Ensuring Customer Loyalty: Designing Next-Generation Loyalty Programs

An Oracle White Paper
February 2005

ORACLE
SIEBEL
CUSTOMER RELATIONSHIP MANAGEMENT

ORACLE

Ensuring Customer Loyalty: Designing Next-Generation Loyalty Programs

Loyalty is a positive belief in the value that a company provides, leading to increased purchases over time.

INTRODUCTION

Loyalty programs are everywhere in business. Customers interact with them multiple times almost every day—whether shopping at a grocery store, buying a cup of coffee, flying on an airline, staying at a hotel, or paying a cell phone bill. In other words, companies have become convinced that it is possible to buy customers' loyalty. Do loyalty programs really work, or are these companies just wasting their money? Can a loyalty program change how people behave and get them to spend more money with that company? Can loyalty programs reduce the likelihood that customers will move their business to a competitor?

This white paper analyzes these questions and takes a detailed look at the current environment for loyalty programs and the strategies businesses are using in implementing these programs. In addition, the paper presents a series of best practices that can create meaningful competitive advantages for companies that offer loyalty programs (that is, "host companies"), their partners, and their customers.

CURRENT LOYALTY PROGRAM LANDSCAPE

The first mileage-based loyalty program was launched by American Airlines more than 23 years ago (May 1981).[3] Today, loyalty programs are ubiquitous. There are more than one billion people worldwide enrolled in loyalty programs,[2] and in some industries such as airlines and hotels, loyalty programs have become one of the most critical means by which companies manage their customer relationships.

- More than 125 million people worldwide are enrolled in airline loyalty programs.
- About 76 percent of all U.S. grocery retailers with 50 or more stores have a loyalty program.[2]
- Almost 50 percent of the top U.K. retailers have loyalty programs.[30]
- About 75 percent of Americans belong to at least one loyalty program.[2]

Loyalty coalitions are especially popular in Europe: Payback by Loyalty Partner in Germany has more than 25 million members,[19] and Nectar in the U.K. has more than 20 million members.[29]

DEFINING LOYALTY

Before examining how loyalty programs work, it is important to define exactly what is meant by loyalty in the context of business development and retention. Several broad definitions exist, including the following:

- "The commitment of customers to a particular brand or company"[23]
- "The extent to which your customers continue with key loyalty behavior when competitors offer more attractive prices, products, and/or services"[23]
- "Faithful to any person or thing conceived of as deserving fidelity... characterized by or showing faithfulness"[24]

For this white paper, loyalty is defined as follows: "Loyalty is a positive belief, generated over the course of multiple interactions, in the value that a company and its products and/or services provide, which leads to continued interactions and purchases over time."

Loyalty should not be confused with customer satisfaction. Although loyalty is built on satisfaction, organizations can have satisfaction without loyalty. Customer satisfaction is an "opinion measure" about company performance and how customers feel their needs were met in past interactions or by past purchases, whereas customer loyalty is a results measure that includes expectations of future behavior.[6] For example, 75 percent of consumer wireless customers are "satisfied" with their current service, but 72 percent would be willing to switch to a competing provider.[1] Thus, when designing a rewards program to build loyalty, it is critical to think about how to encourage true long-term customer loyalty and not just fleeting customer satisfaction.

LOYALTY PROGRAM BASICS

Companies typically have several goals when launching loyalty programs, all of which are focused on generating greater profits from the program's members. These goals include

- Improving knowledge of the customer
- Leveraging that knowledge to increase the sales of undersold and/or highly profitable products/services
- Increasing customer retention and purchase frequency

The most common type of loyalty program begins when a customer enrolls. From that point forward, the organization accurately tracks information about that "member," captures the member's purchases, credits points to the member based on the rules stored in a loyalty "engine," categorizes the member in tiers or groups based on the member's value to the organization, and enables the member to redeem points for products or services when various point levels are attained. The specific types of behavior that are tracked and rewarded are unique to each industry/company and are typically linked to the organization's profitability drivers. The table below provides a glossary of key loyalty terms.

Term	Description
Member Profile	A record of relevant member information such as occupation, address, family, communication preferences, transaction history, and tier history, plus industry-specific attributes such as travel preferences (travel and hospitality) or service plan and phone history (communications).
Tiers/Segments	Groupings of members who share common characteristics (segments) or who share the same status with a company (tiers).
Accruals	The points a member earns for purchasing different products/services (from both the host company and partners) or by performing desired nonpurchase actions (such as purchasing via a low-cost channel such as the Web).
Promotions	Targeted accrual rules that encourage members to purchase selected products/services or perform designated actions during a defined time period.
Redemptions/Rewards	The points a member uses in order to "purchase" a product/service from either the host company or a partner.
Transactions	The basic data structure and functionality used to store and display members' purchases/actions (for example, for an airline, each time a member completes a flight segment, an accrual transaction is created). The term refers to both automatic and manual transaction creation and processing. All accrued/debited points are the result of a transaction.
Engine	A software application that performs a variety of actions, including awarding or deducting a member's points, moving members between tiers, expiring points, and creating statements.
Partners	Partner companies that participate in the host company's loyalty program. Partner companies can, for example, enroll members in the program, and members can earn points by purchasing the partner's products/services ("earn") or use points to purchase a product from the partner ("burn").
Loyalty Web Site	A site on the Internet that enables members to perform self-service, such as updating their personal profile, viewing their transaction history, and submitting service requests.
Analytics	Software that allows users to analyze key loyalty program data for multiple purposes, such as evaluating the program's status, a promotion's ROI, or a partner's value to the host company.
Technology Architecture	The underlying architecture that enables a company to accomplish its loyalty goals. Loyalty technology generally includes four components (outside of the basic technical platform/architecture used to design the system): employee-facing applications, member-facing applications, partner-facing applications, and a loyalty engine.

BENEFITS OF LOYALTY PROGRAMS

Numerous companies across multiple industries have made substantial investments in loyalty programs, which begs the question "Do loyalty programs work?" In short, the answer is a resounding yes. A properly executed loyalty program can deliver significant, long-lasting benefits to the host company in the areas of customer knowledge, product and service differentiation, customer retention, and profitability.

Greater Customer Knowledge

A loyalty program enables a company to gain detailed knowledge about its customer base with the customer's consent; customers actually want to provide transaction and detailed profile information to ensure that they receive the full benefits of being a member of the program. In some market segments—such as business-to-business—companies already possess significant knowledge about their customers. As a result, these firms will not see customer knowledge as an important component of a loyalty program's value. However, for most business-to-consumer companies, gaining this level of intimate customer knowledge is a critical benefit of a loyalty program. In such B2C industries, loyalty programs enable companies to match their faceless customer purchase data (what was bought, when, at what store) with specific customer profile information,[5] which can then be used to create targeted marketing promotions or redesign services around high-value customers' needs.

Increased Customer Retention

A well-honed loyalty program improves customer retention rates, by increasing a member's "switching costs," which are costs a member would bear in order to switch to a competing provider. These costs can include decreased service and the time and resources required to build a new relationship. The higher a member's switching costs, the more likely that member is to remain loyal.

Most loyalty programs today do not create high enough switching costs for members. For example, airline industry frequent-flier programs all provide virtually the same product (a seat, perhaps with a few extra inches of legroom) and the same membership benefits (separate customer service number, priority boarding, priority upgrades, and bonus miles). If gold-tier members on one airline want to switch to a competitor because the competitor just added nonstop service on their favorite routes, all they have to do is fax the competitor their last frequent-flier statement, and they will immediately be made gold members of the competitor's frequent-flier program. Because the products and services these two airlines and their loyalty programs provide are virtually identical, the members can switch to a competing carrier at virtually no cost to themselves.

However, if the first loyalty program offered a unique set of benefits that the competing carrier could not easily duplicate, it would be much less tempting for members to switch. Companies use their loyalty programs to create these switching costs, by

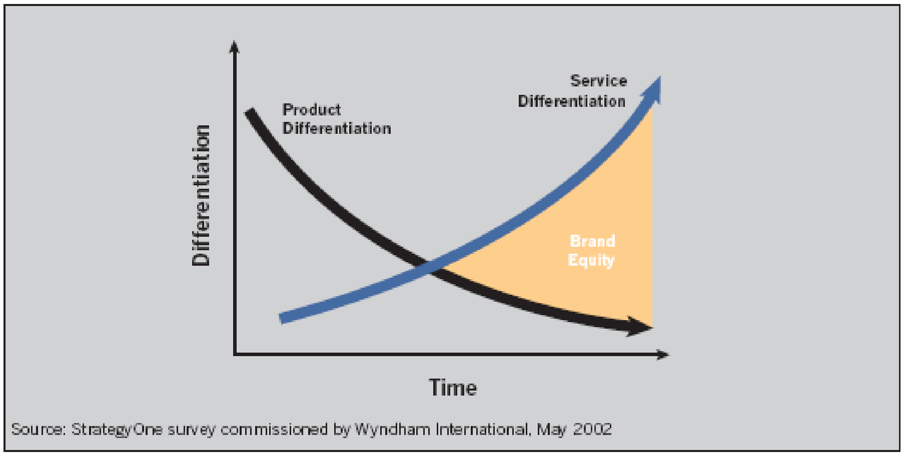
- Leveraging in-depth member profile and transaction data to create unique offers and product/services that a competitor, which does not know as much about the member, cannot match
- Providing targeted service consistently across all channels

By using the personalized data provided by their loyalty program, companies can create a win-win relationship with their members that cannot easily be replicated by their competitors.

Differentiated Service and Brand Equity

Most companies do not want to compete on price. Even those whose business models are initially predicated upon providing the lowest-cost service (for example, low-cost carriers such as Southwest Airlines and JetBlue Airways) often find that they must focus on providing value beyond price as they mature, their costs rise, and new upstarts beat them on price.

In addition, for companies that have not traditionally competed on price but suddenly find that their products are becoming commodities, brand equity is often determined by the additional value these companies can provide beyond products alone. Today, companies in a number of industries are in this position. Examples include airlines that have reduced their offering to basically a seat with no food or frills, "big box" retail stores that have depersonalized the shopping experience, and wireless firms whose networks have now reached parity.



Brand equity is a source of sustainable competitive advantage.

Companies can create this additional value by moving away from generic, one-product-meets-all-requirements products to targeted products and services that address their customers' unique needs. A loyalty program provides this detailed information on transactions, demographics, and personal preferences required to successfully identify the unique groups among a company's customer base and then design products or services that meet those segmented members' needs. For example, retailers can use their loyalty data to ensure that the products desired by high-value customers are always in stock, are easy to find and reach, and are prominently displayed.

While consumers agree that price is important, they'd choose a slightly higher rate for added service.

– Forrester, April 2002

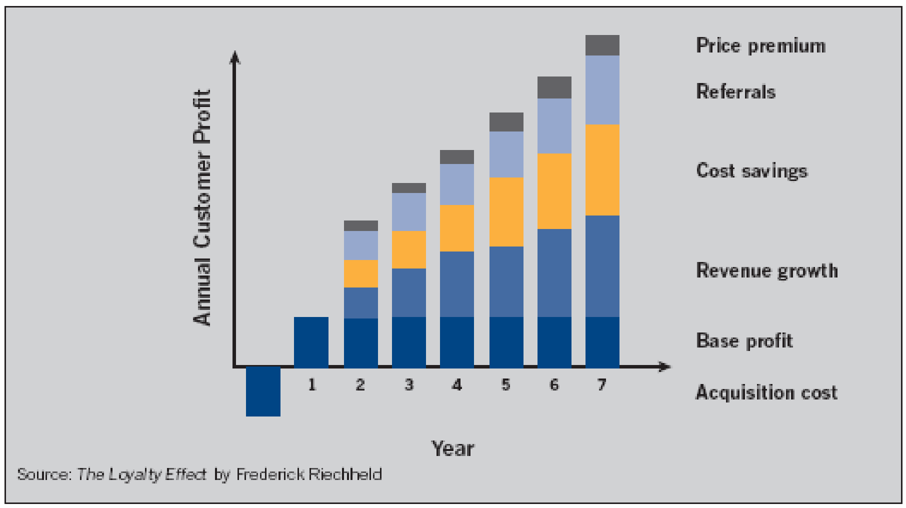
It is critical to note that customers are typically willing to pay for those products and services that do a better job of meeting their underserved needs. For example, 83 percent of hotel guests say that personalized service and attention to their needs provides value. It is "value," rather than price, that defines a good deal for these customers.[25] Brand equity, which is achieved by providing highly valued, well-differentiated products and services, is the cornerstone of loyalty. It is the additional value that customers believe a company provides relative to its competitors that encourages loyalty to the host company and makes customers potentially willing to pay more for its products and services.

Improved Profitability

All of the benefits discussed to this point lead to a loyalty program's key goal and most important metric of success: improved profitability. Greater profits are a result of

- Profitable customer retention
- Higher prices paid for unique products/services
- Increased average purchase size
- Decreased marketing and systems costs
- Decreased unsold expired inventory

Increasing customer retention significantly improves a company's profitability. According to Frederick Reichheld of Bain & Company, a 5 percent increase in customer retention results in a 25 percent to 100 percent increase in profitability. There are several sources of these additional profits, which Reichheld breaks down into price premium, referrals, cost savings, revenue growth, and acquisition cost.[10]



Research by Bain & Company has shown that a 5 percent increase in a customer retention produces an increase in profitability of 25 percent to 100 percent.

The examples in the table below demonstrate the link between loyalty and profitability:

Industry	Company	Program Results
Retail	Dorothy Lane	• Sales have increased by 58 percent since the company launched its loyalty program four years ago, growth the CEO attributes to the loyalty program[1] • Gross margin increased by 3 percent[1] • Uses the loyalty program to decide what products to carry[1]
Retail	LG Home Shopping	• Implemented loyalty program to provide differentiated service to prolific shoppers[20] • Resulted in decreased churn among most profitable customers[20]
Telecom	TIM	• 400,000+ post-paid consumer members[20] • Loyalty program reduced customer churn by approximately 30 percent[20]
Telecom	European Operator	• 72 percent decrease in "intention to churn" among loyalty program members[19] • 14 percent increase in revenue per customer for customers in the program[19]
Travel	Deutsche Bahn	• Improved ability to compete against alternative modes of transportation, especially individual motor car traffic and short-haul airlines • Enabled direct service and individual marketing campaigns targeted at highest-value customers • Decreased service costs by motivating customers to move bookings to the Internet
Travel	United	• One of the world's most popular loyalty programs with more than 40 million members[20] • United sells points to partners, providing the company with incremental revenue and net income
Hospitality	Harrah's	• Increased share of gambling wallet from 36 percent to 43 percent[1] • Occupancy rate exceeds 90 percent vs. industry average of 60 percent to 80 percent[1] • Increased slot revenue 12 percent by using loyalty data to redesign its casino floor[1] • Generated an additional $165 million per year from top-tier guests[7]

LOYALTY PROGRAM COSTS

Despite their many benefits, loyalty programs can be expensive to develop and maintain. The costs associated with loyalty programs generally fall into two categories: program costs and system costs.

- Program costs are nontechnical expenses related to administering the program's points, rewards, and services.
- System costs are those invested in the technical infrastructure to support the loyalty program. Although some costs are directly attributable to the program—for example, loyalty program management software—there are other costs a company would likely incur even without a loyalty program,

such as marketing software and hosting a Web site. However, even these costs can be increased due to factors such as integrating the marketing software with loyalty software or providing additional loyalty-related functionality on the company Web site.

Cost Category	Examples
Program Costs	• Point accruals (for instance, $0.02 per point paid to host company)[3] • Free products provided as rewards/redemptions • Specialized customer service • Employees to manage and staff the program (for example, program manager, service and support representatives, and partner manager)
System Costs	• Loyalty, marketing, and analytics applications • Web site • Call center • Integration with multiple internal systems and partners' systems

A company's program costs will vary significantly, depending on the rewards that are provided. For example, airlines and hotels, which are high-fixed-cost, low-variable-cost businesses, will have lower program costs. This is because airlines can allow members to use points to redeem only those seats that would otherwise go unsold. The cost to fly additional people who purchased their tickets with points is trivial. Further, although members can use airline points to purchase products with any of the airline's partners (hotels, car rental agencies, and selected retailers), people place such a high value on airline seats that nonairline flight redemptions account for only approximately 3 percent of all airline loyalty program redemptions.[3]

Other companies, such as retailers, in which every product redeemed for points must be paid for by the company with cash, will have higher program costs. For example, depending upon the program's rewards and generosity, a retailer's loyalty program can cost between 2 percent and 10 percent of a customer's total expenditures.[1]

LIMITATIONS OF CURRENT LOYALTY PROGRAMS

Many current loyalty programs have not achieved their goals, because of incorrect strategy and/or inadequate technology.

Although some firms have successful loyalty programs, many companies that have implemented loyalty programs have not achieved their desired goals. For example, although hospitality firms (along with airlines) are generally seen as loyalty leaders, studies have shown that hotel loyalty programs do not significantly ensure repeat business or improve the hotel chain's profitability:

- Only 22 percent of consumers booking hotel reservations online cited the hotel's loyalty program as influencing their decision[4]
- About 47 percent of consumers who are members of a hotel loyalty program had no interest in the program[2]
- Without company logos, members of a focus group could not identify the differences between hotel loyalty programs[2]

Two primary obstacles typically prevent companies from achieving their loyalty goals:

- Incorrect strategy
- Inadequate technology

Incorrect Strategy

There are a variety of reasons for the failure of current loyalty programs to deliver value. First among them is that most companies do not follow an optimal loyalty program management strategy. The three most common strategic mistakes are

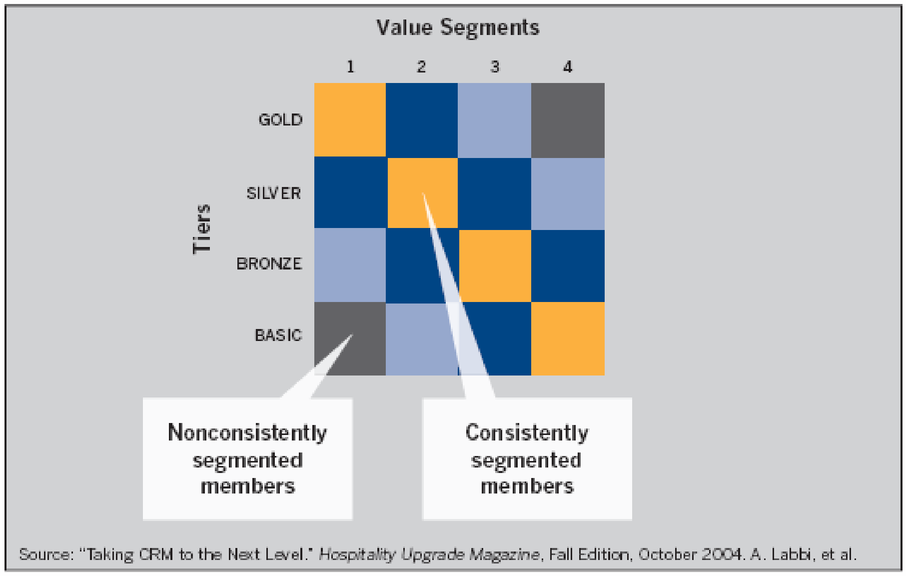
- Failure to understand and manage the long-term nature of loyalty
- Failure to differentiate members by value
- Implementation of customer value tracking schemes that do not match members' true value

In addition, many companies make the mistake of trying to build loyalty one transaction at a time. Their entire programs are driven by individual purchase and interaction incentives, ignoring the long-term treatment and management of members. True loyalty is built upon a sequence of mutually beneficial transactions and interactions, and companies need to manage these as a cohesive whole.

Many loyalty programs, particularly those in the retail and wireless industries, have been implemented without differentiation of customers by their expected value. The purpose of a loyalty program is to create incentives for customers to increase their spending with the host company, and most often this is accomplished by construction of a tiered set of incentives that provides increasingly attractive rewards the more a customer performs the desired actions (as measured by the number of purchases, flights, or stays; the purchase size; or the profitability of the purchased items). Without these incentives, a loyalty program has little effect on customers' purchase behavior. For example, most consumers will sign up for each of their local grocers' loyalty programs and then choose where they shop, based on other criteria, such as location, advertised specials, or the presence of a bakery or fresh fish market. Such programs do little to help retailers build relationships with the customers they want to retain.[9]

Companies need to rethink how they manage and segment their customers to ensure that the groupings truly differentiate members by value.

Even among firms that differentiate members based on their expected value, there is usually a gap between a member's tier status and the actual value of that member to the company. For example, an analysis of airlines' frequent-flier databases reveals that the current tier structures do not, except for the top 10 percent of fliers, correlate with a customer's true value.[13] To this point, companies need to rethink how they manage and segment their customers to ensure that their groupings truly differentiate members by value.



An analysis of loyalty databases usually reveals that the tier structure often does not strongly correlate with customers' true value.

Inadequate Technology

Even when leading-edge companies recognize the strategic problems inherent in their loyalty programs, they are often hampered in their efforts to address these problems by significant technology limitations. In the past, loyalty systems have often prevented companies from offering a precisely targeted, highly valued loyalty program. Firms were typically provided a limited set of choices:

- Inflexible legacy systems with high maintenance costs
- Poorly integrated point solutions with limited functionality

For example, most large airlines and hotel chains use loyalty systems that were leading-edge when they were first developed in the 1980s to early 1990s, but they can no longer provide the functionality to make the airline or hotel successful in today's increasingly competitive market.[21] The technology limitations imposed by these legacy systems and point solutions are the cause of many of the issues facing loyalty programs today.

The Net Result: Costly, Ineffective Loyalty Programs

Loyalty programs are supposed to increase a customer's loyalty to the host company by creating a unique value proposition that competitors cannot easily match. However, strategic and technology limitations have left many companies with loyalty programs that do not provide a significant competitive advantage. Many programs have essentially the same characteristics and are approaching a "parity deadlock," no longer serving as brand differentiators.

Technology Limitation	Results
High Maintenance Costs	• The high cost of legacy technology has kept even leading-edge companies from introducing innovations into their loyalty programs. • One European carrier spends more than $2 million per year to manage more than 500,000 members, equal to $4 per year per member in maintenance costs alone.[21]
Minimal Flexibility	• Programs cannot flexibly adapt to changing market and competitive dynamics. • For example, it used to take a European carrier six months to change a tier requirement (such as adjusting the requirement for Silver status from 30,000 to 35,000 points). This carrier estimates that with its next-generation system, this can now be accomplished in as little as one day.
Limited Functionality	• Results in incomplete customer profiles. • Hampers a company's ability to create complex, targeted promotions.
Poor Integration	• Inadequate cross-channel (for example, employee- and member-facing) and cross-system (for example, loyalty, marketing, analytics, and call center) integration. • Information on loyalty Web site generally lags what employees see on the internal system. • Disconnected databases provide different information across channels.
Minimal Analytical Capabilities	• Analytical capabilities are not provided to people who make the decisions (for example, marketing manager, customer service manager, or a loyalty executive). • Analysis of inventories, promotion effectiveness, and other components cannot be conducted in real time. • No clear loyalty program ROI measurements or tracking.

The increasing dynamism of most consumer and business markets has a significant impact on loyalty programs. As the pace of business change increases—which affects the competitive landscape, pricing, and consumer buying behavior—member expectations and requirements are also constantly shifting, and businesses need loyalty programs that are flexible enough to respond. Most companies that have implemented programs based on previously available technologies have found that those systems cannot be easily or quickly changed. In turn, the efficacy of their programs is steadily decreasing.

Many companies have not achieved their desired business outcomes, due to limitations imposed by inadequate technologies.

Issue	Business Pain Points
No Competitive Differentiation	• Unable to ensure the loyalty of the most profitable customers. • Switching costs are low. Top-tier members can easily defect to competitors' loyalty programs and be instantaneously awarded the same preferred status in that program, receiving virtually the same level of benefits.
Inadequate Customer Profile	• Unable to identify either the most profitable or least profitable customers. • Cannot provide highly targeted services based upon customers' unique needs and preferences.
Inflexible Accrual Rules	• Accruals are not tightly tied to a product's profitability. For instance, it is difficult and costly for airlines to move from one amount of points given for a flight to a variable amount of points based upon ticket and/or booking class. • Customers are not motivated to behave in the most profitable manner (for example, referring friends to the program, using online self-help).
Inflexible Tier Requirements and Benefits	• Tier rules and bonuses do not closely correspond to customers' needs or desires. • Members' incentives are not maximized to yield the greatest return for the host company.
Lengthy Promotion Creation Process	• Minimal net new revenue because promotions do not effectively increase the sale of distressed inventory. • Cannot identify key pieces of distressed inventory in real time and then rapidly create and execute a loyalty promotion that sells these items. • Inventory (airline seats, hotel rooms) expires and all potential profit is permanently lost. • Unnecessary discounts offered early when additional full-priced sales could still be generated.
Poorly Targeted Promotions	• Expensive, low-response marketing campaigns. • Customer dissatisfaction from receiving multiple irrelevant promotions. • Decreased promotion effectiveness because members withdraw from email lists or ignore all promotions.
Limited Segmentation and Customer Value Analysis	• Unknown customer value because tiers/segments do not map to a member's true value. • Increased churn among profitable members who are not part of the standard top tiers or segments. • Unable to identify and increase the profitability of low-value customers.
Inconsistent Treatment of Customers across Channels	• Dissatisfied customers due to raised expectations and inconsistent service. • Increased churn.
Expensive Maintenance	• High ongoing maintenance costs preclude investing in significant functionality upgrades.
Unknown ROI	• Cannot make sound investment decisions—for example, which members to target or which promotions to run.

In summary, due to strategic and technology limitations, most companies implementing loyalty programs have found that they do not receive the return they expected, because the programs do not adequately change their members' short-term behavior or engender long-term loyalty.

ASSESSING WHETHER A LOYALTY PROGRAM IS RIGHT FOR YOUR COMPANY

Before deciding whether to create a loyalty program, organizations need to assess whether such a program is likely to provide competitive advantage in their particular industry. As noted previously, one of the primary purposes of a loyalty program is to keep members from defecting to competitors' products. This is especially difficult in industries with commodity products, such as in the airline industry, where one seat is nearly identical to every other seat.

If it is fairly easy for customers to switch to a competitor's product, then switching costs are low. Nonloyalty factors that might increase a customer's switching costs include integration costs (for example, if the current product has been technically integrated into a larger system), physical location (if using a different provider would be geographically more costly or less convenient), and long-term contracts with significant early-termination penalties.

In order for a loyalty program to increase switching costs, the host company must be able to differentiate the service it provides to its loyalty program members. Companies do this in many ways:

- Tailoring products and services based on customers' preferences (for example, adding extra legroom for seats occupied by frequent fliers or opening a separate checkout lane for loyalty members)
- Providing ancillary services or additional amenities (such as preboarding an airplane or delivering wine, newspapers, or fruit in hotel rooms)
- Offering a specialized customer service line or Web site for members
- Helping members get the most of out of their expenditures by using the members' transaction history and profile data to create unique promotions

A company's analysis should identify whether there are ways to use a loyalty program to more effectively differentiate the products and services it provides.

Other important questions companies should consider before deciding to create a loyalty program include the following:

- Can program benefits be delivered to the person making the purchase decision?
- Are purchasers willing to identify themselves?
- Can rewards be offered at a reasonable cost?
- Will customers make enough purchases to receive benefits from the program?

For example, airlines focused on business travelers need to determine whether purchase decisions are made by individual travelers or corporate travel planners. In the former instance, a traditional loyalty program targeted at the individual traveler makes sense. However, in the latter instance, a traditional program would reward individual fliers even though they were only doing what had already been decided for them. In such cases, the loyalty program should be targeted at travel managers and parent companies—for example, points could be awarded to the parent company each time an employee travels with the airline. These points could then be redeemed by the company for free business trips.

In addition, if customers make purchases only infrequently (for instance, carpet cleaning services are generally used only once or twice a year), a company-sponsored loyalty program will not be valuable, because customers will not interact frequently enough to receive benefits from the program.[14] In such instances, a "coalition" loyalty program (discussed later in this paper) may be more appropriate.

DESIGNING AN OPTIMAL LOYALTY PROGRAM

Only through careful differentiation can enterprises succeed in creating true loyalty.

—"The Loyal and Profitable Customer," Gartner, 2003

The popularity of loyalty programs has led numerous companies to offer loyalty programs that simply mimic the program offered by the leader in their industry. Rather than providing a competitive advantage, this strategy simply creates a competitive stalemate while driving up expenses due to the cost of maintaining the loyalty program.

The key point is that a company must design its loyalty program to create competitive advantage today and in the future. In addition, when choosing a system to support a loyalty program (a process this paper reviews later), it is important to select a system that provides the flexibility to cost-effectively make changes as required.

What follows is a high-level, step-by-step process for designing a successful loyalty program. It is essential that in the beginning, companies focus on mapping customer interaction points and identifying key goals and business processes. The key is to clearly define key business goals and processes. Once that is complete, these goals and processes can be mapped back to existing systems to identify any technology requirements. This ensures that an organization's technology investments will be made to support business goals, minimizing the chance that technology limitations will later dictate business strategy.

Based on our experience in helping companies implement loyalty programs in numerous industries, we have developed a 10-step process for designing a successful program. These steps do not necessarily have to be followed in the order specified below. Although there are some logical sequences—for example, Step 1 should always be completed before Step 2—the order in which the other steps are performed can vary, depending on a company's preferred method of analysis. The 10 steps can be summarized as follows:

Step 1: Identify key customer interaction points.

Step 2: Map associated business processes.

Step 3: Identify desired business outcomes.

Step 4: Identify key profitability drivers.

Step 5: Design an integrated marketing strategy.

Step 6: Define loyalty analytics requirements.

Step 7: Segment members.

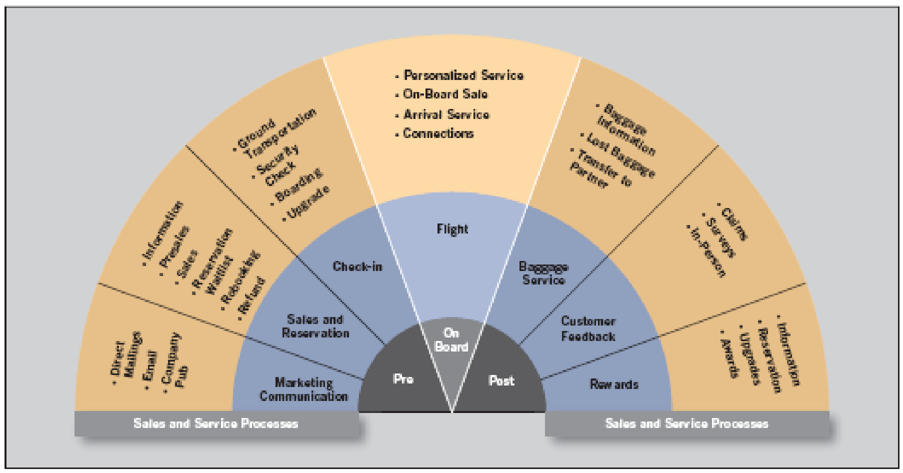
Step 8: Design the incentive structure.

Step 9: Define the partnering strategy.

Step 10: Choose the appropriate technologies and vendor.

Step 1: Identify Key Customer Interaction Points

There are multiple ways to analyze how a company interacts with customers. One way is by identifying all of the points at which a customer interacts with the company and then showing them as an integrated process. The following "fan slide" graphic shows the continuum of interactions that customers can have with an airline.

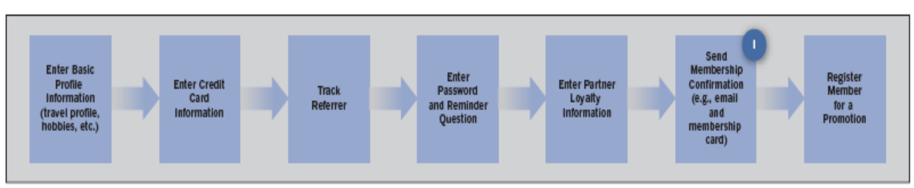


This Airline Customer Interaction Map shows the continuum of interactions that customers can have with an airline.

Step 2: Map Associated Business Processes

Once customer interaction points have been clearly defined, it is critical to ensure that the loyalty program supports all of the business processes used to manage these interactions. At this stage, it is not critical that every minute detail be captured. Instead, companies need to ensure that all the key process elements are captured at a reasonable level of granularity, so that all users clearly know what is included.

For example, one airline used Microsoft PowerPoint to define its member registration process in the following manner:



Note the circled *I* on the sixth substep. This airline was defining its requirements for a new frequent-flier system. Although the carrier's key focus at this stage was to map its business processes, it identified all of the integration ("I") points where its frequent-flier system would have to interact with other (internal or external) systems. The carrier then used this information in a subsequent stage when defining its system integration requirements.

To ensure that a full range of requirements is mapped, business processes should be created for each major set of users. For example

- Loyalty administrators
- Member services representatives
- Member services managers
- Marketing managers
- Partner managers
- Members (on Web site)
- Partners

Step 3: Identify Desired Business Outcomes

This is step 3 rather than step 1 because some companies have found that first identifying all of the interaction points and business processes helps them identify and articulate a concise set of hard-hitting goals. On the other hand, some companies prefer to articulate a set of goals first and then revisit and update the goals as needed, based on any new ideas uncovered during the mapping steps.

At a high level, a loyalty program's goal is obvious: to improve profitability. However, companies generally need to also establish additional, more specific goals for their loyalty program, such as the following:

- Increase the sale of expiring inventory
- Increase the frequency at which customers purchase
- Improve the service provided to the most valuable members
- Identify the least valuable members and then either improve their profitability or implement a strategy for removing them from the customer base

Clearly articulating specific goals helps ensure that the actions and mind-sets of everyone who contributes ideas to the program are aligned. Some companies choose to have a few high-level goals, such as those listed here, and then more detailed goals organized in a variety of ways (such as goals for customer service and partner management).

Step 4: Identify Key Profitability Drivers

At heart, loyalty programs reward changes in customer behavior. The specific actions targeted should be the ones that are most likely to increase a customer's profitability, which will vary by both industry and company.

For example, a wireless carrier might focus on the length of the contract, service plan level, number of services used, family calling plans, and roaming charges as the primary profitability levers. These levers would be different for a wireless company that was focused on prepaid plans as opposed to contracts. Their relative importance would also depend on the unique characteristics of the carrier's current and target customer base.

Loyalty promotions are the primary lever used for changing members' short-term behavior.

It is critical to identify not only the profitability drivers but also the underlying factors that drive people's behavior as it relates to each of these drivers. For example, what criteria do consumers use when deciding whether to purchase add-on features such as three-way calling or call forwarding? These are the actions that could be built in to the loyalty program's incentive structure to encourage more-profitable behavior.

Note that a change in strategy often requires reexamining profitability levers. For example, if a company decides to target a new customer segment, this group will likely have at least some profitability drivers that are different from those of the current customer base. The loyalty program's incentives would need to be adapted to meet these changing requirements.

Step 5: Design an Integrated Marketing Strategy

Developing and implementing an effective loyalty marketing strategy is critical to generating a positive return from a loyalty program, because marketing promotions will be the primary lever used to get members to change their behavior and purchase undersold and/or more profitable products or to use more-cost-effective customer service and purchasing channels. Companies generally have two types of marketing programs:

- Proactive—targeted at improving customer profitability
- Reactive—providing incentives for customers to purchase undersold products

Proactive Campaigns

The goal of a proactive marketing strategy is to increase members' long-term profitability by executing a series of actions that shift a member from a less profitable to a more profitable customer segment.[13] When creating the campaigns to implement this strategy, many companies use data mining capabilities to identify what types of promotions (specifically, which rewards) are most likely to cause the desired changes in customer behavior. Cutting-edge companies not only define member segments and model how those segments are expected to respond to an individual promotion or series of promotions but they also manage the changes in customer value over time, by creating multistage marketing campaigns. These campaigns are based on how customers respond to a series of promotions, where the goal of each promotion is to move members through a series of tiers so that they are eventually raised from a lower-profitability to a higher-profitability tier.[13] The best-performing companies recognize that a member's loyalty is based not on a single transaction but on a sequence of transactions with a company and that all of these interactions need to be managed as a cohesive whole.[14]

When creating a proactive marketing strategy, leading firms optimize their marketing spending by defining which promotions to offer to different groups, based on their company's budget, risk tolerance, and desired payoff. This optimization should be done across the entire loyalty marketing portfolio, not just for an individual promotion.[13]

A proactive loyalty marketing strategy should identify and target members whose value to the business appears to be dropping or who are likely to churn. Rather than waiting for a member to leave and then instituting a win-back campaign, the characteristics of customers who are likely to defect need to be identified. A series of customer retention marketing actions can then be done to keep valued customers from leaving. For example, marketing campaigns can be timed according to the most recent transactions made by customers rather than to the historical time between transactions (for instance, offers can be e-mailed to people who have not made a purchase in 1.5 times their average time lag).[11] These actions are generally less costly and more effective than trying to win back customers once they have left.[14]

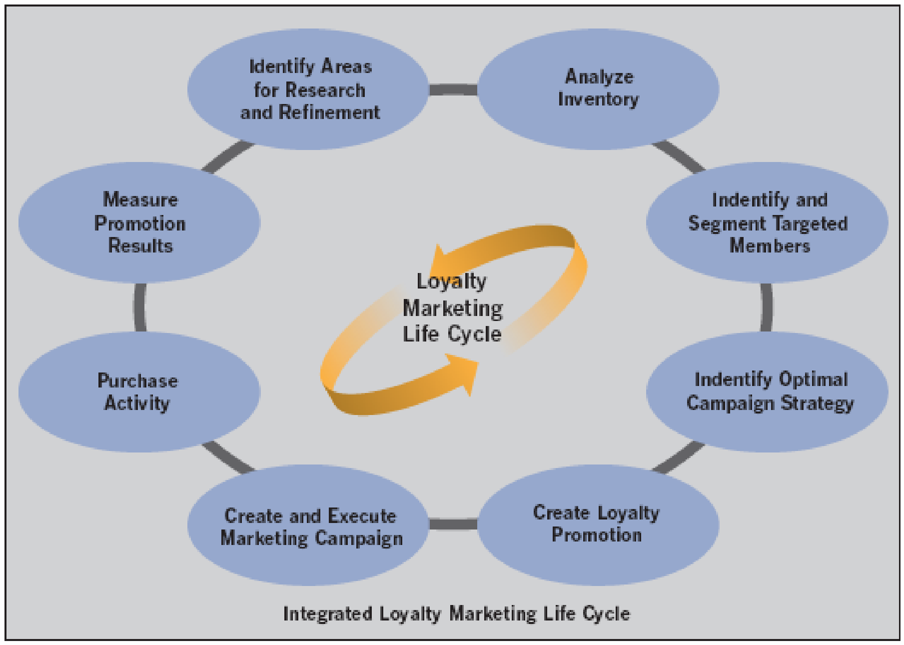
Reactive Campaigns

Reactive campaigns are focused on improving short-term profitability by getting members to purchase undersold products. This is especially critical in industries with expiring inventory. In general, a reactive campaign will involve several stages:

1. Determining the target (product/service/market segment) for a promotion
2. Identifying customers (individually via segmentation or by using predefined segments) that may be interested in a specific product
3. Identifying which promotion will most cost-effectively change the targeted customers' behavior and how this promotion should be presented to these members to maximize their response rate
4. Creating the loyalty "promotion." (A loyalty promotion tells the loyalty engine how many points to credit or debit a member for purchasing or redeeming a specified item.)
5. Creating the overall marketing "campaign." (A campaign is the umbrella structure used to organize and manage how information about the promotion will be communicated to members.)

6. Creating the marketing "offers." (Offers are the actual medium used to tell a member about the promotion's requirements and rewards. Multiple offers can be associated with a single promotion if it is determined that the same bonus should be presented in different ways to different segments, based on each segment's unique set of preferences and characteristics.)
7. Executing the campaign
8. Analyzing promotion, campaign, and offer effectiveness and identifying lessons learned for improving future promotions and campaigns

These activities must be managed comprehensively as part of a single process—the "Loyalty Marketing Life Cycle."



A company's loyalty, marketing, analytics, and transactional systems must all work together to enable closed-loop marketing.

Step 6: Define Loyalty Analytics Requirements

Companies now recognize that analytics play a key role in a successful loyalty program. Traditionally, analytics applications have been developed and implemented separately from the overall loyalty system and then "bolted on." One of the main reasons for this approach was the limited functionality of analytics tools, many of which were difficult to integrate with multiple data sources and required significant technical skills to use. Now, with the recent emergence of powerful analytical applications that allow business users to easily pull and analyze data from disparate systems, managers can generate tremendous value for their companies by leveraging data in the design and ongoing management of their loyalty management program.

Three requirements have been identified that analytics applications must meet to deliver the greatest value to the business:

- Insight to action
- Embedded analytics
- Integrated loyalty and marketing analytics

Insight to Action

Loyalty analytics must deliver the right insight to the right person at the right time.

"Insight to action" means that the loyalty analytics application provides information in a timely manner and in a form that is understandable to the people who need to act upon it. In many companies, users of the loyalty system cannot perform analyses on the information; they have to submit requests for reports to the company's IT group. Not only is this expensive and time-consuming but it also means that loyalty program users must often act without the knowledge they need in order to make truly informed decisions.

With analytics applications that meet the "insight to action" requirement, a company ensures that all users have the information they need in order to make better decisions, from front-line employees to managers and executives. IT still maintains overall responsibility for setting up the analytics application and defining who has access to what data, but business users are given the power to conduct real-time analyses on their own. Each user—whether a customer service agent, marketing manager, or partner manager—can perform the necessary analyses themselves.

Right Insight	• **Current** information, based on the most recent, up-to-the-moment data about customers and the business • **Complete** information, bringing to bear all relevant data available across enterprise data sources • Insight based on **detailed data**—many of the most powerful insights stem from free exploration down any path, using the most granular data • **Advanced analytics**, incorporating insight from historical trends and data mining/predictive capabilities
Right Person	• **Relevant** insight, without extraneous information, personalized for each person's role
Right Time and Place	• **Timely** information, provided at the right time for a person to use it to take action that can make a difference • Provided **in context** of a person's job or a business process, delivered to each person so that it can be easily consumed

Analytics must deliver the right insight to the right person at the right time and place.

For example, customer service representatives (CSRs) often receive calls from members requesting that their tier status be upgraded—even though they have not met the higher tier's formal requirements—based upon their past value to the company, expected future purchases, or the amount of business they are moving from a competitor. This is exactly the point at which the CSR needs an analytics application to help decide whether to grant this upgrade.

Analytics should be embedded in a company's loyalty business process.

In most loyalty programs, CSRs have access to basic profile data, transaction histories, future reservations, and members' tier status. However, this information is typically displayed on a variety of screens and it is the responsibility of a CSR to evaluate all of that data promptly in order to decide whether to upgrade a member's tier. Without an analytics application that meets the "insight to action" requirement, even the most skilled CSRs struggle to consistently make the correct decision; they must analyze too much data, presented in disparate ways, to adequately understand and process it in a short amount of time.

With next-generation analytics applications, CSRs can perform their own real-time analysis to make the right decision. Companies can even use loyalty analytics to calculate member value scores, numerical values representing each member's value to the company. These scores can be used to help make tier change decisions. For instance, if a member's value score were 87—high for a silver member—it would be easy for a CSR to know to approve an upgrade to gold.

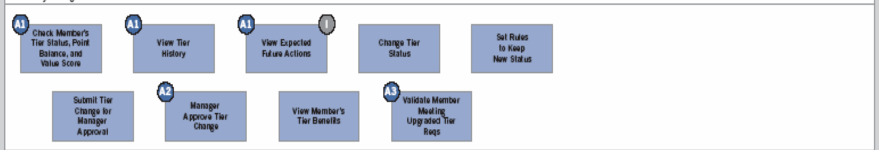
Embedded Analytics

To get the most value from analytics investments, companies need analytics that can be embedded in all customer loyalty management processes. Companies can use the business process mapping previously discussed in this paper to define their specific loyalty analytics requirements. Keep in mind that loyalty analytics applies every time an employee must make a decision. The information required for making that decision will help define which systems must be integrated with loyalty analytics, which information employees need to access, and what reports employees will need to create. For each business process, you can answer the following questions to help define the detailed requirements for your analytics application:

- Business process
- Business subprocess
- High-level question asked
- Mid- to low-level question asked
- Data required to answer the question(s)
- Data sources
- Action(s) to take based on the decision reached

For example, one airline carrier developed the following loyalty analysis for the Manually Change Tier Status business process.

Overall Process	Process Substep 1	High-Level Question	Medium- to Low-Level Questions	Data to Answer Questions	Data Sources	Actions to Take
Manually Change Tier Status						



Overall Process	Process Substep 1	High-Level Question	Medium- to Low-Level Questions	Data to Answer Questions	Data Sources	Actions to Take
Manually Change Tier Status	Check Member's Tier Status, Point Balance, and Value Score	A1. Should member's tier be upgraded?	•What is the member's history (tiers, points earned, revenue generated, etc.)? •What is the member's estimated value? •Manual tier upgrade history	Tiers (dates started and ended, manual or automatic approval), points earned (lifetime, this qualifying period), revenue/profits generated (lifetime, this qualifying period), future travel already purchased (revenue/profit from it, points will earn)	Loyalty, Billing	Submit member's tier upgrade to manager, or reject upgrade request
Manually Change Tier Status	Manually Approve Tier Change	A2. Should member's tier be upgraded?	Same as above question	Same as above question	Same as above question	Approve or reject tier upgrade
Manually Change Tier Status	Validate Member Meeting Upgrade Tier Reqs	A3. Should member keep new tier or be put back to lower tier?	•What is the member's history since tier upgrade? How does this compare to agreed upon requirements? •What currently booked future actions are expected?	Since tier change: transactions, points earned, revenue/profit generated. Actions that were required to keep new tier status (# of flights, points, revenue/profit). Future booked travel: transaction, revenue/profit, points.	Loyalty	Keep member in new tier or move back to lower tier

The carrier is now using these business processes to define the specific data structures that its loyalty analytics application needs to support, the systems with which it must integrate, and the dashboards it should create in advance for each class of employee.

For example, you could divide up your users into four groups: CSRs, loyalty marketing managers, loyalty partner managers, and executives. For each group, some of the processes in which you may want to embed analytics are

Customer service representative and manager

- Analyze member feedback
- Loan points
- Manually change tier status

Loyalty marketing manager

- Segment members
- Calculate member value scores
- Identify which promotions to run and which members to target
- Measure promotion's results

Loyalty partner manager

- Measure joint promotion effectiveness
- Evaluate joint members
- Analyze partner's value

Executives

- Analyze program's status
- Track the budget
- Evaluate membership trends and details
- Summarize rewards and redemption trends

- Understand customer value
- Evaluate partner effectiveness and value

Integrated Loyalty and Marketing Analytics

When defining analytics requirements, it is important to think holistically about the business processes and functions that need to be supported. The best analytics solutions not only support a company's loyalty program and processes but also support other departments in the organization that plan and execute nonloyalty campaigns.

Loyalty analytics and marketing analytics should be integrated as part of a holistic process.

At a minimum, an analytics solution should enable the following base marketing analyses:

Campaign performance

- Analyze campaign results by offer, customer segment, and so forth
- Measure the effectiveness of marketing expenditures and identify root causes for both good and bad performance
- Monitor marketing expenditures versus budget and revenue in real time

Member insight

- Provide product affinity, market base, and next product purchase analyses
- Provide demographic data and information on the impact of marketing activities on customer behavior
- Identify which customers are the best cross-sell/up-sell opportunities

An analytics solution should also be able to link the analyses above with the company's loyalty program and promotions. For example, combined loyalty and marketing analyses could include the following:

- Creating member segments based on loyalty data (such as member profile, transaction, and tier history) and marketing data (such as offer response rate)
- Analyzing both the costs of executing a marketing campaign and the costs of the loyalty promotion (for example, the bonus points given away)
- Evaluating members' responses to certain types of offers and promotions to understand which offers are most effective and fine-tune campaigns in real time
- Identifying which marketing channels are the most effective for particular loyalty promotions and member segments
- Identifying the most-attractive products/services to offer to each member segment

In addition, some of the most advanced companies use their analytics applications to optimize their marketing budgets—for example, optimizing the sequence of marketing actions, such as loyalty- and nonloyalty-based promotions, to maximize the likelihood that a customer/loyalty member will become more profitable over time.[13]

Step 7: Segment Members

Most loyalty programs segment a company's members by using tiers. There are usually two criteria used to place customers in a tier: the number of qualifying points earned or taking some other targeted action (flying a certain number of flights, for example). Unfortunately, although the general goal of a loyalty program is to reward a company's most valuable customers and offer incentives to less profitable customers to become more profitable, a member's tier does not always correlate with the member's actual value to the organization.

Companies need to improve their tiers as well as move beyond purely tier-based segmentation.

Companies need to take two actions to ensure that they are appropriately identifying and managing their members according to the value they deliver:

- Redefine tier requirements to more closely match members' value
- Move beyond tiers when segmenting members

Redefine Tier Requirements

Tiers have become poor measures of customer value for three reasons:

- Technology limitations
- Program inertia
- Inability to track important profitability drivers

Technology Limitations

Most large companies that implemented loyalty programs in the 1980s and 1990s built homegrown systems, because they were unable to find packaged solutions that met their requirements. Tier requirements in these systems are generally hard-coded. Moreover, the systems can track and use only a limited number of activities to determine a member's tier status. Thus, companies find it extremely difficult to modify their loyalty programs, even though members' needs and purchase patterns have evolved, the competitive environment has changed dramatically, and most companies now have a much better understanding of profitability drivers. Upgrading these homegrown systems is exceptionally complicated, costly, and time-consuming. For example, one airline estimated that with its legacy loyalty system, it would require multiple months of reprogramming just to change a single tier requirement.[21]

Program Inertia

Even if a company is willing to make the investment to change, it must battle inertia. Many companies that have had loyalty programs for years believe that customers are comfortable with the present design and would react negatively to any major changes.

> **Among of the foundations of successful CRM are the ability to allocate your resources most effectively and the realization that value potential … requires you to organize around customer segments.**
>
> **—Claudio Marcus, Research Director, Gartner Group**

Airlines have proven that program inertia can and should be overcome. The original tier requirements were based purely on miles/kilometers flown, which is a very poor measurement of profitability, because customers can pay widely varying prices (by thousands of dollars) for the same flight. In the past several years, most airlines have introduced variable points based on the ticket class purchased (for instance, first-class tickets earn 200 percent of the miles flown, business class 150 percent, economy 100 percent, and discounted economy—such as those purchased through third-party Web sites—0 points), which is a much better measurement of profitability. There was no widespread member revolt, and now airlines' tiers reflect members' profitability much more accurately.[21] Still, it is likely that the airlines would have made these kinds of changes much earlier, reaping the corresponding benefits, had it not been for the difficulty of modifying their legacy systems.

Important Profitability Drivers Cannot Be Tracked

Although companies can improve the correlation of loyalty program tiers with customer profitability, tiers will never be an exact measure, because numerous profitability drivers cannot be tracked in a way that allows them to be a tier status requirement. For an activity to be used to determine a member's tier status, it must be easy to track, customers must view it as a valid measure, and companies must be willing to tell people that they are tracking and using this type of information. In addition, the requirements must be fairly simple and easy to understand, or members will become confused and disgruntled. Thus, many of the criteria that determine a member's value, such as basic profile data or ability to influence other members' purchases, cannot be used.

Moving Beyond Tiers

In addition to improving the effectiveness of tiers, companies should analyze and segment customers according to non-tier-based criteria. The foundation of this analysis is understanding which criteria drive a customer's current or potential profitability and then segmenting these customers into distinct groups. The profitability drivers used will vary, based on the industry, company, customer base, and product or service provided.

This type of value-based segmentation analysis, which groups customers based on their potential lifetime value, produces interesting new clusters with characteristics not previously considered, as illustrated by the experience of a European carrier that used it to create the following customer segments:[31]

- Sporadics
- High value
- Very high value
- High-potential value

- High-potential women
- Summer travelers men

In addition to customer segments, many companies have found that a customer value score (CVS) is a powerful tool. The lifetime value of a customer can be defined as the future financial value the customer offers to the company minus the cost of acquiring and retaining that customer. Acquisition and retention costs can include the costs of incentive and reward programs as well as the pricing discounts associated with long-term purchase commitments.[20] In addition, the broader concept of customer value can be divided into two key components: transaction value and network value. The first component is extrapolated from a customer's historical transaction activity (historical value) as well as the historical transaction activity of similarly segmented customer groups. The second key component is the potential value that exists in the customer's network of relationships.[20]

To fully realize the benefits of loyalty investments, companies must not only understand the data the system provides but also enable employees to exploit that information to actively build and grow profitable customer relationships.[20] Customer value scores are beneficial, because they are easy to understand and help employees treat customers in a way that maximizes the company's profits while improving customer service and building loyalty. For example, if a CSR receives a call from a member requesting compensation for an incident at one of the company's outlets, the CSR can use the customer value score to identify whether to apologize but not provide compensation, provide limited compensation, or provide significant compensation. The company's costs are lowered, because low-value members do not have to be compensated whereas the most-valuable members are treated in a way that is appropriate for the value they bring to the organization and help ensure their continued long-term loyalty.

Step 8: Design the Incentive Structure

Loyalty programs are designed to change members' behavior by providing a web of overlapping incentive structures. A company must design and manage each structure, as well as the relationship between the different incentives, in order to ensure that members are motivated to behave in the desired manner. Popular incentive areas include

- Bonuses and rewards
- Tier requirements
- Purchase accrual rules
- Nonpurchase accrual rules
- Redemption rules
- Promotions
- Product offering

Bonuses and Rewards

Companies encourage changes in members' behavior by offering customers rewards or bonuses for behaving in a desired manner. There are accrual rewards (where the member receives something for making a purchase or completing an action), redemption awards (where the member receives discounts or even free products or services, generally by redeeming points or using a voucher), and service awards (where the member receives specialized services). For a loyalty program to be successful, these rewards must be aligned to encourage members to take actions that make them increasingly valuable to the host company.[6]

It is important to strike a balance between short- and long-term incentives. Members should feel that a program provides value in a reasonably short period of time, which is accomplished by having rewards that a member can fairly easily reach. In addition, customers should also be encouraged to strive for something they truly value, which is done by creating "aspirational" awards, which are difficult to attain but leave a significant and lasting impression.[19, 2]

When choosing rewards, companies should optimize the use of accrual, redemption, and prioritized service awards, based on what members value and the company's cost structure. For example, if it is expensive to give away products as redemptions (as in the case of a retailer), it might be better to focus on lower-cost prioritized service rewards such as separate checkout lanes or earlier store hours for members on sale days.[9] When targeting wealthier members and those who are frequent purchasers and have large point balances, these "soft benefit recognition elements" that are designed to convey a feeling of importance are even more critical to ensuring customer loyalty.[2]

Tier Requirements

Members need to be given a reason to increase their spending with the host company, and bonuses provided for reaching a higher tier status are the best incentive. One of the most common criticisms of current retail programs is that all members are essentially treated the same—everyone receives the same bonuses (pricing discounts), and there is no extra incentive to members for unifying their spending with one chain.[9]

Tiers have been discussed in detail throughout this paper. The key considerations with tiers include the following:

- Systems should be designed so that tiers can be added or removed, and qualifications can easily and cost-efficiently be changed.
- Tier qualifications should be tightly linked to the member attributes that drive company profitability. It is best to limit these to no more than two or three, in order to avoid confusing members.

Purchase Accrual Rules

Members typically earn points by purchasing products from the host company or its partners. The rules that govern how many points a member earns are called "purchase accrual rules." Members can earn two types of points: qualifying and nonqualifying (also called bonus). Qualifying points count toward a member's tier status. Nonqualifying or bonus points can be used for redemptions but do not count toward tier status.

The redemption and accrual rules should focus on key profitability drivers and be flexible enough to allow for continual adjustments and refinements.

Qualifying points are often awarded for the base purchase, whereas any additional bonuses (such as a tier bonus or a limited-time special offer) are usually nonqualifying points. The key to successful purchase accrual rules is that the points that are given must closely match the value/profitability of that purchase to the host company. Rules need to be complex enough to drive profitable behavior but simple enough for all members to understand. (If customers do not understand the rules, it will not be possible to change their behavior.)

Loyalty systems need to meet two requirements to support purchase accrual rules:

- Point allocation rules should be flexible enough to map to profitability drivers.
- The system must allow a company to easily change the point accrual rules for purchases from both the host company and its partners.

Nonpurchase Accrual Rules

In addition to providing incentives for specific purchases, companies want to encourage members to take valuable nonpurchase actions such as referring new members, updating their profiles online, or using the company's Web site rather than its call center to process redemptions. The loyalty system should allow the host company maximum flexibility in designing which nonpurchase actions it wants to encourage.

Redemption Rules

Once members have earned their points or vouchers, the loyalty program must provide attractive ways for these rewards to be used. This is governed by redemption rules. The key to a successful redemption policy is that the offering must match the profitability of the actions that were taken to earn the points or vouchers. Most companies try to do this by giving away fewer points for less profitable purchases and more points for more profitable purchases.

The issue is that these rules can be "gamed" by members and that the most profitable members are not always rewarded for their loyalty. For example, airlines generally reserve only a limited number of seats for point redemptions, and these are given away on a first-come, first-served basis. Thus, members who always buy discounted economy tickets can plan ahead and use their points to get one of the limited seats on the most-desirable routes (such as to Hawaii), whereas executives who have been platinum members for years and generally buy business- or first-class tickets but who are too busy to plan his vacations early cannot get on that flight.

A well-designed loyalty program should include a method to ensure that the most-profitable members receive the appropriate level of service when redeeming rewards. For example, using the airline case above, the airline could segment the seats that are reserved for reward travel to Hawaii; a small set could be set aside for members who have earned points in any manner, whereas a larger number could be reserved for members who were either part of a top tier or who had earned the points they were using by purchasing business- or first-class tickets. The redemption and accrual rules should focus on key profitability drivers and be flexible enough to allow for continual adjustments and refinements.

Further, a balance must be struck between short- and long-term rewards. For example, a hotel might make it fairly easy to earn enough points to a stay at a moderately priced location during nonpeak season while making it very difficult to earn enough points to stay at a top-notch hotel at an attractive location during high season.

Promotions

Companies use promotions to provide added incentives for members who perform a specific action within a specified time frame. A promotion generally has a set of requirements (such as the products that must be purchased, the channel that must be used, and the time frame in which the member must act on the offer) and one or more rewards for members meeting those requirements, such as bonus points or free vouchers.

Loyalty programs of all types feature some combination of the following promotions:

- **Enrollment**—Companies can specify whether (a) no enrollment is required (any member who meets the requirements for the promotion will receive the reward) or (b) only those members who both enroll and meet the promotion's requirements will receive the reward. Companies often limit promotions to those who have enrolled, in order to minimize the cost of the promotion. If enrollment is not required, the company could be giving away rewards unnecessarily to members who would have purchased the product anyway and were not aware that there was a special bonus.
- **Selected members**—Only selected members (for example, only silver-tier members, people in a specified customer segment, or members on a list that was created just for this promotion) will receive the bonus reward.
- **Flat bonus**—The member receives a fixed reward (such as 1,000 bonus points or a free upgrade voucher).
- **Percentage bonus**—The bonus is based on the base accrual points the member earned for purchasing the product. For example, if a hotel is offering

a 50 percent bonus for staying at a specific resort on a specific weekend, the bonus members earn will depend on the base points they would earn for renting the room (50 percent of 100 points for a standard room or 50 percent of 250 points for a suite).

- **Maximum awards**—Some loyalty promotions specify the maximum number of promotions that can apply to one transaction. For example, if there are two promotions running that could both apply to a single purchase, a company must choose whether members can receive a bonus from each promotion or have only one apply. If only one should apply, the company needs to set rules to determine how the loyalty engine will process the transaction and determine which promotion will be used. In addition, most companies want to limit the number of times a member can receive a bonus from a given promotion. For example, airlines often run promotions that offer a large number of bonus points if a passenger flies a specific number of times. However, carriers typically limit this, so that if a frequent traveler were to fly two or three times the required number of flights, that passenger would still only receive one bonus.

A loyalty system should allow for the real-time targeting of promotions at near-term expiring inventory.

Other standard types of loyalty promotions include the following:

- **Basic purchase**—Buy a product and receive the reward.
- **Simple frequency—**Take a qualifying set of actions (fly three times between SFO and BOS, for instance), and receive a reward. The bonus is awarded immediately after the final required purchase.
- **Complex frequency**—Receive an increasing bonus based on the number of times a member completes targeted actions by a specified date. For example, buy three and get 500 points; buy four or five and get 1,000 points; or buy more than six and receive 3,000 points. The member does not receive the bonus until after the end of the bonus period.
- **Partner**—Rather than pertaining to purchases of products from the host company, this promotion applies to purchases from partners. It can be any type of promotion listed above.
- **Joint**—The bonus is given when products are purchased from any of multiple companies.
- **Action-based**—Promotions targeting nonpurchase actions (for example, enrolling in the loyalty program, referring someone to the program, or using a lower-cost channel to update the member profile).

The best reactive promotions are developed and run in near real time, based on an analysis of immediate undersold or distressed inventory. In other words, a loyalty system should not require extensive amounts of time to create and launch a reactive loyalty promotion and the associated marketing campaign.

Product Offering

Rather than simply using a loyalty program to encourage members to buy what is already being produced, the most-successful loyalty programs also use the data collected to redesign the actual products and services the company provides. These firms identify which products and features are desired by different customer segments and then redesign the products to meet those needs or, if the products are already available, to ensure that they are always in stock.

Redesigning a product/service offering can yield a significant competitive advantage, because competitors will not have access to the same data and, thus, will not be able to adapt their own products. For example, Harrah's used the data from its loyalty programs to redesign its casino floors to better meet the needs of its "low-roller" customers, generating a 12 percent increase in slot machine revenues.[1]

Step 9: Define the Partnering Strategy

Loyalty programs often involve a web of partners that together create an extended "loyalty ecosystem." When designing a loyalty strategy, companies can choose from three models:

- Solo
- Host company with partners
- Multifirm coalition

A "solo" program means that a single company operates the loyalty program and that members can earn and redeem points only with that one company. With a "host company with partners" program, one company maintains the loyalty program and tracks the points that members earn, but members can also earn and use those points with other partner companies (for example, earning airline points for renting a car). A "multifirm coalition" means that the points and program are not associated with one host company. Instead, some of the firms band together to create a unified program in which members earn and use "coalition" points at any of the partners. If an external, nonparticipating party runs the coalition, this type of multifirm coalition is called a "third-party coalition." Examples of multifirm coalitions are the Payback program in Germany (which is run by Loyalty Partners) and the Nectar program in the U.K.

Several criteria can be used to help determine which partnership model is best for a company:

- Purchase frequency
- Single-company versus multicompany purchases
- Brand attractiveness
- Financial resources

Purchase Frequency

Members must purchase frequently enough from a company to make becoming part of a solo loyalty program worthwhile. If purchases are infrequent, it generally makes sense for a company to implement a loyalty program based on one of the two partnering models.

Single Company Versus Multicompany Purchases

If a member can purchase a product or service without interacting with any other firms, then a solo program is feasible. However, if a member generally must purchase a specific product along with products from other companies—especially if the host company is aligned with one or more of these potential partners—it often makes sense to create a multicompany loyalty program that offers incentives for members to make purchases from designated partners.

Brand Attractiveness

If a company has a strong brand (or product or service offering), then it is more feasible to have a solo loyalty program. However, if there are other companies in related businesses, these companies may want to team up or join a multicompany coalition.

Another consideration is that if a company has a strong brand image, it may be worthwhile to allow partners into a program, because selling points to these partners can be a very profitable operation.

Financial Resources

As discussed previously, running a loyalty program can be expensive. If a key requirement is minimizing costs, a company should consider jointly hosting a loyalty program with partners or participating in a multifirm coalition program. Although this still requires having a loyalty system that can track purchases, forward that information to a centralized program for processing, and accrue and redeem points, system costs may be lower, because the fixed expenses can be allocated across all participating companies. Program management costs may also decrease, because personnel will not be needed to define the program's incentive structures, manage partners, or handle other responsibilities. However, if a company has to pay a central group or third party for the accrual points given, multifirm coalition programs can end up being significantly more expensive.

Step 10: Choose the Appropriate Technologies and Vendor

For rolling out a new loyalty program, there are several potential system strategies companies can follow:

- Completely replace everything.
- Follow a system-by-system replacement plan, starting with loyalty, but continue to use current marketing, business intelligence, and other applications until an upgrade is required.

- Add upgraded analytics capabilities to the existing system.

The best strategy for a given organization will depend on a variety of considerations, including cost, time frame, systems integration requirements, and IT resources available to support the project. For example, if a company currently has a fairly robust loyalty application but has not realized the expected returns, adding a more powerful analytical tool that will help the company perform more-targeted, value-based marketing and customer service can be a cost-effective way to increase the program's ROI in the short term. On the other hand, if a company's current loyalty application is running on an old, expensive mainframe, the company's first course of action would be to replace it with a new loyalty system.

The final task for a company is assimilating all the knowledge gathered in the 10-step process and using that to choose the best technologies and vendor(s) to help implement a successful loyalty program. A recommended best-practices approach to this selection process is as follows:

- Identify key business processes (completed as part of step 2).
- Map the company's current systems to those processes.
- Identify any key gaps in the current systems' ability to enable these processes.
- With the goal of closing these gaps, identify which applications need to be replaced. This decision may change during vendor evaluations, but it is valuable to have an initial guide to keep the scope of the project manageable.

The ultimate goal is to integrate all the systems that support the loyalty program. Before inviting vendors into the planning process, companies should

1. Identify the key features needed to support the business processes associated with the loyalty program.
2. Design three or four usage scenarios that exemplify the most common, as well as some of the more complex, business processes (these scenarios should cut across several processes).
3. Ask the initial group of vendors to explain (a) how their capabilities correspond to the desired feature set and (b) how they would enable the three or four usage scenarios selected.
    - If a vendor will be supplying multiple loyalty management applications (loyalty, marketing, call center, analytics, and Web site), then the vendor should demonstrate how it can implement a fully integrated solution.
    - If the vendor is a point solution provider, it should clearly describe when users would need to rely on other systems, what information would need to be passed back and forth (and the interfaces required to support this

exchange), and when the user would return to using the original system.

4. Once the field has been narrowed down to a few top vendors, companies should choose the desired partner, by

    - Having the business side of the company thoroughly test each vendor's system to assess how well it supports the business processes associated with the loyalty program

    - Having the IT group evaluate the system's architecture, scalability, reliability, and integration capabilities

The exact features and criteria that are used to evaluate the potential technologies and vendors will vary. However, they can often be grouped in this following manner:

Loyalty System Functionality Evaluation Categories

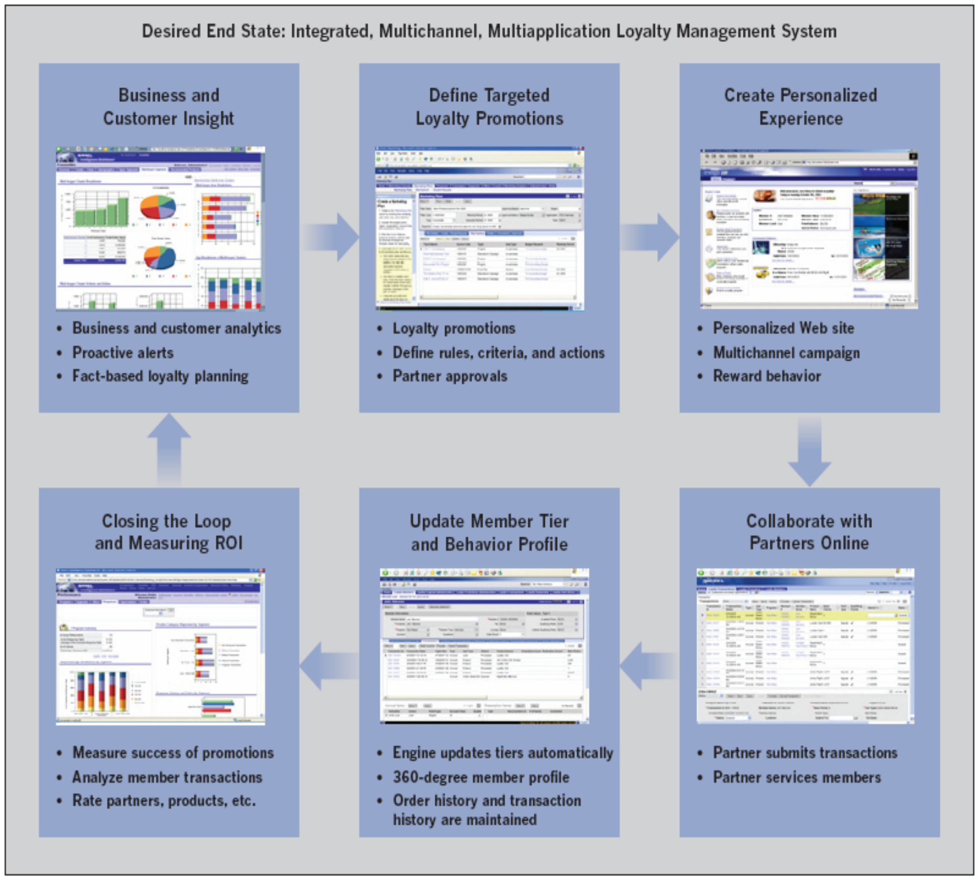
Technical
- Multilanguage support
- Multichannel integration
- Scalability
- Performance
- Reliability
- Security
- Ease of integration
- Overall architecture

Costs
- Implementation
- Ongoing maintenance
- Upgrades
- Purchase licenses vs. ASP vs. BPO

Provider
- Mutal alignment of visions
- Financial viability
- Previous customer successes

Functionality
- Integrated member profile
- Promotions
- Tiers
- Vouchers
- Statements
- Nonpurchase bonuses
- Accrual and points management
- Automated and manual transactions
- Redemption management
- Customer service
- Referrals
- Member hierarchy
- Supports B2B, B2C, and B2Household
- Membership cards
- Point expiration
- Business user flexibility
- Ease-of-use
- Changes requiring IT work
- Industry-specific features
- Member Web site
- Partner management
- Integrated marketing
- Planned future enhancements

Companies will reap far greater benefits if they leverage the new system's abilities to optimize business processes wherever possible. Many companies have been using existing systems for so long that they are not aware of how their loyalty program has been constrained by technology limitations. Further, if a company is purchasing an application from a vendor, it should implement the application in phases. Once the application is up and running and employees have been using basic functionality for three to six months, the company should reevaluate its business processes to identify better ways to do things.



CHANGE MANAGEMENT

For companies implementing a loyalty program for the first time or significantly redesigning their loyalty strategy, the process does not stop once the systems and applications are purchased and deployed. Managing the requisite corporate change is a critical requirement for success. For example, if a loyalty program requires cooperation from units that have previously operated independently (such as with a chain of boutique hotels that now will share one common loyalty program), everyone involved in each of the defined business processes must be committed to the required changes and fully supportive of the implementation. Even if the new systems have been properly designed and implemented, everyone from management to the CSRs who interact directly with customers must consistently use the systems, or customer satisfaction scores and loyalty may actually decrease. A new loyalty program can make customers—especially the most valuable ones—anxious regarding the level and consistency of service they will receive. If a company raises expectations and then delivers on these expectations only from time to time, the outcome is worse than if the company had never promised better service in the first place. Thus, change management is critical to ensuring that companies reap the gains from their investment in new loyalty programs.

SOURCES

1. "Trends: Loyalty Programs." CIO Insight. 12/1/03. Margaret L. Young and Marcia Stepanek.
2. "Loyalty Trends for the 21st Century." Colloquytalk. Michael T. Capizzi and Rick Ferguson.
3. "Fly me to the moon." *The Economist.* 5/2/2002.
4. "Loyalty Program Bookers Put Price before Points." Forrester: The *Technographics Data Snapshot.* 7/24/01. Henry H. Harteveldt with Becky Bermont.
5. "The Colloquy Expert Witness Program." Claudio Marcus. Gartner Group.
6. "The Loyal and Profitable Customer." Gartner Strategic Analysis Report. 7/8/2003. A. Sarner and T. Berg.
7. "Harrah's Uses Client-Analysis System to Tailor Its Sales Efforts toward Frequent Visitors." Darrell Dunn.
8. "Harrah's Wages on Upgraded E-Loyalty Programs." CRMDaily.com. 7/26/01. Jay Wrolstad.
9. "Five Ways to Improve Retail Customer Loyalty Programs." Gartner Research Note. 2/8/02. W. Janowski.
10. *The Loyalty Effect.* Frederic Reichheld. Harvard Business School Press, 1996.
11. "Analytical Life Stages: Using Loyalty Analytics to Grow from Data Infancy to Adulthood." *DM Direct Newsletter.* 3/26/04. Kelvin Taylor.
12. "Fixing Grocery Loyalty Programs." Forrester: *The TechStrategy Report.* January 2003. Christine Spivey Overby with Kate Delhagen and Amy Dash.
13. "Taking CRM to the Next Level." *Hospitality Upgrade Magazine,* Fall Edition, October 2004. A. Labbi, et al.
14. "Keeping Customers Loyal." The Forrester Report. Shar VanBoskirk with Charlene Li and Jennifer Parr. 5/2001.
15. "Driving Profitable Growth through Improved Customer Loyalty." McKinsey Marketing Practice.
16. "Management Update: Using Six Building Blocks and CRM to Achieve Customer Loyalty." A. Sarner. Gartner. 8/20/03.
17. "CRM in the Air." Urs Binggeli, Sanjay Gupta, and Carlos de Pommes. *The McKinsey Quarterly.* 2002, Number 3.
18. "Sainsbury's Business Transformation Program: Setting a Course for the Future." Accenture.
19. "More Than Miles: Designing Successful Loyalty Programs in the Communications Industry." Jorg Tuchen and Simon Crisp. Accenture. December 2001.
20. "Measuring and Managing Customer Lifetime Value." Siebel Systems. May 2002.
21. Company's own internal numbers/information as provided to Siebel Systems.
22. Bain, 2001.
23. Customer Loyalty Research Center, 2001.
24. *Webster's Collegiate Dictionary.* Random House, New York. 1991.

25. StrategyOne survey commissioned by Wyndham International. May 2002.
26. Forrester, April 2002.
27. Siebel CRM Strategy Team, 2003.
28. 2003 Annual Report. United Airlines.
29. MetroGroup Future Store Initiative Web site. December 29, 2004.
30. "The State of the Industry: Retail." *1to1 Magazine.* August 13, 2003. Ruth P. Stevens.
31. "The Value of IBM's Customer Equity and Lifetime Management (CELM)." IBM Travel and Transportation Group. 6/9/2004.

Ensuring Customer Loyalty: Designing Next-Generation Loyalty Program
April 2006

Oracle Corporation
World Headquarters
500 Oracle Parkway
Redwood Shores, CA 94065
U.S.A.

Worldwide Inquiries:
Phone: +1.650.506.7000
Fax: +1.650.506.7200
oracle.com