



**IMPACT OF SERVICE QUALITY ON CUSTOMER
SATISFACTION AND CUSTOMER LOYALTY:
A STUDY OF ISLAMIC BANKS IN BAHRAIN**

BY

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**A dissertation submitted in fulfilment of the requirement for
the degree of Doctor of Business Administration**

**Graduate School of Management
International Islamic University Malaysia**

SEPTEMBER 2016

ABSTRACT

In today's intensive competitive world, capability of high-quality service is maintained by firms as a source of competitive advantage which is sustainable. Well satisfied customers are attained by firms which could provide higher quality services, which in turn results in loyal customers. For that matter, the satisfaction of customers has become the pivotal study of service marketing and operations management. Service firms such as banking services, including Islamic banking service, are vital to the economy of any country, as this sector contributes increased portion to its Gross Domestic Product (GDP) and higher employment rate. The survival, profitability and competitive advantage of the bank in today's environment, lie on the bank's ability to offer excellent service quality. Therefore ways to provide high quality products and services to satisfy existing and potential customers to make them remain loyal is utmost important. In spite of the increasing numbers of Islamic Banks in the Bahraini banking industry, very little empirical investigation has been carried out in understanding the impact of service quality that lead to customer satisfaction and customer loyalty. The current study thus endeavours to close the gap in the literature by focusing on the impact of service quality on customer satisfaction and customer loyalty in the Islamic banking sector of Bahrain. The present study has used SERVPERF model of service quality proposed by Cronin and Taylor (1992). Quantitative method was used for the current research. A well-structured questionnaire was personally administered by the researcher to obtain what will be the primary data for this research. A 7 point Likert scale has been used with "1" being strongly disagreed and "7" being strongly agreed. The study has used statistical software SPSS 20 to organize, classify and analyse all the data collected. The results indicated that the effect of Service Quality (SQ) on Customer Satisfaction (CS) and also the effect of Customer Satisfaction (CS) to Customer Loyalty (CL) were statistically significant supporting Hypothesis (H1) and Hypothesis (H3). Meanwhile, Service Quality (SQ) had not any significant effect on Customer Loyalty (CL) rejecting Hypothesis (H2). Furthermore, the results showed that Customer Satisfaction (CS) fully mediates the relationship between Service Quality (SQ) and Customer Loyalty (CL) which supported the hypothesis (H4). From the moderation analysis, it was found that neither Gender nor Educational level of respondents could moderate the relationship between Service Quality (SQ) and Customer Satisfaction (CS). Therefore the hypotheses (H5) and (H6) were rejected. This empirical study adds value to the current knowledge of Islamic banking service providers' practices. To apply these findings to craft a strategy for better future and concentrate on their positioning in the market and also to offer enhanced service quality to their customers, would lead the Islamic banks in general and Bahrain in particular to new heights of competitiveness and sustainability.

خلاصة البحث

في عالم اليوم شديد المنافسة، تحتفظ الشركات بقدرتها على تقديم خدمات ذات جودة عالية كمصدر للميزة التنافسية المستدامة. رضا العملاء يتحقق بواسطة الشركات القادرة على توفير خدمات ذات جودة عالية، والتي بدورها تؤدي إلى كسب ولاء العملاء. لأجل ذلك فقد أصبح رضا العملاء محورا لدراسة تسويق الخدمات وإدارة العمليات. تعد شركات الخدمات، مثل شركات الخدمات المصرفية بما في ذلك الخدمات المصرفية الإسلامية ذات مكانة ذات أهمية اقتصادية جوهرية للدولة. ذلك لأن هذا القطاع يسهم في زيادة حصة الناتج المحلي الإجمالي والرفع من معدل توظيف الموارد البشرية. البقاء والربحية والميزة التنافسية للبنك في البيئة المعاصرة، تعتمد على قدرة البنك على تقديم خدمات نوعية ممتازة. لذلك فإن وسائل توفير منتجات وخدمات عالية الجودة لكسب رضا العملاء الحاليين والمحتملين وضمان ولاؤهم للشركات شيء في غاية الأهمية. وعلى الرغم من تزايد أعداد البنوك الإسلامية في الصناعة المصرفية البحرينية، تم تنفيذ جهود متواضعة جداً في مجال البحث التحريبي لفهم تأثير جودة الخدمة على رضا العملاء وولائهم. وبالتالي تسعى الدراسة الحالية إلى سد الفجوة في الدراسات السابقة من خلال التركيز على أثر جودة الخدمة على رضا العملاء وولائهم في القطاع المصرفي الإسلامي في البحرين. وقد استخدمت هذه الدراسة نموذج (SERVPERF) لجودة الخدمة الذي اقترحه كرونين وتاييلور (1992). وقد استخدم البحث الحالي الأسلوب الكمي. وأشرف الباحث شخصياً على عملية توزيع استبانة منظمة بشكل جيد للحصول على البيانات الأولية لهذا البحث. وقد تم استخدام مقياس (LIKERT) المحتوي على 7 نقاط، حيث تمثل النقطة "1" معترض بشدة و تمثل النقطة "7" موافق بشدة. وقد استخدمت الدراسة البرنامج الإحصائي (SPSS 20) لتنظيم وتصنيف وتحليل جميع البيانات التي تم جمعها. وأشارت النتائج إلى أن تأثير جودة الخدمة (SQ) على رضا العملاء (CS)، وكذلك تأثير رضا العملاء (CS) على ولائهم (CL) كانت ذات دلالة إحصائية داعمة لفرضية (H1) وفرضية (H3). وفي الوقت نفسه، لم يكن لجودة الخدمة (SQ) أي تأثير كبير على ولاء العملاء (CL) رافضة لفرضية (H2). وعلاوة على ذلك، أظهرت النتائج أن رضا العملاء (CS) يتوسط تماماً العلاقة بين جودة الخدمة (SQ) وولاء العملاء (CL) داعماً لفرضية (H4). ومن ناحية تحليل الاعتدال، تبين أنه لا الجنس ولا المستوى التعليمي يتوسط العلاقة بين جودة الخدمة (SQ) ورضا العملاء (CS). لذلك تم رفض الفرضيات (H5) و (H6). أضافت هذه الدراسة التحريبية قيمة للمعرفة الحالية في ممارسات مقدمي الخدمات المصرفية الإسلامية. لتطبيق هذه النتائج في صياغة استراتيجية لمستقبل أفضل والتركيز على إنزالها في السوق المناسبة، وأيضاً لتقديم وتعزيز جودة الخدمة لعملائها، من شأنه أن يقود البنوك الإسلامية بشكل عام والبحرين بشكل خاص إلى آفاق جديدة من التنافسية والاستدامة.

APPROVAL PAGE

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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Say: *“Indeed, my Lord has guided me to a straight path - a correct religion - the way of Abraham, inclining toward truth. And he was not among those who associated others with Allah.”*

Say, *“Indeed, my prayer, my rites of sacrifice, my living and my dying are for Allah, Lord of the worlds.”* (Quran 6: 161-162)

In accordance with the above Quranic injunction, I dedicate this study to Allah (s.w.t) – The Lord and Sustainer of the entire universe. It is also dedicated to all those who value education and who will not allow age to dissuade them from striving to acquire knowledge for the benefit of mankind as Prophet Muhammad (PBUH) said: “Seek knowledge from cradle to grave.”

*I would like to dedicate this work in the loving memory of my grandfather, **Ch. Nazir Ahmed**. His love for me and thirst for knowledge continue to inspire me today.*

*I dedicate this study to my beloved mother, **Prof. Mussarat Ara**. From an early age, she instilled in me a longing to learn and made sacrifices so I would have access to a high quality education. She always taught me that education guides every path in life. The strongest advice she offered was that, no matter what I do in life, to make sure that I do my best and reach to the highest levels possible. Without her love, support and guidance I would not be here where I am today.*

*I also dedicate this study to my uncle, **Dr. Khalid Farooq Ahmed** and my dear sisters, **Sadia Javed** and **Imama Tayyaba**, for their constant support and love.*

*Finally, I dedicate this study to my son **Fateh Ali Ahmed**, my nephews **M. Musa**, **M. Harun**, **M. Ibrahim** and **M. Ismael** and nieces **Maryam** and **Sarah Ahmed** whose smiles, kisses and hugs were truly a source of peace during times of stress, deadlines and numerous responsibilities.*

ACKNOWLEDGEMENTS

Over the course of the past two years, while writing my dissertation for Doctor of Business Administration (DBA), I have realized two things: first no dissertation is ever really finished and second thanking every collaborative person who helped me to accomplish this work is truly important to me in my career advancement.

The journey to a doctoral degree was a trek demanding puritanical consecration. No such endeavour could be realized without congeries of support able to set the milieu capable of stimulating the requisite motivation. I first thank Allah (*s.w.t.*) as the prime organizer who set in place all the necessary factors that I would need to begin, to continue, and to complete this journey.

This DBA dissertation would not have been possible without the guidance and the help of my family, professors and mentors, friends and several individuals who in one way or another contributed and extended their valuable assistance in the preparation & completion of this study.

To my family, thank you for encouraging me in all of my pursuits and inspiring me to follow my dreams. I am especially grateful to my beloved mother, who supported me emotionally and financially. I always knew that you believed in me and wanted the best for me.

I would like to express my deepest appreciation to my supervisor, ***Prof. Dr. Khaliq Ahmad***, for providing the support, encouragement, and guidance needed in completing the dissertation process. His assistance, knowledge, and dedication greatly contributed to my success and helped me persevere through the hard times and celebrate the good times. He was always available to answer my calls and respond to my texts to answer questions, offer hope and provide a perspective. During the course of my programme at the Graduate School of Management, International Islamic University Malaysia Prof. Dr. Khaliq Ahmad struck me as a thorough and unrelenting supervisor as well as a fine academic mentor.

I also like to acknowledge my co-supervisor ***Asst. Prof. Dr. Tahir Jan*** who provided me thorough, meaningful and constructive feedback throughout the process. His patience and considerate nature made him accessible whenever I needed his assistance. He made me a real researcher by providing his insight in analysing the collected data and applying appropriate statistical tools. I am grateful in every possible way & hope continues to receive his blessings in the future.

I want to thank all of those people who, once upon a time, were my teachers and who helped me begin this long journey. Specifically I would like to mention ***Prof. Dr. M. Arif Zakaullah***, former Head of Master of Management program at Graduate School of Management, International Islamic University Malaysia who is, undoubtedly, a great scholar. He inspired me to continue learning and sharing with others. Throughout my doctoral studies, he proved to be the ideal mentor and a true friend, qualities I hope I can emulate, and for that I shall always be greatly indebted to

him. As a mentor, he inspired the necessity of a spirit of creativity in scholarship, which he himself expertly modelled, to explore texts anew from alternative perspectives. As a friend, he encouraged critical engagement while never withdrawing his support even in the midst of disagreement. Words alone inadequately express the great respect and love I have for him. I owe a special debt of gratitude for his support and guidance throughout my journey.

I gratefully acknowledge the financial support received from **YBhg. Datuk Syed Ali Mohamed Alattas**, the President of both National Chamber of Commerce and Industry of Malaysia (NCCIM) and Malay Chamber of Commerce (DPMM). Words cannot express my sincere appreciation to you for your help in financing my studies. I will be eternally thankful for all your kindness and help.

My special appreciation goes to **Puan Shakila Noor Mohamed**, the President of the Malaysian Association of Self Employed Women for her constant support, kindness and love. I will always be indebted to you for all you have done for me.

I sincerely thank the entire academic and non-academic staff of the Graduate School of Management, International Islamic University Malaysia who provided cooperation and assistance regarding university matters in conducting this research successfully.

I would like to thank all the anonymous respondents for their precious time and effort to answer my questionnaire. Without their sincere responses, this study would not have seen the light. I would also like to thank all those who helped me to distribute the questionnaire to generate the responses.

Finally, I would like to thank everybody who was important to the successful realization of my dissertation, as well as expressed my apology that I could not mention personally their names.

Despite these acknowledgements the weaknesses and limitations of this dissertation remain all mine.

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CHAPTER ONE

INTRODUCTION

1.1 OVERVIEW

The introductory chapter of the dissertation will present the readers with an overview of the research topic. It starts with a concise discussion of the background that will be followed by the some important key concepts relevant to the research topic. The problem statement part is presented which includes the research objectives, research questions, significance and limitation of the research. An overview of the growth of the Islamic banks in Bahrain is also presented. Finally, the outline of the dissertation gives the reader an insight on how the dissertation is arranged in five chapters.

1.2 BACKGROUND OF THE STUDY

The pressure of present marketing environment and dynamics of the free marketing forces have significantly revolutionized the service sector in the 90s. According to Ayuba and Aliyu (2015) competition is one of the main reasons for this advancement. This is due to the conflicting industrial, geographical, and regulatory boundaries, manufacturing new products, service varieties/range, equal market chances, and generating supplementary knowledge and system based business and management processes.

The banking services environment, around the world, has been considerably altered by technological, regulatory and structural factors in the final two decades of the twentieth century (Manjunath & Aluregowda, 2013). In an environment which tend to be (or is becoming) progressively competitive, service quality, as a vital measure of company's performance, keeps on compelling the consideration of

banking organizations and it stays in the limelight of service marketing writings (Chen & Chen, 2014; Panwar, 2014). It was observed by researchers (Al-Hawari, 2015; Lakshmi & Santhi, 2015; Sreekumar & Mahapatra, 2015) that the importance given to service quality is mainly due to demand of greater service quality which eventually leads to higher customer satisfaction and loyalty. Perceived quality contributes to higher readiness to propose to others, decrease in objections and complaints, and enhanced retention rate of customers. In the background of banking services, Peng and Moghavvemi (2015) mentioned that service quality is primarily important as it offers greater level of customer satisfaction and therefore it turns out to be a vital competitive advantage. Moreover, a bank's achievements and performances are greatly impacted by the service quality (Pradhananga, 2014).

The global economic recession and unrest in financial markets has greatly damaged the confidence of banking and finance sector consumers all over the world. Banking industry has become greatly competitive in the existing business setting. Banks are greatly realizing the need to single out themselves from the competitors, on various criteria which can boost customer satisfaction and loyalty, since banks are offering approximately homogenous products to the customers. The result has shown paramount importance of customer satisfaction and loyalty for the enhanced performance of an organization in the long run (Hallowell, 1996). With the aim of enhancing confidence of customers in the abilities of service provider, customer satisfaction and loyalty are the vital factors deliberated in the current literature (Chakraborty & Sengupta, 2014; Kim et al., 2015).

The most outstanding economic and financial marvel of the twentieth century is the development of an alternative banking system, the Islamic banking system, in the Muslim world (Ringim & Yussof, 2014). Islamic banking can be termed as

banking activities that are in line with principles of *Shariah* (Islamic Law) and are led by Islamic economic theories and practices (Teru, 2015). A rapid growth has been witnessed by the Islamic banking and finance industry in the global financial markets with the annual growth rate of about 15% to 20% (Nafith et al., 2014). Assets of Islamic financial institutions have grown by an average of 19% per annum over the past four years to reach over \$1.3trillion in 2011 (Ernst & Young-The *World Islamic Banking Competitiveness Report 2012–13*: 4), suggesting healthy demand for *Shariah* compliant investing. Globally, Islamic banking assets are expected to grow to \$3.4trillion by 2018 (Ernst & Young-The *World Islamic Banking Competitiveness Report 2013–14*: 42).

As a result of fast growth and development, Islamic banks are encountering cut throat rivalry not only from conventional banks but also from existing and new Islamic banks entering into the industry. Owing to rapid globalization, the competition between conventional and Islamic banks is most likely to increase in the future. The global market, as a result of liberalization, is quickly congregating into a single market place. It is essential for the Islamic banks to enhance the service quality and offer innovative products with the intention of taking benefit of the openings created by the dynamics of globalization. Accordingly, Islamic banks are likely to witness increased competition not only from conventional but also from within Islamic banks in future. Therefore, an Islamic bank must develop a marketing strategy to achieve competitive advantage and create a solid competitive position based on quality of service.

An organization's competitiveness is impacted or measured by service quality which is one of the vital accomplishment elements. Therefore, by delivering great service quality, a bank can single out itself from rival banks. Over the past decade, in the retail banking sector, service quality has remained one of the greatest enticing

areas of research (Gajera & Desai, 2013; Masarrat & Jha, 2014; Mistry, 2013; Malviya, 2015). Many researchers have found customer satisfaction a vital result of service marketing (Mandal & Bhattacharya, 2013; Rainayee et al., 2013). Customer satisfaction is lifeblood of achievement in competitive banking industry. Saha et al. (2014) stated that customer is the king. Increased customer satisfaction is vital in creating a loyal customer base. It was cited by Izogo and Ogba (2015) that superior service quality would increase customer satisfaction and loyalty. It was claimed by Peng et al. (2015) that customer loyalty is the main reason for profit and growth stimulation and the outcome of customer satisfaction is customer loyalty. It was established by Izogo and Ogba (2015) that customer satisfaction is the result of service quality. The satisfaction of the customers would result in their loyalty that benefits a company in long run regarding market share, return on investment and profit (Erjavec, 2014).

The role of customer loyalty is significant in an organizational sustainability because customer retention means keeping the viability of the organization. Led by his own loyalty and long-term cumulative experience, the longer a loyal customer of a product/service is expected, the higher the profits earned by an organization (Singh & Khan, 2012). It has been shown by research that the cost of retention of a loyal customer is much lesser than that of recruiting a potential fresh customer.

Bahrain enjoys a long history in the Islamic Banking and Finance industry in GCC nations. In the Kingdom of Bahrain, the first Islamic commercial bank, Bahrain Islamic Bank (BIB), was established in 1979. In the Middle East region, Bahrain has the highest number of financial institutions and banks which offer different array of services that includes portfolio management and money market, guidance on investment and insurance products encompassing risk transfer and capital growth. The

banking system, especially in Bahrain and the region in general, is noticing the entry of new players and strategic alliance among the current players. Thus, the banking sector has remained a cornerstone in the economy of the Kingdom of Bahrain.

The increasing number of Islamic Banks in Bahrain has led to a strong competition between Islamic and conventional banks in general, and among Islamic Banks in particular. Service quality, customer satisfaction and customer loyalty are matters that need to be addressed by the competing Islamic banks in Bahrain using the most contemporary techniques to strengthen the Islamic banking industry so it can stand alongside the well-established conventional banks.

1.3 PROBLEM STATEMENT

The globalisation process has substantially influenced the contemporary banking business. The effect is expressed, mainly in the liberalization of financial market that will result in an increased competition. To endure in such competitive struggle, banks ought to provide somewhat new and comparatively inexpensive alternatives to their customers, for the reason that the competitive supremacy of a bank is greatly defined by the level of its compliance to the needs of its customers. In this era of information explosion, companies need new capabilities for competitive triumph in areas such as managing relationship with customers, product advancement, product branding and mass customisation, employee skills, inspiration, and use of information technology.

After the financial crisis of 2008, banks are witnessing sharp decline in the demand of financial products and services, and are struggling for survival. Banking sector is finding it difficult to sustain capital level and attract new investors' for increased investment. In this gloomy situation, Islamic banks proved to be a ray of hope for the banking industry as an alternative system for the banking industry.

The necessity to become customer centred in the rapidly varying marketing setting has never been more significant for financial service organizations and Islamic banks than it is these days. Under the current conditions, customers are turning out to be more demanding and progressively selective between contending financial service providers. All Islamic banks, in a dynamic competitive market, are confronted with difficulties of retaining current customers and enticing new customers. To keep the existing customer base of banks is especially more vital than capturing new customers. Moreover, customers usually carry out business with several financial institutions, it is critical that a bank contends for the bigger share of a customer's wallet to achieve a share of product portfolio of a customer so as to augment and preserve long term profitability of the organization.

The financial organizations that will develop and flourish in this competitive setting are the ones that thrive in developing a base of loyal clients and are competent to distinguish themselves through exceptional service quality (Araujo & Pels, 2015). Hence, providing quality service, for enhancing satisfaction and loyalty are essentials to the success of banks and crucial to an Islamic bank for a continuous competitive advantage. For the future and continuous profitability of banks, customer satisfaction and loyalty are treated as the most significant competitive elements.

Bahrain Islamic banking and finance sector complies with *Shariah* principles and is one of the earliest and very well advanced systems in the world. It is yet developing but at a fast pace. Growth for both conventional and Islamic banking has been fuelled by liquidity in the GCC region. However, in the last few years Islamic banking segment has grown at a greater pace as compared to the conventional segment. An increasing desire of customers who want to transact according to *Shariah* Laws has being witnessed by the Islamic Banking industry in Bahrain.

Globally, Bahrain is one of the major centres for offering the activities of Islamic Banking and Finance. According to Central Bank of Bahrain, there are twenty-four (24) Islamic Banks, seven (7) Islamic insurance companies (Takaful) and two (2) Re-Takaful companies operating in the Kingdom. Bahrain, leading the Islamic Banking industry in the GCC region, has developed as a natural and suitable place in the Middle East region as Islamic Finance hub. The creation of legal framework for Islamic banks was pioneered by Bahrain in the GCC region and is one of the few markets that accommodate dual banking system.

Banking sector in Bahrain has somehow matured as a result of which customers in Bahrain now have a solid bargaining power. There is no assurance that what is known as excellent service, in Islamic retail banking, today may remain the same the next day. It is crucial for the Islamic banks, with the aim of remaining competitive in serving Islamic banking customers, to devise innovative approaches to advance service quality for customer satisfaction that may yield customer loyalty. Products and services being offered by Islamic banks are analogous to the conventional banks (Aris et al., 2013). Therefore, banks need to frequently improve their service quality to attract and retain existing customers (Ahmad & Bashir, 2014).

Islamic Banking is well-recognized in Bahrain but to the best knowledge of the researcher, no study in the areas of service quality, customer satisfaction and customer loyalty of any Islamic banking service providers has been done. In the light of the above deliberations, it can be said that the current research endeavours to fill this gap in literature, in the context of Islamic Banks of Bahrain. It is predicted that the outcomes of the study would be of great advantage to Islamic Banks of Bahrain in terms of retaining the existing and attracting potential customers.

1.4 RESEARCH OBJECTIVES

The objectives of this research are:

- 1- To investigate the impact of service quality on customer satisfaction.
- 2- To investigate the impact of service quality on customer loyalty.
- 3- To investigate the impact of customer satisfaction on customer loyalty.
- 4- To investigate the mediating role of customer satisfaction in the relationship between service quality and customer loyalty.
- 5- To investigate the moderating role of gender in the relationship between service quality and customer satisfaction.
- 6- To investigate the moderating role of education in the relationship between service quality and customer satisfaction.

1.5 RESEARCH QUESTIONS

The main research questions for this study are as follows:

- 1- What is the impact of service quality on customer satisfaction?
- 2- What is the impact of service quality on customer loyalty?
- 3- What is the impact of customer satisfaction on customer loyalty?
- 4- Does customer satisfaction play a role of a mediating variable in the relationship between service quality and customer loyalty?
- 5- Does gender moderate the relationship between service quality and customer satisfaction?
- 6- Does education moderate the relationship between service quality and customer satisfaction?