Service Quality and Customer Retention in Indian Private Sector Banks: An Empirical Study

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Abstract

Purpose – The purpose of this study is to examine the influence of service quality on customer retention in Indian private sector banks, with particular emphasis on the mediating role of customer satisfaction.

Design/methodology/approach – The study adopts an empirical research design using primary data collected from 1,000 long-term customers of a leading Indian private sector bank. Service quality is measured using an extended SERVQUAL framework comprising tangibility, reliability, responsiveness, assurance, empathy and access. The data were analyzed using descriptive statistics, reliability and validity tests, multiple regression analysis, service quality gap analysis and Structural Equation Modeling (SEM).

Findings – The results indicate that all service quality dimensions significantly influence customer satisfaction, with reliability and responsiveness emerging as the strongest predictors. Customer satisfaction, in turn, has a significant positive effect on customer retention and fully mediates the relationship between service quality and retention. The study also identifies negative gaps between customer expectations and perceptions across all service quality dimensions, highlighting areas requiring managerial attention.

Practical implications – The findings suggest that private sector banks should prioritize reliability-driven service delivery, responsive customer support and continuous monitoring of service quality gaps to enhance customer retention.

Originality/value – The study contributes to the banking literature by empirically validating the mediating role of customer satisfaction in the service quality–customer retention relationship in the Indian private banking context.

By integrating service quality gap analysis with a mediation-based SEM framework, this study extends bank marketing literature by explaining how service quality translates into customer retention in an emerging market context.

Keywords: service quality, customer satisfaction, customer retention, SERVQUAL, private sector banks, India

1. Introduction

The Indian banking sector has undergone profound structural and operational changes following economic liberalization, technological advancements, and increasing globalization. Private sector banks have emerged as key players by adopting customer-centric strategies, advanced technologies, and innovative service delivery mechanisms. However, intensified competition has made customer retention more challenging than ever, compelling banks to differentiate themselves primarily through superior service quality.

Unlike tangible products, banking services are characterized by intangibility, heterogeneity, inseparability, and perishability. As a result, customers evaluate banks largely based on service encounters, employee behavior, and overall service experience. Prior research has consistently emphasized that high service quality enhances customer satisfaction, builds trust, and fosters long-term relationships, ultimately leading to customer retention and profitability.

Customer retention is particularly critical for banks, as acquiring new customers is significantly more costly than retaining existing ones. Retained customers tend to engage in repeat transactions, cross-buy financial products, and generate positive word-of-mouth, thereby contributing to sustained financial performance. In this context, understanding how customers perceive service quality and how these perceptions influence retention becomes strategically important.

Although several studies have examined service quality in banking, empirical research linking service quality dimensions to customer retention—particularly in Indian private sector banks—remains limited. Moreover, there is a need to examine the mediating role of customer satisfaction in this relationship. This study seeks to bridge this gap by empirically analyzing the impact of service quality on customer retention through customer satisfaction using data from a leading Indian private sector bank.

This study contributes to the banking and service marketing literature in three ways. First, it empirically validates the SERVQUAL framework in the context of Indian private sector banking using a large customer sample. Second, it establishes customer satisfaction as a mediating mechanism linking service quality and customer retention, thereby extending relationship marketing theory. Third, by incorporating service quality gap analysis alongside SEM, the study offers an integrated perspective on both perceptual deficiencies and behavioral outcomes in banking services.

1.1 Research Gap and Motivation

Despite extensive research on service quality in banking, limited empirical studies have simultaneously examined service quality gaps, customer satisfaction, and customer retention within a single integrative framework, particularly in the context of Indian private sector banks. Moreover, the mediating role of customer satisfaction has not been sufficiently tested using structural equation modeling alongside perceptual gap analysis. This study addresses these gaps by developing and empirically testing an integrated model that links service quality dimensions, customer satisfaction, and customer retention

2. Review of Literature

2.1 Service Quality in Banking

2.1.1 Digital Banking and SERVQUAL Dimensions

In recent years, the rapid adoption of digital banking channels such as mobile banking, internet banking, and AI-enabled service interfaces has significantly reshaped how customers evaluate service quality in the banking sector. Digital banking influences traditional SERVQUAL dimensions by redefining tangibility through user-friendly interfaces, reliability through system accuracy and uptime, responsiveness through real-time service delivery, assurance through data security and privacy protection, and empathy through personalized digital interactions. Recent banking studies emphasize that while technology enhances efficiency, the fundamental SERVQUAL dimensions remain relevant, operating in both physical and digital service environments. Therefore, private sector banks must align their digital transformation initiatives with core service quality dimensions to sustain customer satisfaction and retention.

Service quality is defined as the extent to which a service meets or exceeds customer expectations. Parasuraman et al. (1988) conceptualized service quality using the SERVQUAL model, identifying five core dimensions: tangibility, reliability, responsiveness, assurance, and empathy. Subsequent studies have adapted this framework to the banking context, confirming its relevance and applicability.

In banking, service quality encompasses both functional aspects (how services are delivered) and technical aspects (what services are delivered). Researchers have found that customers place greater emphasis on reliability, responsiveness, and assurance due to the financial risks involved in banking transactions.

Recent studies in the ***International Journal of Bank Marketing*** highlight that service quality remains a dominant determinant of customer satisfaction and retention even in technology-driven banking environments (Yilmaz et al., 2018; Ojasalo et al., 2021).

2.2 Customer Satisfaction

Customer satisfaction refers to a customer’s overall evaluation of a service experience based on the comparison between expectations and perceived performance. In banking, satisfaction is influenced by service encounters, problem resolution, employee competence, and convenience. Numerous studies confirm that service quality is a primary antecedent of customer satisfaction.

2.3 Customer Retention

Customer retention reflects a customer’s intention to continue a relationship with a service provider. In banking, retention is associated with repeat usage, loyalty, and resistance to switching. Prior studies indicate that satisfied customers are more likely to remain loyal and less sensitive to price or competitor offerings

2.4 Service Quality, Satisfaction, and Retention Relationship

Empirical evidence suggests that customer satisfaction mediates the relationship between service quality and customer retention. High service quality enhances satisfaction, which subsequently strengthens customer loyalty and retention. However, limited studies have tested this mediation effect using SEM in the Indian private banking context, highlighting a significant research gap.

3. Research Objectives and Hypotheses

Objectives

1. To assess customers' perceptions and expectations of service quality in private sector banks.
2. To analyze the impact of service quality dimensions on customer satisfaction.
3. To examine the influence of customer satisfaction on customer retention.
4. To identify service quality gaps between customer expectations and perceptions.

Hypotheses

- **H1:** Service quality dimensions significantly influence customer satisfaction.
- **H2:** Customer satisfaction has a significant positive impact on customer retention.
- **H3:** Customer satisfaction mediates the relationship between service quality and customer retention

4. Research Methodology

4.1 Research Design

The study adopts a descriptive and empirical research design to examine causal relationships among service quality, customer satisfaction, and customer retention.

4.2 Data Collection and Sample

Primary data were collected from **1,000 customers** of HDFC Bank branches in Tamil Nadu. Respondents had a minimum banking relationship of five years, ensuring informed evaluations of service quality.

4.3 Measurement Instrument

A structured questionnaire based on the **SERVQUAL model** was used. Responses were measured using a five-point Likert scale.

Table 1. Dimensions and Variables Used in the Study

Construct	Dimensions
Service Quality	Tangibility, Reliability, Responsiveness, Assurance, Empathy, Access
Mediator	Customer Satisfaction
Outcome	Customer Retention

4.4 Reliability Analysis

Table 2. Reliability Statistics

Variable	Cronbach's Alpha
Service Quality	0.91
Customer Satisfaction	0.88
Customer Retention	0.86

All values exceed the recommended threshold of 0.70, indicating high internal consistency.

4.5 Sampling Technique

Convenience sampling was adopted due to accessibility constraints; however, the sample was restricted to customers with a minimum of five years of banking relationship to ensure informed evaluations.

4.6 Validity and Common Method Bias

Construct validity was ensured through factor analysis, while Harman's single-factor test indicated no significant common method bias.

4.7 Ethical Considerations

Participation in the study was voluntary, and respondents were informed about the purpose of the research. Confidentiality and anonymity were assured, and no personal identifying information was collected. The study complied with standard ethical guidelines for academic research.

5. Data Analysis and Results

5.1 Descriptive Statistics

Table 3. Mean Scores of Service Quality Dimensions

Dimension	Mean
Reliability	4.12
Responsiveness	4.05
Assurance	3.98
Empathy	3.85
Tangibility	3.76
Access	3.69

Reliability and responsiveness emerged as the most influential dimensions.

5.2 Service Quality Gap Analysis

Table 4. Expectation–Perception Gap

Dimension	Expectation	Perception	Gap
Reliability	4.45	4.12	-0.33
Responsiveness	4.38	4.05	-0.33
Assurance	4.30	3.98	-0.32
Empathy	4.20	3.85	-0.35
Tangibility	4.10	3.76	-0.34

Negative gaps indicate unmet customer expectations.

5.3 Regression Analysis

Table 5. Impact of Service Quality on Customer Satisfaction

Dimension	Beta	t-value	Significance
Reliability	0.38	9.21	0.000
Responsiveness	0.31	8.44	0.000
Assurance	0.24	6.37	0.000

5.4 Structural Equation Modeling Results

Structural Equation Modeling (SEM) was employed to simultaneously examine the relationships among service quality, customer satisfaction, and customer retention, and to test the mediating role of customer satisfaction. The analysis was conducted using AMOS, following a two-step approach involving assessment of the measurement model and the structural model.

Measurement Model Assessment

The measurement model was evaluated to assess construct reliability and validity. All observed variables loaded significantly on their respective latent constructs, with standardized factor loadings exceeding the recommended threshold of 0.60, indicating adequate convergent validity. Composite reliability values for all constructs were above 0.70, further confirming internal consistency. Discriminant validity was established as the square root of the average variance extracted (AVE) for each construct exceeded the inter-construct correlations.

These results indicate that the measurement model demonstrates satisfactory reliability and validity and is suitable for structural model testing.

Structural Model Fit

The structural model exhibited a good fit to the data. The chi-square to degrees of freedom ratio (χ^2/df) was below the recommended threshold of 3.0, indicating acceptable model parsimony. Incremental fit indices also demonstrated strong model adequacy, with the Comparative Fit Index (CFI) and Tucker–Lewis Index (TLI) exceeding 0.95. The Root Mean Square Error of Approximation (RMSEA) was below 0.06, suggesting a close fit between the hypothesized model and the observed data.

Overall, the fit indices confirm that the proposed structural model adequately represents the underlying relationships among service quality, customer satisfaction, and customer retention.

Path Analysis and Hypothesis Testing

The results of the structural path analysis revealed that service quality has a significant positive effect on customer satisfaction ($\beta = 0.72$, $p < 0.001$), supporting Hypothesis H1. This finding indicates that improvements in service quality dimensions substantially enhance customer satisfaction in private sector banking.

Customer satisfaction was found to have a significant positive impact on customer retention ($\beta = 0.64$, $p < 0.001$), thereby supporting Hypothesis H2. This result confirms that satisfied customers are more likely to maintain long-term relationships with their banks.

Mediation Analysis

To test the mediating role of customer satisfaction, a bootstrapping procedure with bias-corrected confidence intervals was employed. The indirect effect of service quality on customer retention through customer satisfaction was found to be statistically significant. Furthermore, the direct effect of service quality on customer retention became insignificant when customer satisfaction was included in the model, indicating **full mediation**.

These findings provide strong empirical support for Hypothesis H3 and suggest that customer satisfaction serves as a critical mechanism through which service quality translates into customer retention.

Summary of SEM Results

The SEM analysis confirms that service quality influences customer retention primarily through customer satisfaction rather than through a direct relationship. This underscores the importance of managing customer satisfaction as an essential strategic outcome of service quality initiatives in the banking sector

6. Conclusion

The study confirms that service quality is a critical determinant of customer retention in Indian private sector banks. Customer satisfaction plays a significant mediating role, emphasizing the need for banks to focus on both service delivery and customer experience management.

Overall, this study advances service marketing theory by demonstrating that customer satisfaction acts as a critical mechanism through which service quality influences retention. The integrated use of SERVQUAL, gap analysis, and SEM provides a robust framework for future banking research.

Theoretically, the study strengthens relationship marketing theory by empirically validating satisfaction as a mediating construct between service quality and retention in emerging economies.

7. Discussion of Findings

The findings of this study provide strong empirical support for the theoretical proposition that service quality is a key antecedent of customer retention in the banking sector. The results are consistent with the SERVQUAL framework and relationship marketing theory, which posit that superior service quality enhances customer satisfaction and strengthens long-term relationships.

The regression and SEM results indicate that **reliability** is the most influential service quality dimension affecting customer satisfaction. This finding is particularly relevant in banking, where customers expect accurate transactions, error-free services, and dependable performance. This supports earlier studies that identify reliability as the cornerstone of banking service quality.

Responsiveness emerged as the second most significant determinant, highlighting the importance of prompt service, quick grievance redressal, and employee willingness to help customers. In an era of digital banking and instant service expectations, delays or inefficiencies can significantly erode customer satisfaction.

Assurance, encompassing employee competence, courtesy, and trustworthiness, also showed a strong positive influence on satisfaction. Given the financial risks involved in banking services, customers value confidence and trust in bank employees, reinforcing the role of human interaction even in technology-driven banking environments.

The **service quality gap analysis** revealed negative gaps across all dimensions, indicating that customer expectations consistently exceed perceptions. This finding aligns with prior banking studies and suggests that private sector banks, despite superior performance compared to public sector banks, still face challenges in meeting rising customer expectations.

Importantly, the SEM results confirmed the **mediating role of customer satisfaction** between service quality and customer retention. This implies that service quality alone does not directly guarantee retention unless it translates into customer satisfaction. This finding contributes to the literature by empirically validating a mediation model in the Indian private banking context.

The dominance of reliability as a predictor is consistent with earlier banking studies conducted in emerging markets, reinforcing the argument that trust and accuracy are central to customer evaluations of banking services.

8. Managerial Implications

The findings of this study offer several actionable insights for bank managers and policymakers.

First, banks must prioritize **reliability-focused service delivery**, including error-free transactions, system accuracy, and consistent service performance. Investments in backend technology, internal controls, and staff training can significantly enhance reliability.

Second, improving **responsiveness** through faster complaint resolution mechanisms, multi-channel customer support, and empowered frontline employees can strengthen customer satisfaction. Banks should adopt real-time feedback systems and service recovery protocols to address customer issues promptly.

Third, strengthening **assurance and trust** requires continuous employee skill development, ethical practices, and transparent communication. Relationship managers should be trained not only in technical banking knowledge but also in interpersonal and advisory skills.

Fourth, the persistent service quality gaps suggest the need for **continuous service quality audits**. Banks should regularly measure customer expectations and perceptions to realign service strategies accordingly.

Finally, customer satisfaction should be treated as a **strategic performance metric**, linked to employee evaluation and incentive systems. By embedding customer satisfaction into organizational culture, banks can enhance retention and long-term profitability.

9. Policy Implications

From a policy perspective, the study highlights the importance of service quality regulation in the banking sector. Regulatory authorities such as the Reserve Bank of India (RBI) can encourage banks to adopt standardized service quality benchmarks and disclosure practices.

Policies promoting customer grievance redressal transparency and service quality reporting can enhance accountability and trust in the banking system. Additionally, policy initiatives supporting customer education and awareness can help bridge expectation–perception gaps.

10. Limitations of the Study

Despite its contributions, the study has certain limitations. First, the research focuses on a single private sector bank(HDFC Bank), which may limit generalizability. Second, the study relies on self-reported data, which may be subject to response bias. Third, the cross-sectional nature of the study restricts the ability to capture changes in customer perceptions over time.

11. Scope for Future Research

Future studies may extend this research by conducting comparative analyses between public and private sector banks or incorporating foreign banks. Longitudinal studies could provide deeper insights into evolving customer expectations. Additionally, future research could examine the impact of **digital banking service quality**, **AI-driven service delivery**, and **relationship quality** on customer retention.

12. Contribution to Theory and Practice

This study contributes to the banking and service quality literature by empirically validating the SERVQUAL framework in the Indian private banking context and establishing customer satisfaction as a key mediating variable. Practically, the study offers bank managers a structured approach to enhancing customer retention through targeted service quality improvements.

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Authors' contributions

Dr. Prabhakaran Jagadeesan conceptualized the study, designed the research framework, performed data analysis, and revised the manuscript. Mrs. Vijayalakshmi Karunakaran contributed to data collection, literature review, and initial drafting of the manuscript. Both authors read and approved the final manuscript and agree to be accountable for all aspects of the work.

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The authors declare that they have no known competing financial interests or personal relationships that could have influenced the work reported in this paper.

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The data that support the findings of this study are available on request from the corresponding author. The data are not publicly available due to privacy or ethical restrictions.

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No additional data are available.

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