CAPITAL ONE FINANCIAL CORP
Form 10-Q
May 10, 2011

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2011

OR

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

For the transition period from _____ to ______

Commission File No. 1-13300

CAPITAL ONE FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	54-1719854 (I.R.S. Employer Identification No.)
1680 Capital One Drive, McLean, Virginia (Address of Principal Executive Offices)	22102 (Zip Code)

Registrant’s telephone number, including area code:
(703) 720-1000
(Not applicable)
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes T No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes T No o

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

Large accelerated filer T Accelerated filer o Non-accelerated filer o Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act)

Yes o No T

As of April 29, 2011, there were 459,144,879 shares of the registrant’s Common Stock, par value $.01 per share, outstanding.

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PART I—FINANCIAL INFORMATION

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

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") should be read in conjunction with our unaudited condensed consolidated financial statements and related notes in this Report, and the more detailed information contained in our 2010 Annual Report on Form 10-K ("2010 Form 10-K"). This discussion contains forward-looking statements that are based upon management's current expectations and are subject to significant uncertainties and changes in circumstances. Please review "Forward-Looking Statements" for more information on the forward-looking statements in this report. Our actual results may differ materially from those included in these forward-looking statements due to a variety of factors including, but not limited to, those described in this Report in "Part II—Item 1A. Risk Factors" and in our 2010 Form 10-K in "Part I—Item 1A. Risk Factors."

SUMMARY OF SELECTED FINANCIAL DATA

Below we provide selected consolidated financial data from our results of operations for the three months ended March 31, 2011 and 2010, and selected comparative consolidated balance sheet data as of March 31, 2011 and December 31, 2010. We also provide selected key metrics we use in evaluating our performance.

Table 1: Consolidated Financial Highlights (Unaudited)

	Three Months Ended March 31,			
(Dollars in millions)	2011	2010	Change	
Income statement				
Net interest income	$3,140	$3,228	(3	)%
Non-interest income	942	1,061	(11	)
Total revenue	4,082	4,289	(5	)
Provision for loan and lease losses	534	1,478	(64	)
Non-interest expense	2,162	1,847	17	
Income from continuing operations before income taxes	1,386	964	44	
Income tax provision	354	244	45	
Income from continuing operations, net of tax	1,032	720	43	
Loss from discontinued operations, net of tax(1)	(16)	(84)	81	
Net income	$1,016	$636	60	%
Common share statistics				
Earnings per common share:				
Basic earnings per common share	$2.24	$1.41	59	%
Diluted earnings per common share	2.21	1.40	58	
Weighted average common shares outstanding:				
Basic earnings	454.1	451.0	1	
Diluted earnings	460.3	455.4	1	
Dividends per common share	$0.05	$0.05	**	
Stock price per common share at period end	51.96	41.41	25	
Total market capitalization at period end	23,652	18,713	26	

Average balances			
Loans held for investment	$125,077	$134,206	(7)%
Interest-earning assets	173,540	181,902	(5)
Total assets	198,075	207,232	(4)
Interest-bearing deposits	108,633	104,018	4
Total deposits	124,158	117,530	6
Borrowings	40,538	59,973	(32)
Stockholders’ equity	27,009	23,681	14
Performance metrics			
Revenue margin(2)	9.41 %	9.43 %	(2)bps
Net interest margin(3)	7.24	7.10	14
Net charge-off rate(4)	3.66	6.02	(236)
Risk-adjusted margin(5)	6.77	4.99	178
Return on average assets(6)	2.08	1.39	69
Return on average equity(7)	15.28	12.16	312
Non-interest expense as a % of average loans held for investment(8)	6.91	5.50	141
Efficiency ratio(9)	52.96	43.06	990
Effective income tax rate	25.5	25.3	20

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	March 31, 2011	December 31, 2010	Change
Balance sheet (period end)			
Loans held for investment	$124,092	$ 125,947	(1)%
Interest-earning assets	172,849	172,024	**
Total assets	199,300	197,503	1
Interest-bearing deposits	109,097	107,162	2
Total deposits	125,446	122,210	3
Borrowings	39,797	41,796	(5)
Stockholders' equity	27,550	26,541	4
Tangible common equity ("TCE")(10)	13,520	12,558	8
Credit quality metrics (period end)			
Allowance for loan and lease losses	$5,067	$ 5,628	(10)%
Allowance as a % of loans held of investment	4.08 %	4.47 %	(39)bps
30+ day performing delinquency rate(11)	3.07	3.52	(45)
30+ day delinquency rate	3.79	4.23	(44)
Capital ratios			
Tier 1 common equity ratio(12)	8.4 %	8.8 %	(40)bps
Tier 1 risk-based capital ratio(13)	10.9	11.6	(70)
Total risk-based capital ratio(14)	14.2	16.8	(260)
Tangible common equity ratio ("TCE ratio")(15)	7.3	6.9	40

** Change is less than one percent.

(1) Discontinued operations reflect ongoing costs related to the mortgage origination operations of GreenPoint's wholesale mortgage banking unit, GreenPoint Mortgage Funding, Inc. ("GreenPoint"), which we closed in 2007.

(2) Calculated based on annualized total revenue for the period divided by average interest-earning assets for the period.

(3) Calculated based on annualized net interest income for the period divided by average interest-earning assets for the period.

(4) Calculated based on annualized net charge-offs for the period divided by average loans held for investment for the period. Average loans held for investment include purchased credit impaired loans acquired as part of the Chevy Chase Bank acquisition.

(5) Calculated based on annualized total revenue less net charge-offs for the period divided by average interest-earning assets for the period.

(6) Calculated based on annualized income from continuing operations, net of tax, for the period divided by average total assets for the period.

(7) Calculated based on annualized income from continuing operations, net of tax, for the period divided by average stockholders' equity for the period.

(8) Calculated based on annualized non-interest expense, excluding restructuring and goodwill impairment charges, for the period divided by average loans held for investment for the period.

(9) Calculated based on non-interest expense, excluding restructuring and goodwill impairment charges, for the period divided by total revenue for the period.

(10) Tangible common equity is a non-GAAP measure consisting of total assets less assets from discontinued operations and intangible assets. See "Supplemental Tables—Table A: Reconciliation of Non-GAAP Measures and Calculation of Regulatory Capital Measures" for the calculation of this measure and reconciliation to the comparative GAAP measure.

(11) See "Consolidated Balance Sheet Analysis and Credit Performance—Credit Performance—Nonperforming Assets" for our policies for classifying loans as nonperforming by loan category.

(12) Tier 1 common equity ratio is a non-GAAP measure calculated based on Tier 1 common equity divided by risk-weighted assets. See "Liquidity and Capital Management—Capital Management" and "Supplemental Tables—Table A: Reconciliation of Non-GAAP Measures and Calculation of Regulatory Capital Measures" for additional information, including the calculation of this ratio and non-GAAP reconciliation.

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(13) Tier 1 risk-based capital ratio is a regulatory measure calculated based on Tier 1 capital divided by risk-weighted assets. See "Liquidity and Capital Management—Capital Management" and "Supplemental Tables—Table A: Reconciliation of Non-GAAP Measures and Calculation of Regulatory Capital Measures" for additional information, including the calculation of this ratio.

(14) Total risk-based capital ratio is a regulatory measure calculated based on total risk-based capital divided by risk-weighted assets. See "Liquidity and Capital Management—Capital Management" and "Supplemental Tables—Table A: Reconciliation of Non-GAAP Measures and Calculation of Regulatory Capital Measures" for additional information, including the calculation of this ratio.

(15) Tangible common equity ratio ("TCE ratio") is a non-GAAP measure calculated based on tangible common equity divided by tangible assets. See "Supplemental Tables—Table A: Reconciliation of Non-GAAP Measures and Calculation of Regulatory Capital Measures" for the calculation of this measure and reconciliation to the comparative GAAP measure.

INTRODUCTION

Capital One Financial Corporation (the "Company") is a diversified financial services holding company with banking and non-banking subsidiaries that offer a broad array of financial products and services to consumers, small businesses and commercial clients through branches, the internet and other distribution channels. Our principal subsidiaries include:

Capital One Bank (USA), National Association ("COBNA") which currently offers credit and debit card products, other lending products and deposit products.

Capital One, National Association ("CONA") which offers a broad spectrum of banking products and financial services to consumers, small businesses and commercial clients.

The Company and its subsidiaries are collectively referred to as "we", "us" or "our" in this report. CONA and COBNA are collectively referred to as the "Banks" in this Report.

Our revenues are primarily driven by lending to consumers and commercial customers and by deposit-taking activities, which generate net interest income, and by activities that generate non-interest income, including the sale and servicing of loans and providing fee-based services to customers. Customer usage and payment patterns, credit quality, levels of marketing expense and operating efficiency all affect our profitability. Our expenses primarily consist of the cost of funding our assets, our provision for loan and lease losses, operating expenses (including associate salaries and benefits, infrastructure maintenance and enhancements and branch operations and expansion costs), marketing expenses and income taxes. We had $124.1 billion in total loans outstanding and $125.4 billion in deposits as of March 31, 2011, compared with $125.9 billion in total loans outstanding and $122.2 billion in deposits as of December 31, 2010.

Our principal operations are currently organized, for management reporting purposes, into three major business segments, which are defined based on the products and services provided or the type of customer served: Credit Card, Consumer Banking and Commercial Banking. The operations of acquired businesses have been integrated into our existing business segments.

Credit Card: Consists of our domestic consumer and small business card lending, national small business lending, national closed end installment lending and the international card lending businesses in Canada and the United Kingdom.

Consumer Banking: Consists of our branch-based lending and deposit gathering activities for consumer and small businesses, national deposit gathering, national automobile lending and consumer home loan lending and servicing activities.

Commercial Banking: Consists of our lending, deposit gathering and treasury management services to commercial real estate and middle market customers.

Certain activities that are not part of a segment are included in our “Other” category.

Table 2 summarizes our business segment results for the three months ended March 31, 2011 and 2010. We report our business segment results based on income from continuing operations, net of tax.

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Table 2: Business Segment Results(1)

	Three Months Ended March 31,							
	2011				2010			
	Total Revenue(2)		Net Income (Loss)		Total Revenue(2)		Net Income (Loss)	
(Dollars in millions)	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total
Credit Card	$2,615	64 %	$643	62 %	$2,831	66 %	$489	68 %
Consumer Banking	1,169	29	215	21	1,212	28	305	42
Commercial Banking	392	9	148	14	354	8	(49)	(7)
Other(3)	(94)	(2)	26	3	(105)	(2)	(25)	(3)
Total from continuing operations	$4,082	100 %	$1,032	100 %	$4,292	100 %	$720	100 %

(1) See “Note 14—Business Segments” for a reconciliation of our total business segment results to our consolidated U.S. GAAP results.

(2) Total revenue consists of net interest income and non-interest income.

(3) Includes the residual impact of the allocation of our centralized Corporate Treasury group activities, such as management of our corporate investment portfolio and asset/liability management, to our business segments as well as other items as described in “Note 14—Business Segments.”

EXECUTIVE SUMMARY AND BUSINESS OUTLOOK

We generated net income of $1.0 billion ($2.21 per diluted share) in the first quarter of 2011, which represented a significant improvement of $380 million, or 60%, over net income of $636 million ($1.40 per diluted share) in the first quarter of 2010. Although the economy remains fragile, it is gradually recovering with a decrease in unemployment rates, an increase in retail spending and continued declines in bankruptcy filings and delinquency rates from a year ago. Our first quarter 2011 financial performance reflected the impact of the improvement in economic conditions and positive trends in our business fundamentals. Below are highlights of our results of operations for the first quarter of 2011 compared with the first quarter of 2010.

Financial Highlights

The most significant driver of the $380 million improvement in our results for the first quarter of 2011 was a substantial decrease in the provision for loan and lease losses, which was partially offset by a decrease in total revenue and an increase in non-interest expenses.

- Decrease in Provision for Loan and Lease Losses: The provision for loan and lease losses decreased by $944 million, or 64%, from the first quarter of 2010 to $534 million in the first quarter of 2011, attributable to strong credit trends, including reduced charge-offs and delinquency rates across all of our businesses. As a result, we recorded an allowance release of $561 million in the first quarter of 2011.

- Decrease in Total Revenue: Total revenue decreased by $207 million, or 5%, in the first quarter of 2011 from the first quarter of 2010, largely due to a decline in non-interest fee income. The decline in non-interest income reflected a decrease in our provision for mortgage repurchase losses, lower fees attributable to a reduction in customer accounts and loan balances and the implementation of provisions of the Credit CARD Act of 2009 (the "Card Act") that reduced penalty fees. Although average loan balances declined by 7%, our net interest income only declined by 3% due to an improvement in our cost of funds. Our cost of funds continued to benefit from the shift in the mix of our funding to lower cost consumer and commercial banking deposits from higher cost wholesale sources. In addition, the overall interest rate environment, combined with our disciplined pricing, contributed to the decrease in our average deposit interest rates.

- Increase in Non-Interest Expense: Non-interest expense increased by $315 million, or 17%, in the first quarter of 2011 from the first quarter of 2010, primarily due to legal expenses in our Credit Card business, an increase in operating expenses related to recent credit card loan portfolio acquisitions and an increase in marketing expenses.

Below are additional highlights of our first quarter 2011 financial performance. These highlights generally are based on a comparison between our results of operations for the first quarter of 2011 and our results of operations for the first quarter of 2010. The highlights of changes in our financial condition and credit performance are generally based on our financial condition and credit quality metrics as of March 31, 2011, compared with our financial condition and credit quality metrics as of December 31, 2010. We provide a more detailed discussion of our results of operation, financial condition and credit performance in "Consolidated Results of Operations," "Consolidated Balance Sheet Analysis and Credit Performance" and "Business Segment Financial Performance."

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- Credit Card: Our Credit Card business generated income of $643 million in the first quarter of 2011, compared with income of $489 million in the first quarter of 2010. Continued favorable credit performance was the primary driver of the improvement in our Credit Card business results, resulting in a significant decrease in the provision for loan and lease losses. The provision decrease was partially offset by a decline in total revenue and an increase in non-interest expense. The decline in revenue was attributable to lower average loan balances and a reduction in penalty fees resulting from Federal Reserve guidelines regarding reasonable fees that became effective in the third quarter of 2010. The increase in non-interest expense was attributable to increased operating costs related to the acquisitions of the private-label credit card loan portfolios of Sony and Hudson's Bay Company ("HBC"), higher legal fees and increased marketing expenditures.

- Consumer Banking: Our Consumer Banking business generated income of $215 million in the first quarter of 2011, compared with income of $305 million in the first quarter of 2010. The decrease in income reflected the impact of a one-time pre-tax gain of $128 million recorded in the first quarter of 2010 from the deconsolidation of certain option-adjustable rate mortgage trusts and an increase in net interest income that was offset by an increase in the provision for loan and lease losses and non-interest expense. Although average loan balances declined in our Consumer Banking business, margins improved due to higher pricing for new auto loan originations and deposit growth resulting from our continued strategy to leverage our bank outlets to attract lower cost funding sources. The increase in the provision for loan and lease losses was largely due to a lower allowance release in the first quarter of 2011 compared with the first quarter of 2010. Non-interest expense rose due to higher infrastructure and marketing expenditures, primarily related to our retail banking operations.

- Commercial Banking: Our Commercial Banking business generated income of $148 million in the first quarter of 2011, compared with a loss of $49 million in the first quarter of 2010. The improvement in results for our Commercial Banking business was attributable to an allowance release in the first quarter of 2011, which resulted in a negative provision for loan and lease losses. The decrease in the allowance and provision reflected the continued improvement in our Commercial Banking credit metrics.

- Total Loans: Total loans held for investment decreased by $1.8 billion, or 1%, in the first quarter of 2011 to $124.1 billion as of March 31, 2011, from $125.9 billion as of December 31, 2010. This decrease was primarily due to expected seasonal pay downs that have historically taken place during the first quarter of the year and the expected run-off of installment loans in our Credit Card business and home loans in our Consumer Banking business. Excluding the impact of our run-off loan portfolios, the decline in loan balances was approximately $800 million during the first quarter of 2011.

- Charge-off and Delinquency Statistics: Net charge-off and delinquency rates continued to improve during the first quarter of 2011. The net charge-off rate decreased to 3.66%, from 4.45% in the fourth quarter of 2010 and 6.02% in the first quarter of 2010. The 30+ day performing delinquency rate decreased to 3.07% as of March 31, 2011, from 3.52% as of December 31, 2010.

- Allowance for Loan and Lease Losses: As a result of the continued improvement in credit performance, we reduced our allowance by $561 million in the first quarter of 2011 to $5.1 billion. The allowance as a percentage of our total loans held for investment was 4.08% as of March 31, 2011, compared with 4.47% as of December 31, 2010.

- Representation and Warranty Reserve: We have established a reserve for our mortgage loan repurchase exposure related to the sale of mortgage loans by our subsidiaries to various parties under contractual provisions that include various representations and warranties. This reserve reflects inherent losses as of each balance sheet date that we consider to be both probable and reasonably estimable. We recorded a provision for this exposure of $44 million in the first quarter of 2011, of which $5 million was included in non-interest income and $39 million was included in discontinued operations. In comparison, we recorded a provision of $224 million in the first quarter of 2010, of which $100 million was included in non-interest income and $124 million was included in discontinued operations. Our representation and warranty reserve totaled $846 million as of March 31, 2011, compared with $816 million as of December 31, 2010.

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- Capital Adequacy: Our financial strength and capacity to absorb risk remained high as of the end of the first quarter of 2011. We completed the remaining regulatory phase-in of the assets resulting from our January 1, 2010 adoption of the new consolidation accounting standards during the first quarter of 2011, which resulted in the addition of approximately $15.0 billion of assets to the denominator used in calculating our regulatory ratios. The addition of these assets contributed to a decrease in our regulatory capital ratios. Our Tier 1 risk-based capital ratio declined to 10.9% as of March 31, 2011, from 11.6% as of December 31, 2010, but was comfortably above the current minimum regulatory requirement of 4.0%. Our non-GAAP Tier 1 common equity ratio under Basel I declined to 8.4% as of March 31, 2011, from 8.8% as of December 31, 2010. Our earnings of $1.0 billion in the first quarter of 2011 caused our non-GAAP TCE ratio to increase 45 basis points during the quarter to 7.3% as of March 31, 2011, from 6.9% as of December 31, 2010. See “Supplemental Tables” below for a calculation of our regulatory capital ratios and a reconciliation of our supplemental non-GAAP capital measures.

Business Environment and Recent Developments

Recent Business and Regulatory Developments

While overall unemployment is expected to remain elevated for some time, the labor market showed signs of improvement during the first quarter of 2011, including a drop in the unemployment rate in March 2011 to its lowest level in two years and a sharp drop in the pace of new job losses. The improvement in our credit performance has generally outpaced the modest and fragile economic recovery. The strategic decisions we made in managing our credit risk during the recession, including tightening our underwriting standards and focusing on our most resilient businesses, have contributed to strong credit performance in our most recent loan vintages. The run-off of the loan portfolios we exited is beginning to subside and the elevated level of charge-offs is beginning to abate. Our recent partnerships have contributed to new account originations and an increase in purchase volumes.

The regulatory changes resulting from the CARD Act have created a more level playing field, which we believe will provide opportunities for us. We are continuing to assess the potential impact of proposed rules promulgated by the agencies charged with implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act”), including rules relating to resolution plans and credit exposure reports, the FDIC's orderly liquidation authority, derivatives, risk retention and other securitization matters. These rules may result in modifications to our business models and organizational structure and may subject us to escalating costs associated with any such changes.

Acquisitions and Partnerships

We regularly explore opportunities to enter into strategic partnership agreements or acquire financial services companies to expand our distribution channels and grow our customer base. We recently acquired the existing private-label credit card loan portfolios of HBC and Kohl’s Department Stores (“Kohl's”).

Hudson’s Bay Company

On January 7, 2011, we acquired the private-label credit card loan portfolio of HBC, one of the largest retailers in Canada, from GE Capital Retail Finance. The acquisition and partnership with HBC significantly expand our credit card customer base in Canada, tripling the number of customer accounts, and provide an additional distribution channel. The acquisition included outstanding credit card loan receivables with a fair value of approximately $1.4 billion and a transfer of approximately 400 employees directly involved in managing HBC’s loan portfolio. The acquired loan portfolio is reflected in the operations of our International Card business.

Kohl’s

In August 2010, we entered into a private-label credit card partnership agreement with Kohl's. In connection with the partnership agreement, effective April 1, 2011, we acquired Kohl's existing private-label credit card loan portfolio from JPMorgan Chase & Co. The existing portfolio, which consists of more than 20 million Kohl's customer accounts, had an outstanding principal and interest balance of approximately $3.7 billion at acquisition. The partnership agreement has an initial seven-year term and an automatic one-year renewal thereafter. Under the credit card partnership, we will issue Kohl's branded private-label credit cards to new and existing Kohl's customers. We expect to share a fixed percentage of revenues, consisting of finance charges and late fees, with Kohl's, and we expect Kohl's to reimburse us for a fixed percentage of credit losses incurred. We expect that the revenue-sharing arrangement with Kohl's will reduce the overall revenue margins for our Domestic Card business beginning in the second quarter of 2011. However, because we are replacing lower yielding cash and other investments with the Kohl's receivables, we do not expect the addition of the Kohl's portfolio to have a material impact on our total company revenue margin or net interest margin.

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Business Outlook

We discuss below our current expectations regarding our total company performance and the performance of each of our business segments over the near-term based on market conditions, the regulatory environment and our business strategies as of the time we filed this Quarterly Report on Form 10-Q. The statements contained in this section are based on our current expectations regarding our outlook for our financial results and business strategies. Our expectations take into account, and should be read in conjunction with, our expectations regarding economic trends and analysis of our business as discussed in "Part I— Item 1. Business" and "Part I—Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" in our 2010 Form 10-K. Certain statements are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Actual results could differ materially from those in our forward-looking statements. Forward-looking statements do not reflect (i) any change in current dividend or repurchase strategies, (ii) the effect of any acquisitions, divestitures or similar transactions or (iii) any changes in laws, regulations or regulatory interpretations, in each case after the date as of which such statements are made. See "Forward-Looking Statements" in this Quarterly Report on Form 10-Q for more information on the forward-looking statements in this report and "Item 1A. Risk Factors" in our 2010 Form 10-K for factors that could materially influence our results.

Total Company Expectations

We believe we are gaining traction across all of our businesses as a result of our focus on franchise building customer relationships, such as transactor customers and new partnerships in our Credit Card business, deposit customers in our Consumer Banking business and Commercial Banking customers with an emphasis on primary banking relationships. As a result, we believe we are in a strong position to deliver attractive and sustainable results over the long-term, including moderate growth and attractive risk-adjusted returns on assets in our Credit Card and Auto Finance businesses, moderate growth in low-risk loans in our Commercial Banking business and strong growth in low-cost deposits and high-quality commercial and retail customer relationships. Based on recent trends and our targeted initiatives to attract new business and develop customer relationships, we believe the period of declining loan balances during the recession came to an end during the first quarter of 2011 and that we will return to modest growth beginning in the second quarter of 2011. We expect modest year-over-year growth in ending loan balances in 2011. Although we expect growth in our period-end loan balances in 2011, we expect that our average loan balances for 2011 will be comparable to our average loan balances for 2010 given the lower starting point for our loan balances in 2011.

Business Segment Expectations

Credit Card Business

In our Credit Card business, we expect loan growth in the second quarter as a result of the addition of the Kohl's portfolio on April 1, 2011, which we believe will largely offset the decline in the first quarter of 2011. Based on the traction we are gaining in our Domestic Card business, we believe that our Domestic Card loan balances reached a low point in the first quarter of 2011. We expect modest loan growth in the second half of 2011, as the headwinds of elevated charge-offs and the run-off of the installment loan portfolio continue to diminish. We believe we are well positioned to gain market share in the new level playing field resulting from the CARD Act. We believe the improved credit performance in our Credit Card business will continue despite elevated unemployment.

Consumer Banking Business

In our Consumer Banking business, we expect that auto originations and returns will remain strong and drive modest growth in auto loans in 2011. We expect that the continuing run-off of the mortgage portfolio will largely offset the growth in auto loans. While we expect that our Auto Finance business will continue to deliver strong credit performance and economic results, we believe that we are likely approaching a low point for the Auto Finance charge-off rate. We expect the Auto Finance charge-off rate will increase in the second half of 2011, driven by seasonal patterns, competitive factors and expected changes in auction prices for used vehicles. We believe loan pricing in some segments is approaching historic highs and is likely to moderate or decline over time.

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Commercial Banking Business

In our Commercial Banking business, we believe that the worst of the commercial credit downturn is behind us and there is positive trajectory. However, we continue to expect some quarterly uncertainty and volatility in commercial charge-offs and nonperforming loans. We have been growing low-risk commercial loans and expect further modest growth to continue in 2011. Growth in treasury management and capital market services is driving higher fee revenues and deepening relationships with our commercial customers.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in accordance with U.S. GAAP requires management to make a number of judgments, estimates and assumptions that affect the reported amount of assets, liabilities, income and expenses in the consolidated financial statements. Understanding our accounting policies and the extent to which we use management judgment and estimates in applying these policies is integral to understanding our financial statements. We provide a summary of our significant accounting policies in “Note 1—Summary of Significant Accounting Policies” of our 2010 Form 10-K.

We have identified the following accounting policies as critical because they require significant judgments and assumptions about highly complex and inherently uncertain matters and the use of reasonably different estimates and assumptions could have a material impact on our reported results of operations or financial condition. These critical accounting policies govern:

- Fair value
- Allowance for loan and lease losses
- Asset impairment
- Representation and warranty reserve
- Revenue recognition
- Derivative and hedge accounting
- Income taxes

We evaluate our critical accounting estimates and judgments on an ongoing basis and update them as necessary based on changing conditions. The use of fair value to measure our financial instruments is fundamental to the preparation of our consolidated financial statements because we account for and record a significant portion of our assets and liabilities at fair value. Accordingly, we provide information below on financial instruments recorded at fair value in our consolidated balance sheets. Management has discussed our critical accounting policies and estimates with the Audit and Risk Committee of the Board of Directors.

Fair Value

Fair value is defined as the price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants on the measurement date (also referred to as an exit price). The fair value accounting guidance provides a three-level fair value hierarchy for classifying financial instruments. This hierarchy is based on whether the inputs to the valuation techniques used to measure fair value are observable or unobservable. Fair value measurement of a financial asset or liability is assigned to a level based on the lowest level of any input that is significant to the fair value measurement in its entirety. The three levels of the fair value hierarchy are described below:

Level 1:	Quoted prices (unadjusted) in active markets for identical assets or liabilities.
Level 2:	Observable market-based inputs, other than quoted prices in active markets for identical assets or liabilities.
Level 3:	Unobservable inputs.

The degree of management judgment involved in determining the fair value of a financial instrument is dependent upon the availability of quoted prices in active markets or observable market parameters. When quoted prices and observable data in active markets are not fully available, management judgment is necessary to estimate fair value. Changes in market conditions, such as reduced liquidity in the capital markets or changes in secondary market activities, may reduce the availability and reliability of quoted prices or observable data used to determine fair value.

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We have developed policies and procedures to determine when markets for our financial assets and liabilities are inactive if the level and volume of activity has declined significantly relative to normal conditions. If markets are determined to be inactive, it may be appropriate to adjust price quotes received. When significant adjustments are required to price quotes or inputs, it may be appropriate to utilize an estimate based primarily on unobservable inputs.

Significant judgment may be required to determine whether certain financial instruments measured at fair value are included in Level 2 or Level 3. In making this determination, we consider all available information that market participants use to measure the fair value of the financial instrument, including observable market data, indications of market liquidity and orderliness, and our understanding of the valuation techniques and significant inputs used. Based upon the specific facts and circumstances of each instrument or instrument category, judgments are made regarding the significance of the Level 3 inputs to the instruments' fair value measurement in its entirety. If Level 3 inputs are considered significant, the instrument is classified as Level 3. The process for determining fair value using unobservable inputs is generally more subjective and involves a high degree of management judgment and assumptions.

Our financial instruments recorded at fair value on a recurring basis represented approximately 22% of our total assets of $199.3 billion as of March 31, 2011, compared with 22% of our total assets of $197.5 billion as of December 31, 2010. Financial assets for which the fair value was determined using significant Level 3 inputs represented approximately 2% of these financial instruments (less than 1% of total assets) as of March 31, 2011, and approximately 2% of these financial instruments (1% of total assets) as of December 31, 2010.

We discuss changes in the valuation inputs and assumptions used in determining the fair value of our financial instruments, including the extent to which we have relied on significant unobservable inputs to estimate fair value and our process for corroborating these inputs, in "Note 13—Fair Value of Financial Instruments."

Key Controls Over Fair Value Measurement

We have a governance framework and a number of key controls that are intended to ensure that our fair value measurements are appropriate and reliable. Our governance framework provides for independent oversight and segregation of duties. Our control processes include review and approval of new transaction types, price verification and review of valuation judgments, methods, models, process controls and results. Groups independent from our trading and investing function, including our Valuations Group and Valuations Advisory Committee, participate in the review and validation process. The Valuation Committee includes senior representation from business areas, our Enterprise Risk Oversight division and our Finance division.

Our Valuations Group performs monthly independent verification of fair value measurements by comparing the methodology driven price to other market source data (to the extent available), and uses independent analytics to determine if assigned fair values are reasonable. The Valuations Advisory Committee regularly reviews and approves our valuation methodologies to ensure that our methodologies and practices are consistent with industry standards and adhere to regulatory and accounting guidance.

For additional information on our critical accounting policies and estimates, see "Part II—Item 7. MD&A —Critical Accounting Policies and Estimates" of our 2010 Form 10-K.

CONSOLIDATED RESULTS OF OPERATIONS

The section below provides a comparative discussion of our consolidated financial performance for the three months ended March 31, 2011 and 2010. Following this section, we provide a discussion of our business segment results. You should read this section together with our "Executive Summary and Business Outlook" where we discuss trends and other factors that we expect will affect our future results of operations.

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Net Interest Income

Net interest income represents the difference between the interest income and applicable fees earned on our interest-earning assets, which include loans held for investment and investment securities, and the interest expense on our interest-bearing liabilities, which include interest-bearing deposits, senior and subordinated notes, securitized debt and other borrowings. We include in interest income any past due fees on loans that we deem are collectible. Our net interest margin represents the difference between the yield on our interest-earning assets and the cost of our interest-bearing liabilities, including the impact of non-interest bearing funding. We expect net interest income and our net interest margin to fluctuate based on changes in interest rates and changes in the amount and composition of our interest-earning assets and interest-bearing liabilities.

Table 3 below presents, for each major category of our interest-earning assets and interest-bearing liabilities, the average outstanding balances, the interest earned or paid and the average yield or cost for the periods ended March 31, 2011 and 2010.

Table 3: Average Balances, Interest Yields and Rates Paid

	Three Months Ended March 31,					
	2011			2010		
(Dollars in millions)	Average Balance	Interest Income/ Expense(1)	Yield/ Rate	Average Balance	Interest Income/ Expense(1)	Yield/ Rate
Assets:						
Interest-earning assets:						
Consumer loans:(2)						
Domestic(3)	$86,587	$2,706	12.50 %	$96,669	$2,980	12.33 %
International	8,697	354	16.28	7,814	305	15.61
Total consumer loans(3)	95,284	3,060	12.85	104,483	3,285	12.58
Commercial loans(3)	29,793	357	4.80	29,723	373	5.03
Total loans held for investment	125,077	3,417	10.93	134,206	3,658	10.90
Investment securities	41,532	316	3.04	38,087	349	3.67
Other interest-earning assets:						
Domestic	6,250	16	1.02	8,960	22	0.98
International	681	3	1.76	649	1	0.62
Total other interest-earning assets	6,931	19	1.10	9,609	23	0.96
Total interest-earning assets	$173,540	$3,752	8.65 %	$181,902	$4,030	8.86 %
Cash and due from banks	2,000			6,714		
Allowance for loan and lease losses	(5,629)			(8,349)		
Premises and equipment, net	2,720			2,726		
Other assets	25,444			24,239		
Total assets	$198,075			$207,232		
Liabilities and Equity:						
Interest-bearing liabilities:						
Deposits	$108,633	$322	1.19 %	$104,018	$399	1.53 %
Securitized debt obligations:						
Domestic	21,582	117	2.17	40,033	209	2.09
International	3,933	23	2.34	5,548	33	2.38

Total securitized debt obligations	25,515	140	2.19		45,581	242	2.12	
Senior and subordinated notes	8,090	64	3.16		8,758	68	3.11	
Other borrowings	6,933	86	4.96		5,634	93	6.60	
Total interest-bearing liabilities	$149,171	$612	1.64	%	$163,991	$802	1.96	%
Non-interest bearing deposits	15,525				13,512			
Other liabilities	6,370				6,048			
Total liabilities	171,066				183,551			
Stockholders' equity	27,009				23,681			
Total liabilities and stockholders' equity	$198,075				$207,232			
Net interest income/spread		$3,140	7.01	%		$3,228	6.90	%
Interest income to average interest-earning assets			8.65	%			8.86	%
Interest expense to average interest-earning assets			1.41				1.76	
Net interest margin			7.24	%			7.10	%

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(1) Past due fees included in interest income totaled approximately $245 million and $332 million for the three months ended March 31, 2011 and 2010, respectively.

(2) Interest income on credit card, auto, home and retail banking loans is reflected in consumer loans. Interest income generated from small business credit cards also is included in consumer loans.

(3) Interest income on interest-earning assets and average yield on loans held for investment have been revised to conform to the internal management accounting methodology used in our segment reporting. The previously reported and revised interest income and average yields for each period affected are presented below.

(Dollars in millions)	Three Months Ended March 31, 2010		Three Months Ended June 30, 2010		Three Months Ended September 30, 2010		Six Months Ended June 30, 2010		Nine Months Ended September 30, 2010		Full Year 2010	
Previously reported:												
Interest Income :												
Consumer Loans (Domestic)	$2,961		$2,882		$ 2,846		$ 5,844		$ 8,691		$11,444	
Consumer Loans	3,266		3,178		3,148		6,445		9,594		12,656	
Commercial Loans	391		298		299		689		988		1,278	
Average yield on loans held for investment:												
Consumer Loans (Domestic)	12.25	%	12.63	%	12.72	%	12.44	%	12.53	%	12.51	%
Consumer Loans	12.50		12.88		13.00		12.69		12.79		12.79	
Commercial Loans	5.27		4.04		4.06		4.65		4.46		4.32	
Revised:												
Interest Income :												
Consumer Loans (Domestic)	$2,979		$2,815		$ 2,767		$ 5,795		$ 8,563		$11,228	

Consumer Loans	3,284		3,111		3,069		6,396		9,466		12,440	
Commercial Loans	373		365		378		738		1,166		1,494	
Average yield on loans held for investment:												
Consumer Loans (Domestic)	12.33	%	12.34	%	12.36	%	12.33	%	12.35	%	12.28	%
Consumer Loans	12.57		12.61		12.67		12.59		12.62		12.57	
Commercial Loans	5.03		4.94		5.13		4.99		5.03		5.06	

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Table 4 presents the variance between our net interest income for the three months ended March 31, 2011 and 2010 and the extent to which the variance was attributable to: (i) changes in the volume of our interest-earning assets and interest-bearing liabilities or (ii) changes in the interest rates of these assets and liabilities.

Table 4: Rate/Volume Analysis of Net Interest Income

	First Quarter 2011 vs. First Quarter 2010(1)		
	Total	Variance Due to	
(Dollars in millions)	Variance	Volume	Rate
Interest income:			
Loans held for investment:			
Consumer loans	$ (225)	$ (294)	$ 69
Commercial loans	(16)	1	(17)
Total loans held for investment, including past-due fees	(241)	(293)	52
Investment securities	(33)	30	(63)
Other	(4)	(7)	3
Total interest income	(278)	(270)	(8)
Interest expense:			
Deposits	(77)	17	(94)
Securitized debt obligations	(102)	(110)	8
Senior and subordinated notes	(4)	(5)	1
Other borrowings	(7)	19	(26)
Total interest expense	(190)	(79)	(111)
Net interest income	$ (88)	$ (191)	$ 103

(1) We calculate the change in interest income and interest expense separately for each item. The change in net interest income attributable to both volume and rates is allocated based on the relative dollar amount of each item.

Our net interest income of $3.1 billion for the first quarter of 2011 decreased by 3% from net interest income of $3.2 billion for the first quarter of 2010, driven by a 5% decrease in average interest-earning assets, which was partially offset by a 2% (14 basis points) expansion of our net interest margin to 7.24%.

The decrease in average interest-earning assets reflected the continued run-off of businesses that we exited or repositioned, including our installment, mortgage and small-ticket commercial real estate loan portfolios, elevated charge-offs during 2010 and relatively low levels of loan origination activity during 2010.

The increase in our net interest margin in the first quarter of 2011 was primarily attributable to an improvement in our cost of funds, which was partially offset by a modest decline in the yield on our interest-earning assets. Our cost of funds continued to benefit from the shift in the mix of our funding to lower cost consumer and commercial banking deposits from higher cost wholesale sources. In addition, the overall interest rate environment, combined with our disciplined pricing, contributed to the decrease in our average deposit interest rates. While average loan yields improved modestly, the shift in the mix of our interest-earning assets to a higher proportion of investment securities relative to loans coupled with a decline in the average yield on our investment securities resulted in a decline in the average yield on our interest-earning assets. The improvement in average loan yields reflected the benefit from the run-off of lower margin installment loans, a reduced level of new accounts with low introductory promotional rates and an increased recognition of billed finance charges and fees due to the improvement in credit performance.

Non-Interest Income

Non-interest income consists of servicing and securitizations income, service charges and other customer-related fees, interchange income and other non-interest income. We also record the mortgage loan repurchase provision related to continuing operations in non-interest income. The servicing fees, finance charges, other fees, net of charge-offs and interest paid to third party investors related to our consolidated securitization trusts are reported as a component of net interest income.

Table 5 displays the components of non-interest income for the three months ended March 31, 2011 and 2010.

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Table 5: Non-Interest Income

(Dollars in millions)	Three Months Ended March 31, 2011	2010
Servicing and securitizations	$ 11	$ (36)
Service charges and other customer-related fees	525	585
Interchange	320	311
Net other-than-temporary impairment ("OTTI")	(3)	(31)
Provision for mortgage repurchase losses(1)	(5)	(100)
Other	94	332
Total non-interest income	$ 942	$ 1,061

(1) We recorded a total provision for mortgage repurchase losses of $44 million and $224 million in the first quarter of 2011 and 2010, respectively. The remaining portion of the provision for repurchase losses is included in discontinued operations.

Non-interest income of $942 million for the first quarter of 2011 decreased by $119 million, or 11%, from non-interest income of $1.1 billion for the first quarter of 2010.

The decrease in non-interest income reflected the impact of a one-time pre-tax gain of $128 million recorded in the first quarter of 2010 from the deconsolidation of certain option-adjustable rate mortgage trusts. A reduction in investment gains and lower penalty fees as a result of the CARD Act also contributed to the decrease. The decline resulting from these factors was partially offset by decreases in the provision for mortgage loan repurchases and other-than-temporary impairment losses. We provide additional information on representation and warranty claims in "Consolidated Balance Sheet Analysis and Credit Performance—Potential Mortgage Representation and Warranty Liabilities."

The net other-than-temporary impairment losses of $3 million and $31 million recorded for the first quarter of 2011 and 2010, respectively, primarily resulted from the deterioration in the credit quality of certain non-agency mortgage-backed securities due to the continued weakness in the housing market and elevated unemployment. We also recorded other-than-temporary impairment on certain other non-agency mortgage-backed securities in the first quarter of 2010 because of our intent to sell the securities. We provide additional information on other-than-temporary impairment recognized on our available-for-sale securities in "Note 4—Investment Securities."

Provision for Loan and Lease Losses

We build our allowance for loan and lease losses through the provision for loan and lease losses. Our provision for loan and lease losses in each period is driven by charge-offs and the level of allowance for loan and lease losses that we determine is necessary to provide for probable credit losses inherent in our loan portfolio as of each balance sheet date.

Our provision for loan and lease losses decreased to $534 million in the first quarter of 2011, from $1.5 billion in the first quarter of 2010. The substantial decline in the provision was attributable to strong credit trends, including reduced charge-offs and delinquency rates across all of our businesses.

See "Consolidated Balance Sheet Analysis and Credit Performance—Allowance for Loan and Lease Losses" for a discussion of changes in our allowance for loan and lease losses and details of our provision for loan and lease losses and charge-offs by loan category for the three months ended March 31, 2011 and 2010.

Non-Interest Expense

Non-interest expense consists of ongoing operating costs, such as salaries and associated employee benefits, communications and other technology expenses, supplies and equipment and occupancy costs, and miscellaneous expenses. Marketing expenses also are included in non-interest expense. Table 6 displays the components of non-interest expense for the three months ended March 31, 2011 and 2010.

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Table 6: Non-Interest Expense

(Dollars in millions)	Three Months Ended March 31, 2011	2010
Salaries and associated benefits	$ 741	$ 646
Marketing	276	180
Communications and data processing	164	169
Supplies and equipment	135	124
Occupancy	119	120
Other (1)	727	608
Total non-interest expense	$ 2,162	$ 1,847

(1) Consists of professional services expenses, credit collection costs, fee assessments and intangible amortization expense.

Non-interest expense of $2.2 billion for the first quarter of 2011 was up $315 million, or 17%, from the first quarter of 2010. The increase was primarily due to an increase in operating expenses related to the recent Sony and HBC credit card loan portfolio acquisitions, higher legal fees and an increase in marketing expenses. As the economy has gradually improved, we have increased our marketing expenditures to attract and support new business volume through a variety of channels.

Income Taxes

We recorded an income tax provision based on income from continuing operations of $354 million (25.5% effective income tax rate) in the first quarter of 2011, compared with an income tax provision of $244 million (25.3% effective income tax rate) in the first quarter of 2010. The variance in our effective tax rate between periods is due, in part, to fluctuations in our pre-tax earnings, which affects the relative tax benefit of tax-exempt income, tax credits and permanent tax items.

We recorded tax benefits of $42 million and $50 million in the first quarter of 2011 and 2010, respectively, related to the resolution of certain tax issues and audits, which lowered our effective income tax rate for those periods. Our effective income tax rate excluding the benefit from these discrete tax items was 28.6% and 30.5% in the first quarter of 2011 and 2010, respectively.

We provide additional information on items affecting our income taxes and effective tax rate in our 2010 Form 10-K under “Note 18—Income Taxes.”

Loss from Discontinued Operations, Net of Tax

Loss from discontinued operations reflects ongoing costs, which primarily consist of mortgage loan repurchase representation and warranty charges, related to the mortgage origination operations of GreenPoint’s wholesale mortgage banking unit, which we closed in 2007. We recorded a loss from discontinued operations, net of tax, of $16 million in the first quarter of 2011, compared with a loss of $84 million in the first quarter of 2010. The decrease in the loss from discontinued operations was attributable to the reduction in the provision for mortgage repurchase losses. We recorded a pre-tax provision for mortgage repurchase losses of $44 million in the first quarter of 2011, of which $39 million ($29 million, net of tax) was included in discontinued operations. In comparison, we recorded a pre-tax provision for mortgage repurchase losses of $224 million in the first quarter of 2010, of which $124 million ($33 million, net of tax) was included in discontinued operations.

BUSINESS SEGMENT FINANCIAL PERFORMANCE

Our principal operations are currently organized into three major business segments, which are defined based on the products and services provided or the type of customer served: Credit Card, Consumer Banking and Commercial Banking. The operations of acquired businesses have been integrated into our existing business segments.

The results of our individual businesses, which we report on a continuing operations basis, reflect the manner in which management evaluates performance and makes decisions about funding our operations and allocating resources. Our business segment results are intended to reflect each segment as if it were a stand-alone business. We use an internal management and reporting process to derive our business segment results. Our internal management and reporting process employs various allocation methodologies, including funds transfer pricing, to assign certain balance sheet assets, deposits and other liabilities and their related revenue and expenses directly or indirectly attributable to each business segment. We may periodically change our business segments or reclassify business segment results based on modifications to our management reporting methodologies and changes in organizational alignment. See “Note 20—Business Segments” of our 2010 Form 10-K for information on the allocation methodologies used to derive our business segment results.

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We summarize our business segment results for the three months ended March 31, 2011 and 2010 in the tables below and provide a comparative discussion of these results. We also discuss changes in our financial condition and credit performance statistics as of March 31, 2011, compared with December 31, 2010. See "Note 14—Business Segments" of this Report for a reconciliation of our business segment results to our consolidated results. Information on the outlook for each of our business segments is presented above under "Executive Summary and Business Outlook."

Credit Card Business

Our Credit Card business generated net income from continuing operations of $643 million in the first quarter of 2011, compared with $489 million in the first quarter of 2010. The primary sources of revenue for our Credit Card business are net interest income and non-interest income from customer and interchange fees. Expenses primarily consist of ongoing operating costs, such as salaries and associated benefits, communications and other technology expenses, supplies and equipment, occupancy costs, as well as marketing expenses.

Table 7 summarizes the financial results of our Credit Card business, which is comprised of Domestic Card and International Card operations, and displays selected key metrics for the periods indicated. The existing HBC credit card loan portfolio of approximately $1.4 billion that we acquired on January 7, 2011 is included in our International Card business. The acquisition of the HBC loan portfolio did not have a material impact on the overall results of our Credit Card business in the first quarter of 2011; however, it did have a material impact on our International Card business.

Table 7: Credit Card Business Results

(Dollars in millions)	Three Months Ended March 31, 2011		2010		Change	
Selected income statement data:						
Net interest income	$1,941		$2,113		(8	)%
Non-interest income	674		718		(6	)
Total revenue	2,615		2,831		(8	)
Provision for loan and lease losses	450		1,175		(62	)
Non-interest expense	1,178		914		29	
Income from continuing operations before income taxes	987		742		33	
Income tax provision	344		253		36	
Income from continuing operations, net of tax	$643		$489		31	%
Selected performance metrics:						
Average loans held for investment	$60,586		$65,922		(8	)%
Average yield on loans held for investment(1)	14.68	%	14.88	%	(20	)bps
Revenue margin(2)	17.26		17.18		8	
Net charge-off rate(3)	6.13		10.30		(417	)
Purchase volume(4)	$27,797		$23,924		16	%

(Dollars in millions)	March 31, 2011		December 31, 2010		Change	
Selected period-end data:						
Loans held for investment	$59,305		$ 61,371		(3	)%
30+ day delinquency rate	3.88	%	4.29	%	(41	)bps
Allowance for loan and lease losses	$3,576		$ 4,041		(12	)%

(1) Average yield on loans held for investment is calculated by dividing annualized interest income for the period by average loans held for investment during the period. In preparing our first quarter 2011 Form 10-Q, we determined that beginning in the second quarter of 2010 our management accounting processes excluded certain accounts that should have been included in the calculation of the average yield on loans held for investment. The mapping error was limited to the average yields on loans held for investment for our Credit Card business and had no impact on income statement amounts or yields reported for any other business segments or for the total company. The previously reported and corrected average loan yields for our Credit Card business for each period affected are presented below.

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Three Months Ended				Six Months Ended	Nine Months Ended
March 31, 2011	December 31, 2010	September 30, 2010	June 30, 2010		