

# LOYALTY PROGRAMS CHALLENGES IN RETAIL BANKING INDUSTRY

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## Abstract

The purpose of this paper is to examine the challenges of loyalty programs in retail banks in Lithuania. Case study methodology was chosen to analyze the loyalty programs launched by various banks to show how banks are building the loyalty of individual customers and what challenges these banks face. The findings suggest that the majority of analyzed loyalty programs reward a repeat purchasing. Lithuanian retail banks launching loyalty programs for two customer segments – the potentially profitable customers and customers who are willing to keep money in bank accounts. Most of the retail banks loyalty programs offer their customers only a discount on the transaction costs and it could be viewed as an indirect price cut policy which leads to the constant battle for the price. Furthermore, a conclusion is reached that Lithuanian retail banks are offering non-customized loyalty programs and that marketing specialists are not enough familiar with the factors that determine the choice of loyalty programs.

*Keywords:* loyalty, loyalty programs, retail banking.

## Introduction

**Relevance.** Lithuanian retail banking sector has been going through constant changes during the last fifteen years. These changes were caused by establishment and bankruptcy of new commercial banks; the changes of monetary policy; establishment of foreign capital banks, bank mergers and acquisitions. Changes continue to reshape Lithuanian banking business. Over the last years banking market has been undergoing a constant change with intense competition in growing demand for banking services and products during the period of three years (2005-2007) and dramatically declining demand in early 2008. Global financial market crisis that began in the second half of 2008 encourages financial service providers review their customer relationship.

According to Foo, Duglas & Jack (2008), retail banking sector is an increasingly competitive industry where the differentiation level of banking products and services is still very low. Intense competition in financial market is increasing day by day and pushing retail banks that used to be product-oriented to change their strategy; to focus on the customer; to apply the principles of relationship marketing and to see customer loyalty as one of the most important tasks. As financial products and services have attained similar levels of development and technology it can be stated that increasingly demanding consumer is not satisfied with the attributes of banking products (Beerli, Martin & Quintana, 2004). However most of the banks still presents a newly modified products, credit cards, compete on the broader opportunities to provide services through lower-cost sales channels and often "lost themselves" between the technological characteristics of the product and forgot the essential objectives – to build relations with the customer (Colgate & Hedge, 2001; Holland & Westwood, 2001; Ferguson & Hlavinka, 2007). A number of issues such as the commodization of financial products and services, greater choice of financial service providers, new sales channels, more mobile and better informed customers, all contrive to discourage the loyalty of retail bank clients (Colgate & Hedge, 2001; Holland & Westwood, 2001; Beerli *et al.*, 2004; Ball, Coelho & Machas, 2004; Ferguson & Hlavinka, 2007).

**Research problem** – What kind of loyalty programs challenges retail banks are facing in Lithuania?

**Purpose** – This paper aims to examine the challenges of loyalty programs in retail banks in Lithuania.

**Methodology** – Case study methodology was chosen to analyze the loyalty programs launched by various banks to show how banks are building the loyalty of individual customers and what challenges face.

This paper is structured as follows. First, we review the literature on key issues involving customer loyalty concept. We subsequently present case analysis of the loyalty programs launched by Lithuanian banks to retail customers and demonstrate the challenges banks face. We come to an end of the paper with conclusions and future research directions.

### Different approach to customer loyalty concept

There are no common definitions of loyalty - Dick & Basu (1994) defined loyalty as a consumer commitment to the brand or approach to the brand (service, product category, etc.). Loyalty is also interpreted as an expectation to continue a relationship with a particular brand (Wilson, 1995). Generally loyalty has been explained as (1) an active loyalty when a consumer re-use the brand and recommend the brand to others, and (2) a passive loyalty, that is characterized as a not switching even when brand provides less positive conditions. Researchers argue that loyalty is a permanent interaction process between the brand and the user rather than the outcome (Ball *et al.*, 2004; Gee, Coates & Nicholson, 2008). According to Beerli *et al.* (2004) loyalty can be described as (1) a loyalty, based on inertia, when the user purchases a brand again because he/she used to do it, however if the conditions allow the user will replace the product with the competitors brand; and (2) a true brand loyalty when the decision to repeat purchase is made on satisfactory experience and positive attitude toward the preferred brand.

Mostly researchers distinguish between two types of loyalty - behavioural loyalty and attitudinal loyalty (Dick & Basu, 1994; Dekimpe *et al.*, 1997; Samuelson & Sandvik, 1997).

Attitudinal loyalty – a loyalty as an attitude that causes a gradual long-term relationship with the brand. Attitudinal commitment (or strong positive attitude) is a mandatory condition to build true loyalty toward the brand (Uncles, Dowling & Hammond, 2003). The attitudinal loyalty concept was described in a number of research papers, where it was shown that the attitudinal-loyal customers were much stronger affected by negative information about the brand than disloyal customers and were willing to recommend the brand to other users (Uncles *et al.*, 2003; Beerli *et al.*, 2004; Ball *et al.*, 2004). Strong positive arguments toward the brand purchased and positive beliefs can be assessed by the survey, asking how much the user says he/she likes the brand, how much he/she wishes to recommend it to others (Uncles *et al.*, 2003).

Behavioural loyalty model explained by taking references on series of past purchases and only after the consumer motivation and commitment toward a particular brand where analyzed (Uncles *et al.*, 2003). Studies have shown that the vast majority of consumers are "polygamous" - loyal to the line of brand-names in category, and only a limited number of users can be attributed to the "monogamous" (completely loyal to a single brand) or "promiscuous" - disloyal to any trade mark (Uncles *et al.*, 2003). Behavioural loyalty model can be described as a loyalty formed after a number of product purchases when consumer was likely satisfied with the brand attributes and found out that all brands in category are more or less similar (Uncles *et al.*, 2003; Ball *et al.*, 2004). According to Ball *et al.* (2004) both loyalty models - behavioural and attitudinal loyalty - are "highly intertwined".

Uncles *et al.* (2003) identified the third popular profile of loyalty (when the purchase is influenced by individual's characteristics, the environment and the purchase situations) and show that even a positive attitude and strong brand commitment don't matter when the product purchase is confronted with certain co-determined factors (Uncles *et al.*, 2003).

Ball *et al.*, (2004) explain the loyalty as integrity of brand satisfaction, company image, communication and trust, and emphasize that in both business-to-business and business-to-consumer markets loyalty primarily is explained by all the constructs mentioned. Researchers divided the antecedents of loyalty into four main groups: (1) characteristics of the environments; (2) characteristics of relationship; (3) characteristics of the consumer; (4) consumer perception of the company (Ball *et al.*, 2004).

Gustafsson, Johnson & Roos (2005) also singled out three aspects of user loyalty that are essential to the development of the long-term relationship between the consumer and brand (Calculative commitment, Affective commitment and Brand satisfaction). Rowley (2005) proposed categorization of customer loyalty types by segmenting loyal ones into four categories – Captive, Convenient seeker, Contented and Committed – and gave brief description of typical behaviours and attitudes associated with each category.

As Gee *et al.* (2008) state, there are no one commonly accepted description of loyalty and even now still many debates take place on what customer loyalty is and what the key drivers that cause loyalty are. The complexity of loyalty concept leads to persistent debates and differences in interpretation of the concept, even more, researchers stressed the need to examine the concept of loyalty together with the effectiveness of loyalty programs and CRM elements as instruments to build loyalty (O'Malley, 1998; Uncles *et al.*, 2003; Meyer-Waarden, 2008).

## Customer loyalty in financial service sector

According to Ball *et al.* (2004), banking market is specific because of long-term relationships with customers and customers in that sector are valued and encouraged to be loyal by offering a range of values and discounts to them. Beerli *et al.* (2004) highlight that customer retention is one of the key factors that increase the income of the retail bank. According to Baumann, Burton, Elliot & Kehr (2007), although service quality in banking industry is an important factor when building customer loyalty, overall customer satisfaction leads to more loyal customers. In banking business both satisfaction and switching costs can be regarded as loyalty antecedents; however, satisfaction influence on loyalty is greater than the influence of switching costs (Beerli *et al.*, 2004). Researchers established a relationship between overall satisfaction and customer intentions to recommend a bank and to remain a customer. Despite the fact that financial products still are not differentiated, the customers in banking sector can not make objective assessments of service quality, that is why the concept of trust is very important here (Heffernan, O'Neill, Travaglione & Droulers, 2008).

New participants in the financial services market such as on-line brokers, retailers, telecommunication companies have had a huge impact on competitive strategies of market incumbents and forced them to change their strategy, to invest in banking technologies (Holland & Westwood, 2001). On the other hand, the introduction of new technologies may not always have a positive impact on relationships between customer and service provider, and such kind of negative effect is seen in banking sector as well (Colgate & Hedge, 2001; Foo *et al.*, 2008). According to Petersen & Nysveen (2001), the possibility to have financial services through agents changed the attitudes of consumers – customers began to choose financial services forced by rational incentives, their loyalty has decreased. Competition in the retail banking market and relatively low level of differentiation among financial products and services, as well as several other reasons cause permanent changes in the sector and banking marketers are forced to expand using incentive schemes and loyalty programs to build relationships with the customers (Ferguson & Hlavinka, 2007).

Recent changes in worldwide economy forced customer in every market segment to think about relationships with the brands. We could predict some changes in consumer behaviour as well – customers will be more price sensitive, but they also would want being treated even better than before – so economy downturn is a time for service providers (as well as retail banks) to improve communication and service quality, and try to build loyalty through these. A number of studies had identified the links between loyalty customer service, satisfaction and trust. Beerli *et al.* (2004) state that in retail banking sector impact of satisfaction on loyalty is considerably stronger than the cost of switching, and satisfaction is an antecedent of perceived quality. Ball *et al.* (2004) explain the banking sector customer loyalty through the European Customer Segmentation Index model. The survey data shows that banking sector customer loyalty is primarily explained by satisfaction, quality, image and communication, while effect of communication (both the direct and indirect effect) was unexpectedly high (Ball *et al.*, 2004).

This leads to conclusion that in so called “bad times” retail banking service with very low product differentiation level (Colgate & Hedge, 2001; Petersen & Nysveen, 2001; Ball *et al.*, 2004; Ferguson & Hlavinka, 2007) should recognize importance of well-structured communication and spend enough time and resources on creating information that is useful, attractive and valued by customer. Also it could be predicted that if banks will not do a good job in focusing on their customer during the period of economic downturn, soon we will see a high degree of attrition in retail banking segment.

## Building loyalty programs

Tactical marketing approaches like loyalty programs are commonplace in almost all business industries. A company develops and implements loyalty programs as a tool to manage customer loyalty and retention. Loyalty programs are created for a number of reasons, i.e.: to increase brand loyalty, to reduce consumer price sensitivity and their desire to test alternative brands, to reinforce positive word-of-mouth support, to increase the number of users and the number of products purchased, to generate information, to manipulate customer behaviour, etc. (O'Malley, 1998; Uncles *et al.*, 2003; Berman, 2006; Nunes & Dreze, 2006; Meyer-Waarden, 2008).

As O'Malley (1998) states, loyalty programs should provide value to the participants (because of that customer became loyal to the brand), stressed the importance of providing all five elements of value to the customer (rebates or cash value, the range of rewards offered, aspiration value, relevance and convenience) and noticed that not every loyalty program is created like that. According to Uncles *et al.* (2003), loyalty

programs (1) offer economic benefits to brand users and (2) enhance emotional bond between the consumer and the brand. According to Nunes & Dreze (2006), a company must build loyalty program when clear business objectives are identified and it's an only way to establish a proper mechanism and decide whether it works sufficiently. Loyalty program may create exit barriers to customers, encourage consolidation of purchases and buying new products (Nunes & Dreze, 2006). Loyalty programs based on rewards should increased customer loyalty and sales of the brand, encourage behavior change, lowered customer price sensitivity, however some loyalty programs reward not loyalty itself but program membership (Berman, 2006). Foo *et al.* (2008) state that very attractive economic benefits provided by loyalty is a trap - at the end of day we will see established close relationships with the benefits but not with the brand. Even more, loyalty schemes based only on cash value could be easily copied by rivals and it caused nothing more than the price competition between brands. Well maintained loyalty program helps managers to get detailed information about customer behavior that could be helpful while developing personalized communication and offers (Berman, 2006).

Although these programs are expensive to set up and maintain, there are little evidence that any changes in customer loyalty could be gained. Even more, just few current research papers are discussing empirical evidence on effectiveness and profitability of the schemes (Uncles *et al.*, 2003; Berman, 2006) in finance service industry.

### **Loyalty programs in the Lithuanian banking sector**

Customer loyalty and profitable relationships with customers continue to be an important task in banking industry. Nowadays managers in retail banking sector are looking for proper ways to decrease the attrition degree; to generate repeat orders; to measure the loyalty and the profitability of the customers; and to create effective loyalty program designed to build the loyalty.

In this paper loyalty programs launched by the Lithuanian banks are analyzed in order to show how banks are building the loyalty of individual customers and what challenges they face. Case study methodology was chosen to examine bank loyalty programs.

Lithuanian retail banks have recognized the importance of building and strengthening customer loyalty. Loyalty programs do exist in almost every bank in Lithuania. The survey data allows us to clarify some trends in banking sector loyalty creation and we see three categories of loyalty programs adopted in the market:

Relationship banking programs (Ferguson & Hlavinka, 2007). Such programs are known and placed in the worldwide retail bank market for several years, however in Lithuania we found just one bank trying to build customer loyalty under this program. Relationship banking concept programs could be described as programs where customers are recognized and rewarded for the entire relationships with the bank (Ferguson & Hlavinka, 2007); such programs evaluate the usage of all (or multi) financial products and services and provide special service, special price and/or price discount to the customer. The loyalty program launched by Nordea Bank can be referred to as defensive marketing approach that rewarded existing customers because of their adoption of different deposit and loan products. The customer, who has expressed the intention to be the participant of the program, must actively use his/her bank account and a number of financial products. Based on customers' turnover and profitability, the bank classifies the customers in bronze, silver and golden groups, and provides more favorable pricing and customer service to them. When a customer meets the requirements of the golden client, the bank appoints a relationship manager (or service manager) to serve the customer. The analysis of Nordea Bank loyalty program clearly shows that the program was designed as a system of discounts, provided for existing customers. However, the program does not attract potential customers or those that have relationships with other banks as financial service providers. Also we see warning signs indicating that the price cut for bank service, interest rate bonuses are not sufficient stimulus to attract the interest for a customer to use a greater number of banking products or use them more often. We would argue that survey results indicated negative output to the program up-selling and cross-selling expectations.

Programs based on points – these multi-product programs reward points to the customers based on their past purchases and are able to offer specialized communication and promotion, include a comprehensive database, the use of data mining, highly targeted mailings and offers (Berman, 2006). The programs could be described as a powerful tool for relationship marketing strategy. Swedbank launched ZOOM loyalty program opened only to a selected group of young consumers. The program is targeted to

bank customers from 14 to 22 years of age and offers them an attractive design of payment cards. When a person participates in the program, he/she accumulates points. The attractiveness of this program is created by online investment game, various quizzes and prizes. It could be noticed that ZOOM program enables the bank to precisely target special group of customers. Evermore, it could be stated that bank considers on a long time value of the customer rather than on the profit from the recent transactions. The critical aspect for this program is to retain the program members as loyal customers after they will not participate in the ZOOM because of age limit or simply are annoyed with the full-fledged rewards program.

Pure rewards programs – the incentive schemes based on rewards are common in almost all Lithuanian banks and reward the customer for maintaining specific products, rather than focusing on absolute relationship. Various banks, such as Parex, Snoras, Šiaulių Ūkio, etc. today strive to attract competitors' customers to keep money in time deposit accounts and are in constant battle for the price. The banks offer the customer an attractive interest rate for time deposit contracts and extra interest when the deposit is extended, and this is viewed by customer as nothing more but a straight premium on purchases. Such types of schemes provide the same deal for an occasional consumer as well as for a profitable one (Berman, 2006). We could state that pure rewards programs as an aggressive marketing tool can be helpful to increase the portfolio of fixed-term deposits and improve short-term financial performance rates of the banks. Although incentive schemes based on rewards are intended to encourage customer behaviour change, it is questionable whether they will build the long-term customer loyalty. According to Uncles *et al* (2003), the user, who is buying a certain product based on inertia, easily will change the habit if he/she will see any economical or other benefits in doing this. It could be stated that employing pure rewards programs loyalty to the benefits (i.e. program rewards provided) rather than to a brand will be established (or already has been established) in Lithuanian retail banking market. Pure rewards programs are very simply structured, easy to copy and definitely will not create any competitive advantage to the banks participating in the current price war.

### **Limitations and conclusions**

Two main limitations are associated with this case study. First, we have not collected the financial performance data and therefore are not able to discuss cost effectiveness and profitability of the schemes. The second limitation is related to the drivers of customer loyalty in retail banking industry. Future investigations should focus on loyalty program component analysis, customer loyalty measures, customer attraction and profitability, and design and costs of loyalty programs.

The findings suggest that the majority of the analyzed loyalty programs reward a repeat purchasing. The retail banks automatically record individual customer's details and transactions that provide an opportunity for marketing people to organize segmentation and targeting, and create relationship marketing strategy as well as individual marketing offers to the clients. However, the research shows that the banks are basically concentrated on two customer segments – the potentially profitable customers and the customers, who are willing to keep money in their bank accounts. Most of the retail bank loyalty programs offer their customers only a discount on the transaction costs. It could be viewed as an indirect price cut policy, which leads to the constant battle for the price.

The critical issue for the most programs launched by the Lithuanian banks is to reinforce the value proposition of the bank brand, to enhance loyalty toward the brand, not just toward the rewards. Relationship marketing strategy and relationship based loyalty programs are important to retail banking service providers, because it is a right way to build relationship and loyalty.

Furthermore, a conclusion is reached that Lithuanian retail banks are offering non-customized loyalty programs and that marketing specialists are not familiar enough with the factors that determine the choice of loyalty programs.

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