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Building and sustaining *profitable* customer loyalty for the 21st century

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Abstract

The concept of customer loyalty is conspicuous by it's ubiquity. Therefore, there is no surprise that it is one of the most widely studied areas by researchers and one of the most widely implemented marketing initiatives by practitioners. This article draws upon past research to review important findings related to customer behavior and attitude in the context of customer loyalty. Further, research related to linking loyalty to profitability and forward looking metric such as the customer lifetime value is reviewed to propose a conceptual framework for building and sustaining loyalty and profitability simultaneously at individual customer level. A two-tiered rewards structure is presented as a means for marketers to operationalize the framework. The conceptual framework hopes to serve as a platform to understand the evolving dominant logic of loyalty programs for building and sustaining loyalty in the twenty first century as well as induce further research in that direction.

Keywords: Customer loyalty; Investment; CRM

Contents

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Introduction

The concept of 'loyalty' has been around for centuries. In the olden times, 'loyalty' was used to maximize power and control. Strong Generals of the great ancient Roman Empire often used the loyalty of their army to gain political leverage or to overthrow the emperor. Napoleon Bonaparte, the most feared French commander of the early nineteenth century, achieved extraordinary results through the unrelenting loyalty of the soldiers under his command.

Coming to the civilized world of 21st century, we see Generals in the form of marketers striving to defend or capture market share with the help of a loyal customer base. Customer loyalty has been universally recognized as a valuable asset in competitive markets (Srivastava, Shervani, & Fahey, 2000). Investments in loyalty management is especially important if consumers face low switching costs, because they are not locked in by a contract (Shapiro & Vivian, 2000).

The concept of customer loyalty has pervaded several industries in the past decade (Lewis, 1997). Membership to customer loyalty initiatives provides members with rewards and additional value, making it popular among consumers (Liebermann, 1999). This has led to an increasingly competitive landscape with different companies within the same retailing industry vying with one another to woo the same set of customers. Consequently, consumers often enroll in loyalty programs of multiple companies within the same industry (Passingham, 1998). For example, it is commonplace to expect consumers to carry loyalty 'club cards' from multiple grocery stores. There is also a growing tendency amongst firms to launch a loyalty program as a defensive marketing strategy (Dawkins & Reichheld, 1990) rather than a well thought out CRM initiative. This may be the reason why there is a glut of similar sounding loyalty programs. In absence of any clear differentiation or special value proposition, companies often squander valuable marketing resources attempting to build loyalty that may or may not result in a profitable outcome (Reinartz & Kumar, 2002).

Then, the imperative question is—what does it take to build and sustain 'true' loyalty? Specifically, where should research effort be invested to enhance behavioral loyalty, cultivate attitudinal loyalty and generate profitability simultaneously? The answers may lie in rectifying some fundamental level problems prevalent with the way customer loyalty is managed and interpreted by companies. For instance:

(a) Customer loyalty is managed at the aggregate customer level with minimal or no differentiation across the entire customer base. Thus, individual customer level differences (psychographic, demographic, behavioral, attitudinal and so on) may get ignored.
(b) There is a weak correlation between customer loyalty (behavioral loyalty) and profitability (Reinartz & Kumar, 2002).
(c) Most loyalty programs are not scalable and become unprofitable with increase in membership of customers enrolling in the loyalty program (example: Safeway and Latin Pass Program discussed later in the article). This is because loyalty programs of most companies are linked to spending or frequency of usage and not profitability.

The objective of this article is to develop an integrative conceptual framework for building and sustaining customer loyalty and profitability simultaneously based on an extensive review of the relevant literature and marketplace reality. We feel that this conceptual framework may serve as a basis to understand the new evolving dominant logic of managing customer loyalty in the 21st century.

This article is organized as follows: We first review research literature on customer loyalty. We then present a conceptual framework for building and sustaining profitable customer loyalty. We then discuss a two-tiered reward-based approach as a possible means to operationalize the framework. Next, we discuss strategic implications on implementing such a framework. Finally, we compare the emerging dominant logic of customer loyalty with our framework and discuss possible future directions for research.

Review of customer loyalty concept

Traditionally, customer loyalty has been defined as a behavioral measure. These measures include proportion of purchase (Cunningham, 1966), probability of purchase (Farley, 1964; Massey, Montgomery, & Morrison, 1970), probability of product repurchase (Lipstein, 1959; Kuehn, 1962), purchase frequency (Brody & Cunningham, 1968), repeat purchase behavior (Brown, 1952), purchase sequence (Kahn, Kalwani, & Morrison, 1986), and multiple aspects of purchase behavior (Ehrenberg, 1988; DuWors & Haines, 1990). In the retailing context, following measures of customer behavior are commonly applied by practitioners – share of purchase (SOP) that measure the relative share of a customer's purchase as compared to the total number of purchases and share of visits (SOV) that measure the number of visits to the store as compared to the total number of visits (Magi, 2003). Other commonly used measures in the industry include Share of Wallet (SOW) – that is expenditure at a specific store as a fraction of total category expenditures (Berger et al., 1998) which is analogous to share of purchase (SOP); Past Customer Value (PCV) – based on the past profit contribution of the customer; Recency, Frequency and Monetary Value (RFM) – measure of how recently, how frequently and the amount of spending exhibited by a customer (Hughes, 1996).

All of these measures help Marketers evaluate behavioral loyalty. That is, loyalty of a customer as observed from the customer's purchase behavior. A majority of existing loyalty programs follow these measures to reward behavioral loyalty. That is, the more you spend with the company, the more rewards you earn. The problem is that customers may sometimes end up associating their loyalty (as defined by purchase behavior) towards a particular rewards program (e.g.

AAdvantage Program) rather than the brand (e.g. American Airlines) (Dowling & Uncles, 1997). A more serious problem with the current loyalty programs is the presence of a weak relationship between behavioral loyalty and profitability (Reinartz & Kumar, 2002). Reinartz and Kumar (2002) profiled four companies across different industries—high technology, catalog, grocery and retail finance to empirically prove that the correlation between behavioral loyalty (as measured by the respective firms) and profitability was less than 0.5 for all four companies. Further, Reinartz and Kumar found empirical evidence in support of Dowling and Uncles (1997) refuting the four commonly believed benefits of customer loyalty (Reichheld, 1996):

- The costs of serving loyal customers are less;
- Loyal customers are less price sensitive;
- Loyal customers spend more time with the company;
- Loyal customers pass on positive recommendations about their favorite brands or suppliers.

Therefore, it was clear that:

- Behavioral loyalty by itself cannot be a measure of 'true' customer loyalty.
- Behavioral loyalty can be an unreliable predictor of customer profitability.

Loyalty programs that reward customer behavior (such as purchase/visit frequency) without considering profitability run the risk of imminent failure. Take Airlines as an example. Most frequent flyer programs (until recently) rewarded customers on the basis of the distance traveled and not on the 'fare' paid by the customer. As a result, the customer who could get a cheap ticket at a fraction of the price from a web-site like http://www.priceline.com/ would get the same value reward as a customer who would have paid the full published fare. The result of this inconsistency could certainly be a factor in the financial results of the airlines with major airline companies such as United, Delta and American Airlines reporting losses. It is only recently that airlines (such as Lufthansa airlines, effective August 1, 2004) have begun to align their loyalty programs on the basis of ticket fare (function of profitability) and not distance (function of frequency) after learning a lesson the hard way. This trend is observed in other retailing industries as well where marketers are focusing their loyalty programs on customer spending (e.g. credit card companies, grocery stores, and departmental stores). However, this approach too suffers from some fundamental inadequacies. For instance, the measure of profitability or customer-spend employed by current loyalty programs is not forward looking (Reinartz & Kumar, 2003). In other words, customers are rewarded for their actions committed today (instant rewards) or in the past (delayed rewards) accruing from accumulated miles or points (Yi & Jeon, 2003). These approaches fail to consider the future potential of a customer. Research indicates that customers who have performed well in the past (in terms of their spending and profitability to the firm) need not perform similarly in future (Reinartz & Kumar, 2000, 2003). The question is, would it be possible to develop a customer loyalty program that can pro-actively reward customers 'today' for their 'future' spending?

Another important consideration is regarding the definition of 'true loyalty'. What do we mean by 'true' loyalty? According to Shoemaker and Lewis (1999), truly loyal customers are customers "*who feel so strongly that you (the company) can best meet his or her relevant needs that your (the company's) competition is virtually excluded from the consideration set; these customers buy almost exclusively from you (the company)*". This observation by Shoemaker and Lewis implied that 'true' customer loyalty is difficult to build and sustain without including the underlying attitudinal aspects of the customer that drive customer behavior.

'Attitude' has been defined as 'a psychological tendency that is expressed by evaluating a particular entity with some degree of favor or disfavor' (Eagly & Chaiken, 1993). Then, what entails attitudinal loyalty? Attitudinal loyalty has been often defined in the context of brand as it captures the affective and cognitive aspects of brand loyalty, such as brand preference and commitment (Gremler & Brown, 1998; Mellens, Dekimpe, & Steenkampe, 1996; Traylor, 1981). Attitudinal loyalty represents a higher-order, or long-term, commitment of a customer to the organization that cannot be inferred by merely observing customer repeat purchase behavior (Shankar, Smith, & Rangaswamy, 2000). Attitudinal loyalty is important because it indicates propensity to display certain behaviors, such as the likelihood of future usage (Liddy, 2000) or how likely is it that customers would recommend the company to their friends or a colleagues (Reichheld, 2003).

Several researchers in the past have emphasized the importance of considering both behavioral and attitudinal aspects of loyalty (e.g. Pritchard, Howard, & Havitz, 1992). Day (1969) and Lutz and Winn (1974) have proposed loyalty indexes based on composites of attitudinal and behavioral measures. Jacoby and Chestnut (1978) have explored the psychological meaning of loyalty. Engel and Blackwell (1982) defined 'true' loyalty as the preferential attitudinal and behavioral response toward one or more brands in a product category expressed over a period of time by a consumer. A psychological approach including cognitive, affective, and conative elements was analyzed by Oliver (1999). Attitudinal loyalty can sometimes lead customers to provide unprecedented value to the company through positive word of mouth (Dick & Basu, 1994; Hagel & Armstrong, 1997; Reichheld, 2003). Failure to account for attitudinal loyalty could lead to spurious loyalty (Dick & Basu, 1994). Therefore, to achieve 'true' loyalty, firms should concurrently focus on building both behavioral and attitudinal loyalty.

Building and sustaining loyalty: a conceptual framework

We propose a conceptual framework to build and sustain profitable customer loyalty as shown in Fig. 1. The figure

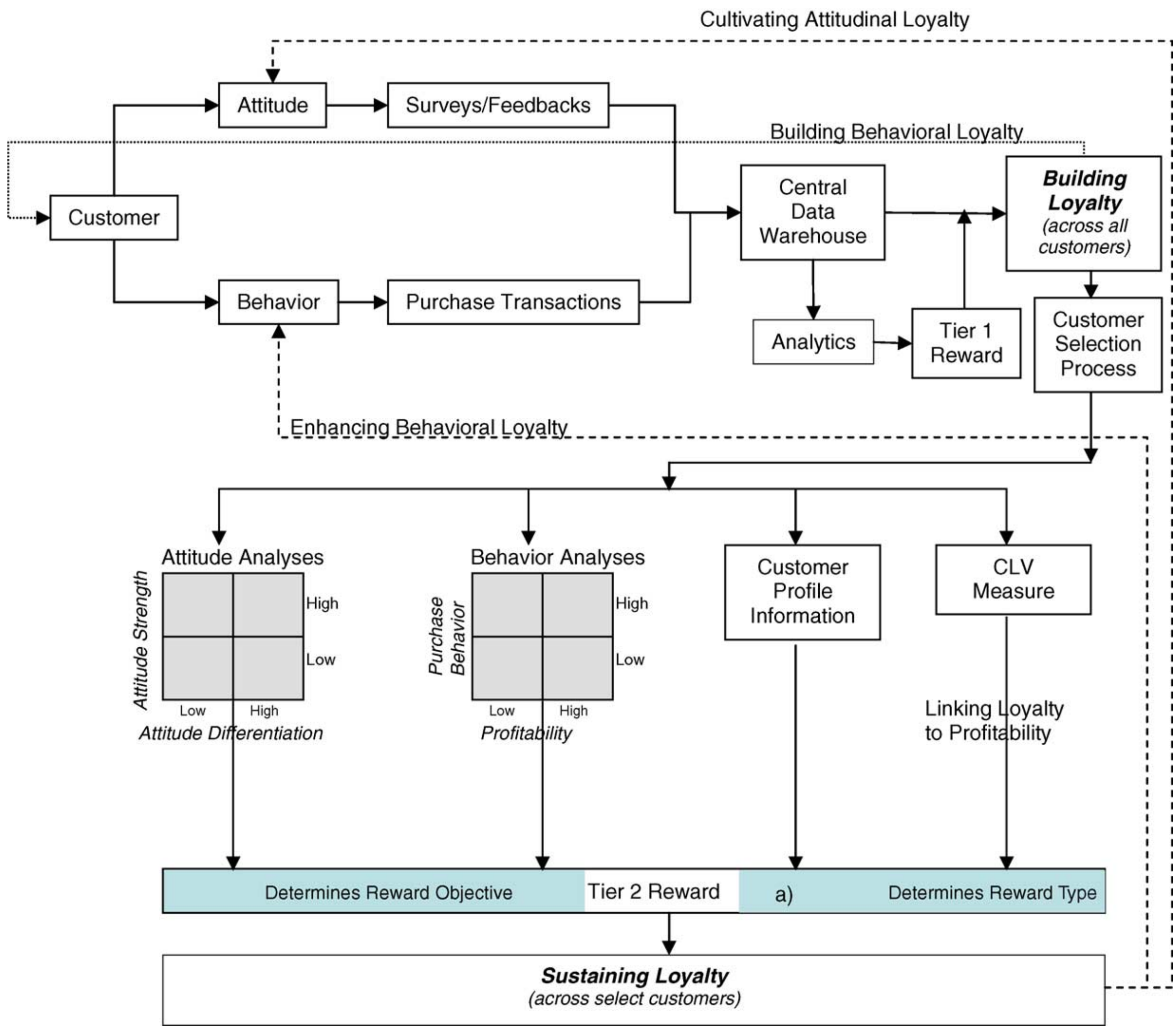

Fig. 1. Conceptual framework for building and sustaining *profitable* customer loyalty.

shows how a customer possessing an *attitude* towards the company (or store) brand transacts with the company through purchase *behavior*. The customer's attitude and behavior is captured in the company's *central database* through *surveys* and *transaction data*, respectively. We call the database as the central database as we assume that the database would consolidate any transaction data of the customer irrespective of the shopping channel (for example, the company may have website and catalogs through which customers can purchase in addition to physical stores). The extent of information captured in the central database would determine the efficacy of the framework (Berger, 1998).

The different components of the framework as shown in Fig. 1 may be explained through the discussion of the three fundamental objectives fulfilled by the framework:

1. Building (and enhancing) behavioral loyalty;
2. Cultivating attitudinal loyalty;
3. Linking loyalty to profitability.

Building (and enhancing) behavioral loyalty

In the earlier section, we reviewed two forms of loyalty—behavioral loyalty and attitudinal loyalty. Behavioral loyalty focuses on the 'value of the customer to the brand' (Schultz & Bailey, 2000). For any firm, customer loyalty becomes more meaningful only when it translates into purchase behavior. Purchase behavior generates direct and tangible returns to the firm as compared to the effects of pure attitudinal loyalty (which may be commitment or trust that need not translate into actual purchase behavior). Therefore, it is imperative for a firm to build behavioral loyalty. Pure attitudinal loyalty of a customer without behavioral loyalty may provide only limited or no tangible returns to the firm.

Most loyalty programs in existence today reward behavioral loyalty. However, a good majority of these programs are operationalized at the aggregate level of customer behavior. That is, if a customer spends US$ 100 in a departmental store, he/she would earn the same reward or points as compared to another customer spending the same amount. There is no differentiation on the basis of purchase pattern underlying the US$ 100 spend. For instance, did the customer spend the US$ 100 across different departments or product categories or did he/she spend it all on one department or product category? Did the customer spend US$ 100 on sale items or on full price items or on both? Does the customer frequently buy high-margin products or low margin products? Answers to the former two questions would give insight about customer's purchase behavior. Answers to the latter two questions would give insight about customer's profitability.

Therefore, different customers exhibiting same amount of spending may differ substantively on the following purchase behavior related dimensions:

- Purchase behavior;
- Profitability to the firm (as a consequence of the purchase behavior);

Differences like these cannot be recognized by loyalty programs operating at aggregate level of purchase behavior.

Fig. 2 maps customers varying in *purchase behavior* and *profitability* dimensions. The *purchase behavior* measure used for analyses in Fig. 2 may vary by industry based on the specific product/service offerings. For example, a departmental store stocking multiple products may be concerned about the *degree of cross-buying* exhibited by a customer. However, a single-product, single-price vendor such as Greyhound Bus Service would be concerned more about the purchase (travel) *frequency* of its customers. Irrespective of the purchase behavior measure used, it is imperative to analyze the underlying purchase behavior against the profitability of the customer. The outcome of such an analyses would serve as a decision support for marketing intervention to recognize an exceptionally strong purchase behavior (represented by Cell 1) or a corrective action in terms of increasing purchase behavior (for example increasing cross-buy) for customers in Cell 2 or increasing profitability for the customers in Cell 4. Cell 3 represents low revenue potential customers or new customers. In case they are low revenue potential customers, they should be managed with minimal marketing investments such as adopting low cost marketing channels (e.g. online customer service, e-newsletter) and so on. In case they are new customers, they may be offered an upfront incentive to spend more with the company and thereafter their performance should be closely tracked before investing further.

Cultivating attitudinal loyalty

The importance of attitudinal loyalty was discussed in the earlier section. Customer attitudes have been known to influence customer behavior (Ajzen & Fishbein, 1980). However, customers exhibiting a positive attitude may not translate that into purchase behavior due to a relatively more favorable attitude toward another brand (Dick & Basu, 1994). The positive attitude strength of a customer needs to be complemented by high attitude differentiation (compared to other brands) in order for the firm to expect sustained purchase behavior from the customer in the long run.

In the 2 × 2 matrix shown in Fig. 3 (adapted from Dick & Basu, 1994), customers in Cell 1 and Cell 2 are the best bets to invest in cultivating attitudinal loyalty whereas customers in Cell 3 represent the weakest attitude orientation towards the brand of a company/store. Customers in Cell 4 (high attitude strength, low attitudinal differentiation) may have multi-brand loyalty. Companies need to augment behavioral loyalty for these customers and try to increase their share of wallet (or share of purchase) through appropriate marketing initiatives.

Attitudinal aspects of the customer are typically measured through surveys to obtain data at the customer level. Other methods include focus groups and customer feedback. While measuring attitudes through survey, only a sample of customer base may be selected for a particular timeframe, and a different sample for another timeframe. The outcome of such surveys measured from different samples over different timeframes can be used to impute values for the entire database of customers by applying sophisticated statistical techniques.

We use the word 'cultivating' (as opposed to building) for attitudinal loyalty as 'cultivating' attitudinal loyalty takes more than simple rule-of-the-thumb marketing intervention. Attitudinal loyalty may often result as an outcome of a long

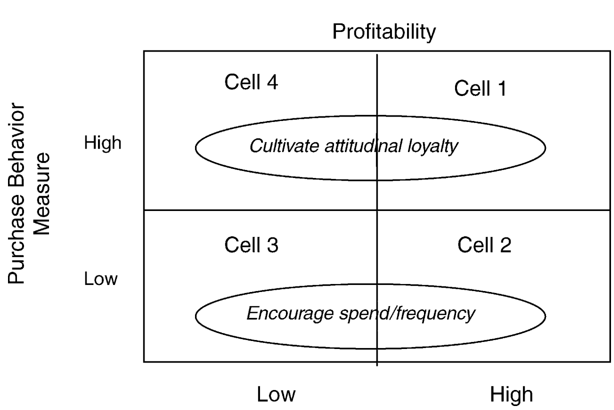

Fig. 2. Behavior analyses.

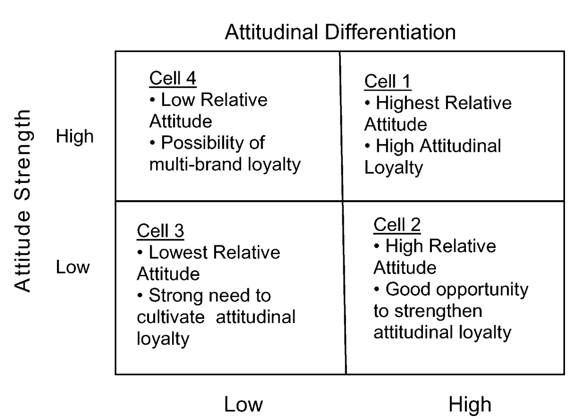

Fig. 3. Attitude analyses.

fruitful relationship between the company and the customer over time.

Just as behavioral loyalty is important to companies for generating profitability, attitudinal loyalty helps companies to build an invisible exit barrier for their customers, especially in non-contractual situations where switching costs are low (Shapiro & Vivian, 2000). To be effective and selective in cultivating attitudinal loyalty, companies need to know their customers well, beyond the customers' purchase history. Customer profile information comprising customer heterogeneity in terms of psychographic and demographic descriptives is important to predict future customer profitability (Reinartz & Kumar, 2003) as well as for relationship marketing (Sheth & Parvatiyar, 1995). Therefore, we include *customer profile information* as an important and integral component of our framework (See Fig. 1).

Linking loyalty to profitability

The ultimate goal of any corporate initiative is profitability. Customer loyalty is one of the means to achieve that objective (Reinartz & Kumar, 2002). Any resources invested in building loyalty without focusing on profitability may tantamount to failure over time. Lessons from the past reinforce our conviction. For example, Safeway's ABC Card (PR Newswire, 2001), introduced in 1995, was touted as the most innovative loyalty scheme in the U.K. grocery industry. However, the program was not linked to customer profitability. As a result, as more members were added, the communication and operation cost to run the program outweighed the program benefits. Consequently, the ABC Card was abandoned by Safeway, UK in April, 2000. Similarly, Latin Pass (PR Newswire, 2001), a frequent flyer consortium of 10 Latin American airlines, ran a promotion in 1994 promising one million miles to any customer who could visit 10 Latin American countries and utilize hotel and rental car partners within a certain timeframe. 50 people qualified in three months, forcing Latin Pass to terminate the promotion earlier than planned and generating negative costs of up to US$ 10,000 per customer.

We discussed the importance of profitability in conjunction with behavioral loyalty earlier. However, our definition of profitability for that discussion implied past or present customer profitability. A more sophisticated approach is to compute the future customer profitability by applying the concept of customer lifetime value (Reinartz & Kumar, 2000).

Customer Lifetime Value (CLV) may be defined as the "measure of expected value of profit to a business derived from customer relationships from the current time to some future point in time" (usually three years in the case of most business). In recent years, CLV and its applications have received increasing attention (e.g. Berger & Nasr, 1998; Mulhern, 1999; Reinartz & Kumar, 2000, 2003; Rust, Lemon, & Zeithaml, 2004). The popularity of CLV comes from the fact that it is the only forward looking metric that incorporates into one, all the elements of revenue, expense and customer behavior that drive profitability. Also, it is consistent with the customer-centric paradigm of marketing.

CLV is a more superior metric as compared to other traditional measures discussed earlier such as RFM, Share of Purchase (or Wallet), and Past Customer Value (PCV) (Reinartz & Kumar, 2000). None of these measures is forward looking and do not focus on profitability of the customer (with the exception of PCV that focuses on past profits). Therefore, in our framework, we propose to use CLV as a decision support tool to set the maximum dollar value limit for marketing investment on a loyal customer without running the risk of over-spending. For example, if a customer exhibits a CLV of US$ 200 with high risk of attrition, then in order to retain him (or sustain his loyalty), the company can offer him a maximum incentive of US$ 200 value. Any incentive over US$ 200 could lead to unprofitable lifetime duration of the retained customer. In this manner, CLV can ensure profitability without compromising loyalty. Also, being a forward looking metric, marketers can use the metric for pro-active marketing interventions (versus traditional reactive marketing interventions).

Operationalizing the framework

We later propose a two-tiered[1] rewards strategy as a possible means to operationalize the framework. The two tiers are classified on the basis of their end-objectives and the level of differentiation. A key challenge here is the ability to discriminate between customers based on differences in their purchase behavior, attitude, profile and profitability potential without running the risk of alienating the customers. Another challenge is the ability to build and sustain 'true' loyalty without trading off profitability. A detailed explanation of the two tiers follows:

Tier 1 rewards

Tier 1 rewards are directed towards meeting the following strategic objectives:

(a) Provide a simple, explicit and fair baseline reward mechanism to reward all customers for *their present and past purchases* irrespective of their attitude or purchase pattern. This ensures that all customers are cognizant of the rewards program (including new customers who may have never transacted with the company before).
(b) Provide a means for the firm to capture customer transaction data (Day, 2000). Most loyalty programs log customer transactions data by issuing a magnetic strip loyalty card to the customer. The customer usually needs

[1] The tiered approach differs significantly from multi-tiered loyalty programs used by Airlines and few Casino companies where loyal customers are classified based on their total amount spent with the company (Example Platinum, Gold and Silver status).

to swipe the customer loyalty card or key in the card number at every transaction to be able to earn points). The presence of Tier 1 rewards would serve as an incentive for all customers to record their transactions with the company at every purchase instance.

(c) Ensure scalability of the loyalty program by rewarding customers in proportion to their spending. That is, the more a customer spends with the firm, the more he/she earns rewards. (Ideally, going with the philosophy of this article, we would recommend Tier 1 reward to be based on customer profitability and not spending. That is, a customer spending US$ 100 on a high margin luxury item for a retailer should earn more points than another customer spending the same amount on a low margin item at the same retailer. However, this may pose operational issues especially for retailers that practice hi-lo pricing or frequent clearance sales on different items to get rid of inventory. Thus, for the sake of simplicity and practical feasibility, we propose Tier 1 reward to be based on spending alone and not profitability).

Hence, given these three objectives, Tier 1 will represent a standard uni-dimensional rewards strategy where customers are given rewards or points on the basis of their total spending, thereby serving as a means for instant gratification. Tier 1 rewards would be administered at an aggregate level for *building loyalty* across all customers as shown in Fig. 1. The terms of earning and redeeming points for Tier 1 rewards would be the same for all customers and would be explicitly stated in form of a general policy. Hence, Tier 1 rewards would be easy to replicate by competition. A majority of loyalty programs in existence today operate at Tier 1 that reward behavioral loyalty at an aggregate customer base level.

Tier 2 rewards

Contrary to Tier 1, Tier 2 rewards are forward looking and aimed at *influencing customer behavior or attitude in future* given the past performance of the customer (as observed on the attitudinal and behavioral dimensions). Thus, Tier 2 rewards would be special rewards given to select customers to cultivate attitudinal loyalty or enhance behavioral loyalty or both. Unlike Tier 1 rewards, here companies can internally control 'who' should receive the Tier 2 reward?; 'what' should be the type of reward?; and 'how' much should it be worth?

As shown in Fig. 1, all customers qualify for Tier 1 reward that is directed towards *Building Loyalty*. From this customer pool, companies can cull out select customers through the *Customer Selection Process*. The Customer Selection Process is essentially a process of measuring CLV for each customer. The high and medium CLV customers are then extracted as they represent high value customers. These customers are then queried on four critical parameters—Attitude Analyses, Behavior Analyses, Customer Profile Information and CLV Measure as shown in Fig. 1. The outcome of Attitude and Behavior Analyses of a customer can help determine the specific objective to be fulfilled by Tier 2 reward for a given customer. For example, if a customer sores high on all attitude related dimensions, high on profitability dimension, and low on purchase behavior dimension such as cross-buy, then the primary objective of the Tier 2 reward would be to motivate the customer to cross-buy. Once the objective is known, the next step is to determine the 'type' and 'value' of Tier 2 reward. As shown in Fig. 1, this may be determined from the outcome of Customer Profile Information and CLV measure. Customer Profile Information provides data specific to a customer for designing a customized reward that is *relevant* to the customer. For example, a steep discount offered to a customer, say Nancy to cross-buy in the sporting goods section would have lesser impact as compared to offering her similar value discount to cross-buy in the cosmetics section (assuming that we know that Nancy is a 25-year old woman who does not currently shop from either of these sections). Then, the question is, what 'value' of steep-discount should the company offer Nancy to cross-buy from the cosmetics section? It is important here that the company does not invest in Nancy (through Tier 2 reward) more than what the company expects from her in the form of future business. In other words, the marketing action should justify a positive return on investment for every customer. This is where a forward looking measure like Customer Lifetime Value helps manage loyalty and profitability simultaneously. CLV measure provides a dollar value for the net present value of the future worth of a customer. In doing so, it takes into account all cost and revenue components associated with the consumer including Tier 1 rewards that may have been awarded to the customer to date. Therefore, CLV measure in a way helps set the ceiling on the dollar value of Tier 2 reward that may be given to the customer. Otherwise, the value of Tier 2 reward may become highly subjective and susceptible to human judgment. Worse, it may lead to unprofitable transaction.

To summarize our discussion, Tier 2 rewards (when implemented by a company) would represent highly differentiated rewards, awarded selectively at individual customer level to only those customers that the company is interested in 'sustaining' loyalty. Tier 2 rewards (unlike Tier 1) are not explicitly divulged to the customers as they are administered at the discretion of the company on a customer-by-customer basis. Hence, they are invisible to competition. Take the example of three exclusive credit card companies that are dishing out unique and innovative rewards for their high spending customers[2]. Stratus Rewards Visa, a new U.S. bank credit card company carefully selects its customers by invitation only and then treats them to rewards such as use of private jet, time with celebrities or shopping at an upscale store with the assistance of a personal shopper. Audi Visa (Credit) Card offers its customers the option to earn points towards the purchase of a new Audi (analogous to what GM Credit

[2] Source: 'Hey, Big Spenders', Business Section – The Hartford Courant, May 19, 2004.

Card is offering as well). While, American Express selectively chooses from its existing customers to bestow special privileges such as 24-hour trip advisers, exclusive shopping, or complimentary stays at 5-star hotels. Clearly, these cards are offering rewards that are over and beyond standard Tier 1 type rewards.

In our framework, Tier 1 and Tier 2 rewards are designed to operate in tandem, often complementing one another. Tier 2 rewards are designed to be 'bonus' rewards with very specific objectives that are not met with Tier 1 rewards. For instance, Tier 2 rewards could help stimulate customers' feelings of belonging and being treated special (O'Brien & Jones, 1995). They could also stimulate what is known as the reciprocity norm: customers evoking obligation towards companies who treat them well or provide value (Dewulf, Odekerken-Schroder, & Iacobucci, 2001).

One of the authors of this paper (who has been a customer with a major domestic airline for the last 17 years) was recently contacted through a personalized letter offering a chance to upgrade to the highest elite (Platinum) status despite missing the qualification criteria by few thousand miles. In a separate and unrelated communication, the same airline upgraded the author's spouse (airline customer for three years) to elite status despite falling short by a few thousand miles. Clearly, the airlines was selectively choosing only those customers from its database that exhibited strong behavioral loyalty and bestowing to them special privileges (Tier-2 like rewards) to cultivate attitudinal loyalty. Another notable aspect is the fact that the airlines seems to be systematically targeting customers based on future revenue potential from the customer and not tenure or other considerations. As of today, both the author and his spouse owe strong attitudinal and behavioral loyalty to this airline.

Tier 1 and Tier 2 operating concurrently can give immense flexibility to any loyalty program. Most importantly, they can help achieve attitudinal loyalty, behavioral loyalty and profitability simultaneously and give the power to marketers to pro-actively invest in their best customers 'today' based on their 'future' potential and not just past history of transactions. In a way, Tier 2 adopts the operational philosophy of a customer loyalty program on one hand and the data analyses algorithm of a sophisticated CRM program on the other hand.

Designing Tier 2 rewards

So, what can Tier 2 rewards look like? How do we design the right reward for the right customer? The answer lies in research. Systematic data mining of the components of our framework can enable researchers to develop an algorithm to configure the most optimal and relevant Tier 2 reward for a customer.

In recent times, consumer researchers have argued that consumer behavior may be best understood as goal-directed behavior (e.g. Bandura, 1989; Cantor, 1990; Carver & Scheier, 1996). Huffman, Ratneshwar, and Mick (2000) have developed an integrative model drawn from different consumer research paradigms to propose a hierarchical goal structure comprising of six discrete levels of consumer goals rank ordered by level of abstraction and endurance over time. We present a simplified version of customer goals as shown in Fig. 4.

Basically, consumers are known to have goals that co-exist at different levels. Higher level goals are more abstract such as life themes and values and life projects. Examples of higher level goals include desires/aspirations such as to be successful in life, to visit exotic places around the world, to achieve social recognition, and so on. Lower level goals are less abstract and include short-term objectives such as to buy a new car, to pick up the week's grocery, to save money for some annual event (like a birthday or an anniversary gift), and so on. Likewise, companies too have a hierarchy of marketing goals with higher level goals representing strategic objectives such as relationship building, sustained growth, increased profitability and lower level goals representing marketing tactics such as customer acquisition programs, price promotions, marketing communication and so on.

In this context, our definition of a successful loyalty program that can sustain over time is the one that can meet both customer and corporate goals concurrently. Our two-tiered framework can be applied to design rewards that can strive to fulfill both levels of consumer and corporate goals simultaneously. For example, Tier 1 reward comprising of a tangible reward may meet lower level goals for both consumer and the firm while Tier 2 reward comprising of tangible, intangible or experiential reward may help meet higher (as well as lower) level goals for both the consumer and the firm as shown in Fig. 4. By adopting a customer-centric rewards strategy, companies can offer their customers more value and options

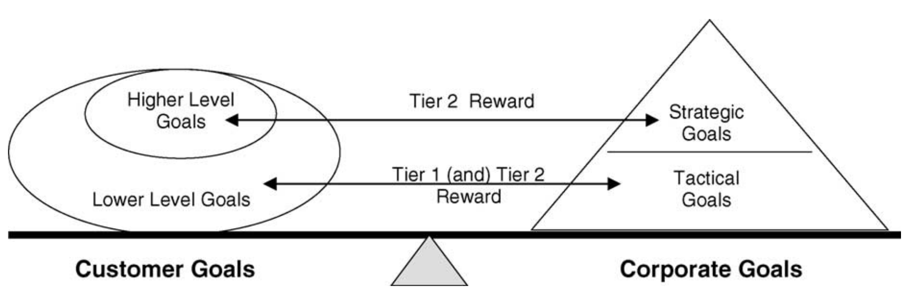

Fig. 4. Balancing corporate goals with customer goals.

to their customers, thereby fulfilling more needs and goals of the customers over and above what is met by the company's products and services. For example, a customer shopping in a departmental store chain may get base level rewards in form of discounts on select products and say cash-back rewards for his/her everyday purchases. However, if the company profiles the customer to be an extremely loyal customer exhibiting high customer lifetime value, it may issue a Tier 2 reward in the form of a free travel to an exotic destination or say a ticket to the Superbowl game. The challenge lies in determining which customer should get a ticket to the Superbowl and which customer should get a ticket to an exotic destination or something else. The answer lies in sophisticated data collection and analytical techniques that may enable companies to capture multiple data points comprising of different relevant aspects of the customer. These data points may then be integrated to create a 360° view of the customer, enabling the company to get a deeper understanding of the customer. By doing so, the company may be in a position to fulfill implicit aspirational needs of the customer that may never be fulfilled through everyday cash-back or price discounts. In return, the customer's attitudinal loyalty may get reinforced like never before as the customer may see his/her shopping in grocery store as a means to accomplish things that he/she may never ordinarily achieve elsewhere.

However, it is important that the rewards associated with a loyalty program evenly balance off corporate and consumer goals. Any loyalty program that may lean heavier on consumer goals' front may have scalability issues and possibly fail due to serious erosion of company's bottom-line over time due to the increase in reward redemption. Likewise, any program that may lean heavier on corporate goals' front may turn out to be unpopular with its members. In such a scenario, customers may leave for a better loyalty program being offered by competition. Very few loyalty programs in the retailing industry today have the resilience to balance goals to the extent that our framework with the two-tiered rewards approach proposes to accomplish.

Strategic implications of our framework

Most companies max out their resources through rewards programs that resemble Tier 1. This often results in a poor or a steadily deteriorating ROI as the loyalty program is susceptible to imitation from competition which reduces the competitive advantage of the loyalty program. Further, such loyalty programs are designed to award the maximum reward to customers who are the highest spenders. Chances are a good majority of the top-spenders may comprise of customers that genuinely appreciate the company's products and/or services and would have continued to spend irrespective of the rewards as evinced by the research findings of Safeway[3] discussed next.

[3] Source: Arthur Hughes M., How the Safeway Club Built Loyalty, *Database Marketing Institute*, http://www.dbmarketing.com.

An analysis conducted by the grocery chain—Safeway-USA revealed that its top decile of customers shopped almost entirely at Safeway by habit and/or strong liking for Safeway and therefore there was minimal scope for any incremental sales from them. In such a scenario, the company ran the risk of cannibalizing its own business if it were to subsidize its most profitable customers through tangible rewards aimed at inducing incremental purchase behavior. Instead, a better approach (adopting the two tiered framework) would be to administer a moderate level of Tier 1 rewards and reallocate the surplus resources towards Tier 2 rewards to cultivate attitudinal loyalty amongst the top spenders, thereby setting up an invisible 'exit barrier' (Klemperer, 1987). This is imperative considering the fact that the top-spending customers are likely to be targeted the most aggressively by competition.

Another major advantage of our framework is the immense flexibility on the resource allocation front. The surplus resources conserved from moderation of Tier 1 rewards may be used freely at company's discretion for Tier 2 rewards. Since Tier 2 rewards are invisible to customers (and competition) and not obligatory, companies have the liberty to vary the level of Tier 2 rewards any time without running the risk of any backlash from the customers. The same does not hold true for Tier 1 rewards.

Further, the two-tiered framework may be used to cross-sell and up-sell to the customers by sending out Tier 2 rewards that influence the desired behavioral outcome. Tier 2 rewards directed towards cultivating attitudinal loyalty may be integrated with the company's relationship management initiatives.

All in all, to derive the maximum benefit of the framework, it should be well integrated within the overall CRM initiatives of the organization.[4]

Evolution of Loyalty Programs—towards a new dominant logic

Building and sustaining loyalty simultaneously seems to be the primary focus of twenty first century loyalty programs. As discussed earlier, past researchers have emphasized the importance of both attitudinal loyalty and behavioral loyalty (e.g. Dick & Basu, 1994). We reviewed the criticality of linking loyalty to profitability (Reinartz & Kumar, 2002, 2003) and development of forward looking metrics such as the customer lifetime value (e.g. Berger & Nasr, 1998) that enable computation of net present value of a customer. This is complemented with the fact that in the last few years, information

[4] According to Margo Georgiadis, Partner-McKinsey & Company, "A major problem with most loyalty programs is that they are not part of an integrated loyalty strategy. At many companies, the loyalty programs can become a hobby of the marketing department and, therefore, is not embedded in the business overall. When this happens, programs often fail to deliver attractive returns because they under-leverage key assets and miss the opportunity to use customer specific data". Source: Marketing Leadership Council Case Book, September 2001.

Table 1
Evolving dominant logic for loyalty programs

No.	Dimension	Earlier loyalty programs: program centric	Evolving loyalty programs: customer centric
1	Operationalization level	Aggregate level	Customer level
2	Program type	Standardized, based on usage or spend	Customized, based on type of usage or type of spend
3	Rewarding scheme	Standard and uniform aimed at repeat purchase	Personalized and relevant, aimed at influencing specific behavioral change or attitudinal gratification
4	Reward options	Minimal	Multiple (usually made possible through partners and alliances)
5	Reward mechanism	Reactive	Reactive + proactive
6	Reward type	Tangible	Tangible + experiential
7	Program Objective	Build market share, increase revenues, build behavioral loyalty through repeat purchase or usage	Link loyalty to profitability, Influence behavioral loyalty, cultivate attitudinal loyalty
8	Metrics used	RFM, PCV, SOW[a]	CLV
9	Technology and analytics usage	Minimal	Extensive

[a] RFM: recency, frequency and monetary value; PCV: past customer value; SOW: Share of Wallet.

technology – especially database-management software – has opened up a new era in loyalty marketing by enabling sophisticated and individualized tracking of customers (Buss, 2002).

Past and present research findings, coupled with advances in database management technologies have all contributed towards the emergence of a new dominant-logic paradigm of customer loyalty programs that is characterized by ‘personalization’ and ‘customization’ at individual customer level.

As summarized in Table 1, changes in the following dimensions of customer loyalty programs seem to evince a discernible evolving dominant logic:

1. *Operationalization level*
   The most fundamental level change is the management of loyalty programs from an aggregate level to individual customer-level. Loyalty cards (bearing a magnetic strip or bar code), frequent flyer numbers, customer ID, and so on are means through which companies can capture individual customer level data and later use that information for loyalty program management at individual customer level. Subsequent examples illustrate how some companies with advanced database technology show strong signals of early adoption of the evolving dominant logic.
2. *Program type*
   Earlier loyalty programs rewarded a customer based on usage or spend. For example, if a customer flew 1000 miles he/she earned 1000 bonus miles or if a customer spent US$ 100 in a store, he/she earned 100 points. However, this is transforming to a more sophisticated means of accounting. Few airlines (as discussed earlier) have already started rewarding miles based on fare paid. For example, Continental Airlines accounts for only 50% of the miles flown towards an elite status on a discounted fare ticket, 100% for economy class ticket and 150% for a full published fare ticket.[5] So, if a customer flies 1000 miles, he/she would earn 500, 1000 or 1500 miles towards elite status depending on how much fare the customer paid for the ticket. Similarly, in the context of a retail store, a customer spending US$ 100 would earn points that may be equal to, less than, or greater than 100 points based on the profit margins associated with the expenditure of US$ 100. We are not aware of any major retailer practicing this method to date. This may be due to complexity at implementation stage (as discussed earlier while describing Tier 1 rewards). However, migration to accounting of customer loyalty points that is linked to a profitability metric seems inevitable.
3. *Rewarding scheme*
   Rewards will play a critical role in the new dominant logic. Earlier (and even existing) programs provide standard rewards across all customers. For example, if a store is giving away a free travel bag for purchases of US$ 100, that reward will be applicable to all customers irrespective of their profile or purchase pattern. The new dominant logic points towards personalized rewards that are aimed at influencing specific behavioral change or attitudinal gratification. For example, CVS Pharmacy[6] collects three types of customer information in its ExtraCare database: demographics, personal interests and purchase behavior to send out personalized and relevant rewards to each customer. This may range from a coupon or promotion (to influence specific purchase behavior) or free newsletter relevant to the area of interest of the customer to demonstrate care and concern (aimed at cultivating attitudinal loyalty).
4. *Reward options*
   Loyalty programs are steadily increasing the reward options in an effort to service customer heterogeneity. Since different customers may perceive different value for the same reward, multiple reward options can help satisfy different customer needs. This is often being achieved through coalition with multiple partners whose products/services are then included in the basket of possible reward options. This way companies do not need to limit

[5] Source: Continental Airlines Website (http://www.continental.com).

[6] Source: CVS; Parks, Liz (2001), “Shopper Cards Help Retailers Offer Rewards, Gather Data”, *Drug Store News*.

the reward options to their own products/services. For example, TESCO,[7] a leading UK grocery retailer has tied up with several companies to offer a huge range of reward options where TESCO's customers may redeem their points towards hotel bookings, sports events, shopping, free airline tickets, movie rentals, fitness club and so on.

5. *Reward mechanism*
Traditional loyalty programs reward customers based on past and current spending or service usage. Thus, the reward mechanism is *reactive* and similar to Tier 1 reward of the framework. However, the evolving trend is to *proactively* offer rewards to high-value customers to influence *future* behavior and purchase motivation. For example, Wyndham International, a leading hotel chain, uses customer profile information to surprise high-value ByRequest (Wyndham's loyalty program) members with proactive rewards upon arrival such as a free round of golf (for a member who had listed his/her leisure preference as golf) or a free wall street journal newspaper in the room for a business traveler and so on.[8]
6. *Reward type*
Companies are increasingly becoming creative to include intangible and experiential rewards for their customers in addition to the traditional tangible rewards. Many companies have or are in the process of designing unique and compelling rewards such as once-in-a-lifetime experiences or lifestyle-themed rewards that appeal to the customer's dreams and aspirations. For example, La Quinta Hotel chain offers its members the opportunity to earn a white water rafting expedition. American Super Laundry—a Los Angeles-based chain of laundromats offers its modest-income frequent customers the opportunity to take the entire family to Disneyland. Neiman Marcus's InCircle program rewards range from complimentary drinks to a private six-day European golf tournament with 15 guests traveling in a private luxury jet.[9] The objective is to touch upon higher level goals and attitudinal aspects of the customer that may not be ordinarily met through tangible rewards.
7. *Program objective*
As the discipline of loyalty marketing matures, the objective of customer loyalty programs is shifting towards simultaneous goals such as linking loyalty to profitability and cultivating attitudinal loyalty. In terms of tactical objectives, companies are leveraging their customer behavior data to target specific aspects of customer behavior as explained earlier in the context of Tier 2 rewards and *Rewarding Scheme*. In contrast, earlier programs focused on building market share and increasing revenues that may or not result in proportional increase in profitability. Also, traditional loyalty programs tend to focus on building behavioral loyalty alone at aggregate customer level.
8. *Metrics used*
One of the hallmarks of the new dominant logic is the ability of the customer loyalty program to be forward looking and hence empower the company to be *proactive* in its marketing actions. This necessitates the new dominant logic to adopt a forward looking metric such as the CLV and apply it in a similar way as evinced in our two-tiered conceptual framework. CLV measure not only enables marketers to take proactive marketing decisions for a customer, but also serves to track the efficacy of the marketing initiative (such as a proactive reward) by measuring the change in CLV for that customer. Wyndham International's ByRequest program (mentioned earlier) uses CLV as a primary decision support tool to offer special surprise rewards to guests that score high on the CLV score.
9. *Technology and analytics usage*
With the advent in database technology and information technology, companies have the means to gain a 360° view of their customer. Harrah's, a leading casino chain has an impressive IT infrastructure that can profile 25 million gamblers from any of Harrah's location scattered across USA and within minutes compute lifetime value scores for each of the customers with an analyses of which customer to be targeted through direct mail for future business.[10] Technology and sophisticated analytics will continue to play a vital role in shaping future loyalty programs. In days to come, customers can expect companies to use high technology gizmos such as Smart Cards, RFID and other wireless methods to improve the speed and accuracy of customer related data.[11]

The signs of an evolving dominant logic in loyalty programs seem unmistakable and present a fresh set of exciting and challenging research opportunities for researchers. Our two-tiered conceptual framework imbibes all the basic ingredients of this new evolving paradigm and strives to be a starting point for researchers to understand and develop it further.

General discussion and future research directions

Customer loyalty is an important construct for all marketers and defines a means to develop relationship with

[7] Source: TESCO: http://www.tesco.com.
[8] Marketing Leadership Council Case Book, September 2001.
[9] Source: Colloquy Talk, Paper 6.03, July 2003.

[10] Source: The Guardian Online (http://www.guardian.co.uk), January 15, 2004.
[11] Smart Cards are like normal plastic loyalty cards but they have a small memory chip mounted on them instead of a magnetic stripe. The chip can store all customer related transactions and hence offers the flexibility to the customer to instantly earn and redeem points in real-time without waiting for the time taken for the reward points to be registered in the central database of the computer (which may take a few hours). RFID or radio-frequency identification devices provide contact less communication with point of sale devices (usually within four feet distance). The device helps track and identify loyalty members without the need for them to explicitly swipe their loyalty card.

customers and hence increased business and customer retention. Customer loyalty programs provide a means to communicate to the customers that "we recognize and value your patronage". The rewards associated with loyalty programs provide a means to establish reciprocity between the customer and the company. That is, rewards may generate a feeling of obligatory response from the customer in the form of more business which in turn may lead to more rewards offered from the company and so on. The challenge lies in managing the gamut of these sequential and cyclical events in a way that is profitable and effective in competitive marketplace. In this direction, this article seeks to addresses critical research issues such as:

How to sustain loyalty? By leveraging the information in the database and the power of sophisticated analytics, companies can identify individual customer-level differences to design rewards that are relevant and perceived as high value by the customers. As discussed earlier, some companies are augmenting the reward options by partnering with other firms. Also, there is a growing propensity to offer experiential and intangible rewards related to special recognition or special experience as opposed to standard cash-back or gift type of rewards. Such rewards touch upon the higher level goals and attitudes of the consumers, thereby creating an effect that is enduring and more effective towards engendering steadfast loyalty. However, care must be taken in terms of the dollar value spent on the rewards. Customer loyalty holds no significance for a company if it does not result in profitability. This brings us to the second critical research issue: How to manage loyalty and profitability simultaneously? In Table 1, we see the CLV metric as the superior metric of the future, known to outperform and replace other traditionally used metrics such as RFM, PCV, and SOW (Reinartz & Kumar, 2000). By applying CLV, companies can incorporate a forward looking measure into their system that can integrate all components that drive customer profitability.

Further, not much research in the past has explored 'rewards' as a dependent variable to operationalize a sophisticated loyalty program. The two-tiered rewards approach to operationalize the conceptual framework offers tremendous flexibility to marketers to implement a highly differentiated loyalty program at individual customer level.

In essence, this article contributes towards the customer-centric marketing paradigm (e.g. Winer, 2001) by extrapolating the principles of CRM to a customer level theoretical framework aimed at building and sustaining loyalty and profitability simultaneously. The two-tiered rewards approach to operationalize the framework may serve as a basis for the dominant logic of emerging loyalty programs. We hope to see it as a starting point for researchers to enhance this framework further.

Several questions emerge from the framework. For instance, the suitability of a customer loyalty program for a particular company to start with. Prior to implementing a customer loyalty related initiative, companies need to research whether a customer loyalty program is really needed in the context of their business. Fortune 1 company and top retailer in the world—Wal Mart Corporation, operates successfully without any customer loyalty program. In contrast there may be niche-product companies having a relatively smaller customer base (e.g. Bose[12]) for whom it may suffice to operate a customer loyalty initiative only at Tier 2 without Tier 1. Similarly, there could be a mass merchandiser selling a product with virtually no differentiation (e.g. milk, eggs) who may find it cost effective to have a simple loyalty program operating only at Tier 1. Future research may focus on exploring these special cases.

Another area for future research is related to the 'timing' of Tier 2 reward. As per the framework, Tier 2 reward may be offered pro-actively to the customer at virtually any time instance. Further research related to the optimal timing of Tier 2 reward so as to maximize the impact is warranted.

The framework talks about integration of customer level data related to behavioral and attitudinal dimensions to determine the objective of Tier 2 reward. In practice, it may not be feasible for companies to have attitudinal data for each customer. This may be circumvented by applying statistical techniques to impute the missing data for a set of customers based on the available attitudinal data for another set of customers. Researchers need to explore this limitation further to identify alternative ways to resolve the issue. This is the ideal scenario. Alternatively, companies can still operationalize Tier 2 rewards on the basis of behavioral data alone by integrating it with profitability, customer profile information and CLV measure as practiced by a major airline experienced by one of the authors).

Finally, the framework proposed here is conceptual in nature and based on past research and anecdotal evidence. We invite researchers and practitioners to test the robustness of our framework by subjecting it to empirical testing in different retail contexts. It may be interesting to see the framework perform in a retail service provider as well as a retail product store context.

We conclude on the note that customer loyalty can be a double edged sword. If mismanaged, it can seriously hurt the company's bottom-line. That is, profitability may be compromised for loyalty. But, if customer loyalty is managed prudently and in conjunction with profitability, it could be the most potent weapon against competition in the company's marketing arsenal.

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[12] Bose sells high quality audio equipments. The company is known for its cutting edge research in acoustics and sound engineering. Source: Bose Website: http://www.bose.com.

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