

Linking Service Quality Dimensions to Customer Loyalty: The Mediating Influence of Customer Satisfaction in the Nepali Banking Sector



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Abstract

This study examines the influence of service quality dimensions on customer loyalty in the banking sector of Nepal, with particular emphasis on the mediating role of customer satisfaction. The research is based on the SERVQUAL model, which evaluates five key dimensions of service quality: tangibility, reliability, responsiveness, assurance, and empathy. A quantitative method with a descriptive and causal research design was employed to meet the study objectives. Primary data were collected from a convenience sample of 205 respondents using structured questionnaires and analyzed using the Statistical Package for the Social Sciences (SPSS). The reliability analysis indicated a high level of consistency in the results. Regression analysis showed that service quality dimensions significantly explain variations in customer loyalty. Among the five dimensions, empathy and reliability were identified the most significant predictors of customer loyalty. Furthermore, mediation analysis confirmed that customer satisfaction partially mediates the relationship between service quality and customer loyalty. The study concludes that banks in the Kathmandu Valley of Nepal could prioritize emotional engagement with customers and ensure consistent and reliable service delivery to enhance customer satisfaction and foster long-term loyalty.

Keywords - Customer loyalty, Customer satisfaction, Nepali banking sector, Service quality dimensions, SERVQUAL

Paper – Research paper

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1. Introduction

In the contemporary era of globalization, achieving and sustaining high levels of customer satisfaction has become a critical challenge, particularly in the service sector, where services are intangible, heterogeneous, and difficult to standardize (Alzaydi et al., 2018). As customer expectations continue to evolve due to increased awareness, technological advancement, and global exposure, service quality has emerged not merely as an operational tool but as a strategic asset that significantly contributes to competitive advantage, customer satisfaction, and organizational profitability (Grönroos, 1984; Tam, 2004). High service quality enables organizations to differentiate themselves in competitive markets and establish long-term relationships with customers (Chaudhary et al., 2025; Famiyeh et al., 2018). Thus, service quality is closely associated with customer satisfaction, which is widely recognized as a key determinant of customer loyalty. Satisfied customers are more likely to engage in repeat transactions, maintain long-term relationships with service providers, and generate positive word-of-mouth communication (Oliver, 1999; Zeithaml et al., 1996). On the other hand, poor service quality may result in dissatisfaction, customer switching behavior, and loss of trust. Therefore, maintaining high service quality is essential for enhancing customer satisfaction and ensuring long-term customer retention.

To deliver superior services, organizations must understand customer expectations and perceptions in order to identify gaps in service delivery (Zeithaml et al., 2002). The SERVQUAL model, developed by Parasuraman et al. (1988), provides a widely accepted framework for measuring service quality across five key dimensions: tangibility, reliability, responsiveness, assurance, and empathy. This model has been extensively applied in service industries, including banking, to evaluate service performance and identify areas for improvement. In the banking sector, the relationship between service quality, customer satisfaction, and customer loyalty is particularly important due to the high level of customer interaction and the intangible nature of financial services (Famiyeh et al., 2018). The rapid adoption of technology, including automated teller machines (ATMs), online banking, mobile banking, and digital payment systems, has significantly transformed customer experiences and expectations (Bitner et al., 1990; Ladhari, 2009). While these innovations enhance convenience and efficiency, they also increase the need for banks to maintain consistent and high-quality service across both physical and digital channels (Li et al., 2021).

In the context of Nepal, the banking sector has experienced rapid growth and increased competition, prompting banks to focus more on improving service quality to meet changing customer expectations (NRB, 2023). However, globalization and rising competition have made it challenging for banks to consistently satisfy customers (Khanal, 2020; Shrestha, 2019). Further, service quality emerges from service providers and when the employees are provided with better environment such as flexible work arrangements, this increases willingness to engage in providing better service (Adhikari et al., 2025; Shilpakar et al., 2024). Therefore, this study aims to identify the major factors affecting customer satisfaction, assess the level of customer loyalty, and examine the key service quality dimensions that influence customer loyalty in Nepali commercial banks.

2. Literature Review and Hypotheses Development

Theoretical Background

Service quality has been extensively studied as a key determinant of customer satisfaction and loyalty in the service sector. According to the SERVQUAL model developed by Parasuraman et al. (1988), service quality can be measured through five dimensions: tangibility, reliability, responsiveness, assurance, and empathy. Tangibility reflects the physical facilities, equipment, and appearance of employees, while reliability measures the ability to provide promised services accurately and consistently. Responsiveness refers to the willingness of employees to help customers and respond promptly to their needs. Assurance reflects the knowledge, competence, and courtesy of employees, which instills trust and confidence, and empathy emphasizes personalized attention and understanding of individual customer needs (Grönroos, 1984; Brady & Cronin, 2001). These dimensions provide a theoretical basis for evaluating service quality in various service industries, particularly banking.

Customer satisfaction is conceptualized as a psychological state resulting from a customer's evaluation of service experiences relative to expectations (Oliver, 1999). It acts as a mediator between service quality and behavioral outcomes such as customer loyalty and retention. Satisfied customers are more likely to engage in repeat transactions, recommend services to others, and maintain long-term relationships with

the service provider (Anderson & Sullivan, 1993; Zeithaml et al., 1996). In banking sector, where services are intangible and trust is critical, the link between service quality, satisfaction, and loyalty becomes particularly significant. Understanding these relationships allows banks to design strategies that enhance customer experience and foster long-term commitment (Ladhari, 2009; NRB, 2023; Pokhrel et al., 2022).

Relationship between Variables

Tangibles and Customer Loyalty

Tangibles, such as the physical appearance of banking facilities, modern equipment, and professional staff, significantly affect customers' first impressions and overall experiences. Sharma and Mahato (2018) highlighted that in Nepal, aesthetically pleasing and well-maintained bank branches enhance customer satisfaction. Similarly, Saqib (2017) noted that tangibles form the initial point of interaction, creating lasting perceptions of quality. Thus, it is hypothesized that;

Hypothesis (H1): Tangibles has a positive relationship with customer loyalty

Reliability and Customer Loyalty

Reliability, defined as the ability to deliver promised services accurately and dependably, is another vital dimension of service quality. Studies such as Khadka and Sharma (2020) emphasized that customers highly value error-free and timely service delivery, particularly in the banking sector where trust is paramount. Trust developed through consistent reliability that fosters customer satisfaction and forms the foundation for loyalty. Thus, it is hypothesized that;

Hypothesis (H2): Reliability has a positive relationship with customer loyalty

Responsiveness and Customer Loyalty

Responsiveness, or the ability of banks to address customer needs promptly, has also been shown to have a strong correlation with customer satisfaction and loyalty. Shrestha and Bajracharya (2020) found that quick complaint resolution and efficient service handling significantly impact customer perceptions in Nepal's competitive banking landscape. On this basis, it is hypothesized that;

Hypothesis (H3): Responsiveness has a positive relationship with customer loyalty

Assurance and Customer Loyalty

Assurance, which encompasses the competence, courtesy, and professionalism of bank staff, is equally important. Knowledgeable employees who can confidently address customer needs enhance satisfaction by instilling trust and confidence (Shrestha & Bajracharya, 2020). Therefore, it is hypothesized that;

Hypothesis (H4): Assurance has a positive relationship with customer loyalty

Empathy and Customer Loyalty

Empathy, characterized by personalized and caring attention, has a profound impact on satisfaction and loyalty. Chaudhary et al. (2024) and Sharma and Mahato (2018) noted that personalized service strengthens the emotional connection between customers and the banks, making customers feel valued and respected. Thus, it is hypothesized that;

Hypothesis (H5): Empathy has a positive relationship with customer loyalty

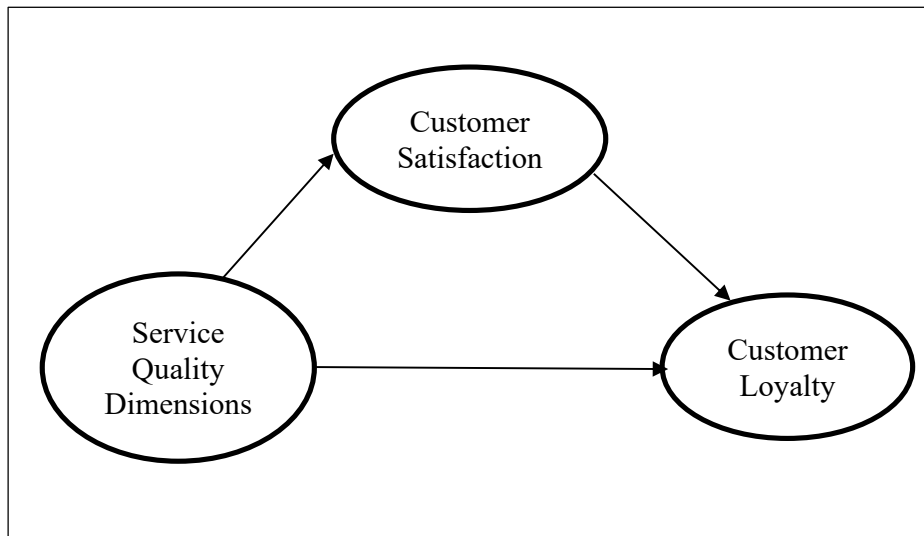
Customer Satisfaction and Customer Loyalty

Customer satisfaction acts as a mediator in the relationship between service quality dimensions and customer loyalty. Empirical studies have consistently demonstrated that high service quality leads to greater customer satisfaction, which in turn fosters loyalty. For instance, Mahamad and Ramayah (2010) in Tehran, Iran, observed that satisfaction bridges the gap between service quality and loyalty. Similarly, Siddiqi (2011) in Bangladesh confirmed a positive correlation between satisfaction and loyalty in the banking sector. On the basis of the argument, it is hypothesized that;

Hypothesis (H6): There is a positive relationship between customer satisfaction and customer loyalty.

Hypothesis (H7): Customer satisfaction mediates the relationship between service quality dimensions and customer loyalty

Figure 1
Research Framework



Note. Gorondutse and Hilman (2014); Wilson et al. (2012)

3. Research Method

Research Design and Sampling

This study adopted a quantitative research approach and employed a descriptive and causal research design to investigate the relationships among service quality dimensions, customer satisfaction, and customer loyalty. It was a cross-sectional survey-based study conducted in Kathmandu Valley, Nepal. The target population comprised all customers of commercial banks operating in the Kathmandu Valley. Due to the large and undefined population size, a sample of 295 customers was initially targeted; however, after data cleaning and removal of incomplete responses, the final usable sample size was 205. A non-probability convenience sampling technique was used. Respondents were selected from various bank branches who came to take the bank services as well as through online platforms wherever they were conveniently available and willing to participate. The unit of analysis was the individual customer.

Primary data were collected using a structured, self-administered questionnaire developed in English and Nepali language. The instrument was pilot-tested on 30 respondents to ensure clarity, relevance, and reliability before full-scale instrument was distributed. Verbal consent was obtained from every participant, and those who declined were excluded. The questionnaire consisted of two main sections: demographic and banking behavior information. All ethical considerations were strictly followed: participants were fully informed about the purpose of the study, their participation was voluntary, and complete anonymity and confidentiality of responses were guaranteed. No personal identifiers were collected.

Measurement

The questionnaire was developed focusing on customers' perceptions of service quality (SERVQUAL dimensions), customer satisfaction, and customer loyalty. All variables were measured using a 5-point Likert scale: 1 = Strongly Agree, 2 = Agree, 3 = Neutral, 4 = Disagree, 5 = Strongly Disagree. The characteristics of the variables were analyzed by using descriptive statistics. The relationship between independent variables (service quality dimensions), dependent variable (customer loyalty), and mediating variable (customer satisfaction) was analyzed using correlational and regression analysis expressed through tables. The overall analysis of the data was done with the help of SPSS software.

Table 1
Reliability Test

Variables	Cronbach's Alpha	No. of Items
Overall	0.841	28

Table 1 presents the reliability analysis of the overall scale used in the study. The Cronbach’s Alpha value is 0.841 for 28 items, which is well above the acceptable threshold of 0.70 and falls in the “good” range (0.80–0.90). This high value confirms strong internal consistency among all items measuring service quality dimensions, customer satisfaction, and customer loyalty. It indicates that the questionnaire items were highly correlated and reliably measure the underlying constructs without significant random error. It can therefore be confidently used the scale for further statistical analysis. Overall, the instrument demonstrates excellent reliability suitable for drawing valid conclusions from the data.

4. Analysis and Results

Demographic Profile of the Respondents

Table 2
Frequency Distribution of Demographic Variables

Demographic Variables and Banking Behaviors	Categories	Frequency	Percent (%)
Gender	Male	124	60.48
	Female	81	39.51
Age	20-30	143	69.75
	30-40	50	24.39
	40-50	10	4.87
	50-60	2	0.97
	60 and above	0	0
	Less than 20000	75	36.58
Income (In NPR)	20000-30000	40	19.51
	30000-40000	39	19
	40000-50000	10	4.87
	50000 and above	41	20
	SEE	10	4.87
Educational Qualification	+2 Graduate	55	26.82
	Bachelor Degree	100	48.78
	Master Degree	40	19.51
Frequency of visiting bank	Once in a week	5	2.43
	Monthly	31	15.12
	Once in every 2 Month	34	16.58
	Yearly	135	65.85
	Less than 1 year	10	4.87
Years of Relationship with bank	1-2 Years	20	9.75
	2-5 Years	105	51.21
	More than 5 Years	70	34.14

Table 2 presents the demographic and banking behavior profile of respondents. The sample is predominantly male (60.48%), young (69.75% aged 20-30), educated (48.78% bachelor’s degree), and long-term customers (51.21% with 2-5 years relationship) who visit banks infrequently (65.85%) yearly.

Table 3
Descriptive Statistics of Variables

Variables	Mean	Std. Deviation
Tangible	1.6000	0.59440
Reliability	1.5427	0.59435
Responsiveness	1.6000	0.56858
Assurance	1.5061	0.58023
Empathy	1.5744	0.56307
Customer Loyalty	1.6366	0.54705
Customer Satisfaction	1.6207	0.59285

Note: 1= Strongly Agree, 2= Agree, 3= Neutral, 4= Disagree, 5= Strongly Disagree

Table 3 presents the mean and standard deviation for each variable on the 5-point Likert scale. All means fall between 1.50 and 1.64, indicating that respondents generally “Agree” with positive statements about service quality, satisfaction, and loyalty. The lowest mean is for Assurance (1.5061), while Customer Loyalty has the highest mean (1.6366). Standard deviations range from 0.547 to 0.594, showing moderate spread in responses and no extreme variability. Overall, perceptions are favorable but not exceptionally strong, suggesting room for improvement in service delivery.

Table 4
Correlation between Independent and Dependent Variables

	Tangible	Reliability	Responsiveness	Assurance	Empathy	Customer Loyalty
Tangible	1					
Reliability	.818**	1				
Responsiveness	.738**	.830**	1			
Assurance	.734**	.799**	.812**	1		
Empathy	.744**	.749**	.779**	.827**	1	
Customer Loyalty	.658**	.705**	.701**	.721**	.826**	1

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

Table 4 shows the Pearson correlation matrix among service quality dimensions and customer loyalty. All dimensions are positively and significantly correlated with customer loyalty at the 0.01 level. Empathy has the strongest correlation with loyalty ($r = 0.826$), followed by Assurance ($r = 0.721$) and Reliability ($r = 0.705$). The dimensions themselves are also highly inter-correlated (r ranging from 0.734 to 0.830), indicating they collectively represent overall service quality. This table confirms that improvements in any dimension are likely to be associated with higher loyalty.

Table 5
Model Summary

Model	R	R-Squared	Adjusted R-Squared	Std. Error of the Estimate
1	.837a	.700	.692	.30345

Table 5 summarizes the overall fit of the multiple regression model. The multiple correlation coefficient (R) is 0.837, showing a strong linear relationship between the five service quality dimensions and customer loyalty. The R-Squared value of 0.700 means that 70 % of the variance in customer loyalty is explained by the service quality dimensions. The adjusted R-Squared (0.692) is very close to R-Squared, confirming the model remains robust after accounting for the number of predictors. The standard error of the estimate (0.30345) is relatively low, indicating good precision in predictions.

Table 6
ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	42.727	5	8.545	92.802	.000b
	Residual	18.324	199	.092		
	Total	61.051	204			

Table 6 presents the ANOVA test for the regression model. The regression sum of squares (42.727) is much larger than the residual sum of squares (18.324), showing that the model explains a substantial portion of total variance. The F-statistic of 92.802 with a significance value of 0.000 ($p < 0.001$) confirms that the overall model is statistically significant. This means the five service quality dimensions, taken together, have a highly significant influence on customer loyalty and are not due to chance.

Table 7
Regression Analysis

Model		β	Std. Error	Beta	t	Sig.
1	(Constant)	.317	.068		4.676	.000
	Tangible	-.025	.066	-.028	-.382	.703
	Reliability	.174	.079	.189	2.205	.029
	Responsiveness	.034	.077	.036	.444	.657
	Assurance	.005	.077	.005	.063	.949
	Empathy	.654	.074	.673	8.858	.000

Table 7 displays the unstandardized and standardized coefficients for each predictor. Empathy has the largest positive effect ($\beta = 0.654$, Beta = 0.673, $p = 0.000$), followed by Reliability ($\beta = 0.174$, $p = 0.029$). Tangible, Responsiveness, and Assurance show non-significant effects ($p > 0.05$). The constant is also significant. This table highlights that only Empathy and Reliability are statistically significant drivers of customer loyalty when all dimensions are considered simultaneously.

Table 8
Mediation Effect

Relationship	Total Effect	Direct Effect	Indirect Effect	Confidence Interval (Lower-Upper)	t-statistics	Conclusion
SQ → CS → CL	0.8230	0.5685	0.2545	0.1550 – 0.3595	9.5133	Partial Mediation

Note: SQ= Service Quality, CS= Customer Satisfaction, CL= Customer Loyalty

Table 8 reports the results of the mediation analysis using Hayes' PROCESS Macro (Model 4). The total effect of service quality on loyalty is strong (0.8230, $p = 0.000$). After including customer satisfaction, the direct effect drops to 0.5685 but remains significant, while the indirect effect through satisfaction is 0.2545 with a 95 % confidence interval (0.1550–0.3595) that does not include zero. The t-statistic of 9.5133 confirms significance. Thus, customer satisfaction partially mediates the relationship.

5. Discussion

This study has provided valuable insights into the relationship between service quality dimensions and customer loyalty in the Nepali banking sector, with a particular emphasis on the mediating role of customer satisfaction. The findings reveal several important patterns that both align with and diverge from existing

literature, offering nuanced implications for banking practice in a rapidly evolving market. Empathy emerged as the strongest predictor of customer loyalty ($\beta = 0.654$, $p < 0.001$), followed by reliability ($\beta = 0.174$, $p = 0.029$). This result is consistent with Zeithaml et al. (2002) and Parasuraman et al. (1988), which underscore the critical role of personalized attention in building emotional connections and long-term loyalty. In the Nepalese context, where personal trust and relational bonds play a significant role in banking decisions, empathy appears to outweigh functional aspects. A notable discrepancy, however, exists with studies that prioritize reliability or tangibles in other service industries; here, empathy's dominance may reflect the intangible and ongoing nature of banking relationships in Nepal, where customers value feeling understood over purely transactional efficiency.

Reliability also demonstrated a significant positive influence on customer loyalty, reinforcing the importance of consistent, error-free service delivery. This aligns with Khadka and Sharma (2020), who emphasized that trust built through reliability is foundational in the banking sector. The finding suggests that while emotional factors are paramount, operational consistency remains essential to prevent customer switching. Customer satisfaction was confirmed as a partial mediator between service quality dimensions and customer loyalty (indirect effect = 0.2545, 95% CI [0.1550, 0.3595]). This supports the findings of Mahamad and Ramayah (2010) and Siddiqi (2011), indicating that satisfaction bridges service quality and loyalty but does not fully explain the relationship. The partial mediation implies that banks can achieve loyalty through direct improvements in service quality (especially empathy and reliability) even when satisfaction levels vary. This highlights the need for banks to address both cognitive (satisfaction) and affective (emotional connection) pathways to loyalty.

In contrast, tangibles, responsiveness, and assurance showed weaker or non-significant direct effects on customer loyalty in the regression analysis, despite strong correlations. This finding diverges from earlier studies (e.g., Berry et al., 2003) that emphasized physical environment and staff assurance. The limited role of tangibles may be attributed to the growing shift toward digital banking in Nepal, where physical infrastructure matters less than digital interfaces and responsiveness. Assurance and responsiveness, while important for satisfaction, appear less decisive for long-term loyalty among the predominantly young, educated respondents in this sample.

Demographic factors further contextualize the results. The sample was dominated by young (69.75% aged 20–30), male (60.48%), and educated (48.78% bachelor's degree) customers who visit banks infrequently. This profile likely explains the stronger emphasis on empathy and reliability over tangibles, as younger customers prioritize relational and digital experiences. Previous studies with more diverse or older samples (e.g., Sweeney & Soutar, 2001) often found greater weight on reliability and personal interactions, suggesting that the present findings reflect a generational shift toward tech-centric banking expectations.

Overall, the results confirm the universal relevance of SERVQUAL dimensions while highlighting Nepal-specific nuances driven by cultural emphasis on personal relationships and rapid digital adoption. The study fills a critical research gap by providing context-specific evidence from Nepalese commercial banks, where limited prior research has examined the mediating role of satisfaction alongside individual dimension impacts.

6. Conclusions

This study reaffirms the significant relationship between service quality dimensions and customer loyalty in the Nepali banking sector, with customer satisfaction serving as a partial mediator. Among the five SERVQUAL dimensions, empathy and reliability emerged as the most influential drivers of loyalty, while tangibles, responsiveness, and assurance exhibited comparatively weaker direct effects. The partial mediation by customer satisfaction indicates that service quality influences loyalty both directly and indirectly through enhanced satisfaction levels.

The findings underscore that delivering superior service quality mainly through empathetic and reliable interactions remains a strategic imperative for banks seeking sustainable competitive advantage. By aligning service strategies with customer expectations in a rapidly digitizing and competitive environment, Nepali commercial banks can foster stronger emotional connections, higher satisfaction, and enduring loyalty. This research contributes baseline empirical evidence tailored to the Nepalese context, addressing gaps in localized studies and offering a foundation for future investigations into demographic variations, digital service quality, and long-term loyalty dynamics.

7. Implications

The findings of this study carry important practical implications for banking institutions, policymakers, and researchers aiming to strengthen customer relationships in Nepal's competitive banking landscape. Banks should invest in comprehensive staff training programs focused on emotional intelligence, active listening, and personalized customer care so that empathy becomes a core part of service delivery, while simultaneously strengthening operational systems to ensure error-free and timely service across both physical and digital channels. Continuous feedback mechanisms, rapid complaint resolution, and proactive service improvements are essential to enhance overall customer satisfaction, and resources should be strategically shifted toward digital enhancements rather than solely on physical infrastructure. For policymakers and regulators, the study offers clear evidence-based guidance for Nepal Rastra Bank to formulate policies that promote service quality standards, digital innovation, and customer-centric banking practices, including guidelines for employee training in empathy and reliability. Finally, researchers are encouraged to build upon this work by adopting probability sampling with more diverse respondents from rural areas and different demographic segments, using longitudinal designs to track loyalty over time, and exploring additional mediators such as trust, commitment, or perceived digital service quality to develop a more comprehensive understanding of customer behavior in the Nepalese banking context. By implementing these recommendations, banks can cultivate stronger customer relationships, achieve higher retention rates, and secure long-term profitability in an increasingly competitive and digitalized market.

8. Limitations and Direction for the Future Research

The present study has several limitations. The data were collected only from customers of the Kathmandu Valley using convenience sampling, which restricts the generalizability of findings to other regions or the entire Nepali banking sector. Customer perceptions of service quality are subjective and can vary based on personal expectations, experiences, and cultural backgrounds, potentially introducing response bias. The cross-sectional design captures perceptions at a single point in time and cannot account for how relationships between variables evolve over time. Moreover, rapid advancements in digital banking (mobile apps, internet banking) may have influenced customer expectations in ways not fully captured by the traditional SERVQUAL model. External factors such as economic conditions, competition, and regulatory changes were also not controlled in the analysis.

Future studies should address these limitations by employing probability sampling and including more diverse respondents from rural areas, different age groups, income levels, and bank types (public vs. private) to enhance generalizability. Longitudinal research designs would help examine how customer loyalty develops over time in response to service quality improvements. Additional mediators such as trust, commitment, or perceived digital service quality could be incorporated to provide a more comprehensive model. Comparative studies across cultural or regional contexts within Nepal, as well as cross-country comparisons, would further enrich the literature. Finally, future research could explore the impact of emerging technologies (AI chatbots, fintech solutions) on service quality dimensions and loyalty in the Nepali banking sector.

Conflict of Interest

Author declares no conflict of interest while preparing this article.

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