

## **TRAVEL RELATED SERVICES FINANCIAL REVIEW**

### **Description of the Business**

American Express Travel Related Services TRS, Inc. (including its subsidiaries, unless the context indicates otherwise, "TRS"), which includes card, merchant, network, Travelers Cheque and travel businesses, provides a variety of products and services worldwide, including, among others, global card network services, customized charge card and credit cards for consumers and businesses worldwide, other consumer and small business lending products, American Express® Travelers Cheques and prepaid card products, business expense management products and services, business travel and travel management services, consumer travel services, tax, accounting and business consulting services, merchant acquiring and transaction processing, point-of-sale and back-office products and services for merchants and magazine publishing. TRS is a wholly-owned subsidiary of American Express Company ("American Express").

### **Results of Operations**

TRS reported net income of \$2.9 billion in 2004, a 17 percent increase from \$2.4 billion in 2003, which increased 14 percent from 2002.

The quality of TRS' card customer base, the breadth of its product portfolio, the benefits of its reward-based, spend oriented business model and its improved revolving credit capabilities combined to create a competitive advantage that was leveraged effectively to deliver strong TRS results. TRS' continued investments in growth initiatives over the past several years have resulted in strong growth in cardmember spending in the retail and everyday spending categories and continued improvement in the travel and entertainment sector, significant increases in cards-in-force from expansion of both proprietary and network card businesses, and quality lending balance growth.

TRS' owned portfolio is primarily comprised of cardmember receivables generated by its charge card products, unsecuritized U.S. cardmember loans, and international cardmember loans.

As discussed more fully in the TRS Liquidity and Capital Resources section below, TRS securitizes U.S. cardmember loans as part of its financing strategy; consequently, the level of unsecuritized U.S. cardmember loans is primarily a function of TRS' financing requirements. As a portfolio, unsecuritized U.S. cardmember loans tend to be less seasoned than securitized loans, primarily because of the lead time required to designate and securitize each loan. TRS does not currently securitize international loans. Delinquency, reserve coverage and net write-off rates have historically been broadly comparable between TRS' owned and managed portfolios.

The following management discussion includes information on both a GAAP basis and managed basis. TRS presents its information on a managed basis because that is the way management views and manages the business. It differs from the accompanying financial statements, which are prepared in accordance with GAAP, as managed basis presentation assumes there have been no securitization transactions, i.e., as if all securitized cardmember loans and related income effects are reflected in TRS' balance sheet and income statement, respectively. Management believes that the trends in TRS' cardmember lending business are more accurately portrayed by evaluating the performance of both securitized and non-securitized cardmember loans. Asset securitization is just one of several ways that TRS funds cardmember loans. Use of a managed basis presentation, including non-securitized and securitized cardmember loans, presents a more accurate picture of the key dynamics of the cardmember lending business, avoiding distortions due to the mix of funding sources at any particular point in time. For example, irrespective of the mix, it is important for management and investors to see metrics, such as changes in delinquencies and write-off rates, for the entire cardmember lending portfolio because it is

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more representative of the economics of the aggregate cardmember relationships and ongoing business performance and trends over time. It is also important for investors to see the overall growth of cardmember loans and related revenue and changes in market share, which are significant metrics in evaluating TRS' performance and which can only be properly assessed when all non-securitized and securitized cardmember loans are viewed together on a managed basis. Asset securitization activity of TRS is discussed in detail in TRS Liquidity and Capital Resources section.

On a GAAP basis, results reflect finance charge revenue on the owned loan portfolio as well as finance charge revenue on the retained seller's interest from securitization activity. GAAP basis results also include investment income on TRS' investments in other subordinated retained interests from loan securitization issuances.

Additionally, on a GAAP basis, results reflect net securitization income, which is comprised of the non-credit provision components of the net gains and charges from securitization activities, excess spread related to securitized loans, net finance charge revenue on retained interests in securitized loans, and servicing income, net of related discounts or fees. Excess spread, which is net positive cash flow from interest and fee collections allocated to the investor's interests after deducting the interest paid on investor certificates, credit losses, contractual servicing fees and other expenses is recognized in securitization income as it is earned. Net securitization income of \$1.1 billion increased slightly in 2004 compared to 2003 as the impact of higher average securitized loan balances was partially offset by lower net gains from securitization activities. Net securitization income increased 5 percent to \$1.1 billion in 2003 primarily as a result of a higher average balance of cardmember lending securitizations. See Selected Statistical Information for data relating to TRS' owned loan portfolio.

During the years ended December 31, 2004, 2003 and 2002, TRS recognized net gains of \$26 million (\$17 million after-tax), \$124 million (\$81 million after-tax) and \$136 million (\$88 million after-tax), respectively, from net securitization activities. For the year ended December 31, 2004, the net gains consist of \$230 million of income from the the sale of \$1.4 billion of certain subordinated reated interests and the securitization of \$3.9 billion of cardmember loans, including the impact of the related credit reserves on the sold loans. This amount is partially offset by \$204 million of charges related to the maturity of \$3.0 billion of previously outstanding issuances, changes in interest-only strip assumptions and a current year reconciliation adjustment to lending receivable accounts. For the year ended December 31, 2003, \$3.5 billion of U.S. lending receivables were securitized and \$1.0 billion of securitization transactions matured.

Management views any net gains from securitizations as discretionary benefits to be used for card acquisition expenses, which are reflected in both marketing, promotion, rewards and cardmember services and other operating expenses. Consequently, the managed basis presentation for the years ended December 31, 2004, 2003 and 2002 assumes that the impact of this net activity was offset by higher marketing, promotion, rewards and cardmember services expenses of \$16 million, \$74 million and \$81 million respectively, and other operating expenses of \$10 million, \$50 million and \$55 million, respectively. Accordingly, the incremental expenses, as well as the impact of this net activity, have been eliminated.

The five-year table reconciles the GAAP basis for certain TRS income statement line items to the managed basis information, where different.

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### Results of Operations - GAAP Basis

#### *Revenues*

In 2004, TRS' net revenues increased 12 percent to \$21.6 billion primarily due to higher discount revenue from record cardmember spending and a greater number of cards-in-force, higher travel and other commissions and fees, increased cardmember lending net finance charge revenue, from higher average lending balances, and increased net card fees. Net revenues of \$19.2 billion in 2003 were 8 percent higher than 2002 as a result of increased discount revenues, cardmember lending net finance charge revenue, and travel and other commissions and fees.

Revenues and expenses are affected by changes in the relative values of non-U.S. currencies to the U.S. dollar. The currency rate changes had a favorable effect on revenue growth of approximately two percentage points in 2004 and 3 percentage points in 2003.

Discount revenue is TRS' largest single revenue source and is primarily driven by billed business volumes and the average discount rate earned on those volumes. Discount revenue rose 17 percent to \$10.2 billion in 2004 as a result of an 18 percent increase in billed business partially offset by a lower discount rate. The average discount rate in 2004 was 2.56% compared to 2.59% in 2003 primarily reflecting changes in the mix of spending between various merchant segments due to the cumulative impact of stronger than average growth in the lower rate retail and other "everyday spend" merchant categories (e.g., supermarkets, discounters, etc.). Based on TRS' business strategy, it expects to see continued changes in the mix of business. This, combined with volume-related pricing discounts and selective repricing initiatives, will probably continue to result in some discount rate erosion over time. Discount revenue rose 11 percent to \$8.8 billion during 2003 as a result of a 13 percent increase in billed business partially offset by a lower discount rate.

The 18 percent increase in billed business to \$416.1 billion for 2004 resulted from a 13 percent increase in spending per proprietary basic card worldwide and 8 percent growth in cards-in-force. U.S. billed business rose 16 percent to \$304.8 billion reflecting 16 percent growth within the consumer card business, 20 percent growth in small business services volume and a 12 percent increase within corporate services. U.S. non-T&E related volume categories, which represented approximately 67 percent of U.S. billed business in 2004, increased 19 percent over 2003 while U.S. T&E volumes rose 11 percent reflecting continued strengthening across all T&E industries. Total billed business outside the U.S., excluding the impact of foreign exchange translation, grew 15 percent reflecting strong double-digit improvement across all regions. Worldwide airline volumes, which represented 12 percent of total billed business volumes during 2004, increased 14 percent as a result of a 15 percent growth in transaction volumes, partially offset by a 1 percent decrease in the average airline charge. Additionally, network volumes grew over 30 percent as compared to last year.

U.S. cards-in-force rose 9 percent in 2004 to 39.9 million reflecting the benefit of continued strong card acquisition spending, an improved average customer retention level within proprietary issuing business and strong growth in U.S. network cards. Non-U.S. cards-in-force increased 6 percent in 2004 to 25.5 million due to growth in both proprietary and network partnership cards. Worldwide network cards-in-force increased over 30 percent during 2004. In 2003, U.S. cards-in-force rose 4 percent to 36.4 million and non-U.S. cards-in-force increased 9 percent to 24.1 million.

Cardmember lending net finance charge revenue of \$2.2 billion rose 9 percent in 2004 primarily due to a 15 percent growth in the average balance of the managed lending portfolio partially offset by lower average yields. The net interest yield on the owned worldwide lending portfolio decreased to 9.3% in 2004 from 9.8% in 2003 reflecting a higher average proportion of the portfolio on introductory or

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promotional rates during the year, lower revolve rates and improved credit quality, which reduces the proportion of the portfolio at default interest rates. In 2003, cardmember lending net finance charge revenue increased 12 percent to \$2.0 billion.

Net card fees increased 4 percent to \$1.9 billion in 2004 reflecting 8 percent growth in cards-in-force partially offset by a slight decrease in the average annual fee per card. Key aspects of TRS' business strategy are retention of cardmembers as well as driving growth in cards-in force, whether organically, through related business opportunities, or through joint ventures and acquisitions. The average annual fee per proprietary card-in-force decreased to \$34 in 2004 from \$35 in 2003 which reflects the increase in the number of fee-free cards issued by TRS. Net card fees increased 6 percent to \$1.8 billion in 2003 reflecting 6 percent growth in cards-in-force and the benefit of selected annual fee increases.

Travel commissions and fees rose 19 percent to \$1.8 billion in 2004 due to a 25 percent increase in travel sales, reflecting the Rosenbluth acquisition in late 2003 and improvement within the travel environment, partially offset by lower transaction fees related to growth in on-line transaction activity. The volume and type of travel sales are important as TRS earns revenue based on both the number of transactions as well as the sales mix of travel purchased. Travel commissions and fees rose 7 percent to \$1.5 billion in 2003 as a result of higher revenue earned per dollar of sales coupled with a 3 percent increase in travel sales, primarily due to the acquisition of Rosenbluth in the fourth quarter of 2003.

Other commissions and fees of \$2.2 billion increased 17 percent on greater volume-related foreign exchange conversion fees and higher card-related assessments and network partner-related fees. Other commissions and fees increased 4 percent in 2003 to \$1.9 billion due to higher card-related fees and assessments.

### *Expenses*

During 2004, TRS' expenses were up 12 percent to \$17.5 billion reflecting greater marketing, promotion, rewards and cardmember services expenses, higher human resources expenses and increased total other operating expenses, partially offset by reduced provisions for losses and lower interest costs. Expenses in 2004 included \$64 million in aggregate charges recorded in the fourth quarter principally relating to the restructuring of business travel operations. These charges include \$46 million of employee severance obligations included in human resources expense and \$18 million of other exit costs primarily relating to the termination of certain real estate property leases. Also included in 2004 expenses was a \$117 million net gain on the fourth quarter sale of the equipment leasing product line in the small business financing unit. Expenses in 2003 of \$15.6 billion were 7 percent higher than 2002 primarily due to greater marketing, promotion, rewards and cardmember services, human resources and total other operating expenses, partially offset by reduced provisions for losses and interest costs.

Marketing, promotion, rewards and cardmember services expenses increased 30 percent in 2004 to \$4.9 billion reflecting both greater reward costs and higher marketing and promotion expenses. The growth in rewards costs is attributable to a higher redemption rate, strong volume growth and the continued increase in cardmember loyalty program participation. The increase in marketing and promotion expenses is primarily due to TRS' new global brand advertising campaign and the continued focus on business building initiatives. Marketing, promotion, rewards and cardmember services expense increased 26 percent in 2003 to \$3.8 billion on the continuation of brand and product advertising, an increase in selected card acquisition activities and higher cardmember rewards and services expenses reflecting higher volumes and a higher redemption rate.

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Total provisions for losses decreased 3 percent in 2004 primarily as a result of a reduction in cardmember lending provision offset by a net increase in other provisions. Provision for losses on the worldwide lending portfolio decreased 7 percent to \$1.1 billion in 2004, despite growth in loans outstanding and increased reserve coverage levels of past due accounts, due to well-controlled credit practices. The worldwide lending provision decreased 11 percent in 2003 to \$1.2 billion. The net write-off rate for the worldwide lending portfolio was 4.0% in 2004 as compared to 5.1% and 5.9% in 2003 and 2002, respectively.

Other provisions increased in 2004 primarily reflecting a reconciliation of securitization-related cardmember loans, which resulted in a charge of \$115 million (net of \$32 million of reserves previously recorded), for balances accumulated over the prior five-year period as a result of a computational error. The amount of the error was immaterial to any of the periods in which it occurred.

Separately, other provisions were favorably impacted by a reduction in merchant-related reserves of approximately \$60 million reflecting changes made to mitigate loss exposure and ongoing favorable credit experience with merchants.

In 2003, total provisions decreased 11 percent primarily due to the decrease in the lending provision noted above and an 11 percent reduction in the provision for losses on charge card products primarily due to strong credit quality reflected in an improved past due percentage and loss ratio.

Charge card interest expense declined 9 percent and 22 percent during 2004 and 2003, respectively, due to a lower effective cost of funds, partially offset by a higher average receivable balance. During the fourth quarter of 2004, TRS experienced an increase in the effective cost of funds.

Human resources expense increased 15 percent to \$4.4 billion in 2004 primarily due to increased costs related to merit increases, greater management incentives and higher employee benefit costs as well as the impact of the late 2003 acquisition of Rosenbluth and \$46 million of severance related restructuring costs noted earlier. Human resources expense increased 9 percent in 2003 primarily due to merit increases and higher employee benefit and management incentive costs, partially offset by the benefits of reengineering efforts.

Total other operating expenses of \$5.3 billion increased 6 percent during 2004 primarily due to increases in professional fees and occupancy and equipment expenses, partially offset by the \$117 million net gain in connection with the sale of the equipment leasing product line noted earlier. The increase in professional fees primarily reflects the impact of higher business volume-related technology outsourcing costs. Occupancy and equipment expenses increased primarily due to outsourced data processing services and increased depreciation of data processing equipment as well as the impact of the fourth quarter restructuring charges noted earlier. In 2003, total other operating expenses rose 8 percent to \$5.0 billion due to the impact of greater business and service volume-related costs, including outsourcing activities, partially offset by the benefits of reengineering initiatives and other cost containment efforts.

The effective tax rate was 31 percent in 2004 versus 32 percent in 2003. The effective tax rate was lower in 2004 as compared to 2003 primarily as a result of one-time and ongoing benefits related to the changes in international funding strategy during 2004, favorable variances between estimates of foreign tax expense and returns actually filed and favorable tax audit experience. The shifts in international funding strategy, which diversify funding sources and increase liquidity, are expected to benefit TRS' effective tax rate in future periods despite somewhat higher related funding costs.

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*The following discussion addresses results on a managed basis.*

### **Results of Operations - Managed Basis**

#### ***Revenues***

In 2004, TRS' net revenues increased 12 percent to \$22.5 billion primarily due to higher discount revenue from record cardmember spending and a greater number of cards-in-force, higher travel and other commissions and fees, increased cardmember lending net finance charge revenue, from higher average lending balances, and increased net card fees. Net revenues of \$20.1 billion in 2003 were 8 percent higher than 2002 as a result of increased discount revenues, cardmember lending net finance charge revenue, and travel and other commissions and fees.

Revenues and expenses are affected by changes in the relative values of non-U.S. currencies to the U.S. dollar. The currency rate changes had a favorable effect on revenue growth of approximately 2 percentage points in 2004 and 3 percentage points in 2003.

Discount revenue is TRS' largest single revenue source and is primarily driven by billed business volumes and the average discount rate earned on those volumes. Discount revenue rose 17 percent to \$10.2 billion in 2004 as a result of an 18 percent increase in billed business partially offset by a lower discount rate. The average discount rate in 2004 was 2.56% compared to 2.59% in 2003 primarily reflecting changes in the mix of spending between various merchant segments due to the cumulative impact of stronger than average growth in the lower rate retail and other "everyday spend" merchant categories (e.g., supermarkets, discounters, etc.). Based on TRS' business strategy, it expects to see continued changes in the mix of business. This, combined with volume-related pricing discounts and selective repricing initiatives, will probably continue to result in some discount rate erosion over time. Discount revenue rose 11 percent to \$8.8 billion during 2003 as a result of a 13 percent increase in billed business partially offset by a lower discount rate.

The 18 percent increase in billed business to \$416.1 billion for 2004 resulted from a 13 percent increase in spending per proprietary basic card worldwide and 8 percent growth in cards-in-force. U.S. billed business rose 16 percent to \$304.8 billion reflecting 16 percent growth within the consumer card business, 20 percent growth in small business services volume and a 12 percent increase within corporate services. U.S. non-T&E related volume categories, which represented approximately 67 percent of U.S. billed business in 2004, increased 19 percent over 2003 while U.S. T&E volumes rose 11 percent reflecting continued strengthening across all T&E industries. Total billed business outside the U.S., excluding the impact of foreign exchange translation, grew 15 percent reflecting strong double-digit improvement across all regions. Worldwide airline volumes, which represented 12 percent of total billed business volumes during 2004, increased 14 percent as a result of a 15 percent growth in transaction volumes, partially offset by a 1 percent decrease in the average airline charge. Additionally, network volumes grew over 30 percent as compared to last year.

U.S. cards-in-force rose 9 percent in 2004 to 39.9 million reflecting the benefit of continued strong card acquisition spending, an improved average customer retention level within proprietary issuing business and strong growth in U.S. network cards. Non-U.S. cards-in-force increased 6 percent in 2004 to 25.5 million due to growth in both proprietary and network partnership cards. Worldwide network cards-in-force increased over 30 percent during 2004. In 2003, U.S. cards-in-force rose 4 percent to 36.4 million and non-U.S. cards-in-force increased 9 percent to 24.1 million.

Cardmember lending net finance charge revenue of \$4.1 billion rose 4 percent in 2004 primarily due to a 15 percent growth in the average balance of the managed lending portfolio partially offset by lower

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average yields. The net interest yield on the managed worldwide lending portfolio decreased to 8.6% in 2004 from 9.1% in 2003 reflecting a higher average proportion of the portfolio on introductory or promotional rates during the year, lower revolve rates and improved credit quality, which reduces the proportion of the portfolio at default interest rates. In 2003, cardmember lending net finance charge revenue increased 7 percent to \$3.9 billion.

Net card fees increased 4 percent to \$1.9 billion in 2004 reflecting the growth in cards-in-force. Key aspects of TRS' business strategy are retention of cardmembers as well as driving growth in cards-in-force, whether organically, through related business opportunities, or through joint ventures and acquisitions. The average annual fee per proprietary card-in-force decreased to \$34 in 2004 from \$35 in 2003 which reflects the increase in the number of fee-free cards issued by TRS. Net card fees increased 6 percent to \$1.8 billion in 2003 reflecting growth in cards-in-force and the benefit of selected annual fee increases.

Travel commissions and fees rose 19 percent to \$1.8 billion in 2004 due to a 25 percent increase in travel sales, reflecting the Rosenbluth acquisition in late 2003 and improvement within the travel environment, partially offset by lower transaction fees related to growth in on-line transaction activity. The volume and type of travel sales are important as TRS earns revenue based on both the number of transactions as well as the sales mix of travel purchased. Travel commissions and fees rose 7 percent to \$1.5 billion in 2003 as a result of higher revenue earned per dollar of sales coupled with a 3 percent increase in travel sales, primarily due to the acquisition of Rosenbluth in the fourth quarter of 2003.

Other commissions and fees of \$2.4 billion increased 16 percent on greater volume-related foreign exchange conversion fees and higher card-related assessments and network partner-related fees. Other commissions and fees increased 4 percent in 2003 to \$2.1 billion due to higher card-related fees and assessments.

### ***Expenses***

During 2004, TRS' expenses were up 11 percent to \$18.4 billion reflecting greater marketing, promotion, rewards and cardmember services expenses, higher human resources expenses and increased total other operating expenses, partially offset by reduced provisions for losses and lower interest costs. Expenses in 2004 included \$64 million in aggregate charges recorded in the fourth quarter principally relating to the restructuring of business travel operations. These charges include \$46 million of employee severance obligations included in human resources expense and \$18 million of other exit costs primarily relating to the termination of certain real estate property leases. Also included in 2004 expenses was a \$117 million net gain on the fourth quarter sale of the equipment leasing product line in the small business financing unit. Expenses in 2003 of \$16.6 billion were 6 percent higher than 2002 primarily due to greater marketing, promotion, rewards and cardmember services, human resources and total other operating expenses, partially offset by reduced provisions for losses and interest costs.

Marketing, promotion, rewards and cardmember services expenses increased 32 percent in 2004 to \$4.9 billion reflecting both greater reward costs and higher marketing and promotion expenses. The growth in rewards costs is attributable to a higher redemption rate, strong volume growth and the continued increase in cardmember loyalty program participation. The increase in marketing and promotion expenses is primarily due to TRS' new global brand advertising campaign and the continued focus on business building initiatives. Marketing, promotion, rewards and cardmember services expense increased 27 percent in 2003 to \$3.7 billion on the continuation of brand and product advertising, an increase in selected card acquisition activities and higher cardmember rewards and services expenses reflecting higher volumes and a higher redemption rate.

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Total provisions for losses decreased 6 percent in 2004 primarily as a result of a reduction in cardmember lending provision offset by a net increase in other provisions. Provision for losses on the worldwide lending portfolio decreased 9 percent to \$2.1 billion in 2004, despite growth in loans outstanding and increased reserve coverage levels of past due accounts, due to well-controlled credit practices. The worldwide lending provision decreased 7 percent in 2003 to \$2.3 billion. The net write-off rate for the worldwide lending portfolio was 4.3% in 2004 as compared to 5.2% and 5.9% in 2003 and 2002, respectively.

Other provisions increased in 2004 primarily reflecting a reconciliation of securitization-related cardmember loans, which resulted in a charge of \$115 million (net of \$32 million of reserves previously recorded), for balances accumulated over the prior five-year period as a result of a computational error. The amount of the error was immaterial to any of the periods in which it occurred.

Separately, other provisions were favorably impacted by a reduction in merchant-related reserves of approximately \$60 million reflecting changes made to mitigate loss exposure and ongoing favorable credit experience with merchants.

In 2003, total provisions decreased 9 percent primarily due to the decrease in the lending provision noted above and an 11 percent reduction in the provision for losses on charge card products primarily due to strong credit quality reflected in an improved past due percentage and loss ratio.

Charge card interest expense declined 9 percent and 20 percent during 2004 and 2003, respectively, due to a lower effective cost of funds, partially offset by a higher average receivable balance. During the fourth quarter of 2004, TRS experienced an increase in the effective cost of funds.

Human resources expense increased 15 percent to \$4.4 billion in 2004 primarily due to increased costs related to merit increases, greater management incentives and higher employee benefit costs as well as the impact of the late 2003 acquisition of Rosenbluth and \$46 million of severance related restructuring costs noted earlier. Human resources expense increased 9 percent in 2003 primarily due to merit increases and higher employee benefit and management incentive costs, partially offset by the benefits of reengineering efforts.

Total other operating expenses of \$5.3 billion increased 6 percent during 2004 primarily due to increases in professional fees and occupancy and equipment expenses, partially offset by the \$117 million net gain in connection with the sale of the equipment leasing product line noted earlier. The increase in professional fees primarily reflects the impact of higher business volume-related technology outsourcing costs. Occupancy and equipment expenses increased primarily due to outsourced data processing services and increased depreciation of data processing equipment as well as the impact of the fourth quarter restructuring charges noted earlier. In 2003, total other operating expenses rose 8 percent to \$4.9 billion due to the impact of greater business and service volume-related costs, including outsourcing activities, partially offset by the benefits of reengineering initiatives and other cost containment efforts.

The effective tax rate was 31 percent in 2004 versus 32 percent in 2003. The effective tax rate was lower in 2004 as compared to 2003 primarily as a result of one-time and ongoing benefits related to the changes in international funding strategy during 2004, favorable variances between estimates of foreign tax expense and returns actually filed and favorable tax audit experience. The shifts in international funding strategy, which diversify funding sources and increase liquidity, are expected to benefit TRS' effective tax rate in future periods despite somewhat higher related funding costs.

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### Airline Industry Matters

Historically, TRS has not experienced significant revenue declines resulting from a particular airline's scaling-back or closure of operations due to bankruptcy or other financial challenges because the volumes generated from the airline are typically shifted to other participants in the industry that accept TRS' card products. Nonetheless, TRS is exposed to business and credit risk in the airline industry primarily through business arrangements where TRS has remitted payment to the airline for a cardmember purchase of tickets that have not yet been used or "flown". This creates a potential exposure for TRS in the event that the cardmember is not able to use the ticket and TRS, based on the facts and circumstances, credits the cardmember for the unused ticket. Historically, this type of exposure has not generated any significant losses for TRS because of the need for an airline that is operating under bankruptcy protection to continue accepting credit and charge cards and honoring requests for credits and refunds in the ordinary course in furtherance of its reorganization and its formal assumption, with bankruptcy court approval, of its card acceptance agreement, including approval of TRS' right to hold cash to cover these potential exposures to provide credits to cardmembers. Typically, as an airline's financial situation deteriorates TRS increases cash held to protect itself in the event of an ultimate liquidation of the airline. TRS' goal in these distressed situations is to hold sufficient cash over time to ensure that upon liquidation the cash held is equivalent to the credit exposure related to any unused tickets.

### Liquidity and Capital Resources

#### SELECTED BALANCE SHEET INFORMATION (GAAP BASIS)

December 31, (Billions, except percentages)	2004	2003
Accounts receivable, net	\$ 31.8	\$30.2
Travelers Cheque investments	\$ 8.4	\$ 7.7
Cardmember loans	\$ 26.9	\$25.8
Total assets	\$ 87.8	\$79.3
Travelers Cheques outstanding	\$ 7.3	\$ 6.8
Short-term debt	\$ 17.2	\$21.8
Long-term debt	\$ 28.3	\$16.6
Total liabilities	\$ 79.0	\$71.4
Total shareholder's equity	\$ 8.8	\$ 7.9
Return on average total shareholder's equity	33.4%	31.3%
Return on average total assets	3.5%	3.4%

Net accounts receivable and worldwide cardmember loans increased as compared to December 31, 2003, primarily as a result of higher average cardmember spending and an increase in the number of cards-in-force.

Total debt increased compared to December 31, 2003 primarily as a result of increased funding requirements due to the noted increases in cardmember receivable and loan balances as well as the contingent liquidity program discussed below. New long-term borrowing activity during 2004 is described below.

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### *Financing Activities*

TRS funds its cardmember receivables and loans using various funding sources, such as short- and long-term debt, medium-term notes, and sales of cardmember receivables and loans in securitizations. In 2004 and 2003, TRS had uninterrupted access to the money and capital markets to fund its business operations.

TRS funds its receivables and loans primarily through five entities. Credco finances the vast majority of cardmember receivables, while Centurion Bank and FSB principally fund cardmember loans originated from TRS' lending activities. In addition, two trusts are used by TRS in connection with the securitization and sale of receivables and loans generated in the ordinary course of TRS' card businesses. The assets securitized consist principally of U.S. consumer cardmember receivables and loans arising from TRS' charge card and lending activities.

TRS' funding needs are met primarily through the following sources:

- Commercial paper,
- Bank notes, institutional CDs and Fed Funds,
- Medium-term notes and senior unsecured debentures,
- Asset securitizations, and
- Long-term committed bank borrowing facilities in selected non-U.S. markets.

TRS' debt offerings are placed either directly, as in the case of its commercial paper program through Credco, or through securities brokers or underwriters. In certain international markets, bank borrowings are used to partially fund cardmember receivables and loans. During 2004, TRS diversified its funding base by borrowing under committed bank credit facilities as part of a change in local funding strategies in select international markets.

The following table highlights TRS' outstanding debt (including intercompany balances) and off-balance sheet securitizations as of December 31, 2004 and 2003:

December 31, (Billions)	2004	2003
Short-term debt	\$ 17.2	\$ 21.8
Long-term debt	28.3	16.6
Total debt (GAAP basis)	\$ 45.5	\$ 38.4
Off-balance sheet securitizations <sup>(a)</sup>	20.3	19.5
Total debt (managed basis)	\$ 65.8	\$ 57.9

*(a) Includes securitized equipment leasing receivables of \$0.1 billion at December 31, 2003.*

Short-term debt is defined as any debt with an original maturity of 12 months or less. The commercial paper market represents the primary source of short-term funding for TRS. Credco's commercial paper is a widely recognized name among short-term investors and is a principal source of debt for TRS. At December 31, 2004, Credco had \$3.8 billion of commercial paper outstanding, net of certain short-term investments. The outstanding amount, net of certain short-term investments, declined \$5.0 billion or 57 percent from a year ago primarily as a result of a change in Credco's funding strategy in certain international markets. Average commercial paper outstanding, net of certain short-term investments, was \$5.7 billion and \$7.7 billion in 2004 and 2003, respectively. TRS currently manages the level of commercial paper outstanding, net of certain short-term investments, such that the ratio of its committed bank credit facility to total short-term debt, which consists mainly of commercial paper, is not less than 100%.

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Centurion Bank and FSB raise short-term debt through various instruments. Bank notes issued and Fed Funds purchased by Centurion Bank and FSB totaled approximately \$5.2 billion as of December 31, 2004. Centurion Bank and FSB also raise customer deposits through the issuance of certificates of deposits to retail and institutional customers. As of December 31, 2004, Centurion Bank and FSB held \$4.5 billion in customer deposits. Centurion Bank and FSB maintain \$320 million and \$300 million, respectively, of committed bank credit lines as backup to short-term funding programs. Long-term funding needs are met principally through the sale of cardmember loans in securitization transactions. The Asset/Liability Committees of Centurion Bank and FSB provide management oversight with respect to formulating and ratifying funding strategy and to ensuring that all funding policies and requirements are met.

Medium- and long-term debt is raised through the offering of debt securities in the U.S. and international capital markets. Medium-term debt is generally defined as any debt with an original maturity greater than 12 months but less than 36 months. Long-term debt is generally defined as any debt with an original maturity greater than 36 months. At December 31, 2004, TRS and its subsidiaries had the following amounts of medium- and long-term debt outstanding (including intercompany balances):

December 31, 2004 (Billions)	Medium-term Debt	Long-term Debt	Total Medium- and Long-term Debt
Credco	\$12.2	\$6. 4	
Centurion Bank	3.0	1.4	4.4
FSB	1.6	–	1.6
Other Subsidiaries	1.7	2.0	3.7
Total TRS	\$18.5	\$9. 8	

In 2005, TRS along with its subsidiaries, Credco, Centurion Bank and FSB, as well as through its securitization trusts, expects to issue approximately \$13 billion in medium- and long-term debt to fund business growth and refinance a portion of maturing medium- and long-term debt. TRS expects that its planned funding during the next year will be met through a combination of sources similar to those on which it currently relies. However, TRS continues to assess its needs and investor demand and may change its funding mix. TRS' funding plan is subject to various risks and uncertainties, such as disruption of financial markets, market capacity and demand for securities offered by TRS, accounting or regulatory changes, ability to sell receivables and the performance of receivables previously sold in securitization transactions. Many of these risks and uncertainties are beyond TRS' control.

As of December 31, 2004, Credco had the ability to issue approximately \$7.3 billion of debt securities under shelf registration statements filed with the SEC.

### *Cost of Funds*

Cost of funds is generally determined by a margin or credit spread over a benchmark interest rate. Credit spreads are measured in basis points where 1 basis point equals one one-hundredth of one percentage point. Commercial paper and other short-term debt funding costs are based on spreads benchmarked against London Interbank Offered Rate (LIBOR), a commonly used interest rate. Costs for unsecured long-term debt and securitized funding are based on spreads benchmarked against LIBOR, U.S. Treasury securities of similar maturities, or other rates.

## TRAVEL RELATED SERVICES FINANCIAL REVIEW

### *Asset Securitizations*

TRS, through its subsidiaries, periodically securitizes cardmember receivables and loans arising from its card business. The securitization market provides TRS with very cost-effective funding for its long-term funding needs. Securitization of cardmember receivables and loans is accomplished through the transfer of those assets to a special purpose entity created for the securitization, generally a trust, which in turn issues securities to third-party investors that are collateralized by the transferred assets. The issued securities represent undivided interests in the transferred assets. The proceeds from issuance are distributed to TRS, through its wholly-owned subsidiaries, as consideration for the transferred assets. Securitization transactions are accounted for as either a sale or secured borrowing, based upon the structure of the transaction.

Securitization of cardmember receivables generated under designated consumer accounts are accomplished through transferring cardmember receivables to the American Express Master Trust (the Charge Trust). Securitizations of these receivables are accounted for as secured borrowings because the Charge Trust is not a qualifying special purpose entity (QSPE). Accordingly, the related assets being securitized are not treated as sold and the securities issued to third-party investors are reported as long-term debt on TRS' Consolidated Balance Sheets. There were no issuances of securities from the Charge Trust during 2004 and 2003. During 2004 and 2003, \$1.1 billion and \$2.0 billion, respectively, of previously issued trust securities matured.

Securitizations of cardmember loans arising from various portfolios of consumer accounts are accomplished through the transfer of cardmember loans to a QSPE, the American Express Credit Account Master Trust (the Lending Trust). Securitizations of loans transferred to the Lending Trust are accounted for as sales. Accordingly, TRS removes the loans from its Consolidated Balance Sheets and recognizes both a gain on sale and other retained interests in the securitization as discussed below. As of December 31, 2004 and 2003, the Lending Trust held total assets of \$24.7 billion and \$26.8 billion, respectively, of which \$20.3 billion and \$19.4 billion, respectively, had been sold.

TRS' continued involvement with the securitized assets includes the process of managing and servicing the securitized loans. In addition, TRS, through its subsidiaries, maintains an undivided, pro-rata interest in all loans transferred (or sold), referred to as seller's interest, and is generally equal to the balance of the loans in the Lending Trust less the investors' portion of those assets. As the amount of the loans in the Lending Trust fluctuates due to customer payments, new charges, and credit losses, the carrying amount of the seller's interest will vary. However, the seller's interest is required to be maintained at a minimum level of 7% of outstanding principal in the Lending Trust. As of December 31, 2004, the amount of seller's interest was approximately 18% of outstanding principal, well above the minimum requirement.

Additionally, TRS also retains subordinated interests in the securitized loans. Such interests include one or more investments tranches of the securitization and an interest-only strip. The investments in the tranches of the securitization are accounted for at fair value as Available-for-Sale investment securities in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," and are reported as investments in TRS' Consolidated Balance Sheets. As of December 31, 2004 and 2003, the ending fair value of these retained interests was \$0.1 billion and \$1.8 billion, respectively. The interest-only strip is also accounted for at fair value consistent with a SFAS No. 115 Available-for-Sale investment but is reported in other assets on TRS' Consolidated Balance Sheets. The fair value of the interest-only strip is the present value of estimated future excess spread expected to be generated by the securitized loans over the estimated life of those loans. Excess spread is the net positive cash flow from interest and fee collections allocated to the investors' interests after deducting the interest paid on investor certificates, credit losses, contractual servicing fees, and other expenses is recognized in securitization

## **TRAVEL RELATED SERVICES FINANCIAL REVIEW**

income as it is earned. As of December 31, 2004 and 2003, the fair value of the interest-only strip was \$207 million and \$225 million, respectively.

In accordance with the Lending Trust agreements, the excess spread in the Lending Trust is required to be maintained at a level greater than 0% at any point in time in the Lending Trust. As of December 31, 2004, the percentage of excess spread was approximately 10%, well in excess of the minimum requirement.

Under the respective terms of the Lending Trust and Charge Trust pooling and servicing agreements, the occurrence of certain events could result in either trust being required to paydown the investor certificates before their expected payment dates over an early amortization period. Examples of these events include:

- for either trust, the failure of the securitized assets to generate specified yields over a defined period of time,
- for the Lending Trust, the decline of the total of the securitized assets' principal balances below a specified percentage of total investor amounts outstanding after the failure to add additional securitized assets as required by the agreement, and
- for the Charge Trust, the decline of the total of the securitized assets' principal balances below a specified percentage of the total principal component.

TRS does not expect an early amortization trigger event to occur. In the event of a paydown of the Lending Trust, \$20.3 billion of assets would revert to the balance sheet and an alternate source of funding of a commensurate amount would have to be obtained. Had a total paydown of the Lending Trust hypothetically occurred at a single point in time at December 31, 2004, the one-time negative effect on results of operations would have been approximately \$800 million pretax to re-establish reserves and derecognize the retained interests related to these securitizations that would have resulted when the securitized loans reverted back onto the balance sheet. Subject to the performance of the loans, the one-time negative effect would be offset by finance charge revenue over the life of the loans. Virtually no financial statement impact would occur from a paydown of the Charge Trust, but an alternate source of funding for the \$1.9 billion of securities outstanding at December 31, 2004 would have to be obtained.

With respect to both the Lending Trust and the Charge Trust, a decline in the actual or implied short-term credit rating of TRS below A-1/P-1 will trigger a requirement that TRS, as servicer, transfer collections on the securitized assets to investors on a daily, rather than a monthly, basis or make alternative arrangements with the rating agencies to allow TRS to continue to transfer collections on a monthly basis. Such alternative arrangements include obtaining appropriate guarantees for the performance of the payment and deposit obligations of TRS, as servicer.

No officer, director or employee holds any equity interest in the trusts or receives any direct or indirect compensation from the trusts. The trusts in TRS' securitization programs do not own stock of TRS or the stock of any affiliate. Investors in the securities issued by the trusts have no recourse against TRS if cash flows generated from the securitized assets are inadequate to service the obligations of the trusts.

### ***Liquidity***

TRS balances the trade-offs between having too much liquidity, which can be costly and limit financial flexibility, with having inadequate liquidity, which may result in financial distress during a liquidity event (see Contingent Liquidity Planning section below). TRS considers various factors in determining its liquidity needs, such as economic and financial market conditions, seasonality in business operations, growth in business segments, cost and availability of alternative liquidity sources, and credit rating agency considerations.

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In 2004, TRS continued to strengthen its liquidity position by reducing its reliance on short-term debt, extending and spreading out its debt maturities and enhancing the capacity and flexibility of its contingent funding resources. Short-term debt on a GAAP basis as a percentage of total debt declined to 38% at December 31, 2004 from 57% at December 31, 2003. Short-term debt on a managed basis as a percentage of total debt declined to 26% at December 31, 2004 from 38% at December 31, 2003.

TRS estimates it will have funding requirements of approximately \$16 billion within the next year related to the maturity of long-term debt obligations. These requirements include \$6.4 billion related to certain securitization transactions that will enter their scheduled amortization period. In addition, TRS expects to maintain net short-term debt balances of approximately \$14 billion over the period. TRS believes that its funding plan is adequate to meet these requirements.

TRS believes that its existing sources of funding provide sufficient depth and breadth to meet normal operating needs. In addition, alternative liquidity sources are available, mainly in the form of the liquidity portfolio, securitizations of cardmember receivables and loans and committed bank credit facilities, to provide uninterrupted funding over a twelve-month period should access to unsecured debt sources become impaired.

### *Liquidity Portfolio*

During the normal course of business, funding activities may raise more proceeds than are necessary for immediate funding needs. These amounts are invested principally in overnight, highly liquid instruments. In addition, in the fourth quarter of 2003, TRS began a program to develop a liquidity portfolio in which proceeds raised from such borrowings are invested in U.S. Treasury securities. At December 31, 2004, TRS held \$4.0 billion of U.S. Treasury notes under this program.

The invested amounts of the liquidity portfolio provide back-up liquidity, primarily for the commercial paper program at Credco, and also flexibility for other short-term funding programs at Centurion Bank and FSB. U.S. Treasury securities are the highest credit quality and most liquid of investment instruments available. TRS can easily sell these securities or enter into sale/repurchase agreements to immediately raise cash proceeds to meet liquidity needs.

### *Committed Bank Credit Facilities*

TRS maintained committed bank credit facilities with 54 large financial institutions totaling \$13.8 billion (including \$1.96 billion at the Parent Company and the \$2.3 billion Australian Credit Facility discussed below) at December 31, 2004. As contemplated, in the second quarter of 2004, Credco borrowed \$1.47 billion under these facilities as part of a change in local funding strategy for business in Canada. Credco has the right to borrow a maximum amount of \$12.7 billion (including amounts outstanding) under these facilities, with a commensurate reduction in the amount available to the Parent TRS. These facilities expire as follows (billions): 2005, \$3.8; 2006, \$2.2; 2007, \$1.0 and 2009, \$6.3. The remaining lines of \$0.5 billion have no expiration date.

The availability of the credit lines is subject to TRS' compliance with certain financial covenants, including the maintenance by TRS of consolidated tangible net worth of at least \$8.75 billion, the maintenance by Credco of a 1.25 ratio of combined earnings and fixed charges to fixed charges, and the compliance by Centurion Bank and FSB with applicable regulatory capital adequacy guidelines. At December 31, 2004, TRS' consolidated tangible net worth was approximately \$13.0 billion, Credco's ratio of combined earnings and fixed charges to fixed charges was 1.36 and Centurion Bank and FSB each exceeded the Federal Deposit Insurance Corporation's "well capitalized" regulatory capital adequacy guidelines.

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In the third quarter of 2004, Credco entered into a new 5-year multi-bank credit facility for Australian \$3.25 billion (approximately U.S. \$2.3 billion) and borrowed Australian \$2.7 billion (approximately U.S. \$1.9 billion) under this credit facility to provide an alternate funding source for business in Australia. The availability of the Australian credit facility is subject to Credco's maintenance of a 1.25 ratio of earnings to fixed charges.

Committed bank credit facilities do not contain material adverse change clauses, which may preclude borrowing under the credit facilities. The facilities may not be terminated should there be a change in TRS' credit rating.

### *Contingent Liquidity Planning*

TRS has developed a contingent funding plan that enables it to meet its daily funding obligations when access to unsecured funds in the debt capital markets is impaired or unavailable. This plan is designed to ensure that TRS and all of its main operating entities could continuously maintain normal business operations for at least a twelve-month period in which its access to unsecured funds is interrupted. From time to time, Credco, Centurion Bank or FSB may increase its liquidity portfolio in order to pre-refund maturing debt obligations when financial market conditions are favorable. These levels are monitored and adjusted when necessary to maintain short-term liquidity needs in response to seasonal or changing business conditions. In addition, TRS maintains substantial flexibility to reduce its operating cash requirements, such as through its share repurchase program, and the delay or deferment of certain operating expenses.

The funding sources that would be relied upon depend on the exact nature of such a hypothetical liquidity crisis; nonetheless, TRS' liquidity sources are designed with the goal of ensuring there is sufficient cash on hand to fund business operations over a twelve-month period regardless of whether the liquidity crisis was caused by an external, industry or TRS specific event. The contingent funding plan also addresses operating flexibilities in quickly making these funding sources available to meet all financial obligations. The simulated liquidity crisis is defined as a sudden and unexpected event that temporarily impairs access to or makes unavailable funding in the unsecured debt markets. The contingent funding plan includes access to diverse sources of alternative funding, including but not limited to its liquidity investment portfolio, committed bank lines, intercompany borrowings, sale of consumer loans and cardmember receivables through its existing securitization programs and sale of other eligible receivables, such as corporate and small business receivables and international cardmember loans and receivables, through enhanced securitization programs. TRS estimates that, under a worst case liquidity crisis scenario, it has in excess of \$30 billion in alternate funding sources available to cover cash needs over the first 60 days after a liquidity crisis has occurred.

### *Contingent Securitization Capacity*

A key source in TRS' contingent funding plan is asset securitization. Management expects that \$17 billion of additional consumer loans, small business loans and cardmember receivables could be sold to existing securitization trusts. TRS has added the capabilities to sell a wider variety of cardmember receivables portfolios to further enhance TRS' flexibility in accessing diverse funding sources on a contingency basis.

TRS believes that the securitized financing would be available even through adverse conditions due to the structure, size and relative stability of the securitization market. Proceeds from secured financings completed during a liquidity crisis could be used to meet current obligations, to reduce or retire other contingent funding sources such as bank credit lines, or a combination of the two. However, other factors affect TRS' ability to securitize loans and receivables, such as credit quality of the assets and the legal, accounting, regulatory and tax environment for securitization transactions. Material changes in any of these factors may potentially limit TRS' ability to securitize its loans and receivables and could introduce

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certain risks to TRS' ability to meet its financial obligations. In such a case, the use of investment securities, asset dispositions, asset monetization strategies and flexibility to reduce operating cash needs could be utilized to meet its liquidity needs.

### ***Risk Management***

For TRS' charge card and fixed rate lending products, interest rate exposure is managed through a combination of shifting the mix of funding toward fixed rate debt and through the use of derivative instruments, with an emphasis on interest rate swaps, that effectively fix TRS' interest expense for the length of the swap. TRS endeavors to lengthen the maturity of interest rate hedges in periods of falling interest rates and to shorten their maturity in periods of rising interest rates. For the majority of its cardmember loans, which are linked to a floating rate base and generally reprice each month, TRS uses floating rate funding. TRS regularly reviews its strategy and may modify it. Non-trading interest rate products, primarily interest rate swaps, with notional amounts of approximately \$37.8 billion, a portion of which extends to 2009, were outstanding at December 31, 2004.

The detrimental effect on TRS' pretax earnings of a hypothetical 100 basis point increase in interest rates would be approximately \$61 million (\$50 million related to the U.S. dollar) and \$64 million (\$50 million related to the U.S. dollar), based on the 2004 and 2003 year-end positions, respectively. This effect is primarily a function of the extent of variable rate funding of charge card and fixed rate lending products, to the degree that interest rate exposure is not managed by derivative financial instruments.

TRS' foreign exchange risk arising from cross-currency charges and balance sheet exposures is managed primarily by entering into agreements to buy and sell currencies on a spot or forward basis. At December 31, 2004, foreign currency products with total notional amounts of approximately \$7.5 billion were outstanding.

Based on the year-end 2004 and 2003 foreign exchange positions, but excluding forward contracts managing the anticipated overseas operating results for the subsequent year, the effect on TRS' earnings of a hypothetical 10 percent change in the value of the U.S. dollar would be immaterial. With respect to forward contracts related to anticipated overseas operating results for the subsequent year, a 10 percent change would hypothetically impact pretax income by \$68 million and \$57 million related to the 2004 and 2003 year-end positions, respectively.