FOURTH QUARTER 2011

Southwest Economy

FEDERAL RESERVE BANK OF DALLAS

States Still Feel Recession's Effects Two Years After Downturn's End

In This Issue

President's Perspective

The Dodd–Frank Wall Street Reform and Consumer Protection Act—one of the most significant responses to the financial crisis—was signed into law a little more than a year ago. The act establishes a new regulatory infrastructure for promoting financial stability.

Dodd–Frank mostly provides high-level direction, leaving critical decisionmaking and a number of details to regulatory discretion. Many of its most prominent features, including the Financial Stability Oversight Council and new Federal Reserve responsibilities overseeing some nonbank financial companies, are explained in greater detail by Dallas Fed Executive Vice President Robert D. (Bob) Hankins in the "On the Record" feature in this issue of *Southwest Economy*.

A primary purpose of Dodd–Frank is ending "too big to fail." During the recent financial crisis, when smaller banks got into deep trouble, regulators generally took them over. Failing big banks, however, were allowed to lumber on with government support, despite extensive fallout. Big banks that gambled and generated unsustainable losses received a huge public benefit: too-big-to-fail support.

If we have not eradicated too big to fail from our financial infrastructure with the myriad rules and regulations we are writing and implementing, financial reform and stability will have eluded us yet again.

As a result, the most imprudent lenders and investors were protected from the consequences of their decisions. This strikes me as counter to the very essence of competition that is the hallmark of American capitalism. In crafting Dodd–Frank mandates, we need to restore market discipline in banking and let the market mete out its own brand of justice for excessive risk taking, rather than prolong the injustice of too big to fail.

We still have work to do. The top 10 banking institutions now account for 65 percent of banking assets, substantially more than the 26 percent of 10 years ago. When it comes to these largest institutions, we must apply Dodd–Frank extensively and vigorously. If we have not eradicated too big to fail from our financial infrastructure with the myriad rules and regulations we are writing and implementing, financial reform and stability will have eluded us yet again.

I trust regulators will rise to the challenges posed by the financial crisis and too big to fail. By doing so, we will leave a legacy of success and functional infrastructure for next-generation supervision and regulation.

Richard W. Fisher
President and CEO
Federal Reserve Bank of Dallas

States Still Feel Recession's Effects Two Years After Downturn's End

By Jason Saving

The U.S. economy entered a financial-market-driven recession in December 2007 from which it has yet to fully recover. The boom of the mid-2000s has been replaced with a stubborn national reality of high unemployment and sluggish output growth, with no clear indication when economic activity will return to more normal levels.

The nation ultimately is the sum of its parts and cannot fall into a serious recession without it affecting most states and their finances.

Yet the states have, in many ways, borne the brunt of the recession. Demand for public services increased at the very moment tax revenue—especially from property taxes—declined. As late as this October, a full two years after the recession ended, states from Florida to California to New York warned of new shortfalls that must be addressed through spending cuts and tax increases. In Texas, lawmakers completed work on cuts totaling at least $15 billion for the upcoming two-year budget cycle.

As the nation's economic woes continued, the federal budget deficit climbed, posing potential limits on aid Washington could provide. The deficit soared to $1.4 trillion in 2009 and is expected to remain above $1 trillion annually until 2013. At least one major ratings agency downgraded the country's top-tier credit rating, warning as part of its unprecedented action that officials must do more over the short term to stabilize and improve the deficit picture. Other ratings firms have similarly cautioned that their assessments of U.S. creditworthiness could be cut if fiscal imbalances aren't addressed.

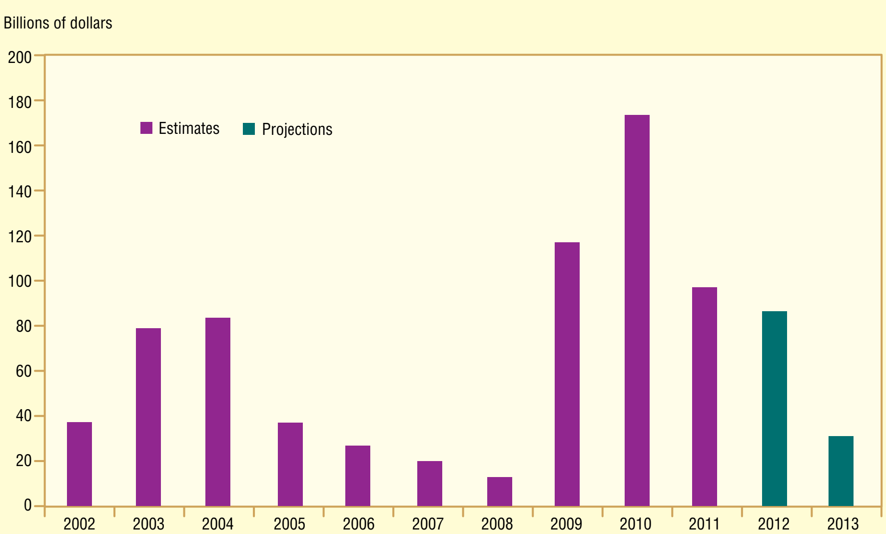
How Have States Done?

Following the 2001 recession, state budget outlooks improved. After posting collective budget gaps of about $80 billion in 2003 and 2004, fiscal retrenchment coupled with above-average economic growth virtually eliminated shortfalls by mid-decade. Even in the first full year of the most recent recession, 2008, it appeared states might weather the national economic storm relatively unscathed.

Unfortunately, the nation ultimately is the sum of its parts and cannot fall into a serious recession without it affecting most states and their finances. On the revenue side, job losses and wage cuts reduced individual income and consumption, crimping state revenue. And at the very moment revenue fell, residents beset by poor economic conditions increased their demand for an array of state-provided social services ranging from Medicaid to job training, driving up expenditures beyond projections. The result: a dramatic widening of state fiscal gaps.

The depth of the recent recession is vividly illustrated by ballooning state deficits in 2009–11, which produced an unprecedented three consecutive years of more than $90 billion shortfalls (*Chart 1*). In 2010 alone, 43 states confronted a cumulative $174.7 billion budget hole—the largest ever recorded. And while those deficits narrowed somewhat in 2011, they are not

Chart 1
State Shortfalls Reach Record $174 Billion in 2010



SOURCE: National Conference of State Legislatures.

expected to return to prerecession levels for at least two years amid the relatively weak economic recovery.

With balanced budgets required in 49 of the 50 states by law or state constitution, jurisdictions coming up short must cut services (or raise taxes) to bring spending plans into balance. To be sure, budgetary tricks—for example, strengthening near-term economic assumptions or making favorable assumptions about social-service caseloads—can sometimes soften the blow. These devices can only go so far, ensuring that some sacrifices will be required.[1]

But were those measures limited to unnecessary and little-used programs, or did states reduce funding to key budget areas, such as health and education?

In 2010 (the last year for which data are available), 43 states reduced funding for higher education, according to the National Association of State Budget Officers (*Chart 2*). This coincided with a period when out-of-work individuals increasingly turned to colleges for occupational retooling. Some states also enacted policy changes to reduce support for higher education over the longer term, continuing a trend seen over the past few decades.

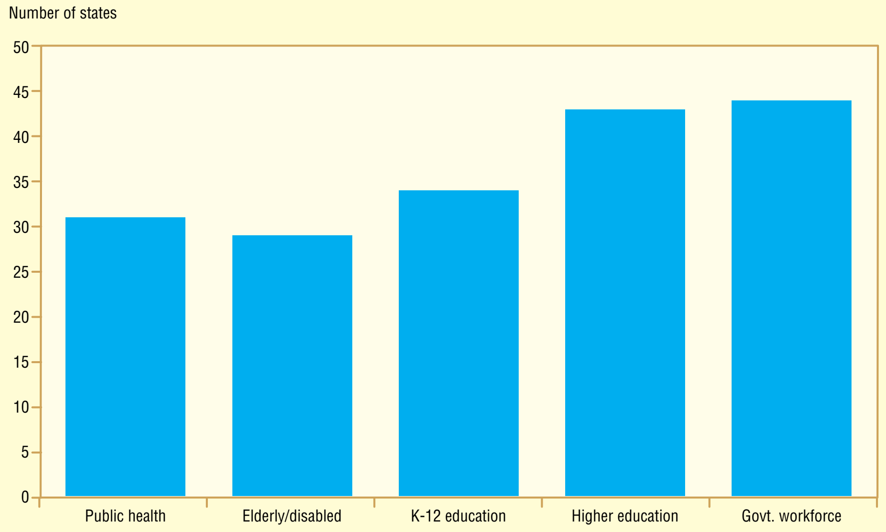
A slightly less common target was K-12 education, which 34 states cut in fiscal 2010 (October 2009 to September 2010). The reductions coincided with debate over whether class sizes had become too large and student test scores too low. Since a majority of most states' outlays go to education and health, substantial budget cuts cannot—from a purely mathematical perspective—occur without affecting either item. Typically, such reductions are at least partially restored in later years as the economy improves. The 2007–09 recession's aftereffects have lingered longer than many expected, perhaps delaying by several years the reinstatement of funding.

Public health programs were pared in 31 states; support for the elderly and disabled was trimmed in 29. These cuts revealed a paradox. States, while well-positioned to help individuals when most citizens (and the tax base) are healthy, struggle to offer their standard menu of benefits when widespread and pervasive economic shocks increase the number of people needing assistance.

The difficulty could be mitigated by giving states more leeway to incur deficits. But, as has become evident at the federal level, deficit spending can create problems of its own, at least over the medium to long term.

Chart 2

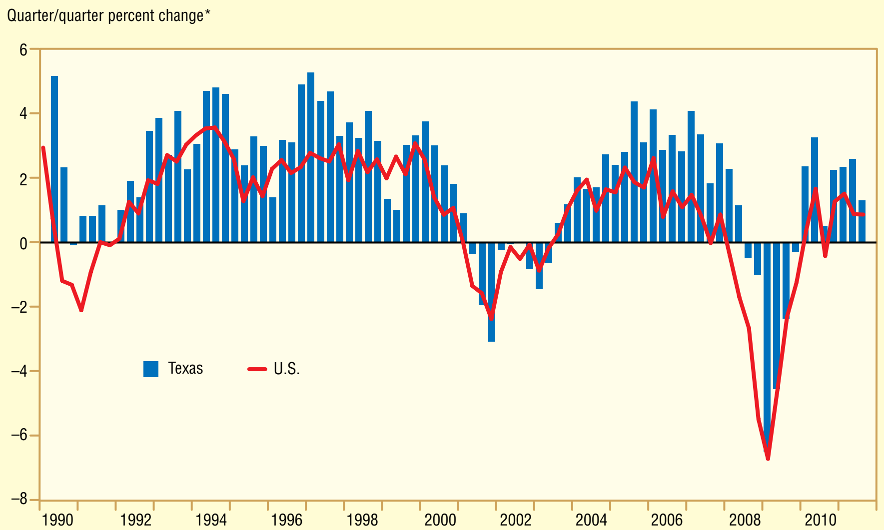
Most States Cut Health, Education, Other Areas in 2010



SOURCE: National Association of State Budget Officers.

Chart 3

Texas Exceeds Nation in Job Growth



* Seasonally adjusted annualized rate.

SOURCES: Bureau of Labor Statistics; Texas Workforce Commission; Federal Reserve Bank of Dallas.

What About Texas?

As a majority of state economies entered recession in late 2007, Texas continued growing (*Chart 3*). And as most state economies emerged from recession in 2009–11, Texas outperformed the remainder of the country in employment growth by a full percentage point—about equal to Texas' historical advantage over the past few decades.

Texas' favorable performance stems from a number of factors, including its oil and gas industry, a low cost of living, favorable demography, restrictive home-lending laws, an attractive business climate and a housing sector that held up better than it did elsewhere. These items do not and cannot guarantee growth here will exceed that of the nation—Texas trailed the U.S. in 10 of the 86 quarters depicted in Chart 3, for

How Dependent Is Texas on Federal Funding?

Texas has significantly trailed the national average in federal spending per capita since the late 1980s and has been somewhat below the national average in federal spending per tax dollar paid to Washington. This means the Texas economy isn't as dependent on federal spending as the typical state and receives less for its contributions.

In 2005—the latest year for which complete data are available—Texas received roughly $6,500 per person in federal outlays, compared with a national average of $7,600. The Texas figure is 86 percent of the national average and places the state 42nd out of 50 in per capita federal funding.

Another way to address the conceptual question of Texas' dependency on federal funding is to examine federal aid to state governments themselves, a narrower but somewhat less volatile measure of federal support for a region. Here the answer is similar: Texas received $1,179 per person, compared with the national average of $1,460, putting it in 43rd place.

This makes Texas somewhat of an outlier in its "neighborhood." New Mexico routinely receives larger per capita federal outlays than any other state, for example—about 50 percent more than Texas. Louisiana is also somewhat above the national average, receiving about 15 percent more than its much larger neighbor.

What about stimulus funding? Might it be that Texas has received an influx of funding whose sudden withdrawal would cause hardship relative to other states?

It turns out that official government data on stimulus funding by states are broadly consistent with other outlay data. To date, Texas has been awarded $674 per person in stimulus-related contracts, grants and loans from the federal government. While this puts Texas in second place among the states in total dollars received, Texas ranks 48th on a per capita basis, behind only Florida (whose governance resembles Texas' in many respects) and New Jersey. The bottom line: Texas is not disproportionately dependent on stimulus monies.

One final issue concerns the possibility of a downgrade to Texas' credit rating if the nation's creditworthiness were reduced. Texas is currently one of 15 states to boast a top-tier rating from Moody's, for example. Five of those 15 were recently placed on a downgrade watch and would face a likely cut if there were a technical default by the U.S. But Texas was not one of the five, in part because it is less dependent on federal funding. So while the possibility of a state downgrade cannot be ruled out, there are few indications it will happen in the near term.

As most state economies emerged from recession in 2009–11, Texas outperformed the remainder of the country in employment growth by a full percentage point—about equal to Texas' historical advantage over the past few decades.

example. But they do suggest that, other things being equal, Texas economic activity should be at least slightly stronger than the national average.

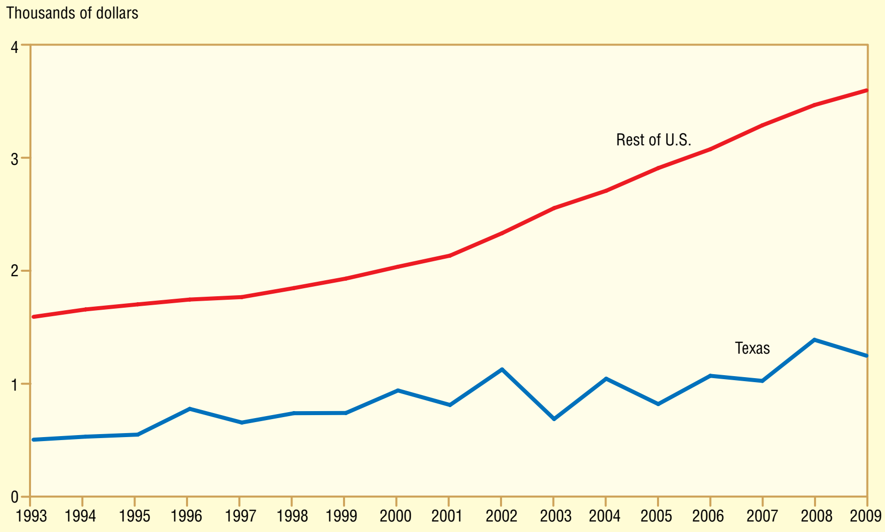
Despite this relatively favorable environment, Texas entered the 2012–13 budgeting biennium with a shortfall of between $15 billion and $27 billion, depending on the spending baseline chosen.[2] This gap represents about 10 percent of state spending and 1 percent of economic activity over the two-year cycle. In light of the $3 billion to $4 billion in debt accumulated by the federal government daily, roughly $20 billion over two years may not seem especially significant. But it is a large amount in a state that offers little assistance to the poor and prides itself on a business-friendly (read: small and efficient) tax and regulatory regime. (*See accompanying box.*)

The Legislature passed and the governor signed a $172.3 billion budget for fiscal 2012–13—about $10 billion below the previous two-year budget and $15 billion less than actual 2010–11 expenditures. Each spending category depicted in Chart 2 was cut, with an especially large proportion borne by health services. A variety of elements prevented even larger reductions. These included increased revenue from a recovering state economy, a larger-than-expected withdrawal from the state's rainy-day fund and just under $5 billion in "nontax revenue enhancements" such as higher license and registration fees.

Downgrading Debt?

As if state budget cuts were not enough, questions about excessive state government indebtedness have arisen. Following S&P's downgrade of U.S. borrowings, ratings firms said debt-ridden states might themselves be lowered in the near future—as Nevada and New Jersey were earlier this year and California was in 2010. Texas, however, has not been cited as a

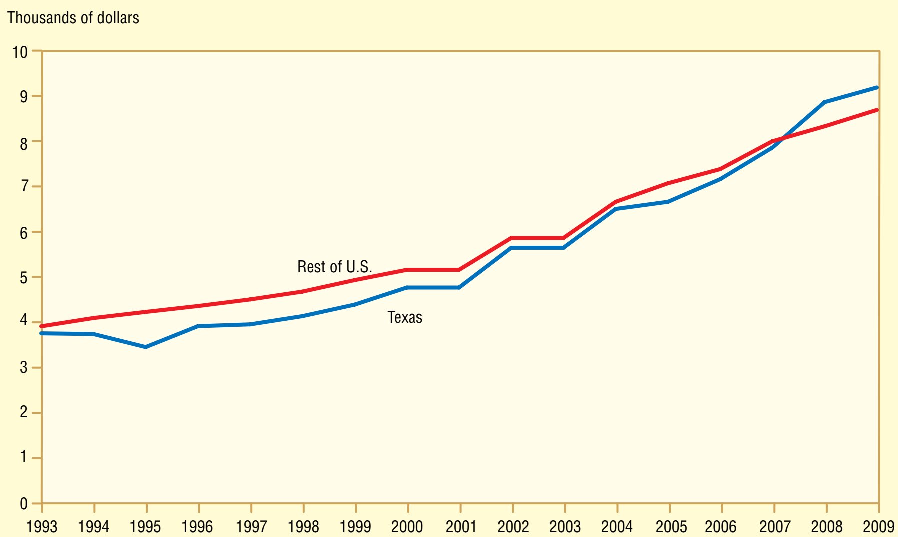
Chart 4
Texas Trails Rest of Nation in State Per Capita Debt



SOURCES: Bureau of the Census; U.S. Treasury.

Texas has historically enabled localities—cities, counties and school districts—to undertake functions that elsewhere might be done (or at least paid for) by the state.

Chart 5
Texas Mirrors Rest of Nation in State and Local Per Capita Debt



SOURCES: Bureau of the Census; U.S. Treasury.

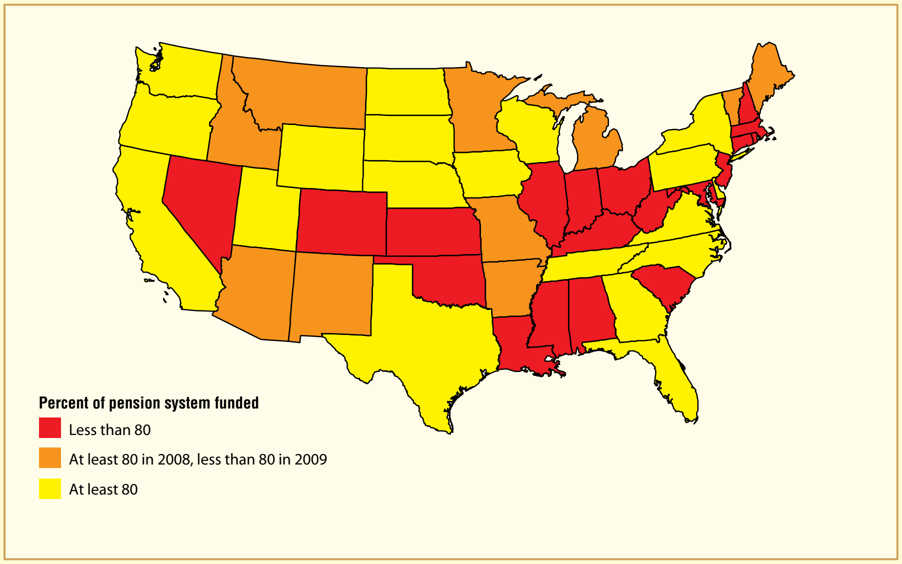
downgrade candidate. How do its debt levels compare with those in other parts of the country?

Such a comparison would generally use per capita state debt. Over the past two decades, per capita state debt shows Texas at about one-third the debt level of the rest of the nation (*Chart 4*). In 1993, for example, Texas incurred per capita state debt of $478 versus $1,576 for the remainder of the nation. In 2009, the last year for which data are available, the comparison was $1,228 versus $3,599.

However, Texas has historically enabled localities—cities, counties and school districts—to undertake functions that elsewhere might be done (or at least paid for) by the state. This suggests that a more valid comparison would need to include local as well as state debt.

In terms of state and local per capita debt, Texas essentially tracked the rest of

Chart 6
Texas Pension Funding Exceeds Recommended 80 Percent in 2009



SOURCE: Pew Center on the States.

the nation over the past two decades, with a slight uptick over the past several years (*Chart 5*). This suggests that looking at state government data alone may provide a misleading impression of the extent to which Texas is a small-government state. Rather, Charts 4 and 5 illustrate what economists sometimes call "fiscal federalism"—the delegation of responsibilities to the smallest government unit able to carry them out. (Florida is also notable in this regard.)

Such a structure is neither inherently desirable nor inherently undesirable on economic grounds alone. On one hand, delegating tasks to localities can help government better tailor the services it provides to the needs of individual communities and may improve efficiency by making civil servants more accountable to their constituents. On the other hand, it can exacerbate income inequality by impeding revenue-sharing across jurisdictions and perhaps reduce economies of scale that larger jurisdictions may produce. There is some economic evidence that empowering localities can boost state economic growth, though both state and local debt patterns must be considered when this is done.

States have an additional key liability not captured by debt-issuance figures: the degree to which their pension programs are underfunded. Any time a jurisdiction makes pension promises to its workers without adequately setting aside revenue streams to pay for them, future taxpayer liabilities are created, even though these promises do not immediately increase measured state debt. Media reports have revealed states with large and under-recognized fiscal gaps in their pension systems. That liability will eventually swamp the rest of their debt and require very large fiscal adjustments. Might this be true for Texas?

Chart 6 illustrates the extent to which the continental states have adequately funded their pension systems. Nineteen states, including Texas, were at least 80 percent funded in both 2008 and 2009, a benchmark for sustainable pension systems. In those states, relatively modest fiscal adjustments should be enough to maintain solvency over the medium to long run. Nineteen other states fell below the 80 percent threshold in both years, sometimes by a significant margin. In those states, considerable adjustments may eventually be necessary, whether they come in the form of reduced benefits or higher tax revenues, or both. The remaining 10 states fall between these two extremes.

Texas doesn't appear to be an outlier when it comes to government debt and unfunded pension liabilities.

Meeting Service Needs

State finances have eroded considerably over the last few years, leading to cutbacks across wide swathes of program areas nationwide. Texas joined this group in the 2012–13 budget cycle, addressing a $15 billion to $27 billion shortfall almost exclusively through expenditure reductions.

Across the country, state debt issuance has risen in recent years. Texas has followed suit, though its overall borrowing levels and unfunded pension liabilities lie well within national norms.

Provided the nation does not fall back into recession, state shortfalls are expected to gradually recede toward more usual levels by about 2013. But sizable fiscal challenges will remain in the areas of infrastructure, education and health as states struggle to catch up in the aftermath of the recession and slow recovery. Across the nation, including Texas, those issues can be addressed when economic headwinds diminish.

Saving is a senior research economist in the Research Department of the Federal Reserve Bank of Dallas.

Notes

[1] This article will look primarily at state expenditures. For more information on the revenue side of the equation, see "Poor State Finances Deepen Recessionary Hole," Federal Reserve Bank of Dallas *Southwest Economy,* Fourth Quarter 2010.

[2] When matching previous spending levels, unadjusted for inflation and population growth, the figure is $15 billion. Addressing these factors and compensating for certain previous spending cuts raises the figure to roughly $27 billion.

A Conversation with **Robert D. Hankins**

Dodd–Frank: Toward Greater Financial System Stability

Robert D. (Bob) Hankins is an executive vice president at the Federal Reserve Bank of Dallas, responsible for the Eleventh District's banking supervisory activities. In July 2010, Congress approved the Dodd–Frank Wall Street Reform and Consumer Protection Act in response to the global financial crisis. At almost 2,000 pages, the act spells out new laws and regulations whose ramifications for financial institutions are broad and complex. In this interview, Hankins fields questions about the act and its implications.

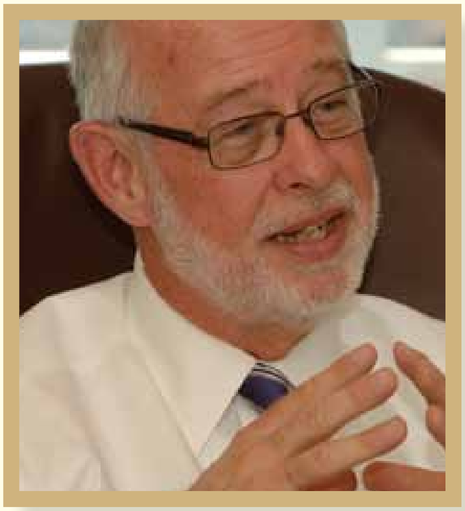
Q. What are the major goals of the financial reforms as laid out in the Dodd–Frank Act?

A. The best summary of Dodd–Frank's goals is found in its preamble, which states that the act aims to promote financial stability, end "too big to fail" (failing banks allowed to continue operating because they are considered too large to be closed), protect taxpayers by ending bailouts and protect consumers from abusive lending practices. Of course, whether it accomplishes these objectives has been the subject of a considerable debate.

Q. Dallas Fed President Richard Fisher has spoken at length about the dangers of financial institutions that are too big to fail. How does Dodd–Frank address this? Are the changes likely to be effective?

A. Protecting the financial system and taxpayers from the consequences of difficulties at large financial institutions was one of Dodd–Frank's main goals. The legislation contains a number of safeguards and changes to the supervisory apparatus intended to accomplish this. For instance, large, systemically important institutions—and not just banks, by the way—will be subjected to enhanced prudential supervision, which is to be more stringent and rigorous than what we do for smaller institutions.

The banking supervision function is also undergoing some fundamental changes. In addition to focusing on individual institutions, we are also taking a more macroprudential perspective that looks at threats to the stability of the entire financial system. Finally, Dodd–Frank implements a new resolution regime that allows failing financial firms such as large bank holding companies or other important financial firms to enter into receivership to facilitate an orderly wind down of operations. This option wasn't available during the crisis and should help deal with too big to fail.



Q. You said even nonbank firms that are designated as systemically important will now be subjected to enhanced supervision. How will this designation be made? Have any nonbank firms been identified yet?

A. The Financial Stability Oversight Council, composed of all major financial market regulators, will determine which nonbank firms are systemically important. Dodd–Frank lists 10 criteria that the council must consider. These include things such as size, leverage, interconnectedness and importance as a source of credit. The council issued an Advanced Notice of Proposed Rulemaking in October 2010 that sought input on developing a framework for making its designations. After getting public comment, the council issued a formal request for comment on its proposal of how to select nonbank firms for enhanced supervision. But, reflecting the importance and significance the council places on these decisions, it recently indicated that it will seek additional comment. So, no firms have yet been named. Any determination requires a two-thirds vote by the council, including the chairman's approval. Even after that, a company has the right to a hearing before the council, which is required to submit a report to Congress regarding the decision. The determination is also subject to judicial review.

Q. How are institutions going to be supervised? What changes, in particular, are in store for the Dallas Fed?

A. The Federal Reserve is now responsible for supervising all organizations that are deemed systemically important. This will include bank holding companies with $50 billion or more in assets and the nonbank financial firms that the Financial Stability Oversight Council decides are important to financial stability. The Fed will also be responsible for developing enhanced prudential standards for these institutions. The goal is to subject these systemically important financial institutions, or SIFIs, as they have come to be known, to greater oversight and more rigorous standards that reflect the heightened risks they may pose. Things such as capital requirements, liquidity requirements and overall risk-management strategies are going to be more stringent for the SIFIs.

As far as the Dallas Fed is concerned, we have one institution that meets the act's minimum-size requirement for enhanced supervision, Dallas-based Comerica Inc. Dodd–Frank also places the supervision of savings-and-loan holding companies under the Fed, since the act does away with the Office of Thrift Supervision. For us, that means supervision of about 25 extra organizations, one of which, San Antonio's USAA, is the largest financial institution based in Texas.

Q. During the crisis, the Federal Reserve introduced a number of emergency measures to help stabilize financial markets. Does Dodd–Frank affect the Fed's ability to respond to future crises?

A. In response to events that unfolded at an incredibly rapid pace during the crisis, the Fed

"Until someone invents a crystal ball that works, the best we can do is try to minimize the impact of the next crisis through effective, though not stifling, supervision and preservation of capital."

mostly invoked Section 13(3) of the Federal Reserve Act, which allowed it to lend to any entity under "unusual and exigent circumstances" as long as five members of the Board of Governors approved. Dodd–Frank requires that any such aid program or facility be broad-based and not directed at any one institution. Also, while the Fed consulted with the Treasury before setting up the various programs, it wasn't required to do so. Now, the legislation requires that the Fed gain the Treasury's approval before establishing any similar programs or facilities.

Q. Since Dodd–Frank imposes additional regulation and fees on the banking industry, will these greater costs affect banks' ability to lend? Is there a difference between small and large banks?

A. Studies have shown that the cost and burden of regulation fall disproportionately on smaller banks. Larger banks can more easily absorb the increased expense, and that is why it is important that as much as possible be done to minimize the impact on smaller banks. And, of course, the potential impact on lending for banks of all sizes increases with rising cost structure and staff time devoted to ensuring compliance with laws and regulations. At the same time, we have seen the result of reckless lending practices and disregard for prudent risk management on credit availability as banks work to repair balance sheets and rebuild capital. So, I guess the real question is whether the cost of prevention—the intent of Dodd–Frank—is cheaper than the cure? I would argue for the former, but I certainly understand the frustration felt by those who played by the rules and who must now bear some of the burden for those who did not.

Q. What are you hearing from the Dallas Fed's district banks? What are the biggest changes they will confront?

A. As I participate on regulatory panels and with President Fisher in CEO forums around the district, the common theme is concern about the increased regulatory burden and associated cost. The Dallas district consists largely of community banks. While Dodd–Frank was aimed primarily at enhancing the supervision of the largest organizations that create the biggest risk to financial stability, community bankers are concerned about the trickle-down effect. They are anxious that Dodd–Frank regulations and policies adopted by the supervisory agencies will be written and applied as one-size-fits-all. The bankers I talk to are worried about how they will absorb increased compliance costs and remain profitable and viable, meeting the credit needs of their communities.

To allay these concerns, the Federal Reserve is trying to provide more guidance to bankers and examiners about what applies to community banks and what doesn't. Additionally, the Federal Reserve's Supervision Committee has established a subcommittee to focus on the effects of proposed rules on community banks. Each Federal Reserve district has also created a Community Bank Depository Institution Advisory Council. A representative from each of the councils meets twice a year with the Board of Governors to provide direct feedback on issues affecting community banks.

Q. If the supervisory structure and regulations in Dodd–Frank had been in effect during the recent housing boom and bust, do you think the financial market crisis that ensued would have been more limited in depth and breadth? Please explain.

A. You would certainly like to think so, but you will never know. The real question, I think, is whether Dodd–Frank will prevent another crisis. My response is, probably not. Responding to the savings-and-loan and banking crises of the 1980s and early '90s, Congress passed the Financial Institutions Reform, Recovery and Enforcement Act of 1989 and the Federal Deposit Insurance Corporation Improvement Act of 1991 with the idea they would prevent a future crisis. Obviously, they did not. To quote my good friend Thomas Hoenig, who until Oct. 1 was president of the Kansas City Fed, "I have a crystal ball on my desk. It doesn't work."

Until someone invents a crystal ball that works, the best we can do is try to minimize the impact of the next crisis through effective, though not stifling, supervision and preservation of capital. Lessons have been learned and will be applied going forward. But by their nature, laws and regulations are backward-looking, designed to prevent the cause of the last crisis from being the cause of the next one.

Q. So, what is your overall assessment of Dodd–Frank?

A. Legislation this sweeping and comprehensive is bound to be controversial, and Dodd–Frank is no exception. We've certainly heard many doubts about whether it really ends taxpayer bailouts and too big to fail, and we've heard a number of complaints about increased regulatory burden. There is also concern about the inevitable unintended consequences. These are all valid. But instituting a more macroprudential approach to the supervisory process, along with a new resolution regime for failing firms, and extending regulatory oversight to important players within the financial system that aren't banks are important steps that hopefully will result in a safer and more sound financial system.

Private Equity Industry: Southwest Firms Draw on Regional Expertise

By Alex Musatov and Kenneth J. Robinson

The private equity industry runs the gamut from small venture-capital investments in startup companies to multibillion-dollar buyouts of well-known public corporations.

Neiman Marcus, Harrah's, Petco, J. Crew—these well-known names are among the holdings of companies owned or co-owned by private equity (PE) firms in the Federal Reserve's Eleventh District. The region is home to more than 175 PE firms, including the world's third-largest, Fort Worth-based TPG Capital.[1] Together, these entities have raised more than $109 billion over the past 10 years and sit on $31 billion pending investment.[2]

While the PE business model goes back to the times of early seafaring enterprises funded by limited private partners, its modern U.S. iteration dates back to the 1950s and the first venture capital funds. More recently, the industry and its sometimes opaque operations have come under increased regulatory scrutiny amid concern about their riskiness and systemic importance to the financial system. Although detailed data are hard to come by, regionally based PE firms are distinguished from their counterparts nationwide by the sectors they favor.

What 'Private Equity' Means

The term "private equity" is used very broadly—often inconsistently—because it encompasses a vast range of strategies for investing in companies whose shares are not publicly traded. In its simplest form, a PE firm consists of a team of professional investors who declare their intent to raise a fund of specified size with an expressed investment strategy. The team solicits accredited investors—primarily institutional money managers and high-net-worth individuals—to raise the targeted amount.

Once a fund is closed to additional investors, the firm deploys its capital through a series of acquisitions, generally occurring over a period of up to three years. The next five years or so are spent managing, advising and improving the portfolio of companies.

The final stage of the private equity cycle—the exit stage—entails divestiture, with the acquired firms typically operationally stronger and more valuable, reflecting the PE sector's benefits to the economy. Exits can take the form of an initial public offering of shares or a sale to a corporate buyer or another PE firm. The full cycle often requires a 10- to 15-year commitment from investors, highlighting the long-term, generally illiquid characteristics of private equity financing.

Nonpublic Funding

The PE industry runs the gamut from small venture-capital investments in startup companies to multibillion-dollar buyouts of well-known public corporations. They all share a nonpublic funding structure under the leadership of a professional general partner who deploys capital raised from limited partners. The PE universe is most often segmented by the life-cycle stage of target companies—from startups to mature operations.

"Venture capital" firms invest almost exclusively in young companies, often before their first revenues materialize. Venture capitalists are often willing to lose their entire principal on most investments in order to hit a home run with one potentially revolutionary technology or business method that reaps enormous returns. The earlier the stage targeted, the higher the risks and the greater the potential rewards. In addition to capital, venture capital entities often provide technical know-how and industry expertise to their portfolio firms. Google, Microsoft and Apple are some of the most illustrious venture capital success stories.

"Growth equity" and "mezzanine debt" funds target companies in later stages than venture capital. These PE participants provide capital—either equity or debt—to young but stable businesses that require bridge financing between venture capital and public financing.[3] PE firms in this particular segment hope to capitalize on rapid growth and typically exit the investment once the firm can access bank loans or public equity markets. Mezzanine debt refers to cases when a PE fund opts to lend to, rather than provide equity in, a growing firm. The loans typically have very flexible terms but rank below senior debt in the event the company defaults. For this added risk, mezzanine funding comes with relatively high interest rates.

The "leveraged buyout," or LBO, is by far the largest and most recognized private equity strategy. Many think of PE and LBO as synonymous. LBOs are often involved in the acquisition of famous brands, combining equity with large amounts of borrowing to employ significant leverage and gain control of target companies.

Debt is a key component of this business model because the leverage employed can amplify the returns generated by an initial equity investment. Buyout firms target companies that have strong, predictable cash flows since those will be needed to repay large borrowings. This makes the buyout segment highly dependent on the debt markets for financing. The banking industry plays a key role in LBOs. As of June 30, U.S. banks reported $115.4 billion in leveraged loans and securities on their books.

In addition to these primary styles, PE firms pursue various specialized investment strategies. This "other" group includes firms that invest exclusively in financially distressed businesses and companies on the brink of bankruptcy (or already in bankruptcy proceedings) and PE firms that invest in other PE firms, so-called secondaries.

Funds committed to LBOs account for the largest relative amount of PE capital available for investment in each of the major strategies (*Chart 1*).

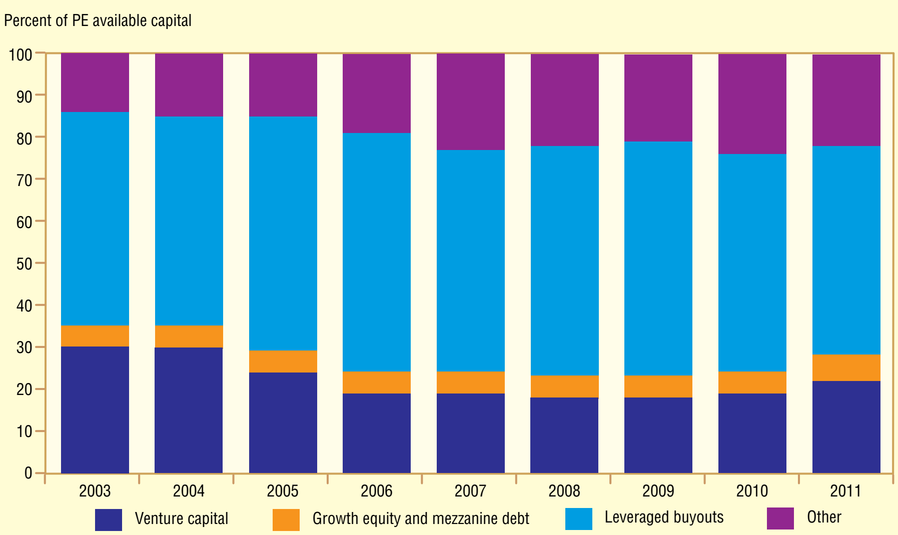
Within each segment, PE firms specialize primarily by industry and size of target firm. With the exception of the largest PE firms, which tend to diversify across industries, fund managers prefer to acquire firms within very specific subsegments, often leveraging one portfolio firm to help another one grow or even merging related business into a single entity. Narrow industry specialization has been shown to produce higher returns, and industry participants—including potential acquisition targets—prefer PE firms with deep experience in a particular sector.[4]

Surviving the Financial Crisis

The PE industry has largely recovered from the recent global economic turmoil,

Narrow industry specialization has been shown to produce higher returns, and industry participants—including potential acquisition targets—prefer private equity firms with deep experience in a particular sector.

Chart 1
Leveraged Buyouts Are Largest Share of Private Equity Available Capital



NOTES: "Available capital" refers to capital not yet invested at year-end. 2011 data are through second quarter.

SOURCE: Preqin.

A large portion of the capital attracted during the 2005–08 peak years remains dormant because of limited profitable investment opportunities.

reflecting the long-term nature of its model, with investors committing funds for 10 to 15 years and anticipating a lack of interim liquidity. The industry, therefore, tends to experience less instability than equity and fixed-income markets.[5] Still, with the onset of the financial crisis, PE capital declined steadily as the inflow of new investment funding slowed; capital peaked at almost $900 billion globally in 2008.[6]

The industry has also been placed under increased regulatory scrutiny. The Dodd–Frank Wall Street Reform and Consumer Protection Act, signed into law in July 2010, requires that PE and hedge funds as well as other private pools of capital with at least $150 million in assets under management register with the Securities and Exchange Commission.[7] The law also imposes new record-keeping and disclosure requirements that will give financial supervisors information to evaluate both individual firms and the state of the overall market, closing a regulatory gap that had existed in this sector of the financial marketplace.[8]

The economic downturn and heightened investor risk aversion affected the industry's dynamics. A large portion of the capital attracted during the 2005–08 peak years remains dormant because of limited profitable investment opportunities. Although investors curbed some incremental commitments, and total funds raised contracted after 2008, PE firms couldn't spend the large cash positions they had already built up (*Chart 2*).

In response, some PE firms diversified outside of their standard business models, pursuing alternative investment strategies that include hedge funds and real estate funds. In addition, the relative health of corporate balance sheets has increased competition for purchase targets. Corporations now periodically outbid PE firms in auctions for business acquisitions.[9]

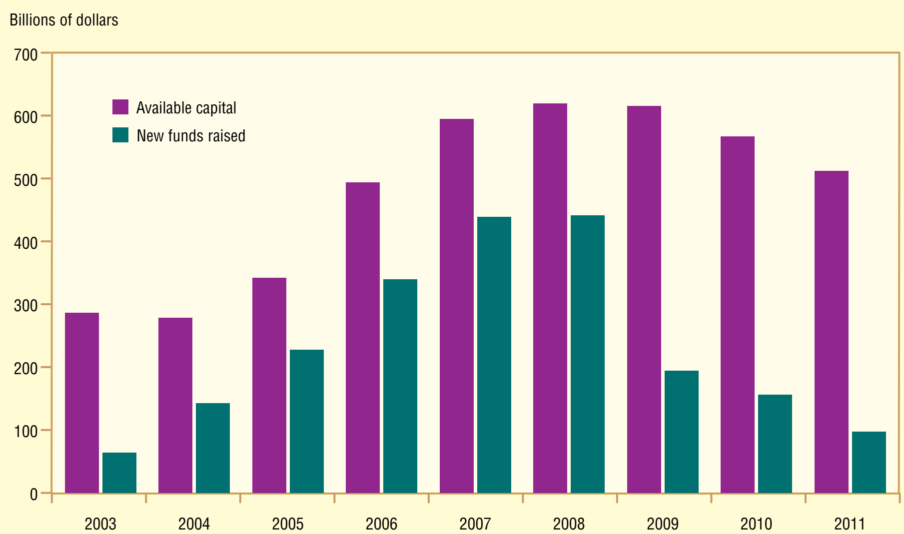
Southwest Private Equity

While PE is global in most respects—U.S. investment interests can raise money from a European pension fund and invest it in Asia—individual firms tend to cluster near hubs of their target industries. Proximity allows fund managers to build industry relationships, identify potential targets and manage a company more actively after its acquisition. Also, PE firms prefer to hire insider experts directly from their target industries—and expert staff is often reluctant to relocate.

Proximity can be especially important for venture capital firms, which must often identify promising investments even before a formal company exists. Out of 29 PE firms in Austin, for example, 19 focus on high-tech venture capital. Largely due to the presence of prominent high-tech companies such as Dell and a large university population, Austin is home to almost one-third of all venture capital firms in Texas.

Chart 2

Ready Capital in U.S. Remains High Despite Decreased Fundraising

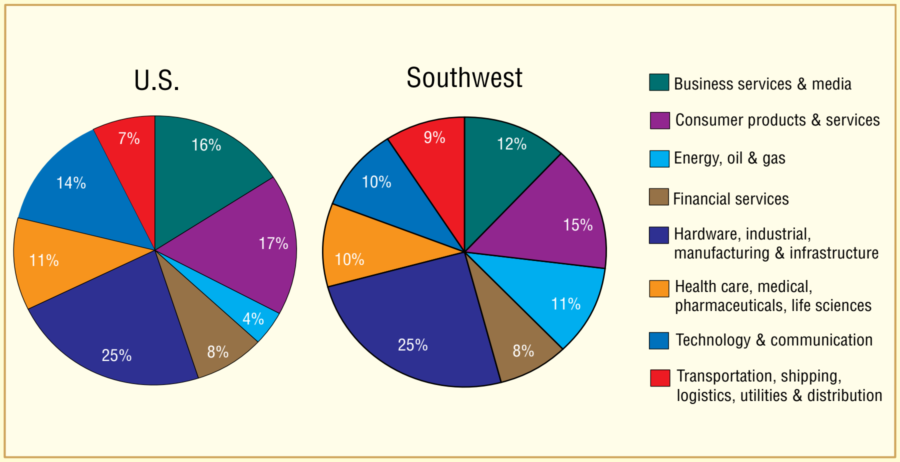


NOTES: "Available capital" refers to capital not yet invested at year-end. 2011 data are through second quarter.

SOURCE: Preqin.

Chart 3

Private Equity Transactions Differ in Southwest Region
(January 2005 to July 2011)



NOTE: Percentages may not add to 100 due to rounding.

SOURCE: Prequin.

This locational aspect of the PE industry suggests that PE firms based in the Southwest (defined as Texas, Louisiana, New Mexico and Oklahoma) might differ somewhat in their focus. PE firms both nationally and in the region invest across a wide number of industries (*Chart 3*). Not surprisingly, Southwest-based PE entities participate more in energy industry transactions, given the region's traditional focus on oil and gas.

Of all PE transactions by regional firms since 2005, 11 percent targeted the oil and gas sector, almost triple the national rate of 4 percent.[10] In contrast, Southwest PE firms are somewhat less concentrated in the technology and communication sector (10 percent versus 14 percent nationally) and in business services and media (12 percent versus 16 percent nationally). Southwest PE firms tend to invest in other industry groups in fairly similar proportions to national trends.

Regional Advantage

PE is an important source of capital for emerging companies and mature corporations. Firms in the four-state Southwest region hold $31 billion in ready-to-invest capital, a significant amount in the context of the $51 billion in business loans on the books at banks in the Federal Reserve's slightly smaller Eleventh District.

Like much of the financial services industry, PE is in a period of transition borne of economic turmoil and regulatory change. Some firms have moved outside their traditional boundaries. Yet the increasingly global industry retains its regional flavor, reflecting a desire to capitalize on the advantages and specialized knowledge of industries at home.

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Notes

[1] As measured by total funds raised in the past 10 years. The Eleventh District encompasses Texas and parts of Louisiana and New Mexico.

[2] This compares with the U.S. total of $1.65 trillion raised over the past 10 years and $455 billion awaiting investment, known in the trade as "dry powder."

[3] Growth equity and mezzanine debt are both very flexible, diverse strategies and may pursue firms at any stage. For simplicity, we focus on their preference for mid-cycle companies.

[4] See "Playing to Their Strengths? Evidence that Specialization in the Private Equity Industry Confers Competitive Advantage," by Robert Cressy, Federico Munari and Alessandro Malipiero, *Journal of Corporate Finance,* vol. 13, no. 4, 2007, pp. 647–69.

[5] Changes in asset values are not directly observable because there is no public market for firms owned by PE investors.

[6] All data on the PE industry are from Preqin.

[7] Venture capital funds are exempt from registration requirements.

[8] See U.S. Senate Report 111-176, 111th Congress, 2d Session, April 30, 2010, pp. 71–72.

[9] See "Corporates Outbid Private Equity for Good Assets," by Marietta Cauchi, Marketwatch.com, June 24, 2011.

[10] The data in Chart 3 are based on number of transactions. Data on the dollar amount of investments by industry are available for roughly 30 percent of transactions.

Not surprisingly, Southwest-based private equity entities participate more in energy industry transactions, given the region's traditional focus on oil and gas.

NoteWorthy

QUOTABLE: *"Texas' exports face headwinds from two sources: a slowdown in Mexico and emerging Asia—particularly China—and a stronger dollar."*

—Anil Kumar, Senior Research Economist

PERSONAL INCOME: Further Declines Seen in Texas and U.S.

Many economic indicators in Texas and the U.S. continued to decline in 2010 even though the recession ended in 2009. While Texas still lags behind in certain key measures of citizens' well-being, some of the gaps appear to be narrowing.

Texas' real median household income fell 1.6 percent to $47,464 in 2010, compared with a U.S. reduction of 2.3 percent, or more than $1,100, to $49,445, according to the 2011 Current Population Survey Annual Social and Economic Supplement.

Texas' lesser decline allowed it to move closer to the national income level than it has been since 2001.

The share of Texas residents without health insurance decreased 1.5 percentage points during 2010 to 24.6 percent. The U.S. recorded a 0.4 percentage-point drop to 16.3 percent. While Texas experienced the fourth-largest decline in such coverage gaps in the U.S., the state continues to have the largest percentage of people without health insurance—3 percentage points greater than in New Mexico, the next-highest state.

The Texas poverty rate increased to 18.4 percent in 2010, a year-over-year increase of 1.1 percentage points. The national poverty rate rose to 15.1 percent, up 0.8 percentage points. The national and state rates climbed to their highest levels since the early 1990s.

—Christina Daly

RECORD DROUGHT: Agriculture Losses Estimated at $5.2 Billion

Texas' agricultural sector is tallying up record losses due to an unprecedented drought. The 12 months ended in September were the driest since recordkeeping began in 1895. The U.S. Drought Monitor found 92 percent of the state in extreme or exceptional drought as of mid-October.

Crop and livestock losses are estimated at $5.2 billion, or 25 percent of usual agricultural production value, according to the Texas AgriLife Extension Service at Texas A&M University. The total surpasses the previous record for costliest drought of $4.1 billion in 2006.

Low yields and crop abandonment at a time of high commodity prices produced losses of $1.8 billion in cotton, $750 million in hay, $327 million in corn, $243 million in wheat and $63 million in sorghum production. Crop insurance lessened the impact of income losses for many farmers.

The cost to the livestock sector was $2.1 billion, with 82 percent of pastures and rangeland in very poor condition and hay prices increasing twofold to threefold from a year ago. Ranchers culled herds due to water and feed conditions, depressing market prices in the short term. However, prices remain relatively high, mitigating the effect.

In addition, the drought lowered income for agriculture workers and sales of farm services and supplies such as gins, elevators and fertilizer. AgriLife Extension estimates the sum of direct and indirect losses at $8.7 billion this year.

—Yingda Bi

DEFENSE SPENDING: Economic Benefit Likely to Diminish in Texas

National defense strongly influences the Texas economy through 20 area military installations and the companies providing them with goods and services. Additional benefits arise from spending by military personnel and by the Defense Department on aircraft and equipment produced by area manufacturers such as Lockheed Martin and Bell Helicopter.

All told, defense purchases and pay for military and civilian personnel in Texas amounted to $65.6 billion in 2009, or about 9.7 percent of U.S. defense spending. After accounting for spillover effects in the local economy from inputs used by defense contractors and goods purchased by military personnel, total spending in Texas was estimated at $108.6 billion.

Compared with other large states, Texas ranked second behind California in terms of spending. However, on a per capita basis, Texas was ninth at just under $3,500.

The Base Realignment and Closure program instituted in 2005 and ongoing conflicts in Iraq and Afghanistan led to a military influx that had boosted Texas infrastructure investment, particularly benefiting Fort Bliss in El Paso and Fort Sam Houston in San Antonio.

However, the outlook is less rosy. Military spending in Texas will likely fall amid overall defense reductions beginning in 2012 as part of deficit-cutting measures by Congress. Spending in Texas will decline to $51.7 billion by 2015, a 21.2 percent drop from 2009, Defense Department estimates show.

—Jackson Thies

SpotLight

Texas Employment
Gains Aren't Simply a Low-Wage Jobs Story

Amid reports of the nation's weak economic recovery, high unemployment and slow job growth, attention has turned to Texas, the only large state on track to surpass its prerecession peak employment by year-end. Since the U.S. recession concluded in 2009, Texas employment has grown 3.3 percent, compared with 0.6 percent for the rest of the states.[1] Texas added 827,000 jobs, an 8.7 percent increase, between 2001 and 2010 and expanded in every category except manufacturing, information and construction. The nation lost 2.8 million jobs during that period, a 2.3 percent decline.

Texas has benefited from a range of factors, notably high commodity prices, particularly oil, and development of new drilling technologies. Rapidly growing exports, high population growth and robust in-migration of people and businesses also contributed. Relatively healthy banks and the lack of a housing bubble cushioned the blow of the recession.

State job gains, which have benefited from strong fundamentals, have been relatively rapid and broad based. Even so, the wage picture is mixed.

Of the 22 major occupational categories surveyed by the Bureau of Labor Statistics, employment rose in 18 of them in Texas versus 11 in the rest of the states between 2001 and 2010 (*Chart 1*).[2] Texas jobs grew fastest in community and social service, which has a median hourly wage of $19, higher than the $16 median for all U.S. jobs in 2010. Other rapidly growing categories include health care support, with a median wage of $10; personal care and service, with a $9 median, and business and financial operations, with a $29 median.

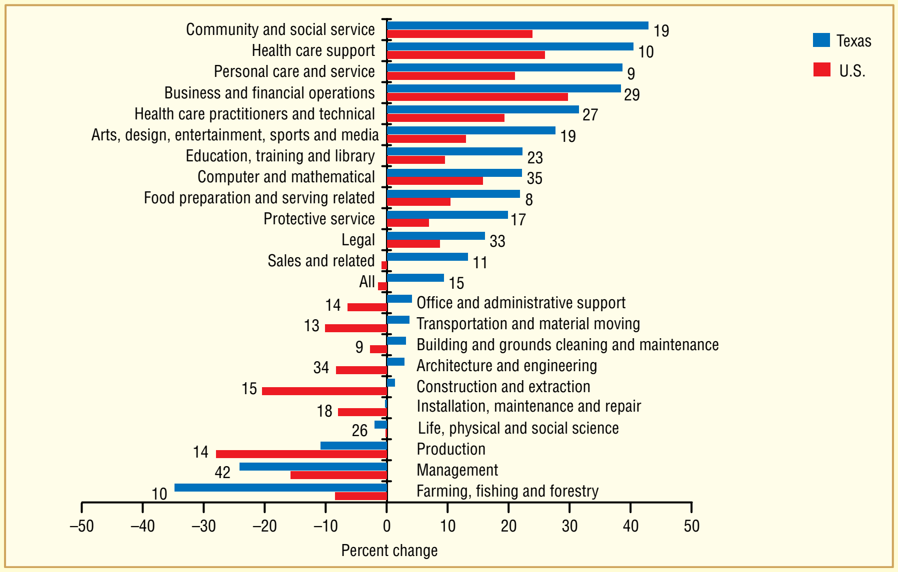
While more lower-wage jobs were created, higher-paying positions grew at a faster rate in the state, making up an increasing proportion of total jobs. Texas jobs in occupational categories with wages above the U.S. median increased 11.9 percent from 2001 to 2010, while jobs with wages below the U.S. median rose 7.9 percent. That translates to 391,000 higher-wage jobs and 470,000 lower-wage ones. Positions in occupational categories paying more than the U.S. median accounted for 36.4 percent of total Texas jobs in 2010, up from 35.5 percent in 2001.

Despite the expanding share of high-wage jobs, Texas pay started and finished the decade at about 93 percent of U.S. levels (*Chart 2*).[3] Clearly, state wages fluctuated with the business cycle, falling during the jobless recovery of 2003–04 and rising in 2009–10. While real (inflation adjusted) wages in Texas increased from $14.87 in 2001 to $15.14 in 2010, they remain below U.S. levels. The difference reflects a lower cost of living. However, Texas workers are also younger and less educated, on average, and more likely to be foreign born.

While Texas wages trail those of the U.S., job creation does not appear to be disproportionately low-wage. State trends over time resemble those of the U.S., with lower wage levels best explained by demographic differences.

—Pia Orrenius and Yingda Bi

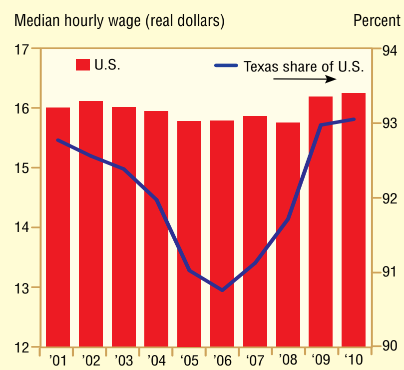
Chart 1
Texas Sees Job Growth in High- and Low-Wage Occupations



NOTES: Percent change from 2001 to 2010. Figures beside category labels are Texas median hourly wages, in dollars.

SOURCE: Occupational Employment Statistics, Bureau of Labor Statistics.

Chart 2
Texas Wages Lag Behind U.S. Pay



SOURCE: Occupational Employment Statistics, Bureau of Labor Statistics.

Notes

[1] Texas employment uses Federal Reserve Bank of Dallas employment data, while employment for the rest of the states is calculated using U.S. National Survey data minus Texas employment. Using Bureau of Labor Statistics data for Texas and the sum of states, Texas employment has grown 3.2 percent, compared with 0.7 percent for the rest of the states.

[2] Occupational Employment Statistics from the Bureau of Labor Statistics provide annual data on employment and wages by detailed occupation at the state and national levels. Wages are expressed in 2010 dollars and exclude the value of fringe benefits. Wages have been deflated using CPI-U, the Consumer Price Index for All Urban Consumers, in Chart 2.

[3] In 2010, the Texas median hourly wage was $15.14; the U.S. median was $16.27.

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