

# Hit or myth: Meaning of 'loyalty' misunderstood

By MATT HASAN

**M**yth: Companies should do the most for their most loyal customers. Many companies in a variety of industries have loyalty programs. The practice, which is based on rewarding frequent buyers, started with the airline industry almost two decades ago, was then adopted by other members of the travel industry, and has now spread to industries ranging from

## Special report

telecom to retail trade. Although each program has its nuances, the basic structure is universal: Award miles or points to customers based on their spend. Almost all such programs allow customers to earn rewards faster by achieving higher levels, such as silver and gold or premier and elite.

The foundation for these programs is the myth that providers should do the most for their most loyal customers.

The first issue that needs clarification is what is meant by "customer loyalty," as the term is used loosely and takes on a wide range of meanings. In this context, loyalty means that a customer continues to do business with a company. The second issue is that the myth seems to imply that customers must be rewarded at increasing rates to keep them loyal. This contradicts the meaning of the word "loyalty," an unconditional and unwavering attachment to something. If it has to be bought, it is not loyalty.

Some might say the issue is one of semantics, and there is merit in that. When providers make statements such as, "We value and reward our loyal customers," they are trying to reinforce a positive trait and elicit desirable action from the customer.

On the face of it, this would be fine if it were simply an issue of semantics with no repercussions for making

effective business decisions. Unfortunately, that is not the case. Companies allocate substantial resources to reward "loyalty" in customers, but are actually providing incentives for the opposite behavior. Customers who stay for rewards, also leave for rewards. Only the ante keeps rising.

To understand the seriousness of this phenomenon, one need only look at the state of the airline frequent flier programs. When the first were introduced, they provided some differentiated value to passengers. This may have prompted some customers to fly more often with that airline, although there is no hard data to validate that assumption. However, as every other airline started its program, the initial differentiating value disappeared. The quest for loyal customers became a contest based on the reward structure. When customer demand for redeeming awards reached a point at which the airlines could not meet it, they imposed restrictions such as blackout dates and designated flights with award seats.

This is tantamount to giving with one hand and taking away with the other. In fact, this makes most of these programs dormant financial time bombs. If every program member demanded everything they are promised at one time, the programs would have to shut down. The essence is that the loyalty programs are good for neither customers nor providers.

What companies need to do is establish win-win relationships with each customer based on an understanding of their internal loyalty intensity. In this approach, the most loyal customers are the ones with the highest inherent propensity to stay with their current provider. Research, including mine, has shown that this internal loyalty intensity can be measured by applying appropriate statis-



tical and neural methods to carefully defined and compiled customer attribute data.

This propensity is based on internal attributes consisting of psychoeconomic-demographic characteristics for consumers and culture-tradition-history-structure characteristics for businesses. The complex interrelationships between these various characteristics determine the implicit cost of switching providers for any given customer.

The higher the implicit switching cost, the more likely it is that that customer will continue to do business with the current provider. From this it follows that customers who are intrinsically most loyal need the least amount of rewards or incentives from their provider.

In order for loyalty programs to be truly effective, companies should determine the inherent loyalty propensity of each customer and allocate rewards to them on the basis of their "true worth," which is calculated from their loyalty intensity score, lifetime revenue stream, and all direct and indirect costs incurred in serving them. ■