



Reserving for Loyalty Rewards Programs

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Agenda

- **What are loyalty rewards programs?**
- **Overview**
- Actuarial roles in loyalty programs
- Basics of loyalty rewards
- Customer behavior
- Basic estimation methods
- Which program should I join?

What are Loyalty Rewards Programs?

Loyalty rewards programs are marketing programs offered by companies to their customers, where future contingent compensation is earned in exchange for repeated current business. Compensation may be in the form of money, goods, or services.

Loyalty programs have become essential across numerous industries in order to:

- Incentivize repeat business from customers
- Develop an emotional connection with brand
- Differentiate itself from competitors
- Gain valuable insight into consumer behavior and demographics

Examples of loyalty rewards programs



Overview – History of Loyalty Rewards Programs

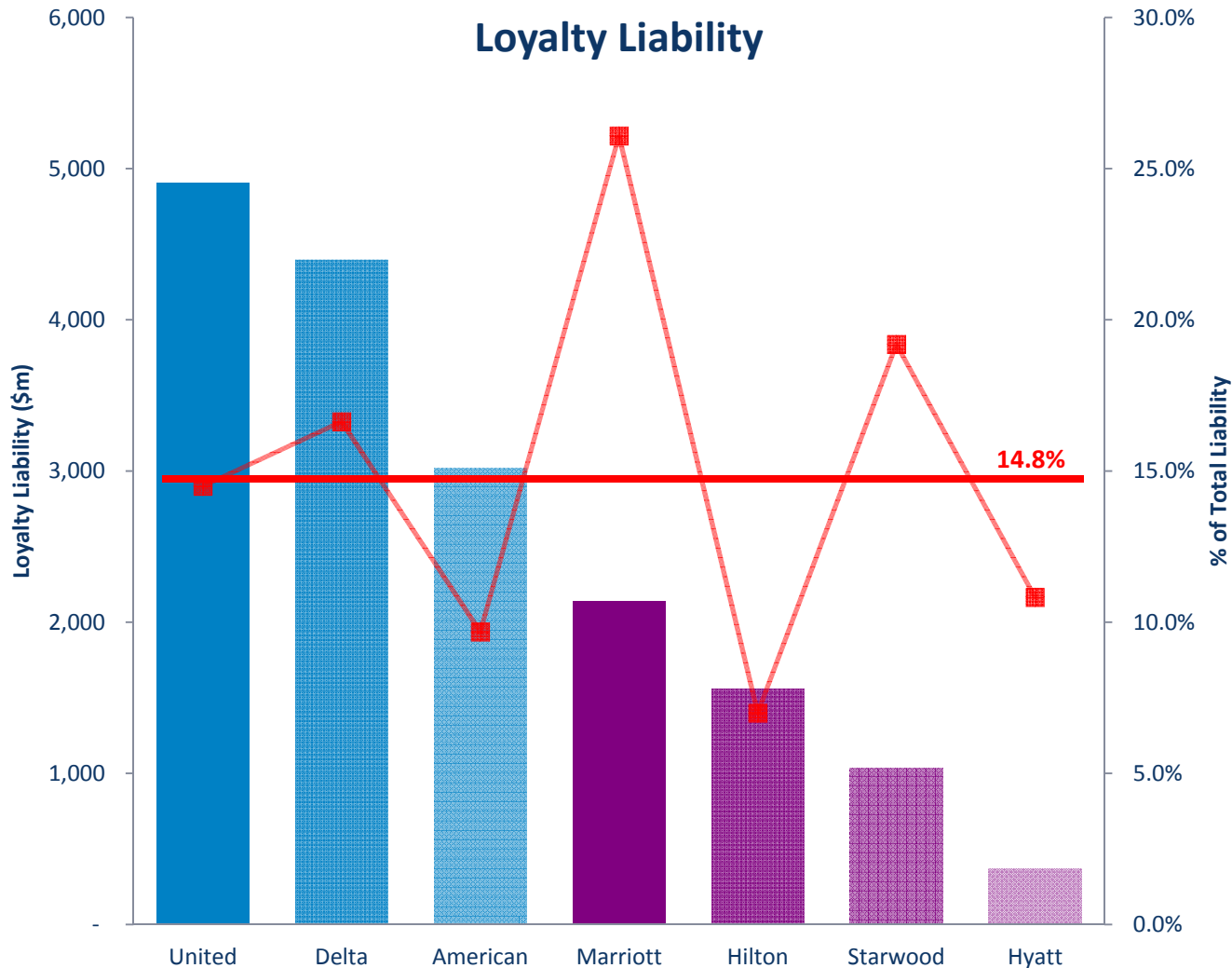
While the use of loyalty programs have varied throughout the years, the ubiquitous spread of these programs can be traced back to the airline industry in the early 80s in the wake of the Airline Deregulation Act in 1978, which increased competition.

- 1981 – Formation of American AAdvantage and other airline programs
- 1983 – Formation of Holiday Inn, Marriott and other hotel programs
- 1989 – Citibank partners with American to offer miles on credit cards

Not all companies were quick to adopt loyalty programs, but the laggards discovered they were losing market share to companies with the programs.

As loyalty programs became more prominent, technological advancements have resulted in cheaper program administration. More importantly, businesses are now utilizing loyalty programs as a key source of data for customer analytics.

Overview – Size of Loyalty Rewards Programs Today



American – 74 million members enrolled with 622 billion miles outstanding at year end 2013

Delta – 271 billion miles redeemed for 11 million flights during 2013

Marriott – Over 50% of room nights in 2013 were purchased by the 45 million enrolled loyalty members

Hilton – 50% of room nights in 2013 were purchased by the 40 million enrolled loyalty members

Source: 10K filings as of December 31, 2013

Overview – How do the programs work?

- Customers enroll as “members” in the loyalty rewards program, agreeing to the programs Terms & Conditions
- As members purchase goods or services, they are awarded “points”
- Members can also earn points via partnerships, such as credit cards
- These points *can* be redeemed for goods or services in the future, subject to the Terms & Conditions (“T&C”)

Overview – Sample Airline Loyalty Program Terms & Conditions

1) Subject to change at any time

2) Conditions of Enrollment

- Open to any person who has legal authority to agree to T&C
- Must complete application
- Only one account per person
- Cannot transfer account nor points to another member

3) Mileage Accrual

- Mileage accruals determined based on nonstop distances between departing and arriving airport
- You may earn mileage only for purchased, eligible, published-fare tickets on qualifying routes – award tickets do not earn miles
- Mileage can also be earned via partners, such as credit cards
- You may request mileage credit for past flights up to 12 months from the transaction date

4) Mileage Redemption

- Available awards and mileage required to be set by the program administrator
- Taxes, fees, and other charges are not included in the award and are paid by the passenger

5) Mileage Expiration

- Mileage subject to expiration after 18 months of inactivity

Overview – Comparison to Insurance

Both insurance and loyalty programs offer to fulfill a future obligation, there are some noticeable differences:

Loyalty Rewards Programs

- Governed by Terms and Conditions (“T&C”)
- Loosely regulated
- Heterogeneous programs
- Limited downside risk for program administrator
- Recorded as an accrued liability or as deferred revenue

Insurance

- Governed by Contract law
- Highly regulated
- Highly standardized products
- Significant downside risk for insurer
- Recorded as accrued liability

These differences need to be considered when using traditional actuarial techniques in estimating the liability for future redemptions.

Overview – Current Accounting Treatment

Companies currently utilize two options to account for loyalty rewards:

- **Incremental Cost approach**– At time of sale, revenue is fully recognized and liability associated with issued points is established. The full revenue and full cost of the redemption are recognized at the time of sale.
- **Deferred Revenue approach**– At time of sale, a portion of the revenue associated with anticipated future redemptions is set aside as a deferred revenue liability to be recognized when the future redemption occurs. Only part of the revenue is recognized at time of sale, while the remaining revenue along with the cost of the redemption are recognized at the time of redemption.
- Key difference is the timing of the recognition of revenue and expenses

Overview – Current Accounting Approaches

Airline Industry

- Either Incremental Cost or Deferred Revenue approach utilized for miles earned from flights
- Deferred Revenue approach utilized for miles sold to credit card companies

Hotel Industry

- Deferred Revenue approach utilized for both points issued from stays as well as points sold to credit card companies

Food Service Industry

- Either Incremental Cost or Deferred Revenue approach utilized for rewards earned from purchases

Overview – Future Accounting Landscape

The FASB and IASB issued a new global revenue recognition standard on May 28, 2014, which will become effective in December 2016. This guidance requires companies to identify “material rights” to specific “performance obligations” and recognize revenue as each “performance obligation” is satisfied.

Given the importance of loyalty programs to the airline and hotel industries and the specific mention of loyalty programs within examples in the guidance, it is likely that loyalty programs will be considered within the scope of the revenue recognition standard.



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