



SERVICE QUALITY AND CUSTOMER LOYALTY IN NEPALESE COMMERCIAL BANKS: A MEDIATING ROLE OF CUSTOMER TRUST

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ABSTRACT: *Service quality assessment is crucial for ensuring that the overall service dimension aligns with the client's expectations. This study aims to examine the mediating effect of customer trust in the relationship between service quality and customer loyalty in the commercial banks of Nepal. Two hundred and sixteen (216) customers of these banks were surveyed using a structured five-point Likert scale questionnaire. Data was collected via online and field survey by visiting the customers at related banks. The study's hypotheses were tested through path analysis using AMOS-26 software. The findings reveal a significant positive relationship between service quality, customer trust, and customer loyalty. This suggests that higher service quality contributes to heightened customer trust and loyalty in Nepalese commercial banks. Notably, customer trust exhibits a partial mediation effect in the connection between service quality and customer loyalty. These results offer valuable insights for bank managers, emphasizing the importance of prioritizing customer satisfaction, trust and loyalty in crafting strategies for competitive advantages.*

KEYWORDS: Service quality, customer trust, customer satisfaction, competitive advantages, financial services.



INTRODUCTION

Quality service provided to the clients has been recognized as the strategic requirement in highly competitive business environments nowadays. Service quality presents unique challenges compared to product quality due to the distinctive features of services, such as intangibility, inseparability, heterogeneity, and perishability (Chang & Yeh, 2002). Service quality, as defined by Parasuraman, Zeithaml, and Berry (1996), denotes the extent of incongruity observed between customers' normative service expectations and their perceptions of service performance. Parasuraman et al. (1985) further elucidate that measuring service quality entails identifying disparities between perceived and expected service levels, providing a valid means to pinpoint gaps in the service offerings, as perceived by management.

In the 21st century, banks are required to be dynamic and to exhibit distinct characteristics to deliver high-quality service. They must adhere to world-class standards, demonstrating unwavering dedication to enhancing customer satisfaction and taking a proactive stance in driving the growth and diversification of the financial sector (Karim & Chowdhury, 2014). The quality of bank services is pivotal in capturing customer attention, ensuring satisfaction, and fostering loyalty. However, numerous issues and grievances from customers persist within the banking sector in Nepal. To tackle these challenges, banks are increasingly leveraging automated technologies to enhance competitiveness and meet customer expectations. Automated services like Automated Teller Machines (ATMs), internet banking, and other e-banking platforms are revolutionizing service delivery, outperforming competitors (Shrestha, 2019). With consumers better informed about banking products and services beforehand, meeting their expectations has become increasingly challenging. Customer satisfaction hinges largely on the quality and reliability of the products and services offered by the service provider. Satisfied customers, in turn, serve as key drivers for heightened customer loyalty (Horstmann, 1998).

In recent times, the banking and financial industry has become increasingly competitive, prompting banks to adopt unique tools and strategies to retain and satisfy customers. Online banking stands out as a key tool for achieving customer retention and satisfaction. Over the past decade, the banking sector has undergone significant transformations due to the rise of a knowledge-based economy and advancements in information and communication technology (Driga & Isac, 2014). Financial services has become widespread in developed countries and is rapidly expanding in developing nations (Fekadu, 2019). Traditional physical branch banking has been largely supplanted by e-Banking, allowing customers to access services via the internet from the comfort of their homes or workplaces instead of visiting a physical bank branch (Driga & Isac, 2014; Poon, 2008). This shift to e-services has provided numerous benefits to both banks and customers, including enhanced convenience, sales security, faster transaction processing, and overall improved service quality (Abdulfattah, 2012).

In today's era of globalization and digitalization, Nepal's banking sector is experiencing rapid growth. Economic liberalization has facilitated the emergence of private and joint venture banks in the country. According to the Nepal Rashtra Bank (2023), there are currently 20 commercial banks operating in Nepal. Key factors such as physical infrastructure, service procedures, and skilled manpower play vital roles in delivering banking services effectively.



Gyawali and Kunwar (2014) indicated a positive and significant correlation between Nepalese banking service quality and customer satisfaction. Koirala & Shrestha (2012) found that customer satisfaction in commercial banks in Nepal is heavily influenced by service quality. In this intense competition within the banking sector, banks are compelled to enhance their offerings. In this competitive landscape, customer satisfaction and loyalty are paramount, both of which hinge on the quality of service provided. Since the service quality is essential to meet the emerging need and satisfy customers (Shrestha, 2018). Furthermore, it is essential to continuously evaluate and enhance the services offered to meet the evolving needs of customers and ensure their satisfaction and retention. In today's competitive landscape, maintaining a high quality of service is imperative for customer satisfaction and loyalty. With the freedom to choose among various service providers, customers may easily switch to alternatives. Therefore, prioritizing the enhancement of service quality is crucial to both enhance customer satisfaction and foster long-term loyalty.

The relationship between service quality and customer loyalty is significant in Nepalese commercial banks (Joshi, 2022; Shrestha, 2018). However, the important variable of customer trust is missing in those studies, which is a major predictor of customer loyalty. Hence, this study primarily aims to investigate the relationship between service quality and customer loyalty within the mediating effect of customer trust in Nepalese commercial banks.

LITERATURE REVIEW

The concept of service has been developed since the 1980s by Churchill and Surprenant (1982), as well as Asubonteng et al. (1996), who propagated the theory of customer satisfaction by gauging a firm's actual service delivery against customer expectations. This alignment, characterized by perceived quality, entails meeting customer desires and needs, surpassing their aspirations. Parasuraman et al. (1988) later extended the concept of service into the five dimensions of service quality: tangibles, reliability, responsiveness, assurance, and empathy. This had been earlier identified and evaluated by Parasuraman et al. (1988) who introduced the service quality model known as SERVQUAL, which was first applied in the service industry specifically for restaurants. Building upon this foundation, Armstrong et al. (1997) further developed the concept of service, delineating it into five dimensions of service quality: tangibles, reliability, responsiveness, assurance, and empathy.

Services represent intangible interactions between a service provider and a user, exerting influence on the user's condition (Kimita et al., 2009). Early research conceptualized quality as a judgment derived from an evaluation process wherein customers juxtapose their expectations against the perceived service received (Gronroos, 1984). Despite a growing body of literature elucidating service quality, a considerable portion defines it in terms of a customer's holistic perception of the product or service (Parasuraman et al., 1985, 2005).

Parasuraman et al. (2005) introduced the E-SQUAL model to explore consumer perceptions of service quality across service and merchandising enterprises. This model defines service quality as comprising both the service outcome and the service delivery process. The service outcome reflects a customer's assessment of the result of the service product, while the service delivery process concerns how the overall effect of the process is conveyed to the service users (Lehtinen & Lehtinen, 1991; Parasuraman et al., 1985).



Zavareh et al. (2012) found a significant positive relationship between customer loyalty and several factors of service quality, including effective and reliable services, fulfillment, security/trust, aesthetics, responsiveness, and ease of use. Similarly, Hammoud et al. (2018) highlighted the importance of reliability, effectiveness, ease of use, responsiveness, communication, security, and privacy in influencing customer loyalty, with reliability exerting the strongest impact. Furthermore, Liebana-Cabanillas et al. (2013) identified variables such as ease of use and availability as significant drivers which promote long-term customer loyalty.

Shankar and Jebarajakirthy (2019) identified reliability, privacy, and security as pivotal factors driving customer satisfaction and loyalty. This finding resonates with research conducted by Sharma et al. (2020), who demonstrated a significant correlation between service quality and customer satisfaction within the online banking sector. Building upon this, Mohamud (2017) further bolstered the importance of these aspects, emphasizing the direct relationship between online banking service attributes such as ease of use, utility, and cost and overall customer satisfaction. Additionally, Mohamud's study underscored the critical role of factors like security, reliability, responsiveness, and effectiveness in shaping customer satisfaction, suggesting that these elements should not be underestimated in the pursuit of heightened customer satisfaction levels.

Tetteh (2022) emphasized the pivotal role of service quality dimensions such as convenience, ease of use, availability, and affordability in driving customer retention. Furthermore, their study elucidated that customer retention serves as a complete mediator in the relationship between these four dimensions of service quality and customer loyalty. In a similar vein, Mwiya et al. (2022) underscored the significance of security, website traits, privacy, responsiveness, effectiveness, fulfillment, and reliability as critical components of electronic service quality. These factors were found to positively impact customer loyalty, corroborating the earlier findings regarding the vital role of service quality dimensions in augmenting customer satisfaction and ultimately nurturing customer loyalty.

Beshir and Zelalem (2020) investigated the influence of service quality dimensions on customer satisfaction and loyalty. Their study identified several key factors—effectiveness, responsiveness, ease of use, privacy, and commission—that significantly predict customer loyalty supported by statistical significance at a 5 percent level. Furthermore, their research revealed a strong positive correlation between customer loyalty, indicating that satisfied customers are more inclined to demonstrate loyalty to the service provider.

Sewaka et al. (2023) unearthed a favorable correlation between service quality, customer satisfaction, and customer loyalty intention within the cohort of online banking users. Their research revealed notable connections: service quality exhibited a positive association with customer satisfaction, service quality positively correlated with customer loyalty, and customer satisfaction demonstrated a positive correlation with loyalty intention.

Trust is widely acknowledged as a critical asset for success across industries, forged through practical interactions (Elizar et al., 2020). It is a deliberate, ongoing process, subject to testing and refinement over time (Euis et al., 2021). Ayunda et al. (2019) asserted that trust forms the bedrock of business relationships, defining the reliability of all parties involved in transactions. In the digital age, characterized by pervasive technology (Ratnasingam, 2002), trust assumes a multifaceted significance, particularly in commerce and trade relationships.

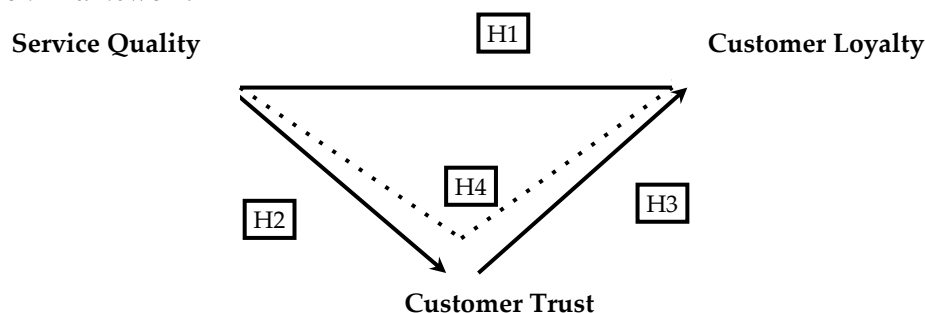


Given that delivery personnel often serve as the face of sellers in e-commerce and m-commerce, customer trust manifests in their positive expectations. Customers gauge transactions not just by products but also by the quality of service and conduct of delivery personnel. Thus, fostering customer satisfaction becomes imperative for enhancing their overall experience (Uzir et al., 2021). Research has consistently demonstrated a positive correlation between trust and customer satisfaction (Ayunda et al., 2019; Resika et al., 2022).

Trust embodies a company's competency and value in the eyes of customers (Rahmawati, 2021) and correlates with their willingness to engage in transactions despite inherent risks (Fajarini & Meria, 2020). Moreover, it serves as a pivotal driver for customer commitment. According to Kassim and Asiah Abdullah (2010), trust exerts a positive and significant influence on commitment of customers, forming a crucial component for securing long-term customer contracts. Sirojudin et al. (2023) asserted that trust materializes when one party harbors confidence in the partnership and international exchanges. Drawing upon the expectation disconfirmation theory, Sari et al. (2016) posited that consumer satisfaction stems from the interplay between expectations, service perceptions, and quality assessments of a product or service (Rizan et al., 2019). Based on these findings, the following research framework has been developed:

Figure 1

Research Framework



Source: Wilson, Zeithaml, Bitner and Gremler (2012)

Research Hypothesis

Based on the empirical evidence concerning the relationship among service quality, customer trust and customer loyalty, it is evident that there exists a significant positive relationship between service quality and customer loyalty (Koirala & Shrestha, 2012; Gyawali & Kunwar, 2014; Pradhan & Shrestha, 2017; Lamichhane, 2018). Additionally, it has been observed that customer trust serves as a mediator in the connection between service quality and customer loyalty (Rajeswari, Srinivasulu & Thiyagarajan, 2017; Gautam & Sah, 2023). Drawing from the presented evidence, the hypotheses of this study are formulated as follows:

H1: Banking service quality has a positive effect on customer loyalty.

H2: Banking service quality has a positive effect on customer trust.

H3: Customer trust has a positive effect on customer loyalty.



H4: Customer trust mediates the relationship between banking service quality and customer loyalty.

RESEARCH METHODS

This study is based on positivist research philosophy and employs a descriptive research design. Primary data was collected from the customers of all 20 commercial banks on personal visit, through email and social media apps. All together, 280 customers were approached from a total of 20 commercial banks based on random sampling technique. Out of them, 225 questionnaires were returned back. The response rate is 77.1%. Nine (9) responses were found incomplete and the remaining 216 were used thoroughly. The distributed questionnaires used a five-point Likert scale—point one for a strong disagreement and point five for a strong agreement. Path analysis was applied to analyze the data with the help of analysis of moment structure (AMOS) software. The profile of respondents according to age groups, marital status, academic qualification, occupation and monthly income is presented in the table 1 below:

Table 1

Respondents' Profile

Variables	Frequency	Percent
N	216	
Gender		
Male	150	69.4
Female	66	30.6
Age		
Below 25	75	34.72
25-45	80	37.04
46-65	40	18.52
Above 65	21	9.72
Marital Status		
Married	171	79.17
Unmarried	45	20.83
Academic Qualification		
10+2 and below	65	30.10
Undergraduate	81	37.5
Graduate	60	27.78
Post Graduate	10	4.62
Occupation		
Unemployed	10	4.63
Jobholders	90	41.67



Businessman	85	39.35
Others	31	14.35
Monthly Income		
Less than 15,000	10	4.63
15,000-30,000	48	22.22
30,000-45,000	104	48.15
45,000-60,000	32	14.81
More than 60,000	22	10.19

Source: Field Survey, 2024

Table 1 shows that out of the total respondents, more than two-third are male. Likewise, of the total respondents, 34.72% customers are below the age of 25 years, 37.04% fall in the age category of 25-45 years, 18.52% in 46-65 years whereas only 9.72% fall in the age category of more than 65 years. The table reflects that the majority of the respondents are in the age category of 25-45 years. The table also shows that around 80% of the customers are married. The majority of the respondents (i.e., 37.5%) are undergraduates, 27.78% are graduates, 30.10% are 10+2 level and below and 4.62% are post graduates. Out of the total respondents, 4.63% are unemployed, 41.63% are jobholders, 39.35% are businessmen, and 14.35% are others. Among the respondents, 4.63% have a monthly income of less than Rs. 15,000, 22.22% has Rs. 15,000-30,000, 48.15% have a monthly income of Rs. 30,000-45,000, 14.81% have Rs. 45,000-60,000 and 10.19% have more than Rs. 60,000.

ANALYSIS AND RESULTS

Reliability and Validity Analysis

The internal consistency was assessed by computing Cronbach's alpha to evaluate item reliability. The commonly accepted threshold for Cronbach's alpha is > 0.7 which all the dimensions exceed (Carmines & Zeller, 1988). It proves that the model is reliable. The average variance extracted for all the dimensions are well above the acceptable level of 0.5 (Fornell & Larcker, 1981). There are significant loadings onto the respective latent constructs ($p < 0.50$) supporting the convergent validity. The square root of the AVE values is greater than the inter-construct correlations (loadings) supporting the discriminant validity.

Table 2

Reliability and Validity Analysis

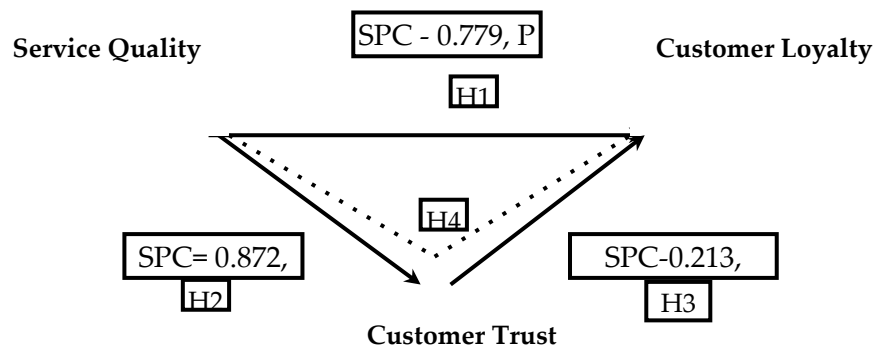
Constructs	Cronbach Alpha	CR	AVE	MaxR (H)	1	2	3
Service Quality	0.90	0.908	0.667	0.927	0.816		
Customer Trust	0.87	0.865	0.574	0.946	0.366**	0.758	
Customer Loyalty	0.885	0.901	0.663	0.975	0.683***	0.452***	0.814

Path Analysis and Test of Hypotheses

The path analysis was performed based on SEM showing the Service Quality-Customer Loyalty relationship model with the mediation role of Customer Trust. The final measurement based on the structural model of this study is presented in Figure 2.

Figure 2

Direct and Indirect Effect of Service Quality on Customer Loyalty



A significant relationship between Service Quality and Customer Loyalty is found (SPC = 0.779, $P < 0.01$). Hence, H₁ (Service Quality significantly influences Customer Loyalty) is accepted. This is in line with the findings by Kumar and Ansari (2020) who found that there is a positive and highly significant relationship between perceived service quality of the organization and customer retention. It is also consistent with the findings of Orute, Mutua, Musiega and Masinde (2015) and Ogochukwu and Ikon (2019) who concluded that Service Quality significantly affects customer retention.

It is also seen that Service Quality and Customer Trust are significantly related to each other (SPC = 0.872, $P < 0.01$). Hence, H₂ (Service Quality has a positive influence on Customer Trust) is accepted. This finding is consistent with Orute, Mutua, Musiega and Masinde (2015) who argued that Service Quality had a statistically significant effect on customer loyalty. The relationship between Trust and Customer Loyalty is also found significant (SPC = -0.213, $P < 0.01$). Hence, H₃ (Customer Trust significantly affects Customer Loyalty) is accepted. This finding is similar to Miah's (2018) study.

Table 3

Regression Scores

Regression weight		Estimate	S.E.	C.R. (t)	P
Customer Loyalty ← Service Quality	←	0.779	0.042	18.334	<0.01
Customer Trust ← Service Quality	←	0.271	0.067	4.040	<0.01
Customer Loyalty ← Customer Trust	←	0.879	0.060	14.696	<0.01



To explore the mediation role of Customer Trust in the relationship between Service Quality and Customer Loyalty, several statistical steps and assumptions were considered, following different methodologies. These methodologies suggest that if the exogenous variable (Service Quality) has a statistically significant impact on the proposed mediating variable (Customer Trust), and if the mediating variable significantly affects the endogenous variable (Customer Loyalty), while the direct path between the exogenous variable and endogenous variable is statistically non-significant (indicating full mediation) or significant (indicating partial mediation), the mediating construct is deemed to be present (Bae, 2006; Hair et al., 2006; Kline, 2005). The analysis shows that Service Quality has a statistically significant impact on Customer Loyalty (SPC = 0.959, $P < 0.01$) without the mediating role of Customer Trust. While adding the mediating variable Customer Trust, the effect of Service Quality on Customer Loyalty was reduced (SPC = 0.872., $P < 0.01$). Hence, the result shows the partial mediation by Customer Trust in Service Quality–Customer Loyalty relationship.

Table

4

Direct and Indirect Effects of Service Quality

Constructs	Total effect	Direct effect	Indirect effect
Customer Loyalty ← Customer Trust ← Service Quality	0.959	0.779	0.185

On the basis of above presentations, the summary of following hypotheses testing results are presented in Table 5 below:

Table 5

Summary of Hypotheses Testing Results

Hypothesis	Relationship	Result
H1	Service Quality → Customer Loyalty	Accepted
H2	Service Quality → Customer Trust	Accepted
H3	Customer Trust → Customer Loyalty	Accepted
H4	Service Quality → Trust Customer → Customer Loyalty	Accepted

DISCUSSION AND ACTION IMPLICATION

This study empirically investigates the relationship between banking service quality, customer trust, and customer loyalty within the Nepalese commercial banks. Additionally, it explores the mediating role of customer trust between banking service quality and customer loyalty. The findings reveal a significant positive association among banking service quality, customer trust, and customer loyalty. Moreover, the study identifies the partial mediation effect of customer trust in the relationship between banking service quality and customer loyalty. These results



align with prior research by File and Prince (1992); Lenka, Saur, and Mohapatra (2010); Mosahab, Mahamad, and Ramayah (2010); Pradhan and Shrestha (2017); Tee, Preko, and Tee (2018); and Gautam and Sah (2023), and are supported by the theory of customer satisfaction and loyalty, suggesting that higher service quality tends to lead to increased customer satisfaction and loyalty. Given the strong positive connections observed among service quality, customer trust, and customer loyalty, enhancing banking service quality is likely to foster increased customer satisfaction and loyalty. The analysis revealed the presence of both direct and indirect effects of service quality on customer loyalty. Consequently, service providers should prioritize enhancing service quality which develops trusted customers and which ultimately creates customer loyalty. Satisfied and loyal customers significantly bolster the competitive prowess of the organization (Oliver, 1999).

The result of the analysis showed that there is a significant impact of service quality on both customer trust and customer loyalty. Likewise, customer trust is found to affect customer loyalty significantly. It was also found that customer trust mediated the relationship between service quality and customer loyalty partially.

The insights gleaned from this study hold significant value for decision makers within the Nepalese banking sector, offering pathways to enhance service quality and foster customer loyalty. Moreover, it affords commercial bank managers a nuanced understanding of customer perceptions regarding banking service quality within the Nepalese context. These findings thus serve as a compass for practitioners, facilitating a delicate balance between leveraging the more costly traditional elements of marketing and promotional mix and the more cost-effective soft factors tied to employee engagement, given that employee attitudes and behaviors play a pivotal role in enhancing service quality dimensions. By doing so, the overall service quality can be elevated, thereby positively impacting both customer satisfaction and loyalty.

A practical implication arising from this study is its illumination of critical areas for bank managers to prioritize in order to competitively navigate the Nepalese banking landscape. To this end, it is essential for bank managers to emphasize and effectively communicate service quality attributes with customer expectations, trust and ultimately loyalty. The findings of the study imply that service quality can foster an environment and system to satisfy customers, which directs the employees to increase their work engagement for better organizational performance.

LIMITATIONS AND DIRECTION FOR FUTURE RESEARCH

This study has examined service quality, customer trust, and loyalty within Nepalese commercial banks. Future research endeavors could explore all five dimensions of service quality to provide a more comprehensive understanding. In this study, a simple mediation model was employed to analyze the data, with customer trust acting as a mediator in the relationship between service quality and customer loyalty. However, future researchers are encouraged to explore parallel and serial mediation effects using additional mediating variables for further analysis. Furthermore, investigating the impact of moderator variables on satisfaction and loyalty within the same study could offer valuable insights into the underlying mechanisms influencing customer behaviour. This study focuses solely on the banking sector



of Nepal. Further research could explore other service sectors to assess their service quality, customer trust, and loyalty.

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