Policy brief

Investing in cities

How can the Commonwealth act to leverage private finance?

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Abstract

Tackling the climate crisis requires a radical restructuring of the carbon footprint of cities and rapid implementation of adaptation measures; however there is a huge gap in the finance needed to address these challenges. The Commonwealth Heads of Government Meeting being held in Kigali, Rwanda in June 2022, with its theme 'Delivering a common future: connecting, innovating, transforming', provides an ideal platform for discussing innovative and collaborative action by the Commonwealth to support the mobilisation of private finance for green cities. Three options for improving cities' access to private finance, that would benefit from collective action by Commonwealth members, are presented here.

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About this publication

This think piece has been prepared as part of the Africa–Europe Mayors' Dialogue with the Commonwealth Local Government Forum (CLGF). The Africa–Europe Mayors' Dialogue platform, coordinated by ODI, brings together over 20 cities across Africa and Europe to work on shared challenges. The platform's priorities include improving cities' access to finance to rapidly scale up investment in sustainable urban development. The CLGF is an international network with over 200 members in 47 Commonwealth countries. It coordinates the Commonwealth Sustainable Cities Network, which brings together Commonwealth mayors and managers to support cities and human settlements in responding to the challenges and opportunities of urbanisation.

For further detail and discussion of the academic and policy evidence see: Tyson, J. (2022) *Capital markets for cities*. ODI Working Paper. London: ODI (www.odi.org/publications/capital-markets-for-cities).

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The challenge: barriers to cities' access to private capital are high, and overcoming them is difficult for cities acting alone

The gap in city financing runs into the trillions of dollars. But cities often can't access the private finance that could close this gap. Cities can lack the mandate or capacity to raise debt and revenues, and so can't obtain credit ratings to attract private investors. International financial institutions (IFIs) typically do not provide finance at the city level, only at the national or international level, including the blended finance and guarantees which can crowd-in private finance. Where private finance is successfully accessed, it is usually as project finance. This is typically provided to finance the development, construction and operation of a specific infrastructure project, with debt repayments matched to cash flows. It is generally costly and small-scale. As a consequence, city budgets remain primarily based on public financing and own-source revenues, tailored more to the delivery of public services and recurring costs than long-term infrastructure investment.

Capital markets offer vast pools of capital – and at a lower cost and longer maturity than bank lending or project finance. Global capital markets are valued at over $200 trillion. They are dominated by institutional investors (such as pension funds, mutual funds and insurers) who require lower risk-return, long-term investments – making them ideal investor partners for cities. While cities have long-term development plans which include infrastructure priorities, many have difficulty obtaining credit ratings and meeting specialist requirements (such as certification for green or impact investments), have insufficient financial expertise and their projects are too small-scale to be suitable for capital markets. This is especially the case for smaller cities or those with limited resources, such as cities in low- and middle-income countries.

Creating a robust pipeline of projects is a key barrier. Issues include cities' capacities in project preparation. The lack of national government efforts to support cities to create a pool of these projects - and provide a pipeline of critical infrastructure projects - is also a major shortcoming.

Barriers have increased due to political and economic uncertainty, which is creating greater risk aversion in global financial markets. The effects of the Covid-19 pandemic and the war in Ukraine have created a surge in inflation. Monetary policy is tightening and negatively impacting investment, especially for emerging economies. The global political situation is highly volatile. At the same time, the need to finance the low carbon transition, resilience and climate adaptation is increasingly urgent. COP27 in November 2022 offers an opportunity to progress a positive agenda against this difficult background.

Current policy initiatives to improve cities' access to finance are delivering technical assistance, project preparation facilities and guarantees. Efforts to accelerate cities' development of bankable projects are visible through, for example, the C40 Cities Finance Facility, partnering with cities to provide technical assistance for investment proposals. The City Climate Finance Gap Fund is providing technical assistance and capacity-building to help cities develop a pipeline of climate-smart investments. The United Nations Capital Development Fund (UNCDF)'s Technical Assistance Facility is supporting cities to access capital markets through its partnership with Meridiam, fund manager of the International Municipal Investment Fund. Some intermediaries, such as green banks, have specific mandates to mobilise private finance for cities and are acting on them.

Such interventions, while welcome, have only mobilised very limited private finance for a modest number of projects. Much more needs to be done if cities' financing needs are to be met.

Three possible solutions for collective action by Commonwealth members

Summary

- **CHOGM, with its theme 'Delivering a common future: connecting, innovating, transforming', provides an ideal platform for discussing innovative and collaborative action** by the Commonwealth to support the mobilisation of private finance for green cities. A focus on green infrastructure and support for climate adaptation and resilience, guided by strong inclusive principles, is critical.
- **Three options for improving cities' access to private finance are presented:** (i) 'Double down' on existing policy initiatives for cities to achieve scale and close financing gaps; (ii) Create a collective city-focused fund for Commonwealth cities; and (iii) Tap into new 'city-aligned' green bonds and carbon credits.
- **We ask the Commonwealth Secretariat and Heads of Government to work with CLGF, Commonwealth cities and the private sector** to progress these three options, and for the UK government to support these initiatives in its year as COP Host Country. This should include welcoming partners from the private sector to work with the Commonwealth and ensure that marketable propositions are developed.

1. 'Double down' on existing policy initiatives for cities to achieve scale and close gaps

Municipal authorities and development agencies have sought to implement policy interventions to help overcome barriers to city financing. These include capacity-building focused on public financial management and improving own-source revenue collection, which contribute to making cities more credible borrowers. Regulations and legislation have also been reformed, though the regulatory environment between central and local governments remains a significant barrier for too many cities when it comes to raising finance for urban investments. National governments must do more to remove regulatory constraints and support cities to access private finance.

Some initiatives have achieved success, with the best programmes often providing a 'one stop shop' to tackle multiple barriers, including building the project pipeline. For example, UNCDF's Municipal Investment Financing technical assistance programme provides technical assistance to prepare projects, and then 'feeds' them to an independent fund manager who seeks finance for them from capital markets. Financial intermediaries including publicly owned intermediaries and 'green' banks are also connecting cities to investors. Credit guarantees and anchor capital have helped reduce risk for private investors and, hence, crowded them into deals. But they have not mobilised the scale of finance needed, and investors are reluctant to take on risk in 'secondary' cities and low- and middle-income countries.

A stronger focus on project preparation is essential. More innovative thinking is needed as to how this might be done, as the current approach, with each project being developed individually and with high levels of tailoring and in-city preparation, creates high-quality projects, but not at the speed and quantity needed. Ideas for how this might be done include using 'templates' – where projects are standardised and then replicated across cities – and greater use of digital preparation and delivery. More new ideas are needed in this area to balance scale with public buy-in.

The Commonwealth could leverage its influence to bolster 'doubling down' on these approaches, to scale and refine them in policy circles, and through their allocation of donor capital. This would include supporting greater integration of cities into national plans (such as Nationally Defined Contributions and National Adaptation Programmes). IFIs and development finance institutions (DFIs) could reform their mandates to provide finance directly to, or otherwise prioritise, cities (such as via sovereign lending). Grants should be provided for early-stage project preparation. Established city-dedicated departments at the World Bank, the European Investment Bank (EIB), the European Bank for Reconstruction and Development (EBRD), the Asian Development Bank and UNCDF could be extended, including more guarantees and seeking finance from capital markets.

2. A collective city-focused fund for the Commonwealth

A collective Commonwealth fund with a mandate to work across cities could be established to accelerate the mobilisation of private finance. This fund could provide project preparation, early-stage finance, financial structuring and access to investor networks with a mandate to serve a broad range of cities from across the Commonwealth, and to access capital markets as well as bank finance and private investment. It could be housed in an existing institution or be a new, independent intermediary.

A fund would be reliant on a sufficient number of 'finance-ready' projects being available. This needs acceleration of the project pipeline, as discussed in Option 1. But funds could also use mature assets held on the portfolios of DFIs and IFIs. Some DFIs – such as the ERBD and the African Development Bank (AfDB) – have done this. There are limits relating to, for example, preferred creditor status and scale requested by investors. But, nevertheless, this approach could be maximised within these constraints.

Key would be pooling assets across a large number of cities to allow the fund to provide securities that are attractive to institutional investors. A collective intermediary can finance individual city projects, pool them and then structure securities (such as funds, bonds and securitizations) that are attractive to investors because of the diversification benefits that such pooling brings. This could be of particular value to investors given the current uncertainty and volatility in financial markets.

Importantly for the Commonwealth, this would allow lower credit-rated and smaller cities and projects to participate, and hence to access more finance than they can when acting alone. Pooling assets from different cities with a range of different credit ratings, geographical locations and projects of varying scale and sector would allow securities to be created with diversification benefits and enhanced risk–return payoffs. Further, many small projects and cities are also an advantage in such pooled funds because they provide greater diversification benefit than a few, large assets.

This would support mobilising finance from international capital markets for cities, hence overcoming barriers for cities with undeveloped domestic capital markets. Such pooled funds are especially attractive for institutional investors in international capital markets with their more conservative risk appetite, ongoing 'search for yield' and need for commoditised investment products.

Similar financial intermediaries have already proved successful and could provide models for Commonwealth cooperation. Examples include the International Finance Corporation (IFC)'s Managed Co-lending Portfolio Programme, which has raised over $10 billion from institutional investors for infrastructure in developing countries; the International Municipal Investment Fund managed by Meridiam, which has raised more than €700 million for urban development projects; and the FCDO-sponsored Mobilising Institutional Capital Through Listed Product Structures Platform (MOBILIST), which is accessing UK capital markets for green infrastructure in low-income countries. There is also an emerging example in the UK's Cities Climate Investment Commission (UK CCIC), which is aiming to develop a pipeline of projects with major cities across the UK which can then be aggregated to attract investment into low and net zero carbon projects. There is high potential to support replication of the UK CCIC's approach in other Commonwealth countries.

Careful design and public support will be needed. In the past, some financial intermediaries have been mismanaged or poorly designed. Care needs to be taken to design a mandate that balances the needs of cities, incentives within intermediaries and the requirements of investors.

3. Tap into new 'city-aligned' green bonds and carbon credits

Globally, there has been huge growth in the green bond market in the last decade, with the market reaching $2 trillion annually. This provides an opportunity to tap into this new pool of capital to finance the transition and development of green urban infrastructure. Some cities have already seized this opportunity. Toronto has issued multiple green bonds to finance its capital projects. Cape Town, Johannesburg and Lagos – all lower credit-rated cities – have also all successfully issued green bonds. But getting green bond certification can be complex and difficult for cities, and help is needed.

Cities can also use the sale of carbon credits to unlock private finance from new sources. The Kyoto Protocol created a robust and legitimate system for carbon trading, whereby developing countries could gain certifications for cutting emissions and then sell them, generating a stream of income. The certification system was called the Clean Development Mechanism (CDM), but numerous other credible certification schemes have also emerged, whether national/supranational or voluntary schemes.

Several cities have used carbon credits certified and sold under the CDM successfully, for example to build low-carbon housing (Cape Town) and for waste-to-energy (Abidjan). These initiatives have tended to be small-scale because of the project-linked nature of the finance, and have faced significant difficulties in certifying and then selling the credits because of the complexity of the process. However, the growing market for credible carbon offsets means that this is now a viable financing source for certain types of low-carbon investments.

Mandating this focus could be combined with the proposed collective Commonwealth fund, through a mandate to raise finance from new 'city-aligned' capital, including green bonds and carbon credits. It could deliver and share expertise in green bond standards, impact certification and climate and greenhouse gas emissions certification, which otherwise is difficult, time-consuming and costly for individual cities. A financial intermediary that focuses (strongly or exclusively) on such new pools of capital – and especially green and impact investors – would be particularly valuable given the specialist knowledge required by the market and the opportunity they present.

In conclusion, while private finance can be mobilised successfully, we also need to recognise that the barriers for cities to access private finance are likely to remain substantial, especially for 'second tier' cities and for cities in low- and middle-income countries. As such, there is a significant ongoing need for direct public finance. More varied and larger-scale use of public capital for guarantees and blended finance for cities will also be needed.