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What do we know about loyalty programs?

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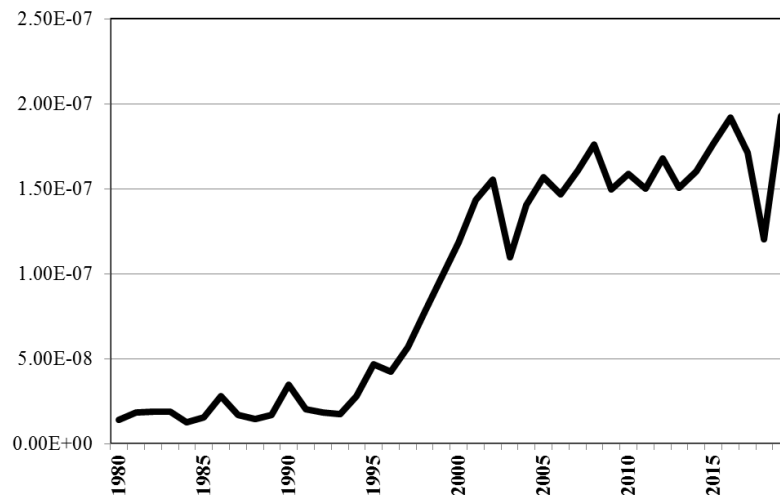
What Do We Know about Loyalty Programs?

Loyalty and rewards program currently abound with every major hotel chain, airline, and car rental company having one. These programs are not just in the travel industry. Major supermarkets, restaurants, coffee shops and movie theaters also have them. Even the tiny family owned local Asian bistro next to our office has its own loyalty card.

Loyalty programs are not only ubiquitous, but some are very profitable. In 2022 Delta, United and American Airlines reported they earned a combined \$8.4 billion from their loyalty program, which was greater than the three airlines combined operating income.¹ This money primarily comes from co-branded credit cards that give users airline miles based on their spending.

Nagle (1971) shows loyalty program in the U.S. can be traced back to colonial times. Data from Google's Ngram program gives us the ability to see when people start using phrases. Figure 1 shows "Loyalty Program" and "Loyalty Rewards" were rarely used in English in the 1980, exploded in usage starting in the mid-1990s, and have not waned since. The falling cost of computers and data processing is making sophisticated rewards program available even to the smallest size companies.

Figure 1: Frequency of "Loyalty Program" and "Loyalty Rewards" in English Publications



Researchers have spent quite a bit of effort trying to figure out what makes loyalty programs effective since the explosion in the mid-1990s.

Why Do Loyalty Programs Work?

¹ In 2022 loyalty programs earned Delta \$2.9 billion, United \$2.4 billion and American \$3.1 billion. Operating income in 2022 for Delta was \$3.6 billion, United \$2.3 billion and American \$1.6 billion. All figures from each company's annual 10-K report.

One of the most important findings is that loyalty and rewards programs give customers the impression that they received a gain. This makes them feel appreciated, resulting in a sense of belonging and an elevated sense of status. Customers that feel appreciated tend to increase their purchases with the company over time, which boosts revenue for companies with loyalty programs (Bijmolt, Dorotic, & Verhoef, 2011).

Loyalty programs have two types of impact. In the short-run the programs often boost purchase frequency, especially for customers who are already frequent buyers. In the long-run the programs often boost retention attrition rates, especially by locking in the most frequent and least frequent buyers (Gopalakrishnan et al., 2021)

There are two well-known mechanisms for how loyalty programs impact consumer behavior. First, consumers tend to drive their spending up just before getting a reward. This is called the “points-pressure effect” (Kivetz et al. 2006). Common examples are people taking trips to nowhere at year end to ensure they have enough points or miles to maintain elite status. However this effect is temporary in nature, with travelers not being close to elite status forgoing mileage runs.

The second impact is that some customers boost their purchases after receiving their reward due to a “rewarded-behavior effect.” Getting a reward makes customers feel special, and these customers spend more because they now have a reason to purchase from the company. Examples, of this are people who start flying only one airline after earning a particular status. This “rewarded-behavior” is more enduring than the “points-pressure” (Taylor and Neslin 2005).

Types of Loyalty Programs

There are two main types of loyalty programs; customer tiers and frequency rewards. Tier programs put customers into categories like silver, gold and platinum, where each category provides customized benefits based on customer profitability. Customers with less profitability, like those in the silver tier, get fewer benefits than the highest tier most profitable customers.

The second type of loyalty programs offer simple fixed rewards that apply to everyone (Blattberg et al., 2008). Examples of fixed reward programs are coffee shops offering free drinks or snacks for a set number of points.

Researchers have looked at what makes a successful tier program (Bijmolt et al., 2011) and come up with five key points. First, companies must be able to identify and segment customers based on profitability (Kumar and Shah, 2004). It makes no sense to give generous rewards to frequent but unprofitable customers. Second, the best programs create long-term loyalty through a combination of points-pressure and rewarded-behavior effects.

Third, the number of tiers should be kept relatively small (Dr`eze and Nunes, 2009). Fourth, extra care must be taken when dealing with the highest tier customers. The size

of the highest tier needs to be kept relatively small so that the highest tier conveys superior status. Beyond status, the highest tier expects a higher quality of service (von Wangenheim and Bay'on, 2007). Last, the lowest tiers should not feel alienated by the program (Kivetz and Simonson, 2003).

Successful frequency programs have three reward factors that are important; type, timing and expiration. First, frequency based programs typically provide either in-kind rewards such as hotel chains that give frequent customers a free night stay or monetary rewards, such as cash back programs. In-kind rewards are typically cost effective and generate a more sustainable loyalty by giving away things like hotel rooms that were not already used. (Phillips Melancon et al., 2010). Monetary rewards are more effective (Keh and Lee, 2006) but also more costly for companies (Kim et al., 2001).

The timing of frequency rewards can be immediate or delayed. Immediate rewards are typically of low value and preferred by non-loyal customers. Delayed benefits often have a higher face value, which resonates better with more loyal customers.

Last, in some frequency reward programs the points expire within a certain period of time. Expiration dates creates pressure to increase purchase frequency and accumulate more points (Kopalle and Neslin, 2003), but this same pressure creates dissatisfaction among customers who fear losing what they have accumulated.

Making Changes to Loyalty Programs

Recent inflationary pressures have forced many companies to increase their reward "prices." Even the most successfully run loyalty programs cannot escape from this trend. When companies pare rewards programs back or make rewards harder to earn there is often significant customer pushback. Over the past year Starbucks, Dunkin, Bestbuy, and Delta have all seen large amount of backlash, especially on social media, after changing their loyalty programs.

Some companies have raised the bar for rewards across the board as their costs have risen. Others, like Starbucks, have played a balancing act; making less popular items, like hot coffee harder to "earn," while having more popular ones, liked iced coffee, easier to claim.

Given the vast amounts of loyalty data that reward programs generate businesses need to tailor their programs using a customized approach to infuriate the fewest number of customers. Using data analytics tools, these companies can create customer or segment-specific loyalty response models which can both boost profits and antagonize the number of customers.

Conclusions

While loyalty programs are ubiquitous it is important to understand that loyalty programs only provide temporary loyalty. Giving customers a free cup of coffee, 10 percent off a purchase or

letting them board an airline first helps tip the balance toward repeat purchases. It takes far more time and effort to create a truly loyal group of customers, who have devotion and faithfulness to a company and product that transcends all manner of ups and downs.

Only a few companies have been able to build cult offerings that produce fanatical fans, who are willing to forgive major mistakes and continue to buy. Examples are companies like Apple and Tesla who occasionally produce dud products or services which their rabid fans shrug off. What neuroscience really teaches us is that people want to be recognized as individuals, treated nicely and given value when making a purchase. Loyalty and reward programs only provide temporary respite from the anonymous, micro-targeted world. Instead, give people what they really want. The top line brands of hotels, restaurants don't need or push loyalty programs because their customers feel valued and are loyal when problems happen.

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