Islamic Banking Experience of Pakistan: Comparison between Islamic and Conventional Banks

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Abstract

This study examines the relationship between service quality and customer satisfaction regarding Islamic banks as well as conventional banks in Pakistan. It also investigated how service quality affects customer satisfaction by assessing the magnitude of the relationship between selected variables. This study is important due to an emerging trend of Islamic banking practices in Pakistan in the existence of conventional banking system. Data were collected from 720 bank customers by using stratified random sampling. SPSS 15.0 version is applied for data analysis. The results reflect that there is strong positive relationship between service quality and customer satisfaction in case of Islamic banks as well as in case of conventional banks. Findings showed that there is stronger positive relationship between service quality and customer satisfaction in Islamic banks as compared to Conventional banks in Pakistan. The study has a number of implications for bankers, policy makers and academicians.

Keywords: Islamic banking, Bank customers, Service quality, Customer satisfaction, Pakistan, Conventional bank

1. Introduction

Banks are performing multiple functions to provide a variety of products and service for different segments of the economy. Since its creation, Pakistani banking sector has experienced very turbulent environment due to unstable policies and uncertainty. Private sector banks dominated during 1950s and 1960s but they were nationalized in 1974. Nationalized banks showed very poor performance due to inferior products/services that resulted into the privatization of banking sector in 1992. State Bank of Pakistan has initiated working for the inception of Islamic banking practices in 2000 and Meezan Islamic bank was registered as first full-fledged Islamic bank in 2002. Islamic banks are new entrants in the Pakistani banking industry and also require a comparative study to assess the performance of their operations and products/services. Services industry particularly banking sector is growing across the globe during the decade of 1990s. The 21st century came with blending of opportunities and threats for the banking sector due to inception of Islamic banking practices in different countries like Malaysia, Pakistan, Bangladesh, Bahrain and even in non-Muslim parts of the globe. Islamic banks affect monetary system by adjusting the demand and supply forces for money. It is found that Islamic banking system is superior to conventional banking system as it ensures more stable financial sector (Khan, 1986). In another study, it was empirically verified that Islamic banking system showed excellent performance by supporting financial sector in Tunisia (Darrat, 1988). There is an empirical evidence to find out the influence of Islamic banking practices on monetary stability of Iran. The study showed mixed results, both for some evidence in favor to support and stabilize monetary system and somewhat against it (Yousefi, Abizadeh and Mccormick, 1997).

The existence of Islamic and conventional banks created competition among banks to meet customers' expectations for long term benefits. There are two banking systems that exist in Pakistan namely Islamic banking and conventional

banking. The Islamic bank (IB) and conventional bank (CB) is differentiated on the basis of objectives, Riba and risk sharing practices. IB follows principles of Sharia'h given by Allah Almighty while CB follows manmade SOPs; IB generates income as profits that is variable while CB earns from the interest that is fixed; risk is shared among lender, borrower and bank in IB while CB transfers the whole risk to others; IB is trade oriented unit while CB works as a pure financial intermediary to deal on the basis of interest. SBP plays an active role to establish a sound Islamic banking system in Pakistan according to principles of Sharia'h as mentioned in its mission statement that read "To promote and develop Islamic Banking industry in line with the best international practices, ensuring Sharia'h Compliance and transparency". SBP issued detailed criteria in December 2001 for the establishment of full-fledged Islamic bank in the private sector. Al Meezan Investment Bank received the license from SBP in January 2002 and started its operations with the name of Meezan Islamic bank as the first Islamic bank from March 20, 2002 (SBP, 2002).

Islamic banks have a number of opportunities in Pakistan with a population of more than 96% Muslims. Islamic banks have to face multiple challenges due to strong reaction from conventional banks because they were deep rooted and popular among the public to meet their requirements. The increasing number of conventional and Islamic banks created a healthy competition for the provision of quality service to retain satisfied customers for long-term benefits. The banking industry experienced an expansion due to diversification and innovation of products/services. Everyone tries to introduce innovative products and services by beautiful blending of traditional facilities and modern technology to cope with each other for greater number of customers that leads to more profitability. Pakistani banking sector witnessed a major change due to key role of private sector having about 80% of banking assets (Economic Survey of Pakistan, 2007-08). The ups and downs in the growth of banking sector requires a study to analyze the performance by considering quality of services offered by banks in relation to customer satisfaction. There are studies about two banking systems (Islamic banking and conventional banking); plenty of studies are available regarding different aspects of conventional system while rare for the other. The acute shortage of literature regarding Islamic banking system inspired the researchers to conduct a comparative study in Pakistan. This study examines how service quality affects the customers' judgments towards satisfaction of the Islamic banks as well as conventional banks in Pakistan This research is an effort to fill this gap in the literature. This study aims to examine the two banking streams i.e. Islamic banking and conventional banking in Pakistan with reference to service quality and customer satisfaction. This study may help the practitioners, bank managers, academician and policy makers to find out the pattern of satisfaction for bank customers in Pakistan. This study is also important because Islamic banking is growing in terms of size and structure at a rate of 114 percent per annum (SBP, 2006).

2. Literature Review

Islamic banks are striving to capture the maximum number of customers to compete with conventional banks by providing a large number of products as an alternative for interest based products. In Pakistan, banks are providing a wide range of products and services and facing intensive competition to attract potential customers. Persuraman *et al.* (1985, 1991b) devised SERVQUAL model and investigated the service quality. They explored ten dimensions of service quality and refined into five dimensions. It was documented that an increase in service quality and professional behavior resulted a greater customer satisfaction and reduced customer erosion (Leeds, 1992). The relationship between service quality and customer satisfaction is becoming crucial with the increased level of awareness among bank customers (Sureshchander *et al.* 2002).Islamic banks showed remarkable progress. It has captured a reasonable market share with excellent growth rate of 114% per annum. The increasing number and size of Islamic banks is also a positive sign of development and success. There are six full-fledged Islamic banks working in different cities of Pakistan and 13 conventional banks have started partial Islamic banking practices by establishing a large number of branches exclusively engaged in Islamic banking practices (SBP, 2006).

Mishkin (2001) reported that banking and financial services are the integral part of services industry and its contribution is increasing with the passage of time. However, expansion of global and integrated banking sector has to face many challenges of legislation, technological and structural changes (Angur *et al.* 1999). The relationship between service quality and customer satisfaction is investigated by a number of researchers across the globe. It is concluded that there is strong association between dimensions of service quality and overall customer satisfaction (Anderson and Sullivan, 1993). It is found that the banking industry has a link between service quality and customer satisfaction (Avkiran, 1994). Islamic banking practices resulted into a notable increase in the supply of loans. It is found that government intervention played an important role to manage funds besides other economic factors in the economy (Makiyan, 2003).

Levesque and McDougall (1996) investigated the influence of key determinants of service quality on customer satisfaction in financial institutions. They found a substantial impact of service problems on customer satisfaction and their intensions to switch. It is suggested that service quality is an essential determinant of customer satisfaction (Yavas *et al.*, 1997). Islamic banks working in different parts of the world assessed their performance in reference to service quality and customers' responses. An empirical study was conducted to measure customer awareness and satisfaction by using a sample of 206 respondents towards Islamic banking in Jordan. It is observed that customers have awareness about

products of Islamic bank but expressed a sense of dissatisfaction towards some of the services (Naseer, Jamal and Al-Khatib, 1999). Bahia and Nantel (2000) developed an alternative scale for measurement of service quality in retail banking. They developed BSQ and compared with SERVQUAL. They found that BSQ dimensions are more reliable than SERVQUAL dimensions. In another study SERVQUAL is compared with Technical/Functional quality of services in private banks. Results showed that Technical/Functional quality model is better (Lassar et.al, 2000). A survey of 801 customers indicated that customers' perception of service quality differs in terms of demographic characteristics (gender, ethnicity, education and income) of the respondents (Urban and Pratt, 2000).

Oppewal and Vriens (2000) empirically investigated the relationship between service quality and customer satisfaction by using original SERVQUAL instrument with 10 dimensions as devised by Parasuraman *et al.* (1985). This study gave a direction to relate service quality and customer satisfaction. Service quality gained significance with the passage of time due to increased competition among service firms. It was examined that how customer satisfaction affects the customers' behavioral consequences. The study found a strong impact of customer satisfaction on their decision to stay with the existing service provider; and restrain their negative behavioral intentions. (Athanassopoulos, Gounaris and Stathakopoulos, 2001). Kayis, Kim and Shin (2003) conducted a comparative analysis of Australian and Korean banks to find out the quality management practices and its outcomes. They found a meaningful relationship between perceived service quality and customer satisfaction. They suggest that organizations should focus on service quality as an input to customer satisfaction for long-term benefits and business success. Now banks have realized the importance of service quality for successful survival in today's global and highly competitive environment (Wang *et al.* 2003). Jamal (2004) investigated the customer behavior in retail banking by considering service quality and its outcomes. It was observed that customers have varied experiences of satisfaction and dissatisfaction for utilization of self-service technologies. Financial sector is becoming more conscious about the performance evaluation regarding quality of products/services according to customers' expectations. In another study, findings reveal a positive correlation between financial performance and customer service quality scores (Duncan and Elliott, 2004).

Curry and Penman (2004) reported that service quality is inevitable for differentiation to compete in the banking sector. They suggested that the right service could retain the customers for long-term benefits. So, Banks should maintain the level of services by proper allocation of resources to meet customer requirements. Findings indicated that financial institutions require reasonable procedures to evaluate the overall satisfaction of their customers. However, understanding of changing needs and expectations of customers is an essential prerequisite for the financial sector (Joseph *et al.* 2005). Jabnoun and Khalifa (2005) proposed and tested a measure of service quality to compare conventional and Islamic banks in UAE. The study found that four dimensions were significant in case of conventional banks. While only personal skill and values were crucial in determining service quality in Islamic banks. It is found that bank-customer relationship quality is evident between satisfied and dissatisfied customers. Both types of customers have clearly distinctive feelings regarding their service experience (Nelson and Chan, 2005). Al-Hawari and Ward (2006) found that customer satisfaction plays an inter-mediator role in the relationship between service quality and financial performance of the banks. In another study, overall customer satisfaction was investigated in Malaysian banking industry by collecting data from 220 customers of 15 retail banks. It was found that overall customer satisfaction is one of the key determinants of relationship quality (Nelson, 2006). It is suggested that bank should start service quality improvement programs to enhance customer satisfaction and customer loyalty (Razak *et al.*, 2007). On the basis of existing literature, this study examines the perception of bank customers regarding service quality and its impact on customer satisfaction in Pakistani banking sector, we test the following hypotheses.

H1: There will be positive relationships between service quality and customer satisfaction regarding Islamic banks in Pakistan.

H2: There will be positive relationships between service quality and customer satisfaction regarding Conventional banks in Pakistan.

3. Method of the Study

This study investigates satisfaction level of bank customers regarding products offered by Islamic and conventional banks in Pakistan. The population of the study consists of the customers of Islamic banks and conventional banks operating in Pakistan. A sample of 720 respondents is selected for this study by using stratified random sampling. The stratification has been done based on the nature of bank i.e. Islamic bank or conventional bank. From each group of bank, customers were selected randomly to assess their responses. A structured questionnaire was developed to record their responses. From each group of bank (Islamic bank or conventional bank), customers were approached to collect data by self-administrated questionnaires. The study also adopted "personal contact" approach i.e. respondents were approached personally. The researchers explained the questionnaire and the objective of survey by telling its purpose, the meaning of the items and what is expected from the respondents. Following Banks were included in the study that is listed in table 1.

Conducting a comprehensive literature review and consulting with bank managers, professionals and customers enabled the researchers to modify and refine the research instrument in Pakistani environment. The researchers used structured questionnaire in English to collect data from customers of IB and CB. Customers' responses regarding service quality were collected by a modified version of SERVQUAL model developed by Parasuraman et al. (1988, 1991). It contains 22 items and divided into five dimensions i.e. tangibility, reliability, responsiveness, assurance and empathy. Each items is assessed by a seven point Likert scale as it stands for 1 = strongly disagree to 7 = strongly agree. Customer satisfaction was judged by a modified version of research instrument applied by Sureshchnader *et al.* (2002). It consisted of 29 items that were classified into five dimensions i.e. core service or service product; human elements of service delivery; systematization of service delivery (non-human element); tangible of service (servicescapes) and social responsibility. Customers were asked to give their feelings of satisfaction related to their banking experiences. Customers' responses were evaluated on a seven point Likert scale ranging from 1 (reflects very high dissatisfaction) to 7 (reflects very high satisfaction) with respect to all 29 items. The data were collected from the respondents residing in the 10 major cities of Pakistan i.e. Islamabad, Rawalpindi, Lahore, Karachi, Gujranwala, Sargodha, Multan, Sialkot, Gujrat, and Faisalabad. The researchers selected the most populous cities that represent the approximately 20% of total population of the Pakistan (World Gazette, 2009). A total of 1000 questionnaires were distributed among respondents to gather their responses. There were 720 completed and useable questionnaires available for data analysis. The response rate is 72% that is reasonable to perform statistical analysis by using SPSS 15.0 version.

4. Results and Discussion

Descriptive statistics are used to have a snapshot of demographic characteristics of the respondents. While Pearson correlation and regression test is applied to examine the relationship between service quality and customer satisfaction in the banking sector of Pakistan. Demographics of the respondents reflect that male customers are greater than female customers. In case of IB 79% are male customers and 21% of the sample is represented by female customers. While the CB reflects that 77% respondent are male and 23% are female. Male customers are more inclined towards IB as compared to CB but female customers prefer CB as compared to IB. It is consistent with the literature as men and women are differentiated due to role and perception in the society (Woldie and Adersua, 2004). Social, cultural and religious factors also influence the banking activities. Men are responsible for financial activities outside the home while female performs domestic duties inside the home (Obbe, 1980). The distribution of customers according to age reflects that young and mature people (25-34) are more interested to interact with IB while young people (18-24 years) are inclined towards CB. It is found that the majority of primary bank customers are male between 20 to 55 years old in Nigeria (Ojo, 1994). While most of the customers of Islamic banks fall in the age group of 25-35 years (Khan, Hassan and Shahid, 2008).

A summary of relationship between service quality and customer satisfaction is shown in table 2. Table 2 shows the relationship between IBSQL and IBCS. It is found that there is strong positive relationship (r = 0.8640) between IBSQL and IBCS. It supported the hypothesis that service quality is positively related to customer satisfaction in Islamic banks working in Pakistan. It is consistent with the literature as it is reported that there is a positive relationship between service quality and customer satisfaction (Razak, Chong and Lin, 2007). Similarly, findings reveal that there is a strong positive correlation (r = 0.777) between CBSQL and CBCS. It supported the hypothesis that service quality is positively related to customer satisfaction in conventional banks working in Pakistan. The results reflect that the service quality leads to greater satisfaction among bank customers. It is found that there is positive relationship between service quality and customer satisfaction in Pakistan (Jamal and Naseer, 2003). It is reported that the meeting of customers' expectation is crucial to increase customers' satisfaction by delivery of better quality services (Gao, Jia and Zhao, 2006). However, results indicate that service quality offered by Islamic banks leads to greater satisfaction among Islamic bank customer as compared to customer of conventional bank.

Table 3 shows the results of IBSQL-IBCS model. The coefficient of determination is 0.745 that indicates the goodness of the model. There is highly significant linear relationship (i.e. p= 0.000) between service quality and customer satisfaction in Islamic bank. F-statistics (210.595) shows that variation (influence) of Independent Variable (IBSQL) is appropriately explained in the dependent variable (IBCS). The estimated regression model is IBCS = 0.739 + 0.854 (IBSQL). It indicates that service quality has significant (p<0.005) impact on customer satisfaction in Islamic banks. Table 4 represents the results of CBSQL-CBCS model. The coefficient of determination is 0.604 that indicates the goodness of the model. It shows significant linear relationship (i.e. p= 0.000) between service quality and customer satisfaction in conventional banks. F-statistics (545.714) reflects that variation (influence) of Independent Variable (CBSQL) is appropriately explained in the dependent variable (CBCS). The estimated regression model is CBCS = 1.174 + 0.756 (CBSQL). It reflects that service quality has significant (p<0.005) impact on customer satisfaction in conventional banks.

The results show that male customers are greater than female customers that used products/services of selected banks working in Pakistan. It is consistent with literature as men and women bank customers could be differentiated due to social, cultural, and religious factors. It is evident from previous research that male customers perform more banking

activities than female customers (Obbe, 1980; Alsop, 1984; Woldie and Adersua, 2004). Similarly, the most of the customers fall in the age group of 25-34 years in case of IB and 18-24 year in case of CB. It is in line with literature, it is reported that the most of the bank customers dealing with Islamic banks fall in the group of 25-35 years besides education level and income group (Khan, Hassan and Shahid, 2008).

There is strong positive relationship between IBSQL and IBCS (r=0.846). It is in line with previous research that there is strong positive relationship between service quality and customer satisfaction in Pakistan (Jamal and Naseer, 2003). Similarly, it is found that there is strong positive relationship between CBSQL and CBCS (r=0.777). Furthermore, the relationship between service quality and customer satisfaction is stronger in Islamic banks as compared to Conventional banks in Pakistan. The results are consistent with the literature, as a strong relationship is reported between service quality and customer satisfaction regarding products offered by Islamic banks (Metawa and Almossawi, 1998). The findings supported the hypotheses and null hypotheses are accepted due to positive relationship between selected variables. The results also supported the previous studies (Athanassopoulos *et al.*, 2001; Jabnoun and Khalifa, 2005; Nelson, 2006). Similarly, Iglesias and Guille`n (2004) reported a direct and positive relationship between service quality and satisfaction level of customers regarding their banking experiences. There are a number of studies that reported a positive relationship between service quality and customer satisfaction in the banking sector (Levesque and McDougall, 1996; Yavas *et al.*, 1997; Bahia and Nantel, 2000; Oppewal and Vriens, 2000; Arasli *et al.*, 2005; Al-Hawari and Ward, 2006; Tahir and Abu Bakar, 2007).

5. Summary and Concluding Remarks

Financial services industry especially banking sector witnessed unprecedented growth during the last few years in every part of the world. A large number of new banks have started operations in Pakistan at the beginning of 21st century. Similarly, inception of Islamic banking operations in 2002 opened new avenues to exploit the opportunities. Islamic banks are getting popularity due to interest free products, risk sharing activities and strong ties with the religion. Islamic banks work as welfare organization to promote trade and economic activities in line with the instructions of Islam to provide a number of interest-free products/service. The existence of Islamic and conventional banks in Pakistan created stiff competition among banks to attract and retain greater number of customers by the provision of quality services. This study examined the relationship between service quality and customer satisfaction by comparing Islamic and conventional banks operating in Pakistan. A structured questionnaire is used to collect data regarding service quality and customer satisfaction. The researchers collected data from 720 respondents using products/services of Islamic bank and conventional by stratified random sampling. The responses of bank customers were analyzed by Pearson's Correlation and regression techniques using SPSS 15.0 version. The results show that there is strong direct and positive relationship between service quality and customer satisfaction. The magnitude of relationship between service quality and customer satisfaction is greater in Islamic banks as compared to conventional banks. The findings supported the hypotheses being consistent with the previous literature (Sureshchnader *et al.* 2002; Jamal, 2004; Arasli *et al.*, 2005; Al-Hawari and Ward, 2006; Razak *et al.*, 2007). Bankers can attract more customers by launching effective marketing campaigns to enhance awareness towards quality of their services. It helps to enhance the understanding of bank customers about service quality regarding Islamic and conventional banks in Pakistan. Bank managers should take quality initiatives to improve their products by considering demographic characteristics of the customers.

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Table 1.

Islamic Banks	Conventional Banks
Meezan Islamic Bank	National Bank of Pakistan
Dubai Islamic Bank Limited	Habib Bank Limited Pakistan
Albaraka Islamic Bank Limited	MCB Bank Limited
Bank Islami Pakistan Limited	United Bank Limited
First Dawood Islamic Bank Limited	Askari Bank Limited
Qatar Islamic Bank Limited	Bank Alfalah Limited

Table 2. Summary of Correlation between Selected Variables

Variables	Pearson Correlation	Sig. (2-tailed)
IBSQL and IBCS	0.864**	0.000
SBSQL and CBCS	0.777**	0.000

** Correlation is significant at the 0.01 level (2-tailed).

Table 3. Summary of the IBSQL-IBCS Linear Regression Model (based on SPSS results)

(Coefficients, Standard Error in Parenthesis, t-values in Brackets & p-values in italics)

Constant	IBSQL	R^2	F-Statistics
0.739	0.854	0.746	210.595
(0.139)	(0.026)		
[5.311]	[32.437]		
0.000	*0.000*		*0.000*

Predictor (Constant), IBSQL (Islamic Bank Service Quality)

Dependent Variable: IBCS (Islamic Bank Customer Satisfaction)

Table 4. Summary of the CBSQL-CBCS Linear Regression Model (based on SPSS results)

(Coefficients, Standard Error in Parenthesis, t-values in Brackets and p-values in italics)

Constant	CBSQL	R^2	F-Statistics
1.174	0.756	0.604	545.714
(0.163)	(0.032)		
[7.188]	[23.361]		
0.000	*0.000*		*0.000*

Predictor (Constant), CBSQL (Conventional Bank Service Quality)

Dependent Variable: CBCS (Conventional Bank Customer Satisfaction)