CHARGE!

American Express CEO Ken Chenault is about to launch a huge credit-card war. Backed by an antitrust ruling, he's gunning for Visa and MasterCard. Let the fight begin. BY MARA DER HOVANESIAN

THIS IS THE MOMENT KENNETH I. CHENAULT, chief executive of American Express Co., has waited for his entire career. As a fresh recruit in charge of strategic planning more than two decades ago, he sought to move AmEx beyond its lucrative niche as an upscale charge card—an idea too radical for the company's old guard. Later, as head of consumer cards, he began a dogged campaign against industry giants Visa USA Inc. and MasterCard International Inc. and the lock they have on issuing cards through banks. "I've had a willingness to take on conventional views, to shake things up," says the 53-year-old Chenault.

Willingness is one thing, opportunity another. And now Chenault has both. This fall, the U.S. Supreme Court is expected to uphold a ruling by the U.S. District Court for the Southern District of New York that Visa and MasterCard—which together control 79% of the U.S. card market—stifle competition and innovation by forbidding the banks that own them from issuing rival cards. For the first time in its 154-year history, AmEx will have carte blanche to issue plastic through U.S. banks and flood the market with millions of its green, gold, and platinum cards. The ruling, the culmination of an antitrust case launched by the Dept. of Justice six years ago, "will create competition in our industry for the first time," says David W. Nelms, chairman and CEO of Morgan Stanley's Discover Financial Services Inc. unit.

NIGEL PARRY

The Supreme Court's decision—and Chenault's plans to exploit it aggressively—would change the $2.1 trillion card business for good. Already, the industry is in the midst of the biggest fight in its history for share of a saturated market. All the major brands and banks are in a frenzy to woo fickle high spenders. Their weapon of choice: souped-up rewards programs, a marketing tool AmEx pioneered. AmEx now gives big cash rebates and mileage points redeemable for space travel. U.S. Bancorp offers private yoga lessons with actress Gwyneth Paltrow on its new Stratus Rewards Visa cards. And in the hunt for more outlets, once-exclusive cards such as Citigroup's Diner's Club will soon be accepted in Wendy's as well as the Waldorf-Astoria. Says John C. Grund, partner with First Annapolis Consulting Inc., a Maryland-based industry specialist: "It's now a matter of how to steal share from one another, innovate, and tap new markets."

The free-for-all is ushering in the long-predicted cashless society. Uncle Sam takes plastic; welfare benefits and salaries are paid by loading a card with cash. Yet American consumers still use cash or checks to pay for about 59% of the $8.2 trillion a year they spend on everything from housing to hamburgers. If the card industry can capture even a modest part of those $4.8 trillion cash outlays, it will experience fast growth. *The Nilson Report*, an industry newsletter, forecasts combined debit- and credit-card

AmEx charges higher fees, but many merchants appreciate its cardholders, who far outspend Visa and MasterCard users

spending will grow 13% a year through 2007. "You're talking about the most profitable retail banking product in the world. The competition among the titans is going to be fierce," says *Nilson* publisher David Robertson. "They are already clobbering each other."

The slugfest seems certain to whack the card companies' margins, which are under legal attack by merchants and regulators. AmEx has the most to lose. It charges merchants about 2.6% of customers' bills, more than the roughly 2% levied by Visa and MasterCard. Indeed, AmEx's average fee fell by 2.3% last year, according to company filings. Traditionally, card companies have been loath to negotiate on fees. But some merchants are being so ardently courted that they're able to bargain. In April, Costco Wholesale Corp., the nation's No. 1 warehouse retailer, signed a 10-year exclusive contract with AmEx because it got better (but undisclosed) terms than rivals would offer. "Visa and MasterCard's fees are outrageous," says Costco CEO James D. Sinegal. "Neither gave us any wiggle room."

Hey, Big Spender

WITH HIS MARGINS UNDER PRESSURE, Chenault must drive up how much consumers spend using his cards. He's doing just that; in the second quarter this year such spending leapt 19%, topping $100 billion for the first time. His strategy is simple: First, he wants to get more cards in people's hands by persuading banks to switch customers from Visa and MasterCard to AmEx. Then he aims to coax cardholders to spend more—and, while they're at it, buy other AmEx products.

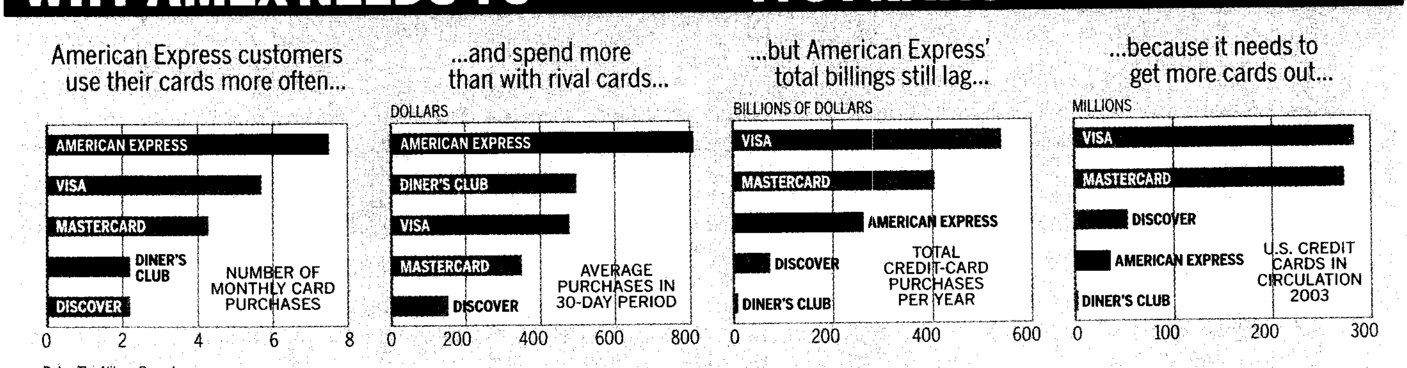
AmEx isn't looking to snag just any customer from Visa and MasterCard. It wants those from the affluent investor class, who earn between $100,000 and $1 million a year. They charge up a bundle, keeping the card's profile high, and pay off their balances in full. With thousands of new big spenders in the fold, Chenault's battalion of 12,000 financial advisers would move in to sell them advice and financial plans, which start at $500 a pop. Then they'll sell insurance and investment products, including AmEx's own. "We have to be the No. 1 provider to high-spending customers for both cards and financial advice," says Chenault. "We will have an advantage because we have a very clear focus on these customers."

At the same time, AmEx will step up its drive to wean large companies and small businesses from checks to corporate plastic. Analysts figure a $400 billion-a-year U.S. market for procurement as well as payroll is up for grabs. And, although AmEx is five times bigger than its nearest competitor in providing commercial cards to small-business owners, Chenault is chasing after a bigger share of their $4 trillion worth of spending. Just $90 billion of those outlays are made with credit cards.

Even before AmEx issues its first card through a U.S. bank, competitors are fighting back. They are promoting heavily gold and platinum cards aimed at AmEx's high-end customers. In mid-July, Visa launched a media blitz for its redesigned Signature Card, through which customers spent $80 billion last year. MasterCard is revamping its World MasterCard. Brokerages and banks are wading in, too. "A lot of cards don't completely meet the needs or desires of the upper class," says Christopher L. Pieroth, senior vice-president of product and marketing for U.S. Bancorp of Minneapolis, the eighth-largest U.S. bank, which launched its Stratus Rewards Card in April. Cardholders can accumulate points toward private tours of the Louvre and Egyptian Pyramids, as well as private jet travel. "The players are recognizing this is a very lucrative market; you are going to see a big push."

Chenault is betting the high status of AmEx' cards can help him grab a good chunk of future market growth. The key is to make his cards stand out among the 848 million circulating in the U.S. today. Last year, some 8,000 card issuers mailed five billion solicitations—40 per household. The response rate has plunged. Instead of adding cards to their wallet, people now replace the ones they have, says John Gould, a director at Tower Group, a Needham (Mass.) financial consultancy. And that, he says, should should open the door for AmEx: "They are creative. They have something of in-

WHY AMEX NEEDS TO ITS FRANCHISE



Data: *The Nilson Report*

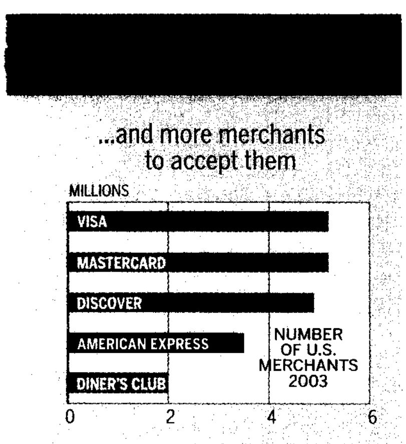
CHART BY ERIC HOFFMANN/BW

LAST FRONTIER All the card companies are pushing hard into the small-ticket end of the market

JOHN WILKES

terest to the issuers that Visa and MasterCard do not—prestige."

AmEx has more to offer than just prestige. Because it charges merchants about half a percentage point more than Visa and MasterCard, it can afford to give banks a bigger slice of its fees. The mix appealed to MBNA, the first bank to strike a deal to issue AmEx-branded cards as early as the end of this year. That was quite a coup for Chenault. MBNA issues more MasterCards and Visas—some 56 million altogether—than any other bank. "You generally don't like helping your competitors, but sometimes it makes sense," says MBNA Chief Executive Bruce Hammonds. "We are both able to make more money and expand our business." McLean (Va.)-based Capital One Financial Corp., another big customer of the giants, could be the next convert, say analysts. (Capital One declined to comment.) Meantime, Chenault is courting dozens of banks he thinks would sign on if the courts outlaw Visa's and MasterCard's restrictive contracts.



Chenault's gamble could pay off big on AmEx' bottom line. For one thing, the banks issuing AmEx cards will bear the cost if customers don't pay their bills, which AmEx shoulders on its own cards. And, with more cards in circulation, Chenault should be able to extract significant economies of scale from AmEx' network linking merchants, banks, and customers. "More cards will be issued, more merchants will choose to take the card, and the economics of the entire firm start to lift," says Howard K. Mason, a senior bank analyst with Sanford C. Bernstein & Co. For each 10% rise in card billings, he figures, AmEx will incur just 1.5% more in network costs. So AmEx' current 20% return on equity should get a big boost. Adds Richard Freeman, a management professor at New York University's Stern School of Business: "If they get access to the bank business, I think there is a huge potential upside."

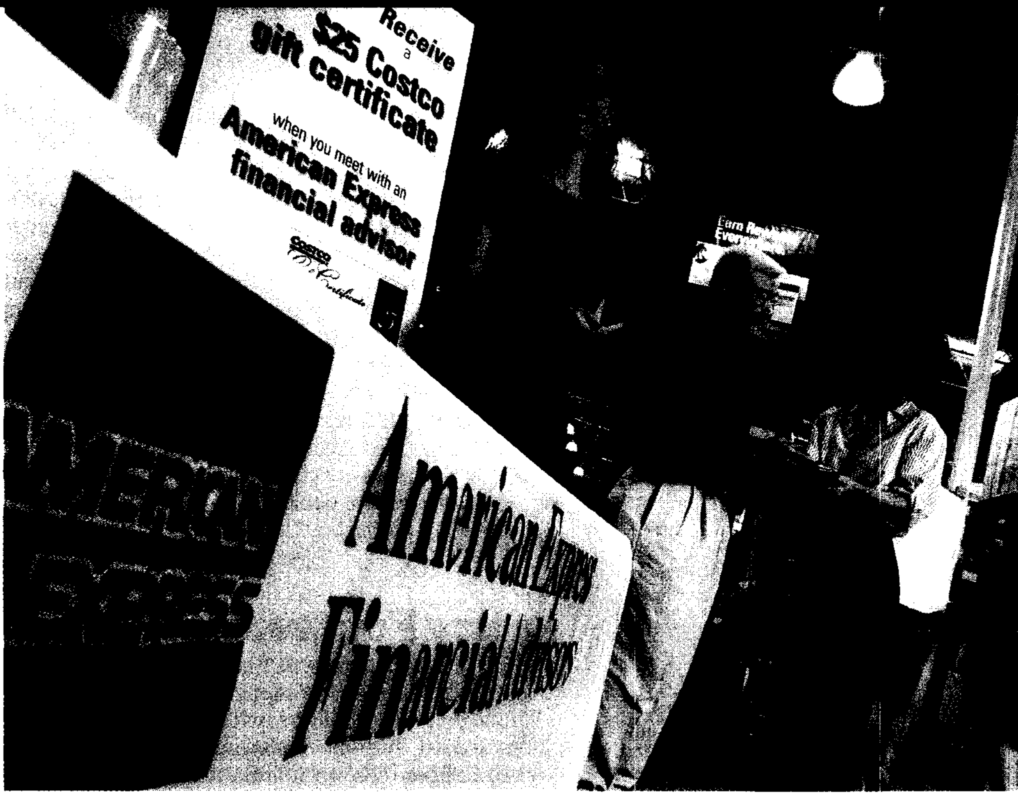
Fancy Footwork

FIRST, THOUGH, CHENAULT has to pull off some fancy footwork. His trickiest maneuver will be to recruit millions more cardholders without diluting AmEx' gold-standard brand. According to the *BusinessWeek*/Interbrand 2004 ranking, it was the 14th most valuable in the world, worth nearly $18 billion. What's more, AmEx won't have debit cards, which are growing 17% a year—twice as fast as credit cards, until Chenault sets up a system to link them with bank accounts. And the money-management business is still recovering from years of missteps. For the last three years, less than one-fifth of AmEx' 72 retail equity mutual funds ranked in the top quartile of their peer group, according to fund-tracker Lipper Inc.

In fact, Chenault has to juggle several problems simultaneously if he is to achieve his goal of dominating the high end of both the card and financial-advice businesses. He has to gain market share without allowing AmEx' margins to shrink too much. He has to coax enough extra merchants to accept his card and pay his higher fees. And he has to persuade banks to let him offer AmEx' financial services alongside their own. "Who owns the consumer?" asks William H. McCracken, chief executive of the consumer market researcher Synergistics Research Corp. in Atlanta. "Is it the issuing bank, or American Express, or both? If it's both, that raises some thorny questions."

For now, banks seem attracted by AmEx' willingness to pay them more. But Chenault's main rivals are trying to close the gap. In April, they raised their merchant fees on credit cards by about 5%, so they can pay banks more, according to *Nilson*. Critics say the ploy is bound to backfire. "If the strategy is to help banks reach more into merchant's pocket, that's a dangerous prospect," says Kenneth A. Posner, credit-card analyst for Morgan Stanley, who figures half of the $24 billion a year they already earn from such fees could be at risk.

Merchants are already upset. Last year, they wrestled a $3 billion settlement (to be paid over 10 years) from Visa and MasterCard in an antitrust class action, led by Wal-Mart Stores Inc. The suit alleged that the card groups strong-armed merchants into paying high fees for debit-card transactions, which the groups denied. Some big merchants who opted out of the class action, including Home Depot, are still seeking damages in other suits. Discover, for one, sees an opportunity. "We could be the solution



AMEX EXCLUSIVE Costco signed a 10-year deal after AmEx beat its rivals on fees

RICK DAHMS

for angry merchants," says Discover's Nelms. Merchants pay up to 15% less on average to Discover than Visa and MasterCard, according to The Nilson Report. "We obviously are taking to heart the lessons," adds Robert W. Selander, president and CEO of MasterCard. "If you settle for a billion dollars, obviously, you do more than just write some checks." Bottom line: MasterCard is ready to haggle with big merchants.

The Merchant Gap

NOW, AMEX IS FACING A CHALLENGE over its own fees. Last August, attorney Blaine H. Bortnick of New York's Liddle & Robinson and Gary B. Friedman of Friedman & Shube filed an antitrust suit on behalf of several small merchants alleging that AmEx charges excessive fees. "The Wal-Mart case was part of the inspiration," says Bortnick, who is trying to gain class action status for the suit. AmEx says it will fight such cases vigorously.

Such suits would appear to be a major headache for Chenault. AmEx gets about 65% of its card revenues from merchant fees, while Visa and MasterCard generate about 20% of revenues from their share of the merchant fees. That's because rivals rely on interest on outstanding balances, while AmEx depends on high levels of spending. Chenault expects to sacrifice some of his margins to grasp the opportunity presented by unfettered competition. By cherry-picking banks and merchants, he believes he can increase not only the number of transactions on his card but also the amount spent on each. Says Chenault: "I'm not complacent or unaware of the pressures. The burden on us is that we have to deliver value for the premium price."

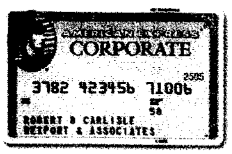
What the merchants value most is the number of high-spending clients that Chenault can deliver. AmEx customers are attractive because they use their cards more often than those of rivals and spend an average of more than $8,000 a year—about twice as much as Visa and MasterCard users. Still, Chenault is playing catch-up with Visa and MasterCard. They each have 5.2 million merchants on their rosters, vs. 3.5 million for AmEx. "We're everywhere AmEx wants to be," quips Tim Attinger, a senior Visa executive.

By some measures, that's streets ahead of AmEx. Visa's 430 million cards account for $1.1 trillion in spending in the U.S. vs. AmEx' 35 million cards that account for $260 billion in charges. Visa's everyday spending category is growing about $100 billion a year or 5.5%, primarily thanks to debit cards. "AmEx is a niche player today and is going to be even more so because of the explosive growth that's coming in prepaid and debit," says Elizabeth Buse, executive vice-president for product development at Visa.

Chenault aims to close the gaps by launching new products and rewards programs galore to entice customers to spend more. AmEx' Blue card—aimed at capturing everyday spending on items from groceries to dry cleaning and postage stamps—now offers up to 5% cash rebates and double bonus points. New prepaid cards loaded with cash, which AmEx may customize for big-ticket events such as weddings and bar mitzvahs, are designed to tap a market worth some $105 billion. And it's testing ExpressPay, a payment device linked to its cards and activated by radio, at more than 600 locations, including chains Eckerd Drugs, Blimpie Subs & Salads, and Carl's Jr. And AmEx is pushing hard to get charge cards accepted by landlords and cash-or-carry wholesale suppliers. Last year, for example, it teamed up with New York's Related Cos. to allow tenants to pay their rent with plastic at 16 luxury buildings.

Because Chenault's whole strategy hinges on his ability to keep his cardholders spending big, he will be picky about which banks he signs up. Their customers will have to spend enough to maintain AmEx' averages. He also insists that the banks use some of the extra money they earn from him to develop their own customized rewards programs. If banks don't deliver, "we absolutely pull the plug," says Chenault. That's no idle threat: Chenault ended a card deal with Canadian Imperial Bank of Commerce (CIBC) by mutual agreement in June after just 18 months. "The cards were not meeting our financial objectives," says CIBC spokeswoman Susan McDougall.

Critics contend that such tough conditions could deter some banks from issuing AmEx cards. Chenault counters that he's offering far more than just cards. For a fee, community banks, credit unions, and midsize banks will be able to tap AmEx' expertise in corporate T&E and procurement cards for small business, two areas in which it is a market leader. Some have sold AmEx annuities for years. Chenault says he can help



Chenault believes he can strike lucrative deals with the banks. One ace in the hole is AmEx' lead in corporate T&E and small business cards

banks do a better job selling investments and advice to the affluent. Banks account for about 17% of $180 billion in annual mutual-fund sales and 1% of $480 billion life insurance sales, according to Celent Communications LLC. Says U.S. Bancorp's Pieroth: "Banks are probably not the most creative when it comes to targeting niche markets." Indeed, banks are way behind brokers who have captured nearly two-thirds of the sales of investments to high net worth customers.

In Pursuit of Investors

AMEX NEEDS NEW OUTLETS to sell its financial planning services—and banks offer a tempting prospect. The more plans Chenault sells, the more likely he'll sell other products: Last year, financial plans sold by AmEx advisers led to three-quarters of the $1.4 billion of mostly retail sales by the company's Minneapolis-based American Express Financial Advisors Inc. (AEFA) unit. If banks bristle at the idea of AmEx' advisers selling to their customers, Chenault won't insist—though he thinks they would be making a mistake. "Customer needs and competitor pressures [are opening] up the system," he says.

He is also pushing large companies that offer AmEx funds in their 401(k) retirement plans to host investment seminars. Such programs accounted for about 18% of AmEx' new clients last year. And he has placed advisers in more than 300 Costcos nationwide. Existing cardmembers have yet to be tapped for their full potential, says James M. Cracchiolo, AEFA's chief executive. He figures they have about $80 billion in cash and investments at banks and brokerages that he would like to consolidate at AmEx.

Financial plans may be an easier sell than AmEx' investment products. Since he became CEO, however, Chenault has shuffled AEFA's executive management, hired new money managers, and added a new lineup of products for retail and institutional investors. New lines such as the AXP Partners funds, managed by top-notch firms such as Gabelli Asset Management Inc. and Wellington Management Co., have performed better than AmEx' in-house funds, averaging a one-year 14% return, vs 8%. Better yet, they've attracted $4.8 billion from retail investors since January, 2001. The result: AEFA revenues rose 18% in the second quarter, and assets grew 55% to $380 billion over the past year.

Skeptics doubt whether Chenault can snare big outfits such as Citigroup, which is busy building its own credit-card brand and financial-services business. Citi's chief operating officer and president, Robert B. Willumstad, told analysts in February that a partnership with AmEx was unlikely, though executives from the two companies have met. Besides, Citi put its high-end, but languishing, Diner's Club (the first charge card on the market, since 1950) in direct competition with AmEx by partnering with MasterCard in April. However, Bernstein's Mason figures they may relent, if only to give their customers a choice. "Attrition is a nasty thing," he says. "Citi and others must factor in the cost of not doing business with AmEx." Adds MasterCard's Selander: "It's certainly not going to be an exodus; my guess is it will be more of an experiment."

Whatever obstacles Chenault faces in the U.S., he knows that his strategy has been road-tested abroad. And it worked. Wherever AmEx has been free to sign up banks, competition for cards and financial services has thrived. Since its launch in 1999, AmEx' global network services, one of its fastest growing divisions, has signed up 84 banks in 94 countries. Last year, its billings topped $12 billion; spending jumped 30% in the second quarter.

In his three years as head of AmEx, Chenault has faced several severe tests. Four months after he became CEO in January, 2001, the company was rocked by revelations of a $1 billion loss on a junk-bond bet gone bad. Then, September 11 not only dislodged AmEx from its Lower Manhattan headquarters but also stopped the company's core corporate travel and entertainment business in its tracks. Profits halved and AmEx' future looked so bleak that rumors flew around Wall Street that it might soon be snapped by the likes of Citigroup. "Anything that could have been thrown at us was," says Chenault.

He soon regained the initiative. He swallowed

KEN CHENAULT'S FOR REINVENTING AMEX

1 GET MORE CARDS INTO CONSUMERS' HANDS

SIGN UP U.S. banks to market its cards and convert their Visa and MasterCard customers into new Platinum, Gold, and Green cardholders

EXPERIMENT with new products, such as ExpressPay, a prepaid, radio-activated card that requires no signature

PUSH the reloadable TravelFunds and gift cards to replace traditional travelers' checks and gift certificates

2 SPUR CARDHOLDERS TO SPEND MORE

ENABLE them to use their cards in new places such as fast-food restaurants, dry-cleaners, gas stations

ENCOURAGE payment of cable, phone, and other monthly bills with plastic

OFFER luxury rewards such as concierge services and private jet travel to big spenders

PAY instant cash rebates of up to 5% on everyday spending

3 PUSH FINANCIAL SERVICE SALES

GIVE customers more investment choices such as access to hedge funds and 12 new mutual funds managed by outside money managers

TEAM up with Costco to offer auto and homeowners insurance, credit, and financial planning

TAP big corporate clients to sponsor investment seminars at which employees meet with AmEx advisers

Data: *BusinessWeek*, American Express Co.

the $1 billion loss on junk bonds and cut risky corporate lending in half. As business disappeared in the wake of September 11, he slashed 14,500 jobs, 16% of the workforce, and outsourced 2,000 tech jobs to IBM. By the end of this year, he will have shaved a cumulative $4 billion off costs. "Investors were doubtful that the company could recover," says analyst David A. Hendler of CreditSights Ltd. "Chenault has done an awesome job."

It was a job of building as well as cutting. While other CEOs hunkered down during the recession, Chenault bought two companies—AmEx' first sizable acquisitions in more than a decade. Since 2002, he has pumped $7.8 billion into marketing, promotion, and rewards programs—almost 12.2% of revenues. Bolder still, he turned AmEx' business model on its head. Before September 11, two-thirds of its card billings came from corporate T&E and a third from regular consumer spending. By last year, the ratios were reversed. "We are engaged in a very important transformation for this company," says Chenault. "American Express is a new story."

A story with a big payday, at that. On July 26, AmEx reported record profits of $876 million and record revenues of $7.3 billion for the second quarter. Says former IBM Chairman Louis V. Gerstner Jr., who ran AmEx for 11 years and recruited Chenault from consultants Bain & Co. in 1981: "Once he figures out what he needs to do, he has the drive to take the risk and to make it happen. He is a superb problem-solver."

The solution to his latest challenges lies in the hands of consumers. His competitors won't surrender ground without a struggle, but Chenault believes their customers will switch to his card when they get the chance. As he tells bankers he's now trying to sign up: "Change is in the cards." It surely will be if the Supreme Court changes the rules of the game. ■

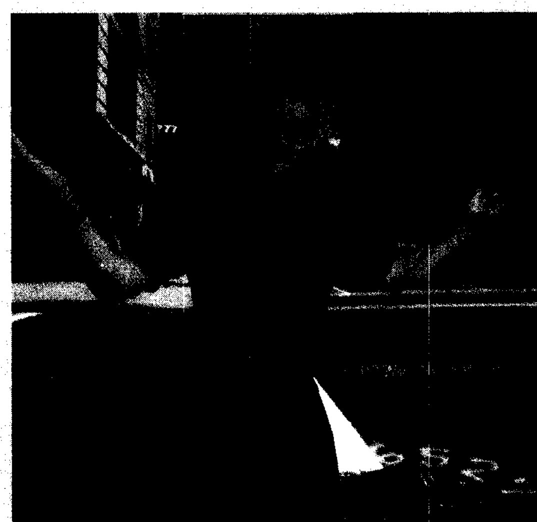
THIS BLACK CARD GIVES YOU CARTE BLANCHE

A real T-shirt-and-jeans kind of guy, Peter H. Shankman certainly doesn't look like a high roller, but American Express Co. knows better. After he was snubbed by salesmen at a Giorgio Armani boutique on Fifth Avenue in New York recently, the 31-year-old publicist—who was made available to *BusinessWeek* by AmEx—saw "an unbelievable attitude reversal" at the cash register when he whipped out his black AmEx Centurion Card. In June, a RadioShack cashier refused the card, thinking it was a fake. "'Trust me,' I said. 'Run the card,'" recalls the chief executive of Geek Factory Inc., a public-relations and marketing firm. "I could buy a Learjet with this thing."

An exaggeration, perhaps. But AmEx' little black card is decidedly the "It" card for big spenders. Launched in late 1999, Centurion is given out by invitation only to customers who spend at least $150,000 a year on other AmEx cards and meet other requirements. The chosen cardholders pay an annual fee of $2,500, raised from $1,000 two years ago.

Although AmEx has spent zilch on promotion, some would-be customers go to absurd lengths to get what they see as a must-have status symbol. Hopefuls have written poems to plead their case. Others say they'll pay the fee but swear not to use the card—they want it just for show. "Every week I get phone calls or letters, often from prominent people, asking me for the card," says AmEx' head of consumer cards, Alfred F. Kelly Jr.

Who, he won't say. In fact, AmEx deliberately builds an air of mystery around the sleek card, keeping hush-hush such details as the number of cards in circulation. Analysts say AmEx earns back many times what it spends on perks for black-card customers in both marketing buzz and fees.



STATUS SYMBOL
AmEx offers the Centurion to customers like Shankman who bill $150,000 a year

The card is now being flattered by imitators. In April, Merrill Lynch & Co. and MBNA Corp. launched a black-colored Visa card with a credit limit of up to $250,000. The card offers bonus points that can be used to pay for brokerage charges—or a night at the Ritz. "Our goal wasn't to come out with a me-too card," says Peter Barsoom, director of card payments for Merrill Lynch. "Our clients needed a better card in their wallet." J.P. Morgan Chase & Co. also is sizing up its own version. Says Jamie Dimon, the bank's chief operating officer and president: "We may want to try to outdo that at some point."

Basic services on the Centurion card include a personal travel counselor and concierge, available 24/7. Beyond that, almost anything goes. Feel like shopping at Bergdorf Goodman or Saks Fifth Avenue at midnight? No problem. Traveling abroad in first class? Take a pal—the extra ticket is free.

The royal treatment often requires elaborate planning. One AmEx concierge arranged a bachelor party for 25, which involved a four-day trip that included 11 penthouse suites, travel by private jet, and a meet-and-greet with an owner of the Sacramento Kings basketball team. The tab was more than $300,000.

How did Shankman, who says his firm has no business dealings with AmEx, earn his card? All the travel and entertainment charges he racks up hosting his clients prompted AmEx to send it to him. It arrived in December, along with a 43-page manual. Recently, Shankman sought reservations for Spice Market, an often-overbooked restaurant in Manhattan, to impress a friend. He called his concierge. "Half an hour later it was done," says Shankman. Membership does have its privileges.

–By Mara Der Hovanesian in New York

ALLISON LEACH