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Joseph C. Paradi
H. David Sherman
Fai Keung Tam

Data Envelopment Analysis in the Financial Services Industry

A guide for practitioners and analysts
working in Operations Research
using DEA



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A Guide for Practitioners and Analysts
Working in Operations Research Using DEA

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*To our significant others: Monika, Linda,
and Bernice; David's supportive daughters
Amanda and Caroline; and Joseph's sons
Joseph and David and grandchildren
Andrew, Laura, and Sophie*

Foreword

I am extremely pleased that the authors have written this book and honored that they have invited me to develop the foreword.

I have known Joe Paradi and David Sherman for a number of years and have followed their pioneering research from the beginning. Joe was the first to utilize extensive data visualization to communicate DEA results to managers, while David wrote the first introductory monograph explaining DEA for the service sector. Both have extensive consulting experience and managerial expertise which produce a unique and valuable perspective. Over the years, they have developed separate impressive research agendas. I am very pleased that they have joined forces with Fai Keung Tam to produce this book. We have had many discussions of the critical need for such a book collecting together and showcasing studies of managerial importance. The result should help the reader better appreciate the power of DEA as a novel approach for organizing and analyzing data to produce valuable insight.

As mentioned in their introduction, there has been a host of DEA-related articles produced in the past 40 years. The DEA bibliography that I maintain now contains around 15,000 books, dissertations, and articles published since 1978. Unfortunately, the majority of these articles are not particularly useful. Many are a simple study of a specific industry in a single country at one point in time for which the results simply state the relative efficiency scores for a list of DMUs. Such articles are not valuable in that they are a simple ordering of units and do not provide helpful insight for managers such as trends, comparisons across regions, organizational subgroups or ownership types, multinational comparisons, etc. In short, the explanatory power is small frequently due to the shortage of temporal data, failure to perform a thorough analysis across multiple models, model extensions, and various subsets of the data and/or shortcomings of the experimental design.

This book seeks to address this problem by showcasing articles from the financial services area that describe innovative approaches and novel applications that provide insight and uncover transferable best practices. Of course the models, approaches, and advice while stated in the context of financial services are easily applicable to other industry sectors.

My hope is that DEA researchers will familiarize themselves with these compelling applications and approaches and heed the authors' guidance and advice. Hopefully this will result in a significant increase in the number of useful DEA articles for which rigorous analysis produces valuable insight and directly impacts managerial practice. Such an advancement will enhance the field and more fully realize the potential of the DEA methodology.

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Once a person writes a book, s/he learns the hard lesson that it takes several times more effort than anticipated, longer than planned and the completion almost becomes an obsession. Of course, aside from the authors of the book, a lot of others make contributions, some more, some less, but all are essential to success.

First, we would like to thank the owners of the copyrighted materials they so graciously allowed us to use and include in this book. All good contributions to science are based on the work that has been done by many others in the far as well as in the recent past.

Aside from the use of copyrighted materials from external sources, we made use of a substantial amount of research results and work completed or being worked on by our own students. These outstanding young women and men form the foundation of the future in not only DEA but all aspects of our society. We appreciate their enthusiasm in helping us with this book. They deserve much of the credit for the ideas, development, and progress in the application of DEA to real-life problems. Here they are and our postdoctoral fellows:

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We also thank all who suggested ways to do things, provided examples of how to view real-world problems, and added the “reality” factor to the work we reported on. We thank dozens of professionals who collaborated with us in the work, without

whom the underlying research and therefore this book could not have been completed. Among these stands out David Paradi who is a master at using PowerPoint and has contributed his knowledge and enthusiasm to the production of figures we present here, and many other technical issues.

A special thank you is due to Professor Joe Zhu who suggested to us that a book like this was needed and then answered all our questions. He is one of today's most respected authors and authorities on DEA. Very much is owed to our late friend, Prof. W.W. (Bill) Cooper, who was one of the creators of DEA and was first to introduce us to the boundless problem-solving capabilities of this excellent tool.

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Contents

Part I Data Envelopment Analysis, in Brief with Little Math!

1	DEA Models Overview	3
	Basic DEA Models	4
	Introduction	4
	Model Types	5
	Radial Models: CCR	5
	Radial Models: BCC	9
	Additive Models	11
	SBM Model	12
	Practical Extensions	13
	Input, Output, and Data Issues	16
	Inputs and Outputs	16
	The DEA “Family Tree”: Evolution of Applications and Methodology	17
	Summaries of DEA Research and Publications	18
	Methodological Developments	20
	Application Developments	23
	First Use of DEA in Banking by Topic: DEA Banking Timeline	26
	Appendix: Chapter 1 (Sherman and Zhu 2006)	30
	How DEA Works and How to Interpret the Results	30
	The Mathematical Formulation of DEA	34
	References	37
2	Survey of the Banking Literature	41
	Introduction	41
	Literature Pertinent to This Work	41
	References	47

3	Survey of Other Financial Services Literature	51
	Introduction	51
	Thriffs and Similar Institutions	51
	Insurance	53
	Investment Funds (Mutual Funds, Hedge Funds and Pension Funds)	56
	Mutual Funds	56
	Hedge Funds	58
	Pension Funds	59
	Stock Selection	61
	Concluding Remarks	63
	References	64

Part II DEA in Banking

4	Banking Corporation Studies: In-Country Studies	71
	Introduction	71
	Case 1: Indonesia	71
	Case 2: India	73
	Different Points of View Result in Different Outcomes	75
	References	77
5	Banking Corporation Studies: Multinational Studies	79
	Introduction	79
	Cross-Country Bank Branch Comparisons	79
	References	86
6	Bank Branch Productivity Applications: Basic Applications – Efficiency Measurement	87
	Introduction	87
	References	99
7	Bank Branch Productivity Applications: Managing Bank Productivity	101
	Introduction	101
	Applying DEA to Growth Bank	102
	Specifying Resource Inputs and Service Outputs	103
	DEA Branch Productivity Results	105
	Conclusions	111
	References	111
8	Bank Branch Productivity Applications: Focused Applications to Improve Performance	113
	Introduction	113
	Improvement Targets for Efficient DMUs	117
	References	127

9 Bank Branch Productivity Applications: Strategic Branch Management Issues Addressed with DEA	129
Introduction	129
Concluding Remarks	141
References	142
10 Bank Branch Operational Studies Using DEA	145
Introduction	145
Mergers and Acquisition: Potential Use of DEA to Monitor and Manage the Process	145
Product Efficiency and Business Growth	152
Conclusions	157
References	157
11 Bank Branch Benchmarking with Quality as a Component	159
Introduction	159
Topic 1: Incorporating Quality Variables into a DEA Model	159
Topic 2: Incorporating Quality as a Separate Dimension in DEA	164
Introduction	164
Incorporating Quality into DEA Benchmarking	165
Model I: Standard DEA Model	167
Model II: Quality as an Output in a Standard DEA Model	168
Model III: Independent Quality and Productivity Dimensions	171
Model IV: Quality-Adjusted DEA: Q-DEA	173
Q-DEA Benchmarking with Application to a Bank Branch Network	176
Phase 1: Improve Branch Network Quality	178
Phase 2: Use Q-DEA to Reduce Branch Network Operating Costs	178
Results of Q-DEA Benchmarking	181
Conclusion and Future Directions	183
References	184
Part III Non-banking Financial Services	
12 Securities Market Applications: Risk Measurement of IPOs	187
Introduction	187
Objectives	189
Phase I: Comparable Selection	190
Pool of Candidates	192
Variable Selection	193
Algorithm of Phase I	198
Phase II: Short-Term Risk Assessment	199
Stock Pricing Model	200
Distribution of Stock Price 90 Days After the Issuing Day	201

Calibrating the Distance Equation	203
Validation of the Proposed Methodology	204
Conclusion	204
References	205
13 Securities Market Applications: Pension, Mutual and Hedge Fund Insights with DEA	207
Topic 1: Pension and Mutual Funds	207
Introduction	207
Background on Pension and Mutual Funds	208
Pension Funds (PFs)	208
Mutual Funds (MFs)	210
Comparing Pension Funds and Mutual Funds	210
Data and Variables	211
Methodology: Directly Comparing PFs and MFs	212
Results and Discussion: Directly Comparing PFs and MFs	214
Considering All DMUs	215
Combining Efficient DMUs	217
Methodology: Bridging Pension Funds and Mutual Funds Indirectly	218
Results and Discussion: Bridging Pension Funds and Mutual Funds Indirectly	221
Conclusions	223
Topic 2: Hedge Funds	224
Introduction	224
Examining Funds of Funds Type Hedge Funds	225
Hedge Fund Performance	225
Hedge Fund Efficiency	226
Hedge Fund Strategies	227
Concluding Remarks Regarding Hedge Funds and DEA	229
References	229
14 Securities Market Applications: Stock Market Valuation of Securities and Financial Services – Insights with DEA	233
Introduction	233
Topic 1: Stock Market Pricing Efficiency	233
Topic 2: Private Firm Valuation	240
Topic 3: Market Value Relationship to Corporate (Banking) Activity	246
Introduction	246
Topic 4: Stock Selection for Portfolios	252
Introduction	252
Conclusions	256
References	256

15 Financial Services Beyond Banking: Credit Unions	259
References	264
16 Financial Services beyond Banking: Insurance	265
Introduction	265
Topic 1: The Canadian Insurance Industry	265
Insurance Models and Input/output Specifications	266
Model I: Production Performance Approach	267
Model II: Investment Performance Approach	268
Analysis and Results	269
Analysis by Insurer Characteristics	274
Summary and Conclusions	275
Topic 2: The Chinese Insurance Industry	276
Conclusions	280
References	281
17 Financial Services Beyond Banking: Corporate Failure	
Prediction	283
Conclusions	308
References	310
18 Financial Services Beyond Banking: Risk Tolerance	
Measures for Portfolio Investors	313
References	325
Part IV Guidance on Applying DEA, Interpreting Results, Recognizing Caveats and Other Useful Information	
19 Guide to DEA Model Formulation	329
Introduction	329
DEA Model Formulation: A Guide to Applying DEA to Evaluate and Manage Performance	329
Objectives of the Analysis	330
Operations of the Set of DMUs	331
Defining Inputs and Outputs: Adequacy and Completeness of the Data	333
Preliminary DEA Analysis: Testing the Reasonableness of the Results	335
Using the Efficiency Scores: Limitations of Ranking	337
Using the Information on Excess Resources and Excess Capacity	338
Increasing the Power of the Analysis: Adjusting Constraints and Weights on Inputs and Outputs	339
Impact of Other DMU Characteristics: Categorical Variables, Segmenting the Analysis, Quality	340
Developing Best Practice Benchmarks	341

Management of the Process: Converting DEA Results into Initiatives to Improve Performance	341
Pitfalls and Roadblocks	342
Results Interpretation (Graphs, Reports, Etc.)	345
Conclusions	350
References	351
 Part V Conclusions	
20 Conclusions and Recommendations	355
Reference	356
 List of DEA Software	357
 About the Authors	359
 DEA Books	363
 Index	367

List of Figures

Fig. 1.1	Radial improvement target (A') from CCR model for a 2-input and 1-output case	6
Fig. 1.2	Graphic representation of the five bank branches	31
Fig. 5.1	Profitability score distribution	82
Fig. 5.2	Productivity score distribution	84
Fig. 5.3	Comparison of efficiency scores for Country Red	85
Fig. 6.1	Sensitivity of spread ratio (scores from output wt. restricted/ unrestricted VRS models using all outputs) to permitted variation in AR constraints	94
Fig. 6.2	Number of efficient DMUs vs. permitted variation in AR constraints	94
Fig. 6.3	Convex envelopment surface defining DEA production possibility space – DMUs on blue hyperplanes are fully-efficient, those on red hyperplanes are weakly-efficient	97
Fig. 7.1	All branch types (A, B and C) use the same set of resources to provide all branch services used for the DEA analysis of Growth Bank's branch productivity. Each branch is using a different amount of each of the resources and offers all of the services. Each branch provides a different volume and mix of these services, depending upon its customer demand. Examples of branch types include urban, suburban, and shopping mall branches	104
Fig. 8.1	The theoretical, practical, and empirical frontiers	117
Fig. 8.2	Methodology to establish practical DEA frontier	118
Fig. 8.3	Comparison of DEA and P-DEA efficiency score distributions	121
Fig. 8.4	Input and output variables used in Tochaie 2003	123
Fig. 8.5	CRS efficiency score distribution for all branches	123

Fig. 8.6	CRS efficiency score distribution for large branches	124
Fig. 8.7	CRS efficiency score distribution for small branches	124
Fig. 8.8	Distribution of the bank's WFI score for large branches	126
Fig. 8.9	DEA efficiency score distribution vs. the bank's WFI scores for large branches	127
Fig. 9.1	Potential input reduction at the current output level for Branch B	131
Fig. 9.2	Potential output enhancement at the current input level for Branch B	131
Fig. 9.3	Individual report for branch B	132
Fig. 9.4	Distribution of the scores obtained from the second stage, overall model	137
Fig. 10.1	Branch operational efficiency model from Paradi et al. (2010)	150
Fig. 10.2	Branch profitability model from Paradi et al. (2010)	151
Fig. 10.3	Churn model efficiency distribution	156
Fig. 10.4	Aggregate market model efficiency distribution	157
Fig. 11.1	Distribution of client service ratio by branch size group	161
Fig. 11.2	Distribution of throughput ratio by branch size group	162
Fig. 11.3	Comparison of DEA efficiency and client service ratio	162
Fig. 11.4	Comparison of DEA efficiency and the bank's existing customer satisfaction benchmark	163
Fig. 11.5	Efficient frontier (all branches service 1,000 transactions), where A(100) = Branch A with quality rating = 100	167
Fig. 11.6	Quality-productivity branch distribution – high and low quality and productivity quadrants	172
Fig. 12.1	General layout of the DEA model	193
Fig. 12.2	Several potential improvement directions for DMU E	197
Fig. 13.1	Snapshot of theoretical methodology	220
Fig. 14.1	Quarterly Treynor measure for software portfolios	239
Fig. 14.2	DEA inputs and outputs of modified valuation model from Anadol et al. (2014)	241
Fig. 14.3	Bank intermediation efficiencies, single DEA analysis on the entire data sample	249
Fig. 14.4	Bank intermediation efficiencies, DEA analysis using 5-year windows	250
Fig. 14.5	Bank production efficiencies, DEA analysis using 5-year windows	251
Fig. 15.1	Difference of mean scores between healthy and failed credit unions over time from different models, assets greater than \$2 million	262

Fig. 16.1	Model I – inputs and outputs included in the production performance model	268
Fig. 16.2	Model II – inputs and outputs included in the investment performance model	269
Fig. 16.3	Unadjusted and adjusted mean risk management efficiency of Chinese insurers	279
Fig. 16.4	Unadjusted and risk-adjusted mean efficiencies of Chinese insurers	279
Fig. 16.5	Differences in mean efficiencies between SOEs and non-SOEs	280
Fig. 17.1	Current limitations of DEA and other methodologies in bankruptcy prediction	286
Fig. 17.2	Bankrupt and non-bankrupt classification accuracy 1-year prior	289
Fig. 17.3	Total classification accuracy comparison between Altman and DEA (SBM)	291
Fig. 17.4	Illustration comparing regular (<i>left</i>) and Negative (<i>right</i>) DEA	292
Fig. 17.5	Type I error from Z-score by years prior to bankruptcy	301
Fig. 17.6	Variation of classification and error rates by cut-off layer from IS model, up to 1 year prior to bankruptcy	303
Fig. 17.7	Comparison between layering and non-layering techniques – 1 year prior to bankruptcy	306
Fig. 17.8	Distribution of second-stage layered scores	307
Fig. 17.9	Probability of bankruptcy as a function of layered score	309
Fig. 18.1	Comparison of DEA and FinaMetrica scores for all clients only	318
Fig. 18.2	Comparison of DEA and FinaMetrica scores for all subjects	319
Fig. 18.3	Quadratic fit of average risk tolerance vs. age	321
Fig. 19.1	Commercial bank branch DEA model	346
Fig. 19.2	Individual results: Branch 78 score = 0.91	346
Fig. 19.3	Comparison chart to benchmark: Branch 6 cost-efficiency = 0.78	347
Fig. 19.4	Efficiency and asset size in two models of the Canadian life and health insurance industry	348
Fig. 19.5	Insurer ownership type and efficiency	349
Fig. 19.6	Comparison between client results and DEA	349
Fig. 19.7	Portfolio types and their efficiency in earnings	350

List of Tables

Table 1.1	Timeline of DEA banking applications	27
Table 1.2	Illustrative example of five bank branches	28
Table 1.3	DEA results for five bank branches	32
Table 1.4	Inefficiency in branch B2 calculated by DEA	33
Table 1.5	Multiplier form of DEA mathematical model	35
Table 4.1	Descriptive statistics for inputs and output in 2006 and 2007 (in billion rupiahs)	72
Table 4.2	Descriptive statistics of the DEA efficiency measures, 2006 and 2007	73
Table 4.3	Banking data of commercial banks in India as of June 1998	74
Table 4.4	Descriptive statistics of efficiency scores by bank ownership	74
Table 4.5	Key questions regarding stakeholder views from Avkiran and Morita (2010)	76
Table 5.1	Profitability model data – means, in USD	80
Table 5.2	Productivity model data – means	81
Table 5.3	Intra-country profitability model results	82
Table 5.4	Inter-country profitability model results	82
Table 5.5	Intra-country productivity model results	83
Table 5.6	Inter-country productivity model results	84
Table 6.1	Inputs of production model	89
Table 6.2	Average efficiency scores of the branch system	90
Table 6.3	Data statistics, standard times and average salaries	91
Table 6.4	Results for DEA models	93
Table 6.5	Comparison of overall and within group DEA results: all outputs, VRS	95

Table 6.6	Summary of normalized data for small urban branches	98
Table 6.7	Efficiency results of technically inefficient branches	98
Table 6.8	Efficiency results of technically but not scale efficient branches	98
Table 6.9	Summary of input-oriented efficiency results for small urban branches	99
Table 7.1	Growth Bank branch productivity ratings	106
Table 7.2	Growth Bank, potential resource savings in less productive branches	107
Table 7.3	Potential service volume expansion	108
Table 8.1	Example of a DEA benchmark for an inefficient unit, i.e. DMU#12	115
Table 8.2	Optimal DEA input weights for DMU #12	116
Table 8.3	New DEA benchmark determined for an inefficient DMU#12 by prioritizing <i>personnel</i> reduction, i.e. DMU#12'	116
Table 8.4	Data statistics from Sowlati and Paradi 2004	119
Table 8.5	Input and output comparisons for original and newly generated DMU #23	120
Table 8.6	Comparison of inputs, outputs and P-DEA efficiency scores for real and artificial units	120
Table 8.7	Results of changing input and output bounds and δ	122
Table 8.8	Summary of CRS and VRS DEA mean efficiency results by geographical area	125
Table 9.1	Individual report for branch B	133
Table 9.2	Comparison of regular and handicapped DEA results, overall and by bank	136
Table 9.3	Reference vectors for input/output vectors	140
Table 9.4	Statistical descriptions of groups based only on group leaders	141
Table 9.5	Comparison of within group referencing of inefficient DMUs	142
Table 10.1	Annual and average corporate index scores for largest Canadian banks and trust companies	147
Table 10.2	Simulation results summary with $RI = 1.5$	149
Table 10.3	Spearman's rank correlation between the true and estimated efficiencies	150
Table 10.4	Summary of branch efficiencies from basic, CA and NC-DEA models	151
Table 10.5	"Component" market model	153
Table 10.6	"Aggregate" market model	154
Table 10.7	Churn model	154

Table 10.8	Delta model	155
Table 10.9	Cluster statistics	155
Table 11.1	CRS vs. VRS results DEA results for all branches	161
Table 11.2	DEA customer satisfaction results for branch-hour DMUs	163
Table 11.3	Bank branch example	166
Table 11.4	Model I – benchmarking productivity with DEA <i>excluding quality</i>	169
Table 11.5	Model II – benchmarking with quality as an output	170
Table 11.6	DEA productivity ratings	174
Table 11.7	Q-DEA benchmarking	175
Table 11.8	Branch data used for Q-DEA benchmarking	177
Table 11.9	Q-DEA benchmarking applied to a US branch network	179
Table 11.10	Q-DEA benchmarking distribution of productivity ratings in Phase 2 in the US bank application	180
Table 11.11	Potential savings identified with Q-DEA and actual resource savings realized within 6 months of completing the Q-DEA study	181
Table 13.1	Inputs and outputs for DB plans and Combo plans	212
Table 13.2	Inputs and outputs for DC plans	212
Table 13.3	Considering all DB, Combo and MFs for VRS, ND-VRS and MV-DEA models	215
Table 13.4	Considering all DC and MFs for VRS, ND-VRS and MV-DEA models	216
Table 13.5	Combining efficient DB, Combo and MF DMUs for VRS, ND-VRS and MV-DEA models	217
Table 13.6	Combining efficient DC and MF DMUs for VRS, ND-VRS and MV-DEA models	218
Table 13.7	Theoretical classification of pension plans	220
Table 13.8	Results for DB, Combo and DC plans	223
Table 13.9	Input and output variables for the VRS hedge fund model	225
Table 13.10	Input and output variables for hedge fund model	227
Table 13.11	List of hedge fund strategies	228
Table 13.12	Potential input and output variables	228
Table 14.1	DEA pricing efficiency model variables from Tam (2001)	238
Table 14.2	Summary of inverse of DEA efficiency scores from Tam (2001)	238
Table 14.3	Market cap. estimate and upper bound for Cheniere Energy	243

Table 14.4	Distance indicators and MC ranges for Cheniere Energy and its peers	244
Table 14.5	Lower bound MC determination for Costco	245
Table 14.6	Model variables in production model	247
Table 14.7	Model variables in intermediation model	248
Table 14.8	Change in results from adding total or excess return as an additional output to DEA window analysis models	252
Table 14.9	Quarterly returns for the 22 portfolios	255
Table 15.1	Mean failure prediction index and standard deviation for years prior to failure	263
Table 16.1	Number of insurers based on their characteristics	270
Table 16.2	Average efficiency scores and statistical tests of efficiency differences	271
Table 16.3	DEA results – production performance model	272
Table 16.4	DEA results – investment performance model	273
Table 16.5	Efficiency comparison and statistical tests on subsets of insurers	275
Table 16.6	Variables used by Huang and Paradi (2011), along with descriptive statistics	278
Table 17.1	Confusion matrix for prediction outcomes	284
Table 17.2	Non-negative input and output variables	287
Table 17.3	Number of companies in Groups 1 and 2	288
Table 17.4	Cut-off points for SBM model	289
Table 17.5	Classification accuracies of Group 2 firms	290
Table 17.6	Summary of DMUs in data samples	293
Table 17.7	Corporate performance indicators identified in the literature	293
Table 17.8	Variables identified as potential inputs and outputs	294
Table 17.9	Average efficiency scores for bankrupt and non-bankrupt firms in normal DEA models, with optimal cut-off values and the corresponding classification accuracies	294
Table 17.10	Average efficiency scores for bankrupt and non-bankrupt firms in (output-oriented) Negative DEA models, with optimal cut-off values and the corresponding classification accuracies	295
Table 17.11	Classification accuracies for Negative DEA model #3 using the layering technique	296
Table 17.12	Out of sample (i.e. 1996 data) classification accuracies from combining NDEA3 and DEA5 models, using layering	296

Table 17.13	Input and output variables of IS, BSA and BSL (financial) DEA models	298
Table 17.14	Average median ratio values by firm state	299
Table 17.15	Managerial decision-making (MDM) variables	300
Table 17.16	Market and economic (ME) factor models	300
Table 17.17	Summary of first-stage results for IS, BSA, BSL and MDM models	302
Table 17.18	Correlations between first-stage DEA scores	302
Table 17.19	Cut-off layer, and type I error, type II error and accuracy rates for first-stage models	303
Table 17.20	Second-stage model predictions with classifications by zones	304
Table 17.21	Correlation of first-stage models' layered scores	305
Table 17.22	Error from classification by layering of second-stage model and individual first-stage models	305
Table 17.23	Performance comparison of layering and non-layering techniques	306
Table 17.24	Probabilities of bankruptcy (B) and non-bankruptcy (NB) by layer number	308
Table 17.25	Classification by layering and fitted second order 1 year prior to bankruptcy probability polynomials for different windows	309
Table 18.1	Demography of risk tolerance	315
Table 18.2	Data statistics for all respondents and sample of clients only	317
Table 18.3	Summary of results from the SBM DEA model	317
Table 18.4	Variation of average risk tolerance with education level	320
Table 18.5	Variation of average risk tolerance with income level	320
Table 18.6	Variables used in first-stage models in Cooper et al. (2014)	323
Table 18.7	Results from first- and second-stage models	323
Table 18.8	Comparison of risk tolerance scores by gender	324
Table 19.1	DEA overcomes these issues that other methods lack	343
Table 19.2	Regional comparisons	347

Introduction

Data envelopment analysis was first titled with this name in the paper by Charnes, Cooper, and Rhodes in 1978. The initials DEA have since been widely adopted. The concept was previously exposed in Farrell's seminal paper (1957): "The measurement of productive efficiency." Farrell did not have the power of modern computing equipment at his disposal, so the development of practical applications was not feasible in a practical sense. But time passed and technology developed so that Farrell's work became possible to apply to complex problems with multiple inputs and outputs. Linear programming capabilities allowed the DEA models to be used for varied problems. Running DEA often required rerunning a linear program thousands of times, a capability that was not readily available in the 1950s. Today, running numerous linear programming iterations required for DEA can be done on the average personal computer by simply using DEA custom-coded programs or even Microsoft Excel.

Slowly, researchers in operational research and economics began to apply DEA to their problems. With few exceptions, their primary goal was to extend the theoretical foundations of the science and report this in traditional academic refereed journals in management science, economics, social science, and mathematics. As more researchers became involved in looking at DEA as a fruitful approach to management and economic problems and their works were published, the literature grew, at first slowly and in recent years quite rapidly. While in the early days it was possible to keep up with the new papers as they appeared (e.g., Seiford 1997; Emrouznejad et al. 2008), this is now essentially impossible as it would take a person working full time just to assemble the bibliography. The number of books alone now published is around 100 and growing. The DEA technology is now well established but still developing, and relatively small theoretical additions, extensions, and refinements continue to be reported in the academic literature. One of the best sources of the most up-to-date information on DEA is found at A. Emrouznejad's DEA Zone on the web (2017): www.deazone.com.

However, the major challenge and unfinished DEA work is, in our view, that only a small portion of the published works deal with applications of DEA to real-life problems and even fewer result in production systems making use of DEA. The reader might challenge this assertion, so let us clarify. While most recent papers used real data obtained from credible sources, such as the OECD, national statistics from agriculture to retirement homes, and the financial and economic data sources, studies based on such data do not enable managers to obtain directions on how to enact policy or improve practice in their businesses or other organizations. Even when there is the potential to apply the DEA findings to real operating organization datasets, the results of the analyses are published without pursuing the application to generate the potential benefits. While there are examples where the results have been applied and the positive and negative results are reported, these papers reflect an incredibly small fraction of the total DEA published literature. There are applications that have been successful that have not been published, and while we cannot know the universe of the works not published, discussions with academics and end users of DEA suggest that these unpublished applications are not likely to be very large in number. Two fields that stand out in these studies are health care and banking where hundreds of papers were written over the past couple of decades, but with very few being of practical use to the people who operate these institutions.

The early focus of DEA was applying it to units in any organization that have control over their activities, and where there is some manager that assesses performance of each unit and makes decisions about how the unit operates in an effort to improve its outcomes. The term adopted for these operating units was *decision-making units*, or DMUs. These initials, DMUs, are well understood by the DEA community, but this is not a term that is naturally found or used in business, government, or other organizations. The terminology in itself may be sufficiently arcane and unfamiliar to potential users that it may have contributed to the slow adoption of DEA. The current use of DEA continues to heavily focus on understanding and improving the performance of the defined DMUs, but has also broadened to recognize DEA's ability to identify relationships in complex operating data that offer new insights into the way organizations operate and other paths to manage performance (Sherman and Zhu 2013).

The definitions of what a DMU is determine the usability of the results. For economists, the aggregate data is useful when they advise governments on policy or evaluate the national or international health of certain sectors of interest. The DMU may be defined as a political unit, country, industry, etc. But useful direction for the managers of units such as bank branches, hospital departments, farms, retirement homes, etc. is seldom provided, yet this is where real operating benefits can be achieved. For example, when a study is conducted on the efficiency, productivity, or effectiveness of the banking industry, the outcomes for each bank (the DMUs in the models) offer no implementable findings as the data is aggregated and applies to the DMU as a whole. Of course, the outcome of such a study may well be useful for the regulator or government evaluation of the health of the industry and in identifying regulatory policies that would improve overall productivity. A concrete example of DEA being applied to help regulate an industry is the utilities sector,

where it has been used to manage electricity producers in Europe and Brazil (Agrelle et al. 2005).

When the focus is on DMUs that are finite operating units such as bank branches, clinics, physicians, hospitals, nursing homes, and focused services in health care, DEA provides, in addition to an assessment of the DMUs, insights that can allow a manager to directly adjust methods of operations. These adjustments can provide the opportunity to measurably improve the performance of the DMUs analyzed with DEA.

This book is intended to address the challenge of how to apply the DEA technology to data, where the data is relevant and detailed enough to allow results to be useful to the managers by implementing the outcomes from the study to improve the performance of their organizations. In other words, we look at the practitioners' problem of applying improvements to the businesses or institutions where the benefits are directly received by the owners, employees, and/or customers of the firm. Of course, the entire firm benefits from the individual improvements. For example, an analysis of a retail chain store or franchising operation where managers do have the power to implement the improvements suggested by a DEA analysis could result in lower costs for individual operating units (the DMUs in this type of study), improving profitability of these units and thus an augmentation of the system-wide success and attractiveness of owning one of the franchised units.

Our intent and objective is to provide any reader of this book a set of useful approaches and techniques which they can apply and, if done as suggested in this volume, would enable the reader to improve their firm's performance (or that of their client firm if they are consulting for them). However, there are many sectors in a large economy and no single book can cover them all. Therefore, we restricted ourselves to the financial sector where there are a number of studies published examining the actual performance level of the firm and where the firm should go to reap the benefits of the study. Perhaps it would be appropriate to see this book as a *how-to* manual where the practitioner or analyst can find a study that relates to their problem, often directly, while other times they may find an example where there are similarities to their organization but which requires some adaptation to be effective.

References: Introduction

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Part I

Data Envelopment Analysis, in Brief, with Little Math!

Introduction

In Part I of this book we provide an overview of DEA but without a lot of mathematics, except to allow the explanations to make sense. Our intent is to allow the reader to assess the technology and understand it well enough to delve into whatever details he or she feels necessary to their needs. This part also provides a brief survey and summary of some of the large body of published DEA studies on banking and other financial services.

Chapter 1

DEA Models Overview

We begin with the basic DEA Models and some useful extensions (although we expect that some will see it as too much while others as too little). While we promised to minimize the mathematics, some are, unfortunately, unavoidable. We have excluded any specific discussion of the underlying linear programming (LP) mathematics that drives DEA, and while some general understanding of this is helpful for understanding the academic literature, it is not needed to understand the benefits and ways to apply DEA.

The next issue here is how to select what are “inputs” and what are “outputs”. One would assume that this is easy since whatever is used in the production model is an input and what is produced is the output. But there are some issues, such as undesirable outputs (e.g. bad loans) and inputs where we might want more (e.g. deposits in a bank branch). To make matters more confusing, some measures may well be used as inputs in some models while outputs in others – such as bank deposits. We also address some data issues in this part.

Model formation is another subject fraught with controversy and we point to some issues and suggest ways to address these problems.

Finally, we provide a brief history of DEA and its development and sketch out the DEA models family tree to show how things connect together from the Charnes et al. (1978) model to some of the more sophisticated models that have been developed since that seminal paper saw the light of day. Some of the milestone applications of DEA in the financial services are also provided.

Basic DEA Models

Introduction

Data Envelopment Analysis (DEA) is an example of a frontier approach. Frontier approaches identify and assess the areas or examples of best performance or best practice within the sample, i.e. those located on the “frontier”. The frontier identified by DEA suggests the best performance within the group of operating units being evaluated and does not promise or even suggest that these represent the theoretically best performance. These methods can be contrasted with regression techniques that seek to explain the average behavior within a sample. Frontier techniques can be divided into two types: parametric and non-parametric. Parametric techniques specify a frontier function to be fitted to the data, with or without accounting for noise in the data. DEA is a non-parametric approach, meaning that no prior functional form is assumed for the frontier, outside of a simple assumption of piecewise linear connections of units on the frontier. The ability to apply DEA without assuming a functional form is a very powerful characteristic. This means that the analysis can proceed without knowing the production function, which is the way inputs are transformed into outputs. Non-parametric approaches can simultaneously handle multiple inputs and outputs, but do not account for noise in the data, treating all deviations from the frontier as inefficiencies (Cummins and Zi 1998).

As an efficiency measurement and evaluation methodology, DEA is particularly useful in cases where sample units, termed decision making units (DMU), use multiple inputs and outputs, and are operating under comparable conditions. DEA primarily measures technical efficiency, i.e. focusing on levels of inputs relative to outputs, as opposed to economic efficiency which would also consider market prices. The use of levels of inputs and outputs is another powerful characteristic of DEA, in that it can incorporate inputs and outputs in the natural units in which they are measured and does not require them to be converted to the same units of measure – specifically, they are not required to be converted to monetary units.

DEA permits the evaluated DMUs to appear to be as good as possible, a feature that can be deemed as providing a “fair” evaluation of the DMUs in the sense that the analysis should limit objections amongst DMUs regarding their evaluations. This characteristic stems from the optimization underpinning of DEA, where DEA assigns the highest efficiency rating to each DMU compared with the set of DMUs being analyzed. It essentially gives the “benefit of the doubt” to each unit. From a management perspective, DEA will be less likely to erroneously identify an efficient unit as inefficient, and while it may not capture all inefficient units, the ones identified as inefficient will have real potential for improvement.

On the contrary, this same “fairness” can permit DMUs to select evaluation criteria that may be deemed as inappropriate or unrealistic. The DEA results, including the evaluation criteria, can be reviewed and adjusted by the user to rerun DEA to include more appropriate criteria. This is one of several ways DEA can be adapted to the specific operating environment of the DMUs. These