# *Discover Bank*

*Financial Statements for the*
*Years Ended November 30, 2003 and 2002*

# DISCOVER BANK

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## MANAGEMENT'S REPORT ON FINANCIAL STATEMENTS, INTERNAL CONTROL AND COMPLIANCE WITH LAWS AND REGULATIONS

To the Shareholder:

The management of Discover Bank (the "Bank") is responsible for the preparation, integrity, and fair presentation of its published financial statements and all other information presented in this annual report. The financial statements have been prepared in accordance with generally accepted accounting principles and, as such, include amounts based on informed judgments and estimates made by management.

Management is responsible for establishing and maintaining effective internal control over financial reporting, including safeguarding of assets, for financial presentations in conformity with both generally accepted accounting principles and the *Federal Financial Institutions Examination Council Instructions for Consolidated Reports of Condition and Income* ("Call Report instructions"). The internal control contains monitoring mechanisms, and actions are taken to correct deficiencies identified.

There are inherent limitations in the effectiveness of any internal control, including the possibility of human error and circumvention or overriding of controls. Accordingly, even effective internal control can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of internal control may vary over time.

Management assessed the Bank's internal control over financial reporting, including safeguarding of assets, for financial presentations in conformity with both generally accepted accounting principles and Call Report instructions as of November 30, 2003. This assessment was based on criteria for effective internal control over financial reporting, including safeguarding of assets, described in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management believes that the Bank maintained effective internal control over financial reporting, including safeguarding of assets, for financial presentations in conformity with both generally accepted accounting principles and Call Report instructions as of November 30, 2003.

The Audit Committee of the Board of Directors is composed entirely of outside directors who are independent of the Bank's management; it includes members with banking or related management experience, has access to its own outside counsel, and does not include any large customers of the institution. The Audit Committee is responsible for recommending to the Board of Directors the selection of independent auditors. It meets periodically with management, the independent auditors, and the internal auditors to ensure that they are carrying out their responsibilities. The Committee is also responsible for performing an oversight role by reviewing and monitoring the financial, accounting and auditing procedures of the Bank in addition to reviewing the Bank's financial reports. The independent auditors and the internal auditors have full and free access to the Audit Committee, with or without the presence of management, to discuss the adequacy of the internal control over financial reporting and any other matters which, they believe, should be brought to the attention of the Committee.

Management is also responsible for implementing programs and procedures designed to assure compliance with the federal laws and regulations concerning loans to insiders and the federal and state laws and regulations concerning dividend restrictions, both of which are designated by the Federal Deposit Insurance Corporation ("FDIC") as safety and soundness laws and regulations.

Management assessed its compliance with the designated safety and soundness laws and regulations and has maintained records of its determinations and assessments as required by the FDIC. Based on this assessment, management believes that the Bank has complied, in all material respects, with the designated safety and soundness laws and regulations for the year ended November 30, 2003.

| | |
|---|---|
| David W. Nelms | Michael F. Rickert |
| Chairman | Vice President |
| Chief Executive Officer | Chief Accounting Officer and Treasurer |

February 4, 2004

Deloitte.

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## INDEPENDENT ACCOUNTANTS' REPORT

To the Audit Committee of
Discover Bank

We have examined management's assertion, included in the accompanying "Management's Report on Financial Statements, Internal Control and Compliance with Laws and Regulations," that Discover Bank (the "Bank") maintained effective internal control over financial reporting, including safeguarding of assets, presented in conformity with both accounting principles generally accepted in the United States of America and the Federal Financial Institutions Examination Council Instructions for Consolidated Reports of Condition and Income ("Call Report Instructions") as of November 30, 2003, based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO report"). Management is responsible for maintaining effective internal control over financial reporting, including safeguarding of assets. Our responsibility is to express an opinion on management's assertion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that the Bank maintained effective internal control over financial reporting, including safeguarding of assets, presented in conformity with both accounting principles generally accepted in the United States of America and the Call Report Instructions as of November 30, 2003 is fairly stated, in all material respects, based on the criteria established in the COSO report.

Deloitte & Touche LLP

February 23, 2004

Deloitte.

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## INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Shareholder of
Discover Bank

We have audited the accompanying financial statements of Discover Bank (the "Bank") as of and for the years ended November 30, 2003 and 2002, listed in the foregoing Table of Contents. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Bank as of November 30, 2003 and 2002, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

February 23, 2004

# DISCOVER BANK

## STATEMENTS OF CONDITION
## NOVEMBER 30, 2003 AND 2002
## (In thousands, except share data)

| ASSETS | 2003 | 2002 |
|---|---|---|
| CASH AND CASH EQUIVALENTS | $ 805,611 | $ 670,352 |
| FEDERAL FUNDS SOLD | 400,000 | 500,000 |
| INVESTMENT SECURITIES | 8,599 | 8,636 |
| CONSUMER LOANS: | | |
| Credit cards | 16,069,418 | 18,526,062 |
| Loans held for sale | 1,538,661 | 1,500,000 |
| Mortgage and installment | 365,650 | 412,349 |
| Total consumer loans | 17,973,729 | 20,438,411 |
| Less allowance for loan losses | (963,093) | (893,734) |
| Net consumer loans | 17,010,636 | 19,544,677 |
| ACCRUED INTEREST AND OTHER RECEIVABLES | 178,449 | 289,873 |
| AMOUNTS DUE FROM ASSET SECURITIZATIONS | 959,828 | 947,816 |
| DEFERRED INCOME TAXES | 44,883 | - |
| OTHER ASSETS | 129,814 | 154,953 |
| TOTAL ASSETS | $19,537,820 | $22,116,307 |

| LIABILITIES AND SHAREHOLDER'S EQUITY | | |
|---|---|---|
| LIABILITIES: | | |
| Deposits: | | |
| Noninterest-bearing | $ 60,839 | $ 73,790 |
| Interest-bearing | 12,222,785 | 13,093,223 |
| Total deposits | 12,283,624 | 13,167,013 |
| Accounts payable, accrued expenses and other liabilities | 896,554 | 630,869 |
| Deferred income taxes | - | 25,547 |
| Due to parent and affiliates, net | 561,756 | 147,911 |
| Notes payable and other borrowings | 3,100,350 | 5,035,314 |
| Total liabilities | 16,842,284 | 19,006,654 |
| SHAREHOLDER'S EQUITY: | | |
| Common stock ($25 par value; 1,400 shares authorized, issued and outstanding) | 35 | 35 |
| Additional paid-in capital | 778,632 | 778,632 |
| Retained earnings | 1,916,780 | 2,330,911 |
| Accumulated other comprehensive income | 89 | 75 |
| Total shareholder's equity | 2,695,536 | 3,109,653 |
| TOTAL LIABILITIES AND SHAREHOLDER'S EQUITY | $19,537,820 | $22,116,307 |

See notes to financial statements.

# DISCOVER BANK

## STATEMENTS OF INCOME
## YEARS ENDED NOVEMBER 30, 2003 AND 2002
## (In thousands)

| | 2003 | 2002 |
|---|---|---|
| INTEREST REVENUE: | | |
| Consumer loans | $1,857,186 | $2,116,822 |
| Amounts due from asset securitizations | 2,047 | 3,307 |
| Investment securities and federal funds sold | 4,203 | 5,370 |
| Total interest revenue | 1,863,436 | 2,125,499 |
| INTEREST EXPENSE: | | |
| Deposits | 634,757 | 704,186 |
| Notes payable and other borrowings | 30,682 | 66,468 |
| Federal funds purchased | 413 | 694 |
| Total interest expense | 665,852 | 771,348 |
| NET INTEREST INCOME | 1,197,584 | 1,354,151 |
| PROVISION FOR LOAN LOSSES | 1,219,934 | 1,280,139 |
| NET CREDIT INCOME | (22,350) | 74,012 |
| NONINTEREST REVENUES: | | |
| Servicing fees | 1,873,622 | 2,032,189 |
| Interchange, cardmember and other | 1,146,415 | 1,034,281 |
| Total noninterest revenues | 3,020,037 | 3,066,470 |
| NONINTEREST EXPENSES: | | |
| Employee compensation and benefits | 64,436 | 66,894 |
| Information processing and other | 1,924,562 | 1,855,569 |
| Total noninterest expenses | 1,988,998 | 1,922,463 |
| INCOME BEFORE INCOME TAXES | 1,008,689 | 1,218,019 |
| INCOME TAXES | 372,820 | 447,738 |
| NET INCOME | $ 635,869 | $ 770,281 |

See notes to financial statements.

# DISCOVER BANK

## STATEMENTS OF COMPREHENSIVE INCOME
## YEARS ENDED NOVEMBER 30, 2003 AND 2002
## (In thousands)

| | 2003 | 2002 |
|---|---|---|
| NET INCOME | $635,869 | $770,281 |
| OTHER COMPREHENSIVE INCOME, BEFORE TAX: | | |
| Net change in cash flow hedges | (119) | (3,253) |
| Unrealized gain available for sale | 142 | - |
| Total other comprehensive income (loss) before tax | 23 | (3,253) |
| Income tax expense related to items of other comprehensive income | (9) | 1,183 |
| ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX | 14 | (2,070) |
| COMPREHENSIVE INCOME | $635,883 | $768,211 |

See notes to financial statements.

# DISCOVER BANK

## STATEMENTS OF SHAREHOLDER'S EQUITY
## YEARS ENDED NOVEMBER 30, 2003 AND 2002
## (In thousands)

| | 2003 | 2002 |
|---|---|---|
| COMMON STOCK | $ 35 | $ 35 |
| ADDITIONAL PAID-IN CAPITAL | 778,632 | 778,632 |
| RETAINED EARNINGS: | | |
| Balance, beginning of year | 2,330,911 | 1,870,630 |
| Net income | 635,869 | 770,281 |
| Dividends paid | (1,050,000) | (310,000) |
| Balance, end of year | 1,916,780 | 2,330,911 |
| ACCUMULATED OTHER COMPREHENSIVE INCOME: | | |
| Balance, beginning of year | 75 | 2,145 |
| Other comprehensive income (loss), net of tax | 14 | (2,070) |
| Balance, end of year | 89 | 75 |
| TOTAL SHAREHOLDER'S EQUITY | $ 2,695,536 | $3,109,653 |

See notes to financial statements.

## DISCOVER BANK

**STATEMENTS OF CASH FLOWS**
**YEARS ENDED NOVEMBER 30, 2003 AND 2002**
**(In thousands)**

| | 2003 | 2002 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | $ 635,869 | $ 770,281 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Provision for loan losses | 1,219,934 | 1,280,139 |
| Amortization of deferred revenue | (36,691) | (35,506) |
| Other amortization and depreciation | 74,116 | 73,610 |
| Deferred income taxes | (70,669) | 65,456 |
| Gain on credit card asset securitizations, net | (27,163) | (19,899) |
| Gain on sale of consumer loans | (8,408) | - |
| Loss on investment securities, net | 49 | - |
| Change in operating assets and liabilities: | | |
| Accrued interest and other receivables | 111,424 | (85,702) |
| Amounts due from asset securitizations | 15,032 | 216,500 |
| Other assets | (36,058) | (44,665) |
| Accounts payable, accrued expenses and other liabilities | 302,366 | (241,830) |
| Due to parent and affiliates, net | 414,085 | (1,747) |
| Net cash provided by operating activities | 2,593,886 | 1,976,637 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Net proceeds from (payments for): | | |
| Federal funds sold | 100,000 | 150,000 |
| Investment securities | (12) | 1,763 |
| Net principal disbursed on credit card loans | (3,525,600) | (6,693,517) |
| Securitization of credit card loans, net | 4,832,723 | 3,570,080 |
| Purchase of mortgage loans, net | (6,677) | - |
| Sales of consumer loans, net | 213,504 | - |
| Mortgage and installment loans, net | (204,212) | (191,133) |
| Net cash provided by (used in) investing activities | 1,409,726 | (3,162,807) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net (payments for) proceeds from: | | |
| Noninterest-bearing deposits | (12,951) | (83,061) |
| Certificates of deposit | (729,124) | 567,305 |
| Other interest-bearing deposits | (141,314) | (287,957) |
| Federal funds purchased | (302,600) | 775,000 |
| Notes payable and other borrowings | (1,632,364) | 731,724 |
| Dividends paid | (1,050,000) | (310,000) |
| Net cash (used in) provided by financing activities | (3,868,353) | 1,393,011 |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 135,259 | 206,841 |
| CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR | 670,352 | 463,511 |
| CASH AND CASH EQUIVALENTS, END OF YEAR | $ 805,611 | $ 670,352 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | |
| Cash paid during the year for: | | |
| Interest | $ 665,867 | $ 779,355 |
| Income taxes, net of income tax refunds | $ 331,610 | $ 559,263 |
| SUPPLEMENTAL SCHEDULE OF NONCASH ACTIVITIES: | | |
| Unrealized gain on available for sale securities, net of tax effect | $ 89 | $ - |
| Securitization - related hedge transactions | $ (75) | $ (2,070) |
| Interest due from income tax settlement | $ (16,747) | $ (43,188) |

See notes to financial statements.

## 1. INTRODUCTION AND BASIS OF PRESENTATION

Discover Bank (the "Bank"), a Delaware state-chartered bank, is a wholly-owned subsidiary of NOVUS Credit Services Inc. ("NCSI") and an indirect subsidiary of Morgan Stanley. The deposits of the Bank are insured by the Federal Deposit Insurance Corporation ("FDIC") for up to $100,000 per depositor.

The financial statements were prepared in accordance with accounting principles generally accepted in the United States of America, which require management to make estimates and assumptions regarding consumer loan loss levels, the potential outcome of litigation, and other matters that affect the financial statements and related disclosures. Actual results could differ materially from these estimates.

Certain reclassifications have been made to prior year amounts to conform to the current presentation. Included in these reclassifications were assets impacted by regulatory guidance that became effective fiscal 2003 and clarified the treatment of accrued interest and fees on securitized credit card receivables as a subordinated retained interest for accounting purposes (see note 4). Related reclassifications to the fiscal 2002 statement of condition are $389.9 million from consumer loans - credit cards and $176.0 million from accrued interest and other receivables to amounts due from asset securitizations.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

***Cash and Cash Equivalents*** - For purposes of these statements, cash and cash equivalents consist of cash and highly liquid investments (other than federal funds sold) not held for resale with maturities, when purchased, of three months or less.

***Consumer Loans*** - Consumer loans, which consist primarily of general purpose credit card, mortgage and consumer installment loans, are reported at their principal amounts outstanding less applicable allowances. Interest and fees on consumer loans are credited to income as earned.

Interest and fees are accrued on credit card loans until the date of charge-off, which generally occurs at the end of the month during which an account becomes 180 days past due, except in the case of cardmember bankruptcies, deceased cardmembers and fraudulent transactions, which are charged off earlier. The Bank records charged off cardmember fees and interest revenue directly against the income statement line items to which they were originally recorded. Direct origination costs related to the issuance of credit cards are deferred and charged to earnings over periods not exceeding 12 months.

The practice of re-aging an account also may affect general purpose credit card loan delinquencies and charge-offs. A re-age is intended to assist delinquent cardmembers who have experienced financial difficulties. An account is re-aged when the Bank and the customer agree on a temporary repayment schedule that may include concessionary terms. The re-age account and related balance is then returned to current status. Cardmembers may also qualify for a work-out re-age when either a longer term or permanent hardship exists.

Loans held for sale represent credit card loans and other consumer loans that the Bank intends to sell primarily through asset securitizations. These loans are carried at the lower of aggregate cost or market value.

***Investment Securities*** - Investment securities include both those available-for-sale and held-to-maturity. Investment securities consist of primarily mortgage-backed securities issued by government and government sponsored agencies and state agency bonds, which generally have maturities, when purchased, of three months or more.

***Securitization of Credit Card Loans*** - The Bank periodically sells credit card loans through asset securitizations and continues to service these loans. The Bank may retain interests in the securitized financial assets as an undivided seller's interest, accrued interest receivable subordinate to investors' interests (see Note 4), cash collateral accounts, servicing rights, and rights to any excess cash flows remaining after payments to investors in the securitization trust of their contractual rate of return and reimbursement of credit card losses. The exposure to credit losses from securitized loans is limited to the Bank's retained contingent risk, which represents the Bank's retained interest in securitized loans, including any credit enhancement provided. The gain or loss on the sale of the financial assets depends in part on the previous carrying amount of the assets involved in the transfer, and each subsequent transfer in revolving structures, allocated between the assets sold and the retained interests based upon their respective fair values at the date of sale. To obtain fair values, quoted market prices are used if available. However, observable market prices are generally not available for retained interests, so the Bank estimates fair value based on the present value of expected future cash flows using management's best estimate of the key assumptions, including forecasted credit losses, payment rates, forward yield curves and discount rates commensurate with the risks involved. The present value of future net servicing revenues that the Bank estimates it will receive over the term of the securitized loans is recognized in income as the loans are securitized. A corresponding asset also is recorded and then amortized as a charge to income over the term of the securitized loans, with actual net servicing revenues continuing to be recognized in income as they are earned.

As part of the Bank's securitization activities, the Bank provides representations and warranties that certain securitized assets conform to specified guidelines. The Bank may be required to repurchase such assets or indemnify the purchaser against losses if the assets do not meet certain conforming guidelines. In accordance with FASB Interpretation No. 45 ("FIN 45"), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," the Bank is required to disclose information about these obligations. Due diligence is performed by the Bank to ensure that asset guideline qualifications are met. The maximum potential amount of future payments the Bank could be required to make would be equal to the current outstanding balances of all assets subject to such securitization activities. The Bank has not recorded any contingent liability in the consolidated financial statements for these representations and warranties and believes that the probability of any payments under these arrangements is remote.

***Allowance for Loan Losses*** - The allowance for consumer loan losses is a significant estimate that represents management's estimate of probable losses inherent in the consumer loan portfolio. The allowance for consumer loan losses is an allowance applicable primarily to the owned homogeneous consumer credit card loan portfolio that is evaluated quarterly for adequacy and is established through a charge to the provision for consumer loan losses.

In calculating the allowance for consumer loan losses, the Bank uses a systematic and consistently applied approach. The Bank regularly performs a migration analysis (a technique used to estimate the likelihood that a consumer loan will progress through the various stages of delinquency and ultimately charge-off) of delinquent and current consumer credit card accounts in order to determine the appropriate level of the allowance for consumer loan losses. The migration analysis considers uncollectible principal, interest and fees reflected in consumer loans. In addition, the Bank estimates the losses inherent in the consumer loan portfolio based on coverage of a rolling average of historical credit losses. In evaluating the adequacy of the allowance for consumer loan losses, management also considers factors that may impact future credit loss experience, including 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. A provision for consumer loan losses is charged against earnings to maintain the allowance for consumer loan losses at an appropriate level.

***Income Taxes*** - Income tax expense is provided for using the asset and liability method, under which deferred tax assets and liabilities are determined based upon the temporary differences between the financial statement and income tax bases of assets and liabilities, using currently enacted tax rates. The Bank is included in the consolidated federal income tax return of Morgan Stanley. Federal income tax expense (benefit) has been calculated on a separate return basis, with payments made to or received from Morgan Stanley in accordance with intercompany tax allocation arrangements.

***Cardmember Rewards*** - Cardmember rewards include various reward programs, including the Cashback Bonus® award program, pursuant to which the Bank pays certain cardmembers a percentage of their purchase amounts based upon a cardmember's level and type of purchases. The liability for cardmember rewards, included in accounts payable, accrued expenses, and other liabilities, is accrued at the time that qualified cardmember transactions occur and is calculated on an individual cardmember basis. In determining the liability for cardmember rewards, the Bank considers estimated forfeitures based on historical account closure, charge-off and transaction activity. In accordance with Emerging Issues Task Force ("EITF") Issue No. 00-22, "Accounting for 'Points' and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future," the Bank records its Cashback Bonus award program as a reduction of interchange, cardmember and other.

***Financial Instruments Used for Asset and Liability Management*** - The Bank enters into derivative financial instruments for non-trading purposes. These instruments include interest rate swaps. The Bank uses interest rate swaps to manage interest rate risk arising from certain borrowings. The Bank also utilizes interest rate swaps to match the repricing characteristics of consumer loans with those of the borrowings that fund these loans. Derivative financial instruments are designated and qualify as fair value hedges or cash flow hedges in accordance with Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended. For qualifying fair value hedges, the changes in the fair value of the derivative and the gain or loss on the hedged asset or liability relating to the risk being hedged are recorded currently in earnings. These amounts are recorded in interest expense and provide offset of one another. Ineffectiveness relating to fair value hedges, if any, is recorded within interest expense.

***Regulatory Matters*** - On January 8, 2003, the Federal Financial Institutions Examination Council ("FFIEC") issued guidance on "Account Management and Loss Allowance Practices" for credit card lending. The guidance addresses credit line management, overlimit practices, workout and forbearance practices and income recognition and loss allowance practices. The FFIEC expects banking organizations to implement the changes needed to comply with this guidance as promptly as possible. The Bank has implemented changes to and continues to review its existing policies, practices and systems to ensure compliance with the guidance.

## 3. FEDERAL FUNDS SOLD

Federal funds sold are recorded at cost and amounted to $400,000,000 and $500,000,000 on November 30, 2003 and 2002, respectively, and had weighted average annual interest rates of 1.04 percent and 1.35 percent, respectively, with remaining maturities of less than one month.

## 4. CONSUMER LOANS

The Bank's consumer loans, which consist primarily of credit card loans, had net balances of $17.0 billion and $19.5 billion at November 30, 2003 and 2002, respectively.

Activity in the allowance for loan losses for the years ended November 30, 2003 and 2002 was as follows:

| | 2003 | 2002 |
|---|---|---|
| | (In thousands) | |
| Balance, beginning of year | $ 893,734 | $ 814,668 |
| Additions: | | |
| Provision for loan losses | 1,219,934 | 1,280,139 |
| Deductions: | | |
| Charge-offs | 1,246,768 | 1,290,736 |
| Less recoveries | (96,193) | (89,663) |
| Net charge-offs | 1,150,575 | 1,201,073 |
| Balance, end of year | $ 963,093 | $ 893,734 |

Interest revenue was decreased by $265,372,000 and $225,051,000 of charged off credit card loan interest for the years ended November 30, 2003 and 2002, respectively. Cardmember fees accrued on general purpose credit card loans subsequently charged off, recorded as a reduction to interchange, cardmember and other, was $173,280,000 and $162,130,000 for the years ended November 30, 2003 and 2002 respectively.

At November 30, 2003, the Bank had commitments to extend credit on credit cards in the amount of $253.7 billion, provided there is no violation of conditions established in the related agreements. These commitments, which the Bank can terminate at any time and which do not necessarily represent future cash requirements, are periodically reviewed and reevaluated based on account usage and the Cardmember's creditworthiness.

The Bank received net proceeds from credit card asset securitizations of $4.8 billion and $3.6 billion in the years ended November 30, 2003 and 2002, respectively. The outstanding balances of securitized credit card loans were $28.5 billion and $29.0 billion at November 30, 2003 and 2002, respectively.

The estimated fair value of the Bank's consumer loans approximated carrying value at November 30, 2003 and 2002. The Bank's credit card portfolio, including securitized loans, is geographically diverse, with a distribution approximating that of the population of the United States.

The Bank's retained interests in credit card asset securitizations include an undivided seller's interest, cash collateral accounts, servicing rights, and rights to any excess cash flows ("Residual Interests") remaining after payments to investors in the securitization trust of their contractual rate of return and reimbursement of credit losses. The undivided seller's interests less an applicable allowance for loan losses is recorded in consumer loans. The Bank's undivided seller's interests rank pari passu with investors' interests in the securitization trust and the remaining retained interests are subordinate to investors' interests. The cash collateral accounts are recorded in amounts due from asset securitizations The Bank receives annual servicing fees of 2% of the investor principal balance outstanding. The Bank does not recognize a servicing asset or a servicing liability for servicing rights since the servicing contract provides only adequate compensation (as defined in SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities") to the Bank for performing the servicing.

Residual interests are recorded in amounts due from asset securitization and classified as trading and reflected at fair value with changes in fair value recorded currently in earnings. On December 4, 2002, the FDIC in conjunction with other bank regulatory agencies issued guidance, "Interagency Advisory on the Accounting Treatment of Accrued Interest Receivable Related to Credit Card Securitizations," for the purpose of clarifying the treatment of accrued interest and fees ("accrued interest receivable") on securitized credit card receivables as a subordinated retained interest for accounting purposes. At November 30, 2003, the accrued interest receivable was $0.6 billion and is recorded in amounts due from securitizations. Including this accrued interest receivable amount, at November 30, 2003, the Bank had $6.7 billion of retained interests, including $5.7 billion of undivided seller's interest, in credit card asset securitizations. The retained interests are subject to credit, payment and interest rate risks on the transferred credit card assets. The investors and the securitization trust have no recourse to the Bank's other assets for failure of cardmembers to pay when due.

In fiscal 2003, the Bank completed credit card asset securitizations of $4.8 billion and recognized net securitization gains of $27.2 million as servicing fees in the Bank's statements of income. The uncollected balances of securitized general purpose credit card loans were $28.5 billion and $29.0 billion at November 30, 2003 and November 30, 2002, respectively.

Key economic assumptions used in measuring the residual interests at the date of securitization resulting from credit card asset securitizations completed during fiscal 2003 were as follows:

| | |
|---|---|
| Weighted average life (in months) | 5.6-5.9 |
| Payment rate (rate per month) | 17.75%-18.00% |
| Credit losses (rate per annum) | 6.45%-6.90% |
| Discount rate (rate per annum) | 14.00% |

Key economic assumptions and the sensitivity of the current fair value of the residual interests to immediate 10 percent and 20 percent adverse changes in those assumptions are as follows:

| | At November 30, 2003 (Dollars in millions) |
|---|---|
| Residual interests (carrying amount/fair value) | $ 255 |
| Weighted average life (in months) | 5.8 |
| | |
| Payment rate (rate per month) | 18.00 % |
| Impact on fair value of 10% adverse change | $ (17) |
| Impact on fair value of 20% adverse change | $ (32) |
| | |
| Credit losses (rate per annum) | 6.90 % |
| Impact on fair value of 10% adverse change | $ (75) |
| Impact on fair value of 20% adverse change | $ (149) |
| | |
| Discount rate (rate per annum) | 14.00 % |
| Impact on fair value of 10% adverse change | $ (3) |
| Impact on fair value of 20% adverse change | $ (5) |

The sensitivity analysis in the table above is hypothetical and should be used with caution. Changes in fair value based on a 10 percent or 20 percent variation in an assumption generally cannot be extrapolated because the relationship of the change in the assumption to the change in fair value may not be linear. Also, the effect of a variation in a particular assumption on the fair value of the residual interests is calculated independent of changes in any other assumption; 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 credit losses), which might magnify or counteract the sensitivities. In addition, the sensitivity analysis does not consider any corrective action that management may take to mitigate the impact of any adverse changes in the key assumptions.

The table below summarizes certain cash flows received from the securitization master trust:

| | Fiscal 2003 (In billions) |
|---|---|
| Proceeds from new credit card asset securitizations | $ 4.8 |
| Proceeds from collections reinvested in previous credit card asset securitizations | $ 58.9 |
| Contractual servicing fees received | $ 0.6 |
| Cash flows received from retained interests | $ 1.4 |

The table below presents quantitative information about delinquencies, net credit losses and components of managed credit card loans, including securitized loans:

| | At November 30, 2003 (In billions) | | Fiscal 2003 | |
|---|---|---|---|---|
| | Loans Outstanding | Loans Delinquent | Average Loans | Net Credit Losses |
| Managed credit card loans | $ 46.1 | $ 2.8 | $ 48.6 | $ 3.3 |
| Less: securitized credit card loans | 28.5 | | | |
| Owned credit card loans | $ 17.6 | | | |

## 5. DEPOSITS

A summary of interest-bearing deposits at November 30, 2003 and 2002 is as follows:

| | 2003 (In thousands) | 2002 |
|---|---|---|
| Certificates of deposit in amounts less than $100,000 | $ 1,192,129 | $ 1,428,368 |
| Certificates of deposit in amounts of $100,000 or greater (1) | 10,271,539 | 10,764,424 |
| Savings deposits, including money market deposit accounts | 759,117 | 900,431 |
| Total | $ 12,222,785 | $ 13,093,223 |
| Average annual interest rate (2) | 4.90 % | 5.51 % |

(1) These were primarily participated out by brokers in shares of $100,000 or less. Both periods include the fair value adjustments resulting from adoption of SFAS No. 133 in fiscal 2001.

(2) Interest rates exclude the effects of interest rate agreements.

At November 30, 2003, certificate of deposit accounts maturing over the next five fiscal years were as follows:

| Year | (In thousands) |
|---|---|
| 2004 | $ 3,866,040 |
| 2005 | 3,380,448 |
| 2006 | 1,939,707 |
| 2007 | 1,095,513 |
| 2008 | 238,955 |

## 6. NOTES PAYABLE AND OTHER BORROWINGS

The Bank's notes payable and other borrowings at November 30, 2003 and 2002 are summarized as follows:

| | 2003 | | 2002 | |
|---|---|---|---|---|
| | Amount Outstanding (In thousands) | Average Annual Interest Rate | Amount Outstanding (In thousands) | Average Annual Interest Rate |
| Short-term: | | | | |
| Overnight federal funds purchased | $ 472,400 | 1.25 % | $ 775,000 | 1.82 % |
| Term federal funds purchased | 1,245,000 | 1.29 | 3,663,000 | 1.85 |
| Notes payable to parent and affiliates: | | | | |
| NCSI | 1,314,450 | 1.10 | - | 1.77 |
| SCFC Receivables Corp. ("SRC") | - | 1.23 | 528,814 | 1.76 |
| Medium-term: | | | | |
| Notes payable to parent: | | | | |
| NCSI | 68,500 | 6.82 | 68,500 | 6.82 |
| Total | $3,100,350 | 1.46 % | $5,035,314 | 1.91 % |

The debt agreements on notes payable to parent and affiliates (SRC, a wholly-owned subsidiary of NCSI) provide for repayment at any time, subject to certain limitations, with original maturities ranging from on demand to twenty years. Interest rates on these notes are based on a market rate of interest, including any associated borrowing costs. Interest expense on notes payable to parent and affiliates was $6,891,000 and $31,972,000 for the years ended November 30, 2003 and 2002, respectively.

At November 30, 2003, notes payable and other borrowings had maturities in the following fiscal years:

| | (In thousands) |
|---|---|
| 2004 (1) | $3,057,470 |
| 2005-2008 | 3,180 |
| 2009 and thereafter | 39,700 |
| Total | $3,100,350 |

(1) The debt agreements on notes payable to parent and affiliates provide for repayment at any time subject to certain limitations.

## 7. TRANSACTIONS WITH PARENT AND AFFILIATES

At November 30, 2003 and 2002, the net amounts due to parent and affiliates are as follows:

| | 2003 | 2002 |
|---|---|---|
| | (In thousands) | |
| Due to: | | |
| Discover Financial Services, Inc. ("DFSI") (1) | $ 590,024 | $ 143,629 |
| Parent and other affiliates | 758 | 4,906 |
| Total | 590,782 | 148,535 |
| Less amounts due from parent and affiliates | (29,026) | (624) |
| Due to parent and affiliates, net | $ 561,756 | $ 147,911 |

(1) DFSI is a wholly-owned subsidiary of NCSI.

At November 30, 2003 and 2002, amounts included in deposits related to parent and affiliates are as follows:

| | 2003 | 2002 |
|---|---|---|
| | (In thousands) | |
| Noninterest-bearing deposits: | | |
| DFSI | $5,316 | $ 5,278 |
| Interest-bearing deposits: | | |
| NCSI | $4,013 | $ 4,017 |
| Other affiliates | 213 | 210 |
| Total interest-bearing deposits | $4,226 | $ 4,227 |

The average balance in interest-bearing deposit accounts related to parent and affiliates was $4,224,000 and $256,174,000 during the years ended November 30, 2003 and 2002, respectively. Interest on these deposits totaled $65,000 at an average annual rate of 1.54 percent for the year ended November 30, 2003 and $14,576,000 at an average annual rate of 5.69 percent for the year ended November 30, 2002.

Accounts payable, accrued expenses and other liabilities included current federal income taxes due from Morgan Stanley of $90,927,000 and $8,575,000 at November 30, 2003 and 2002, respectively.

Included in accounts payable, accrued expenses and other liabilities was accrued interest on notes payable to parent and affiliates of $1,274,000 and $1,656,000 at November 30, 2003 and 2002, respectively. Also included in accounts payable, accrued expenses and other liabilities was accrued interest on certificates of deposit payable to parent and affiliates of $4,000 and $5,000 at November 30, 2003 and 2002, respectively.

DFSI provides the Bank with marketing, transaction processing, and other support services, primarily related to the credit card business. DFSI also provides the Bank with access to its proprietary merchant network. The costs associated with these activities and services are included in information processing and other noninterest expenses and amounted to $1.8 billion for the year ended November 30, 2003 and $1.7 billion for the year ended November 30, 2002.

Morgan Stanley Dean Witter Credit Corporation ("MSDWCC"), an affiliate of the Bank and a wholly-owned subsidiary of NCSI, provides transaction processing and other support services related to consumer loan products. The costs of providing these services are included in information processing and other noninterest expenses and amounted to $6,501,000 and $4,388,000 for the years ended November 30, 2003 and 2002, respectively.

In May 2003, the Bank entered into an agreement with MSDWCC to periodically sell consumer loan products currently serviced by MSDWCC that meet specific criteria. During fiscal 2003, two such sales of consumer loans totaling $205,096,000 occurred. The Bank received proceeds on these sales of $213,504,000, with a resulting gain of $8,408,000 included in interchange, cardmember and other noninterest revenues at year ended November 30, 2003.

The Bank paid brokerage commissions to an affiliate for the sale of certificates of deposit. These commissions totaled $14,892,000 and $31,021,000 for the years ended November 30, 2003 and 2002, respectively, and are amortized to interest expense over the lives of the related certificates of deposit. Amortization of such commissions was $33,466,000 and $35,454,000 for the years ended November 30, 2003 and 2002, respectively.

## 8. EMPLOYEE COMPENSATION AND BENEFITS

Substantially all employees of the Bank are eligible to participate in a noncontributory defined benefit pension plan (the "Plan") for employees of NCSI and its subsidiaries, after meeting certain age and service requirements. Pension benefits are based on each employee's years of credited service and their career average compensation.

Since the Plan includes employees of the various participating NCSI companies, detailed benefit and asset information on an individual company basis is not available. The Bank expensed $3,547,000 and $1,694,000 for the years ended November 30, 2003 and 2002, respectively, related to this plan. As the Plan is for the various participating NCSI companies, all liabilities for the Plan are recorded at NCSI. The Bank transferred to NCSI $3,547,000 and $1,759,000 for its share of accrued pension liability at November 30, 2003 and 2002, respectively.

At November 30, 2003 employee compensation and benefits expense included a charge of $3,358,000 associated with workforce reductions that occurred in the fourth quarter. Of this amount, $538,000 was included in Plan expenses reported above.

The Bank has unfunded postretirement plans that provide medical and life insurance for eligible retirees, employees and dependents. Eligibility for retiree medical and life insurance benefits is generally based on a combination of age and years of service at retirement. The Bank and the employee share the cost of coverage. For the years ended November 30, 2003 and 2002, the Bank recorded postretirement benefits expense of $336,000 and $204,000, respectively.

Employees of the Bank are eligible to participate in the Morgan Stanley 401(k) plan (the "START Plan") upon meeting certain eligibility requirements. Morgan Stanley matches a portion of each participant's contribution based upon the performance of Morgan Stanley and certain formulas as defined by the START Plan. For the years ended November 30, 2003 and 2002, the Bank's allocated expense was $54,000 and $141,000, respectively.

## 9. INCOME TAXES

The following is a summary of the provision for federal, state and deferred income taxes for the years ended November 30, 2003 and 2002:

| | 2003 | 2002 |
|---|---|---|
| | (In thousands) | |
| Current tax expense: | | |
| Federal | $415,832 | $352,919 |
| State | 27,657 | 29,363 |
| Deferred income tax expense | (70,669) | 65,456 |
| Total | $372,820 | $447,738 |

Deferred income taxes reflect the net tax effects of temporary differences between the financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when such differences are expected to reverse. The components of the Bank's net deferred income taxes at November 30, 2003 and 2002 are as follows:

| | 2003 | 2002 |
|---|---|---|
| | (In thousands) | |
| Deferred income tax assets | $ 394,976 | $ 352,401 |
| Deferred income tax liabilities | (350,093) | (377,948) |
| Deferred income taxes - asset (liability) | $ 44,883 | $ (25,547) |

Deferred income tax assets result primarily from use of the direct charge-off method for loan losses for tax purposes. Deferred income tax liabilities relate principally to capitalized net excess securitization gains and various Cardmember fees, which are recognized currently for financial accounting purposes, but are recognized over time for tax purposes.

The Bank's combined federal and state effective tax rates were 37.0 percent for the year ended November 30, 2003 and 36.8 percent for the year ended November 30, 2002.

## 10. REGULATORY CAPITAL REQUIREMENTS

The Bank is subject to various regulatory capital requirements as administered by the FDIC. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance sheet items, as calculated under regulatory accounting practices. The Bank's 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 Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of November 30, 2003, that the Bank meets all capital adequacy requirements to which it is subject.

As of November 30, 2003 and 2002, the most recent notification from the FDIC categorized the Bank as well-capitalized under the regulatory framework for prompt corrective action. To be categorized as well-capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the following table. There are no conditions or events since that notification that management believes have changed the Bank's category.

In addition to the Bank's capital adequacy requirements, actual capital amounts and ratios for the years ended November 30, 2003 and 2002 are presented in the following table:

| | Actual | | For Capital Adequacy Purposes (1) | | To Be Classified as Well-Capitalized Under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| **(Dollars in thousands)** | **Amount** | **Ratio** | **Amount** | **Ratio** | **Amount** | **Ratio** |
| As of November 30, 2003: | | | | | | |
| Total capital (to risk-weighted assets) | $3,059,759 | 12.3 % | $1,989,905 ≥ | 8.0% | $2,487,381 ≥ | 10.0% |
| Tier I capital (to risk-weighted assets) | 2,695,447 | 10.8 % | 994,953 ≥ | 4.0% | 1,492,429 ≥ | 6.0% |
| Tier I capital (to average assets) | 2,695,447 | 14.7 % | 550,596 ≥ | 3.0% | 917,660 ≥ | 5.0% |
| As of November 30, 2002: | | | | | | |
| Total capital (to risk-weighted assets) | $3,503,748 | 13.0 % | $2,163,990 ≥ | 8.0% | $2,704,988 ≥ | 10.0% |
| Tier I capital (to risk-weighted assets) | 3,109,578 | 11.5 % | 1,081,995 ≥ | 4.0% | 1,622,993 ≥ | 6.0% |
| Tier I capital (to average assets) | 3,109,578 | 14.7 % | 636,791 ≥ | 3.0% | 1,061,318 ≥ | 5.0% |

(1) The minimum Tier I capital (to average assets) regulatory requirement can be higher based on the Bank's CAMELS rating and growth.

Beginning December 31, 2002, the Bank's capital levels include the treatment of accrued interest receivables related to credit card securitizations as a subordinated retained interest as required by the FDIC. Under this regulatory framework, the Bank remains well capitalized at November 30, 2003.

The amount of dividends that a bank may pay in any year is subject to certain regulatory restrictions. Under the current banking regulations, a bank may not pay dividends if such a payment would leave the bank inadequately capitalized. The Bank paid dividends from retained earnings of $1,050 million in fiscal 2003 and $310 million in fiscal 2002.

Morgan Stanley maintains certain credit facilities to support the issuance of commercial paper and general liquidity requirements. These facilities require that the Bank maintain certain minimum net worth levels equivalent to the Bank's regulatory requirements. At November 30, 2003 and 2002, the Bank was in compliance with these requirements.

## 11. CONTINGENCIES

The Bank is involved from time to time in various legal proceedings that arise in the ordinary course of its business. While there can be no assurance about the outcome of litigation in which the Bank is involved and the consequences of the Bank's litigation are not presently determinable, it is the opinion of management, based on consultation with counsel and currently available information, that the litigation will not have a materially adverse effect on the financial position of the Bank.

## 12. FINANCIAL INSTRUMENTS

The Bank's interest rate risk management program is designed to reduce the volatility of earnings resulting from changes in interest rates by having a financing portfolio that reflects the existing repricing schedules of consumer loans as well as the Bank's right, with notice to cardmembers, to reprice certain fixed rate consumer loans to a new interest rate in the future. To the extent that asset and related financing repricing characteristics of a particular portfolio are not matched effectively, the Bank utilizes interest rate contracts to achieve its objective. Interest rate contracts are derivative financial instruments that are entered into with institutions that are established dealers and that maintain certain minimum credit criteria established by the Bank.

At November 30, 2003, the Bank had outstanding interest rate swap agreements, some of which were entered into in previous years. At November 30, 2003 and 2002, the notional amounts of these outstanding agreements were $882,500,000 and $132,500,000, respectively, and the fair values of these agreements were $(20,250,000) and $9,000,000, respectively. Certain of these agreements were with affiliates. At November 30, 2003 and 2002, the notional amount of agreements with affiliates was $610,000,000 and $60,000,000, respectively, and the fair values of these agreements were $(12,500,000) and $6,000,000, respectively. At November 30, 2003, the interest rate swap agreements had maturities ranging from three to twenty years from the date of issuance and had a weighted average remaining maturity of approximately fifteen years.

***Fair Value*** - The estimated fair value amounts of the Bank's financial instruments have been determined by the Bank using available market information and appropriate valuation methodologies. Considerable judgment is required to develop estimates of fair value. Accordingly, these estimates are not necessarily indicative of the amounts the Bank could realize in a current market exchange. The use of different assumptions or estimation methodologies may have a material effect on the estimated fair value amounts. At November 30, 2003 and 2002, the carrying amounts of the Bank's financial assets and liabilities were reasonable estimates of fair value.

* * * * * *

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