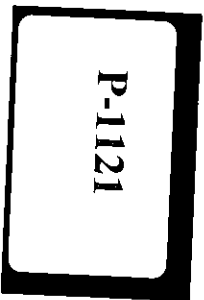


# Debit Card Update

December 16, 1996

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# Objectives

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- Make decision to pilot and agree to “stake-in-the-ground” timeframes. Key factors to consider:
  - ◊ Market environment
  - ◊ Economics
  - ◊ Platform priorities
- To support the decision process we will:
  - ◊ Confirm American Express strategic objectives.
  - ◊ Review American Express capabilities and requirements.
  - ◊ Agree to critical functionality, market acceptance and delivery risk.

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# Debit Card Project Team

Representative	Business Unit	Function
Adam Rothschild	CCSG	New Product Development
Brian Werther	CCSG	New Product Development
Jeanne Lin	CCSG	Acquisitions
Birgitta Mayer	CCSG	Billing
Janette Hausler	E/S	Business Development
Sean Conroy	E/S	Business Development
Greg Kennelly	SVG	Campus Funds
Terri Hasson	AECB	Compliance
Charlotte Patricca	CCSG	Express Cash Operations
Mike Needleman	CCSG	Finance
Mandel Skovronsky	TRS	Finance
Tom Buckingham	AECB	Fraud
Dan Casper	CCSG	Global Statement Development
Robert Kraus	TRS	Legal
Rhonda Senior	CCSG	Market Research
Deborah Campbell	CCSG	Market Research
Sheri Mullins	AECB	New Accounts
Cynthia Barber	CCSG	Operations - New Product Services
Rich Lopez	CCSG	Operations - New Product Services
Maura Albers	CCSG	Product Marketing
Andy Yost	CCSG	Product Marketing
Chuck Qi	CCSG	Risk Management
Hermes Saad	CCSG	Risk Management
Bruno Jimenez	TRS	Technologies
Mike Boland	TRS	Technologies - E-Payments
Cynthia Ryan	TRS	Technologies - U.S. Systems
Don Nielsen	AECB	Technical/ Information Systems

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# Project History

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- In 1984, an off-line debit product was first explored by American Express.
- This is the third team, since 1992, attempting to pilot a debit product.
- The project stalled each time since critical questions with regard to spend, credit losses and customer desire to acquire could not be answered.
- Given today's rapidly changing marketplace, and increased knowledge about the debit market potential, we hope that this time we can avoid further delays to pilot an American Express Debit Card.

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## Product Definition: What is Debit?

Within the card industry today there are four types of debit cards:

- On-Line Debit Cards: Most common card in the market, generally used at automatic teller machines (ATMs).
- On-Line/Off-Line Debit Cards: Aggressively being pushed by MasterCard, Visa and issuing banks. Combines full on-line and off-line functionality. Accepted wherever Visa and MasterCard are welcome.
- Off-Line Debit Cards: Offered by issuers who don't own customer DDA accounts. American Express recommendation.
- Deferred Debit Cards: Works like a charge card, however, once a month a debit occurs when the statement is issued (e.g. autopay, IMA).

(See exhibit A for additional detail; pg. A-3)

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# Executive Summary

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The following points should be considered when reviewing the opportunity for American Express to issue an off-line Debit card.

## Strengths:

- Strengthens brand relevance.
- Drives more transactions/revenue through the existing SE network.
- No interest expense, lower credit/fraud losses.
- Under current assumptions, strong financial performance.

## Weakness:

- Will not provide full ATM functionality.
- Must provide an incentive program to drive acquisitions and usage since Amex does not own the DDA.
- Given current assumptions, business can only lower the merchant discount rate to 175bp, by 1998, and remain marginally profitable.

## Opportunities:

- Significant financial opportunity if current assumptions are understated.
- Future linkages with Network partners, AECB, AEFD, SBS and Campus Funds.

## Risks/Issues:

- Waiting -- Customer behavior is set before American Express establishes a market position.
- Technology/capacity/prioritization issues.
- SE pricing/product challenges.
- Express Cash pricing
- Financial assumptions, specifically credit and spend, have yet to be tested.
- Consumer appeal.
- If pilot is successful, the model could be easily copied by competitors.
- Usage/acquisition costs.

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# Market Situation

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- Primary Debit Card competitors are the banks which issue ATM/debit cards with their accounts. The trade press reported that non-bank issuers such as Discover are considering entering the market but have yet to do so.
- Total debit currently accounts for 1% (approximately \$63 billion in 1995) of all payment methods (e.g. checks, cash, credit cards, etc.)--expected to account for 5% in the Year 2000
- Mid-year 1996 off-line debit transactions and \$ volume increased 52% (from the first six months of 1995), reaching 1 billion transactions and \$38.1 billion in volume. Growth is forecasted to grow at an annual rate of 39% through 2000; then slowing to 18% between 2000-2005.
- Off-line products are driving this exponential growth. In the first half of 1996, off-line debit transactions grew 65% from the previous year while on-line transactions grew 38%.
- The top 15 off-line issuers account for approximately 43% of total off-line cards issued--major issuers include Bank One, First Interstate, and Bank of America (See exhibit C for detail; pg. A-7).

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## Market Situation (continued)

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- Wal-Mart Stores, Inc. and the Limited, Inc. filed an antitrust suit against Visa, arguing they should not be forced to accept Visa check cards (Debit Cards). The suit is based on the fees an SE is charged for an off-line transaction (about 1.04%) versus an on-line transaction (about 10 cents per transaction, equivalent to 0.23% based on average ROC). Bernie's Army-Navy Store of Vineland, NJ filed a similar lawsuit against Visa and MasterCard. At this point in time, given the scale of the pilot, the SE organization plans to hold pricing constant for an Amex debit test. Legal developments are being monitored by the GCO.
- Wal-Mart is developing its own check based, electronic debit capability. Scanners are being installed at POS that record the routing (ABA) and account numbers printed on the bottom of traditional paper checks. The amount of the check, and the ABA/account numbers, are converted to an electronic transaction and are sent through the ACH. The benefits for Wal-Mart developing this system are:
  1. Quicker transaction processing time, fewer "bounced" checks.
  2. Reduces back-end handling/processing costs.
  3. Increases Wal-Marts bottom line by avoiding discount rates imposed by issuers.
  4. Provides flexibility to "challenge" the acceptance of Visa or MasterCard Debit products.
- In the UK, Barclay's Bank had to significantly reduce their Discount Rate for Debit products, after they had a battle with their merchants. The price dropped to approximately 20bp.

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# Visa/MasterCard Strategy

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- Visa dominates the market. The Visa Check Card has captured 86% of the off-line market and 55% of the total on-line/off-line debit market. (e.g. Chase ATM Card).
- Visa and MC issuers continue to aggressively promote off-line products-- by year-end 1995, 32MM Visa (up 52%) and 7.5MM (up 78%) MC branded cards were in force.
- Banks are attracted to the increased transaction revenue, reduced check processing costs and broadened customer relationships associated with issuing the Visa/MC branded debit cards.
- Visa and MasterCard are supporting issuing banks with national product advertising, turn key training and sales incentive programs, marketing materials and usage stimulation incentives (e.g. MasterCard Sweepstakes to win a Chrysler Convertible).
- Visa's off-line debit is priced below credit at 1.04% + \$0.06 (except supermarkets at \$0.36) -- automated Visa interchange for credit is 1.25%. MasterCard has not published a separate rate for off-line debit.

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## Research Findings/Implications

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Both qualitative and quantitative research indicate that there is potential for an American Express debit card.

- Demand for debit continues to grow. However, because consumers show a clear preference for their banks as their debit card provider, American Express will need to enter the market with a product that offers a superior value proposition.
- To increase appeal, American Express will need a 'feature-rich' product. A cash back reward program is appealing to consumers. Additionally, features such as photo ID and purchase protection would add value.

### Key results include:

#### User Behavior: There appears to be potential for significant spend on debit products:

- Users in both mature and infant markets tend to have higher HH incomes than non-users. In addition, those interested in an American Express issued debit product tended to have a higher income than the average debit user.
- Users use their debit cards on average 7X/month. Total debit card spending ranges, on average, from \$288 - \$374 per month.
- In grocery stores, where the debit card is used the most, debit spending replaces cash or check for 93% of respondents, suggesting that the threat of cannibalization to charge and credit spending is small. The median transaction size is approximately \$65.

# Research Findings/Implications

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## Acquisition Intent

- On average, about half of non debit-owners intend to obtain a card within the next year. An American Express issued product would draw most of its share from this group indicating a possibly limited window of opportunity.
- A no-frills concept has some appeal, enabling American Express to capture 2% - 3% market share -- better than our financials. In addition, an enhanced product lifts this share forecast to greater than 7%. A fee free product is significantly more attractive than a fee based product.
- Not surprisingly, the preferred provider of a debit card is the consumer's Bank.
  - ◊ 55% of Cms and 60% of prospects prefer their current institution.
  - ◊ American Express is the second choice of CMs, preferred by 30%.
  - ◊ VISA is the second choice of prospects, preferred by 21%.
  - ◊ American Express is the last choice of prospects.
- Despite our initial concerns, the issuance of an additional statement and incremental plastic would have no impact on the acquisition intent of a majority (roughly 80%) of respondents.
- And, if the statement can be cross referenced to the respondents' checking account, the additional statementing issue almost entirely disappears.
- When asked, "In order for the American Express Debit Card to work, American Express would require direct access to your checking account so funds can be withdrawn from your account when you make a purchase. How would you find this arrangement?" 60% of respondents found this access very or somewhat acceptable. 17% were neutral, 23% negative.

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# American Express Strategic Goals

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## CCSG

- Strengthen our brand relevance in a new purchase category.
- Establish a market position before customer usage patterns are set.
- Support the business' goal of profitably capturing 100% of Customer Plastic Spend.
- Expand recovery business product arsenal.
- Support network initiatives.
- Critical functionality for future Smart Card initiatives.

## ES

- Build S/E relevance by driving more transactions through the existing network.
- Build merchant processor scale through increased transactions.
- Supports ability to price and penetrate low margin segments more profitably (debit has a lower cost structure than credit/charge products).
  - ◊ Zero float - no interest expense.
  - ◊ Lower credit and fraud costs.

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# American Express Strategic Opportunities

## Key Options Considered

- Option 1: Off-line Debit
- Option 2: On-line Debit
- Option 3: On-line/Off-line
- Option 4: Network
- Option 5: Deferred Debit: Statement Driven Direct Debit.

The following page outlines the strengths/weaknesses of off-line debit, the recommended option. At this time, we are recommending a CCSG Off Line Debit pilot as the first step into the market, while we continue to pursue Network feasibility.

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# American Express Strategic Opportunities

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## Option 1: Off-line Debit Card (Recommended)

### Strengths:

- Established POS network (4.77MM) includes all American Express SE's, world-wide.
- Supports the Brand.
- Earns Merchant Discount Revenue.
- Can debit a checking (DDA) account at any bank.

### Opportunities:

- AECB synergies (dual plastic strategy).
- Campus Funds Linkage - allows colleges to promote American Express w/o specific bank alliances.
- SBS applications.
- Can build and test deferred debit capabilities with minimal incremental work/costs.
- Build experience and some technology to support a network product.

### Weakness:

- Cash access limited to Express Cash network. (Fees apply for test purposes). See exhibit E for additional detail; pg. A-12.
- 3-7 day delay before funds are deducted from account.
- Does not provide full ATM functionality (e.g. may not provide cash at own bank).
- Incremental plastic and statement required.

### Risks/Threats:

- Waiting.
- Customers hesitant to release DDA information.
- Incentive program does not provide sufficient value proposition.
- Other non-banks entering the market (Discover, First USA).

(See exhibit D for additional options; pg. A-8)

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# Summary of Debit Economics

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- **Product Target Assumptions:**

- ◇ 0.5% (\$707 million in charge volume) off-line debit market share in Year 1 of roll-out, 1998\*
- ◇ 1.3% (\$5 billion in charge volume) off-line debit market share in Year 5\*
- ◇ 1.4MM Cards in Year 5

\* Based on Debit Market Volume Forecast; The Nilson Report, number 627, 9/96

- **Key Financial Assumptions:**

- ◇ Avg. Spend: \$2,888 (yr. 1) to \$3,697 (yr. 6)
- ◇ Avg. ROC: \$52.5 (yr. 1) to \$57.93 (yr. 6)
- ◇ Monthly Fee: \$1
- ◇ Acquisition Mix:
  - Year 1 - 60% CMs, 40% Prospects
  - Year 6 - 40% CMs, 60% Prospects
- ◇ Response Rate
  - Cardmembers: 2.0%
  - Prospects: 1.0%
- ◇ Credit/Fraud: 70% improvement over Personal Card.
- ◇ SE Discount Rate: 2.65% declining to 2.0% by the year 2000.

- **Based on these assumptions, an American Express Debit product could generate:**

- ◇ \$33.1MM NPV (w/out terminal value)
- ◇ \$75 NPV/acct (w/out terminal value)
- ◇ \$35.2MM PTI in 2002
- ◇ \$46 PTI Per Card (Steady State)
- ◇ 1.16% PTI as % Billings (Steady State)
- ◇ 4.1 year payback
- ◇ 71% ROA in 2002
- ◇ 636% ROE in 2002
- ◇ 1.34% Profit Margin on Spending (Steady State)

(See exhibit G for more detail; pg. A-14)

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# Summary of Debit Economics: Sensitivities

The following illustrates top-line sensitivities for multiple vintages (6 year) to 2002:

<b>Base Case</b>	<b>\$33.1MM NPV*</b>	<b>4.1 year payback</b>	<b>\$35.2MM PTI in 2002</b>
------------------	----------------------	-------------------------	-----------------------------

<b>Cardmembers Only</b>	<b>Spending Increases 10%</b>	<b>Credit Improves Add'l 10%</b>
\$39.1MM NPV*	\$45.8MM NPV*	\$45.7MM NPV*
2.5 year payback	3.5 year payback	3.5 year payback
\$24.0MM PTI in 2002	\$41.5MM PTI in 2002	\$41.3MM PTI in 2002

<b>Spending Decreases 10%</b>	<b>Credit Improvement Decreases 10%</b>	<b>No Fee **</b>
\$20.4MM NPV*	\$20.5MM NPV*	(\$107.1MM) NPV*
4.4 year payback	4.4 year payback	Payback N.A.
\$29.0MM PTI in 2002	\$29.3MM PTI in 2002	(\$28.7MM) PTI in 2002

<b>Budget Increases \$1,500M For 1st Year Reward Program***</b>	<b>Budget Increases For Cash Back Reward Program****</b>	<b>Response Rate Drops; 1% CMs, 0.5% Prospects</b>
\$31.7MM NPV*	(\$12.6MM) NPV*	(\$13.2MM) NPV*
4.1 year payback	7 year payback	6.3 year payback
\$35.2MM PTI in 2002	\$11.3MM PTI in 2002	\$22.5MM PTI in 2002

\* All NPVs are without Terminal Value.

\*\* Spend decreases 50%, Credit reduced by 50%. RR% improves (CM 3%, Pros 2%), CIF increased.

\*\*\* Second year reward program is assumed to be PCR.

\*\*\*\* Assumed at 51.5bp/\$1.00, based on 50% of the costs assumed for Optima Cash Back test (103bp/\$1.00). Fulfillment costs not included.

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# Summary of Debit Economics: Break-Even Analysis

## Sensitivities On A Single Vintage Group: Break Even Values:

- A single vintage group of 40,000 Debit Cardmembers, joining in 1997, will yield an NPV of \$3.01MM in 6 years (w/out terminal value). The following illustrates how much the base case assumptions can be changed for the Debit Card product to break even.

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	Base Case	Break-Even Values			Comments
		Overall	Cardmembers	Prospects	
NPV (w/out t.v.)	\$3.01MM				
per account	\$75.25/acct.				
Spending	\$2,888	\$1,549	\$1,266	\$2,048	The required spending for Cardmembers is lower than Prospects due to RR% and Credit.
Discount Rate in 2000	2.00%	0.711%	0.338%	1.269%	The discount rate is the same as Personal Card through 1998, it can reach these low values by 2000.
Credit Improvement	70%	22%	(11%)	50%	Cardmembers can have worse than Personal Card average for break-even.
Response Rate	1.60%	0.434%	0.342%	0.484%	Can fall significantly and still break-even.
Rewards	0bp	69bp	89bp	39bp	Represents a reward payment in addition to PCR (assumed to be available in 1998).
Funds Access (\$/acct.)	\$0.16	\$23.82	\$30.69	\$13.51	Funds Access fees can be eliminated, and the expenses can be increased to these values for break-even.

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# Summary of Debit Economics: Sensitivities

## Discount Rate Sensitivities:

- The following chart shows the 5 year NPV (w/out terminal value) of the Amex Debit Card should the discount rate fall from the current level of 2.65% to 2%, 1.5% or 1% by the year 1997, 1998 or 2000. The following illustrates the 1997 single vintage group from a blended population of Cardmembers and Prospects.

	<u>1997 Vintage Group</u>			<i>Break Even</i>
	2.00%	1.50%	1.00%	
by 2000	\$3.01MM*	\$1.84MM	\$0.67MM	0.711%
by 1998	\$2.08MM	\$0.21MM	\$(1.67MM)	1.445%
by 1997	\$1.71MM	\$(0.46MM)	\$(2.62MM)	1.605%

\* Base Case

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# Summary of Debit Economics: Worst Case Scenario

- In worst case scenarios, a single vintage group of 40,000 Debit Cardmembers joining in 1997 will generate an NPV losses up to (\$3.48MM). Although the six vintage worst case is extremely negative, the product would be terminated, or modified, long before such losses could be incurred.

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	<u>Base Case</u>	<u>Worst Case A</u> Spend/fees reduced Discount rate lower Higher Credit risk Response rate drop	<u>Worst Case B</u> Same as A except.. Even lower discount rate	<u>Worst Case C</u> Same as A except.. No Fee
NPV (w/out terminal value)				
One Vintage	\$ 3.01MM	(\$ 2.72MM)	(\$ 3.32MM)	(\$ 3.48MM)
Six Vintages	\$33.07MM	(\$109.68MM)	(\$132.23MM)	(\$127.41MM)
<b>Assumptions:</b>				
Spending per Debit Account (1997)	\$2,888	\$1,500	\$1,500	\$1,500
Card Fee	\$11	\$6	\$6	\$0
Discount Rate in 2000	2.0%	1.50%	1.00%	1.50%
Reduction in Credit	70%	50%	50%	50%
Response Rate				
Cardmembers	2.00%	1.00%	1.00%	1.00%
<u>Prospects</u>	<u>1.00%</u>	<u>0.75%</u>	<u>0.75%</u>	<u>0.75%</u>
Average	1.60%	0.90%	0.90%	0.90%

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# Pilot Objectives

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- Validate assumption of CM and prospect receptivity to product and incentive configurations.
- Collect key data to assess product performance (e.g. customer spend, credit performance, coverage requirements) and the risks associated with not delivering on critical functionality.
- We will also:
  - ◊ Test with no rewards nationwide to assess risk of not delivering rewards.
  - ◊ Analyze via research the risk around dual statement (e.g. Amex and bank) and associated consumer confusion, as well as, the impact of Express Cash network limitations (e.g. locations, fees).

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# Pilot Markets

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- Testing for the Debit Card will be focused in four markets (2 debit aware, 2 debit infant) rather than a direct mail random sample.
- The concentrated market approach is based on:
  - the importance of advertising to build spend.
  - the need to effectively manage the incentive program.
  - the need to test additional acquisition channels (e.g. in-bound TM and Direct selling).
- Rewards testing: A national sample of 2,000 accounts (without a rewards program) will be compared to the concentrated markets to assess National receptivity to an American Express debit product and incremental value of the rewards program.
- Fee testing: If possible additional test cells will be created to tes fee impact.
- Tentative cities: San Diego, Phoenix, Baltimore and Milwaukee.
- Cities selected based on relevant S/E coverage (e.g. supermarkets), CM penetration and absolute size, debit awareness.
- 10M CMs per market. Pilot Total: 40,000.
- Pilot duration TBD, pending input from credit.

(See exhibit H for preliminary test plan; pg. A-23)

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# Technologies Pilot Assessment

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- RCP Systems: An RCP focused PDP was completed in August. The PDP focused only on Test Pilot Objectives. A draft PDR is under review. Estimated initial size is in excess of 2,200 hours resulting in an initial investment assumed at \$150,000. Technology work would be completed within 6 months from the beginning of the analyze phase.
- Triumph Systems: An initial (pre-PDP) assessment reveals that the Triumph platform may already meet most of our requirements but is "warm" functionality. It is considered warm since it needs to be thoroughly tested before it is implemented. However, this assessment also revealed some new requirements must be implemented to support Debit on Triumph. To determine the level of effort requires a PDP, and PDP capacity is very limited due, in part, to CCIB.

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(See exhibit I for detailed RCP needs and issues; pg. A-24)

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# Triumph/RCP Capacity Constraints/Impact On Debit

In order to move forward on Debit, it is critical that we make the following decisions:

1. Platform: RCP vs. Triumph
2. Priority: Debit vs. other projects currently underway.

## Platform Issues

- It is probably inappropriate at this time to seriously consider the RCP solution, given its inflexibility for roll-out and given CCIB constraints. However, an RCP solution may be our only viable way of getting some in-market learning prior to 1998.
- Triumph has a number of constraints since this is not a "plain vanilla" product launch. These constraints include:
  1. CCIB: Under the current schedule, CCIB will engulf Triumph resources until at least early 1998.
  2. Donut.
- Based on current Triumph principles which state that 1997 releases are limited to existing Triumph capabilities Debit cannot be considered for a PDP. Until a Triumph PDP is held the following questions will not be able to be addressed:
  1. Can we use Triumph capabilities without CCIB Project slippage?
  2. Can Triumph's warm functionality support a debit pilot or are additional software changes required?
  3. Are there outsourcing options that would allow for a smooth transition onto Triumph at a later date?
- However, we cannot even begin to assess this until PDP capacity is available -- after CCIB PDP's are completed (hopefully late Feb.).

## Priority Issues

- The implication: If we launch Donut on Triumph we will not be able to test a debit product until Mid 1998, unless the Triumph steering committee agrees to slow down CCIB, and coordinate Debit with Donut.

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## Challenges & Risks: Summary

### Challenges:

- Ensuring compelling Amex product since it will not replace ATM plastic (e.g. will not be preferred product for accessing deposit funds)
- Communicating use of Amex product in PIN-based POS situations (e.g. no PIN required/select "credit" option)

### Risks:

- Consumer acceptance given business challenges:
  - ◊ We do not own their bank accounts.
  - ◊ Possible reluctance from customers to release DDA information.
  - ◊ Amex must rely on consumer response and usage of its "value-differentiated" product to ensure success, Visa/MC issuers are simply re-issuing branded debit/ATM cards and providing incentives to boost activation rates to garner positive results .
  - ◊ Dual statementing.\*
  - ◊ Express Cash Pricing.\*
- SE price/product challenges (concerns heightened after Wal-Mart and the Limited filed suit against Visa)
- Internal systems capacity challenges may result in delays that will have negative impact on opportunity to realize potential. Other Non-Bank issuers may beat us to the market.

\* Critical Product Functionality (see exhibit J for full list; pg. A-25).



## Recommendations/Timing

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- **Target Launch Date:** Assuming 40% annual growth rate projections continue, Amex's market opportunity should remain through the Year 2000, yet to maximize our business results rollout should occur no later than early 1998. To meet this target, we must plan to pilot in the first half of 1997 in order to read initial results by year end (recognizing critical functionalities and associated risks). Prioritization issues put these dates at risk.
- Through pilot test, assess capabilities to deliver "debit product" through network which could be leveraged with bank partnerships for future delivery.

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# Next Steps

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## Next Steps:

## Timing

- Agree to Proceed 12/16/96
- Agree to Platform: RCP or Triumph 12/16/96
- Agree on Pilot Design 12/16/96
- Agree on Priority:  
Target 2nd quarter 1997 release Next Triumph Steering Committee meeting  
(if platform is Triumph)
- Approve Pilot Funding of \$5.9mm not included  
in CCSG 1997 SQP. A.S.A.P.
- Present to OCE  
(if necessary) TBD/A.S.A.P.

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