
The Narrow Bank

A Flawed Response to the Failings of Federal Deposit Insurance

Bert Ely

The bankruptcy of the Federal Savings and Loan Insurance Corporation (FSLIC) will cost American taxpayers some \$200 billion in present-value terms. There is now growing concern that the Bank Insurance Fund, which protects depositors in commercial and savings banks, may also need a taxpayer bailout. Narrow banking proposals are a response to the increasing burden federal deposit insurance is placing on taxpayers. Narrow banking is seen by its advocates as the best hope, perhaps the only hope, for reducing future taxpayer losses in federal deposit insurance programs.

In evaluating the narrow bank concept four fundamental questions about the banking business are relevant. Why do governments explicitly or implicitly insure bank deposits? Why do some, but not all, bank managers take excessive risks relative to the on-balance-sheet equity capital invested in their banks? Why has the regulatory process, which traditionally acted as a check on excessive risk-taking by banks, become less effective over the past decade? What insurance principles should be honored in protecting taxpayers against deposit insurance losses? The answers to these questions demonstrate both the flaws of the narrow bank concept and the ways in which the real problems facing taxpayers might be solved through marketplace incentives.

Bert Ely is president of Ely & Company, Inc., a financial institutions consulting firm in Alexandria, Virginia.

In addition to these questions, three specific implications of narrow banking deserve more careful consideration: the fragmentation that will arise from the small bank exemption, a substantial reduction in banking offices, and an inefficient severing of the credit-granting and deposit-taking functions now performed by banks.

A Definition of Narrow Banking

Narrow banking, as envisioned by its advocates (Lowell Bryan, James Burnham, and Robert Litan, to name a few) would create a set of low-risk banks that would constitute the payment system for the American economy. These banks would accept checkable deposits and savings accounts (in the form of passbook savings or certificates of deposit) from individuals, businesses, and governments. Narrow banks would then invest these deposits in low-risk financial assets, such as U.S. government securities or high-grade, privately issued debt, such as commercial paper. Narrow banks' investments would generally be of short- and medium-term maturity to match the maturity of their deposits. All funds transfers, whether in the form of checks or by electronic funds transfers, would flow through narrow banks.

Because narrow banks' assets would be of low risk, the probability of their insolvency would be substantially reduced. Thus, narrow bank advocates argue, federal taxpayers, acting through the federal

government, could afford to insure deposits in narrow banks.

Unfortunately, the narrow bank concept is based on a faulty analysis of the causes of the FSLIC fiasco and the emerging problems of the Bank Insurance Fund. Advocates of narrow banking reason that bank and S&L insolvencies occur because the assets of these institutions lose value. These insolvencies are widespread for two reasons. First, managers of some banks and thrifts take excessive risk with federally insured deposits relative to the amount of equity capital invested in these institutions. Second, government regulators are unable to restrain excessive risk-taking by bank and S&L managers or to force depository owners to invest sufficient equity capital in these high-risk institutions. The answer to these problems, according to narrow bank advocates, is to regulate the problem out of existence. By prohibiting managers of federally insured institutions from making risky investments, narrow bank advocates seek to make the regulators' job more manageable and thus to protect taxpayers.

But the narrow bank solution addresses the consequences of the problem, not the causes. Like any solution that focuses solely on consequences, narrow banking would itself create other difficulties. The narrow bank solution does not come to grips with *why* federally insured banks and S&Ls invest in assets that lose value. Why do some bank managers take on excessive risk? And why are bank regulators unable to prevent excessive risk-taking when it occurs?

The economic incentives faced by bank and thrift owners and managers lie at the root of the excessive risk-taking apparent among depository institutions. Unfortunately, the traditional regulatory view of the world does not attempt to understand or accommodate economic incentives; instead, regulation attempts to force economic actors to behave in a way contrary to their economic incentives. The narrow banking approach is very much in this tradition, relying as it does on regulatory prohibitions to correct an undesirable behavior. It is only by shaking off the shackles of a regulatory world view that we can fully appreciate the role of economic incentives and understand why bank insolvencies have become so costly for taxpayers.

Why Do Governments Insure Bank Deposits?

Although formal government deposit insurance schemes vary from country to country, in reality every industrialized country has a too-big-to-fail policy that effectively protects most bank deposits,

and *all* deposits in large banks, against any loss of principal, interest, or liquidity. Only in limited cases involving small depository institutions are a relative handful of explicitly unprotected depositors forced to suffer a loss.

Losses incurred in exercising the too-big-to-fail policy are imposed on two classes of taxpayers. Healthy banks, and sometimes other financial institutions, are the preferred source of tax revenues to pay for such a policy. Only in extreme situations, such as the FSLIC bankruptcy, do policymakers call on the broader base provided by general taxpayers.

Bank deposits receive such universal government protection because they represent what I have termed "hazardous liabilities." Bank liabilities represent a hazard because these deposits, many of which are payable on demand, are used to fund less liquid bank loans and investments.

Market-driven economies cannot function without hazardous liabilities such as bank deposits and money market mutual funds. No sophisticated

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marketplace can operate unless buyers have access to readily withdrawable financial assets with which to purchase goods and services or to pay their debts. Likewise, a major function of the financial intermediation process carried out by banks is "maturity transformation." That is, banks traditionally stand between borrowers who seek debt that can be repaid over a relatively long period and savers and bank creditors who prefer to have access to their funds on short notice. Thus, the payment instruments we must have are generally invested in assets of longer average maturity.

The resulting hazard embodied in bank deposits means that regulatory attempts to impose bank insolvency losses on depositors will ultimately be more costly to the economy than simply using taxpayer funds to fully protect all depositors. This tradeoff occurs because depositors can run faster than regulators can act. Fleeing depositors will force asset sales by a failing bank that lead to diminished franchise values and fire sale losses. These costs will be compounded by increased dislocations and systemic instability within the economy, and the

total costs will exceed any losses finally imposed on depositors who do not make it out the door before the bank is closed. Worse, the depositors stung by a bank insolvency loss are usually the less sophisticated depositors who garner the greatest amount of political sympathy, as evidenced by the 1990 failure of Freedom National Bank in New York. Thus, regulators consistently make a pragmatic decision, based on both economic and political considerations, and avoid imposing significant bank insolvency losses on depositors.

The narrow bank concept seeks to reduce maturity transformation within federally insured banks by forcing them to invest in short-term liquid securities. It also seeks to reduce the credit risk associated with these assets. A side effect of the strict asset limitations faced by narrow banks would be to shrink substantially the amount of explicitly insured deposits, perhaps by as much as half, or \$2 trillion. But the demand on the part of businesses and individuals to hold financial assets with the characteristics of hazardous liabilities and to seek debt contracts with longer terms will not go away just because the scope of permissible assets for insured banks was narrowed. Thus, mandated narrow banking would shift that demand to uninsured institutions that would exhibit the same risk characteristics now seen in banks and thrifts.

Thus, narrow banking does not solve the problem.

By indirectly encouraging funds to flow out of insured narrow banks into uninsured bank-like institutions, narrow banking would expand a free-rider problem that already exists: the implicit protection of explicitly uninsured institutions such as money market mutual funds.

It merely shifts it to another set of institutions. Indeed, the problem might be made worse because regulators, especially the central bank, would then face greater ambiguity in dealing with uninsured failing institutions funded by hazardous liabilities. Letting such an uninsured institution fail would raise concerns about the solvency of comparable uninsured institutions. Depositors would find it prudent to run from uninsured institutions into government-insured banks and thus would aggravate the economic waste and systemic instability that deposit insurance was designed to prevent.

The pragmatic political response in this situation would be to extend the taxpayer safety net to

uninsured institutions to stabilize them. Surely that would be the response if a major run developed tomorrow on money market mutual funds. The Federal Reserve's discount window would fly open, and billions of dollars would be lent to these funds to stabilize them. Fed loans would be used to fully protect departing money market mutual fund depositors from loss. But such a move in a narrow banking world would defeat a key goal of the narrow bank concept—to shrink the scope of the taxpayer safety net. By effectively encouraging funds to flow out of insured narrow banks and into uninsured bank-like institutions, narrow banking would expand a free-rider problem that already exists, that is, the implicit government protection of explicitly uninsured institutions such as money market mutual funds. The free-rider expansion sparked by narrow banking would worsen, not lessen, taxpayer risk in maintaining financial stability.

Why Do Some Bank Managers Take Excessive Risk?

The classic problem with deposit insurance is that a minority of bank and thrift managers can cause great harm to healthy depositories, to taxpayers, and to the overall economy by assuming more risk than is justified by the equity capital directly invested in these institutions. Because of the hazardous nature of bank liabilities, regulators can then force healthy institutions (and, in the extreme, taxpayers) to contribute funds through the deposit insurance system to absorb the insolvency losses associated with a bank's or a thrift's failure.

Federal deposit insurance is a mispriced option on the capital of other banks because all banks pay the same premium rate regardless of how riskily or prudently each bank is managed relative to its own capital level. As a result, well-capitalized and prudently managed banks pay more than they should for the option they effectively hold on the capital of other banks. Meanwhile, risk-prone bank managers, particularly those in banks with little or no capital, pay far less than they should for the capital of other banks these managers effectively place at risk every time they make a loan or investment. Consequently, the risk-prone, the incompetent, and the criminally minded in the banking world are in an enviable heads-I-win, tails-you-lose situation. The prudent subsidize the wastrels.

The narrow bank concept implicitly reduces the magnitude of this subsidy by presumably narrowing the range of risks any federally insured bank could take. By shifting substantial quantities of hazardous

liabilities from explicitly insured banks to implicitly insured institutions, however, narrow banking would materially increase the incentives problems outside the constricted world of narrow banks. This would occur for two reasons.

First, bank-like organizations that lie outside the world of narrow banks would pay nothing for the option they would effectively hold on the capital of others, nor would they be closely regulated to curb risk-taking. Second, the lack of explicit before-the-fact insurance arrangements would increase uncertainty and confusion whenever circumstances forced the government to protect an uninsured bank-like organization. This confusion was evident in the delay in the congressional appropriation of taxpayer capital to fund the cleanup of the FSLIC mess and in the sudden closure of 45 privately insured credit unions and banks in Rhode Island in January 1991. (The state of Rhode Island decided, after the fact, to protect depositors in the failed institutions against loss of principal but not against loss of interest or liquidity.) This confusion would be even greater when dealing with insolvency losses in explicitly uninsured institutions.

A fully developed marketplace for deposit guarantees would deal with this option-pricing problem by charging each bank an option price that fully reflected the risk that bank represented against the capital of others. Furthermore, as in all marketplace transactions, the capital would have to be supplied voluntarily. Thus, the great conundrum of deposit insurance arises: how does one create a genuine insurance mechanism that voluntarily attracts equity capital sufficient to protect hazardous liabilities against any loss of principal, interest, or liquidity in any economic circumstance in which legal contracts remain fully enforceable? The narrow bank concept sidesteps this issue by failing to address the option-pricing issue explicitly.

Why Is the Regulatory Process Increasingly Ineffective?

In theory, the regulatory process should fully compensate for the mispriced option problem by ensuring that the option will not be exercised. Protecting prudently managed banks' capital from the activities of managers inclined toward risk-taking can be accomplished by closing a bank or a thrift on or before the moment it becomes insolvent, that is, at the moment the depository exhausts the last dollar of its own on-balance-sheet equity capital. Increasingly, regulators are unable or unwilling to close insolvent banks and thrifts, however. Thus, the

mispriced option is being exercised with growing frequency. As a result, deposit insurance premiums paid by surviving banks increased sixfold between 1981 and 1991. Meanwhile, for most banks, the probability of their failing, which is what should drive the price they pay for deposit insurance, is no greater today that it was in 1981.

It is not only healthy banks that are being placed at risk. Despite the rapid escalation in deposit insurance premiums, there is a growing expectation that the Bank Insurance Fund will require an infusion of taxpayer funds. It is this inability of the regulatory process to protect taxpayers against large deposit insurance losses that has sparked interest in the narrow bank concept.

Still, failure on the part of regulators has not always been so apparent. Regulation seemed to be effective in controlling risk-taking among banks for

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some 45 years after federal deposit insurance was introduced. To understand why more stringent regulation will not fully address the problems taxpayers face today, it is necessary to identify what has changed. Narrow banks, of course, represent regulation in the extreme.

Three conditions must exist for effective regulation: a slow rate of change in the regulated industry, ease in segregating regulated from unregulated activities and firms, and homogeneity among the regulated institutions. The rapid rate of change in telecommunications and electronic technology has undermined all three of these conditions, and continuing innovation practically guarantees that the efficacy of regulation will continue to decline for the foreseeable future.

Rapid technological change alters the economics of, and therefore the structure of, the regulated industry. Moreover, the politically directed regulatory process is often unable to adapt. Established interests, which generally wield overwhelming political influence, are frequently harmed by the structural changes set off by an advance in technology. As these interests attempt to mount a rearguard fight



"The masked man? He's the Loan Arranger."

through the political process, regulation becomes dedicated to protecting an increasingly obsolete industrial structure. Despite this protection, however, the new technology will assert itself, usually in the form of unregulated firms' competing for the most profitable segments of the regulated business.

Effective regulation requires a slow rate of change in the regulated industry, ease in segregating regulated from unregulated activities and firms, and homogeneity among those regulated institutions. Technological innovation has undermined these conditions.

In banking, for example, a substantial portion of the business of serving lower-risk borrowers and depositors has shifted to the commercial paper market and to less regulated money market mutual funds. This shift of business from regulated to unregulated firms reduces the profitability of the regulated sector and further undermines the efficacy of the regulatory process.

Technological change has also impaired the second condition for effective regulation, the ease in segregating regulated from unregulated activities

and firms. The increasingly widespread use of computers has made it easy to unbundle and repackage the terms and conditions of most financial contracts. A loan, for example, can now be subdivided into components that can be processed, sold, and recombined in ways and at speeds that were unheard of just a few years ago. Previously integrated segments of financial services have been fragmented, and the components are now offered by a range of less regulated or unregulated firms. The traditional S&L, funding mortgages with its own deposits and servicing them by collecting monthly payments, must now compete increasingly against specialized firms that perform just one of these activities, usually much more efficiently than the old-line S&L. Even without the interest rate crisis of the early 1980s, advances in technology would by now have destroyed the profitability of most traditional S&Ls.

Thus, technological advances have made it increasingly difficult for regulators to segment those activities and firms to which regulations apply. Such ambiguity not only makes it easier for less regulated competitors to intrude on the turf of the regulated, but enables more closely regulated firms to devise products and services that avoid the full regulatory burden.

The unbundling process made possible by advances in computer technology is also destroying the third condition needed for an effective regulatory process. Homogeneity among the regulated, essential to effective regulation if all that are subject to regulation are to have a reasonable chance to prosper under a single set of rules, is disappearing rapidly.

Changes in technology create more opportunities for business strategies of individual firms to diverge. Niche markets become more important. But this divergence complicates the task of regulation. For example, a bank specializing in servicing loans or processing credit card transactions will require a large capital investment and high transactions volumes. A bank focusing on construction lending, on the other hand, will require highly skilled and well-compensated professionals but low capital investments in fixed assets. Gathering deposits by mail and wire transfer, as do the money market mutual funds, has a cost structure radically different from gathering retail deposits through numerous branches. Regulations stretched to fit wide variations among firms often do not serve anyone's interest very well. Regulatory personnel also need to understand the advantages and pitfalls of alternative ways of operating a bank. Gone are the good old days when a bank was a bank, and the only difference

between a money center bank and a local institution was the scale of its operation.

Finally, the unbundling permitted by technological change is increasing the potential for producing and delivering financial products that combine elements traditionally produced in separately regulated industries. Not surprisingly, securities, insurance, and banking regulators are increasingly battling one another as their formerly distinct regulatory turfs continue to meld.

Thus, the political process cannot escape the need to protect the owners of hazardous liabilities from loss, but the traditional mode of minimizing the resulting losses, the regulatory cop-on-the-beat, is rapidly losing its efficacy. The narrow bank concept is, in a sense, a reactionary attempt to breathe new life into an outmoded regulatory process to curb the ever-growing losses spilling out of the banking industry. Because narrow banking relies on more of the same outdated medicine, it will worsen the outcome, not help it.

What Insurance Principles Should Be Honored in Protecting Taxpayers against Deposit Insurance Losses?

Common to all narrow bank proposals is the failure to address deposit insurance as an insurance problem. But the principles of private insurance can easily be applied to deposit insurance. These principles include the role of the insurance deductible, the application of risk-related insurance premiums, and proper capitalization of the insurance entity.

On-balance-sheet equity capital, that is, the capital invested in a bank or a thrift by its owners, represents the deductible in a deposit insurance contract. The deposit insurer does not suffer any loss until a bank's own capital is fully exhausted. Thus, increasing a bank's capital relative to the risks it assumes will lower the probability that the bank will fail and hence will reduce the risk to the deposit insurer. Deposit insurance premiums should be based at least in part, therefore, on a bank's level of capital, under the assumption that the risk undertaken by the bank's managers has been properly measured.

Despite the potential advantages of risk-related premiums, government-sponsored deposit insurers have never charged risk-based premiums although bank insolvency is probably a more insurable risk than most of those assumed by property and casualty insurance companies. Unlike many insurable events, bank failures do not occur suddenly or without warning. The decline of a bank can be

detected and often reversed before the bank fails. Risk-related deposit insurance premiums, if based on leading indicators of banking risk, could spark this reversal process as illustrated in Figure 1. In this figure, capital (or a lack of capital) is used as the proxy for a bank's risk of insolvency.

First, a rising deposit insurance premium would signal that a bank's risk relative to its capital was increasing. The increase in premiums would reduce the bank's profits and would encourage the bank to bring its risk and capital back into line by reducing the risk embodied in its asset portfolio or by increasing its capital level or by doing both. The impact of such self-correcting actions is illustrated by bank 1 in the figure as its capital begins to increase and its premium rate correspondingly begins to decline.

Second, a rising premium rate might lead to changes in management as a result of the takeover or acquisition of the bank by new investors. By providing fresh capital to a deteriorating bank, investors could realize a significant return on their investment in the form of reduced deposit insurance premiums. The current insurance system has no such reward for infusing capital into a troubled bank. Bank 2 illustrates the impact of a fresh capital injection into a deteriorating bank.

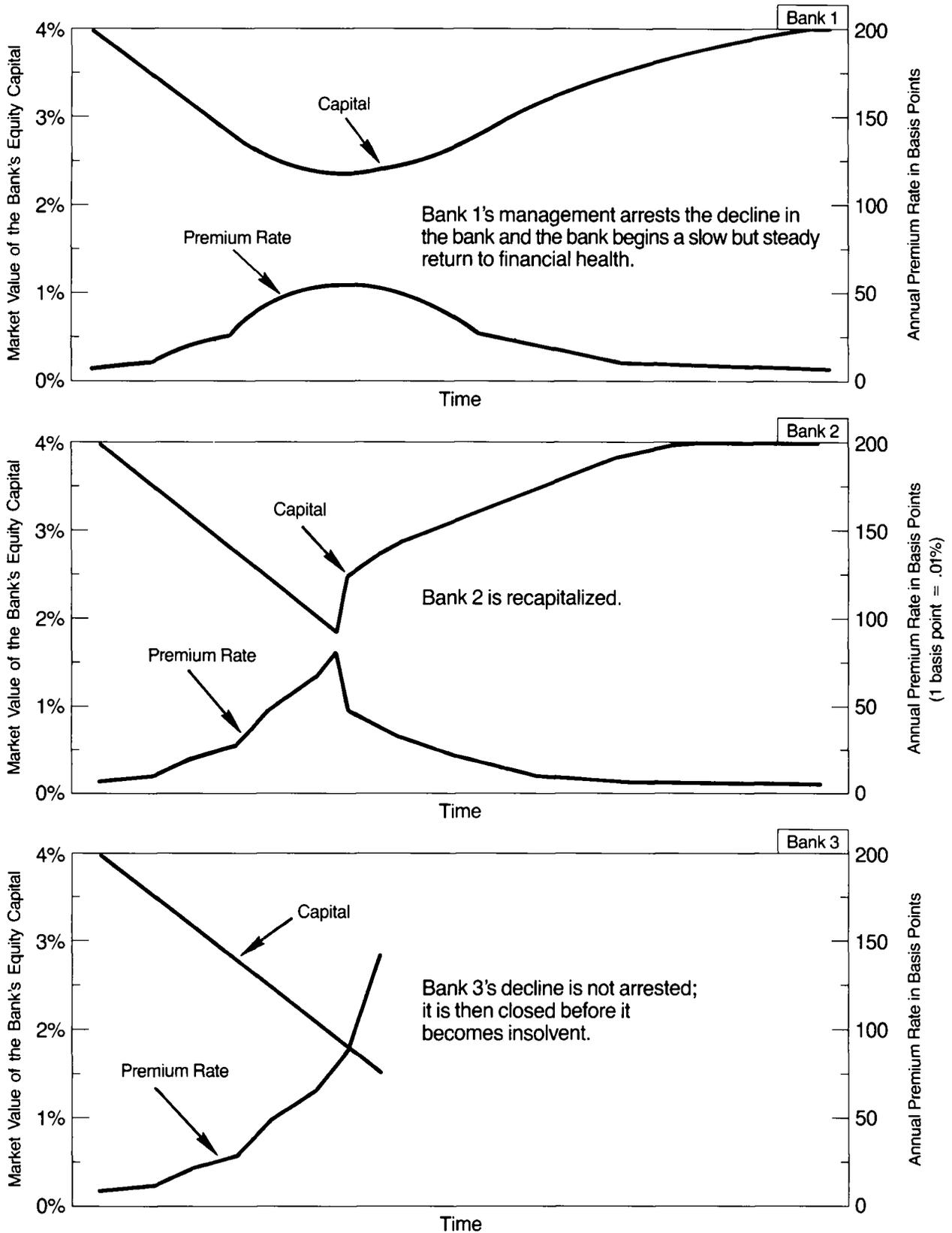
Third, if a rising deposit insurance premium did not result in self-correcting actions or new capital, the risk-based premium would continue to rise until it reached a level signalling that the bank should

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be closed. No such signal exists in the current regulatory process. Bank 3 illustrates this closure signal.

Finally, it is the capital in the deposit insurance mechanism that ultimately protects taxpayers against losses. Among property and casualty insurers, capital is a function of annual premium income. The rule of thumb within the insurance industry holds that at a minimum, an insurer's capital should equal 50 percent of its annual premium income,

Figure 1: Interaction between a Risk-Sensitive Deposit Insurance Premium Rate and Capital Levels for Three Banks



assuming premiums are set on a risk-related basis. This ratio reveals the real reason for insurance company capital: to buy time until risk-related premiums can be brought back in line with the losses incurred. Elsewhere I have developed a cross-guarantee concept as one method for protecting taxpayers against bank insolvencies that honors the insurance principles discussed above.

This theory of insurance capitalization is totally absent, of course, from the current federal deposit insurance system and from any discussion of the narrow bank concept. This absence further demonstrates that the advocates of narrow banking have not explored the causes of the failure of the regulatory process to protect taxpayers from deposit insurance losses.

Other Problems with the Narrow Bank Concept

The narrow bank concept suffers from several other shortcomings. I shall discuss three of the most important of these.

Exempting the Small Bank. Proponents of narrow banking generally recognize the impracticality of applying this concept to smaller banks. Therefore, they usually propose a small bank exemption. Burnham, for example, suggests that banks with assets under \$100 million be fully exempted from narrow bank requirements and that banks in the \$100 million to \$500 million range receive a partial exemption. If we assume that all banks within a multibank holding company would be combined for the purpose of determining the exemption, only 7 percent of all bank and S&L assets were held by institutions with less than \$100 million in assets as of September 30, 1990. Another 12 percent of all bank assets were held by institutions falling into the \$100 million to \$500 million size range. Thus, the narrow bank concept would apply fully to more than four-fifths of the assets owned by American-domiciled banking institutions.

The small bank exemption would prompt the formation of many small banks, especially in urban areas. Although electronic technology increasingly favors smaller organizations, many larger banking organizations are viable competitors in larger urban areas where substantial economies of scale can be captured by acquiring a significant market share. For the most part, the full cost savings arising from these economies of scale are only available in larger metropolitan areas to banks and thrifts with more than \$500 million in assets. Thus, the narrow bank

concept would promote additional fragmentation of American banking and would thus increase financial instability within the economy and add to the inefficiency of the banking industry.

Reducing the Number of Banking Offices. Today there are approximately 87,000 banking offices (including branches) in the United States operated

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by commercial and savings banks and S&Ls. (This count does not include credit unions.) Imposing narrow banking would force federally insured banks and thrifts to reduce the size of their operations and to sharply restrict the range of their loans and investments. As a result, the net interest margin earned by these institutions would decline. Fee income earned by banks and thrifts on their lending activities would also be reduced. Consequently, the income earned by banks and thrifts could easily fall by approximately the same proportion as the asset downsizing required by narrow bank legislation.

If bank and thrift assets shrank by one-third in a world of narrow banking, then conceivably the number of banking offices would also shrink by one-third, or by almost 30,000. Many observers believe there is an excessive number of bank and thrift branches in the United States. But are there twice as many as there need to be? That is doubtful. Therefore, a shift to narrow banking, even with the small bank exemption, could significantly impair the access of many consumers and businesses to banking services.

The reduction in the number of banking offices could be alleviated somewhat if the insured and uninsured subsidiaries of bank holding companies were allowed to share branch offices. Under such an arrangement, the fixed costs associated with operating a branch could be spread across a larger business base. This structure would be less efficient than today's integrated banking activities, however, because of the firewalls that would have to be built to isolate the narrow bank from its less regulated affiliate.

Alternatively, massive closures of branch offices might simply be forbidden. Such a reaction is consistent with the growing attitude that federally insured banks and thrifts should be regulated as if they were public utilities. Restricting branch closings would increase the operating expenses of narrow banks, however, and higher operating expenses would further depress the interest rates paid to depositors, which in turn would drive even more deposits into accounts in uninsured institutions. Such a flight to uninsured institutions would only heighten the risk of financial instability.

Severing Credit-Granting from Deposit-Taking.

Advances in electronic technology have increasingly acted to integrate the production and delivery of financial services, as is evidenced by growing conflicts between various financial regulators. The narrow bank concept moves in precisely the opposite direction by severing, except in small banks, the two classic bank functions: credit-granting and deposit-taking or payment services. In fact, many business banking relationships and an increasing number of personal banking relationships tie these activities together in a single product, within a checking account with overdraft privileges, for example, or in two linked accounts.

Narrow banking, carried to its logical extreme, would bar these types of relationships by forcing credit-granting into an organization legally distinct from a deposit-taking, payment services bank. This is simply an extension of the philosophy underlying the Glass-Steagall Act of 1933, which forced the unnecessary separation of investment from commercial banking. The separation envisioned by narrow banking's advocates would increase further the operating expenses of American banks and thrifts.

Conclusion

The narrow bank concept is a reactionary and an ill-thought-through response to a serious problem—the growing inability of banking regulators to control bank insolvency losses. By dealing with the consequences rather than the causes of the problem, however, narrow banking advocates have crafted a solution that would both increase financial instability within the American economy and decrease the efficiency of the banking business.

Only in America is the narrow bank concept being seriously entertained. Perhaps other industrialized nations understand that there must be a better way to shield taxpayers from the costs of protecting bank depositors from bank insolvency losses. The lack of interest elsewhere in narrow banking is perhaps the most cogent evidence against the narrow bank concept.

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