Do Customer Loyalty Programs Really Work?

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Abstract

In a bid to strengthen relationships with their customers marketers are showing renewed interest in customer loyalty programs. But how effective are these programs? Surprisingly—given their current popularity—the evidence is equivocal. Research on "normal" patterns of loyalty in established competitive markets suggests that in many cases it is hard to obtain exceptional advantages through the launch of a loyalty program. Also, competitive forces tend quickly to erode any differential gains.

Before introducing a loyalty program, managers would be wise to fully cost it (including development, marketing and on-going costs), and compare these costs with a realistic assessment of the benefits of the program—an assessment that goes beyond the rhetoric of relationship marketing. Here we argue that to stand the best chance of success under tough market conditions, a loyalty program must *enhance the overall value-proposition* of the product or service. This in turn will help to *motivate buyers to make the next purchase* of a product, and therefore *support other aspects* of the firm's offensive and defensive marketing strategy.

1. Renewed Interest in Customer Loyalty Programs

Programs to secure customer loyalty have been used by marketers for many years. For example, credit cards like those issued by American Express and the banks have offered regular customers a range of valuable benefits. In business-to-business markets loyal customers have traditionally been treated better than those who buy "on the spot market". In recent years, loyalty schemes have attracted considerable interest as a wider range of companies practice one of marketing's most familiar strategies, namely, "if you see a good idea—copy it".

Loyalty programs which seek to bond customers to an organization or its products and services by offering an additional incentive pose an interesting dilemma for many organizations. Although these schemes often attract widespread customer interest, they are difficult to support from first principles. That is, our current knowledge of competition and buyer behavior suggests that most schemes will not fundamentally alter the structure of markets. They *might* help to protect incumbents and they *might* be regarded as a legitimate part of the marketer's armory—but at the cost of increasing marketing expenditures.

Some of the most well known customer loyalty schemes are the frequent-flyer programs of the major airlines. These and other well patronized programs were originally hailed as imaginative ways to instill and maintain loyalty, but over the years more and more doubt has been cast on these assumptions. They have been criticized in both the academic and trade press with headlines such as: "A failure in competitive strategy", "War in the air. The scramble for points hits turbulence", "Frequent-flyer offers fail to boost loyalty". [1]

Many senior managers are now asking their marketing departments to measure the potential contribution of any program developed to implement loyalty marketing. Awkward questions are being asked: do these programs really create extra loyalty over that which is driven by the relative value of the product/service, do they encourage customers to spend more, or do they merely bribe a customer to repeat buy? More broadly, in a competitive market, is it really feasible for every organization to try to increase customer loyalty by implementing a loyalty marketing program?

Underlying the increasing interest in these programs are some widely-held beliefs among marketing managers about the loyalty of their customers:

(a) a significant number of customers want an involving relationship with the brands they buy,
(b) a proportion of these buyers are hard-core loyal and only buy the one brand,
(c) these hard-core loyal buyers are a profitable group because they are numerically large and are heavy or frequent buyers,
(d) it should be possible to reinforce the loyalty of these buyers and encourage them up a "loyalty ladder", and
(e) database technology can be used to establish a personalized dialogue with customers which will bring about moves up the loyalty ladder.

Such sentiments are often encountered in the rhetoric of relationship marketing, direct marketing, database marketing and so-called "1:1 marketing". [2] However, in this paper we compare these beliefs with a growing body of research which challenges their accuracy. First, we describe the origins and aims of loyalty marketing (Section 2). We then review research which examines empirical patterns of behavioral loyalty (Section 3). We also consider psychological research on rewards, as this is the major component of most loyalty programs (Section 4). These two sections provide the context for commenting on frequent-buyer loyalty programs such as those adopted by the major airlines. This enables us to offer suggestions for designing a customer loyalty program which avoids the common traps which have undermined the cost-effectiveness of many existing schemes (Sections 5 and 6).

2. Why Companies Introduce Customer Loyalty Programs

In the 1970s European researchers studying business-to-business marketing discovered that suppliers who formed close working relationships with their customers tended to have "better" customers.[3] That is, they were more loyal to their suppliers and often gave these suppliers a greater share of their business. The customers also reported having "better" suppliers. In short, it was a win-win arrangement.

Subsequent research by consultants such as Bain & Company claimed that loyal customers are more profitable to a firm.[4] This profitability is thought to be generated by reduced servicing costs, less price sensitivity, increased spending, and the favorable recommendations passed on to other potential customers by loyal buyers. Add to this the claim that it costs much more to entice a new customer to do business with you than to get a current one to repeat purchase,[5] and the strategy of gaining and maintaining loyalty seems like the source of a sustainable competitive advantage.

For a company to practice loyalty marketing however, it is first necessary to know who the loyal customers are. This is a lot easier for smaller than larger businesses. As the number of customers increases, database marketing and market research have to be used in the absence of personal knowledge. Each year, as computerized database technology becomes more sophisticated, so does a firm's ability to monitor its customers' behavior. These techniques are being used by retailers and packaged-goods manufacturers to help efficiently target products and services, and allocate marketing resources to achieve the maximum return.[6] In business markets companies conduct customer profitability analyses and calculate the lifetime value of a (particular type of) customer. However, they are complex and costly processes.

What started off as a strategy for small business, business marketing and catalogue selling has evolved into a new industry. Direct marketing practitioners are endeavoring to create loyalty programs which tie the buyers of a wide range of consumer goods and services to a particular brand or supplier. A question here is whether customers for all these products want a relationship with the supplying company. In a small business deal, or for a risky purchase, the answer may be “yes”. For low-involvement products and brands of the type sold by, say, Nestle, Procter & Gamble, Shell or Unilever it is not so clear that customers really want a relationship.

Scanning the press releases of companies launching their frequent-buyer or customer loyalty programs, suggests that these schemes are expected to achieve a variety of objectives. These, if you will, are the practical measures of success. The most common objective for new category buyers is to entice them to buy the brand with the (best) loyalty scheme. The more common outcomes expected from programs for existing customers are to:

(i) maintain sales levels, margins and profits (a defensive outcome to protect the existing customer base),

(ii) increase the loyalty and potential value of existing customers (an offensive outcome to provide incremental increases in sales, margins and profits), and

(iii) induce cross-product buying by existing customers (this maybe defensive or offensive).

Usually these desired outcomes refer to specific target segments; for instance, heavy buyers, or high-net-worth customers. The underlying belief is that a small percentage of customers generate most of a company’s sales, and that these customers can be “locked-in forever”. The “80/20 Law” is often invoked in support of this viewpoint.

The 80/20 Law says that typically about 80% of revenue comes from just 20% of customers. With such a skewed distribution of customers, it appears to make sense to concentrate most marketing resources on this 20%. The problem with this law for loyalty programs is that the “best” 20% are not necessarily loyal buyers, especially in the sense of exclusive loyalty. As we will describe in the next section, there is reliable empirical evidence to suggest that many/most heavy users will be multi-brand loyal for a wide range of products and services. That is, your most profitable customers will most probably be the most profitable customers of your competitors as well.

For companies which have poor data about their customers, an additional benefit of customer loyalty programs is that members will often self-identify themselves at the point of purchase or service delivery. Membership cards are a quick and efficient way for customers to signal that they deserve special attention. As a by-product the company gains market research information—another espoused benefit of loyalty schemes. However, it must be kept in mind that such a self-selected group is unlikely to be representative of all a company's (potential) customers. Hence, they are only one of many sources of market research information.

All of these espoused benefits are openly discussed in public announcements. In practice however, the decision to launch a program is often motivated as much by fears of competitive parity as anything else. This is rarely stated in public. Therefore we add the following tactical motives to the above list:

(iv) to attempt to differentiate a parity brand,

(v) to pre-empt the entry of a new (parity) brand, and

(vi) to pre-empt a competitor from introducing a similar loyalty scheme.

Many airlines, and leading companies such as American Express, General Motors, Holiday Inn, Nestle, Shell and Unilever have seen enough merit in customer loyalty programs to implement such schemes. Not all these benefits listed above are sought from each program. However, at least some must occur for the scheme to pay its way when its full cost is compared to other marketing alternatives. The crucial question is whether a customer loyalty program offers a better return than an alternative such as a price cut, a move to everyday low pricing, increased advertising, or increasing distribution coverage. For many programs, the answer to this question lies in some interesting academic research reviewed in the next two sections.

3. The Leaky Bucket Theory versus Polygamous Loyalty

When a company expects most of its customers to be highly loyal, Andrew Ehrenberg observes that marketing strategies seem to be designed to replace the "disloyal" customers who leak away with new ones to keep the sales level steady. He dubbed this the Leaky Bucket Theory. But while the marketing strategies of customer loyalty programs are designed this way, is the underlying Leaky Bucket Theory true?

To address this question, and to establish norms of consumer behavior for different markets, Ehrenberg and his colleagues have gathered data from a variety of markets in Britain, Continental Europe, Japan and the USA over a period of more than 20 years. Their research describes the purchase habits of people buying products like coffee, ready-to-eat breakfast cereals, newspapers, aviation fuel, toothpaste, laundry detergents, petrol, television programs, airline usage, ethical drug prescriptions, and even the repeat purchase of management development programs at business schools. The focus is on people's observed behavior, not their needs, motivations, personalities, or their attitude to a brand.[7] Subsequent research by Wendy Gordon has provided qualitative support for why these behavioral norms emerge.[8]

Typically, five types of behavior have been measured over particular periods of time: (a) the percentage of consumers buying a brand, (b) the number of purchases per buyer, (c) the percentage who continue to buy the brand (repeat-buyers), (d) the percentage who are 100% loyal, and (e) the percentage who also buy other specific brands (duplicate buyers). From this data it is straight-forward to determine how much of a buyer's requirement for the category is met by a specific brand. Using statistical analysis it is also possible to predict norms for each type of behavior in a competitive market.[9]

The empirical record and the predictive norms show that only about 10% of buyers for many types of frequently purchased consumer goods are 100% loyal to a particular brand over a one-year period,[10] and extensions of this work show that even in service situations exclusive loyalty is confined to a small number of buyers. Moreover, 100% loyal buyers tend to be light buyers of the product or service. These empirical facts make it difficult to be too enthusiastic about using a loyalty marketing program to create a big group of 100% loyal customers (although, as we have discussed earlier, there may be defensive reasons for having a scheme).

The research of Ehrenberg and his colleagues indicates that in stationary markets, customer "loyalty" is divided among a number of brands—as if there were long-run propensities to buy brands A, B and C some 70%, 20% and 10% of the time (say). Hence, invariably "your" customers do not just buy "your" brand. "Polygamous loyalty" is a better description of actual consumer behavior than either brand switching (a conscious once-and-for-all change of allegiance to another brand—as if propensities were 100% or zero) or promiscuity (the butterfly tendency to flit from brand to brand without any fixed allegiance—where there are no long-run propensities, only next-purchase probabilities).

Polygamous loyalty is readily apparent in markets such as soft drinks and breakfast cereals, but it extends well beyond this. We see it in everything from car hire, through choice of fast-food outlets, to business airline travel. It is also seen in the multiple membership of loyalty schemes. For example, surveys of European business airline travellers show that more than 80% of them are a member of more than one airline loyalty scheme. In 1993, the average membership of airline loyalty clubs was 3.1 schemes per traveller, and the figure seems to be rising not falling.[11]

Many of the reasons for the generalized patterns of divided loyalty, or polygamy, are fairly straight-forward. For example, people buy different brands for different use occasions or because they want some variety. Alternatively, the brand may have been the only one in stock or it may have offered better value-for-money at the time of purchase because of a special deal. Most buyers who change from your brand are not lost forever (or disloyal), usually they just prefer to buy other brands more often than your brand.

Given the amount of research which supports these patterns of buyer behavior, it seems unlikely that a loyalty program could *fundamentally* alter this behavior. This will be especially the case in markets that are established and competitive (where copy-cat responses are most likely). Even a path-breaking scheme may only alter short-run probabilities. Once the market has settled down again, or once imitative schemes have been launched, we should expect to see patterns of divided loyalty reemerge. Then the issue is whether the longer-run propensities settle at the old or new levels.

In markets where some type of competitive response occurs quickly, the expectation is that the market will settle down to its old levels. For example, at the beginning of 1995 there were no national loyalty schemes in the British grocery market, but once one retailer broke rank virtually all others followed within a matter of months. Despite the amount of loyalty-building activity in this market, market shares have been reasonably steady. Much the same had happened ten years before when American Airlines launched the first path-breaking frequent-flyer scheme—within weeks of this event other carriers began to follow suit.[12]

When aggregated across many product and service markets, these research results suggest that the marketing mix of a brand (its product/service formulation, price, promotion, and distribution) determines its market share, and once this settles down, then the level of brand loyalty is strongly correlated with market share. Consequently, although marketers might give brands some fancy names as illustrated in Figure 1, it is better to think about them as either big or small, rather than strong or weak in a loyalty sense.[13]

A secondary effect is that big brands have slightly more buyers, and somewhat more of these (more) buyers are frequent buyers. Equally, small brands suffer "Double Jeopardy" in that there tend to be fewer buyers who buy less frequently.[14] If we define a loyal buyer as one who repeat purchases the brand frequently, then the bigger the brand, the larger the number of (more) loyal buyers. Add to this the (empirical) fact that some large-share brands may have a slightly higher proportion of heavy users (and loyal buyers) than predicted by the Double Jeopardy phenomenon, and we have more bad news for loyalty marketing programs designed to rescue small brands.

Figure 1

Double Jeopardy & Brand Loyalty

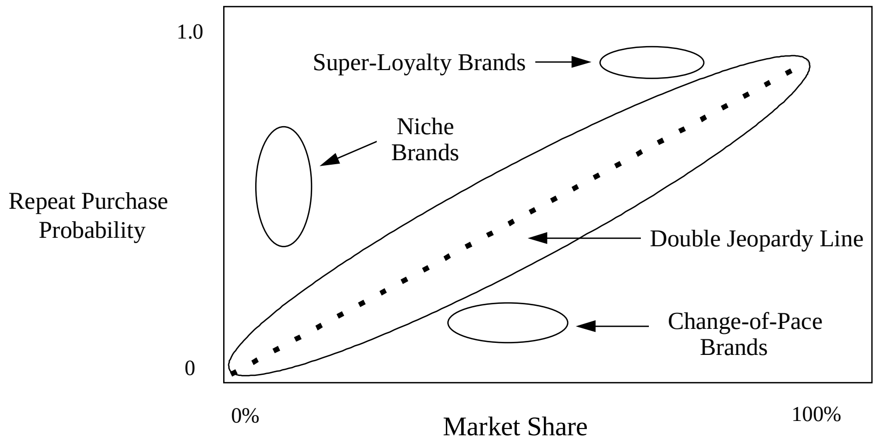


Figure 1 shows the structure of most established and competitive consumer goods and service markets. As noted earlier, consistently single brand loyal customers are relatively rare in these markets.[15] Most brands lie along the Double Jeopardy line. There may also be a group of big brands which exhibit some signs of "super loyalty". That is, they will have more frequent buyers than predicted by the Double Jeopardy law. A niche brand is a small one that has a relatively higher proportion of buyers who are more loyal than would be predicted by the Double Jeopardy law. In its early days the ecologically-based Body Shop was a good example of a niche brand, but as it increased its distribution and appeal it became a "normal" brand. As with most so-called niche brands, those that survive and prosper come to lie along the Double Jeopardy line.

The "change-of-pace" brand is one with a higher than expected market share, but a less than expected proportion of loyal buyers. Many lowalcohol and premium beers fit this description. People buy them only when they are in a special usage situation such as before driving a car, or having a pre-dinner drink in a restaurant. The significant point is that Niche, Change-of-Pace and Super-Loyalty brands are much less common than big or small Double-Jeopardy brands. It should also be noted that any of these brands can be profitable, because profit is determined by margin, not the type or size of brand.

One outcome from this research is of particular interest to marketing managers involved in administering customer loyalty programs. A more effective way to grow a brand's market share (or become big) is to get more people to buy it, rather than try to get current customers to buy it more often. Research by Peter Fader and David Schmittlein suggests that one of the most effective ways to get more buyers is to gain more distribution outlets—it is as simple as that.[16] Leading global players like British Airways, Coca-Cola, Ford and Citibank are only too aware of this, which is why they strive so hard to protect their air-routes, distribution channels, and dealerships. Loyalty programs and other marketing tactics such as price cuts and promotions will only be effective in the long term, to the extent that they entice more distributors to stock the brand or build presence in the marketplace.

In summary, this research implies that in many established and competitive markets the purchasing of products and services is characterized by a number of empirical regularities. Given that these regularities are so widespread, it will be difficult to increase brand loyalty above the market "norms" with anything as easy to replicate as an "add-on" customer loyalty program. This is not to deny that companies *can* have a short term "lucky break", or that they may feel forced to act because of competitive pressures. Our point is that for any customer loyalty program to be as effective as possible, given the prevailing competitive conditions, it will need to provide leverage to the brand's core customer value proposition.

4. Linking Customer Rewards to Loyalty Programs

Products and services provide benefits and/or solutions to problems faced by buyers. These can be functional, economic and psychological. They are the prime sources of customer value. As the research cited in the previous section suggests, it is the (relative) amount of customer value and distribution coverage which drives market share and the number of loyal customers a brand will acquire. The rewards offered by many customer loyalty programs are designed to disturb this relationship.

Exploring the potential for loyalty programs to disturb “normal” patterns of behavior also involves three psychological considerations: the extent to which loyalty is to the brand (a direct effect) or to the program (an indirect effect), the way buyers value the rewards on offer, and the effect of timing on these assessments. We consider each of these in turn.

Michael Rothschild and William Gaidis have used behavioral learning theory to suggest that the type of incentives offered by many customer loyalty schemes may induce loyalty to the program rather than the core product or service.[17] The extent to which this is desirable or not depends on the buyer’s level of involvement with the product. For many “me-too” low-involvement products, the incentive and not the product can become the primary reward—especially if the incentive is exotic and out of all proportion to the amount spent. This might create a point of differentiation in a me-too product (“good”), but once the incentive is taken away the prime reason for purchase disappears (“bad”). Many petrol company loyalty schemes are caught by this trap, locking the companies into a treadmill of continuous promotions.

However, for high-involvement products and services, which are typically accompanied by a small incentive, the product and not the incentive is the primary reward. For example, in the General Motors rebate scheme (the GM card) which allows participants to build up savings towards the cost of a new GM car, the car and not the accumulation of a discount is paramount. This seems to be a more desirable outcome because the creation of a point of difference (“good”) reinforces the longer-term value proposition of the product itself (“good”).

In this way, customer loyalty programs can be classified by whether or not their explicit rewards directly support the value proposition of the product or service that is on offer to customers (e.g., the GM card), or whether the rewards are designed to motivate loyalty by a more indirect route (e.g. free air travel from petrol retailers). We suggest that loyalty programs which directly support the value proposition and positioning of the target product better fit the goals of loyalty marketing.

Psychologists have long been interested in the role of rewards in behavior modification and learning. They have developed numerous cognitive-learning theories which provide insight into how the rewards offered by customer loyalty programs might help to achieve loyalty to the product rather than the program. Louise O'Brien and Charles Jones suggest that there are five elements which combine to determine a program's value.[18] They are the cash value of the redemption rewards (e.g., the ratio of the cost of an airline ticket to the dollar purchases necessary to accumulate enough frequent-flyer points), the range of choice of these rewards (e.g., choice of flight destinations), the aspirational value of the rewards (e.g., exotic free travel is more desirable than a cash back offer), the perceived likelihood of achieving the rewards, and the ease of use of the scheme. To this list we add the psychological benefits of belonging to the program and participating in accumulating (collecting) points.

The potential of a loyalty program to attract members depends not only on the value of the rewards it offers, but also on when the rewards are available. Research in psychology suggests that when a loyalty program's redemption rewards are problematic and delayed they will be a less powerful motivation.[19] Many accumulating benefit programs, such as frequent-flyer schemes, try to (partially) alleviate this problem by sending their members a statement of accumulated points at regular intervals. Typically, these statements are accompanied by material promoting the aspirational values and ease of achieving the various available rewards.

Table 1 classifies different types of loyalty scheme according to whether the reward supports the product/service value proposition and its timing. Our discussion suggests that immediate rewards are preferable to delayed rewards, and that direct support of the target product's value proposition increases the chance that the program will build loyalty for the product and not just the program. Hence, from the customers' perspective, the instant gratification programs in Cells 1 and 3 should be preferred to their counterparts in Cells 2 and 4. However, from the sponsor's perspective, programs in Cells 1 and 2 should be preferred to those in Cells 3 and 4—these make an explicit link between product and program and should have a bearing on longer-term behavior. From either perspective, Cell 4 is the least preferred—yet this is where many recent loyalty schemes are positioned—the Australian *Fly Buys* frequent-buyer program is a good example.

Table 1

Types of Reward Schemes

		Timing of Reward	
		Immediate	*Delayed*
Type of Reward	*Directly Supports the Product's Value Proposition*	1 Retailer/Brand Manufacturer Promotions (Price Promotions)	2 Airline Frequent Flyer Clubs, Coupons & Tokens (The GM card)
	Other Indirect Types of Reward	3 Competitions & Lotteries (Instant Scratchies)	4 Multi-product Frequent-buyer Clubs (Fly Buys)

Fly Buys members can accumulate points toward free air travel and hotel accommodation by using a bank credit card and/or a magnetic strip membership card with the scheme's sponsors—a major retailer, car rental company, and petrol company. Membership is offered at no cost. Within a year of its launch, 1.7 million Australians had taken up this free option.[20] This represented 10% of the Australian population, with one in every four households having a member. The customer's immediate rewards were psychological, namely, a feeling of participation; the anticipation of future rewards; and "a sense of belonging" to the program. The delayed rewards are a bi-monthly summary of accumulated points (an achievement score), and sometimes (the qualification for) a reward.

A customer cost-benefit analysis helps explain why the least desirable loyalty program in Table 1 attracted so many, or is it so few members. On the cost side of the equation, joining the program is free, and each transaction is handled with an easy to use magnetic strip card. Rewards however, were perceived by many people to be so difficult to achieve that a television advertising campaign had to be run to counter this popular belief.[21] On the reward/benefit side, for many people the aspirational value of air travel is high, and others just like being part of a program. Even though *Fly Buys* is a free option, it has not been able to achieve anything like 100% trial or repeat use.

With such a huge market penetration it is tempting to think that this program is a runaway success. While the sponsors hoped that their rewards would be sufficient to increase sales volumes, in practice they have been fairly elusive.[22] Also, with so many members, this is an expensive scheme to maintain.

In summary, both the *Fly Buys* case and the reward research suggest that designing a loyalty program which can disrupt established patterns of behavioral loyalty is difficult. Despite these difficulties many schemes have been launched in recent years. In the next section we review some of their claimed benefits.

5. The Claimed Benefits of Loyalty Programs

Advocates contend that loyalty programs are more profitable to a firm because:

(a) the costs of serving customers are less,
(b) loyal customers are less price sensitive,
(c) they spend more with the company, and
(d) they pass on positive recommendations about their favorite brands/suppliers.

Seemingly, these benefits are very alluring and they go far to explain renewed interest in customer loyalty programs. But, with the notable exception of Reichheld's recent collection of informative case studies,[23] there is little well-documented empirical research to substantiate these claims. As we have outlined, what evidence there is from behavioral loyalty and reward research suggests the opposite. Hence, before willingly accepting that customers in loyalty programs are always more profitable, let's examine each source of increased profitability.

When there are specific start-up costs involved in serving a new customer, such as prospecting, credit checks, and entering the customer's account details on a database, then the costs of serving a new customer exceed those of serving a repeat customer. However, it is not at all clear why the costs of serving a very regular (loyal) repeat customer should in principle be different to those of serving any other type of repeat customer. Why some transactions will differ in cost has more to do with the type of transaction, not the loyalty of the customer or their membership of a loyalty program. The key variables driving cost are: first purchase versus repeat purchase; size and type of order; special versus standard order; etc.—not loyal versus divided-loyal or "disloyal" customers.

Why would we expect loyal customers to be less price sensitive? They may be—but then again they may not. It depends on how important price is to them, and the value proposition (benefits relative to price) offered by the brand. Although one of the (frequent) claims of brand equity researchers is that brand loyalty and higher prices are positively correlated,[24] this does not automatically mean that more loyal buyers are less price sensitive. It may simply be that these people buy a brand at a higher price point because it is perceived to be better. For example, usually a brand is clearly in only one of the price categories of a market. Less price conscious people then have the opportunity to buy at either the cheaper or higher price points depending on whether the brand can offer a good reason (functional or psychological) to justify its higher price. It is perceived brand value, not brand loyalty which drives price insensitivity.

Alternatively, it could be argued that loyal customers may come to expect a price discount, or some form of better service. In other words, what are the rewards to the customer for his or her loyalty? Also, if we take heed of the Double Jeopardy relationship, these loyal customers are likely to be slightly more frequent buyers and hence they may expect some type of volume discount.

The next assumption is that loyal customers spend more with our company. This may be simply because they buy more of the product category than less "loyal" customers (e.g., business air travelers). As such, it is their weight of purchase that matters most, and not necessarily their loyalty. And, as we argue in the next section, this is more likely to be a function of the better value you offer, rather than any add-on loyalty program that you can design.

The last assumption says that loyal customers will pass on favorable word-of-mouth comments about us. This seems a sensible assertion, however there is little research to indicate what percentage of loyal customers help a company to market its products. The interesting question here is whether only loyal customers, or those in a loyalty program are likely to do this, or is it simply that *satisfied customers* are the ones to say nice things about good products and services? If satisfaction is the key driver of positive recommendations, then we should expect any satisfied customer to provide this benefit. The only way that a loyalty program could give extra leverage to a firm's word-of-mouth marketing is for the loyal customers to offer substantially more, or more effective, positive comments. We are aware of no research which demonstrates that this occurs.

In short, the contention that loyal customers are always more profitable is a gross over-simplification. Each company needs to use its customer data to determine the truth or otherwise of these assertions. This is where the behavioral loyalty research has relevance. If your brand fits the conditions under which these research findings hold, then there are some interesting implications for the introduction of a customer loyalty program. These market conditions can be summarized as:[25]

(a) there is open competition;
(b) products and services are functionally equivalent in broad terms (and therefore substitutable);
(c) there is little tendency for any brand to uniquely appeal to a particular subgroup of consumers (despite brands within a product category being non-functionally different); and
(d) there is little dynamic variation over time in competing brands' market shares (despite considerable marketing activity under the surface to maintain these shares).

We can hear your sighs of relief—this doesn't apply to my brand! But are you sure?

Certainly there are some products and services which do not appear to match these market conditions—those for state monopolies, highly innovative new products, and products whose success depends on fads and fashions. We also agree that there is a lot of product differentiation and that some trivial differences seem to affect choice.[26] However, most airlines, banks, beers, business school executive programs, frozen foods, hardware stores, instant coffees, mineral waters, petrol stations, plastic pipes, cars, stationery suppliers, TV soap operas, etc. compete directly with each other (within their product category). Also, when many products and services are not conveniently available, most people will not hesitate to buy a similar brand that is. Or they may deliberately seek variety.

Our argument is that these market conditions hold more often than you may think. The implication is that as a brand gets bigger, you should expect a higher proportion of the buyers to be slightly more brand loyal. The Double Jeopardy line in Figure 1 shows this relationship. Given these effects, the next section offers some suggestions about how to design a loyalty program which offers the best chance of providing a positive return on its investment.

6. Designing a Frequent-Buyer Loyalty Program

Here we focus on loyalty programs which are designed to "lock in" a customer by offering an accumulating benefit. This is designed to increase the switching costs to the buyer over time. These are the programs in Cells 2 and 4 of Table 1. In economic terminology, they try to change the customer's choice process from operating in a spot market to operating in a multi-period contractual (relationship) market. They are potentially the most dangerous for a company to launch because they require long-term commitment and funding. The programs in Cells 1 and 3 of Table 1 are more like short-term promotions, they might well stimulate sales for the duration of the promotion but we would not expect to see any long-term behavioral after-effects.[27]

For frequent-buyer loyalty programs, the level of customer involvement is an important consideration. With a high involvement purchase the consumer is likely to be involved with both the category purchase decision ("Will I fly or go by train from London to Paris?") and the brand choice ("Will I fly *British Airways* or *Air France*?"). For low involvement decisions the level of involvement is likely to be low for both decisions, although somewhat higher for the category purchase decision. We suggest that loyalty programs will be more effective for high as opposed to low involvement products and services. The primary reason for this suggestion is that low involvement products are often bought by consumers out of habit, while for high involvement products, consumers are more receptive to forming a relationship with the supplier (the difference is between the habitual purchase of Nescafe, say, and joining ClubMed).

In either case, to maximize the chances of success the following guidelines will prove helpful.

(1) The loyalty program *must* enhance the value proposition of your product or service. To the extent that frequent-flyer clubs and the GM card enhance the value of the airline or car, these schemes are more worthwhile than a frequent-buyer scheme such as *Fly Buys* which does not. In this respect, probably the least useful rewards for customer loyalty are free gifts such as lottery tickets—these are nice to receive, but they tend to be only short-term tactical froth which can devalue the brand.

(2) Don't allocate all your marketing budget to a loyalty program. These schemes tend to entice your competitors to make some kind of

countermove, so keep some money available for other competitive programs.

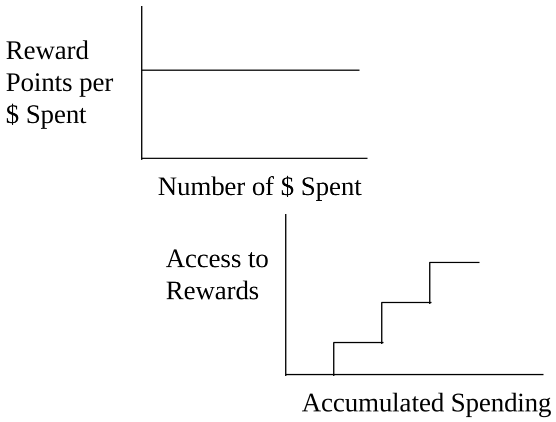
(3) Design a reward scheme which maximizes the motivation of the buyer to make the next purchase of your product. Most existing reward schemes achieve this only indirectly because they don't account for the customer's current situation. (Are they a light or a heavy buyer? What is their current number of accumulated reward points?)

Figure 3 illustrates this. In section (A) we see that for each dollar spent a participant gains the same number of points. Airlines often use a variation of this scheme where an economy class airfare attracts 1 point per kilometer or dollar spent, business class 1.5 points and first class 2 points. The incentive is to spend enough to gain access to different levels of reward.

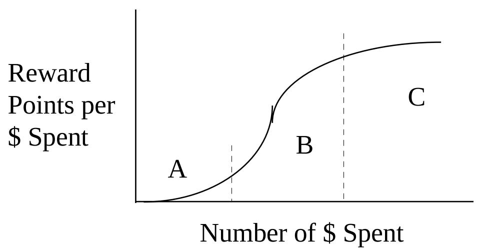
Figure 2

Loyalty Program Reward Schedules

A. Typical Response Functions



B. An Alternative Response Function



Section (B) in Figure 3 illustrates a reward scheme which is more transparent to the buyer. It offers more reward points for each additional dollar spent so that the "next" purchase is increasingly more valuable to the buyer. The three zones (A, B, C) in the response function are designed to balance the costs to the company of having too many unprofitable participants against the motivation of customers to participate in the scheme:

(i) In zone A light users can join, but they will not gain many rewards. Unless your company can be extremely effective in cross-selling other products and services to these people, then you really don't want them in your loyalty program. Maintenance of a database and regular communication with large numbers of these buyers can be costly; however, it is important not to alienate them—they may not think of themselves as "light" or insignificant buyers.

(ii) The response function is steepest in zone B to motivate the medium buyer to continue buying and to allocate more of their purchases to your product. These are likely to be the most profitable type of customer—big enough to be profitable to serve, but not too big so that they request a volume discount.

(iii) The response function is flat in zone C to limit the rewards available to super-heavy buyers. Your value proposition is already good for these customers, and their current level of buying suggests that it will be difficult to entice them to buy even more—unless you enhance the value proposition itself or gain wider distribution.

The point here is that whatever type of reward scheme you adopt, it needs to be designed with the profitability of different types of customer in mind. Ideally, you hope that this will motivate the most profitable type of customer to give you a higher share of their business. But realistically, in a competitive market where copy-cat schemes are inevitable, the aim may be no more than to ensure you maintain market share (with the attendant level of loyalty and divided-loyalty).

(4) Fully cost the loyalty program. There are a number of highly visible costs such as those associated with launching the program, database creation and maintenance, the value of rewards claimed, and issuing regular activity statements (anything up to twelve a year to have a meaningful impact). These can be very high as evidenced by an article in the business magazine *Asian Business* which reports that the costs of the frequent-flyer programs are typically between 3% and 6% of an airline's revenue.[28] As a benchmark against which to compare these costs, this article reports that many airlines peg their advertising spending to approximately 3% of revenue. Many other loyalty costs are less visible, namely, the opportunity cost of managers' time spent

on the loyalty program rather than on other (marketing) activities, and the effectiveness of the loyalty program compared with an alternative use of the funds.

7. Conclusions

There are three main lessons from the research and examples cited in this paper. First, it seems that in practice, competitive considerations are a major reason for the launch of many customer loyalty schemes. They may seek to pre-empt a competitor (and possibly secure first-mover advantages), or respond to a competitor's scheme (as evidenced by most of the frequent-flyer clubs).

Second, apart from purely defensive reasons, if a loyalty program does not support the product/service value proposition, then it might be justified if it can entice more distributors to handle the product—a demand pull effect. As noted earlier, for many products and services, there is a positive relationship between distribution coverage and market share.

Third, the behavioral loyalty research reviewed in this paper suggests that brand loyalty is more likely to be the outcome of the type of market in which you operate and the type of brand you have already, rather than the outcome of an add-on customer loyalty program. In other words, in the majority of cases all that a customer loyalty program will do is cost you money to provide more benefits to your customers—not all of which will be relevant to the brand's value proposition and/or positioning. It is unlikely to significantly increase your relative proportion of loyal customers, or your profitability.

These lessons suggest that customer loyalty programs which (i) directly enhance the product/service value proposition, or (ii) broaden the availability of the product/service, or (iii) neutralize a competitor's program, may be worthwhile. But they also suggest that (iv) it is probably a mistake to introduce a frequent-buyer program if you are selling a parity brand in a competitive market. Your competitors are sure to counter your move with something of equal perceived value. If they offer a price cut then the value of this immediate reward may be more motivating than your promise of a potential delayed reward. If they counter with a similar loyalty program, then it is likely to be better than yours in the hope of winning back any defecting customers.

The three lessons can also be used to help plan the use of customer loyalty programs in different market situations faced by organizations. For example, Table 2 lists twelve such situations and a comment on each one. Because these situations are often not independent, our comments are guidelines, not prescriptions in an applied setting.

Table 2

Can a Customer Loyalty Program Help?

Inhibiting Situations	*Comment*
* Core customers multi-brand buy in the category	* At best only marginally, and not cost effective
* Brands immitate each others startegies	* Unlikely, because any move will be neutralised
* Large-share, niche or change-of-pace brand	* Only as a defensive move which may not be cost effective
* In-use experience is very important to customers	* Unlikely, because the experience is the key
* Technology changes lead to better price/performance	* Unlikely, because better value is the key
* Brand is highly differentiated	* Unlikely, because the difference is the key
* Brand is highly fashionable	* Unlikely, because fashion is the key motivator

Table 2 continued

Can a Customer Loyalty Program Help?

Inhibiting Situation	*Comment*
* Intrinsic retention of customers is low	* Unlikely, because they desire change
Enhancing Situations - if none of the above situations hold	
* Scheme directly supports customer value proposition	* Yes, if its full cost is less than an equally effective alternative
* Relationship building adds to perceived value	* Yes, if it is cost effective relative to other programs
* Lifetime customer value is high	* Yes, if it is cost effective relative to other programs
* Customer retention costs are less than acquisition costs	* Yes, if it is cost effective relative to other programs

As indicated in Table 2 and throughout this paper, our position is that any type of program which is designed to attract loyal customers is likely to be more cost effective if it "goes with the flow" of consumer behavior. We have reviewed one such body of research which indicates that many of the programs so widely discussed in the business press may be seriously flawed. Like some of the more recent guru-led management strategies (or fads), this one seems to have been over adopted.[29] Our aim with this paper is to generate a more critical analysis of the variety of customer loyalty schemes being implemented—especially those which have an "add-on" character designed to stop loyal customers leaking away.

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