10 Loyalty Programs: Design and Effectiveness

10.1 Overview

To retain customers, many firms focus on increasing customer satisfaction levels. And the degree of customer satisfaction is a key measure. But the extent to which customer satisfaction leads to loyalty and thus profitability remains an important issue to be examined. Traditionally, customer satisfaction has been expected to increase retention or loyalty, thus leading to greater profits, as we introduced in Chap. 2. Although customer satisfaction and loyalty are key mediators of profit, they cannot be taken as simple predictors of it. From a business standpoint, it is more important to identify and nurture relationships specifically with *profitable* customers.

This is where loyalty programs come in. Loyalty programs (LP) represent an important CRM tool that can identify, reward, and successfully retain profitable customers. We discuss the objectives and design of various loyalty programs in Sects. 10.2 to 10.6. We also illustrate LP failures to offer insights into what distinguishes a successful program from unsuccessful ones. By reviewing LP characteristics, we also can systematically investigate outcomes and determinants of LP success and provide guidelines for designing optimal programs. The key dimensions of LP design, such as reward and sponsorship, are explained in detail and illustrated using relevant case studies.

The second part of this chapter then deals with the effectiveness of loyalty programs. In the past two decades, many firms have established some type of customer LP. Typically, these programs offer financial and/or relationship rewards to customers. In most cases, the aim is to increase sales revenue by increasing usage/purchase levels or engaging in up- and cross-selling. Loyalty programs also promise stronger relationships with customers. But they are not costless for the provider. Before any firm establishes an LP, it must ask: What is the cost effectiveness of this program? What differentiates an effective LP from an ineffective one? What key drivers ensure the effectiveness of loyalty programs? Understanding goals and design characteristics are critical means to develop and implement effective loyalty programs. It is equally, if not more, important to understand and monitor the features that make an LP effective; we suggest four such drivers. Therefore, after we present some empirical evidence about the performance of LPs across various industry segments, we use two case studies to reveal how firms can create competitive advantages through loyalty programs that are geared to attaining profits and value alignment. With this information, we derive a seven-point checklist for the successful design and implementation of loyalty programs.

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10.2 What Is Loyalty? Behavioral Versus Attitudinal Loyalty

Loyal customers generate more repeat business, develop a larger tolerance to price increases, and are more profitable to the firm. This conventional wisdom has long been accepted, but as we have shown, it is not always true. A very loyal customer may consume an inordinate amount of firm resources by demanding services and discounts. But marketers want to locate and entice new customers who are *profitable*, while also finding appropriate strategies to identify and possibly release unprofitable customers.

In Chap. 1, we noted the concept of *customer value*, defined as the economic value ($-metric) of the customer relationship to the firm, expressed as a contribution margin or net profit. As a marketing metric, customer value provides an important decision aid, beyond its capability to evaluate marketing effectiveness. A firm can both measure and optimize its marketing efforts by incorporating the concept of customer value in the core of its decision-making processes.

Although customer loyalty to a product or service, manifested as repeat purchases, may be due to natural satisfaction and preference for the products' features and benefits, loyalty also can be induced through marketing plans and programs. For example, wireless cellular phone service requires a 1–2-year contractual relationship with the customer – an indirect way of ensuring repetitive and profitable transactions for a predictable period of time.

Whether contractual or motivated through incentives, the success or failure of a LP depends ultimately on the profitability of the customer. The longevity of the relationship also does not automatically translate into tangible profitability. Rather, various customer loyalty programs work to identify, reward, and retain specifically profitable customers.

Before reviewing the structure of these various loyalty programs, it is important to understand the significant difference between behavioral and attitudinal loyalty. Broadly speaking, *behavioral loyalty* refers to the observed actions that customers have demonstrated toward a particular product or service. *Attitudinal loyalty* instead refers to a customer's perceptions and attitudes toward a particular product or service. Ideally, there should be a strong correlation between a customers' attitudes and behaviors, though in some instances, customer behaviors differ radically from their attitudinal perceptions about the product or service.

A Case in Point

A frequent flyer member of ABC airlines might continue the relationship only because she has accrued many points and wants to redeem her miles. Although her attitudinal preference is to travel with XYZ airlines, because of its superior quality of service and experience, she feels compelled to continue transacting with ABC. In this situation, her relationship with ABC reflects strong behavioral loyalty, while her negative perceptions of it reflect poor attitudinal loyalty. Attitudinal loyalty is extremely important; customers who are not attitudinally loyal likely terminate the relationship at the earliest available opportunity. As we will find, not all loyalty programs are interested in creating attitudinal loyalty with the target customers.

10.3 What Is a Loyalty Program? Definition and Key Objectives

In recent years, many companies have introduced loyalty programs (LPs), frequent reward programs, or customer clubs. An LP comprises a marketing process that generates rewards for customers, based on their repeat purchases. As we use it, the term LP subsumes the many different forms of reward programs. Therefore, we recognize that consumers who enter an LP likely transact more with the focal company and give up some of the free choice they possess otherwise. In exchange for concentrating their purchases with the focal firm, they accumulate assets (e.g., points), which they may exchange for products and services, usually those associated with the focal firm. Because of these characteristics, LPs offer an important CRM tool that marketers use to identify, award, and retain profitable customers.

This is not to suggest that they are new additions in the relationship marketer's toolkit. Sainsbury (UK) archives show that in the 1970s, its managers wrote to customers who had not made their usual shopping trips, in an effort to encourage and maintain their patronage. Later, the store used a Green Stamps initiative, which customers enjoyed, despite the demand that they paste the stamps into many books before receiving any reward (Passingham, 1998).

Overall, the *key objectives* of introducing LPs consist of four categories:

1. Building true (attitudinal and behavioral) loyalty
2. Efficiency profits
3. Effectiveness profits
4. Value alignment

Any loyalty program implemented by a firm may pursue all or only some of these goals at the same time.

10.3.1 Building True Loyalty

An LP aims to build greater customer commitment to the product or organization by garnering true loyalty, which combines elements of both attitudinal and behavioral loyalty. According to this logic, customers exhibit behavioral loyalty (i.e., purchase a product repeatedly) for several reasons, including convenience or price, as well as a sense of loyalty. Behavioral loyalty may result from attitudinal loyalty, but it can be driven by other factors too.

Furthermore, though many LPs have the goal of "making customers more loyal," the outcomes of true loyalty – greater commitment, greater word of mouth, and so on – are difficult to observe. Enforcing loyalty by enticing customers with rewards and bonuses is unlikely to create true loyalty, because true loyalty instead is a function of the value provided to customers. It encompasses various factors: degree of involvement in the product category, visibility of product usage, or the value expressive nature of the product, to name a few. None of these aspects can be controlled by the firm.

Take, for example, a low-involvement category – grocery shopping. Inducing true loyalty for grocery shoppers is a tough proposition, because their purchases are nearly always driven by tangible considerations, such as value for money.

10.3.2 Efficiency Profits

Efficiency profits result from a change in the customer's buying behavior, induced by the LP. This change in behavior can be measured in several ways:

- Basket size
- Purchase frequency acceleration
- Price sensitivity
- Share of category requirements (SCR) or share of wallet
- Retention
- Lifetime duration

The most widely used measure of behavioral loyalty is SCR, which describes the extent of purchases in a category that are served by the focal brand or retailer. Efficiency profits are net of LP cost. An LP that attempts to generate efficiency profits works on the assumption that customers build up switching costs when they accumulate loyalty-based assets. This accumulation encourages them to forgo their free choice, because the expected reward makes this reduction appear worthwhile.

There are two key criticisms of this viewpoint. First, for a customer to engage in an LP, the overall utility of being in the LP must be higher than the utility of not being in the LP. The cost for the firm to entice the customer to change behavior accordingly may be higher than it would be without the LP. Carlos Criado-Perez, the one-time CEO of Safeway (1999–2004), thus traded off the benefits: "Scrapping Safeway's (UK) ABC loyalty card scheme saves it £50 million this year, money that will be invested in cutting prices."[1]

Second, a goal of efficiency profits implies that the customer segment most likely to join the LP consists of those who are truly loyal anyway, so their business is already likely. In this case, the question arises about whether LPs actually change buying behavior. Perhaps they do not change behavior as much as they reinforce existing behavior, but at a much higher cost to the firm. For example, loyalty cards have been criticized for rewarding heavy spending rather than true loyalty. The segments most interested in these plans tend to be affluent groups who can afford to build up points, even if they hold cards from more than one store.[2]

Yet, despite the difficulty associated with achieving efficiency profits, many LPs are introduced with just this goal in mind.

10.3.3 Effectiveness Profits

Effectiveness profits refer to the medium- to long-term profit consequences realized through the development of better knowledge about customer preferences. The LP is designed to gather information about individuals, their behavior, and their preferences and then to derive knowledge from this information. This process of learning allows the firm to improve its knowledge of customer preferences and to offer increasingly better-tailored value propositions to various customers. The improvement in the value proposition comes through effective product and communication offerings. Effectiveness profits – more than any other type of LP outcome – are likely to generate sustainable competitive advantages and yield the highest profits in the long run.

Achieving Effectiveness Profits in a Grocery Store

Effectiveness profits require an information-based strategy that gathers and analyzes information about every transaction. For example, in grocery retailing, the system must collect information about every item purchased, down to the color of ink in a pen, along with the time of day, weather, and even the checkout operator's name. Such *data mining* can generate personalized promotions and recommendations so that a vegetarian never receives a promotion for steaks. The knowledge that a customer is a vegetarian might come from either surveys or previous buying behavior. If the store's computer recognizes that a customer never buys meat, it can predict that the customer is a vegetarian, and not that she is buying her meat elsewhere. Although this assumption could be wrong, a store would rather not bother a customer with costly promotions for categories from which that customer has never bought anything.

Promotions of new products rely on an *ideas list*, populated by both new launches and existing products that the data mining algorithms suggest specific customers might desire. For example, if a customer buys a lot of California Chardonnay, the list might suggest that he is likely to try a white Burgundy on special promotion, because it is made from the same grape. The strategy of using an LP to *learn about customer preferences* thus can result in value, as well as impressive gains, for both customers and organizations. Customers get more of what they truly want; firms avoid costly, mass marketing exercises. However, a learning strategy demands a relatively high process sophistication for its implementation. The collection of massive amounts of data may have grown easier, but analyzing, learning about, and implementing the conclusions obtained is much more difficult. Few companies have mastered this strategic capability to a satisfactory extent.

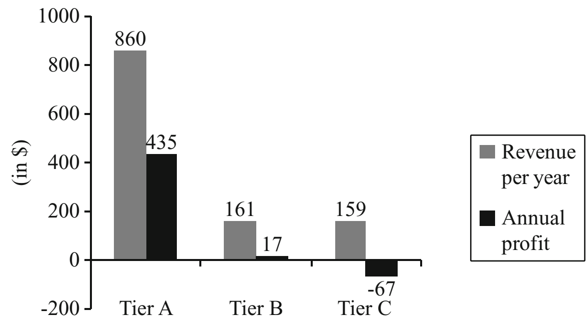
10.3.4 Value Alignment

Finally, value alignment aims to match the cost to serve a particular customer with the value that

[1] Interview with Carlos Criado-Perez, CEO Safeway (UK), on BBC News (May 4, 2000).

[2] Interview with Richard Gaines, Retail Consultant with Mintel Research UK (Spring 2001).

Fig. 10.1 Revenue and profitability of customers



the person brings to the firm. The underlying concept states that for any industry, customers have differential monetary value to firms, and they also are differentially expensive to serve. For example, if a provider of wireless services were to arrange its customers from highest to lowest value, it might discover that its business users generate higher phone bills than casual, occasional users. Likewise, if it were to arrange the same customers according to the costs of serving them, it would find some customers easy to satisfy, whereas others exploit the customer service function constantly. If a firm pursues value alignment, it simply attempts to align the profits it receives from a given customer with the cost incurred to serve that customer. Clearly, not every customer is treated equally – a notion some managers find discomforting. However, this differentiation allows firms to ensure that their best customers get their best service. The goal of value alignment is particularly critical when there is great heterogeneity in customers' value and costs to serve, such as in the airline, hospitality, or financial services industries.

Example
Figure 10.1 illustrates an example of a firm with a highly heterogeneous customer base. It indicates the profitability of a bank, derived from three very different customer profiles: Tier A represents 31% of the customer base, whereas Tier B makes up 42%, and Tier C makes up the remaining 27% of the customer base. More than one-quarter of these customers are unprofitable and must be subsidized by the highly profitable ones – a condition not uncommon in banks.

If this bank were to institute an LP, it might pursue the four different LP goals. If it chooses a particular goal, how can it achieve that outcome most effectively? Such an assessment requires a more detailed understanding of the impact of the drivers of LP success. That is, to reach the goals of an LP, it seems useful to understand some of their characteristics, including the suitability of the goal, cost structures, challenges involved, and the degree of competitive advantage created, as summarized in Table 10.1.

10.4 Loyalty Programs: Increasing in Popularity

Interest in loyalty programs exploded in the late 1990s. Building mainly on the premise that it is cheaper to market to existing customers than to acquire new ones, firms across a multitude of industries raced to implement some form of loyalty schemes. Thus the growth in LP usage has been staggering. In 2006, U.S. loyalty programs counted 1.34 billion members. Just 2 years later, the number had risen to 1.81 billion members – and it continues to increase (Odell, 2009).

Some quantitative examples and the summaries attest to this growth:

- In 2010, "PAYBACK", Germany's largest loyalty program, documented 18.5 million membership accounts, 13.5 million of which represented active users. Holding on average two cards per account, it accounts for about 32% of Germany's population (Lebensmittelzeitung, 2011) and reaches about 42% of German households (Wyndham Worldwide, 2009).

Table 10.1 Key characteristics of loyalty programs

Goal of LP	Commitment, WOM, building communities (true loyalty)	Efficiency profits	Effectiveness profits	Value alignment
Most suited for . . .	All branded products (though larger brands have more difficulty uniquely differentiating their brand and managing customer interactions)	Many industries	▪ Firms with access to much information ▪ Firms that communicate directly with end users	All industries with skewed customer value distributions. Within this class, industries with product perishability (airlines, hospitality, rental cars) are particularly well suited.
Cost of LP may be mitigated by	—	Contributions from manufacturers (promotions)	Contributions from manufacturers (promotions)	Low marginal cost of rewards
Key challenges	▪ Providing meaningful value to create differentiation in consumers' minds ▪ Brand building	▪ Providing acceptable incentives to customers while also controlling costs ▪ Program differentiation	Capability to handle, analyze, learn from, and deploy knowledge from large databases	▪ Implementing the customer differentiation scheme (deployment automation) ▪ Having fair and equitable relationships but ensuring that best customers are treated best
Degree of competitive advantage	*High* (a truly loyal customer base is hard and costly to replicate, because it can only be built over time)	*Low* (it is easy to replicate benefits, and program costs create major challenges)	*High* (capability of learning from customer behavior and using it is very difficult to copy and unique to a company's context)	*Low-medium* (LPs have become standard industry practice)

- By 2002, there were more than 120 million airline frequent flyers worldwide, with most residing in the United States (74 million), Europe (24 million), and Asia (21 million) (Webflyer, 2011).
- "American Advantage" is the largest frequent flyer program in the world. As of December 2009, its membership rolls boasted more than 64 million members (AMR Corporation, 2009).
- With 56 million members globally, who contribute $6.5 billion in room revenue, IHG's (InterContinental Hotels Group) "Priority Club" Rewards is one of the first, largest, and fastest growing guest loyalty program in the hotel industry. The program adds 600,000 members monthly and offers points for stays in 4,300 hotels in nearly 100 countries worldwide. Members can redeem points for future hotel stays, airline miles on more than 40 partner

airlines, car rentals, gift certificates, or hundreds of products available in a rewards catalog (IHG, 2010).

- In the highly competitive U.K. retail industry, Tesco has managed to double its earnings by taking market share from rivals such as Sainsbury's. Its success has been credited to its popular customer loyalty program, which enables shoppers to earn points and redeem them on future visits or with airlines (ABC, 2003).
- The French retailer E. Leclerc spends approximately \$23.5 million each year for LP marketing and management (Meyer-Waarden, 2007).[3]
- According to VSS Communications Industry Forecast, U.S. companies devoted \$2.18 billion to loyalty programs in 2008 (Odell, 2009). Just a few years ago, in 2003, Gartner analyst Adam Sarner declared that U.S. companies spent more than \$1.2 billion on customer loyalty programs (Young & Stepanek, 2003). This enormous growth reflects the great popularity of loyalty programs.

The most well-known examples of loyalty programs remain frequent flyer programs. American Airlines was the first, establishing its "Advantage" program in 1981. During the 1990s, supermarket chains and general merchandise retailers followed suit and established loyalty programs, such as the "Carte de Fidélité" program offered by the French retail chain Carrefour or the "ClubCard" at Tesco. The latest form of loyalty programs involves point collection schemes initiated by third parties (e.g., Webmiles, PAYBACK), where users collect points across a network of member companies.

Although LPs have become immensely popular, it is far from clear whether they actually help firms engender greater customer loyalty and higher profits, partly because of the considerable cost associated with managing an LP, and partly because their management can be so complex.

CRM AT WORK 10.1

Frequent-Flyer Programs

In the airline industry, five main factors drive customers' choices of providers: market coverage, price, schedule, frequent flyer programs, and product attributes. For many years, the common belief in the airline industry was that loyal customers were more profitable, so by rewarding customers based on the miles they flew, the airline could increase their loyalty. But there were some serious shortcomings in this approach. By rewarding all passengers equally, the airline failed to maximize the value for its most profitable customers. Seat class and fare types were ignored in the reward system. When it realized this flaw, the airline industry moved away from basing rewards on miles flown; Airlines, United, Continental, and USAir all multiply the miles flown by a customer by a coefficient derived from the type of seat class the customer paid to receive.

Passengers willing to pay to upgrade to business or first class thus earn more miles and get rewarded sooner and more often. In contrast, customers who hunt for bargains and purchase deeply discounted tickets far in advance or at the last minute earn far fewer miles than those who pay the full fare. This practice makes sense conceptually: bargain-hunting customers tend to be loyal to finding a bargain than to a reward card program or a specific airline. By increasing the rewards granted to passengers who are willing to pay more per seat than the average passenger, the airlines maximize the benefits for their most profitable customers while minimizing rewards for bargain hunters.

Consider Southwest Airline's reward program. It initially was based on the number of flights each passenger took, and eight round-trip flights earned the person a free round-trip flight. In terms of rewards, a flight from Providence, Rhode Island, to

[3] Based on a conversion rate of 1 Euro = 1.305 USD, as of February 1, 2005.

Baltimore, Maryland, was worth the same as a flight from Baltimore to Las Vegas, Nevada – despite the great difference in distance. On a conceptual level, it might make sense, because the cost of operating a plane is largely independent of the distance flown; flight crew, airport desks, and luggage handling costs are all constant. But customers who fly longer distances tend to pay more, because fares reflect distances. This extra revenue gets offset by the cost of the extra fuel used during the flight and the fewer per-day flights for a plane on a longer route.

But the conceptual argument was not sufficiently convincing. Therefore, Southwest relaunched its frequent flyer program as the "All-New Rapid Rewards" in March 2011, basing the rewards on dollars spent on flights by customers. Similar to other airline programs, this LP takes different fare types into account. It also allows passengers to earn points with partners in the retailing, lodging, dining, rental car, and banking industries.

Finally, the new program features a four-tier system that distinguishes Standard, A-List, A-List Preferred, and Companion Status customers. To reach A-List Status, a flyer must take 25 qualifying one-way flights or earn 35,000 Tier Qualifying Points in a calendar year. These members then enjoy benefits such as priority boarding, 25% earning bonus, and an A-List dedicated phone line for customer service. Companion Status (reached with 100 qualifying one-way flights or 110,000 Tier Qualifying Points in a calendar year) allows the member to designate a companion and receive a free ticket for that companion on every flight the member takes during the year. With this revision, Southwest attracts the business of high-value customers who tend to fly at least once a week (Southwest, 2011).

Examples of Loyalty Programs

- *Frequent buyer programs*. The simplest initiatives are based on punch-cards that offer a free complimentary product. City Bagels, a sandwich retail chain, offers customers a tenth sandwich free, after they garner nine stamps from previous purchases. The purpose is to increase both sandwich consumption and customer retention. Stores such as BigY, Kroger, and CVS offer discounts on certain store merchandise to cardholders, to ensure their loyalty and retention.
- *Volkswagen Club and Card*. The Volkswagen Club and Card concept attempts to establish a direct relationship with end customers. Customers collect points when Volkswagen (VW) services their car or if they buy VW accessories, as well as from partners, such as car rental companies and tour operators. The points can be redeemed for dealer services, price reductions on car purchases, or catalog merchandise. The purpose is to establish a better communication between VW dealers and customers, to bind them more closely to the brand.
- *Star Alliance Frequent Flyer Program*. The Star Alliance is a group of 27 airlines across all continents that cross-list flights, share facilities, and recognize their respective frequent flyer programs. Any flight on any Star Alliance airline counts toward a member's frequent flyer program. With 1,160 airports in 181 countries worldwide, the Star Alliance has become the largest airline network in the world.
- *Webmiles.de*. Webmiles.de, founded in 1999, claims to be the largest Internet-based loyalty program. It operates an LP that allows members to collect and redeem assets with a network of more than 470 retail partners. Thus, the retailers become members in Webmiles' partner network. Webmiles manages the program and communication with more than 2.6 million active members in Germany, Austria, and Switzerland.
- *Neiman Marcus*. A luxury retailer based in Dallas, Texas, Neiman Marcus offers its

"InCircle" LP to all its customers. Using a shopping card, customers accumulate points that can be redeemed for exclusive rewards.

10.5 Problems with Loyalty Programs

Although LPs have become widespread and popular, the benefits are not always clear. Many companies, such as ANZ Bank, invest millions of dollars into this CRM tool, only to find that it sucks up great resources without any obvious return.

CRM AT WORK 10.2

Example: ANZ Bank

In May 2003, ANZ Bank (Australia's third-largest bank) increased its annual fees by $50 on credit cards linked to its reward programs. This increase was primarily due to the increased point acquisition by frequent flyers and the potential fee reduction for inter-bank credit card transactions (Moneymanager, 2011). Specifically, ANZ Bank planned to raise fees on credit card holders who paid their balance monthly (taking advantage of the interest-free period). This was a wake-up call for corporations that had invested their marketing dollars in LPs (Kjellerup, 2003), because the primary reason for the price hikes was to stem losses incurred by the cost of running credit card related reward programs. The costs had risen to the point that the programs no longer were sustainable. Therefore, the bank needed to choose: reduce reward program benefits or increase annual fees to pass some of the costs on to customers.

Examples such as this may mark the beginning of a trend, in which large corporations that have spent millions of marketing dollars on LPs closely evaluate their costs and tailor reward programs more accurately to achieve better profitability.

Most companies need to revisit their business model, not only to reflect on the impact of loyalty programs on their bottom line, but also to determine how customer service initiatives add value and ensure future revenue streams. For some companies, this reassessment leads to the decision to eliminate any further investments in loyalty programs:

The LP test run by the U.K. chain ASDA Supermarkets (purchased by Walmart in 1999) cost £8 million in 1 year. The company chose not to invest in a full rollout, which would have cost £60 million (Direct Marketing, 2011). According to a spokesperson for ASDA, "We decided we didn't have to invest in points and plastic to make our customers loyal." And this assessment seems accurate: At the time it tested its pilot LP, ASDA's market share was 17.2%. A year later, it had risen to 17.6%.

Safeway terminated its LP in April 2000, which saved the company approximately $85 million in annual LP costs.[4] This chain's rationale was that "People have lost interest in (loyalty card) points and don't think they give value. What they really appreciate are straightforward product offers at great prices," according to the CEO Carlos Criado-Perez in May 2000.

A few years ago, Continental Airlines downgraded its liberal upgrading policy because it was too expensive. The company estimated a $100 million loss in revenue from upset frequent flyers. A class action suit also followed. What initially was designed to be a customer LP turned out to be a disappointing failure.

Despite their immense popularity, the aspects that distinguish a successful LP from an unsuccessful one remain unclear. Our discussion in the next section therefore reviews several LP characteristics to investigate the outcomes and determinants of LP success systematically, and thus to provide guidelines for designing optimal programs.

[4] Based on 1 British Pound = 1.7 USD, as of November 25, 2003.

10.6 Design Characteristics of Loyalty Programs

The multitudes of LPs attest to the various discretionary choices that arise for designers of such programs. Furthermore, LPs differ substantially both within and across industries. Managers can exercise discretion regarding the composition and the choice of dimensions to include in their LP design, as well as the corresponding weights assigned to each dimension. In this sense, we characterize LPs along the following key dimensions, which must be defined when designing a program:

- Reward structure
  - Hard versus soft rewards
  - Product proposition support (choice of rewards)
  - Aspirational value of reward
  - Rate of rewards
  - Tiering of rewards
  - Timing of rewards
  - Rewards based on specific criteria
- Participation requirements
  - Voluntary or automatic enrollment
  - Open versus closed LP
  - Automatic or manual point accumulation
- Payment function
- Sponsorship (existence of partner network, network externalities)
  - Single versus multiform LP
  - Within- versus across-sector LP
  - Ownership (focal firm versus other firm)
- Cost and revenues of LPs

10.6.1 Reward Structure

The principal motivation for consumers to enroll in LPs is to accrue benefits from rewards from their purchase transactions over time. From a consumer's perspective, the rewards attained through an LP membership are the key design benefit.

Hard versus Soft Rewards
Financial or tangible rewards (hard) differ from those based on psychological or emotional benefits (soft). Hard rewards run the gamut from price reductions to promotions and free products to preferred treatment. For example, a member of KLM's "Flying Dutchman" frequent flyer program may receive a free airline ticket for travel within Europe after collecting 20,000 miles – a hard reward. Soft rewards instead are linked to special recognition of the buyer, which offers the psychological benefit of being treated in a special way or having special status. For example, many frequent travelers with Silver or Gold status consider their membership in the category something special (often called the *badge effect*). Of course, the psychological recognition of loyalty status often comes with tangible benefits, such as preferred customer service (e.g., special service phone number).

Product Proposition Support
The rewards from a loyalty program may be linked to the company's product offering or be entirely unrelated. The U.S. bagel franchise Finagle-A-Bagel operates an LP that allows participants to redeem their accumulated bonus points only for the firm's own products – sandwiches and drinks. The reward thus directly supports the firm's product proposition. Other LPs allow members to redeem points for products completely unrelated to the focal firm's offering, such as BP's program, in which users can redeem points earned from gasoline-related purchases for merchandise such as first-aid kits, coffee mugs, or Barbie dolls.

Aspirational Value of Reward
From time to time, consumers engage in *hedonic consumption* of products that are mainly associated with pleasure and fun. Research in consumer psychology reveals that consumers prefer hedonic goods rather than utilitarian ones when receiving a gift. Consumers indulge more easily in luxury consumption when they get "something for nothing," as in the case of a gift or LP reward.

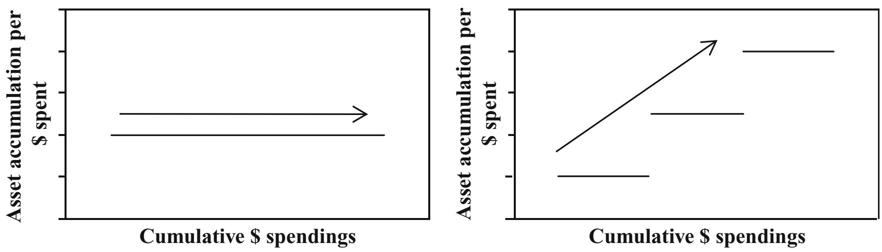


Fig. 10.2 Change in cumulative spending for two response functions

A free flight to an exotic destination thus might be worth more to a buyer (at least perceptually) than vouchers for the local supermarket, even if they have the same face value. Companies try to differentiate their LPs by highlighting the inspirational or hedonic value of their rewards. For example, the German TV channel PRO7 maintains the "PRO7 Club", one of whose most popular rewards is VIP service, which offers preferred access to talk show visitors or the chance to meet actors backstage. Mercedes-Benz's LP makes it possible to transform points into a flight in a MIG 29 combat aircraft. The luxury retailer Neiman Marcus catalogs a list of "wow and cool" rewards each year – such as having a world-famous photographer visit the customer's home to take family pictures.

Rate of Rewards

The *rate of rewards* refers to the ratio of reward value to transaction volume (both in monetary terms). In other words, it tells you how much a consumer gets in return for concentrating his or her purchases. Consumers prefer higher reward rates, but reward redemptions are a key cost factor for firms that run LPs. Rate of rewards is one of the, if not the primary, drivers of LP enrollment and active usage.

Tiering of Rewards

Rewards follow an asset accumulation response function, which describes how assets or rewards get accumulated as a function of spending behavior. Tiered rewards programs might follow constant, hierarchical, offer-related, or cyclical functions. With constant rewards, customers receive enduring, stable incentives (see case 1), but hierarchical or graded rewards increase with greater spending levels (case 2). In the case of offer-related assets, customers receive rewards that are exclusive to a particular special offer, such as PAYBACK's 10-times points coupons that can be used only during a specific time period. Finally, cyclical rewards encourage a certain consistency in behavior, such as when LP providers use special occasions such as Christmas or the customer's birthday to express appreciation in the form of a reward.

Figure 10.2 depicts two different response functions. In case 1 on the left, the buyer receives the same amount of rewards per dollar spent regardless of spending level. In case 2 on the right, the buyer receives more rewards per dollar spent as his or her spending level increases. The program in case 2 thus is relatively more attractive for high spenders; many airline programs, as well as Bloomingdale's, follow this pattern.

CRM AT WORK 10.3

Bloomingdale's Rewards Plus Program

Bloomingdale's Rewards Plus program consists of three tiers whose levels of rewards to customers vary according to their annual spending level. Regardless of spending levels, all members with a Bloomingdale's credit card receive the benefits of the "Premier Insider" program: access to exclusive travel and entertainment offers, preview days before sales begin, and extra savings for using their cards during membership days. Women's shoe purchases by Premier Insider members also are automatically tracked, and members receive 25% off their sixth pair of full-priced women's shoes.

The second tier, "Premier Plus Insider", is reserved for members who spend more than $1,000 annually. These customers receive the same rewards as Premier Insiders, as well as a host of other benefits. They can achieve certificates toward future Bloomingdale's purchases, earned at a rate of 3% for all purchases made at Bloomingdale's and 1% for all purchases made elsewhere with that credit card. During special double- and triple-reward events, the rebate increases to 6% or 9%. Premier Plus members also receive 12 free gift-wraps each year.

The pinnacle is the "Ultimate Premier Insider". These customers spend more than $2,500 each year and thus are exclusively offered some of the very best rewards, including unlimited free gift-wrapping and free local delivery of their purchases. Ultimate Insiders also have access to a customer service line reserved solely for their use, exclusive events, and offers.

By offering this differentiated rewards program, Bloomingdale's seeks to distribute the most rewards to its best customers. The rebate system effectively pays for itself by generating revenue from customers who carry a balance on their card. However, some of the other benefits, such as free delivery, can prove costly to the retailer.

Timing of Rewards

The timing of reward redemption is an important design feature. It is more attractive for the firm to create redemption rules that favor long accumulation periods, to ensure customer retention over time. This effect is also called *lock-in*. Customers build up assets over time, which function as switching costs for them. Customers instead favor immediate rewards or short accumulation periods. Managers must determine how long it takes to accumulate assets for a representative reward, given a certain buying pattern (e.g., average interpurchase time). The timing of rewards should be determined by the minimum redemption rules, type of reward given, and reward rate. The longer it takes to build up a certain reward level, the greater the *breakage*, or the amount of rewards never redeemed.

Rewards Based on Specific Criteria

Rewards can be designed to fit certain parameters, such as the time period, person, categories/brands, and distribution channels. When rewards refer to a specific time period, retailers pursue two main goals: generating additional revenue and increasing sales during weak sales periods. Offering rewards targeted to a specific group of card holders, such as customers whose last transaction was long ago, can help to activate "sleeping" customers. Furthermore, some companies tie rewards to specific categories, brands, or distribution channels to boost sales in these areas.

10.6.2 Participation Requirements

Another important characteristic of LPs are the requirements for becoming a member and the way points get collected.

Voluntary or Automatic Enrollment

When designing a loyalty program, companies must choose between voluntary and automatic enrollment. With automatic enrollment, the company deliberately enrolls all of its customers in the LP without differentiation. Voluntary programs are more common, because they allow consumers to self-select if they want to join. However, automatic enrollment is an appealing option if the company wants to track all consumers' transaction data (e.g., banks, credit cards).

Open versus Closed Loyalty Programs

Open LPs are accessible to anyone; closed LPs are deliberately restricted to a particular group of users, usually through the requirement of a membership fee. Both types of programs offer several advantages, as listed in Table 10.2:

Table 10.2 Open versus closed loyalty programs

Open loyalty program	Closed loyalty program
Reach critical numbers in the loyalty program faster	Concentrated target group due to access restrictions
More comprehensive database	Database mainly holds members with high interest in the assortment
Simplified acquisition/address of potential new customers and customers of competitors	Allows for more effective communication due to clearly defined member group
Greater efficiency of the LP due to larger customer base	Membership conditions (e.g., fee) limit number of members and associated costs
	Conveys feeling of exclusivity to program members

Automatic or Manual Point Accumulation
Most loyalty programs automatically record points, once the issued loyalty card is offered at checkout or the card number is entered in Internet transactions. Some programs such as "My Coke Rewards" or the German "Genusspunkte-Programm" (Nescafé Dolce Gusto Club) instead require online consumers to enter a code that can be found on products. Although consumers generally prefer automatic point accumulations, for companies, a manual system can be more cost effective.

10.6.3 Payment Function

For some LP providers, it has become common practice to endow loyalty cards with a payment function. Paying with a loyalty card can facilitate a comfortable purchase process for customers, and companies benefit as well because it is easier to generate purchase statistics at the individual customer level. In the United States, approximately 60% of all consumers own reward-based credit cards. The relevance of combining rewards with credit cards offered by retailers is strongly evidenced by Visa Claims reward cards, which now make up more than half of all credit cards and about 80% of money spent on credit (Credit Cards, 2011).

Retailers offer two types of loyalty cards that include payment functions. If the transactions aim to debit the customer's account and credit the retailer's account, the card must involve a banking partner (open loop). If instead the transactions do not actually pay for the purchase but rather grant the retailer access to an existing customer account (e.g., automatic debit transfer systems), no banking partner has to participate. The latter form is called a closed loop.

10.6.4 Sponsorship

The sponsorship function refers to supply-side features that describe the LP owner.

Single- versus Multi-Firm LP
Organizations may establish LPs that include only transactions with their own customers. For example, BP France accepts only transactions by members made at BP stations in France. In contrast, members of Tesco's "ClubCard" accumulate points by purchasing from the energy provider E. on. Such alliances with partners are a major growth axis in LP design. The advantage of bringing in partners is the increased attraction of LP members, who have additional opportunities to accumulate assets. However, the focal company also runs the risk that its LP loses meaning if it includes too many partners. In this case, customer transactions with the focal vendor and asset accumulation may become completely unrelated.

Within/Across Sectors
Another supply-side dimension that is specific to multi-firm LP designs is the degree of cross-sector partners. That is, do customers accumulate assets within the same sector or across different sectors? For example, the Star Alliance includes SAS, Lufthansa, United Airlines, Varig, and various other airlines, so this LP structure covers the same sector. However, the LP maintained by

AOL and American Airlines, with more than 2,000 partners, spans many industries.

Ownership
In multi-firm LPs, the ownership dimension reveals who owns the LP in the network. Is it the focal firm, a partner firm, or a firm whose sole purpose is to manage the LP? An example of the latter case is Webmiles, an organization that draws together a network of partners across many industries, with the sole purpose of LP management.

10.6.5 Cost and Revenues of LPs

In an empirical study, Leenheer, Bijmolt, Van Heerde, and Smidts (2002) show that the costs related to four of the seven loyalty programs they analyze are higher than the returns generated. Thus, any evaluation of the benefits of LPs must consider the various sources of both costs and revenues.

Cost factors include set-up/implementation, operating, and variable costs. The implementation costs accrue during the phases dedicated to planning and introducing a loyalty program (e.g., buying hard- and software, external consultancy, personnel training, initial promotions). After the LP has been launched, several expenses persist: maintenance of a service center, administration of the customer database, and (if applicable) inventory costs for the rewards themselves. Finally, variable expenses include discounts, rewards, sales costs (packaging, shipping), and communication, which determine the total cost of a loyalty program.

Compared with the evaluation of costs, the calculation of revenues turns out to be far more difficult. Two sources of revenues (indirect and direct) exist. Assessments of direct revenues (e.g., membership fees, sales of special editions) are rather straightforward, but indirect revenues, which consist of the retention and development of existing customer relationships and the acquisition of new customers, prove very complex and difficult to estimate.

CRM AT WORK 10.4

Tesco's Green ClubCard Points: Sustainability in Loyalty Programs
Companies reward their customers not only for purchasing but also for not purchasing. What do we mean? Since August 2006, Tesco has granted customers one ClubCard point for every new carrier bag that they do NOT use. This incentive aims to encourage shoppers to reuse their plastic shopping bags. As a result, more than 9.5 million ClubCard customers now reuse their bags. These Green ClubCard points can be spent the same way as any other ClubCard points. Then Tesco began to reward shoppers with points when they recycled their cell phones and printer ink-jet cartridges. The launch of recycling machines at Tesco stores, which issued the Green ClubCard points to customers who used them, doubled the recycling rates at sites featuring the machines.

But in March 2009, Tesco stopped issuing Green ClubCard points for recycled plastic and glass items, due to widespread misuse of the system. The grocer realized that customers were cutting up their plastic bottles and inserting the separate pieces in the machines to get more points. Currently recycling machines issue points only for aluminum cans. The recycling units, installed at more than 40 stores across England since their launch in 2005, take in more than a million items per week, according to Tesco.

10.7 Drivers of Loyalty Program Effectiveness

The factors that drive the effectiveness of a loyalty program can be structured into three main categories:

1. LP design characteristics
2. Customer characteristics
3. Firm characteristics

The configuration and interaction of these drivers determine whether an LP achieves its desired objective(s).

10.7.1 Loyalty Program Design Characteristics

The LP design characteristics, as we have noted, can be classified according to their:

- Reward structure
- Participation requirements
- Payment function
- Sponsorship (existence of partner network, network externalities)
- Cost and revenues

Thus three key questions must be answered to determine if a LP is effective:

1. From the consumer's perspective, are rewards attainable?
2. From the consumer's perspective, are rewards relevant?
3. From the firm's perspective, is the LP design aligned with desired goal(s)?

The first question asks how attractive the payoff is to the consumer. If the LP does not provide sufficient value (e.g., timing, rate of rewards), the customer cannot justify concentrating purchases, and no change in behavior will follow. For example, a traveler can redeem miles for a free flight after attaining the minimum mileage necessary. The level at which the airline sets this minimum mileage determines how many less frequent customers enroll in the program.

The second question pertains to whether the LP is relevant, regardless of attainability of rewards. It thus considers the degree to which an accumulation of assets in the program is relevant in terms of type of rewards (hard/soft, aspirational). If a consumer cares little for recognition and only wants hard rewards, an LP program that offers few hard rewards will not be relevant. The firm then must decide whether it wants to design its program to align with the desired benefits of a particular target segment.

Finally, is the LP's design aligned sufficiently with the firm's goals? For example, if an LP offers hard rewards and promotions that focus on changing short-term behavior, the LP likely will have a greater impact on behavioral loyalty and less of an influence on attitudinal loyalty. If effectiveness profits are the declared goal, the LP instead must be designed to allow the firm to collect as much information as possible about the customer.

10.7.2 Customer Characteristics

The key customer characteristic relevant to the effectiveness of LPs is the skewness of the customer value distribution (or value heterogeneity). This skewness varies greatly across industries. In some industries, the value of individual customers or accounts is widely similar, whereas in others, these values diverge greatly. For example, in the gasoline industry, the average driver's monthly consumption of gasoline varies only moderately. However, in the financial services or telecom industries, usage patterns and customer profitability are widely varied.

How does this skewness determine the effectiveness of LPs? If an LP is designed to achieve value alignment, it can succeed best in an environment where customers exhibit high value heterogeneity. Thus, a value alignment goal is feasible in industries such as airlines, hotels, rental cars, pharmacies, telecom, and financial services.

10.7.3 Firm Characteristics

Factors relevant to LP effectiveness in terms of organizational characteristics include the:

- Perishability of a product
- Breadth and depth of the firm offering the product at the store/retail level

That is, the success of LPs depends on the characteristics of the product that the firm sells – and particularly whether that product is perishable. This point is why LPs are so widespread in

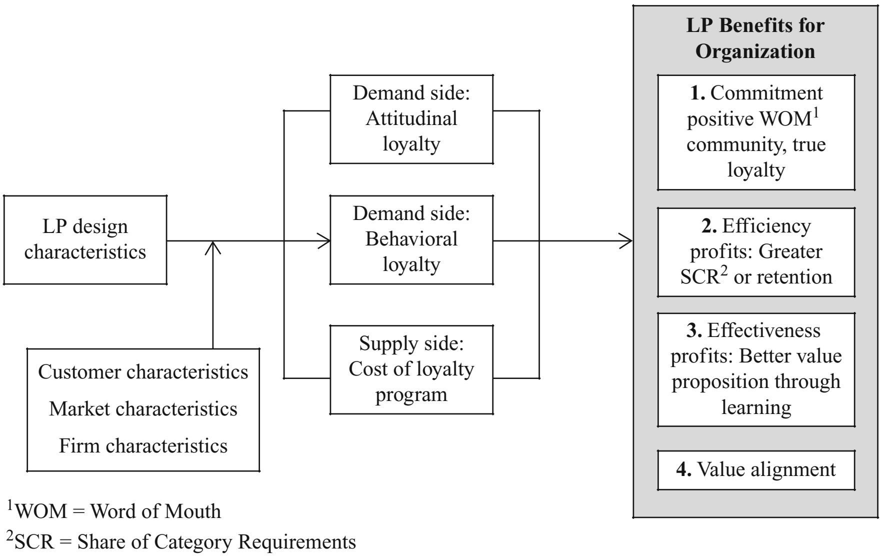


Fig. 10.3 Drivers of effectiveness

the airline and hospitality industries. Thus a crucial feature of hotel LPs is that frequent users can get upgrades to "better" rooms when those offerings are not already taken up by paying customers.

In terms of the variety of products and brands offered at the retail level, an effective LP attains more opportunities for efficiency profits with greater breadth and depth at the store level, for several reasons:

- Buyers are more likely to be able to fulfill their needs.
- Buyers encounter more opportunities for one-stop shopping (which increases time savings).
- Buyers have more opportunities for behavioral loyalty (through more purchase occasions).

Thus, LPs generally should be more effective in terms of behavioral loyalty when the buying environment features greater choice. In addition, there should be opportunities for effectiveness profits with greater breadth and depth of offerings at the store level, because the latitude of purchases grants the firm more opportunities for learning about customer preferences and cross-selling products. Figure 10.3 summarizes how the drivers of LP effectiveness affect its outcomes.

10.7.4 Achieving a Competitive Advantage

Any firm develops its LP to create competitive advantage, or the ability to operate more profitably over a sustained period of time. In a 1999 survey conducted by McKinsey & Co. with 1,200 customers across 16 product categories, the effect of LPs varied depending on the industry category. First, a highly frequented category, like grocery stores, is more likely to attract members to its LP than less frequent purchase categories, such as casual apparel stores. Second, a far larger percentage of customers admitted to spending more as a result of the LP in the grocery stores than in casual apparel stores.

The evidence we have seen so far indicates that LPs that aim to create efficiency profits actually provide the smallest basis for competitive advantage. Once every major firm in the market matches the first mover, all firms are back to square one, *except that every firm now has higher costs.*

Thus, the key challenge when pursuing efficiency profits is to keep the costs of the LP under control. For the supermarket industry, which operates on razor-thin margins, this is a huge challenge, and perhaps the reason that most grocery LPs include manufacturer partners. Without manufacturers' funding, such as promotions and rebates, a supermarket LP could not offer decent or appealing rewards. Clearly then, organizations must be ingenious to keep LP costs under control. But still, the value of participating in an LP must be greater than the value of not participating for customers – otherwise, there is no reason for customers to be interested.

In contrast, LPs designed to create effectiveness profits have a good chance of creating competitive advantages. Effectiveness profits probably have the greatest appeal to large firms, and the continuous developments in IT make information-based strategies possible and even easy in some cases. The capability of learning from customer behavior through continuous monitoring, analyzing this information appropriately, and using newly found insights for designing and deploying LPs remains challenging though. Even with widely available, sophisticated technology, we still find great differences in firms' abilities to implement LPs that improve their effectiveness profits.

Finally, the goal of value alignment might yield low-to-medium competitive advantages. In certain industries (e.g., airline, hotel), value alignment is a necessary, standard industry practice. Little competitive advantage comes from the program itself. However, industries such as financial services or telecom services can expect to reap competitive advantages if they pursue this goal, because execution matters, and firms differ in their ability to execute such programs.

CRM AT WORK 10.5

Tesco: From Price Promotions to Marketing Efficiency

The British supermarket chain Tesco successfully implemented an LP aimed at achieving effectiveness profits. In 1997, Tesco was ranked third among grocery retailers in the United Kingdom, operating on a traditional model of promotion- and price-based competition. Data about customers' purchase behavior were, in principle, available from scanner checkout data, but the data were collected only at the store level, not for individual customers. In February 1995, Tesco had launched the first LP in the British supermarket industry, initially relying mainly on its incentive aspect. In time Tesco realized that it could capture both market share and share-of-category, though some debate continues about whether these gains came from the expansion of its sales areas, improved service, or its LP.

U.K. Supermarket Market Share in Percentages

	1996	2000	2006	2010
Tesco	20.9	25.0	30.6	30.8
Sainsbury	19.0	17.9	16.3	16.1
ASDA (Walmart)	12.1	14.1	16.6	16.9
Safeway's (Morrisons)	9.5	10.4	11.1	11.6

Source: TNS Worldpanel, Kantar Worldpanel

Over time, Tesco made more use of its sales data to target benefits and steer customers into new consumption areas. In addition, Tesco established a segmentation scheme to determine which customers it should aim to serve primarily. The LP reflects this segmentation; it offers specific cards to students, families, top customers, and seniors. Within its LP, Tesco also found ways to provide value for special groups, such as families with babies. In Tesco's Baby Club, parents can meet, obtain information about infant health and food, enroll in courses, and get special rebates on baby-related products. Thus, Tesco tries to align its LP offerings with each member's needs, as opposed to offering general incentives.

Its knowledge about individual customers' and segments' preferences comes from its extensive analyses of the data gathered within the LP. In addition, Tesco merges customer transaction information gleaned from its website with point-of-sale data (e.g., products, which store, time of the day, basket size). Thus Tesco can customize its product offerings and communications based on specific customer needs, as well as each customer's economic value. Tesco's segmentation is so precise that it sends 80 different versions of its promotion mailings to members and publishes four versions of its ClubCard magazine.

As a result, Tesco's loyalty program now displays few of the incentive scheme characteristics it offered when the idea started. Today, it is all about increasing the efficiency of Tesco's marketing efforts – which leads to happier consumers and more profitability for the grocer.

10.8 Empirical Evidence on Loyalty Program Effectiveness

More and more empirical evidence in markets indicates how successful LPs really are in achieving their stated goals. But limited empirical evidence details the success or failure of specific loyalty programs. It is particularly difficult to get unbiased information about the performance of firm-specific LPs, because proper metrics rarely are in place, and few firms are likely to admit to their poor performance. Appendix I lists a few studies that have examined LP outcomes, each of which covers only selected industries. In addition, the small number of studies limits our ability to make strong empirical generalizations. However, we can draw a few conclusions from these published studies:

- Published evidence that LPs create attitudinal loyalty is rare, though firms might have more proprietary information on this point.
- The evidence regarding the relationship between loyalty programs and behavioral loyalty measures, such as share-of-wallet, is mixed. Some studies attest to a positive effect of LPs on behavioral loyalty (to varying degrees), but other empirical research fails to identify such an impact.
- There is very little information on the cost efficiency of LPs. Companies may not have the knowledge themselves, due to a lack of proper accounting or a reluctance to reveal it. Individual cases (e.g., Safeway, ASDA) suggest the great expense of managing LPs.
- Using LPs as a value alignment tool seems viable.

10.9 Loyalty Programs, Shackle or Reward: And to Whom?

Convincing evidence indicates that loyalty programs, as they exist today, fall short in terms of creating attitudinal loyalty. The name *LP* is a misnomer in that sense. Furthermore, programs that focus on incentives, deals, and promotions are often costly for the firm – unless it can offer mainly underutilized, perishable assets, such as unbooked hotel rooms or unrented cars. Costly rewards, on top of the razor-thin margins in the grocery industry, hardly seem sustainable in the medium to long run. Surviving LPs thus will be those that save companies money by replacing other communication tools, rather than just draining their resources. Designed properly, an LP can gather data that ultimately improve the efficiency and effectiveness of the marketing function.

The LPs that are most likely to provide sustainable competitive advantages are those that leverage data obtained from consumers into more effective marketing decisions, such that they result in true value creation for customers and thus the company. Loyalty is likely to follow in these cases (Reinartz, 2002). Furthermore, firms with admirable levels of true customer loyalty, such as Harley-Davidson, offer no loyalty programs. For them, LPs and being loyal do not go hand in hand, because true loyalty does not need hard incentives; it is based on attitudes.

10.10 The Seven-Point Checklist for Successful LP Design and Implementation

We offer a checklist for developing, designing, and implementing a successful LP, with seven key points:

- *Clearly determine your LP's goals*. Is its goal compatible with your marketing strategy and the positioning of your organization in the market?
- *Align the design of your LP with the characteristics of your market, your customer base, and your firm*. Knowing the customer base is important, because segments' preferences for LP benefits vary. For example, senior citizens may not value the long-term accumulation of redeemable points as much as immediate price discounts on a product.
- *Manage the costs of LPs*. LPs are expensive, so cost management will always be a critical component. Consider all the costs involved (e.g., opportunity cost of the time of the managers involved). Can these costs be mitigated by marginal cost rewards or contributions from manufacturers?
- *Measure the predicted benefits of the LP for your organization*. Although it is difficult to specify these benefits accurately, you should attempt to conduct a trade-off analysis between the cost and gains of the LP. Also consider the time horizon (short versus long term).
- *Avoid withdrawing an existing LP, which can have negative consequences in the form of customer dissatisfaction and defection*. Customers do not like it when LPs are withdrawn, once they have grown accustomed to the benefits. Thus, design faults will not only result in losses but haunt you later, in the form of customer dissatisfaction.
- *Design the LP to achieve maximum effectiveness in marketing operations*. This goal can be achieved by learning customer preferences and responding to these preferences with the offering.
- *Ensure that your firm has the necessary capabilities to manage its LP effectively*. These capabilities include data storage, data analysis, and empowerment of employees, among others.

10.11 Summary

The satisfaction–profit chain (SPC) is based on the idea that improving product and service attributes leads to better customer satisfaction, which then produces greater customer loyalty, which means increased profitability. Although empirical studies concentrate on aggregate, firm-level results, this chain needs to be implemented at a disaggregated or individual level.

Improving customer satisfaction comes at a cost, and it may not even deliver the anticipated business results. There is an optimum satisfaction level for any firm, beyond which increasing satisfaction does not pay off. To find this level, firms must conduct longitudinal satisfaction studies and find changes in customer satisfaction over time, linking them to improvements in their offering. By focusing on customer retention, managers can move closer to the ultimate dependent variable: profits. Graphical representations of data reveal that the link between satisfaction and retention is asymmetric (i.e., dissatisfaction has a greater impact on retention than does satisfaction). It is also nonlinear, such that the impact of satisfaction on retention is greater at the extremes, with a flat part in the middle of the curve called the zone of indifference.

According to a hypothesis proposed by Frederick F. Reichheld (2000), long-term customers spend more per period over time, cost less to serve, have greater propensity to generate word-of-mouth, and pay a premium price compared with that paid by short-term customers. However, Reinartz and Kumar (2002) have tested this hypothesis and demonstrated that across firms, a segment of customers is loyal but not very profitable (because they use up excessive firm resources), and another segment generates very high profits despite its short tenure with the firm. Considering that these short-term customers can be very profitable, loyalty cannot be the only path to profitability. This finding points to the importance of remembering the ultimate end of the satisfaction–profit chain: Customer profits ultimately are required to demonstrate the value of good marketing decisions.

The findings also suggest the need to understand different forms of loyalty. Behavioral loyalty refers to observed actions by customers; attitudinal loyalty entails their perceptions and attitudes. Customers who are not attitudinally loyal are likely to end the relationship at the earliest available opportunity, but a loyalty program aims to keep them by offering rewards to customers for their repeat purchasing. In exchange for concentrating their purchases with the focal firm, customers can accumulate assets (e.g., points) and exchange them for products or services. The success or failure of a loyalty program, whether contractual or incentive-based, depends on the profitability gained from the customers. Furthermore, LPs offer an important CRM tool that marketers can use to identify, award, and retain profitable customers.

The key objectives of introducing LPs include building true (attitudinal and behavioral) loyalty, efficiency profits, effectiveness profits, and value alignment. True loyalty is a function of the true value provided to the customers. Efficiency profits, which are net of LP cost, are the profits that result from a change in customers' buying behavior due to the LP. The most widely used measure of behavioral loyalty is share of category requirements or share of wallet, though LPs might not change behavior as much as they reinforce existing behavior – at a much higher cost to the firm. Effectiveness profits are the medium- to long-term consequences realized through better learning about customer preferences, which are more likely to generate sustainable competitive advantages and produce higher profits in the long run. Value alignment aims to match the cost to serve a particular customer with the value he or she provides the firm. It becomes particularly critical when there is great heterogeneity in customers' value and costs to serve. Across these goals, LPs may not be truly effective in helping firms engender greater customer loyalty and higher profits, considering the costs and special challenges posed by managing an LP. Most companies need to revisit their business model, not only to reflect on the impact of LPs on their bottom line but also to determine how customer service initiatives add value to future revenue streams.

From customers' perspective, rewards are the key design benefit of LPs. Hard rewards offer price reductions, promotions, free products, or preferred treatment, whereas soft rewards provide psychological recognition. Regardless of their type, rewards can be directly or indirectly linked to the company's product offering. Consumers also prefer hedonic goods over utilitarian goods when receiving a gift, so companies work to differentiate their LPs on the basis of their inspirational or hedonic value. The rate of rewards (i.e., ratio of reward value to transaction volume) is a key driver of LP enrollment and use; it depends on the chosen asset accumulation response function. For example, a tiered structure offers different levels of rewards and privileges to customers in differing tiers. The timing of reward redemption instead is determined by the minimum redemption rules, type of reward, and reward rate.

Sponsorship refers to supply-side features, such as the introduction of partners – a growing trend in LP designs. If LP members can accumulate assets at organizations associated with the focal firm, the design also must consider the degree of cross-sector partnerships. Do customers want to accumulate assets within the same sector, or across divergent, different sectors?

These design factors drive the effectiveness of an LP, together with customer and firm characteristics. The configuration and interaction of these drivers determine whether an LP achieves its desired objective(s). This effectiveness thus depends on the attractiveness of the LP from the consumer's perspective, the degree to which asset accumulation is relevant to the consumer, and whether the LP design aligns with the firm's goals. It also reflects the skewness of customer value distribution (value heterogeneity). Finally, on the organizational level, the perishability of the product and the breadth and depth of the firm offering influence LP effectiveness. When a firm cannot capitalize on the perishability of its products, the reward expenses come directly from its bottom line, which reduces the economic viability of an LP. Greater breadth and depth of offerings at the store level means the latitude of purchases allows the firm more opportunities for learning customer preferences and cross-selling products.

No published evidence shows that LPs create attitudinal loyalty, though there is evidence of an impact of LPs on behavioral loyalty. Moreover, we find very little information about the cost efficiency of LPs, though using LPs as a value alignment tool seems viable.

A firm develops an LP to create a competitive advantage and operate more profitably over a sustained period of time. Thus a key challenge is keeping the costs of managing the LP under control. The LPs designed to create effectiveness profits have the highest chance of creating competitive advantage; the effectiveness profit goal thus has great appeal for most (large) firms. Value alignment instead should yield low to medium competitive advantages. It may be necessary in certain industries such as the airline or hotel industry, where value alignment has become a standard industry practice. However, industries such as financial services or telecom can expect to reap competitive advantage when pursuing this goal since execution matters and firms differ in their ability to execute the programs well.

Loyalty programs, as they exist today, appear to be falling short in terms of creating attitudinal loyalty. Instead, perhaps LP managers need to emphasize its promise as a method to gather data to improve the efficiency and effectiveness of the marketing function.

Exercise Questions

1. Explain the difference between behavioral and attitudinal loyalty. Provide an example of each.
2. What are the key objectives of loyalty programs? Which of these objectives provide the strongest competitive advantages?
3. You are a consultant to a credit card organization that wants to establish a loyalty program. The CEO has just read about how most loyalty programs result in money-losing propositions. How do you alleviate the CEO's concerns?
4. Do companies profit by introducing loyalty programs? Is the success of a company's loyalty program dependent on its industry category?
5. How can you measure loyalty? How does loyalty relate to the profitability of a company?
6. Would low-ticket items (coffee, candy, sodas) benefit from loyalty programs? What kind of incentives might work best?
7. Design a loyalty program for your neighborhood gas station. Describe the incentives. Determine the cost structure. Set benchmarks, and evaluate the profitability of the program across possible scenarios.
8. What are the ethical issues that surround loyalty programs? Should the gaming industry be allowed to use loyalty instruments for example?

Minicase 10.1

Loyalty Program Management at Starwood Hotels

Starwood is one of the world's largest hotel and leisure companies. The company's services range from exclusive hotels, such as the St. Regis and the Luxury Collection, to five-star Sheraton and Westin hotels, down to the moderately priced Four Points hotel chain. With approximately 1,000 properties, Starwood functions in most major markets worldwide. The company also operates a customer loyalty program, "Starwood Preferred Guest" (SPG), which allows customers to accumulate points for staying and spending with Starwood. The program is unique in the industry, in that its points never expire, and Starwood does not impose any so-called black-out dates (i.e., dates when customers cannot use their points for redemption).

Despite these program advantages compared with major competitors, the company is struggling to exploit the full potential of the program and address several challenges. First, though it collects information on individual customer behavior (movie watching, minibar use, room service use, restaurant use), it is not clear how it can use that information. Some customers like that the company learns about their preferences, but many others remain concerned about possible privacy invasions and simply want to be left alone – or at least have control over the kind of information the company uses. Second, though roughly seven million Starwood customers are members of the loyalty program, another six million customers are not. Thus, the company has very little knowledge about nearly half of its customer base. Third, the company targets existing program members with customized offerings and communications, but it yet has to figure out how much customers are willing to be bothered by such communications. Although Starwood wants to maximize its cross-selling and up-selling opportunities, it recognizes that some customers will react negatively if they get too many offerings.

Questions

1. How can a large company such as Starwood exploit customer data while still safeguarding and respecting customer privacy?
2. What should Starwood do to attract loyalty program nonusers into the program or find out more about the behavior and preferences of this large group?
3. How far should Starwood push its direct offerings to its program members? How can it discover the boundary?

Appendix I. Key Studies of LPs with Notable Empirical Findings

No.	Organization details	Industry	Findings
1	Six partner companies of the FlyBuy program in Australia	General retail	LP has hardly any effect on repeat purchase patterns (behavioral loyalty) (Bolto et al., 2000)
2	Credit card firms (single firms) in three European countries	Credit cards	LP members are more likely to overlook negative experiences with the focal company
			LP members have higher usage levels and higher retention (Deighton/Shoemaker, 2000)
3	Single firm	Hospitality	20% of member stays are because of LP
			Strategy of using LP as a value alignment tool is successful
			LP is profitable (Crié et al., 2000)
4	—	Grocery industry in France	Being a LP member does not modify purchase behavior
			Events and promotions associated with LP seem to have clear effects on purchase
			The effects of LP are mostly short rather than long term. Thus, they seem to work as promotional tools rather than a means to induce loyalty (Reinartz/Kumar, 2003)
5	U.S. direct marketing firm	General merchandise	LP membership is associated with the longer duration of customer–firm relationships
			No information on cost-efficiency (Rajiv, 2001)

(*continued*)

No.	Organization details	Industry	Findings
6	—	U.S. grocery industry	LP is operationalized as a shocker program (e.g., turkey bucks), not a traditional long-term card program, so it can better be described as a long promotion There is significant increase in spending (market basket)
			LPs seem to affect "cherry-pickers" most
			Program is profitable (Meyer-Waarden/Benavent, 2001)
7	—	Cross-sector sample of 7 LPs	LPs are classified according to their objectives and characteristics
			The two main purposes of LPs are customer heterogeneity management or creating switching costs (behavioral loyalty)
8	—	U. S. grocery	LP increases sales through "point pressure" (short-term) and "rewarded behavior" (long-term) (Taylor/Neslin, 2005)
9	—	Coffee and music on Internet	LP induces purchase acceleration through the progress toward a goal (Kivetz et al., 2006)
10	Spanish supermarket chain	Grocery	LP members are more behavioral and affectively loyal than other participants
			Few customers change purchase behavior after joining the program (García Gómez et al., 2006)
11	Convenience store chain	Retailing	Positive influence of LP on consumers' purchase frequency and transaction size holds only for light and moderate buyers (Liu, 2007)
12	—	Airline industry	Only high-share firms experienced sales lifts from their loyalty programs
			Because high-share firms tend to possess complementary product and customer resources, they are more likely to gain from their loyalty programs than firms with a smaller market share (Liu/Yang, 2009)
13	Albert Heijn, Super de Boer, Edah, Integro, Konmar, COOP, Jan Linders	Dutch supermarket industry	Small positive, yet significant effect of loyalty program membership on share-of-wallet
			In terms of profitability, each program generates more additional revenues than additional costs in terms of saving and discount rewards (Leenheer et al., 2007)
14	—	Grocery industry	Customers satisfied with the rewards of LPs are more loyal to the store and allocate a higher proportion of their budget and patronage frequency to the store than unsatisfied customers (Demoulina/Ziddab, 2008)
15	Health and beauty provider	Retailing	LP was a significant predictor of store loyalty, in support of the contention that loyalty programs are capable of engendering loyalty (Bridson et al., 2008)

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