

Factors Affecting the Technical Efficiency of Production of the Brazilian Banking System: A Comparison of Four Statistical Models in the Context of Data Envelopment Analysis.

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Abstract

This paper uses an output oriented Data Envelopment Analysis (DEA) measure of technical efficiency to assess the technical efficiencies of the Brazilian banking system. Four approaches to estimation are compared in order to assess the significance of factors affecting inefficiency. These are nonparametric Analysis of Covariance, maximum likelihood using a family of exponential distributions, maximum likelihood using a family of truncated normal distributions, and the normal Tobit model. The sole focus of the paper is on a combined measure of output and the data analyzed refers to the year 2001. The factors of interest in the analysis and likely to affect efficiency are bank nature (multiple and commercial), bank type (credit, business, bursary and retail), bank size (large, medium, small and micro), bank control (private and public), bank origin (domestic and foreign), and non-performing loans. The latter is a measure of bank risk. All quantitative variables, including non-performing loans, are measured on a per employee basis. The best fits to the data are provided by the exponential family and the nonparametric Analysis of Covariance. The significance of a factor however

varies according to the model fit although it can be said that there is some agreements between the best models. A highly significant association in all models fitted is observed only for nonperforming loans. The nonparametric Analysis of Covariance is more consistent with the inefficiency median responses observed for the qualitative factors. The findings of the analysis reinforce the significant association of the level of bank inefficiency, measured by DEA residuals, with the risk of bank failure.

1 Introduction

The main objective of this paper is to compute measures of technical efficiency based on Data Envelopment Analysis (DEA) for the Brazilian banks and to relate the variation observed in these measurements to covariates of interest. This association is investigated in the context of four alternative models fit to DEA residuals. The DEA residuals are derived from a single output oriented DEA measure obtained under the assumption of variable returns to scale. This approach explores Banker (1993) and Souza (2001) results for the univariate production model.

The causal factors considered here are bank nature, bank type, bank size, bank control, bank origin and risky loans (nonperforming loans). Output is measured as a combined index formed by investment securities, total loans and demand deposits. The three input sources are labor expenses, capital and loanable funds. All production variables are normalized by an index of personnel.

2 Data Envelopment Analysis Production Models

Consider a production process with n production units (banks). Each unit uses variable quantities of m inputs to produce varying quantities of s different outputs y .

Denote by $Y = (y_1, \dots, y_n)$ the $s \times n$ production matrix of the n banks and by $X = (x_1, \dots, x_n)$ the $m \times n$ input matrix. Notice that the element $y_r \geq 0$ is the $s \times 1$ output vector of bank r and $x_r \geq 0$ is the $m \times 1$ vector of inputs used by bank r to produce y_r (the condition $x_r \geq 0$ means that at least one component of the input vector

is strictly positive). The matrices $Y = (y_{ij})$ and $X = (x_{ij})$ must satisfy: $\sum_i p_{ij} > 0$ and $\sum_j p_{ij} > 0$ where p is x or y . The output vector y as well as the input vector x need not in general to be measured in physical quantities.

In our application $s = 1$ and $m = 3$ and it will be required $x_r > 0$ (which means that all components of x_r are strictly positive).

Definition 2.1: *The measure of technical efficiency of production of bank o under the assumption of variable returns to scale and output orientation is given by the solution of the linear programming problem $\text{Max}_{\phi, \lambda} \phi$ subject to the restrictions*

1. $\lambda = (\lambda_1, \dots, \lambda_n) \geq 0$ and $\sum_i^n \lambda_i = 1$.
2. $Y\lambda \geq \phi y_o$.
3. $X\lambda \leq x_o$.

Suppose that the production pairs (x_j, y_j) , $j = 1, \dots, n$ for the n banks analyzed satisfy the deterministic statistical model $y_j = g(x) - \epsilon_j$, where $g(x)$ is an unknown continuous production function, defined on a compact and convex set K . We assume $g(x)$ to be monotonic and concave. The function $g(x)$ must also satisfy $g(x_j) \geq y_j$ for all j . The quantities ϵ_j are inefficiencies which are independently distributed nonnegative random variables.

One can use the observations (x_j, y_j) and Data Envelopment Analysis to estimate $g(x)$ only in the set

$$K^* = \left\{ x \in K; x \geq \sum_{j=1}^n \lambda_j x_j, \lambda_j \geq 0, \sum_{j=1}^n \lambda_j = 1 \right\}.$$

For $x \in K^*$ the DEA production function is defined by

$$g_n^*(x) = \sup \left\{ \sum_j \lambda_j y_j; \sum_j \lambda_j x_j \leq x \right\},$$

where the sup is restricted to nonnegative vectors λ satisfying $\sum_{j=1}^n \lambda_j = 1$.

For each bank o , $g_n(x_o) = \phi_o^* y_o$, where ϕ_o^* is the solution of the linear programming problem of Definition 2.1.

The function $g_n^*(x)$ is a production function on K^* , in other words, is monotonic, concave, $g_n(x_j) \geq y_j$, and satisfies the property of maximum extrapolation, that is, for any other production function $g_u(x)$, $x \in K$, $g_u(x) \geq g_n^*(x)$, $x \in K^*$.

3 Statistical Inference

It is shown in Souza (2001) that $g_n(x)$ is strongly consistent for $g(x)$ and that the estimated residuals $\epsilon_{nj}^* = (1 - \phi_r)y_j$ have approximately, in large samples, the same behavior as the ϵ_j .

Souza (2001) also discusses two family of distributions for the ϵ_j consistent with the asymptotic results cited above. The gamma and the truncated normal. Since some of the ϵ_{nj}^* in the sample will be exactly zero the general gamma family cannot be estimated by standard likelihood methods. It is possible however to fit the exponential distribution.

Let z_0, \dots, z_q be variables (covariates) we believe to affect inefficiency. Based on Souza (2001) results the following two statistical models can be used to fit the inefficiencies ϵ_{nj}^* under the assumptions of the deterministic model.

Firstly one may postulate the exponential density $\lambda_j \exp(-\lambda_j \epsilon)$ where $\lambda_j = \exp(-\mu_j)$ with $\mu_j = z_{0j}\delta_0 + \dots + z_{qj}\delta_q$. The z_{ij} are realizations of the z_i and the δ_i are parameters to be estimated.

Secondly one may consider the model $\epsilon_j^* = \mu_j + w_j$ where w_j is the truncation at $-\mu_j$ of the normal $N(0, \sigma^2)$. This model is inherited from the analysis of stochastic frontiers and is equivalent to truncations at zero of the normals $N(\mu_j, \sigma^2)$.

For the exponential distribution the mean of the j th inefficiency error is $\exp(\mu_j)$ and the variance $\exp(2\mu_j)$. For the truncated normal the mean is $\mu_j + \sigma\xi_j$ and the variance

$$\sigma^2 \left(1 - \xi_j \left(\frac{\mu_j}{\sigma} + \xi_j \right) \right)$$

where

$$\xi_j = \frac{\phi(\mu_j/\sigma)}{\Phi(\mu_j/\sigma)}$$

$\phi(\cdot)$ and $\Phi(\cdot)$ being the density function and the distribution function of the standard normal, respectively.

These expected values can be used to obtain predicted values for inefficiencies and therefore to measure goodness of fit for the respective models. One such measure is the rank correlation coefficient between observed and predicted values.

In both models the mean and the variance are monotonic functions of μ_j and thus both specifications allow heteroscedasticity.

The modeling alternatives presented here involving the families of exponential and truncated normal distributions may be justified with the deterministic production model. However, even if one is not willing to assume an underlying univariate deterministic production model, those two families of densities are reasonable model alternatives and (hopefully) flexible enough to model the distribution of the ϵ_{nj}^* . Standard maximum likelihood estimation based on random samples will be granted if there is not strong evidence against independence of the ϵ_{nj}^* across the units forming the sample. This latter assumption may be checked by means of the runs test (Wonnacot and Wonnacot, 1990).

Under the assumption of uncorrelated residuals two other models have been used in the statistical analysis of inefficiency measures: the Analysis of Covariance (Coelli, Rao, and Battese, 1998) and the Tobit regression (McCarty and Yaisawarng, 1993).

The Analysis of Covariance model used here has the nonparametric formulation (Conover, 1998)

$$r_j = z_{0j}\delta_0 + \dots + z_{qj}\delta_q + u_j$$

where r_j is the rank of ϵ_{nj} and the u_j are iid normal errors with mean zero and variance σ^2 .

The Tobit model is formulated as

$$\epsilon_{nj}^* = \begin{cases} z_{0j}\delta_0 + \dots + z_{qj}\delta_j + u_j & \text{if } \epsilon_j > 0 \\ 0 & \text{if } \epsilon_j \leq 0 \end{cases}$$

As before the u_j are iid normal random variables with mean zero and constant variance σ^2 .

As pointed out in McCarty and Yaisawarng(1993), the Tobit model is adequate when it is possible for the dependent variable to assume values beyond the truncation point, zero in the present case. They argue that this is the case in the DEA analysis. Their wording on this matter is as follows. It is likely that some banks (hypothetical) might perform better than the best banks in our sample. If these unobservable banks could be compared with a reference frontier constructed from the observable banks, they would show efficiency scores greater than unity (over efficiency). This would lead to a potential nonpositive residual.

4 Specification of Inputs and Outputs

In this paper we follow the intermediation approach. Under this approach banks function as financial intermediaries converting and transferring financial assets between surplus units and deficit units. In this context we take as output the vector $y = (\text{securities, loans, demand deposits})$. This output vector is combined into a single measure, also denoted by y , representing the sum of the values of investment securities, total loans and demand deposits. Here we follow along the lines of Sathie (2001) who, in a similar study of the Australian banking industry, considers demand deposits as output. All output variables, as shown below, are measured on a per employee basis since they are normalized by the number of employees. This approach has the advantage of making the banks more comparable through the reduction of variability and of the influence of size in the DEA analysis.

The inputs are labor (l) measured by labor costs, the stock of physical capital (k) which includes the book value of premises, equipments, rented premises and equipment and other fixed assets, and loanable funds (f) which include, transaction deposits, and purchased funds. Input variables, like the output, are also normalized by the number of employees.

The data base used is COSIF, the plan of accounts comprising balance-sheet and income statement items that all Brazilian financial institutions have to report to the Central Bank on a monthly basis.

The statistical analysis carried out in this paper is restricted to the year of 2001. Output and input variables are treated as indexes relative to a benchmark. In this paper the benchmark for each variable, whether an input, an output or a continuous covariate, was chosen to be the median value of 2001. Banks with a value of zero for l , k or f were eliminated from the analysis.

Output, inputs, and the continuous covariate were further normalized through the division of their indexes by an index of personnel. The construction of this index follow the same method used for the other variables, that is, the index is the ratio of the number of employees by its median value in 2001 (December).

Banks with the y employee normalized values greater than 100 were considered extreme outliers and eliminated from the analysis.

The covariates of interest for our analysis - factors likely to affect inefficiency, are nonperforming loans (q), bank nature (n), bank type (t), bank size (s), bank control(c) and bank origin (o). Nonperforming loans is a continuous variate and it is also measured on a per employee basis. All other covariates are categorical. The variable n assumes one of two values (1 - commercial, 2 - multiple), the variable t assumes one of four values (1 - credit, 2 - business, 3 - bursary, 4 - retail), the variable s assumes one of four values (1 - large, 2 - medium, 3 - small, 4 - micro) the variable c assumes one of two values (1 - private, 2 - public) and the variable o assumes one of two values (1 - domestic, 2 - foreign). There is a bank (Caixa Econômica Federal - CEF) in the data base that requires a distinct classification due to its nature. Bank nature for this sole case was coded 3. Dummy variables were created for each categorical variable. They are denoted $n_1, n_2, n_3, t_1, \dots, t_4, s_1, \dots, s_4, c_1, c_2$, and o_1, o_2 respectively.

5 Data Analysis

We begin the presentation in this section reproducing the table of descriptive statistics (Table 1). The variable of interest is the output oriented DEA measure of technical efficiency obtained under the assumption of variable returns to scale.

Looking at the medians it should be noticed that the most striking differences are observed for bank control were private banks dominate public banks and bank type were credit institutions dominate. These exploratory findings will aid in the choice of the best model fitting the ϵ_{nj}^* .

Several publications dealing with applications of DEA in banking and other areas make use of DEA efficiency measures as dependent variables in regression problems. Typical examples are provided by Coelli, Rao, and Battese (1998), Eseinbeis, Ferrier, and Kwan (1999), and Sathye (2001). These applications typically assume that efficiency measures are uncorrelated. This assumption is justified for the univariate deterministic production model in Banker (1993) under the assumption of independently and identically distributed inefficiencies and, under conditions that do not rule out heteroscedasticity, in Souza (2001). In the latter case one may use a different truncated normal or exponential distribution for each cross sectional unit. Banker (1993) suggests that these results may be extended to multiple outputs but the nature of the

Variable	Level	n	Median	Mean	Std Error
bank nature	commercial	24	0.598	0.574	0.064
	multiple	103	0.508	0.531	0.030
bank type	credit	42	0.641	0.587	0.050
	business	41	0.469	0.501	0.045
	bursary	13	0.554	0.593	0.074
	retail	32	0.508	0.487	0.056
bank size	large	18	0.554	0.510	0.062
	medium	41	0.542	0.535	0.049
	small	28	0.539	0.564	0.059
	micro	41	0.554	0.525	0.050
bank control	private	113	0.586	0.567	0.028
	public	15	0.190	0.293	0.080
bank origin	foreign	47	0.577	0.560	0.044
	domestic	81	0.500	0.521	0.035

Table 1: Descriptive statistics for categorical variables. The standard error is for the mean.

Variable	n	Runs	z	p-value
ϵ_n^*	128	65	0	0.500

Table 2: Runs test for response variable. Under the null hypothesis of randomness the number of runs is normal with mean 65 and variance 31.75.

production model may require deep changes.

A deterministic production model imposes a restrictive behavior in banking since no random error is allowed in the model specification. If one uses DEA as a performance measure not necessarily associated to a theoretical production model the hypothesis of no correlation should be inspected. Here in order to find evidence against this assumption we perform a runs test (Wonnacott and Wonnacott, 1990). The results are shown in Table 2.

It is seen from Table 2 that the null hypothesis of randomness (independence) is not rejected.

5.1 Statistical Models to Assess the Effects of Covariates

To investigate the effect of bank nature, bank type, bank size, bank control, bank origin and nonperforming loans on the inefficiency of Brazilian banks we model the distribution of the inefficiencies ϵ_{nj}^* as truncated normals and exponentials, and the inefficiencies themselves as a linear regression and as a Tobit normal model.

To fit the truncated normal, the exponential and the Tobit model we use maximum likelihood methods.

The presence of potential outliers and heteroscedasticity in the data calls for a nonparametric Analysis of Covariance with the regression approach. This is achieved using ranks of the ϵ_{nj}^* as dependent variables.

The log likelihood for the exponential distribution is given by

$$128 \sum_{j=1}^{128} \ln(\lambda_j) - \sum_{j=1}^{128} \lambda_j y_j^*$$

where

$$\lambda_j = \exp\{-\mu_j\}$$

and

$$\mu_j = a_0 + a_1 n_{1i} + a_2 n_{2j} + b_1 t_{1j} + b_2 t_{2j} + b_3 t_{3j} + c_1 s_{1j} + c_2 s_{2j} + c_3 s_{3j} + d_1 c_{1j} + e_1 o_{1j} + f_1 q_j$$

In the above expressions $y_j^* = \epsilon_{nj}^*$, the x_{ij} , where $x = n, t, s, c, o$, are realizations of the corresponding dummy variables and the q_j are realizations of the nonperforming loans variable q . The quantities a_l, b_l, c_l, d_1, e_1 , and f_1 are parameters to be estimated.

For the truncated normal distribution the log likelihood is

$$-64 \ln(2\pi\sigma^2) - \sum_{j=1}^{128} \ln(h_j) - 1/2 \sum_{j=1}^{128} \text{dif}_j$$

where

$$\text{dif}_j = \frac{(y_j^* - \mu_j)^2}{\sigma^2}$$

and

$$h_j = \Phi\left(\frac{\mu_j}{\sigma}\right).$$

Notice that σ^2 must also be estimated and that $\Phi(x)$ is the distribution function of the standard normal.

For the Tobit model the likelihood function can be seen in Johnston and Dinardo (1997). It is given by

$$\prod_{j:y_j^*=0} \left[1 - \Phi\left(\frac{\mu_j}{\sigma}\right)\right] \prod_{j:y_j^*>0} \frac{1}{\sqrt{2\pi\sigma^2}} \exp\left[-\frac{(y_j^* - \mu_j)^2}{2\sigma^2}\right]$$

where σ is the standard deviation of the normal error component of the model.

The Analysis of Covariance has the standard form

$$r_j = \mu_j + u_j$$

where the r_j are the ranks of the y_j^* and the u_j are iid homoscedastic normal errors.

We compare the exponential and truncated normal distributions. Optimization was performed for the truncated normal and the exponential fits using PROC NLMIXED in SAS v8.2 and the method of Newton-Raphson. The Tobit model was fit with the same technique using E-Views 4.1.

Table 3 shows the goodness of fit of each model measured as a rank correlation between observed and predicted values. The correlation is not strong for any of the

Model	Rank Correlation
Analysis of Covariance	0,439
Truncated Normal	0,151
Exponential	0,471
Tobit	0,273

Table 3: Goodness of fit measures - SAS output.

models. The best performance is for the maximum likelihood fit of a family of exponential distributions followed closely by the nonparametric Analysis of Covariance.

Table 4 shows the log-likelihood of each model fitted by maximum likelihood. These values seem to be in agreement with the results displayed in Table 3.

Model	log-likelihood
Truncated normal	-379.9
Exponential	-338.5
Tobit	-552.4

Table 4: Model log-likelihood - SAS and Eviews(Tobit) outputs.

The analysis of variance table for the Analysis of Covariance is shown in Table 5. The model is significant at the 5% level.

Source	df	Sum of Squares	Mean Square	F value	Pr>F
Model	11	28177.8434	2561.6221	2.03	0.0316
Error	116	146546.1566	1263.3289		
Total	127	174724.0000			

Table 5: Nonparametric Analysis of Covariance - SAS output.

The nonparametric Analysis of Covariance is the model with the highest level of agreement with the observed behavior of the factor level medians shown in Table 1. The test statistics of all factor effects are shown in Table 6.

Source	df	Sum of Squares	Mean Square	F	Pr>F
Nature	2	285.0693	142.5346	0.11	0.8934
Type	3	10928.3752	3642.7917	2.88	0.0388
Size	3	3026.7621	1008.9207	0.80	0.4971
Control	1	6594.3215	6594.3215	5.22	0.0241
Origin	1	695.0160	695.0160	0.55	0.4598
Nonperforming loans	1	18260.6870	18260.6870	14.45	0.0002

Table 6: Significance of factor effects - Analysis of Covariance - SAS output.

Tables 7 and 8 show the results for the exponential fit. Significance of factor effects point to the same direction in the nonparametric Analysis of Covariance and the maximum likelihood fit of the exponential distribution. The main difference is bank size that is significant in the exponential analysis but is not detected in the Analysis of Covariance. Table 1 favors the latter.

For the sake of completeness I show in Tables 10 and 11 the fit of the truncated normal and the Tobit. They are consistent to each other in the sense that the only significant factor is nonperforming loans. It is worth to mention here that the change of error distribution in the Tobit model did not improve the fit.

6 Summary and Conclusions

Output oriented efficiency measurements, calculated under the assumption of variable returns to scale, in the context of Data Envelopment Analysis were investigated for Brazilian banks. In this analysis bank outputs (investment securities, total loans and demand deposits) are combined to produce a univariate measure of production. The resulting output is normalized by the median. The same procedure is applied to inputs (labor costs, loanable funds and stock of physical capital). A further normalization of output and inputs is carried out measuring these variables on a per employee basis. The number of employees of each bank is also divided the median before this final normalization. The year of analysis is 2001.

The response variable of interest is defined subtracting from the DEA output pro-

Parameter	Estimate	Standard Error	z-value	p-value
a_0	-1.0032	1.4967	-0.67	0.5039
a_1	3.3544	1.3511	2.48	0.0143
a_2	3.7245	1.4364	2.59	0.0106
b_1	-1.4966	0.3269	-4.58	< 0.0001
b_2	-0.3379	0.3475	-0.97	0.3326
b_3	-1.7023	0.4477	-3.80	0.0002
c_1	-2.8303	0.4316	-6.56	< 0.0001
c_2	-0.6402	0.2996	-2.14	0.0345
c_3	-0.4452	0.3913	-1.14	0.2573
d_1	0.7998	0.3842	2.08	0.0394
e_1	-0.3912	0.2977	-1.31	0.1912
f_1	0.0078	0.0018	4.29	< 0.0001

Table 7: Exponential Model - SAS output.

Effect	-2 log-likelihood	Test statistic	df	p-value
bank nature	722.4	5.0	2	0.0821
bank type	742.8	25.4	3	< 0.0001
bank size	754.4	37.0	3	< 0.0001
bank control	721.5	4.1	1	0.0429
bank origin	719.2	1.8	1	0.1797
non performing loans	739.7	22.3	1	< 0.0001

Table 8: Likelihood ratio tests for factor effects - SAS output.

Parameter	Estimate	Standard Error	t-value	p-value
a_0	-77.4275	272.51	-0.28	0.7768
a_1	-53.4046	268.54	-0.20	0.8427
a_2	-18.3174	266.87	-0.07	0.9454
b_1	-54.4252	70.14	-0.78	0.4392
b_2	71.2125	60.78	1.17	0.2435
b_3	-30.3106	80.84	-0.37	0.7083
c_1	-79.5144	79.41	-1.00	0.3186
c_2	-36.4302	43.77	-0.83	0.0345
c_3	62.6940	39.47	1.59	0.4068
d_1	-27.8812	58.71	-0.47	0.1147
e_1	-88.8044	37.75	-2.35	0.6362
f_1	0.2461	0.06	4.17	0.0202
σ^2	1029.66	157.84	6.52	<0.001

Table 9: Truncated Normal Model - SAS output.

Parameter	Estimate	Standard Error	t-value	p-value
a_0	14.3001	24.7881	0.57	0.5640
a_1	-5.6246	24.1843	-0.23	0.8161
a_2	-4.6784	23.8867	-0.20	0.8447
b_1	-6.5493	8.8164	-0.74	0.4576
b_2	2.3814	7.6330	0.31	0.3326
b_3	-7.1506	10.0822	-0.71	0.7551
c_1	-7.6838	9.1998	-0.84	0.4782
c_2	-5.0217	5.9632	-0.84	0.4036
c_3	3.8142	6.0349	0.63	0.3997
d_1	2.8684	8.5042	0.34	0.5274
e_1	-4.6691	4.8439	-0.96	0.7359
f_1	0.0619	0.0127	4.86	< 0.0001

Table 10: Tobit Model - E-Views output.

jections the actual output observations. This is the inefficiency error of Banker (1993) and Souza (2001). The errors thus defined as well as the technical efficiency measurements themselves seem to be independently distributed and, in this context, allow estimation with the use of regression like methods. Four models were fitted in this context. Using likelihood procedures, families of exponential and truncated normal distributions were fit following Banker (1993) and Souza (2001) suggestions. The Tobit normal regression with truncation at zero which is somewhat popular in the DEA literature was also tried. Finally a nonparametric Analysis of Covariance was carried out.

The main objective in fitting a regression like equation to the DEA inefficiency errors is the assessment of the significance of factors affecting inefficiency. Potential candidates in this regard here are bank nature, bank type, bank size, bank control, bank origin, and nonperforming loans.

None of the models used showed a particularly impressive fit, judging by the correlation between observed and predicted values. The best results are for the exponential

distribution and the nonparametric Analysis of Covariance. Significance of factors however, do not agree 100% in both models. The likelihood analysis of the exponential fit indicates that bank control, bank size, bank type and non performing loans are significant effects. Bank nature is marginally significant. Bank nature and bank size are not significant in the Analysis of Covariance. The analysis of covariance results are closely related to the median responses of technical efficiencies for each factor.

From a pure descriptive point of view the most striking feature in regard to tables of efficiency by factor effect levels is furnished by bank control. Private banks are almost twice as efficient as public banks. This impression is captured better by the Analysis of Covariance.

All models indicate a strong association between risk and efficiency measures. The rank correlation between these two measurements is 0.594, significantly distinct from zero.

7 References

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