

B Conceptual Basis and Literature Review

This section provides the conceptual foundation for this thesis. Chapter 1 gives a brief description of loyalty programs and its associated key elements. Next, chapter 2 reviews and discusses previous research on consumer decisions in loyalty program memberships. Finally, in chapter 3, the basic idea of the central concept of this dissertation, namely, medium magnitude effects in loyalty programs, is introduced and related phenomena are described.

1 Loyalty Programs

Building on extant loyalty program literature the following sections outline the concept of loyalty programs. This outline includes the development of a holistic definition of this concept which incorporates its key elements. Subsequently, these elements are described in more detail.

1.1 Definition

Loyalty programs can take many forms. In practice, program schemes differ greatly in terms of membership requirements, the number of partnering companies, types and values of rewards offered, as well as medium collection and redemption mechanisms. Some merely focus on a specific product category, others reward purchases of all products and services at a wide range of companies; some programs offer cash-backs and discounts to engage customers in loyal behaviors, whereas others incent program members with special treatments. However, despite the abundance of different loyalty schemes in business practices and various different terms to describe such programs (e.g., reward, frequency, continuity, or affinity programs), there seems to be a consensus among extant academic literature about the concept of loyalty programs and its fundamental elements.

Table 1 gives an overview of selected definitions whose similarities provide the basis for the following discussion of the key elements of loyalty programs. A closer look at this collection of definitions confirms a consistent understanding of loyalty programs and identifies four frequently recurring themes; namely, development and enhancement of loyalty, reward function, program structure, and long-term orientation (see also Dorotic et al. 2012).

Table 1. Selected Definitions of Loyalty Programs

Author(s)	Definition	Key Elements
Dowling and Uncles (1997, p. 71)	"Loyalty programs [...] seek to bond customers to a company or its products and services by offering an additional incentive [...]."	Development of Loyalty, Reward Function
Henderson et al. (2011, p. 258)	"[...] we define a loyalty program as any institutionalized incentive system that attempts to enhance consumers' consumption behavior over time [...]."	Enhancement of Loyalty, Program Structure, Reward Function, Long-Term Orientation
Kim, Shi, and Srinivasan (2001, p. 99)	"Reward programs, a promotional tool to develop customer loyalty, offer incentives to consumers on the basis of cumulative purchases of a given product or service from a firm."	Development of Loyalty, Reward Function, Program Structure
Lal and Bell (2003, p. 179)	"These programs offer various incentives and rewards to consumers on the basis of cumulative purchases from a given provider, be it a store, a service, or a manufacturer."	Reward Function, Program Structure
Lewis (2004, p. 281)	"Such programs encourage repeat buying and thereby improve retention rates by providing incentives for customers to purchase more frequently and in larger volumes."	Enhancement of Loyalty, Reward Function
Liu (2007, p. 20)	"A 'loyalty program' is defined as a program that allows consumers to accumulate free rewards when they make repeated purchases with a firm. Such a program rarely benefits consumers in one purchase but is intended to foster customer loyalty over time."	Reward Function, Program Structure, Enhancement of Loyalty, Long-Term Orientation
Liu and Yang (2009, p. 94)	"We define loyalty programs as long-term-oriented programs that allow consumers to accumulate some form of program currency, which can be redeemed later for free rewards."	Long-Term Orientation, Program Structure, Reward Function
Meyer-Waarden (2007, p. 224)	"Loyalty programs, which represent tools for developing relationships and SOW, offer integrated systems of marketing actions and economic, psychological, and sociological rewards."	Development of Loyalty, Reward Function
Noble, Esmark, and Noble (2014, p. 361)	"Loyalty programs offer customers benefits in exchange for repeat patronage to an organization."	Reward Function
Rayner (1996, p. 8)	"A customer loyalty scheme is a mechanism for identifying and rewarding loyal customers."	Reward Function, Program Structure
Sharp and Sharp (1997, p. 474)	"Loyalty programs are structured marketing efforts which reward, and therefore encourage, loyal behaviour."	Program Structure, Reward Function, Development of Loyalty
Yi and Jeon (2003, p. 230)	"A loyalty program is a marketing program that is designed to build customer loyalty by providing incentives to profitable customers."	Development of Loyalty, Reward Function

First, the fundamental objective of loyalty programs is to develop and enhance attitudinal or behavioral loyalty and, thus, to realize the economic benefit of long-term business relationships. Hence, loyalty programs should encourage existing customers to maintain or increase their purchase amounts and frequencies (e.g., Dowling and Uncles 1997; Sharp and Sharp 1997; Strauss, Schmidt, and Schoeler 2005). The second common thread among loyalty programs is that they recognize and reward their members for their loyalty by providing tangible or intangible incentives in return for repeat business (e.g., Dowling and Uncles 1997; Kivetz and Simonson 2002; Meyer-Waarden 2008). This reward function, in turn, might serve as reinforcement that encourages consumers to maintain their rewarded purchase patterns or even increase their purchase volumes through concentrating as much of their business as possible on one seller (e.g., Keh and Lee 2006; Long and Schiffmann 2000; Taylor and Neslin 2005). Third, loyalty programs follow a defined structure. They are typically membership-based such that, first of all, customers have to sign up to participate (Dorotic et al. 2012). At their most basic, program members then collect some kind of program currency (i.e. program medium) based on their purchase volumes and frequencies which can be exchanged for rewards after reaching a minimal redemption threshold (e.g., Carlsson and Löfgren 2006; Leenheer et al. 2007; Noble et al. 2014; Sharp and Sharp 1997; Wright and Sparks 1999). Thus, besides program requirements, the key specifications of a loyalty program structure include thorough definitions of the medium issuance and redemption mechanisms (Liu and Yang 2009). Fourth, loyalty programs are long-term oriented, as they are explicitly intended to foster loyal behaviors over time. This characteristic separates loyalty programs from other short-term promotional activities which do not create comparable lock-in effects (Liu 2007; Sharp and Sharp 1997). Hence, loyalty programs constitute a long-term investment for both the company and its customers (Dorotic et al. 2012; Liu 2007).

In conclusion, the majority of the compiled definitions of loyalty programs predominantly failed to meet all of the above outlined elements and, hence, might be incomplete (see table 1). Therefore, in this dissertation:

Loyalty programs are defined as long-term oriented relationship instruments intended to develop and enhance customer loyalty by rewarding and, thus, encouraging program members' loyal purchase patterns according to a well-defined program structure.

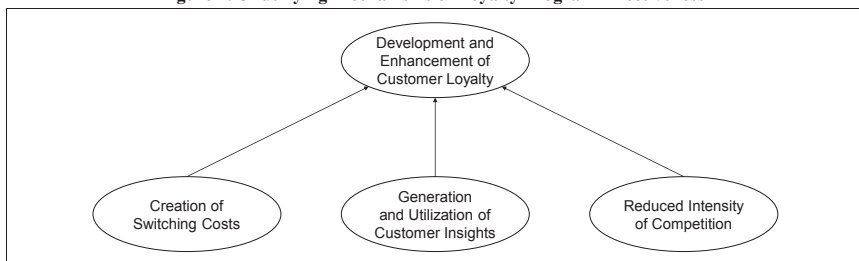
1.2 Key Elements of Loyalty Programs

The following sections discuss the identified program elements—i.e., development and enhancement of customer loyalty, reward function, program structure, and long-term orientation—more precisely.

1.2.1 Development and Enhancement of Customer Loyalty

While the specifics of loyalty schemes widely differ, the core motivation for companies to employ this relationship instrument is to build and increase customer loyalty (e.g., Henderson et al. 2011; Liu 2007; Yi and Jeon 2003) which is reflected in steady or increasing retention and repeat-purchase rates, customer lifetime durations, shares of requirements, purchase frequencies and volumes, as well as higher degrees of cross-buying behavior (e.g., Dowling and Uncles 1997; Lal and Bell 2003; Lewis 2004; Mägi 2003;). Hence, loyalty programs as part of a defensive marketing strategy (Sharp and Sharp 1997) focus on retaining (profitable) existing customers (e.g., Bolton et al. 2000; Kumar and Shah 2004; Lewis 2004) and stimulate their purchase behavior (Meyer-Waarden 2007)—as opposed to acquiring new customers (Noordhoff, Pauwels, and Odekerken-Schröder 2004). Extant research suggests three underlying mechanisms to be conducive to a program's effectiveness in terms of the formation of loyal purchase patterns; namely, the creation of switching costs (e.g., Kim et al. 2001; Kopalle and Neslin 2003; Wirtz, Mattila, and Lwin 2007), generation and utilization of consumer insights (e.g., Graeff and Harmon 2002; Mauri 2003), and reduced intensity of competition (e.g., Kim, Shi, and Srinivasan 1997; Kopalle and Neslin 2003; Lal and Bell 2003; see figure 2). These factors are discussed more detailed subsequently.

Figure 2. Underlying Mechanisms of Loyalty Program Effectiveness



1.2.1.1 Creation of Switching Costs

Loyalty programs can foster customer loyalty by creating different types of switching barriers (e.g., Bolton et al. 2000; Carlsson and Löfgren 2006; Kim et al. 2001; Kopalle and Neslin 2003; von Wangenheim and Bayón 2007) including financial, relational, and procedural switching costs (Burnham, Frels, and Mahajan 2003). First, loyalty program members are locked in since switching providers may imply a loss of accumulated benefits. For instance, program currencies in terms of miles or points accrued through past purchase actions are typically not transferable to another firm (Drèze and Hoch 1998; Meyer-Waarden 2008; Sharp and Sharp 1997; Wirtz et al. 2007; Zhang, Krishna, and Dhar 2000). As the level of rewards usually depends on the length of the relationship between a customer and the focal company, changing providers produces a significant time lag before similar rewards can be obtained from another firm (Verhoef 2003). Second, loyalty programs can create relational switching costs which additionally strengthen lock-in effects (Meyer-Waarden 2007). Customers may appreciate provided rewards giving them a feeling of preferential treatment and a sense of belonging (Dowling and Uncles 1997) reflected in increased levels of commitment and trust toward the company (Morgan and Hunt 1994). Finally, switching providers may also involve procedural costs in terms of expending time and effort, when joining another company's loyalty scheme, to learn its program structure (Wirtz et al. 2007).

1.2.1.2 Generation and Utilization of Customer Insights

Furthermore, loyalty programs enable marketers to collect valuable consumer data (Graeff and Harmon 2002; Mauri 2003; Nunes and Drèze 2006b) and, thus, to acquire and enrich knowledge about their customers (Leenheer and Bijmolt 2008). This customer information, typically comprising personal data—primarily obtained through an initial enrollment process (e.g., Wansink 2003)—and transaction data—gathered through recording of purchases (e.g., Kumar and Shah 2004)—allows the employment of advanced marketing techniques. These techniques, including precise targeting of profitable customers and customer segments (Ashely et al. 2011; Demoulin and Zidda 2009; Hansen, Deitz, and Morgan 2010) via direct, personal, customized or segment-specific communication and offerings aspired toward meeting heterogeneous customer needs (Wansink 2003; Meyer-Waarden 2008; Lacey and Sneath 2006), increase the profitability of marketing actions (Dowling and Uncles 1997) and enhance the ability to build

long-term customer relationships (Wansink 2003; Mauri 2003). Besides, these consumer insights can be harnessed for improving promotions, product and pricing policies, as well as optimizing category management (Cortiñas, Elorz, and Múgica 2008; Lacey and Sneath 2006).

1.2.1.3 Reduced Intensity of Competition

Finally, loyalty programs can help companies to elude competition. Especially in highly competitive markets with limited opportunities to differentiate from competing providers (e.g., grocery and petrol retailing), the implementation of a loyalty program might be an effective strategy to develop a point of uniqueness (Kumar and Rao 2003; Wright and Sparks 1999). However, such a differentiation is often difficult to maintain in the long run, as competitive reactions in the form of imitations might neutralize the value of a single loyalty program (Dowling and Uncles, 1997; Dowling, Uncles, and Hammond 2003; Kopalle and Neslin 2003; Leenheer et al. 2007).

In addition, loyalty schemes might be an appropriate tool to mitigate the intensity of competition by counter-acting new and potential entrants by establishing barriers of market entry (Carlsson and Löfgren 2006; Kopalle and Neslin 2003; Liston-Heyes 2002). Moreover, loyalty programs can soften price competition through the creation of switching costs (e.g., Kim et al. 2001; Klemperer 1987; Lal and Bell 2003; Liston-Heyes 2002) and by solving oversupply problems during seasons of low demand (Kim et al. 1997; Noordhoff et al. 2004).

1.2.2 Reward Function

The second common theme among loyalty programs is that they reward their members for repeated purchases of the focal company's products or services. Psychological research has shown that rewards can be highly motivating (see Latham and Locke 1991 for a review) and, thus, it is reasonable to assume that during participation in a loyalty program, a customer might be disposed to respond to program benefits as intended (Roehm, Pullins, and Roehm 2002). In addition, rewards might be perceived as the firm's appreciation and personal recognition of its customers (Liu 2007) and function as a positive reinforcement to continue rewarded behavioral patterns (e.g., Sheth and Parvatiyar 1995; Taylor and Neslin 2005).

Program rewards are typically classified into economic (e.g., monetary advantages) and non-economic rewards (e.g., emotional, social, or psychological rewards; Demoulin and Zidda

2009; Drèze and Nunes 2009; Leenheer et al. 2007; Noble et al. 2014). Economic rewards, on the one hand, are financial benefits including cash-back rewards, free products or services, discounts, or savings (Arbore and Estes 2013; Demoulin and Zidda 2009; Jang and Mattila 2005; Lal and Bell 2003). However, these incentives are often criticized for being rather easy to imitate by competing firms and programs as well as for attracting price sensitive customers who lack brand loyalty (O'Malley 1998; Phillips-Melancon, Noble, and Noble 2011).

Non-economic rewards, on the other hand, are those benefits that lead to perceptions of belonging, special treatment, and personalized attention such as special privileges, restricted check-in counters, and priority on waiting lists (Arbore and Estes 2013; Dowling and Uncles 1997; Drèze and Nunes 2009; O'Brien and Jones 1995; Phillips-Melancon et al. 2011; Rosenbaum, Ostrom, and Kuntze 2005). This sense of being important—e.g., stimulated through establishing a hierarchy among the company's customers based on spending levels (e.g., Drèze and Nunes 2009; von Wangenheim and Bayón 2007)—can enhance customers' emotional connection to the firm (Bitner 1995; Gwinner, Gremler, and Bitner 1998) and is expected to be more effective in improving customer loyalty than economic rewards (Rosenbaum et al. 2005). An important aspect regarding program members' perception of status is the decision about the number of status levels and the relative size of each tier (Arbore and Estes 2013; Drèze and Nunes 2009; Kopalle et al. 2007). In this context, previous research has shown that—depending on perceptions of branch exclusivity (e.g., airlines versus supermarkets; Arbore and Estes 2013)—three-tier programs (e.g., gold, silver, no status) are more suitable than two-tier programs (e.g., gold and no status; Drèze and Nunes 2009). However, it should be noted that the segment of high-status customers reacts more sensitively to negative events such as denied service due to overbooking than lower-status customer groups (von Wangenheim and Bayón 2007).

In addition, rewards can be distinguished according to their timing in terms of immediate versus delayed rewards (Demoulin and Zidda 2009; Jang and Mattila 2005; Keh and Lee 2006; Noble et al. 2014; Roehm and Roehm 2011; Soman 1998; Zhang et al. 2000). Immediate rewards can be seen as price discounts offered at the time of subscription or for every visit, whereas delayed rewards are incentives that typically require the accumulation of multiple purchases and, hence, pursue to build exit barriers (Keh and Lee 2006; Yi and Jeon 2003). Accordingly, it has been found that immediate benefits are effective in getting consumers to switch away from competing brands, while delayed incentives foster customer retention

through the creation of switching costs by rewarding their future purchases (Kim et al. 2001; Leenheer et al. 2007; Zhang et al. 2000).

Loyalty program benefits also differ regarding their congruence with the company's products and services. A company can either provide direct rewards (i.e. incentives that are closely related to company's products or services) or indirect rewards (i.e. benefits with no linkage with the company's offering; Demoulin and Zidda 2009; Dowling and Uncles 1997; Keh and Lee 2006; Kivetz 2005; Roehm et al. 2002; Yi and Jeon 2003). In terms of their cost efficiency, indirect rewards, in particular cash rewards, are deemed cost inefficient as the consumers' valuation of the reward equals the firm's cost of the reward. In contrast, direct rewards such as a free product of the firm are declared cost efficient incentives as the value to the customer exceeds the reward's cost (Kim et al. 2001).

Finally, the classification of rewards can be further refined by the distinction between luxury and necessity incentives (Jang and Mattila 2005; Kivetz and Simonson 2002), tangible and intangible rewards (Drèze and Nunes 2009; Roehm et al. 2002), as well as between stochastic (i.e. entries into lotteries with uncertain large rewards) and deterministic (i.e. smaller guaranteed rewards) rewards (Kivetz 2003).

Aside from the described types of incentives, loyalty schemes vary among the value of rewards (Kim et al. 2001; Kopalle and Neslin 2003; O'Brien and Jones 1995; Roehm and Roehm 2011; Soman 1998) and their variety (Drèze and Nunes 2007; Kumar and Shah 2004; O'Brien and Jones 1995), which both are influential drivers of the attractiveness and, thereby, effectiveness of loyalty programs (Roehm and Roehm 2011).

1.2.3 Program Structure

Loyalty programs are also similar in that they reward customers according to a predefined program structure. This structure includes specifications of membership requirements, the medium issuance and redemption mechanism, as well as the extent to which the program provider cooperates with partnering companies which also credit and redeem the program currency.

1.2.3.1 Membership Requirements

As the implementation of a loyalty program is accompanied by a discrimination of the customer base between members and non-members (Lacey and Sneath 2006; Leenheer 2004; van Heerde and Bijmolt 2005), the specification of the terms and conditions of participation constitutes a crucial program structure parameter. The registration for a program can be conducted voluntarily by the company's customers or automatically by the company itself (Liu and Yang 2009). In this regard, the degree to which program enrollment is restricted to specific customer groups—i.e. participation exclusivity (De Wulf et al. 2003)—has to be specified (Leenheer 2004). Following O'Brien and Jones (1995), opening loyalty programs to a wide range of participants might involve a waste of resources in over-satisfying less profitable customers, while under-satisfying more valuable customers.

In addition, from a customers' perspective, program enrollment can require economic (e.g., membership-fees; Bolton et al. 2000; Kivetz and Simonson 2002; Liu and Yang 2009) as well as non-economic costs in terms of the amount of disclosed personal information through registration and subsequent identification at transactions (Leenheer et al. 2007); often resulting in a perceived loss of privacy (Ashley et al. 2011; Noble and Phillips 2004; van Doorn et al. 2007). Depending on the type and amount of collected data different types of card technologies are employed (see Worthington and Hallsworth 1999 for an overview).

1.2.3.2 Medium Issuance Mechanism

For a loyalty program to be effective, it should have a structure that enables customers to perceive purchases as a sequence of related rather than independent single transactions (Lewis 2004). Therefore, loyalty programs usually issue some kind of a program medium to their members at the time of purchase; typically depending on the monetary amount spent on the company (e.g., one point per dollar) or on the number of purchased products independent of their price (e.g., one point per coffee; Leenheer et al. 2007; Wright and Sparks 1999). Although program medium units have no value themselves until they are redeemed (Hsee et al. 2003; Rothschild and Gaidis 1981), their accumulation creates an anticipation of positive future benefits which increases consumers' likelihood of staying in the relationship (Lemon, White, and Winer 2002; Liu 2007). Despite their apparent similarity, medium issuance mechanisms in

practice differ regarding several details. By way of illustration, table 2 provides an overview of exemplary medium issuance structures of selected hotel loyalty programs.

Table 2. Selected Hotel Loyalty Programs

Hotel Chain (Loyalty Program)	Medium Issuance	Redemption Threshold (free nights)	Status Levels and Point Bonuses	New Member Enrollment Bonus
Carlson Rezidor Hotel Group (Club Carlson)	\$1 = 20 pts.	9,000 pts.	Silver (15 nights, 25%), Gold (35 nights, 50%), Concierge (75 nights, 75%)	2,000 pts.
Hilton (Hhonor)	\$1 = 10 pts.	5,000 pts.	Silver (10 nights, 15%), Gold (40 nights, 25%), Diamond (60 nights, 50%)	-
Hyatt (Gold Passport)	1\$ = 5 pts.	5,000 pts.	Platinum (15 nights, 15%), Diamond (50 nights, 30%)	-
InterContinental Hotels Group (IHG Rewards Club)	\$1 = 10 pts.	10,000 pts.	Gold (15 nights, 10%), Platinum (50 nights, 50%)	3,000 pts.
Marriott (Marriott Rewards)	\$1 = 10 pts.	7,500 pts.	Silver (10 nights, 20%), Gold (50 nights, 25%), Platinum (75 nights, 50%)	-
Starwood (Preferred Guest)	1\$ = 2 pts.	2,000 pts.	Gold (25 nights, 50%), Platinum (50 nights, 50%)	-

First, the program currencies employed by the hotel chains vary among their magnitude which has an impact on the number of medium units credited for every purchase (e.g., 2 points at Starwood hotels versus 5 points at Hyatt hotels per dollar spent on the company) and, consequently, on the number of points required for redemption (e.g., 2,000 points for a free night at Starwood hotels versus 5,000 points at Hyatt hotels; see also Bagchi and Lee 2011). Second, all illustrated loyalty schemes are characterized by a non-linear medium issuance structure such that the number of earned points per dollar increases as a function of repeat purchase (Leenheer 2004; Hsee et al. 2003; van Osselaer et al. 2004). For instance, after staying 10 nights at a Hilton hotel, program members are promoted to silver status which qualifies them to earn 15 percent more points per dollar spent than basic members. Such ascending point schedules increase switching costs and, thus, enhance customers' motivation for continued business with the firm (Carlsson and Löfgren 2006). Besides the described convex medium

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