

# Why this Bank? Understanding Customers' Preference for an Islamic Bank in a Competitive Market

Radiyah Abdul Kader<sup>1</sup>

Roza Hazli Zakaria<sup>2</sup>

Norhafizan Razali<sup>3</sup>

Nurhidayah Abdullah<sup>4</sup>

## Abstract

This study aims to understand customer preferences in selecting a bank in a competitive market of Islamic banks. Primary data collected from the customers of an outstanding Islamic bank (Bank Rakyat) was analysed using exploratory factor analysis. It is found that customers are attracted to Bank Rakyat because of its quality of service, its returns and its physical image. Analysis of Variance (ANOVA) reveals that Muslim and non-Muslim customers are equally influenced by these factors. The results suggest that when there are many Sharia compliant banks in the market customers are assured of the religious factor and hence look for other criteria in the bank of their choice. The relevant marketing strategies from this study are improvement of customer service satisfaction, attractive cost benefit and provision of good bank ambience.

**Key words:** Islamic bank, consumer bank preference, competitive market

## 1. Introduction

With approximately 50 percent of the population being Muslim, there is a large potential market for Islamic banking in Malaysia. Muslims who strictly adhere to their faith do not patronise conventional banks, as these banks operate on interest, a practice prohibited under the laws of Islam. In fact, the establishment of the first Islamic bank in Malaysia, Bank Islam Malaysia, in 1983 was in response to the

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<sup>1</sup> University of Malaya Kuala Lumpur Malaysia

<sup>2</sup> University of Malaya Kuala Lumpur Malaysia

<sup>3</sup> University of Malaya Kuala Lumpur Malaysia

<sup>4</sup> University of Malaya Kuala Lumpur Malaysia

Muslim public demand for interest-free banking (Ariff, 1988). The bank, which was given a ten-year monopoly, experienced a rapid growth in deposits and depositors during its first few years of operation implying that in a predominantly Muslim market, a single Islamic bank could survive and attract customers solely because of its religious affiliation.

Nevertheless, the policy of a dual banking system launched in 1993 has steered the Malaysian Islamic banking trajectory in a competitive market where a two tier competition prevails. The first tier refers to competition amongst Islamic banks while the second tier relates to competition between Islamic banks and their conventional counterparts. Initially, competition at the second tier was the major challenge. Infant Islamic banks faced tough competition from its long established conventional counterparts. In an uneven playing field where conventional banks surpass the Islamic banks by number and size the way forward for Islamic banks was to at least match the services provided by the conventional banks in terms of variety, price and quality.

Intra competition amongst sister Islamic banks in the first tier developed as the number of players increased. Initially, the first full-fledged Islamic bank faced competition from Islamic windows of conventional banks. Competition continued to grow as the government granted new Islamic banking licenses. In 1999, two conventional banks merged, and their Islamic windows were combined to form the second stand-alone Islamic bank, Bank Muamalat. Conventional banks also upgraded their Islamic windows into Islamic bank subsidiaries which enjoyed the same privileges as full-fledged Islamic banks. The government's policy on financial liberalisation in 2004 to position Malaysia as an international Islamic financial hub, brought in competition from Middle East foreign Islamic banks. By the end of 2009 17 fully-fledged Islamic banks, comprising two stand-alone domestic banks, six foreign banks and nine Islamic subsidiaries of conventional banks, were competing in the market.

It is envisaged that the first tier competition has presented new prerequisites on Islamic banks. Given that those banks are Sharia compliant customers have a wider choice. Customers no longer worry about the religious factor but look for other factors in the bank of their choice. For the Islamic banks, being shariah compliant was considered adequate for survival in the early years. However, as the market becomes competitive Islamic banks are forced to be efficient, cost-effective and innovative in response to customers' market needs which would eventually attract clients away from conventional banks in the second tier.

This study attempts to examine the criteria considered by customers in selecting the Islamic bank of their choice. This study differs from others since it focuses on an outstanding Islamic bank. We argue that studying a specific Islamic bank, that has done exceptional well in recent years, amidst the growing competition would be able to provide more specific bank marketing strategies for Islamic banks, rather than looking at various banks and end up with more universal and general policy implications.

Another reason that makes this study unique is that the bank in focus is not a commercial bank but is a specialized development financial institution, specifically a cooperative bank. The bank, named Bank Rakyat, has evolved into a full-fledged Islamic bank in 2003. Bank Rakyat is well-known for its outstanding performance, as attested by the numerous awards earned in recent years. It was awarded "The Most Outstanding Islamic Retail Bank of 2007" at the national level. In 2008, Bank Rakyat was ranked the twelfth top Islamic financial institution in the world, and the seventh strongest bank in Malaysia (Bank Rakyat website). The bank is also well-known for giving out high annual dividends to its members (shareholders) since 2005.

This article is organised as follows. The next section will provide a literature review of customer bank selection determinants. This will be followed by the research methodology, findings and policy implications.

## **2. Literature Review**

In general, consumer bank selection determinants can be classified into external and internal factors. An external factor that has emerged in the literature is sociological influence. Psychologically, people are prone to react to the recommendations of friends and family members, hence the implicit power of word-of-mouth advertising. The empirical evidence, however, is mixed. Hegazy (1995) reports that advice and recommendations of relatives and friends are the most important determinants of bank selection, while Gray (1977) claims that parental influence is the most important factor. In contrast, studies by Gerrard and Cunningham (2001), Ta and Har (2000) and Wel and Mohd (2003) find that third-party influence is relatively unimportant.

Prior studies have also considered mass media advertising as a powerful social influence that persuades customers to select one bank over another. Commercial banks take advantage of advertising as a strategy to compete with their rivals, allocating considerable resources for mass media advertising, even though there are

uncertainties associated with the return. Evren (2003) finds that advertising plays a significant role in banking and positively affects the profitability of the bank. However, Haron et al. (1994) find that mass media advertising has little, if any, impact on the customer's bank selection.

Besides social influence, customer bank preference may be influenced by factors specific to each bank. Convenience is a potential factor. Convenience is measured by the location of the bank in relation to home and work, the ease of parking and the availability of automated teller machines (ATMs). Almossawi (2001) finds supportive empirical evidence that convenience is a primary factor while Ringgal (1980) finds a significant relationship between convenience of location and the customer's bank choice.

In contrast, a study conducted by Ta and Har (2000) concludes that the main determinant of bank selection is the rates of return, while convenience is ranked as the second factor. This is not surprising, as one of the reasons some consumers hold money in the bank is for investment. Therefore, the high return on deposits is the most important factor to them. Similar findings are reported by Khazeh and Decker (1992) and Gerrard and Cunningham (1997). In a multiracial country such as Malaysia, Rosly (1999) finds that rising interest rates in 1997 have caused significant transfers of investment deposits from Islamic banks to conventional banks especially among non-Muslim depositors. Such behaviour indicates that the rate of return is a decisive factor for non-Muslims when selecting their financial institution.

Banking transactions involve time and effort. It is expected that customers would prefer a speedy and painless banking experience. Therefore, the quality of service provided by a bank is also important to the customer. The Singapore Business (1992), reports that banks cannot really compete on rates of return alone; rather, they need to emphasise on the quality of service. There is common agreement among studies that for conventional banks the quality of service is the major factor in maintaining customer satisfaction. (Tayler and Stanley 1999, Naser et al (1999).

In the case of Islamic banks, Erol and El-Bdour (1989) and Erol Kaynak and El-Bdour (1990) find that in Jordan, service quality, interpreted as efficiency and speed, as well as the bank's image and reputation, has highly influenced individuals to choose particular banks. Haron et al. (1994) indicate that in Malaysia, service quality is an important factor for choosing a bank, both for Muslim and non-Muslims. In a more detailed analysis, Dusuki et al. (2007) and Lamsali et al. (2005) demonstrate that the dimension of service quality that matters most is the friendliness of the bank staff.

The quality of bank service is often associated with the reputation of the bank among its customers. Normally, the customer, motivated to reduce risk, is more attracted to a bank that has an excellent reputation for stability because such a bank is less risky, as evidenced by the findings of Kennington et al. (1996). The reputation of a bank can be measured by the bank's size, where a larger bank corresponds to a better reputation. A larger bank represents security and reliability, as a large bank must perform well to maintain its size. Casalo et al. (2007) finds that a bank's reputation is also indicative of its trustworthiness. Erol and El-Bdour (1989) reveals that the customer perceives a bank's reputation as one of the most important factors of bank selection, whether it is an Islamic or a conventional bank.

A unique factor to be considered in the case of Islamic banking is religious motivation, as the establishment of Islamic banking rests on the demand for a sharia-compliant financial institution. Nonetheless, findings from previous studies fail to establish a consensus that religion is the deciding factor in bank selection by customers. The findings, however, are mixed with respect to this issue. While Omer (1992); Haron et al. (1994); Metwally (1996); Gerrard and Cunningham (1997); Metawa and Almosawi (1998); Othman and Owen (2001); Ahmad and Haron (2002); Zainuddin et al. (2004) and Okumus (2005) find that the religious factor is apparently one of the important criteria to be measured for the selection of a bank, other studies report that the religious factor is the least important and has no impact on the bank selection criteria when compared to the quality of services factor (Erol and El-Bdour, 1989; Erol Kaynak and El-Bdour, 1990; Hegazy, 1995).

More recent studies on customer selection criteria for Islamic banks reveal an interesting observation. It is found that customers in the Indian subcontinent place utmost priority to the religious factor. Khan et al (2008) finds that for Islamic bank customers in Bangladesh the religious principle is the key bank selection criterion. A similar study by Lee and Ullah (2011) in the same region also finds that customers in Pakistan place a high value on the Shar'ia compliance of their banks to the extent that repeated violation of Shari'a would induce the customers to switch banks. In contrast Selamat et al (2012) reveal that both Muslim and non-Muslim Islamic bank customers in Malaysia are not primarily motivated by the religious factor. Instead high emphasis is placed on fast and efficient service, bank's reputation, image and confidentiality.

Overall, previous findings suggest that Islamic and conventional banks share similar important determinants of customer's bank selection such as convenience, quality of service and rates of return, while evidence on the importance of the religious factor as the primary motivation for Islamic bank selection is inconclusive.

### **3. Research Methodology**

The research model for this study shows factors that are likely to have influenced customers to choose Bank Rakyat, based on the literature review. Six factors are constructed in the model, namely, bank reputation, religion, social factors, service quality, returns and convenience. It is worth noting that these factors are not single measurable entities (Norusis 1993). Instead, each factor is the construct of a number of directly observable variables that share a common property with the factor. In all, there are 36 observable bank selection variables in the model. Primary data are collected to assess the extent to which each observable variable has influenced customers in their decisions to select Bank Rakyat. Using factor analysis, we are able to reduce the 36 observable variables into a smaller set of factors representing the bank selection determinants of Bank Rakyat customers.

Primary data were collected by the survey method using a structured questionnaire that consisted of two sections: demographic data of the respondents and observable variables of the six factors in the model. A 4-point Likert scale degree of influence: ranging from (1) None, (2) A little, (3) Strong to (4) Very strong is used to measure the degree to which each variable has influenced the customer in choosing Bank Rakyat.

The sample for this study was Bank Rakyat customers in Peninsular Malaysia, Sabah and Sarawak. Using a sampling frame comprising the number of depositors per state provided by Bank Rakyat, stratified random sampling method was used to select the respondents by state and by branches. A total of 991 cases were selected, of which 875 were Muslims and 116 were non-Muslims. This ratio is consistent with the structure of Bank Rakyat's customer base, where Muslim customers are significantly more than non-Muslim customers. A pilot survey preceded the actual survey which was conducted by trained enumerators at the selected Bank Rakyat branches over a period of three weeks.

Data analysis was conducted using the Statistical Package for Social Science (SPSS). Analysis of variance (ANOVA) was used to differentiate the influence of the observable variables between groups based on demography, while factor analysis was utilised to identify the bank selection determinants. The relevance of factor analysis for the data set was tested by the Kaiser-Meyer-Olkin (KMO) measure of sampling adequacy and the Bartlett Test of Sphericity. The average KMO value for the data set is high at 0.904, indicating that factor analysis is feasible. The Bartlett Test of Sphericity is also highly significant suggesting that the correlation matrix of the variables is not an identity. Hence, factor analysis can be applied to the data set.

The reliability of the 36 items or observable variables listed in the questionnaire is also verified in the sense that each variable will produce similar results each time it is administered to the same person in the same setting (George et al., 2003). For this study, the Cronbach's coefficient alpha reliability test results show that 33 items were reliable with a high alpha score of 0.919.

The orthogonal method with Varimax rotation was employed to ensure that the extracted factors were independent and unrelated to each other. The aim of factor analysis was to group variables with high loadings (correlation) for the same factor. A variable with a high communality (loading) of 0.8, for example, shows a high correlation between that variable and other variables sharing the common factor. For this study, only variables with factor loadings above or equal to 0.5 were included in the analysis, as recommended by Kaiser (Bryman, 1990).

Initially, eight factors with eigenvalues exceeding one (following Kaiser's criterion) were extracted, which explained 60.3 percent of the total variance. However, not all eight factors would be retained. The number of factors selected should be minimised while the total variance is maximised. Using the graphical scree plot as a guideline, it is found that three factors lie on the steep portion of the scree plot. Hence, it was decided that three factors would be selected for this study. These three factors explained 41.2 of the total variance.

## **4. Findings**

### **4.1. Descriptive Analysis**

The distribution of respondents in the sample by gender indicates 56 per cent males and 44 per cent females and 50 percent belong to the active working age group of between 35 and 54 years old. Majority were Malays (86.4 percent) and Muslims (88.3 percent), which is representative of the population of Islamic bank customers. More than half of the sample had secondary education (54.4 percent), while close to 40 percent had tertiary qualification. The majority of respondents (82.8 percent) were gainfully employed, and almost half (47.3 percent) were employees of the public sector. More than half (56.1 percent) earned monthly incomes between RM1001 and RM3000, while a significant proportion (17.7 percent) received a salary between RM3000 and RM5000 a month.

In terms of deposits, majority of the respondents (91.2 percent) had savings accounts, but very few had investment accounts. Apparently Bank Rakyat was not their only bank, as 94 percent of the respondents had accounts in other banks, and of that 94 percent, 86.0 percent had accounts in conventional banks and 14.0 percent had deposits in other Islamic banks. In terms of financing, 64 percent of the respondents received financing from Bank Rakyat, and the majority of them (93.4 percent) were Muslims. In addition, more than half (57.2 percent) of the respondents were members of Bank Rakyat, of which 93 percent were Muslims.

#### **4.2. Determinants of Bank Preference Analysis**

Frequency analysis of the mean scores shows that most of the variables have strongly influenced the customers to choose Bank Rakyat. To get a clearer picture, factor analysis was conducted to reduce the variables into groups of factors. Each factor reflects a common property shared by the variables that cluster under it. The result of the factor analysis, shown in Table 1, reveals that three bank selection determinants (factors) have been extracted. The alpha reliability test also shows high alpha scores, ranging from 0.805 to 0.889 suggesting that the items under each factor are reliable.

In addition, the three factors are independent of each other and can stand as separate constructs. This is confirmed by the component transformation matrix where, in general, the correlations between the three factors are relatively low while the individual correlation for each factor is close to 1 (above 0.7).

The ability of Bank Rakyat to provide all of these factors gives the bank a competitive advantage based on the confidence of its customers. Factor 1 (as illustrated in Table 1) comprises items related to Bank Rakyat's quality of service. All variables under this factor, as shown by the mean scores, have strongly influenced the customers in selecting Bank Rakyat. This result is consistent with the findings of Erol and El-Bdour (1989), Tayler and Stanley (1999), Jamal and Naser et al (2002), Lamsali et al. (2005), Dusuki (2007) and Selamat and Abdul-Kadir (2012). As concluded by Parasuraman et al. (1994), the most important factor that can affect a business unit's performance is the quality of its products and services as compared with that of its competitors. In a service business such as banking, quality depends on the customer's experience with the service delivery. Service quality has been described as a form of attitude that results from the comparison of expectation with the actual performance. This is supported by Gronross (1982), who argues that customers, when evaluating the quality of a service, compare the service they expect with perceptions of the services they actually receive.

**Table 1: Bank Selection Determinants**

	<b>Loading</b>	<b>Eigenvalue</b>	<b>Variance</b>	<b>Mean*</b>	<b>Std.Dev.</b>
<b>Factor 1: Quality of Service</b>					
Bank's reputation and image	0.699	0.810	2.453	3.0838	.78628
Suitable operation hours	0.671	0.719	2.178	2.9707	.84336
Inter-branch facilities	0.662	0.781	2.366	2.7740	.88156
Variety bank services	0.629	1.276	3.866	2.8890	.89544
Friendly, courteous service	0.592	0.954	2.891	3.1312	.79325
Fulfill your needs	0.560	0.412	1.249	3.0898	.82573
Credit facilities available	0.557	0.639	1.937	2.9617	.94096
Fast and efficient service	0.547	1.029	3.120	2.9405	.87703
Bank's ATM facilities	0.515	0.838	2.539	2.7800	.93314
Media publicity	0.536	0.692	2.098	2.9102	.94335
Non burden credit cost	0.531	0.630	1.910	2.7881	.96583
<b>Factor 2: Returns</b>					
Higher deposit return than other Islamic banks	0.796	0.315	0.954	2.7366	.92347
Higher deposit return than conventional banks	0.783	0.223	0.674	2.7296	.93286
High dividend to members	0.640	0.342	1.035	2.9869	.92049
Profit sharing deposit	0.624	0.109	0.330	2.5994	1.04251
Varieties of savings account	0.528	0.333	1.008	2.9445	.86454
No riba	0.571	0.208	0.631	2.8143	1.05593
<b>Factor 3: Physical Image</b>					
Interior of bank	0.885	0.453	1.372	2.5681	.91627
Exterior of bank	0.861	0.475	1.439	2.5358	.93985
Interior comfort	0.740	0.443	1.342	2.7619	.87143

\* Likert scale degree of influence: 1: none, 2: a little, 3: strong, 4: very strong

It has been argued that the quality of service is not a one-dimensional construct. Rather, service quality incorporates various dimensions that relate to both core and augmented service offerings (Bitran and Lojo, 1984; Lewis, 1993). Parasuraman et al. (1994) describe five dimensions of service quality, namely, reliability, tangibles, responsiveness, assurance and empathy. These dimensions are captured in this study, and service quality is represented by the bank's reputation, the variety of services provided, the level of friendly and courteous service provided, the speed and efficiency of the service and the bank's knowledge of and ability to meet the needs of customers. Other service quality dimensions under this factor include the availability of facilities such as ATMs, credit and inter-branch transactions and suitable hours of operation. Friendly and courteous service has the highest mean score. These results imply that Bank Rakyat's reputation for winning various awards over the past few years, which was underscored by media publicity, has increased customers' confidence in the bank's quality of service. These variables support the quality of service offered by Bank Rakyat as the most important selection determinant for its customers.

The second most influential determinant is the return factor, a common feature shared by the variables that are loaded to this factor. This factor is consistent with the findings of Gerrard and Cunningham (1997), Ta and Har (2000) and Haron et al. (2000). The respondents who gave high scores for variables under this factor were most attracted by the high dividends paid to the members (shareholders) of Bank Rakyat. (see Table 1). Another important return criterion is the relatively higher returns offered by Bank Rakyat on its deposits compared to that offered by other Islamic banks and conventional banks. Interest-free return is another important consideration. Customers considered it important that the services of Bank Rakyat are free from *riba* (interest) and that investment deposits earn returns in the form of profits.

The above findings confirm Bank Rakyat's superior performance in providing satisfactory returns to its customers. Bank Rakyat is known for having offered high dividends of up to 15 percent to its members (shareholders) over the past few years. Additionally, the Bank has been offering relatively higher returns on its savings deposits. The bank also offers different types of investment accounts targeted for different market segments. For instance, the *Qiradh* Investment Account for senior citizens offers a profit rate that is 0.5 percent higher than the general *Qiradh* Investment Account (Bank Rakyat website).

The third selection determinant is the physical image, as shown in Table 1. This factor is measured by three variables according to their level of influence, the highest

being the level of comfort within the bank, followed by the bank's interior ambience and external appearance. This finding is similar to that of Haron et al. (1994) where the beautification of the banks' premises and the interior comfort provided by the bank have been accorded top priority by the bank customers. In a recent study Selamat and Abdul-Kadir (2012) have captured this factor as an important factor in Islamic bank selection. This finding suggests that in a developed and modern market where basic banking needs and convenience have been met, customers look for higher levels of service satisfaction in terms of luxury and comfort. Hence this factor should be taken seriously by current bank management in their marketing strategy.

This study further examines whether there are significant differences in the Islamic bank selection determinants between Muslims and non-Muslims. It is hypothesised, for obvious reasons, that Muslims would be more influenced by the religious factor than would non-Muslims. The results of the analysis of variance (ANOVA) appear to support this hypothesis. As shown in Table 2, the differences in means for the religious criteria between the two groups were highly significant. The highest difference, significant at the 5 percent level, is "the status of Bank Rakyat as a full-fledged Islamic bank". Equally highly significant are the Islamic criteria "no riba" and the "investment deposits based on the profit-sharing contract". This high emphasis on the Sharia compliance factor by Muslims is similar to the findings by Khan et al (2008) and Lee and Ullah (2011).

Besides the religious factor, Muslims were also more significantly influenced by the status of Bank Rakyat as a cooperative bank; as indicated by "the high dividends paid to its members" variable. The credit facilities provided and the non-burden credit cost are additional differences that can be explained by the fact that a large majority of the members of Bank Rakyat, as well as those who receive financing from the bank, are Muslim.

It is worth noting that there were no significant differences between Muslims and non-Muslims with respect to the influence of service quality, rate of return and physical image of the bank. The ANOVA test shows that both groups appear to be equally influenced by variables within these factors. This finding further supports the results of the factor analysis, which is representative of the customers of Bank Rakyat at the macro level.

Interestingly, even though Muslims are more inclined to choose an Islamic bank because of their religious beliefs, when there are many Islamic financial institutions to choose from, customers in general place importance to service satisfaction and cost-benefit considerations.

<b>Table 2: ANOVA- Bank Selection Determinants between Muslims and Non-Muslims</b>						
<b>Variable</b>	<b>Mean</b>		<b>Sum of Squares</b>		<b>F</b>	<b>Sig.</b>
	<b>Muslim</b>	<b>Non Muslim</b>	<b>MSB</b>	<b>MSW</b>		
Full fledge Islamic bank	3.21	2.471	56.89	866.79	64.91	0.000*
Fulfill your need	3.10	2.939	2.96	672.04	4.35	0.037*
High dividend to members	3.02	2.69	10.94	827.88	13.07	0.000*
A cooperative bank	3.00	2.70	9.21	831.99	10.95	0.000*
Credit facilities available	3.00	2.60	116.85	859.68	19.39	0.000*
Media publicity	2.94	2.681	6.89	874.10	7.80	0.005*
Islamic pawn broking	2.90	2.62	8.09	1068.86	7.48	0.006*
No riba	2.90	2.15	57.08	1046.75	53.93	0.000*
Non burden credit cost	2.82	2.50	10.90	912.59	11.81	0.001*
Bank's promotion and publicity	2.77	2.54	5.55	962.88	5.70	0.017*
Higher deposit return than other Islamic banks	2.7771	2.4310	12.269	831.991	14.585	0.000*
Profit sharing investment deposit	2.6423	2.2759	13.752	1062.208	12.804	0.000*

Note: \* significant at 5% level.

Other factors that did not appear to significantly impact a person's decision when selecting an Islamic financial institution were convenience and social influence, especially with respect to recommendations by family and friends.

## **5. Policy Implications**

The above findings provide some policy implications with respect to marketing strategies for Bank Rakyat, in particular, and other Islamic financial institutions, in general. First, customer satisfaction, in terms of the quality of service provided by the bank, is an important component of the total value package that customers consider. Therefore, Bank Rakyat should continue to place greater emphasis on making sure its customers are satisfied by maintaining the existing level of service quality and striving to provide even better service quality in the future, as the aim is to ensure customer loyalty and attract new customers.

Second, the importance of the return factor to customers suggests that Islamic financial institutions have little choice but to adopt competitive pricing strategies when offering rates of return on customers' deposits. The Malaysian Islamic banking market is becoming increasingly more competitive. Customers now have more product options and, hence the ultimate deciding factor is the rate of return offered by the bank. To keep the cost of funds low, Islamic banks must adopt efficient and effective methods of deposit mobilisation. In the case of investment deposits, returns would very much depend on bank income accrued from the investment and financing of bank funds. This calls for innovative financing packages that would satisfy the need of customers.

Finally, Islamic financial institutions should also include in their policies a plan to upgrade their premises. The external image of the bank is important to customers because it reflects the bank's reputation while the attractive internal surroundings provide good ambience to customers.

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