottom line is, it's not competitively driven. We are seeing our customers elect shorter durations. So if you go back a couple years ago, the average duration was four years. Today, the average duration is three years. And they're fixed rate loans, so it's just pricing further down the curve.

Matthew Howlett (Analyst - UBS):

Great. Thanks, guys.

Operator:

Jason Arnold, RBC Capital Markets.

Jason Arnold (Analyst - RBC Capital Markets):

I was just wondering if you could comment on what you've seen recently on the split between -- on card loan growth between new and existing accounts. And then maybe comment on the propensity of borrowers to evolve here, if you're seeing any kind of changes in borrowing habits there, as well?

David Nelms (Chairman, CEO):

I think we've commented in the past that most of our growth is pretty balanced between growth in wallet share from existing customers and better retention of customers, as well as being balanced out with a similar amount from new accounts. And we're continuing to see that as similar relationship.

Jason Arnold (Analyst - RBC Capital Markets):

Okay. And then just in general in the industry, it seems like we've seen some of your competitors and peers picking up a little bit on loan balances. Maybe if you could broaden out that observation to what your thoughts are around the space in general?

David Nelms (Chairman, CEO):

Well, I think that it does appear that the industry has finally turned the corner and is no longer shrinking. I think some of our competitors lost a lot of loans over the last several years. And I guess I would just say that I'm not suggesting that our growth rate will necessarily pick up from here, but I think it's probably easier for us to sustain a higher level of loan growth in a growing industry versus a shrinking industry.

Jason Arnold (Analyst - RBC Capital Markets):

Makes sense. Terrific. Thank you very much.

Operator:

Moshe Orenbuch, Credit Suisse.

Moshe Orenbuch (Analyst - Credit Suisse):

I was wondering, David, if you could talk a little bit about what you meant -- I know you probably won't be too specific about the new product launch that you alluded to. Is it aimed at a different segment, or what features should we be looking for?

David Nelms (Chairman, CEO):

I don't want to preempt the launch. I would just say we'll have the details out very soon. The one thing I would say is that we do think our Discover it platform is something that can be leveraged into other products that have some of the advantages that Discover it offers, including free FICOs and pricing features, lots of features that others don't have, but maybe something a little different than our traditional Cashback Bonus program. So stay tuned. We'll give you the details real soon.

Moshe Orenbuch (Analyst - Credit Suisse):

Okay. Just as a follow-up, the provision guidance for 2015 actually is a little lower actually than the provision annualized rate in the fourth quarter. Could you talk a little bit about -- you're expecting higher slightly credit losses. So maybe square for us why the reserve addition's so large this quarter and actually fairly moderate into 2015?

Mark Graf (CFO):

Sure. I'll tackle that one, Moshe. I think the real key driver is -- I'll take you back to the way we establish our reserves. And that is, we sit down at the end of every quarter and we look at the loss content we see embedded in the balance sheet over the forward-looking 12 month period of time.

And it's really a function of -- in response to the earlier question, as I talked about those three years advantage of seasoning, how they're coming along -- it's really a function of how much of those three vintages is under the peak part of that seasoning curve as we sit here and look right now. And it just happens to capture a large portion of each of those three vintages. So you're correct in your assessment of what our guidance is, essentially.

Moshe Orenbuch (Analyst - Credit Suisse):

Great. Thank you.

Operator:

Vincent Caintic, Macquarie.

Vincent Caintic (Analyst - Macquarie Capital):

Just wanted to elaborate a bit more on the competitive environment for Rewards. With your adjusted Rewards rate up 10 basis points year-over-year and, say, call it, 5 basis points because of your Rewards redemption policy, would you say that the other 5 is stable or has room to grow? Is there more competition? And then also, how do you think that plays out in terms of driving spend and loan growth?

David Nelms (Chairman, CEO):

Well, I would say that it still will tend to modestly grow from here. The fourth quarter tends to be a heavier quarter. So I'm not saying grow from the 110, but I'm suggesting that on a year-over-year basis, in addition to the change in redemption, the changes in redemption and breakage, we also have more and more of our book is made up of Discover it that has a flat 1%. And less and less of it, therefore, proportionately, is the up to 1% of our traditional More product. So that will tend to naturally drive it up.

I think that as we think about the competitive intensity in rewards, it is one of the reasons we made the change on redemption. Because customers told us that in some ways, not losing their rewards was even more important than the headline rate. And it was a way for us to meet the competition, have advantages in ways that were perceived of greater value to consumers at lower cost to us, and therefore, is beneficial for us long-term.

Vincent Caintic (Analyst - Macquarie Capital):

Got it. Okay. And then switching products, if you could describe the goodwill impairment on the Discover Home Loans, and then your forward view of the business. It seems like refis have been strong with the low rate environment and just wanted to see what you're also seeing. Thanks.

Mark Graf (CFO):

It's Mark. I'll tackle that one. If you think about it, when you put the goodwill on the books, it's valued based on the assumptions you have at that point in time. And part of those assumptions were that we would have more success, bluntly, penetrating the purchase money marketplace and wouldn't be as refi dependent as the model is today.

So I agree with you. If you think about, with the drop in long rates, the refi pipeline probably looks a little bit stronger today than it did a few months back. No question about it. But the purchase money volume that we were counting on when we acquired the business just hasn't materialized yet. So that's really what's driving the impairment.

In terms of a go forward look, I would anchor back to David's earlier comments, my earlier comments. I think we'll evaluate our strategy around that business, and try and figure out what the right thing to do is.

Vincent Caintic (Analyst - Macquarie Capital):

Got it. Thanks very much, guys.

Operator:

Chris Donat, Sandler O'Neill.

Chris Donat (Analyst - Sandler O'Neill and Partners):

Mark, just wanted to parse your language around the modest net interest margin compression, particularly on the asset side. Because I thought David had commented that there really wasn't much pressure on the asset side, but I'm wondering if you're seeing a mix shift either in your cards or in the broader loan portfolio that's putting a little pressure there? Just wondering if it's something that's more one-time in nature or sustainable?

Mark Graf (CFO):

So how about if I parse it up a little bit more for you? I'm not going to dimensionalize it in terms of the size. Again, I would just state, stick with modest, which again, I think if we were seeing anything giant, we would not choose the word modest.

But if you look at the components of the NIM compression, about half of it is due to higher funding costs, about a quarter of it is due to lower asset yields, and about a quarter of it is due to a combination of loan mix and interest charge-offs which run through margin for us. So that would be the component parts that are driving that NIM compression which, again, I would really underscore is, it's modest NIM compression.

Chris Donat (Analyst - Sandler O'Neill and Partners):

Got it. I just wanted to make sure I'm getting it here. And then switching gears to another product, you mentioned the litigation around PULSE. Going back to September, the American Bankers Association endorsed the Discover Debit product.

I'm just wondering if you're seeing any pick up in that, or do you think maybe that business has been on hold pending, really, the Supreme Court non-decision this week to review the Federal Reserve rules implementing Durbin? So anyway, it looks like now that those rules won't be under the -- subject to appeal, that there's more certainty in that. I'm wondering if you've got any expectations around the Discover Debit product from here?

David Nelms (Chairman, CEO):

You opened up some complicated topics. And of course, I really can't talk about the litigation part. Let me limit my answer to Discover Debit. We were real pleased with the endorsement by the ABA. We've been pleased with the discussions that we're having with issuers.

And I think it's early days to accelerate our offering of a signature debit product. We're the only ones in the world who have it, besides VISA and MasterCard . And I certainly think we look forward to providing better economics and flexibility than the only two options that have been out there up until this point.

Chris Donat (Analyst - Sandler O'Neill and Partners):

Okay. And a sales cycle here will be measured in quarters, right, not weeks or months? Is that fair?

David Nelms (Chairman, CEO):

If we have significant deals, we would announce them. Certainly, there's competitive challenge. And I don't think the Supreme Court decision was really one way or another addressing the competitive challenge that is key to the pressure that's on all the PIN debit networks, and in particular us, that I'm concerned about. But we've announced before that we have a dozen or so very small signature debit issuers. And we're now starting to get -- we're starting to try to really go after some larger players to grow that volume.

Chris Donat (Analyst - Sandler O'Neill and Partners):

Got it. Thanks very much.

Operator:

John Hecht, Jefferies Capital.

John Hecht (Analyst - Jefferies Capital):

The question I have pertains to provisioning and charge-off trends. The guidance is premised on the seasoning of the loan balance and lower recoveries. And I'm wondering, as we step through calendar year '15, do you see these factors neutralizing? I guess what that means is that in the absence of changes to the economic outlook or your consumer trends, is this provisioning rate a good trend rate going forward from there?

Mark Graf (CFO):

I think as you look out, it's going to depend on a number of different things. I know you prefaced it being a stable environment; but I want to be careful with that one, because it is a dynamic process, part of which will depend upon what our growth rates look like.

If our growth rates tick up, that would imply a couple years down the road, so would the provisioning. If they slow down, that would imply, in a stable credit environment, that it would slow down. So it's a multivariate equation. So it's not as simple as just saying, yes, that feels good.

I think the key factors to keep in mind are it's driven by our growth. The fundamental credit backdrop remains really solid at this point in time. If that were to change, that could change it. If our growth rate changes, that could change it.

And then the declining recoveries on the aged charge-offs -- I just remind you, it's not a decline in the recovery rate we're realizing on new charge-offs, it is we have a big pool of aged charge-offs we never sold back from the recession, against which there's a declining ability to realize recoveries. That's maybe 10% of the ultimate impact of the increase, give or take. So it's a declining percentage there.

John Hecht (Analyst - Jefferies Capital):

Okay. Thanks very much for the color.

Operator:

Betsy Graseck, Morgan Stanley.

Betsy Graseck (Analyst - Morgan Stanley):

So I just had a question around the Ariba B2B business. I know you mentioned that it's in the early days, early stages here. But there is a relatively low discount rate on it. Maybe you could give us a sense of what your expectations are for how quickly that business is likely to grow?

I know you mentioned that in the payments area, you thought that B2B would have a negative impact on the overall discount rate, which I get. But it's a small piece, so I'm wondering how fast you're thinking it's going to grow, and if incremental new business would come on at an even lower discount rate than the business you have right now?

David Nelms (Chairman, CEO):

Well, Betsy, I think we're likely to have a little more color by the time we have our investor day later this year. If you look at the $1.5 billion of volume just in the fourth quarter, not that long after launching, you can see that it's probably the most volume we've put on from anything this early in a program.

So it has the potential to put up a lot of volume if it continues to grow and be successful, as the early days suggest. But by definition, it's very low margin business. And so if that becomes more material to the Payment segment, it will have the impact of depressing the overall margin. But we do believe it will be additive to profits, just not at a very high rate. And so overall, we think it's a very good thing.

It's also a little bit hard for us to predict, because the product just hasn't existed in the marketplace. It's unique. Competitors haven't offered it exactly the way we have. We've got a great partner. And it's off to a good start in the early days, but it is still very early days in a very new business.

Betsy Graseck (Analyst - Morgan Stanley):

So I get that. And I'm just thinking out loud about how it's B2B, so clearly everyone's doing the math on either side of the table. And I would think that part of the benefit to you is maybe some float or funding benefits you get from the float associated with the payments.

I don't know if that's accurate or not. And I just raise it in the context of industry shift towards real-time payments, ultimately banking industry moving to real-time payments. Would that, if that were to happen, would that change the dynamic on the pricing on the product?

David Nelms (Chairman, CEO):

As you can imagine, B2B customers are quite sophisticated. And so one of the benefits is it settles, I won't say real-time, but very quickly. So there's not a lot of float. There's not a lot of revenue. But it's a way to leverage our network in a way that we've not traditionally been able to leverage the network, in a unique way, to provide value to new sets of customers. And we think over time, there may be additional products and services that can be bundled with it.

But right now, we are focused on getting those early customers to be successful and to be feeling good about the product so that this thing can gain momentum. Our partner is the leader globally in this B2B space. And so they are very excited about another way to help their customers have more efficient, faster payments in a way that's not been available from any provider, historically. And so we're focused growing the volume right now and having it flow successfully.

Betsy Graseck (Analyst - Morgan Stanley):

Got it. Okay. Thanks.

Operator:

Rick Shane, JPMorgan.

Rick Shane (Analyst - JPMorgan):

I know you've had a couple questions on provision and reserve, but I'd just like to see if we can understand one thing a little bit better. I'm basically trying to figure out if something's a pattern or a coincidence.

A couple years ago, you shifted to a December calendar year-end. And what that meant was that the peak in terms of receivables, December to the trough in receivables, March, became more pronounced than when you were on a November to February year-end. And since that time, it looks like there's been a little bit more of a pattern of higher provisions in the fourth quarter.

And at least the last couple years, what we've seen is a little bit of a reversal of that in the first quarter. It would help, I think, us and other folks to understand if that's something we should anticipate going forward.

Mark Graf (CFO):

Very fair question. I would say two things. Number one, what happens in the first quarter is dependent on what happens in the first quarter. And I don't know what that is yet, so the reserve will be set at the end of the quarter for what happens during the course of the quarter.

But I think it's a very fair statement to say that the shift in the calendar year-end and the way that works did have an impact, an influence on that one. I would say it's very modest, though.

So again, I would say what you're really seeing this year, speaking to this year specifically, is those three years of growth and how much of them happened to be sitting under the peak area, under the peak of that seasoning curve at any one point in time.

Rick Shane (Analyst - JPMorgan):

Okay. Great. Thank you. That's helpful.

Operator:

Owen Lau, Janney Capital.

Owen Lau (Analyst - Janney Capital Markets):

Try to touch on the question on the revenue side again. How should we think about the net interest income in 2015? Just directionally, do you see it going up, flat or down? Also, on the expense side, could you please shed more light on why did you increase spending on the marketing by $27 million year-over-year? So what was the trigger of that? Is it related to the product cycle or high competition on card and personal loans? What was the thought process behind that? Thank you.

Bill Franklin (VP - IR):

Owen, it's Bill. Can you repeat the revenue question, the first part of your question? The second question is on expenses and what are driving expenses up, I think.

Mark Graf (CFO):

And marketing.

Owen Lau (Analyst - Janney Capital Markets):

Sure. So on the revenue side, how should we think about the net interest income in 2015? Just directionally, do you see it going up, flat or down? How do we think about that?

Mark Graf (CFO):

I would say it's going to be a function of a couple different things, Owen. It's going to be a function of asset growth. It's going to be a function of NIM compression. And it's going to be a function of asset mix. All those different pieces of the puzzle.

So in terms of trajectory, I think net interest income will be up. But in terms of the magnitude of that, that's not something I'm prepared to really talk about at this point in time. We don't really give guidance that specific on items like that.

On the expense side of the question, I would say specifically that the key drivers of expenses -- I touched on a couple of them earlier. One of them is about $70 million or $75 million for BSA/AML consent order compliance, program compliance.

In addition to that, I would say there's another not insignificant number related to increased marketing expense. That's really driven by two different things. Number one, we continue to see great new account acquisition, and we continue to see it come on more actively engaged, using the card more frequently and more often than we've seen historically.

So the returns on that marketing spend continue to be very good. So we're continuing to invest there. And then David also alluded to the launch of a new product here in the not-too-distant future, and obviously, there's some marketing expense that goes along with that, as well.

David Nelms (Chairman, CEO):

But I think if you're asking just about that $27 million, it's up 3% year-over-year, which isn't that significant. The fourth quarter tends to be our biggest quarter on marketing expenses, as we move into the holiday periods. And we saw that again this year.

Mark Graf (CFO):

Yes.

Owen Lau (Analyst - Janney Capital Markets):

Okay. Thank you.

Operator:

Great. I'll turn it back to Bill for final remarks.

Bill Franklin (VP - IR):

Thanks, Leslie. We'd like to thank everyone for joining us on today's call. If you have any other follow-up questions, feel free to give me a call. Have a good night.

Operator:

Thank you, ladies and gentlemen. This concludes today's conference.