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Reward redemption effects in a loyalty program when customers choose how much and when to redeem

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ABSTRACT

The redemption of loyalty program (LP) rewards has an important impact on LP members' behavior, particularly on purchase behavior before and after redeeming a reward. However, little is known about the interplay between members' purchase and redemption behavior when members are not pressured with point expiration and they choose for themselves when and how much to redeem. In this context, the effects of redemption are not straightforward, as little additional effort is required from an LP member to obtain the reward. Analyzing the behavior of 3094 members in such an LP, we find that the mere decision to redeem a reward significantly enhances purchase behavior before and after the redemption event, even when members redeem just a fraction of their accumulated points. Conceptually, we refer to this enhancement as the *redemption momentum*, which is an alternative and novel explanation of the existence of pre-reward effects that do not depend on points-pressure. In addition to the overall impact of redemption on purchases, prior purchase behavior also enhances redemption decisions. Finally, we find a number of moderating effects on purchase and redemption behavior that derive from the length of LP membership, age, income and direct mailings. Our study's most important managerial implication is that firms should avoid imposing point expiry and/or binding thresholds in order to enhance members' purchase behavior.

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1. Introduction

In recent years, loyalty programs (LPs) have become the dominant tool for loyalty marketing worldwide. In the United States alone, the number of LP memberships exceeded 2.65 billion in 2012, increasing by 26.7% since 2010 (Berry, 2013). LPs aim to engage program members by rewarding their repeated purchases of a firm's product through (the redemption of) loyalty points that members collect on their purchases. Therefore, the benefits of an LP for a member become the most salient when redeeming a reward (Nunes & Drèze, 2006; Smith & Sparks, 2009a). Yet, as much as one-third of \$48 billion worth of LP currency issued in 2010 remained unredeemed (Gordon & Hlavinka, 2011); likewise, *The Economist* estimated that "the total stock of unredeemed miles was worth more than all the dollar bills in circulation" (The Economist, 2005). To reduce liability, LPs introduced minimum thresholds and/or point expiration; however, this may undermine loyalty building efforts and engender customer frustration (Land, 2013; Stauss, Schmidt, & Schoeler, 2005). For example, point expiration is common in the airline industry where, due to restrictions on the

availability of "award seats," LP points often expire before members have an opportunity to cash in points (average award seat availability is only about 60% at major airlines (McCartney, 2012)). On the other hand, LPs are increasingly opting for a no-expiration (or long-term expiration) policy to avoid negative customer experiences. For instance, 96% of credit-card programs promote "no expiration" as their key sales feature (Land, 2013). On the other hand, without the expiration pressure to redeem points, firms fear that members' active engagement may decline and that their loyalty will fade in turn. Whether firms should encourage reward redemption and consider long-term expiration policies ranks among the least understood aspects of LPs (CRMtrends, 2012; Shugan, 2005).

Reward redemption may have an important impact on members' behavior, particularly on purchase behavior just before and after redeeming a reward. Having to reach a pre-specified threshold on time to obtain a reward motivates members to increase their expenditures—an effect known as *points pressure* (Taylor & Neslin, 2005). However, if a customer already has enough points or (s)he has too few points to be able to reach the threshold, the points pressure becomes negligible (Hartmann & Viard, 2008; Lewis, 2004). The question, then, is whether firms can expect redemption effects in LPs without significant binding deadlines that "require customers to jump through hoops to receive a reward" (Blattberg, Kim, & Neslin, 2008, p. 566).

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Unfortunately, the prevailing theoretical mechanisms to explain such effects are equivocal.

If firm-imposed motivators leading to points pressure are removed, then the presence of redemption effects depends on whether the redemption decision by itself impacts behavior. In LPs with continuous and linear rewarding schemes, members obtain a certain amount of LP currency for each dollar/euro spent and choose when to redeem (redemption timing) and what to redeem (redemption amount), based on their personal reward preferences and the collected balance of points (cf. Stourm, Bradlow, & Fader, 2013). Moreover, in continuous LPs, the program itself and/or its points typically do not expire for a longer period of time (e.g., retail LPs). This context allows us to investigate whether redemption effects on behavior in pre- and post-reward period can be evoked by the act of redeeming itself in the absence of firm-imposed thresholds. The decision to redeem points may precede the moment at which the reward is redeemed or it may occur at a point-of-sales without much prior planning, which has direct consequences on behavior.

Analyzing the purchase and redemption behavior of 3094 members in a Dutch continuous LP, we find that in as much as 70% of redemptions, the decision to redeem is made a short time ahead of the redemption. Having made the decision motivates customers within the LP, resulting in an increase in purchase behavior prior to the redemption event, even when customers subsequently redeem just a small fraction of their overall point balance. We label this effect *redemption momentum* and note that this effect complements the *points pressure* effect, which may occur for members who have an insufficient amount of points in the weeks before a redemption.

In the post-reward period, the redemption enhances feelings of gratitude, importance, satisfaction or obliged reciprocity, which may in turn spur purchase behavior (Palmatier, Jarvis, Bechhoff, & Kardes, 2009). However, empirical findings on the post-reward effects on members' behavior are scarce and the results are mixed in the literature. In some cases, points pressure shifts purchases in time and creates post-redemption dips due to stockpiling. This is not expected to occur when members can choose timing and redemption amounts. Our study provides support for positive post-reward effects when customers do not face binding deadlines and can choose the redemption timing and amount.

Finally, redemption effects on purchase behavior may vary across LP members (Kopalle, Sun, Neslin, Sun, & Swaminathan, 2012; Stourm et al., 2013; Zhang & Breugelmans, 2012). In particular, the effects may be moderated by members' prior experience with the LP (length of LP membership) and various socio-demographic aspects (age, income, etc.), as well as the amount of direct mailing promotions that members obtain (Lewis, 2004). Yet, those interaction effects have not been extensively investigated. In response, we provide an integrated analysis of the main and interaction effects.

In summary, the contribution of this paper is threefold. First, we explore whether LPs can foster redemption effects without imposing restrictive deadlines. To this end, we examine alternative mechanisms that drive (pre-)redemption effects and propose the novel *redemption momentum* mechanism, which goes beyond the traditional points pressure explanations. Second, this study tackles the interrelatedness of purchase and redemption decision-making by simultaneously modeling purchase incidence, purchase amount, redemption decision and redemption amount. Moreover, our model studies the interplay between redemption and purchases, accounting both for endogeneity of redemption and endogeneity of personalized mailings to LP members. Third, this study provides an integrated analysis of potential moderating effects, such as relationship length, socio-demographics and direct mailings, on the relationship between redemption and purchases. In this way, our paper answers the call to simultaneously model diverse LP mechanisms to better understand the underlying processes and sources of incremental sales in LPs (Blattberg et al., 2008; Kopalle et al., 2012).

The paper proceeds by discussing the theoretical background and existing studies on the effects of reward redemption. It then continues with the model formulation, a description of the data, the empirical analyses and the results. We conclude with a discussion of key findings and managerial implications.

2. Prior literature

Marketing literature has extensively studied the effects of LPs on customer behavior (Leenheer, van Heerde, Bijmolt, & Smidts, 2007; Liu, 2007). A synthesis of available evidence indicates that, overall, LPs enhance LP members' behavior (Dorotic, Bijmolt, & Verhoef, 2012) through increases in purchase volume/frequency (Drèze & Hoch, 1998; Lewis, 2004; Liu, 2007; Taylor & Neslin, 2005) and share of wallet at the LP provider (Leenheer et al., 2007; Verhoef, 2003). However, the role that reward redemption itself plays in this increase is not clear. Existing research on LP rewards has mainly focused on the attractiveness of different reward types and their impact on profitability (Kim, Shi, & Srinivasan, 2001; Kivetz & Simonson, 2002; Zhang, Krishna, & Dhar, 2000), while reward redemption effects themselves have received relatively less attention (Dorotic et al., 2012; Smith & Sparks, 2009a).

Below we separately review the literature on three key aspects: pre-reward effects, post-reward effects, and the impact of mailings and other main moderators. Table 1 provides an overview of (selected) prior research, summarizes their main findings, and positions our study.

2.1. Pre-reward effects

Literature to date almost exclusively links pre-reward effects to the goal-pursuit theory and the *points pressure mechanism* (Kivetz et al., 2006; Kopalle et al., 2012; Taylor & Neslin, 2005). Points pressure suggests that pre-reward effects are driven by members' anticipation of obtaining future rewards and/or by switching costs, which together constitute the pressure to collect a sufficient amount of points for a reward (Hartmann & Viard, 2008; Kopalle et al., 2012; Lewis, 2004). Researchers provide evidence of pre-reward effects in short-term LPs, in which members must reach a spending threshold during a time-limited period to obtain a pre-specified reward (e.g., "Spend X on groceries within 3 months, get a free turkey" or "Buy 10, get 1 free") (Kivetz et al., 2006; Lal & Bell, 2003; Taylor & Neslin, 2005). In such sales promotion-like LPs, the points pressure is high due to the high potential sunk costs and saliency of explicit goals.

In continuous LPs, empirical support for pre-reward effects is found for those LPs with distinctive customer tiers (Drèze & Nunes, 2011; Kopalle et al., 2012) and for retailers with specific, firm-defined redemption thresholds (Lewis, 2004; Zhang & Breugelmans, 2012). These studies reaffirm that pre-reward effects occur through explicit threshold reward structures set by a firm (e.g., LP tiers or "for each 500 collected points that customers obtain a voucher/discount"). Such a known external threshold may induce pressure to build up purchases to reach the threshold, thereby spurring the points pressure.

Nonetheless, Smith and Sparks (2009a) found that in a typical continuous retail LP, where customers endogenously choose how much and when to redeem, only the smallest group of analyzed redeemers (approximately 10%) demonstrated a planning behavior of saving points in order to reach a higher-value reward. The majority of redemptions seemed to be driven by the notion of rewarding and treating oneself from the accumulated balance, sometimes on impulse (Smith & Sparks, 2009a,b). Moreover, recent psychological insights indicate that goal-pursuit may not be the only mechanism driving LP behavior (Henderson, Beck, & Palmatier, 2011; Wiebenga & Fennis, 2014). The findings of Stourm et al. (2013) indicate that in the absence of firm-driven restrictions on the amount and timing of redemption, members may form latent thresholds of redemption based on their subjective perceptions of their points' value relative to cash. Therefore, the points-pressure mechanism alone may not be sufficient in explaining

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