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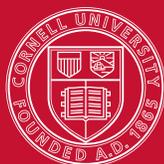


## Building Customer Loyalty: Ten Principles for Designing an Effective Customer Reward Program

### Cornell Hospitality Report

Vol. 10, No. 9, June 2010

by Michael McCall, Ph.D., Clay Voorhees, Ph.D., and Roger Calantone, Ph.D.



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Center for Hospitality Research  
Cornell University  
School of Hotel Administration  
489 Statler Hall  
Ithaca, NY 14853

Phone: 607-255-9780

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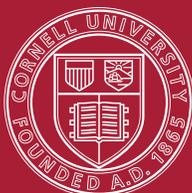
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# Building Customer Loyalty:

## Ten Guiding Principles for Designing an Effective Customer Reward Program

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### EXECUTIVE SUMMARY

**R**eward programs are incentives designed to create loyalty among customers and to provide the best rewards to the “best” customers. These programs have proliferated in the hospitality industry for nearly three decades, with little direct evidence that they actually build either attitudinal or behavioral loyalty. While program implementation seems to have expanded exponentially, the actual components and structure of any given program appears to be driven more by what the competition is offering rather than demonstrated effectiveness. This report (1) identifies program components that have been shown to be effective, and (2) offers a series of guiding principles that hospitality and marketing managers should find useful in designing and modifying their reward programs. Although there is no universal recipe for reward program success, the ten guiding principles adduced in this report could assist managers in leading the conversation on how to make their programs more effective. Key points include finding genuine ways to rewards guests, differentiating the loyalty program from those of competitors, and continually reevaluating tier requirements to ensure continued guest participation.

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## ABOUT THE AUTHORS



**Michael McCall**, Ph.D., is professor and chair of the department of marketing and law in the School of Business at Ithaca College and a visiting scholar at the Cornell University School of Hotel Administration ([mm114@cornell.edu](mailto:mm114@cornell.edu)). He has published over 40 articles in such journals as the *Journal of Food Service Business Research*, *International Journal of Hospitality Management*, *Journal of Applied Psychology*, and *Decision Sciences Journal of Innovative Education*, and *Cornell Hospitality Quarterly*.

**Clay Voorhees**, Ph.D., is an assistant professor of marketing at the Eli Broad College of Business at Michigan State University ([voorhees@bus.msu.edu](mailto:voorhees@bus.msu.edu)).

His chief research interest involves social exchange and influence, including customer experience management, customer relationship development, return on marketing investments, and segmentation models. Among other journals, he has published in the *Journal of the Academy of Marketing Science*, *Journal of Retailing*, *Journal of Service Research*, *Strategic Management Journal*, *Journal of Services Marketing*, and *Cornell Hospitality Quarterly*, and he has made numerous conference presentations.



**Roger Calantone**, Ph.D., the Eli Broad Professor of Business, is chair of the marketing department and is co-director of the Institute for Entrepreneurship at the Eli Broad College of Business at Michigan State University ([rogercal@msu.edu](mailto:rogercal@msu.edu)). His chief research interests include product design and development processes; decision support; pricing and price perception; and economic impact. Among his many publications are articles in the *Journal of Product Innovation Management*, *Journal of the Academy of Marketing Science*, *Journal of World Business*, *Journal of Business Logistics*, and *European Journal of Marketing*. He has received numerous awards for publishing excellence and for his conference presentations.

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**T**he concept of a customer loyalty program can be traced at least as far back as 1896 when Sperry and Hutchinson launched its Green Stamp program. Under this program, Sperry and Hutchinson sold “green stamps” to retailers that were then provided to customers as a reward for their patronage. Customers could paste their stamps into books, and redeem those filled books for a variety of products in the S&H Green Stamp catalog.<sup>1</sup> The green stamp phenomenon provided a clear demonstration of the potential of reward programs, as it created an advantage for retailers that offered the stamps and created a risk for retailers that did not offer such a program. Building on this basic concept of customer rewards, American Airlines launched the first contemporary hospitality industry customer reward program in 1981.<sup>2</sup> Soon after, numerous hospitality and retail firms followed suit and developed rewards programs focused on rewarding their “best” customers, with the goals of securing their loyalty.

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<sup>1</sup> “History of Loyalty Programs,” *FrequentFlier*, <http://frequentflier.com/ffp-005.htm> (as viewed February 3, 2008).

<sup>2</sup> “American Airlines AAdvantage Program Details, AAdvantage, [www.aa.com](http://www.aa.com) (viewed May 23, 2010).

Thirty years later, most hospitality and retail firms maintain some kind of frequent guest rewards program. Despite the programs' proliferation, many questions remain unanswered as to how these programs can be designed and managed for best effect. We have frequently heard the following two questions from managers:

- What are the key success drivers among the best programs?, and
- How can a program differentiate itself in a sea of commoditized reward programs?

Noticeably missing from the hospitality and marketing literature is a comprehensive set of guidelines to address these questions and give direction to hospitality managers on how they might manage their programs. In this report we seek to provide a starting point for managers looking to launch or reinvent their rewards program. We do this by identifying ten guiding principles based on concepts of human behavior and consumer psychology that we believe provide insight into the best and worst of customer reward program practices.

### Basic Components of a Loyalty Program

References to improving the customer experience and fostering loyalty have appeared in the hospitality literature dating back many decades, including the initial bibliography of hospitality publications issued in 1960 in the *Cornell Hotel and Restaurant Administration Quarterly*.<sup>3</sup> Over the years, scores of academics have tackled theoretical and practical issues surrounding customer loyalty and its antecedents. A recent wave of research has attempted to deconstruct the factors that underlie loyalty program effectiveness. In a review of this research, we suggest that the main drivers of loyalty program

<sup>3</sup> Kay Spinney and Blanche Fickle, "A Bibliography Especially Prepared For Hotel And Restaurant Administration and Related Subjects," *Cornell Hotel and Restaurant Administration Quarterly*, Vol. 1, No. 2 (August 1960), pp. 43-103.

effectiveness can be categorized into the following three main "buckets":

- The structure of the loyalty program,
- The structure of the rewards, and
- Customers' fit with the loyalty program.

The recommendations that we put forth in this report are built on these three drivers. We examine how each of the program components interact to produce both positive and negative effects for both the firm and the customer.<sup>4</sup> Exhibit 1, on the next page, presents an overview of these principles.

### Principle 1: Foster Customer Engagement

A key feature of any successful loyalty program rests in its ability to go beyond simple repeat purchase behavior to the point that it engages the customer through numerous positive interactions. Repeat business does not necessarily mean loyalty,<sup>5</sup> and true loyalty is more than repeat purchases. Loyalty programs should be aimed at fostering a deep emotional connection between the customer, its employees, brands, and the broader organization. This type of connection only comes from repeated positive interactions and experiences with a brand.

Programs that are designed to reward a broad set of "loyal behaviors" like engagement activities should see stronger involvement in the program and an increase in both attitudinal and behavioral loyalty among its members. For example, at the basic level, customers could be provided rewards for simply updating and confirming their

<sup>4</sup> M. McCall and C.M. Vorhees, "The Drivers of Loyalty Program Success: An Organizing Framework and Research Agenda," *Cornell Hospitality Quarterly*, Vol. 51, No. 1 (February 2010), pp. 35-52.

<sup>5</sup> R.N. Bolton, R. K. Kannan, and M. D. Bramlett, "Implications of Loyalty Program Membership and Service Experiences for Customer Retention and Value," *Journal of the Academy of Marketing Science*, Vol. 28 (2000), pp. 95-108.

## Ten guiding principles for customer reward program design and management

### Foster Consumer Engagement

- Loyalty is more than repeat purchases, and programs must evolve to foster a deeper emotional connection between the customer and firms.

### Establish a Two-Way Value Proposition

- Programs should offer rewards that simultaneously provide high value to the consumer and carry low internal costs.

### Capitalize on Consumer Data

- Marketers can take use the potential of the loyalty program to capture data on your consumers that can be used to better meet their needs.

### Properly Segment Across and Within Tiers

- Rather than simply adopting tier structures based loosely on precious metals, managers should revisit their programs and segment based on actual spending, engagement, and consumer profiles.

### Develop Strategic Partnerships

- Because consumers crave variety, programs can develop two-way partnerships, and thereby increase their value to consumers.
- Another type of partnership involves more collaboration with academic researchers armed with an array of statistical tools, psychological and economic theories, intellectual curiosity, and the time to take a deep dive into emerging research questions on loyalty program management.

### Develop Dynamic Tiers

- Managers need to develop switching barriers to keep program members loyal to the organization as they clear spending hurdles for tier membership. One mechanism for this is to offer smaller and potentially spontaneous rewards between the major tier milestones to encourage continued customer loyalty and deter switching.

### Cater to Consumers' Desires for Choice and Fairness

- Consumers love choice and control, and so programs can offer a relatively broad set of rewards, based on consumers' desires. Programs can also give members flexibility in their redemption intervals and choices.

### Avoid Commodization through Differentiation

- Just as marketing managers would never blindly copy the marketing mix of their competition, loyalty managers must strive to develop points of differentiation associated with their program and then properly position their programs against the competition.

### Avoid the Price Sensitivity Trap

- By focusing only on future discounts, programs may inadvertently convert loyal customers to price-sensitive ones. Thus programs should disguise or downplay price-related benefits.

### Embrace New Technologies

- Programs should take full advantage of mobile devices to offer rewards. Products like FourSquare and other PDA-enabled programs offer the potential to reward consumers in real time for their rewards and the implications for creative program managers are limitless.

contact information as part of annual program maintenance. A simple effort like this one ensures accurate data and creates a reason for customers to visit program websites and see their membership benefits. Building on this baseline, companies should consider providing rewards for other forms of engagement, such as membership in brand communities or specialized brand events. Generating this level of customer involvement increases opportunities to foster emotional connections with customers and offers the indirect benefits of increasing awareness of the program among a broader customer base.

### **Principle 2: Establish a Two-way Value Proposition**

Design your program so that it offers rewards that provide high value to the customer yet carry low internal costs. A core tenet of customer relationship marketing is that satisfaction is a product of a mutually successful exchange that comes about when both parties believe that they have received something of value.<sup>6</sup> While customers will almost certainly accept product discounts as a reward for patronage, they may not necessarily place a high value on those discounts. As we explain in a moment, discounts may actually diminish the value proposition. Consequently, a retailer may be offering a reward that discounts the price of a product even though the customer would be willing to make the purchase at the original price.

Instead, reward programs should offer rewards that customers truly value. So, in place of a monetary discount on an existing or future hotel stay (low customer value, high cost), the hotel might instead offer that customer free use of a service for which the hotel usually charges (e.g., fitness facilities, wifi). This provides high customer value at low cost. By considering both value and cost, the firm would maximize its flexibility in offering a reward while at the same time optimizing the value-cost relationship.

The challenge with this principle lies in implementation, because it requires knowledge of customers' preferences. Not all customers will place equal value on all activities.<sup>7</sup> Managers will need to use their ability to learn about program members to identify reward categories that have high value to individual customers, while still having relatively low internal cost to the firm. Based on this research the program can offer flexible reward tiers that deliver on both sides of the value proposition.

<sup>6</sup> R. Buchanan and C. Gilles, "Value-managed Relationship: The Key to Customer Retention and Profitability," *European Management Journal*, Vol. 8, No. 4 (1990), pp. 523-526.

<sup>7</sup> P. Danaher, D. Conroy, and J.R. McColl-Kennedy, "Who Wants a Relationship Anyway? Conditions When Consumers Expect a Relationship with Their Service Provider," *Journal of Service Research*, Vol. 1, No. 11 (2008), pp. 43-62.

### **Principle 3: Capitalize on Customer Data**

As we said, programs should be based specifically on customer preferences. When we asked one gaming executive how he felt about his loyalty programs, he replied that they were the best marketing research expense on his balance sheet. He believed that even if the program provided no direct improvement in customer spending, the amount of personal information and purchase data that he can collect via his program makes it his single best source of marketing research data. Thus, hospitality operators should ensure that their programs are optimized to capture data on customers, as well as drive loyalty. Loyalty and research initiatives should be integrated to use customer insights not just for their loyalty programs, but for the broader business operations.

As hospitality firms seek to control costs in all areas, managers often find themselves striving to justify loyalty programs' existence. By documenting the steps that connect program data to customer spending, program managers can demonstrate the value of their programs. Better yet, through collaboration with the marketing research department, controlled studies can be developed that compare expenditures between program members and non-members, which could provide preliminary estimates of the incremental business offered by the loyalty program.

### **Principle 4: Properly Segment across and within Tiers**

The tier structure of loyalty programs must work for your customers. Most reward program tiers seem similar to those of existing programs. We see these as antiquated hierarchies usually based on precious metals (e.g., platinum, gold, silver, or tin). Managers need to take a second look at their tier structure to identify opportunities to collapse tiers or possibly develop new tiers, based on customer spending and interests. For instance, one well-known hotel chain offers their first reward tier after customers stay a minimum of 10 nights. While this reward is relatively easy to earn, the next upgrade occurs when the traveler reaches 50 nights in 12 months. The concern that emerges here is whether these tiers differentiate the chain's customers according to their loyalty behavior. Chances are that the customer who stays 10 nights or less is fairly similar to the customer who stays 11 nights (or a few more than that). However, those customers in the low end of the second tier (staying 11 nights or a bit more than that) are almost certainly different from someone at the top end of that same tier, who stays 49 nights or so. Despite these likely differences, the reward program is structured so that both the 11-night and the 49-night customer are earning the same rewards, even though these two customer groups are likely to have distinctively different needs and desires. Further, the gulf from one reward status to the next is

so great that when a customer achieves the first status level she will likely conclude that the next level (40 additional nights) is not attainable. That customer is likely to shift her spending to the competition for the balance of the reward period in an effort to manage her “portfolio of rewards” for her lodging patronage. Thus, this tier structure provides an unintentional incentive for customers to shift to another hotel brand so that the customer can then earn rewards from multiple brands.

Instead of an arbitrary or imitative tier structure, it makes sense for program managers to look carefully for non-linearities in spending that may represent opportunities to further segment groups. Managers must also attend carefully to within-tier anomalies where both the preferences and needs of customers within a given tier level might differ. Given appropriate market research, the reward structure should match the diverse needs of customers within specific spending tiers.

Managers should also consider the opportunities for segmenting programs based on factors other than spending. For example, CVS recently launched a spin-off from its standard ExtraCare program exclusively for diabetes patients. By making subtle changes to the rewards that are offered and to its supplemental services, the pharmacy may have discovered a simple way to differentiate its program among diabetes patients by simply recognizing their needs and offering rewards that better align with those needs.

### **Principle 5: Develop Strategic Partnerships**

Program managers are beginning to recognize the possibilities for making strategic partnerships. These partnerships allow the programs to improve their offerings, while developing a better understanding of the programs’ true impact. The first type of partnership, which we refer to as “corporate alliances,” offers a program the ability to extend the breadth of rewards. The second, which we term “independent insight,” deals with the need for programs to seek outside evaluation perspectives.

**Corporate alliances.** Loyalty program partnerships involve one firm providing their customers with the option of exchanging their rewards for offerings from firms in other industries. Administration of such arrangements are typically outsourced to a third party or are structured as one-way agreements, where one provider simply compensates other providers for their inclusion in the rewards offerings. We believe that these strategic partnerships, both within and outside the industry, could involve two-way reciprocal agreements, where both organizations bring value to the other’s program. Moreover, hospitality operators should evaluate their existing relationships to develop a simple portfolio of partners that provide maximum value to their customers. The partnerships should strike a balance

between offering a broad set of rewards and overwhelming customers with numerous options. Once again, research efforts focused on capturing program members’ desires could help guide these decisions.

**Independent insight.** We also see an opportunity for more collaboration with independent parties, but we also acknowledge that most managers barely have time to run their operations, let alone think about alternative arrangements or reexamine their assumptions about their programs. One possibility for operating and strategically advancing a rewards program is to engage a firm that specializes in loyalty program design and development. These firms may offer the benefit of an outside perspective coupled with experience in analogous industries. By introducing a fresh perspective on the program’s strategy, it may be possible to identify opportunities for improvement that were masked by internal, operational challenges.

We also believe that firms could partner with academic researchers to investigate issues relating to loyalty programs. We see the needs of managers and marketing academics aligning perfectly in the context of loyalty program management and optimization.<sup>8</sup> Many managers are in need of additional support and insight on their programs, and marketing faculty are constantly searching for opportunities to re-analyze existing databases or develop new studies to better understand customer loyalty.

### **Principle 6: Develop Dynamic Tiers**

Loyalty programs must develop switching barriers that discourage customers from jumping from one program to another, as in the case of the hotel company program that we mentioned above. Since we know that customers will develop a portfolio of loyalty programs within product categories, organizations risk losing those customers’ repeat business as customers clear tier hurdles. As we noted before, once customers achieve a tier reward, if they conclude that they will not be reasonably able to reach the next hurdle, they can shift their business to the competition to solidify their rewards from that competitor’s loyalty program. Switching barriers can discourage your customers from straying to the competition merely for loyalty points. One such barrier is to offer relatively small rewards (possibly undocumented) between the major tier milestones to encourage continued customer loyalty and deter switching.<sup>9</sup> These strategies are based on the basic tenets of reinforcement schedules, where providing a mix of continuous rewards in conjunction with each transaction in combination with seemingly spontaneous, higher value rewards may have the biggest impact on

<sup>8</sup> McCall and Vorhees, *op.cit.*

<sup>9</sup> J.C. Nunes and X. Dreze, “The Endowed Progress Effect: How Artificial Advancement Increases Effort,” *Journal of Consumer Research*, Vol. 32, No. 4 (2006), pp. 504-512.

behavior. As an example, provided the hotel is not sold out, guests in a particular tier could sometimes be offered a choice of room type at no extra charge, a reward that costs the hotel essentially nothing. Managers who are able to offer small rewards that reinforce loyal behavior are likely to see improved patronage from their customers. The operationalization of these strategies will differ based on context, but the identification of low-cost rewards that can keep program members both interested and motivated in the program could greatly reduce brand switching. The following are some other examples of this strategy:

- Hotel chains might offer continuous upgrades in terms of room style, location, and amenities while customers work their way through each tier level;
- Restaurants may be able to provide upgraded beverage service or desserts, or perhaps offer prime-time reservations to program members in certain tiers; and
- Casinos can track customer beverage preferences and offer real-time rewards as the patron moves through the property.

### **Principle 7: Cater to Customers' Desires for Choice and Fairness**

Customers love choice and control,<sup>10</sup> so your loyalty program could provide customers with flexibility in their redemption intervals and choices. Just as most retailers won't carry just one brand in a product category, hospitality operators should not offer a single set of narrow rewards. A key component in the S&H Green Stamp program was that customers could choose their rewards along with the "level" or "timing" of their redemption according to the number of stamp books they filled. Although we're not necessarily suggesting that you maintain a catalog offering kitchenware, folding chairs, and bicycles, flexibility in reward redemption may build engagement from customers when they feel that they have control over the benefits they receive in the program. A simple example of this strategy is Best Buy's Premier Silver program. Among other features, program members can choose when they receive rewards as well as the medium by which the rewards are delivered (i.e., via the program website, via email, or via snail mail), rather than simply mailing rewards at pre-established set intervals. Best Buy also offers customers the opportunity to "bank" their rewards, which provides customers control over their program benefits and may even assist customers in setting upgraded purchase goals.

<sup>10</sup> A. Smith and L. Sparks, "It's Nice to Get a Wee Treat If You've Had a Bad Week; Consumer Motivations in Retail Loyalty Scheme Points Redemption," *Journal of Business Research* (2008).

Building on the notion of control in the program, customers also crave a feeling of fairness in their exchanges. Put simply, customers want to feel that they have earned their rewards, in part because achieving a reward tier is a matter of some distinction. When rewards appear "too easy" to earn, the prestige associated with program and tier membership diminish, along with the allure of the program itself. As a result, managers must carefully develop a rewards mix that aligns with the effort required to earn them. This need for balanced rewards that reinforce feelings of exclusivity further reinforce the need to advance beyond simple price-based reward certificates to experience-based rewards that carry a more visible separation of benefits between tiers. Qantas, for instance, has developed a program feature that applies these principles by adjusting its tier membership requirements. Once a customer has earned status in a tier, the point requirements to retain that status are reduced by 15 percent. This means that the member can retain a particular status level with fewer miles, thus increasing engagement and likelihood of continued involvement in the program. At the same time, mileage requirements are clearly explained to program members at the outset, retaining the feeling that the status has been earned.

### **Principle 8: Avoid Commoditization through Differentiation**

Many of the examples we have given in this report are aimed at this principle: Find ways to differentiate your loyalty program. As with any hospitality industry initiative, competitors quickly copy loyalty programs' structure and rewards. Consequently, loyalty programs are essentially reduced to commodities, become just another cost of doing business, and take on the nature of an indirect price war linked to their rewards discounts.<sup>11</sup> In an effort to break this cycle, managers must strive to develop points of differentiation associated with their program and then properly position their programs against the competition.

We do not pretend that this is a simple matter. Program differentiation may be the single biggest challenge currently facing loyalty program managers. There are only so many ways to differentiate a program when all the details of program structure and tiers are completely transparent. We have seen some success with programs that are differentiated by experiences or service benefits that complement the standard "monetary" rewards. These supplements could be as simple as prioritized service, exclusive events, direct access to and consultation with employees, and flexible program management. Supplementing a program with value-added offerings not only helps with differentiating the program, but

<sup>11</sup> S.M.J. Van Osselaer, J.W. Alba, and P. Manchanda, "Irrelevant Information and Mediated Intertemporal Choice," *Journal of Consumer Psychology*, No. 14 (2004), pp. 257-270.

it also encourages more interaction between the customer and firm, creating an opportunity to foster deeper feelings of loyalty.

In addition to service differentiation, some firms have been able to refresh their programs by adjusting the rules by which they reward customers. For example, JetBlue recently shifted from the common “segments flown” loyalty model that has been a cornerstone of frequent flier programs to a “dollars spent” currency for program status. This subtle change provides a profound shift in the value of the program, because it increases the rewards for high volume business customers who pay premiums for convenience. Instead of giving premium customers the same mileage rewards as low-paying coach passengers, JetBlue is now rewarding its most valuable customers in a manner that is appropriate to their program status and is (momentarily) unmatched by their competitors.

### **Principle 9: Avoid the Price Sensitivity Trap**

Another reason to differentiate your program with nonmonetary rewards is that it's important not to focus your program too heavily on price concessions. Many reward programs are still based on a simple design that provides customers with future discounts as a reward for current spending. While these programs have demonstrated some value to firms, they carry a substantial risk of converting traditionally loyal customers to price sensitive ones.<sup>12</sup> By routinely offering customers price discounts throughout a program, two major areas of risk emerge. First, customers may begin to update their expectations for doing business with a firm and may avoid doing business with that company unless a discount is provided. Second, firms may reinforce the importance of price reductions over quality of service in customers' minds and, as a result, customers update their evaluation criteria to place a premium on price discounts. If this occurs, branded firms that typically capture a premium due to service and reputation may begin losing share to competitors that can better meet customers' price demands.

### **Principle 10: Embrace New Technologies**

Loyalty programs should take advantage of technology advances. The days of the punch card or even plastic loyalty cards are quickly vanishing. Products like FourSquare™ and other PDA-enabled programs offer the potential to reward customers in real time. The implications for creative program designs are limitless. We are not advocating technology for the sake of technology, but if the medium offers new benefits, programs should embrace them and let the customer decide. At the basic level, companies can strive to develop effective web support for their programs that allow for customers to

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<sup>12</sup> M. McCall and D. Ogden, “Loyalty, Rewards, and Value: What Do We Want from Our Customers?,” *Casino Journal*; [www.casinojournal.com/cj/hom/files/PDFs](http://www.casinojournal.com/cj/hom/files/PDFs) (viewed April 1, 2009).

easily update their profiles, review reward options, and streamline their exchanges. These improvements should increase customer involvement and satisfaction with a program, while also reducing operating costs.

Customer cards in grocery stores, for instance, can identify purchasing cycles, product replacement intervals, and shopping patterns. Casino loyalty cards can go even further, as they can track guests' gaming choices and their non-gaming activities including, dining, salon usage, and fitness center activity. In addition to having the ability to track purchasing patterns, recent advances in surveillance equipment offers casino managers the opportunity to visually track patrons as they move through the casino.<sup>13</sup> This allows casino managers the opportunity to provide customers with rewards on the spot (such as a favorite beverage). Having the ability to know what your customers are doing at any time can allow managers to anticipate customer needs and preferences thereby increasing customer satisfaction and differentiating their product from that of their competitors.

### **Making the Loyalty Program Work for You**

Although reward programs have been going strong in the hospitality industry for nearly three decades,<sup>14</sup> there is still a lack of empirical evidence that demonstrates a direct causal relationship between program membership and attitudinal and behavioral loyalty. The recommendations that we have outlined here are practical in orientation, but they are derived from various theories of human decision and consumption behavior. In closing, we must reiterate that these recommendations are meant to serve as broad, guiding principles for programs in the hospitality and gaming sectors. Because each company and each program is distinct, there is no universal recipe for designing a loyalty program that is both effective and beyond imitation.

Above all else, the most important strategic investment in any program is customer research. By understanding your customer base and loyalty program members, managers can make informed decisions on how to advance their programs. We think a review of rewards and loyalty program operations is timely, because many seem to have hit maturity, and the companies that can effectively advance their programs through effective differentiation that meets members' needs will capture a lead in the battle for customer loyalty. We hope that the principles introduced in this report can provide managers with an initial set of factors to consider as they evaluate and advance their programs. ■

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<sup>13</sup> Casinos can use other technology. See: David C. Wyld, “Radio Frequency Identification: Advanced Intelligence for Table Games in Casinos,” *Cornell Hospitality Quarterly*, Vol. 49, No. 2 (May 2008), pp. 134 - 144.

<sup>14</sup> J.L. Hoffman and R.M. Lowitt, “A Better Way to Design Loyalty Programs,” *Strategy and Leadership*, Vol. 36 (2008), pp. 44-49.

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