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# SERVICE QUALITY VIS-À-VIS CUSTOMER RETENTION IN THE BANKING INDUSTRY: THE MEDIATING ROLE OF SERVICE RECOVERY

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***ABSTRACT:This study was focused on the evaluation of service quality of banks and its relationship on customer retention of bank account holders in the City of San Fernando, Pampanga, and the mediating role of service recovery. This study utilized a descriptive-correlational research design in which the three main instruments were from three different studies. The first instrument was adopted, and the other two (2) questionnaires were adapted to answer the objectives of the study. The respondents of the study were confined to the 360 bank account holders in the city. Through data analysis, it was revealed that majority of the respondents agreed that their banks' service quality is clearly exhibited, and the customer retention programs and activities of the banks in City of San Fernando, Pampanga is manifested. There were numerous bank service failures encountered by the bank account holders wherein the problems about malfunctioning ATMs received the highest frequency percentage. Likewise, the respondents agreed that the service recovery programs, and activities of the banks are exhibited. It was also revealed that there is a positive correlation on the assessment of service quality of banks and customer retention and service recovery partially mediates the relationship between service recovery and customer retention. Based on the results, the study recommended programs and guides to address the strongly manifested service failures.***

***KEY WORD**: Service Quality, Customer Retention, Service Recovery, Banking Industry*

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## I. INTRODUCTION AND LITERATURE REVIEW

The primary consideration bank account holders take into account when choosing their banking services providers is the quality of the bank's customer service. It has been proven that the level of service provided to clients is crucial in the banking industry and have a substantial effect on giving customers a satisfying encounter and converting them into loyal customers. Banks group their clients into different segments based on a number of factors so they can better meet the needs of each group and make sure those needs are met.

Service quality has broadly been talked around since 20th century and its thought is still critical to offer help these days (Ali, et al. 2021) and it is an important trademark of any business organization, which attracts and retains its customers. It is also a gauge of quality for assessing how well consumers are being served and what the they thought it is equally important (Vu, 2021). It is also a complicated idea that has been the subject of numerous research in the academic journal of services marketing. Also, it directly improves customer loyalty and retention, which are both very important in the tough banking business. More importantly, it can set the banks apart from competitors and encourage customers to stay with them (Permana and Pratama, 2020).

In the banking industry, a service failure occur when a bank is unable to satisfy and failed to deliver and provide its promised services to its clients. Some of the reasons for these failures include, but are not limited to, the service not being ready when promised, the delivery taking too long, the result being inaccurate or poorly done, or staff being unpleasant or uncaring. Due to the intangible nature of services, failure in the service sector is much more challenging (Gibson, 2017).

When this happens, a client will usually expect to be compensated for the trouble in some way, such as through refunds, credits, discounts, or apologies. The company should have service recovery plans in place, which are the steps they take when something goes wrong in the service delivery process. Research shows that fixing problems quickly and satisfactorily has a major effect on customer happiness, repeat business, brand advocacy, and productivity (Palmer, 2011). Customers who have problems with the service but are satisfied in the end because of the company's response are more loyal than those whose issues are not remedied.

According Asghar Ali et al. (2021), service recovery refers to the plans businesses take to rectify customer perceptions of service failure. When something goes wrong with service delivery, it plays a significant impact in maintaining clients (Mazhar &Hooi, 2020). Furthermore, service recovery entails fixing the client's problems with the service failure carefully to keep the customer. An efficient service recovery program can increase customer satisfaction and the likelihood of a customers' repeat purchase (Githri, 2020).

In Ethiopia, they rely heavily on banking services and the continued development of the banking sector is essential to the nation's economic well-being. The commercial bank of Ethiopia has introduced innovative strategies such as longer business hours, the presence of automated teller machines, internet banking, mobile banking, and other enhanced banking facilities in the interest of enhancing clients' comfort in order to provide its services, retain and attract new customers. These customer-focused initiatives appear pointless unless the bank actually uses them to enhance the delivery of their service. However, complaints and dissatisfactions from consumers occur when they use ATMs due to network failure, inaccessibility, the bank's lack of awareness, and other related problems (Aschenek, 2020).

Since 2010, there has been an increase in competition in the banking sector in an Asian country such as Malaysia. As a result of the intense rivalry in the banking industry, many financial institutions have moved their emphasis from products to clients. Most "moments of truth" in the delivery of services are vulnerable to failure, and occasionally failures occur for reasons outside the control of the service provider making it difficult to achieve the desired outcomes (Mansori, et al., 2014).

Since its inception, the Philippine banking sector has been essential in maintaining the country's GDP growth rate, and as such, the sector places a premium on providing exceptional customer service. Because banking transactions tend to be routine, banks need to build lasting relationships with their clients, which calls for clear and consistent communication. Customers need to be informed of all the latest innovations in banking goods, services, and technology (Talavera, 2020).

According to Chipongian (2014), the Philippines possesses a diverse banking system that features both huge universal banks and smaller rural banks, as well as non-banks. On October 17, 2017, the Bangko Sentral ng Pilipinas issued licenses to 36 universal and commercial banks, 57 savings banks, 492 rural banks, 40 credit unions, and 6,267 non-banks with quasi-banking functions under the General Banking Act of 2000.

According to a survey conducted by the Bangko Sentral ng Pilipinas, over 20 million Filipinos or 29% of the adult population had bank accounts as of 2019. Having a bank account provides Filipinos with a number of benefits, including the ability to save money, make purchases, invest, and protect themselves from financial loss. Many people have issues with the bank's services for various reasons. The BSP received 23,275 complaints in 2020, including requests to reverse disputed transactions and accommodate other customer preferences from BSP-supervised financial institutions (BSFIs). Studies show that if clients have a negative experience, up to 89% will look elsewhere for the same service.

As more Filipinos make the switch to online banking since COVID-19 mobility constraints, the BSP predicted that consumer complaints will top 20,000 in 2022 (Agcaoili, 2022). As the number of customer complaints rises, bank management is under increasing pressure to provide prompt resolutions to the service failures and problems their customers report. This highlights the importance of researching banks' use of and success with service recovery strategies and programs.

The banking industry in the country undergone numerous advancements but still encounters various obstacles. One of its major challenges is the escalating rivalry posed by emerging competitors such as fintech enterprises and digital-exclusive banks which employ cutting-edge technologies and novel business models to challenge the established banking sector, providing customers with unique and improved methods for financial management. In order to maintain a competitive edge, financial institutions must persistently allocate resources towards the development and implementation of digital technologies, while simultaneously embracing novel business models that are more adept at catering to the evolving demands of their clientele.

Also, the Philippine banking industry is confronted with the task of enhancing financial inclusion. Despite its notable advancement, a substantial portion of the population in the country continues to lack access to official financial services. It is imperative for banks to undertake efforts aimed at broadening their scope and enhancing the availability of financial services to encompass Filipinos, irrespective of their geographical placement or socio-economic standing.

Service failure in the banking industry is inevitable due to the intangibility and simultaneous delivery and consumption dimensions of services. With this, bank account holders continuously experience technical difficulties with online banking accounts and services, malfunctioning ATMs, worn-out card readers, broken keypads, faulty receipts, software bugs, poor customer service, mortgage/loan problems, significant errors/mistakes committed by bank employees, failure to honor their practices, rude behavior from tellers, and other issues. This highlights the importance of a company's service recovery programs in the case of a service failure in the banking sector. Furthermore, it was found by Shammout and Haddad (2014) that account opening, account closure, and account management accounted for nearly half of all customer complaints about banking services.

At present, complaining bank account holders file and submit their complaints and concerns to the bank involved. In the event that consumers are unsatisfied with the manner in which the bank addresses their complaints, enquiries, or requests within a reasonable timeframe, they have the option to escalate their problems to the BSP-CAMS, which serves as the secondary avenue for appeal.

The Bangko Sentral ng Pilipinas proposed the guidelines and procedures for the program "Consumer Assistance Management System (CAMS)". According to the circular, the BSP stated that this program primarily serves as a facilitative mechanism with the objective of resolving financial consumer concerns by enabling communication between the involved parties through the BSP. The complaints submitted to the BSP should include relevant information and accompanying documentation.

This program is intended for the BSP-Supervised Financial Institutions (BSFI) wherein it must have a manual of policies and procedures in handling consumer complaints, inquiries, and requests from financial consumers. They are also required to assign a consumer assistance officer who shall receive process, and provide response to a client's concern; and consumer assistance group who shall monitor the assistance process and ensure immediate escalation of any significant complaint to the concerned unit.

There have been numerous studies conducted in the past to assess service quality and customer retention in the banking industry. However, most of these studies followed a similar set of constructs identified by previous researchers and despite the fact that there have been several fields of research regarding the said variables, no study focused into involving service recovery as service failures are inevitable in the service industry because of the intangibility dimension of it.

This paper aimed to study the relationship between banks' service quality in the City of San Fernando, Pampanga with various indicators of customer retention and the mediating role of service recovery. The researcher pursued an in-depth study of the relationship the two variables service quality and customer retention and the mediating role of service recovery between the relationship of service quality and customer retention.

## 1.2 Research Objectives

The objective of the research is to describe the relationship between service quality and customer retention and the mediating role of service recovery in the banking industry.

## 1.3 Research Methodology and Data Analysis

This study used descriptive-correlational research design. The descriptive part of the study was the description of the main variables service quality, customer retention, and service recovery of the universal bank account holders within the City of San Fernando, Pampanga. These were accomplished by providing descriptions of what is being analyzed in order to collect data and other pertinent information. The correlational component was used to correlate the three variables. The role of service recovery in mediating is to see if there is a link between service quality and customer retention.

This study involved the three hundred sixty (360) universal bank account holders in the City of San Fernando, Pampanga. Since there are many universal bank companies in the City, the researcher narrowed down the number of bank companies for possible respondents into universal-private banks that are only located in the City.

In gathering the data needed in the study, the researcher adapted survey questionnaires from three (3) different studies. According to the existing studies and literature, the appropriate instruments are from the following research: (1) Parasuraman, Zeithaml, and Leonard (1988) for the service quality variable, (2) Qadri & Khan (2014) for the customer retention variable, and (3) Boshoff (1999) for the variable service recovery. The instrument for service quality was modified and aligned with the focused industry of the study; the modifications made for the customer retention variables was the conversion of negative statements to positive statement indicators; and the instrument for service recovery was modified in the sense that it was based on actual client experiences.

### 1.3.1 Data Gathering Procedure

The researcher utilized adapted survey questionnaires to gather first-hand information from the respondents. Before the researcher administered the survey questionnaires, the following procedures were followed:

First, the researcher adapted research instruments from three (3) different studies. According to their number of citations show that the public is consented to use the said instruments. Next, a pilot testing was conducted to 29 respondents to test the reliability of the questionnaires. Then, the data undergone the validity and reliability test with the use of Cronbach's Alpha.

Then, the researcher administered the survey questionnaire to the respondents where the former ensured that the respondents have a deep understanding of answering the specific questions in the questionnaire.
Afterwards, the researcher administered the survey questionnaire to the respondents, ensuring that they had a thorough understanding of how to respond to the specific questions in the questionnaire. Finally, the data were be checked, tallied, tabulated, and subjected to statistical treatment.

**1.3.2. Data Analysis**

To advance the systematic flow of the data analysis, the subsequent statistical tools was used:

1. To assess the respondents' agreement on the variables service recovery, customer retention and service quality, the weighted mean computation was used.
2. To validate the respondents' description of service quality and customer retention, the Likert Scale was applied. This was used to analyze the answers of the respondents, which were described using the five-point scale value and the conversion of the qualified weighted mean into a descriptive rating below.

| Scale Value | Range Interval | Description |
|---|---|---|
| 5 | 4.50 – 5.00 | Strongly Agree |
| 4 | 3.50 – 4.49 | Agree |
| 3 | 2.50 – 3.49 | Undecided |
| 2 | 1.50 – 2.49 | Disagree |
| 1 | 1.00 – 1.49 | Strongly Disagree |

3. To validate the respondents' description of service recovery the Likert Scale was applied. This was used in analyzing the respondents' responses which was described using the five-point scale value and the conversion on the qualified weighted mean into a descriptive rating.

| Scale Value | Range Interval | Description |
|---|---|---|
| 5 | 4.50 – 5.00 | Very Large Extent |
| 4 | 3.50 – 4.49 | Large Extent |
| 3 | 2.50 – 3.49 | Neutral |
| 2 | 1.50 – 2.49 | Least Extent |
| 1 | 1.00 – 1.49 | Least Extent |

4. To determine the significant relationship between service quality and customer retention, pearson r was calculated.
5. To know the mediation hypothesis for the present study, the mediation analysis was used to investigated the mediation effect of service recovery in the relationship between service quality on customer retention.

**1.3 Findings and Interpretation**

The analysis focused on a model examining the relationship between service quality and customer retention. The model fit measures indicate a moderately strong positive correlation between the two variables. The coefficient of determination ($R^2$) is reported to be 0.553, suggesting that approximately 55.3% of the variability in customer retention can be explained by changes in service quality. This means that a considerable portion of customer retention can be attributed to the level of service quality provided by the company. The Pearson correlation coefficient (r) is reported to be 0.744, indicating a high positive correlation between service quality and customer retention. This value further reinforces the idea that as service quality improves; customer retention is likely to increase as well. A correlation of this magnitude suggests that service quality plays a significant role in influencing customer decisions to remain loyal to the business. The findings from this linear regression analysis highlight the importance of service quality in customer retention. Businesses that focus on improving and maintaining high levels of service quality are more likely to see positive outcomes in terms of customer loyalty and retention.

| Effect | Label | Estimate | SE | Z | p | % Mediation |
|---|---|---|---|---|---|---|
| Indirect | a × b | 0.20 | 0.0282 | 7.22 | < .001 | 30.1 |
| Direct | c | 0.47 | 0.0388 | 12.19 | < .001 | 69.9 |
| Total | c + a × b | 0.68 | 0.0321 | 21.11 | < .001 | 100 |

For the mediating role of service recovery on service quality and customer retention, the analysis provides mediation estimates to understand the relationship between service quality, service recovery, and customer retention. Mediation refers to the process through which one variable (service recovery) acts as a mediator between another variable (service quality) and the outcome variable (customer retention). Here are the key findings:

Indirect Effect (a × b): The estimate for the indirect effect is reported to be 0.20, with a standard error (SE) of 0.0282. The z-value is calculated to be 7.22, and the corresponding p-value is less than 0.001. This indicates that the indirect effect is statistically significant. The indirect effect size is 30.1%, suggesting that service recovery partially mediates the relationship between service quality and customer retention.

Direct Effect (c): The estimate for the direct effect is reported to be 0.47, with a standard error (SE) of 0.0388. The z-value is calculated to be 12.19, and the corresponding p-value is less than 0.001. This indicates that the direct effect is also statistically significant. The direct effect size is 69.9%.

Total Effect (c + a × b): The estimate for the total effect is reported to be 0.68, with a standard error (SE) of 0.0321. The z-value is calculated to be 21.11, and the corresponding p-value is less than 0.001. This implies that the total effect is statistically significant, encompassing both the indirect and direct effects combined.

The mediation estimates demonstrate that both the indirect effect (mediated by service recovery) and the direct effect (directly influenced by service quality) have significant impacts on customer retention. The indirect effect accounts for 30.1% of the total relationship, while the direct effect accounts for 69.9%. As both the indirect and direct effects are significant, it suggests that service recovery plays a partial mediating role in the relationship between service quality and customer retention. This further implies that the better the service recovery programs the banks have, the more that clients will be satisfied with the banks' service quality and retain with their respective banks.

| **Variables** | | | **Label** | **Estimate** | **SE** | **Z** | **p** | **Meaning** |
|---|---|---|---|---|---|---|---|---|
| Service Quality | → | Service Recovery | a | 0.75 | 0.0465 | 16.23 | < .001 | Significant |
| Service Recovery | → | Customer Retention | b | 0.27 | 0.0335 | 8.06 | < .001 | Significant |
| Service Quality | → | Customer Retention | c | 0.47 | 0.0388 | 12.19 | < .001 | Significant |

For the path estimates, the analysis provides path estimates for the relationships between service quality, service recovery, and customer retention. Path estimates represent the direct effects of one variable on another.

Service Quality (a) → Service Recovery: The estimate for the path coefficient from service quality to service recovery (a) is reported to be 0.75, with a standard error (SE) of 0.0465. The z-value is calculated to be 16.23, and the corresponding p-value is less than 0.001. This indicates that the path from service quality to service recovery is statistically significant. A positive path coefficient suggests that higher levels of service quality are associated with increased service recovery efforts.

Service Recovery (b) → Customer Retention: The estimate for the path coefficient from service recovery to customer retention (b) is reported to be 0.27, with a standard error (SE) of 0.0335. The z-value is calculated to be 8.06, and the corresponding p-value is less than 0.001. This indicates that the path from service recovery to customer retention is statistically significant. A positive path coefficient suggests that effective service recovery positively influences customer retention.

Service Quality (c) → Customer Retention: The estimate for the path coefficient from service quality to customer retention (c) is reported to be 0.47, with a standard error (SE) of 0.0388. The z-value is calculated to be 12.19, and the corresponding p-value is less than 0.001. This indicates that the path from service quality to customer retention is statistically significant. A positive path coefficient suggests that higher levels of service quality are associated with increased customer retention.

The path estimates provide valuable insights into the direct relationships between the variables in the model. It appears that service quality has a significant positive influence on service recovery ($a = 0.75$), and service recovery, in turn, has a significant positive impact on customer retention ($b = 0.27$). Additionally, service quality directly affects customer retention as well ($c = 0.47$).

These findings suggest that both service quality and service recovery are essential factors in influencing customer retention. Higher service quality is associated with more effective service recovery efforts, which, in turn, contribute to improved customer retention rates. This underscores the significance of maintaining excellent service quality standards and implementing robust service recovery procedures to enhance overall customer satisfaction and loyalty.

Based on the results and conclusions of the study, the following recommendations were formulated:

1. It is also recommended that banks may consider keeping, committing, and fulfilling the banks' promises when settling and recovering from a service failure through enabling and empowering employees. The banks may consider empowering their employees by allowing them to take appropriate actions and decisions in handling clients' concerns with proper guidance based on the company manual. Also, recognizing employees' effort and hard work for successfully recovering a service failure may be considered by the banks to boost their confidence and strive to be a more dependable employees.
2. The banks may lessen the number of customers switching to other alternatives through highlighting and addressing clients' pain points as bank clients dislike queuing and long waiting hours. Banks may consider offering free refreshments, free access to limited WiFi, and free access to read books and magazines while waiting for their turn.
3. The banks may consider make developing a compelling offer to clients such as offering service guarantees which will reduce the barriers to avail bank services to make clients stay. Customer service guarantees may be considered by the banks such as if the bank fails to serve clients in less than 30 minutes (or in a specific time period), clients may have a discount on bank rates or their next transaction will be free of charge.
4. The banks may consider opening a 24/7 online chat customer service where clients who experienced ATM malfunctions may immediately report the problems/concerns they encounter to banks' customer service agents. This will also exhibit the banks' way of concern to clients and may reduce agitation about possible non-withdrawal of money or captured ATM cards and other similar ATM-related concerns and may be reported immediately for bank agent's prompt action. In this way, clients may also feel a safer and more secured ATM-related transaction and a way to recover a service failure.
5. It is also recommended for the banks to have a periodic maintenance of their ATMs to avoid malfunctioning and technical glitches. They may have an assigned officer who will be tasked to do a daily inspection and assessment on the machines per given location.
6. Future researchers may use the results of this study as a tool to conduct a similar study in other fields or other bank classifications which they could explore other suitable and relevant variables and concerns.

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