Capital One Financial Corporation

Dodd-Frank Act Company-Run Stress Test Disclosures

July 23, 2015

Explanatory Note

Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) requires that certain bank holding companies, including Capital One, conduct stress tests twice per year to assess the potential impact of certain scenarios on the consolidated earnings, losses, and capital of each bank holding company ("BHC"), taking into account its current condition, risks, exposures, strategies and activities.

Capital One conducted the Dodd-Frank Act Stress Tests ("DFAST") in the second quarter of 2015 using its actual performance through the first quarter of 2015 and information available at that time. Capital One submitted the full results of its stress tests to the Federal Reserve on July 6, 2015.

The Dodd-Frank Act also requires that Capital One disclose a summary of the stress test results under Capital One’s Severely Adverse Scenario. Capital One’s Severely Adverse Scenario represents a hypothetical economic situation which includes assumptions of economic worsening that are at least as severe as the economic conditions experienced in the 2008 recession. The summary of Capital One’s results must include estimates of the aggregate impact of the stressed economic scenario on certain financial metrics over the nine-quarter planning horizon. Capital One must provide estimates of its regulatory capital ratios under the Basel III Standardized Approach framework and for DFAST purposes we are also required to provide the Tier 1 common ratio as calculated under the Basel I capital framework. For additional information regarding the Dodd-Frank Act and U.S. capital rules and their impact on Capital One, see “Part I—Item 1. Business—Supervision and Regulation” of our Annual Report on Form 10-K for the year ended December 31, 2014.

Certain statements and estimates below may be forward-looking, including those that discuss, among other things: loss projections, revenues, income, capital measures, accruals for litigation and other claims against Capital One, future financial and operating results, Capital One’s plans, objectives, expectations and intentions, and the assumptions that underlie these matters. Capital One cautions readers that the results in the summary below are not forecasts, predictions of future performance, or measures of its solvency; actual results could differ materially from those contained in this summary. In addition, these results do not represent Capital One’s current expectations regarding future results of operations or financial condition. They are based on hypothetical scenarios and other assumptions used for the sole purpose of conducting the required stress tests, and Capital One makes no assurances or predictions about the likelihood of any of these scenarios or assumptions actually occurring. Capital One does not undertake any obligation to update or revise any of the information contained herein whether as a result of new information, future events, or otherwise.

The stress test results below are expected to differ from the stress test results produced by the Federal Reserve in its annual Comprehensive Capital Assessment and Review ("CCAR") process due to differences in methodologies and assumptions used to produce the results. Refer to the section below entitled *“Considerations in Assessing our DFAST Projections”* for more information.

Scenario Description

Capital One's Severely Adverse Scenario assumes significant deterioration in economic conditions from current levels, creating large reductions in employment, home prices and GDP, among other factors. Under this scenario, the U.S. is assumed to fall into a severe recession, with the unemployment rate increasing five percentage points to a peak of 10.4% in the fourth quarter of 2016 before improving modestly to 9.9% by the end of the stress horizon (second quarter of 2017). Our Severely Adverse Scenario also projects a significant drop in home prices. Home prices are assumed to decline 26% from the beginning level of the stress test to a low point in the fourth quarter of 2016, while commercial real estate prices decline 29% at their trough.

In addition to the adverse economic assumptions reflected in our Severely Adverse Scenario, we have incorporated the impact of non-economic risks in our projections, including the risk of higher representation and warranty claims arising from mortgages that were originated principally by predecessor companies between 2005 and 2008, elevated levels of operational losses, and other risks related to Capital One's unique risk profile and portfolio composition.

While these risks are not necessarily correlated with the economic conditions reflected in our Severely Adverse Scenario, we assume that they could manifest in an environment generally characterized by the types of conditions described in the scenario. Accordingly, we included the impact of these risks in our Severely Adverse Scenario concurrent with the impacts assumed to result as a direct consequence of the stressed economic environment.

Overview of Stress Test Methodology and Approach

Our stress test methodology considers a broad range of potential stresses to our balance sheet and capital levels, including potential impacts to our interest rate risk position, balance sheet composition, and levels of pre-provision net revenue ("PPNR"), charge-offs, allowance for loan and lease losses, and tax. The stress analysis and underlying assumptions are informed by a number of factors, including the performance we have observed in our portfolios through prior actual stress periods, including the 2008 recession.

In our Severely Adverse Scenario, the largest impact to our capital ratios comes from changes in credit performance and the corresponding impact to our disallowed deferred tax asset ("DTA") position. For our credit card, auto and home loan portfolios, we project stressed losses using account-level econometric models, which incorporate Metropolitan Statistical Area ("MSA") level variables. In our commercial portfolios, most of our loss modeling estimates the impact of a given stress scenario at the borrower-level, capturing the effects of varying loan characteristics and collateral positions, among other factors. In select portfolios, we use more aggregated economic forecasting approaches that incorporate the specific macro-drivers relevant to each portfolio, including customer and relationship-level attributes.

Once credit has been modeled, we translate our overall credit outlook into projected allowance for loan and lease loss levels for each quarter. We also use our stressed views of credit losses to estimate second order impacts of credit worsening, such as the increase in operating costs related to collections and other loss-mitigation activities, the impact on finance charge and other fees (assessments, reversals and reserves), and the reduction in future revenue due to the inevitable reduction in outstanding balances from higher losses. The impacts on fees and operating costs are estimated based on historical data, modified as needed to reflect changes due to new legislation, regulations, or business practices.

We model PPNR based on the expected performance of our various businesses to estimate the impact that our Severely Adverse Scenario would have on our overall financial performance. The projected impacts are based on the characteristics of each asset and liability class and the related support costs for new originations, ongoing management, and underlying infrastructure for each business. Our revenue modeling is divided into net interest income and non-interest income, and our non-interest expense modeling is split between operating and marketing expenses.

In addition to modeling the income statement impact of our Severely Adverse Scenario, we capture the projected impact of the stressed environment on our balance sheet size and composition. The three main factors impacting our balance sheet projections are: (1) the impact to existing loan balances of higher charge-offs; (2) the impact to growth in loan balances due to changes in demand; and (3) the impact to loan growth from fewer lending opportunities meeting our profitability and resilience requirements as our models and underwriting scorecards systematically incorporate leading credit indicators to reflect the worsening credit conditions in the financial projections used in underwriting. As we have observed in prior stress periods, these three factors have the natural result of quickly reducing the size of our combined loan portfolio.

Additionally, because of the high volume of new originations required to maintain and grow our credit card portfolio balances, we incur much higher marketing costs as a percent of risk-weighted assets than most banks subject to stress testing under the Dodd-Frank Act. This distinction is important to note because these costs naturally drop in a worsening credit environment, as our underwriting models are recalibrated to the environment resulting in fewer lending opportunities and less marketing expense.

Results of Capital One Internal Modeling in the Capital One Severely Adverse Scenario under the DFAST Rules

Table 1.1: Actual Q1 2015 and Projected Stressed Capital Ratios through Q2 2017 under the DFAST rules in Capital One's Severely Adverse Scenario

	Consolidated Parent (COFC)[1]		
	Actual	Stressed Ratios[2]	
	Q1 2015	Q2 2017	Minimum
Tier 1 common ratio	13.1%	10.5%	9.5%
Common equity Tier 1 capital ratio	12.5	10.5	10.1
Tier 1 risk-based capital ratio	13.2	11.7	11.3
Total risk-based capital ratio	15.1	13.3	13.0
Tier 1 leverage ratio	10.7	9.8	9.2

(1) The Tier 1 common ratio is calculated based on the Basel I capital framework throughout the forecast horizon and the ratio is only utilized for purposes of the stress tests. The common equity Tier 1 capital ratio, Tier 1 risk-based capital ratio, total risk-based capital ratio, and Tier 1 leverage ratio are calculated based on the Basel III Standardized Approach framework including transition provisions that started in Q1 2014. As an Advanced Approaches BHC we are subject to the revised capital framework that the Federal Reserve adopted in connection with the implementation of the Basel III accord, including the framework's minimum regulatory capital ratios. For more details on the differences between Capital One's Basel I and Basel III Standardized Approach capital ratios, please refer to the Capital Management section of Capital One's 2014 Annual Report on Form 10-K.

(2) The capital ratios presented represent the minimum and the end of period ratios for the nine quarter forecast horizon from Q2 2015 to Q2 2017.

Table 1.2: Actual Q1 2015 and projected Q2 2017 risk-weighted assets under the DFAST rules in Capital One's Severely Adverse Scenario

	Consolidated Parent (COFC)		
	Actual	Projected Q2 2017	
(Dollars in billions)	Q1 2015	General Approach	Basel III Standardized Approach
Risk-weighted assets[1]	$ 238.0	$ 210.9	$ 218.4

(1) For each quarter during the projection window, risk-weighted assets are calculated under the Basel III standardized capital risk-based approach, except for the Tier 1 common ratio which uses the general risk-based capital approach for all quarters.

Table 1.3: Projected Revenue, Losses and Net Income Before Taxes for Q2 2015 to Q2 2017 under the DFAST rules in Capital One's Severely Adverse Scenario

(Dollars in billions)	Consolidated Parent (COFC) Amount	% of Average Assets[1]
Pre-provision net revenue[2]	$ 18.3	6.2 %
Other revenue[3]	—	
Less:		
Provisions	22.3	
Realized losses/(gains) on securities available for sale	0.5	
Trading and counterparty losses[4]	—	
Other losses/(gains).	—	
Net income before taxes	$ (4.5)	(1.5)%
Supplementary information:		
Other comprehensive income[5]	$ (0.6)	
Other effects on capital	**Actual Q1 2015**	**Q2 2017**
AOCI included in capital calculations[6]	$ (0.2)	$ (0.9)

(1) Expressed on a nine-quarter cumulative basis as a percentage of average assets over the same time period.

(2) Pre-provision net revenue includes stress adjustments for operational risk events, and expenses including mortgage representation and warranty and real estate held for sale.

(3) Other revenue includes one-time income and expense items not included in pre-provision net revenue.

(4) Trading and counterparty losses include mark-to-market losses, changes in credit valuation adjustments ("CVA") and incremental default losses and losses arising from the counterparty default scenario component applied to derivatives, securities lending, and repurchase agreement activities.

(5) As an Advanced Approaches BHC under the new capital framework, accumulated other comprehensive income ("AOCI") is included in calculations of regulatory capital subject to the transition provisions. Other comprehensive income includes incremental unrealized losses/gains on available for sale securities.

(6) 40 percent of AOCI is included in capital calculations for 2015, 60 percent of AOCI is included in capital calculations for 2016, and 80 percent is included in capital calculations for 2017.

Table 1.4: Projected Loan Losses by Type of Loans for Q2 2015 to Q2 2017 under the DFAST rules in Capital One's Severely Adverse Scenario[1]

(Dollars in billions)	Consolidated Parent (COFC) Amount	% of Average Portfolio Balances[2]
Loan losses:		
First lien mortgages, domestic	$ 0.1	0.5%
Junior liens and HELOCs, domestic	0.1	5.0
Commercial and industrial[3]	1.2	5.1
Commercial real estate, domestic	0.6	2.6
Credit cards	13.7	18.0
Other consumer[4]	2.5	6.0
Other loans	0.2	1.4
Total loan losses	$ 18.4	9.1

(1) Reflects loan classification under regulatory reporting FR Y9-C - Consolidated Financial Statements for Holding Companies. This classification is different than how Capital One classifies loan product types for Securities and Exchange Commission ("SEC") reporting purposes. For example, FR Y9-C - Consolidated Financial Statements for Holding Companies requires that small business credit card loans be reported under commercial and industrial, whereas these loans are reported under credit card for SEC reporting purposes.

(2) Average loan balances used to calculate portfolio loss rates exclude loans held for sale and are calculated over nine quarters.

(3) Includes small and medium enterprise loans and corporate cards.

(4) Includes auto loans.

Description of Projections

We have calculated our regulatory capital ratios over the second quarter of 2015 to the second quarter of 2017 stress horizon using the Basel III Standardized Approach. For purposes of DFAST, we are also required to calculate our Tier 1 common ratio using the Basel I capital framework. Under the Basel III Standardized Approach, we are required to maintain our common equity Tier 1 capital ratio above 4.5%. Furthermore, the Federal Reserve requires a minimum level of Tier 1 Common of 5%. Our performance under the DFAST stress tests, including these capital ratios, are used by the Federal Reserve for their evaluation of Capital One's capital adequacy.

In our modeling of our Severely Adverse Scenario, our capital ratios are projected to be lower than in our baseline, but would still remain well above current regulatory requirements. Our Tier 1 common ratio under the Basel I capital framework is projected to be our most binding capital ratio and is projected to decline to a low point of 9.5% in the second quarter of 2016. This low point is driven primarily by reserve builds in our consumer lending businesses and a disallowed DTA position. We project capital accretion after the low point, beginning in the third quarter of 2016 through the end of the scenario.

We generally project the Basel III Standardized Approach's common equity Tier 1 capital ratio to be higher than the comparable Basel I Tier 1 common ratio. In our projections, the phase in impacts of new elements in the Basel III Standardized Approach capital calculation such as AOCI in common equity Tier 1 capital, and the differential treatment of other elements that affect capital such as deferred tax assets to the extent that they are disallowed (inclusive of any applicable phase-in provisions), results in a higher absolute common equity Tier 1 capital ratio than the Tier 1 common ratio for the same period.

The largest impact to our projected income forecasts in our Severely Adverse Scenario is due to the provision for credit losses. This impact is most pronounced in our credit card and auto loan portfolios. The provision for credit losses is projected to increase, initially driven by the builds in the allowance for loan and lease losses (reflecting credit deterioration) and later by elevated charge-offs (as the housing and labor markets deteriorate). Consistent with our experience in the last recession, as the economic stress dissipates and our loan balances decline due to elevated charge-offs and reduced new origination activity, we forecast allowance releases toward the end of the nine-quarter period.

In addition to the provision for credit loss impact described above, we project revenues to decline as our loan portfolio contracts and reversals of finance charges and past due fees increase with rising charge-offs. We incorporate modest rate cuts in deposits, along with other management actions, to reduce costs and to partially offset the decline in demand for credit and resulting lower funding needs. We also expect marketing expense to decline (primarily due to lower originations), while operating expenses would be reduced modestly as higher collections and recoveries costs and costs associated with the idiosyncratic risks described above partially offset projected operating expense reductions due to lower originations and a smaller portfolio.

The largest impact to our balance sheet in our Severely Adverse Scenario is to the size of our loan portfolio. In addition to the direct impact of higher charge-offs, in a period of economic stress we typically experience reduced loan demand and, in response to deteriorating credit, our underwriting models systematically recalibrate using leading credit indicators and identify fewer lending opportunities, which naturally reduces marketing. These shifts rapidly help to offset deterioration in both our earnings and capital ratios by reducing non-interest expense and by shrinking the balance sheet. The impact to balance sheet size driven by reduced loan demand and the natural reduction in lending opportunities that occur under economic stress is particularly pronounced for Capital One given the consumer-centric composition of our portfolio. Compared to most banks subject to stress testing under the Dodd-Frank Act, a much larger share of our loan portfolio is in asset classes that attrite quickly, specifically auto loans and credit cards.

Different factors drive the rapid attrition in these two asset types. Auto loans are amortizing loans with original terms typically ranging from four to six years. In addition to the relatively short contractual life of these loans, there is a significant amount of voluntary prepayment on auto loans as consumers pay off loans early, usually due to the sale or trade in of the vehicle. While credit cards are revolving products that do not have the contractual amortization characteristics of auto loans, the impact of elevated losses and other factors, such as the voluntary paydown of balances, results in relatively rapid asset attrition. Due to this natural run-off, our credit card and auto loan portfolios shrink meaningfully absent a high level of new account originations.

As a result of our concentration in consumer lending, our marketing budget is disproportionately large compared to most other banks. For 2014, our marketing expense was $1.6 billion. The natural reduction in our marketing as our underwriting models identify fewer lending opportunities that meet our profitability and resilience requirements is a meaningful lever for improving earnings and capital ratios under stress. The combination of lower loan demand that we expect to occur as the economy deteriorates, and fewer opportunities as our underwriting models systematically recalibrate to the worsening environment, immediately reduces our need for marketing. In our Severely Adverse Scenario, we anticipate that marketing expense would naturally drop beginning in the second half of 2015, partially offsetting the negative impact on our earnings from the downturn.

These assumptions are grounded in historical experience and the dynamics of our business. In addition to the direct impact to loan balances of higher charge-offs, we have observed the dynamics of reduced demand and tighter underwriting in past recessions and anticipate similar dynamics in future downturns. Importantly, these actions do not require us to form assumptions regarding competitor actions like changes in price; rather, they are rooted in our own lending choices, the direct consequence of charge-off-driven reductions in loan balances, and the natural tightening that occurs as fewer lending opportunities meet our profitability and resilience requirements.

Considerations in Assessing our DFAST Projections

Our DFAST stress testing scenarios, methodologies and assumptions are specific to Capital One.

By design, DFAST is a company-specific exercise, with scenarios, assumptions, models and methodologies customized by each participating bank to reflect their unique profile and business model of each of our portfolios. Our models incorporate vast amounts of detailed, internal performance data as well as customer and loan characteristics that we have, for years, systematically captured and used for decision-making and ongoing financial management. As a result, we believe that Capital One's company-run DFAST results provide a reasonable scenario of how our businesses would perform through a period of severe stress.

There are fundamental differences between our DFAST stress testing methodology and the Federal Reserve's approach in CCAR stress testing.

While we do not have insight into the specific inputs or assumptions contained in the CCAR stress test models, the Federal Reserve appears to use industry-wide models without adjustments for differences in business practices and results among banks. To the extent the Federal Reserve uses an "industry average" modeling approach, important differences in our portfolio composition or our business model and practices may not be fully captured, even though our specific portfolio composition and business model have produced historical results that differ meaningfully from industry average, including through the Great Recession. The fundamental differences between our DFAST and the Federal Reserve's CCAR stress testing methodologies have contributed to the divergence between our DFAST stress test projections and the Federal Reserve's CCAR projections in past stress tests. We expect both the methodology differences and the divergence between our DFAST and the Federal Reserve's CCAR stress test results to continue in future stress tests.

Only the Federal Reserve's CCAR stress testing results determine capital distributions capacity.

Since the approval of any proposed capital distributions is ultimately determined by the Federal Reserve's CCAR projections, our DFAST results and projections should not be interpreted as an accurate indicator of our ability to make future distributions of capital.

Our stress test performance could be negatively impacted when we exit parallel run.

We entered Basel III Advanced Approaches parallel run on January 1, 2015, and to exit we must complete a qualification period of at least four quarters. Upon exiting parallel run, we will become subject to the Basel III Advanced Approaches framework for purposes of determining our regulatory capital requirements. Given that we are still in parallel run, there is uncertainty around certain modeling approaches and regulatory interpretations which could impact our risk-weighted asset calculations under the Basel III Advanced Approaches framework. We also cannot be sure what impacts the use of Basel III Advanced Approaches will have on stress testing methodology or results. For additional information, see "Part II—Item 7—Management's Discussion and Analysis of Financial Condition and Results of Operations—Capital Management" of our Annual Report on Form 10-K for the year ended December 31, 2014.

Our performance in future stress periods may not be consistent with past stress periods.

Stress tests have been an important tool in our overall risk and capital management approach for many years. Over time, we have developed a robust methodology and comprehensive set of models to simulate Capital One's performance under a range of scenarios.

While we have incorporated our observations from actual results over the course of past economic downturns - most notably those from the 2008 recession - into our methodologies and models, there can be no assurance that our methodologies and models will be accurate predictors of our performance or capital levels in future downturns. Similarly, while our stress tests include a range of hypothetical economic stress scenarios, there can be no assurance that future recessions will have the same severity or profile as the scenarios we have modeled.