

# Loyalty formation and its impact on financial performance of Islamic banks – evidence from Indonesia

Loyalty formation and its impact

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## Abstract

**Purpose** – This paper aims to examine loyalty formation, including service quality, perceived value, image and satisfaction as determinants, and their effect on the financial performance of Islamic banks.

**Design/methodology/approach** – Data were collected from 280 Islamic bank clients in Indonesia and bank financial performance data from bank financial reports. Variance-based partial least square modelling was used to assess the relationships between loyalty, its determinants and their influence on bank financial performance.

**Findings** – This study finds that client loyalty towards Islamic banks is most influenced by perceived service quality and perceived value. Further, this study documents the importance of client loyalty in influencing bank financial performance and indirect effect of clients' satisfaction on financial performance through the strengthening of client loyalty.

**Practical implications** – This study offers a path for the managers of Islamic banks to enhance financial performance by enhancing client loyalty. To develop client loyalty, this study suggests that Islamic banks should offer economical and service-derived benefits that are superior to those other banks offer. Further, Islamic banks need to ensure that their business operations are compatible with Islamic values.

**Originality/value** – This is an early empirical study attempting to examine the link between customer loyalty and its impact on Islamic bank financial performance.

**Keywords** Satisfaction, Loyalty, Financial performance, Islamic bank

**Paper type** Research paper



## Introduction

The Islamic banking industry is appealing to Muslim customers as it fulfils their banking services needs while meeting their religious obligations (Kartika *et al.*, 2019). Based on the principles of sharing benefits and risks, Islamic banking is a dynamic part of the financial industry in most countries where majority of population is Muslim (Kartika *et al.*, 2019). Although mainly targeting Muslim customers, Islamic banks could potentially attract non-Muslim customers (Saleh *et al.*, 2017). However, as a relative newcomer, Islamic banks are less popular and perceived as less experienced than conventional banks (Nizar and Marzouki, 2015). Thus, for Islamic banks, developing a loyal customer base is an important step towards achieving competitive advantages, including business outcomes such as increased deposits, future revenues and lower operational costs (Saleh *et al.*, 2017; Suhartanto *et al.*, 2019).

Two issues have arisen from the vast amount of research that has scrutinized customer loyalty across many industries, including banking. Within the banking industry, the literature has thoroughly examined the determinants of customer loyalty and, generally, past studies report that quality of service, perceived value, company image and customer satisfaction are building blocks of loyalty (Boonlertvanich, 2019; Hamouda, 2019; Keisidou, 2013). Nevertheless, most of these studies were conducted with conventional banks and little attention has been given to the Islamic banking context (Kartika *et al.*, 2019; Suhartanto *et al.*, 2019). As conventional banks use a different business approach, any loyalty model developed for those banks, especially those using interest rates as a surrogate for value, is hardly going to be suitable for explaining loyalty in Islamic banking, where benefit and loss sharing is central. Therefore, an examination of loyalty formation in Islamic banking is warranted.

Secondly, the literature has established that business performance is influenced by customer satisfaction and loyalty (Eklof *et al.*, 2018; Fathollahzadeh *et al.*, 2011). Yet, even though the association between satisfaction, loyalty and business financial performance is said to be strong (Edvardsson *et al.*, 2000; Heskett *et al.*, 2003; Smith and Wright, 2004), recent studies have reported controversial results, questioning whether having satisfied and loyal customers indeed increases business profitability (Golovkova *et al.*, 2019; Hegner-Kakar *et al.*, 2018; Larivière *et al.*, 2016). Therefore, scholars such as Eklof *et al.* (2018) and Larivière *et al.* (2016) have called for further exploration into the impact of customer satisfaction and loyalty on financial performance. Islamic bank clients are different from conventional bank clients in that client behaviour is not only driven by a need for banking services but also to adhere to religious values. Therefore, the research findings that have found links between satisfaction, loyalty and financial performance in other businesses including conventional banks, may not be generalisable to Islamic banks and their clients.

To address these research gaps, this study examines loyalty formation and its effect on the financial performance of Islamic banks. More specifically this study attempts to:

- assess the antecedents of loyalty formation including service quality, image, perceived value and satisfaction; and
- evaluate the impact of customer satisfaction and loyalty on financial performance.

For this investigation, a focus on Indonesian Islamic banks was chosen primarily for two reasons. Firstly, Islamic banks are not a dominant force in the Indonesian banking industry. In fact, they represent a small part of the market, with a small asset base (5% of the nation's banking assets), a small market share (4.6%) and since 2012, their growth has been lacklustre, as reported by the Indonesian Central Bank (2017). Secondly, Indonesia represents an enormous potential market for Islamic banks as it is the most populous Muslim country with a huge middle class. Taken together, these figures suggest that

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Indonesian Islamic banks have not been able to take advantage of this potential market and their development of customer loyalty could be an important path towards future success.

## Conceptual review and hypotheses development

### *Bank loyalty formation*

Many conceptual models, such as the tripartite theory-based loyalty model, the four-stage Oliver loyalty model and the experience quality-loyalty intention model, have been developed to explain loyalty (Chen and Chen, 2010; Li and Petrick, 2010; Oliver, 1999). Among those conceptual models, loyalty as a behavioural construct and loyalty as an attitudinal construct are widely accepted (Kartika *et al.*, 2019; Suhartanto *et al.*, 2019). The simplest conceptualization of customer loyalty is as a continuation of past behaviour. A bank client is considered to be loyal if they have completed a large number of transactions or have had a relationship with the bank for a long period of time (Bakar *et al.*, 2017; Boonlertvanich, 2019). This behavioural approach has limitations as it cannot distinguish true loyal bank customers from those who have no choice or have selected the bank solely for convenience or cost reasons.

This limitation has led to other more attitudinal loyalty approaches including the widely accepted definition presented by Oliver (1999, p. 34):

[...] a deeply held psychological commitment to re-buy or re-patronize a preferred product/service consistently in the future, thereby causing repetitive same-brand or same brand-set purchasing, despite situational influences and marketing efforts having the potential to cause switching behavior.

Oliver's definition implies that loyal customers are those who will repurchase in the future and withstand the marketing efforts of competitors. This approach treats loyalty as a customer propensity to behave in the future and facilitates the measurement of loyalty strength, from disloyal to very loyal, but it suffers from its arguable predictive power of actual future behaviour (Hamouda, 2019).

Because of the drawbacks of both approaches, scholars have suggested the use of a mixed approach to assess bank loyalty, consisting of both behavioural and attitudinal components (Fathollahzadeh *et al.*, 2011; Wahyuni and Fitriani, 2017). In essence, a loyal client exhibits positive attitudes and behaviours towards a bank. From a managerial perspective, the mixed approach is useful as it is likely to better predict client future behaviour.

Literature notes that loyalty is complex and is influenced by many factors. Specific determinants have been identified, including service quality, satisfaction, perceived value and image. Each determinant is discussed in the following sub-sections, along with their impact on the development of loyalty towards banks.

### *Customer satisfaction*

Satisfaction is a feeling of pleasure experienced when a customer's expectation is met by a product's performance (Oliver, 1999). Satisfaction as a consequence of the confirmation of expectations is termed evaluative satisfaction, whereas satisfaction resulting from non-rational processes is labelled emotion-laden (Bennett and Rundle-Thiele, 2004). The level of perceived service quality is a significant contributor to evaluative satisfaction, so it is important that banks deliver high service quality to facilitate client satisfaction and client loyalty (Bakar *et al.*, 2017; Saleh *et al.*, 2017). In addition, the research considers emotional brand attachment to be the result of an emotion-laden process that impacts customer satisfaction, which contributes to customer loyalty (Levy and Hino, 2016). This discussion confirms the significant role that satisfaction plays in the formation of loyalty among bank clients.

*Service quality*

The service quality concept has been discussed intensively in banking research. Perceived service quality, a consumer's overall assessment of the service performance (Zeithaml, Berry, and Parasuraman, 1996), is part of a bank's core service. Thus, the provision of a high-quality service is essential for any bank, as it is a part of the rational consideration for a customer to be loyal towards the bank. Furthermore, the role of perceived service quality is intertwined with other marketing variables such as customer satisfaction and post-purchase behavioural intention in banking (Bakar *et al.*, 2017). Scholars (Saleh *et al.*, 2017) report that when bank consumers perceive high service quality, they tend to be satisfied and continue their relationship with the bank by remaining a client even if the service price increases. Finally, past empirical studies (Bakar *et al.*, 2017; Kashif *et al.*, 2015) conclude that service quality is critical in developing brand loyalty. Thus, the hypotheses related to service quality in Islamic bank are stated as follow:

H1. Service quality has a positive effect on satisfaction.

H2. Service quality has a positive effect on loyalty.

*Perceived value*

In the banking industry, customer perceived value is interpreted as an evaluation between what the client gives and benefits received in banking services (Hamouda, 2019). In essence, perceived value can be explained with equity theory which assumes that a customer expects the service they receive is relatively equal to the sacrifices they make, whether financial or non-financial (Fathollahzadeh *et al.*, 2011; Keisidou, 2013). A bank client will consider high perceived value if the banking service they receive is of high quality (Al-Hawari, 2006; Eklof *et al.*, 2018), i.e. worth more than what they have spent. High perceived value can strengthen the relationship between customer and bank. In contrast, if they feel that what they have received is less than what they have spent, this would be considered low value, and they would be unsatisfied (Hamouda, 2019; Suhartanto *et al.*, 2019) which could weaken the relationship between client and bank. Perceived value can be multi-faceted, and at least four values have been identified: functional, monetary, social, and physiological (Hamouda, 2019). Arguably, in Islamic banking, an important perceived value of banking service is a monetary value such as profit sharing and transaction cost, but the functional and physiological value can also be present for Islamic banks because they offer services that comply with Muslim values (Saleh *et al.*, 2017; Wahyuni and Fitriani, 2017). Thus, perceived value will impact on loyalty as reported in various past empirical studies (Hamouda, 2019; Keisidou, 2013; Suhartanto, 2019):

H3. Service quality has a positive effect on perceived value.

H4. Perceived value has a positive effect on satisfaction.

H5. Perceived value has a positive effect on loyalty.

*Image*

Image is another important factor in the development of loyalty towards an Islamic bank (Suhartanto *et al.*, 2018). An image consists of two main elements: functional quality and emotional quality (Saleh *et al.*, 2017), where functional quality refers to tangible aspects that can be recognized and appraised and emotional quality is related to the psychological components which are expressed by a customer's attitude towards and experience with a

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business organization. Scholars (Muslim *et al.*, 2013) suggest that in addition to functional and emotional quality, the image in a consumer's mind is shaped by communication from a bank, including its advertising, public relations and association with other entities related to the bank image such as employees, clients, and location. Among these factors, scholars argue that a bank client's direct involvement with the service is the most influential aspect affecting bank image (Saleh *et al.*, 2017; Suhartanto *et al.*, 2018).

The image of a bank is the consequence of all the beliefs, involvement, feelings and understandings that a person has about the bank (Muslim *et al.*, 2013). This explanation implies that the service quality and perceived value are drivers of image (Wahyuni and Fitriani, 2017). As a consequence of satisfactory experience and high perceived value, a favourable image causes a positive assessment of the service and affects a customer's future behavioural intention. In the banking context, scholars (Saleh *et al.*, 2017; Suhartanto *et al.*, 2018) report favourable consequences of an image on customer satisfaction and loyalty intentions towards Islamic banks. This discussion suggests that bank image could be an intermediate link between the quality of service and loyalty behaviour. Therefore, the following hypotheses are proposed:

- H6. Service quality has a positive effect on image.
- H7. Perceived value has a positive effect on image.
- H8. Image has a positive effect on satisfaction.
- H9. Image has a positive effect on loyalty.

#### *Bank financial performance*

In banking, financial performance is a set of measures used to assess the healthiness of banks including some form of risk assessment (Keisidou, 2013), and it is used as a key internal performance measure for every bank entity (Al-Hawari, 2006). Bank financial performance is not limited to quantitative measures and can include indicators of customer relations and the quality of its relationships with other financial institutions (Golovkova *et al.*, 2019). The quantitative measurement of financial performance is usually represented by business profitability as measured by the ratio of return on assets (ROAs), a comparison between total profits with total assets, return on equity (ROE), a comparison between total profits with and total equity and net profit margin (NPM), a percentage of revenue remaining after all expenses have been deducted from sales (Eklof *et al.*, 2018; Saeidi *et al.*, 2015).

Edvardsson *et al.* (2000) propose a "satisfaction-loyalty-performance" logic to explain the link between satisfaction, loyalty and business performance. This logic assumes that satisfaction and loyalty impact on business performance because they shape both customer-related costs and revenues. The cost of obtaining a new customer tends to happen at the beginning of the relationship with the client ("front-loaded"); whereas profit tends to appear after the relationship with the client established for some time ("back-loaded"; Edvardsson *et al.*, 2000). This logic implies that loyal customers will last longer, and during this time will generate more sales, revenues and profits. Past studies in many industries support this logic and provide empirical evidence across a variety of business contexts (Eklof *et al.*, 2018; Golovkova *et al.*, 2019; Otto *et al.*, 2019; Smith and Wright, 2004). However, studies in banking examining the association between satisfaction, loyalty and financial performance have reported mixed results. Keisidou (2013), for instance, found no evidence that customer satisfaction and loyalty affected bank financial performance in Greece. But, Loveman (1998) reported that customer loyalty favourably impacts financial performance at the bank unit

level, and improved customer loyalty is associated with improvements in financial performance at the branch level. A study in Australian banks (Al-Hawari, 2006) reveals that satisfaction mediates the association between quality of service automation and bank financial performance. Al-Hawari (2006) suggests that high-quality service automation needs to be regulated to increase customer satisfaction, which in turn will improve bank financial performance. Recent studies, using customer satisfaction indices, validate that having satisfied and loyal customers can significantly improve a bank's financial performance and can be a strong indicator of future bank profitability (Eklof *et al.*, 2018; Hegner-Kakar *et al.*, 2018). However, no studies have examined these issues in an Islamic banking context. Based on this discussion, it is expected that the link between satisfaction, loyalty and Islamic bank financial performance will be as follows:

- H10. Satisfaction has a significant effect on loyalty.
- H11. Satisfaction has a significant effect on financial performance.
- H12. Loyalty has a significant effect on financial performance.

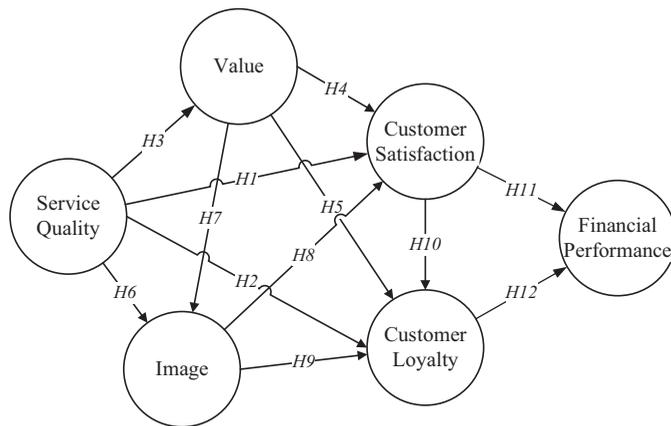
Figure 1 illustrates the proposed associations between loyalty formation and financial performance in Islamic banks.

**Research method**

This study focuses on loyalty formation in Islamic banks based on service quality, perceived value, bank image and satisfaction as its drivers and financial performance as its consequence. As many studies have been conducted using the variables used in this study, where possible, the measurement of the variables has been adopted from the extant literature as shown in Table 1.

All of the items for service quality, perceived value, image, customer satisfaction, and loyalty indicators were measured on a five-point Likert scale, 5 = “strongly agree” and 1 = “strongly disagree”. Prior to collecting the data, the questionnaire was pretested to ensure that the instructions and the questions were well-understood. This process resulted in minor changes for instructions and some items.

There are 43 conventional banks and 12 Islamic banks in Bandung. The client lists of the banks are not available, but the number of accounts can be estimated. The total number of



**Figure 1.**  
Proposed model of the links between loyalty formation and financial performance

**Table 1.**Measurement scale  
and its sources

Construct	# Item	Sources
Service quality	8	Kartika <i>et al.</i> (2019), Keisidou (2013), Suhartanto <i>et al.</i> (2019)
Perceived value	4	Fathollahzadeh <i>et al.</i> (2011), Hamouda (2019), Henrique and Matos (2015)
Bank image	3	Kartika <i>et al.</i> (2019), Suhartanto <i>et al.</i> (2018), Wahyuni and Fitriani (2017)
Customer satisfaction	3	Kartika <i>et al.</i> (2019), Suhartanto <i>et al.</i> (2019), Wahyuni and Fitriani (2017)
Customer loyalty	3	Boonlertvanich (2019), Kartika <i>et al.</i> (2019), Keisidou (2013), Muslim <i>et al.</i> (2013)
Financial performance (ROA, ROE, NPM)	3	Chi and Gursoy (2009), Eklof <i>et al.</i> (2018), Keisidou (2013), Saeidi <i>et al.</i> (2015)

accounts in Indonesian banks is more than 292 million accounts in 2019 (OJK, 2020). This is about the same as the national population so considering the region's population is about 8 million, it is estimated that the number of bank accounts will be approximately 8 million. The Islamic bank share is about 5% (OJK, 2020), so about 400,000 Islamic bank accounts and if we assume that half the population has two bank accounts, there should be approximately 200,000 clients of Islamic banks in Bandung region.

This study used self-administered questionnaires to gather data from Islamic bank customers in Bandung, Indonesia. As a sampling frame of the target population (a list of Islamic banking customers) was unavailable, the use of a random or probabilistic sampling method was not possible. Thus, convenience sampling was used to select respondents.

Members of the general public were approached, often in the vicinity of 1 or more Islamic banks, but also in shopping areas and markets throughout Bandung, and if they were clients of an Islamic bank, they were invited to participate in the research. The survey was administered to 345 customers of Islamic banks during the period of March to April 2019. A total of 280 completed questionnaires were gathered, resulting in an 81% response rate. This sample size satisfied the minimum sample requirements for using multivariate analyses (e.g. 10 times the number of question items) as suggested by Hair *et al.* (2017). Banking performance data was gathered from bank financial reports, from the 2019 financial year.

The scale reliabilities and convergent and discriminant validities of the construct variables were examined using Cronbach's alpha and composite reliability (CR), average variance extracted (AVE) and heterotrait-monotrait ratio, respectively. Partial least square structural equation modelling (PLS-SEM) was used to perform the measurement of the model and latent variables, as it performs well for small and medium samples where the data is non-normality distributed (Chin *et al.*, 2008). The model structure was also tested with PLS-SEM including the calculation of path coefficients (Hair *et al.*, 2017). Following Kock and Lynn (2012) recommendation, full collinearity variance inflation factors (VIFs) were used to test for common method variance prior to testing the model, resulting in the value of 1.894. As this perceived value was less than the cut-off value of 5 (Hair *et al.*, 2017), it was determined that common method variance was not an issue for the study.

## Results

Table 2 presents the profile of the respondents' characteristics.

Variable	Description	Frequency	(%)
Gender	Male	135	48.2
	Female	145	51.8
Age	<25	97	34.7
	25–35	52	18.6
	36–45	90	32.1
	>45	41	14.6
Education	<High school	14	0.05
	High school	44	15.7
	Graduate	203	72.5
	Postgraduate	19	6.8
Income (Million IDR)	<1	41	14.7
	1–5	160	57.1
	6–10	73	26.1
	>10	6	2.1
Retention (Year)	<3	127	45.3
	3–5	128	45.7
	> 5	25	0.09

**Table 2.**  
Respondents' profiles

### Measurement model

To evaluate the model proposed, a two-stage examination was applied. The first stage was conducted to assess the construct reliability and validity through testing the measurement model. Table 3 shows that all items of factor loadings were more than the value of 0.6, with the exception of the item 'The bank has excellent facilities' (loading 0.401), which was eliminated from further analysis. Further, the CR values were above the cut-off value of 0.7 and AVEs higher than the cut-off values of 0.5 indicating satisfactory reliability and convergent validity, respectively (Hair *et al.*, 2017). Finally, the results of the heterotrait-monotrait ratio show that the measurement model had acceptable discriminant validity, as the values of diagonal elements are less than the suggested maximum of 0.9 (Henseler and Sarstedt, 2013).

### Structural model

The second stage of testing assessed the structural model. A bootstrap procedure using 5,000 iterations was used to evaluate the significance of the indicators and path coefficients (Chin *et al.*, 2008). The model goodness-of-fit value was 0.520, meaning that the model fit is considered acceptable (Tenenhaus *et al.*, 2005).  $R^2$  values indicate that 5.5% of financial performance variance could be explained by loyalty and satisfaction. While only a small percentage of financial performance variance could be explained, it is meaningful compared to Keisidou (2013)'s study which reported no  $R^2$  value and no significant relationships between satisfaction or loyalty and bank financial performance. This research found that service quality, perceived value and image explain 46.1% of the variation of satisfaction. The  $R^2$  of loyalty shows that 44.9% of its variance can be explained by service quality, perceived value, image, and satisfaction. Chin *et al.* (2008) suggest that the exogenous variables' influence on tourist loyalty is moderate, as it falls between 33% and 76%. The structural model further was assessed based on parameters of average levels of path coefficient,  $R^2$ , adjusted  $R^2$  and average full-collinearity VIF (AVIF), resulting in values of 0.273, 0.377 and 0.371, respectively (all at  $p < 0.01$ ). The AVIF is 1.766; which is less than the maximum of 5 (Hair *et al.*, 2017). With all the parameters within acceptable ranges, it can be concluded that the tested model is robust.

Construct/item	Loading**	Cronbach	CR	AVE
<i>Service quality</i>		0.844	0.882	0.518
- Staff respond to every customer complaint	0.625			
- Staff are willing to serve all types of customers	0.765			
- Staff try to put the interests of the customers first	0.781			
- Staff provide prompt effective service	0.711			
- Staff meet the needs of customers	0.702			
- Staff are willing to assist customers when needed	0.748			
- I feel safe when making transactions at Islamic banks	0.695			
- The bank has excellent facilities	0.401			
<i>Perceived value</i>		0.736	0.851	0.65
- The revenue share I received is appropriate	0.803			
- The transaction costs offered are low	0.810			
- The time and cost required to get to the bank is low	0.813			
- Bank services complied with Islamic values	0.786			
<i>Image</i>		0.774	0.869	0.689
- Islamic banks can keep promises	0.820			
- Islamic banks have a good name	0.860			
- Islamic banks have a positive reputation	0.810			
<i>Customer satisfaction</i>		0.755	0.86	0.672
- The services were sufficient to meet my needs	0.843			
- I never thought to stop being a customer of the bank	0.842			
- Overall, I am satisfied to be a customer of the bank	0.772			
<i>Loyalty</i>		0.734	0.849	0.653
- I recommend the bank to anyone who asks	0.778			
- I intend to increase the volume of my transactions at the bank	0.798			
- I will continue to be the bank customer	0.847			
<i>Financial performance</i>		0.992	0.995	0.984
- ROA	0.995			
- ROE	0.987			
- NPM	0.994			

**Table 3.**  
Loading, CR  
and AVE

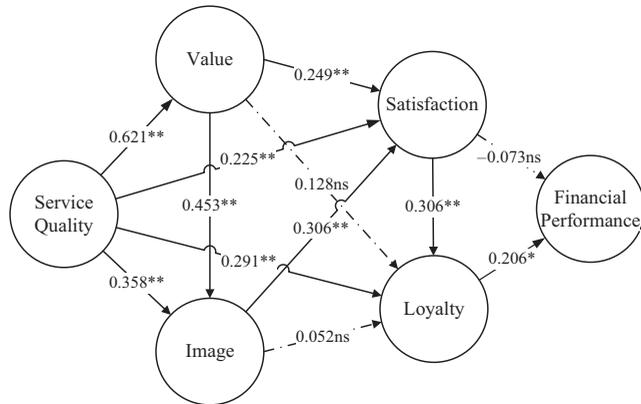
Table 4 depicts that service quality, as hypothesized, has a significant influence on satisfaction ( $\beta = 0.225, p < 0.01$ ), loyalty ( $\beta = 0.291, p < 0.01$ ) and perceived value ( $\beta = 0.621, p < 0.01$ ); thus, hypotheses *H1*, *H2* and *H3* are supported. Perceived value has an influence on satisfaction ( $\beta = 0.249, p < 0.01$ ) but not on loyalty ( $\beta = 0.128, p > 0.05$ ), supporting hypothesis *H4* but not hypothesis *H5*. Service quality significantly influences the image ( $\beta = 0.358, p < 0.01$ ), perceived value affects significantly the image ( $\beta = 0.453, p < 0.01$ ), supporting hypotheses *H6* and *H7*. Next, image significantly affects satisfaction ( $\beta = 0.306, p < 0.01$ ) but not loyalty ( $\beta = 0.052, p > 0.05$ ). Thus, hypothesis *H8* is supported, but hypothesis *H9* is not. Satisfaction significantly impacts loyalty ( $\beta = 0.306, p < 0.01$ ) but failed to significantly influence financial performance ( $\beta = -0.073, p > 0.05$ ), so there was support for hypothesis *H10* but not hypothesis *H11*. Finally, hypothesis *H12* was supported as loyalty significantly influences financial performance ( $\beta = 0.206, p < 0.05$ ). The summary of the relationship between variables is depicted in Figure 2.

To illustrate the indirect and total effects of the variables, the direct and indirect tests were conducted, and the results depicted in Table 5. The result shows that service quality, perceived value, image and satisfaction have a significant total effect on loyalty, although the service quality indirect effect is not significant.

Path (hypothesis)	$\beta$	Direct effect	<i>t</i> -value
Service quality => satisfaction ( <i>H1</i> )	0.225		3.395**
Service quality => loyalty ( <i>H2</i> )	0.291		4.184**
Service quality => perceived value ( <i>H3</i> )	0.621		15.651**
Perceived value => satisfaction ( <i>H4</i> )	0.249		3.402**
Perceived value => loyalty ( <i>H5</i> )	0.128		1.547 <sup>ns</sup>
Service quality => image ( <i>H6</i> )	0.358		6.948**
Perceived value => image ( <i>H7</i> )	0.453		7.262**
Image => satisfaction ( <i>H8</i> )	0.306		4.421**
Image => loyalty ( <i>H9</i> )	0.052		0.969 <sup>ns</sup>
Satisfaction => loyalty ( <i>H10</i> )	0.306		3.798**
Satisfaction => financial performance ( <i>H11</i> )	-0.073		1.245 <sup>ns</sup>
Loyalty => financial performance ( <i>H12</i> )	0.206		1.990*

**Table 4.**  
Hypothesis testing

Notes: \* $p < 0.05$ ; \*\* $p < 0.01$



**Figure 2.**  
Summary of the relationship between variables

**Discussion**

While the literature has clearly identified the link between satisfaction and loyalty towards business financial performance, this is the first time it has been examined in an Islamic banking context. Testing the model of relationships between loyalty formation and bank financial performance, this study can report three critical findings.

Firstly, the results of this study confirm that loyalty formation in Islamic banks is determined by service quality, perceived value, bank image and customer satisfaction. Among these loyalty determinants, this study can report the direct impact of service quality on customer loyalty and significant indirect impact via perceived value, image and satisfaction. This finding is consistent with past studies in Islamic banking (Al-Hawari, 2006; Saleh *et al.*, 2017; Suhartanto *et al.*, 2019), and suggests that when Islamic bank customers experience service quality, they are likely to continue being customers, recommend the Islamic banks to others and increase their transactions with the Islamic bank. In addition, the indirect influence of service quality on customer loyalty means that service quality strengthens satisfaction, perceived value and image which positively affects loyalty. The corollary to this finding is that poor service quality will not only reduce

Path (hypothesis)	Indirect effect		Total effect	
	$\beta$	<i>t</i> -value	$\beta$	<i>t</i> -value
Service quality => satisfaction ( <i>H1</i> )	0.109	3.540**	0.334	5.174**
Service quality => loyalty ( <i>H2</i> )	0.089	3.056 <sup>ns</sup>	0.415	6.707**
Service quality => perceived value ( <i>H3</i> )			0.621	15.651**
Perceived value => satisfaction ( <i>H4</i> )	0.278	6.529**	0.595	13.879**
Perceived value => loyalty ( <i>H5</i> )	0.283	7.035**	0.531	12.047**
Service quality => image ( <i>H6</i> )			0.358	6.948**
Perceived value => image ( <i>H7</i> )	0.222	6.265**	0.675	16.811**
Image => satisfaction ( <i>H8</i> )			0.306	4.421**
Image => loyalty ( <i>H9</i> )	0.091	1.984*	0.148	2.114*
Satisfaction => loyalty ( <i>H10</i> )			0.315	3.798**
Satisfaction => financial performance ( <i>H11</i> )	0.065	1.629 <sup>ns</sup>	-0.008	0.830 <sup>ns</sup>
Loyalty => financial performance ( <i>H12</i> )			0.206	2.990**

Notes: \* $p < 0.05$ ; \*\* $p < 0.01$

**Table 5.**  
Result of testing and indirect and total effect

customer loyalty towards Islamic banks but will make them dissatisfied, lower their perceived value and bank image, which eventually could make them disloyal. This result confirms Saleh *et al.* (2017)' contention that service quality is a core factor in creating loyal clients in Islamic banks.

Secondly, this study shows that the total effect of perceived value on client loyalty is the highest compared to other loyalty determinants. Therefore, perceived value is another key component in developing loyalty towards Islamic banks. The role of perceived value in developing loyalty corroborates with past studies (Fathollahzadeh *et al.*, 2011; Hamouda, 2019; Henrique and Matos, 2015). For Islamic banks, this study measured perceived value as revenue sharing, transaction costs, time and costs required to get the service, as well as compliance with Islamic values. Therefore, in developing client loyalty, this study suggests it is not only important to offer economic and service value but also spiritual value as compliance with the Islamic tenets. This result confirms in Islamic banking what previous studies have reported in other products, namely, that Muslim customers tend not only to be rational, by choosing sellers offering highest service quality and benefit but also valuing firms that match their Islamic values (Abou-Youssef *et al.*, 2015; Muslim *et al.*, 2013). This result strengthens scholars' (Khalil *et al.*, 2012) assertion that consuming a bank service that is compliant with *Sharia* law not only fulfils a customer's banking needs but also a way of fulfilling their religious duty. In terms of loyalty formation, this study highlights that an Islamic bank customer will recommend, intend to increase the volume of transactions and will continue to be a client if the bank offers competitive and attractive benefits while achieving compliance with Islamic values.

Thirdly, this study reveals that customer loyalty significantly influences bank financial performance; but the effect of satisfaction on financial performance is not significant. While past studies have reported the significant influence of both satisfaction and loyalty on business performance (Eklof *et al.*, 2018; Golovkova *et al.*, 2019; Otto *et al.*, 2019), this study tends to support the work of Larivière *et al.* (2016), who found that loyalty directly impacts financial performance, but satisfaction's effect on financial performance is not direct but via loyalty. The results of the current study suggest that satisfaction alone cannot guarantee high financial performance in Islamic banks. Further, as the effect of satisfaction on loyalty is significant, this result implies that, rather than directly impacting financial performance, satisfaction strengthens loyalty which subsequently impacts financial performance.

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This study extends our knowledge on customer loyalty in Islamic banks by extending its effect on bank financial performance. This study lends support for the “satisfaction-loyalty-performance” logic (Edvardsson *et al.*, 2000; Heskett *et al.*, 2003) in the explanation of satisfaction and loyalty effect on Islamic banks financial performance. The support for this logic is evident from the positive link between client satisfaction and loyalty as well as between loyalty and bank financial performance. This study shows that a customer who is satisfied with an Islamic bank tends to continue as a client and recommends the Islamic bank to others and intends to increase their transactions with the Islamic bank.

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### **Managerial implications**

Now that it is known that client loyalty is an important factor in increasing Islamic bank financial performance, this study bears significant practical implications for managers of Islamic banks to increase their financial performance through fostering client loyalty. The result of this study highlights the crucial role of service quality and perceived value in the creation of client loyalty, which subsequently improves bank financial performance. To attract customers and encourage them to behave favourably towards an Islamic bank, including recommending the bank, increasing their transactions and continuing to be bank clients, the bank should focus on providing excellent service and offering competitive economic benefits compared to other banks. Offering and communicating high banking service quality and superior economic benefits is essential to keep existing clients as well as attract new clients.

This study also demonstrates the significant role perceived value has on loyalty formation for Islamic bank clients. In addition to offering high-quality services and economic benefits, convincing the customer that the bank complies with Islamic values may prevent clients from switching to other banks and could encourage them to recommend Islamic banks. The findings of this study suggest that, besides presenting competitive financial benefits, Islamic values are an important factor in encouraging client loyalty. To ensure what constitutes conformity to Islamic tenets, Islamic banks could establish an Islamic Consultative Council, tasked with ensuring that their banking operations are compliant with Islamic values. While establishing such a council is not compulsory, this study suggests that such a council could be viewed by customers as an important safeguard, ensuring the Islamic suitability of banking operations. The establishment of such a group, if well communicated to the public, could be an effective tool to convey compliance to existing and future clients. Such a strategy informing the public of the bank's compliance with Islamic values, if perceived as real and not a “gimmick”, could work together with offerings that are competitive in terms of economic and service benefits and form a successful strategy to retain customers and build a new customer base.

### **Limitation and future research**

Firstly, this study focuses on the customers of Islamic banks in Bandung, Indonesia and this sample may differ from other Muslim populations. Consequently, the results of this study may not generalize to all Muslims. To ensure the result of the model have broad generality, future research could test the model and relationships between the variables in other regions or countries. Secondly, the focus of this study is attributed to the role of service quality, perceived value, image and satisfaction as the drivers of loyalty towards Islamic banks. To obtain a more comprehensive model of loyalty, future research could include other variables such as brand attachment and trust in the model. Thirdly, this study measures loyalty formation and its drivers using customer perceptions. It is possible that the results may differ if satisfaction and loyalty were measured using other means such as secondary data

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or past behavior. For example, customer satisfaction indices from previous customer surveys (to measure satisfaction) could be used and past behaviour, such as customer tenure and number of transactions (for behavioural loyalty) could be used to examine the satisfaction-loyalty-financial performance model. Religiosity is another important factor which could potentially impact on consumer attitude and behaviour. A future study could include this factor as a determinant of customer loyalty. In addition, trust and technology factors could be added to the model and potentially better predict customer loyalty and bank performance. Lastly, the extended loyalty formation–financial performance model could be tested in other Islamic financial services contexts, such as insurance.

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