


# Capital Momentum

New financing options for locally driven capital investment

**Tom Symons**



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Prepared by NLGN  
First floor, New City Court, 20 St. Thomas Street, London SE1 9RS  
Tel 020 7357 0051 . Email [info@nlgn.org.uk](mailto:info@nlgn.org.uk) . [www.nlgn.org.uk](http://www.nlgn.org.uk)

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**Tom Symons**

*July 2010*

## *Foreword*

**Local authorities face an unprecedented challenge over the next five years. We can expect substantial reductions in funding from government, limits on our ability to secure our own resources, and pressures on the delivery of core services. But this could also be a moment of opportunity: to rediscover a powerful role in leading and empowering our communities to play a greater role in influencing the full range of public sector activity in our areas, and securing new powers and flexibilities in the way we work.**

One particular challenge will be managing the reductions in capital spending. We need to retain the momentum for local investment, at a time the private sector is also severely constrained. In Newcastle, as in other cities and towns, we have made a great deal of progress in recent years. But the task of regenerating our neighbourhoods and investing in first-rate infrastructure is far from complete. We must strive to continue this work over the next five years, or risk losing not just the efforts made so far, but also our future economic capacity.

It seems clear that relying on traditional models and sources of finance will not be enough. Capital spending from central government will halve. We will need to be open for business to a recovering private sector. We should make better use of our own local assets and new sources of capital, including pension funds. And we will need to use the government's proposed review of local finance to open up new opportunities for productive and efficient investment as well as Tax Incremental Financing opportunities.

This report from NLGN, supported by the Northern Way and partners from across local government, has addressed this challenge head-on. It explores the costs and benefits of a range of pragmatic responses, including greater ability to tap into markets. It also recognises the need to maintain an adequate flow of public investment as a bedrock for recovery in the private sector. One key point that comes out from this work is the vital importance of local government's existing borrowing freedoms. The system of local prudential borrowing has proved sustainable and affordable, and has helped communities to respond flexibly to the investment needs of their areas. It is vital to maintain, if not strengthen, this important local flexibility.

Local government has a responsibility to respond to the unique demands of their communities, particularly during times of economic change and uncertainty. I welcome this report as a valuable support for this role. I hope that it not only provides an insightful reference for individual local authorities, but also helps us make the case for a more permissive financial settlement for local government as a whole.

**Cllr. John Shipley**

*Leader, Newcastle City Council*

Member of the Northern Way Steering Group

## Summary

**Britain has substantial capital investment needs, yet there are plans to decrease public sector net investment by 50 per cent by 2014 from 2009 levels. While it is important that the nation's budget deficit is brought under control, it is also important that it has a network of infrastructure capable of supporting long-term economic growth. Finding a solution to this conundrum is a worthy policy goal and this report examines whether releasing new sources of capital, which can help enable local authorities to sustain investment, might be part of its resolution. Central to this aim is a recognition that while there will continue to be capital investment over the course of this Parliament, Britain's fiscal position and the limitations of existing financing models (see *Capital Contingencies*, 2009), means that this will inevitably be limited without efforts to redesign how infrastructure is delivered.**

The recent devolutionary agenda has promoted greater local responsibility for economic development and infrastructure provision. Local authorities are now the principal agents behind steps to increase housing supply, improve transport networks, provide 21st century education facilities, promote carbon reduction and increase the international competitiveness of our cities and regions. This role is now under threat by planned decreases in capital investment. The early signals are that housing and transport are two areas likely to be hardest hit.

There is a real risk that future economic growth will be undermined by infrastructure that is unable to meet the demands of a modern, globalised economy. This provides a key imperative to find or design mechanisms that can sustain investment throughout a period of national fiscal consolidation. In the 2009 report *Capital Contingencies*, NLGN argued that while there may be limited capacity within central government during this period, delivery of new or improved infrastructure will be partly dependent on local authorities' ability to continue investment independently of the centre. The report argued that work is needed on three fronts to make this possible; making more of and improving existing approaches, generating new revenue streams and new methods of raising capital.

In this follow-up research this final strand – new mechanisms for raising capital – is explored in greater depth. An era of constrained public finances is likely to motivate the Treasury to look at all the stresses on public borrowing in order to tame the budget deficit, including the potential that current latitude extended towards local authority borrowing may be reined in. This would further limit the availability of capital to invest in infrastructure development making momentum harder to sustain. This, combined with recent changes to lending patterns in the banking sector, has prompted much speculation about alternative ways of raising finance for infrastructure, though little work has been dedicated to mapping how these might work in reality. In response this report looks at the mechanics of using pension funds, municipal bonds and local authority reserves and investments as a source of infrastructure finance. The report aims to establish whether these are viable options for local authorities, and if so what the investment vehicles should look like to enable this.

A key objective of this paper is to urge central Government to commit to protect local authority borrowing freedoms. It would be short-sighted to unnecessarily limit borrowing that leads to productive investment and strong returns in the pursuit of deficit reduction. The inherently prudential nature of local authority borrowing should be built into the new national fiscal framework as it is created, preserving the hard-won freedom of local authorities to borrow so long as it is affordable, sustainable and prudent.

### **Municipal Bonds**

Local authority or municipal bonds have clearly identifiable benefits. They increase financial oversight of a council, enhancing its project finance disciplines, and represent a level of independence and maturity that is more reflective of the changing role of local authorities. However, the more favourable lending conditions on offer at the Public Works Loan Board (PWLB), which we would urge the Government to maintain, mean that it would not be economically sound at this point to recommend borrowing at a more expensive rate, even with some of the benefits that have been identified.

It is conceivable that conditions more conducive to bond issuance may develop. For instance if the PWLB's lending conditions were to become harsher in a time of deficit reduction, as there is historical precedent for, or

if it was no longer able to meet local authority borrowing requirements due to the strain on UK gilt sales. In these circumstances the use of bonds, in particular for projects with their own defined revenue stream, may become a more viable option. In addition, by establishing the inherent credit worthiness of local authorities it may be possible to reduce further the costs of issuance, if not the costs of debt.

## **Pension Funds**

Pension funds present enormous potential to invest in infrastructure. Just 1 per cent of the Local Government Pension Scheme<sup>1</sup> would produce close to £1bn of investment opportunity for local capital projects. The ability of the sector to harness this potential is dependent on the architecture of the investment vehicle that is created to channel the funding. This vehicle must operate at a scale, size and geography that creates the delicate combination of risk, return and social benefit that is required to incentivise a pension fund to invest.

It is likely that the geography the vehicle is required to operate at is sub-regional, city-regional or regional. This would present the opportunity to generate sufficient size of offering while also presenting a sufficiently diverse range of projects to smooth out the risk profile. The technical details of the investment vehicle may need to be bespoke to enable the unqualified alignment of interests on behalf of pension funds and infrastructure investors. This therefore requires dialogue between the two to define these requirements. Efforts are needed to generate this dialogue and build the momentum necessary for this idea to reach critical mass.

## **Local authority reserves and investments**

The increasing demands on local authority reserves looks likely to preclude infrastructure investment as one of their uses. Reserves are typically either earmarked for specific purpose, or are being called in to protect frontline services and cover unforeseen expenditures such as redundancy costs. The overall level of reserves is consequentially decreasing and with cuts of up to 25 per cent looming councils may wish to retain the option of using them to plug gaps in front-line funding.

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<sup>1</sup> As valued at end of financial year 2008-09  
CLG, local government finance statistics no. 20 (2010)

Our research indicated that the demands on investments are less acute and there remains potential in the £30 + bn of local authority investments. With a sizeable quantum of these investments earning minimal interest in the Debt Management Office, it is likely that an infrastructure fund that offers a higher return with a similar liquidity would present local authorities with an attractive offer. This vehicle may require credit rating, along with a substantial number of investors to help produce liquidity. However, assuming these conditions can be satisfied there exists a potential for this to produce a solution that can satisfy many objectives simultaneously. The development of a Public Sector Deposit Fund, designed specifically for local authority investments, may present an opportunity to do this.

### **Future reform**

The scope for reform in local government capital finance policy represents a broader need for a review of financial relationship between central and local government. Through this report, and previous NLGN publications such as Pacing Lyons, Capital Ideas and Capital Contingencies, the imperative for a more facilitative and permissive financial framework for local authorities has been identified. It is therefore a broader objective of this report to make the case for greater devolution of financial responsibility and control ahead of the forthcoming Review of Local Government Finance.

### **Recommendations**

Throughout this report several key recommendations are made that we believe would give local authorities greater capacity to drive local economic development throughout a period of national fiscal consolidation.

**Recommendation:** *That the Government commits to protecting local authority borrowing freedom in the Comprehensive Spending Review or earlier.*

**Recommendation:** *A steering group should be convened to establish the appetite within the Local Government Pension Scheme funds for investing in local, sub-regional and regional infrastructure investment. The steering group should outline the key priorities and requirements of the pension funds that are interested in this opportunity.*

**Recommendation:** *Assuming there is sufficient appetite, serious dialogue with pension fund managers should be undertaken by local authorities, working at an appropriate local, sub-regional or regional scale, to determine the investment vehicle needed to attract pension investment. Following this, agreement can be reached on the type of investment opportunity the pension funds are looking for, and the projects the local authorities require financing. Work can then commence to appoint a fund manager to create a vehicle that can connect these two ambitions.*

**Recommendation:** *Groupings of local authorities, operating at a sub-regional level, or through the Core Cities Group or LGA, should investigate the longer term viability of developing a model through which bond finance could be used as an additional new and cost effective instrument for raising new capital finance.*

**Recommendation:** *That the Public Sector Deposit Fund gives active and serious consideration to the potential of the fund to invest in local infrastructure projects*

**Recommendation:** *We would urge the Government to consider Accelerated Development Zones and Tax Incremental Finance as part of its framework of local incentives to promote growth (as outlined in the Budget 2010). We also argue that capital investment should be considered as a component of the concept of growth. Having access to such financing methods would give local authorities vital flexibility and agility to sustain investment.*

## 1 *Where the capital funding reductions are falling*

**With deficit reduction deemed to be the most urgent issue facing Britain today, stringent measures have been taken to reduce government spending. It was announced in June 2010 that capital spending reductions will be even harsher than plans, outlined in the Budget 2009, for a 50 per cent decrease by 2014. The cuts to be made will impact heavily on the investment plans of local authorities, with early indication that housing, transport and schools are set to be hardest hit.**

Of the total £1.12bn of in-year cuts to local authorities announced in 2010, 30.9 per cent (£360m), were taken from capital expenditure. In addition, the coalition Government has reviewed all spending commitments agreed since the beginning of 2010, including £12bn of capital projects. Following this review, £2bn of capital projects have been cancelled and a further £8.5bn of projects suspended. Many projects which had previously had funding agreed have therefore been put on hold until the autumn spending review, with the possibility that their funding will be lost entirely. The necessity for government to reduce the country's debt directly conflicts with the desire to provide a strong, stable infrastructure for the country, with the short term measures that result from spending cuts having the potential to create long term damage if no alternative forms of funding are found.

The slashing of budgets has meant that local authorities, in addition to the planned 50 per cent reduction in capital grant, have been forced to contend with cuts of £150 million to integrated transport plans, £61 million to big transport projects, £37 million to capital and revenue for road safety. Authorities across England have been instructed to stop their spending on transport projects that have been granted either conditional approval or programme entry. As of June 2010, 63 programmes with an estimated cost of £1.6 billion have been frozen.<sup>2</sup> This is due to the £61 million cut that the major transport projects budget has to contribute to the total in year savings. Schemes frozen include the £127 million extension to the Midland Metro tram scheme, the £235m trolley bus project in Leeds and the £45m rapid

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<sup>2</sup> Local Government Chronicle, *Core Cities Hit by Transport Freeze* (11th June 2010)  
<http://www.lgcplus.com/briefings/services/transport/core-cities-hit-by-transport-freeze/5015786.article>

transit bus project in Blackburn.<sup>3</sup> The outcome of these projects is unclear, with no indication given as to which of them will continue to be given funding until the spending review is carried out. As well as the postponement of projects, the DfT has stopped accepting any new applications for funding, leaving open the question of how future projects will be funded.

It is not only major initiatives which have been affected, the Integrated Transport Block Budget which provides funding to councils for small transport improvement projects has also been cut by £150.9 million with no new funding to be released this year.<sup>4</sup> The effects of these are likely to be more immediately visible to the public than long term projects and at a time when environmental sustainability remains a public priority many of these moves counter attempts to reduce the nation's carbon footprint.

As with transport, housing has seen its budget deeply affected by cuts. The 2009 Housing Pledge promised to increase expenditure on housing by £1.5 billion in 2009/10 and 2010/11 to deliver 20,000 additional affordable housing starts. However, with Grant Shapps, Minister for Housing, claiming that 'the cash for affordable housing has run out', the future of this programme is clearly under threat. The Housing Minister has put forward calculations of a £780 million deficit in the housing budget, which has led to the evaluation of 150 housing projects to see where money can be saved.<sup>5</sup> £1 billion worth of housing and local government related projects are being assessed in order to plug the black hole in funding.<sup>6</sup>

Programmes which it has been confirmed will be cut include the National Affordable Housing Programme by £100 million, Kickstart by £50 million, Housing Market renewal by £50 million and the Gypsy and Traveller Programme by £30 million. In addition to these, further commitments to the remaining uncommitted funds will remain on hold until Government funding decisions are detailed in the Comprehensive Spending Review.<sup>7</sup>

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**3** Ibid

**4** Ibid

**5** Inside Housing, Shapps: the coffers are empty (11th June 2010)  
<http://www.insidehousing.co.uk/news/finance/shapps-the-coffers-are-empty/6510169.article>

**6** Ibid

**7** Homes and Communities Agency, Briefing Note: Impact of HM Treasury announcement on HCA spending (May 2010)

There is now significant doubt over the availability of funding for the Building Schools for the Future (BSF) programme following a decision by the coalition Government to freeze all funding for any scheme not already at the 'financial close' stage. The BSF initiative aimed to rebuild or renew every secondary school in England as part of a commitment to provide 21<sup>st</sup> century education. The freeze on funding will affect 700 schools and is expected to save the Government £1 bn per year.<sup>8</sup> Though the programme has been criticised for its burdensome bureaucracy and top-down approach, some councils have voiced their hopes that the school building plans can continue.<sup>9</sup> However, with limited finance headroom available in central government budgets, there is great uncertainty over the ability of local authorities to invest in schools projects where they are most needed.

### **The Emergency Budget 2010**

The small solace for local authorities is that the Emergency Budget 2010 did not outline any capital spending reductions other than those that have already been announced as part of the £6.2 billion of savings in 2010-11, in addition to commitment to protect the most productive public sector investment. It also makes clear that the level of traditional public funding will be insufficient, calling for 'private' capital to fill the gap wherever possible, with public funding only used where it is not possible to do this. This demonstrates that new approaches and new sources of finance will be vital.

The Budget outlines that the Government intends to publish a national infrastructure plan that will define the UK's infrastructure goals in the spending review 2010. The National Infrastructure plan represents an opportunity to take into account the vital role of local authorities and give scope for them to be able to plan effectively for the long-term infrastructure needs of their communities. The sector would benefit greatly from certainty about the capital funding landscape within which infrastructure will be delivered. If the levels and sources of capital finance and the types of delivery model to which the Government is amenable are clarified by this plan, in addition to medium-long term commitment on the level of capital funding

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<sup>8</sup> LGC, Michael Gove to announce school building cuts (5<sup>th</sup> July, 2010) = <http://www.lgcplus.com/briefings/services/childrens-services/michael-gove-to-announce-school-building-cuts/5016793.article>

<sup>9</sup> LGC, Councils seek to maintain BSF work (7<sup>th</sup> July 2010) = <http://www.lgcplus.com/briefings/joint-working/education/councils-seek-to-maintain-bsf-work/5016904.article>

available from central government, local authorities would be in a far stronger position to plan their future investment.

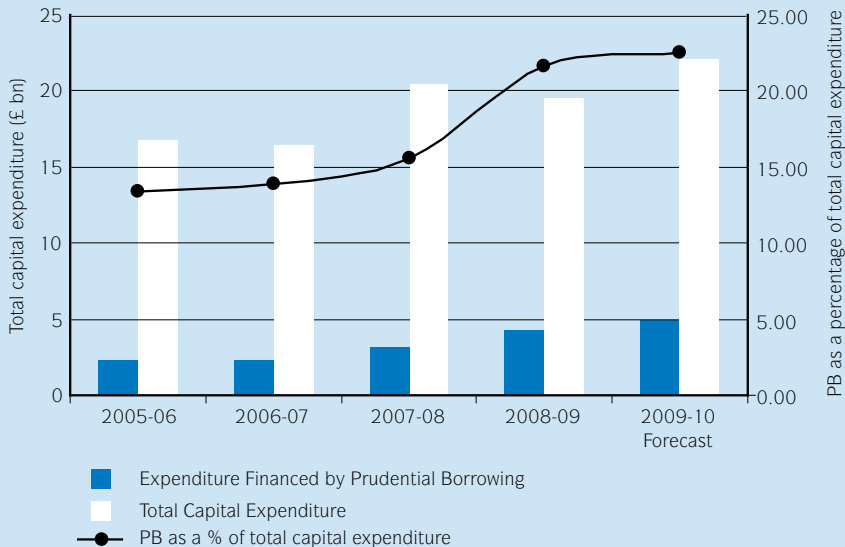
### **New sources of capital may be needed**

With the overall level of capital spending drastically reduced, it is clear that local authorities are going to have to become more adventurous in exploring other options to raise investment capital rather than relying on government grants. This is of high importance so that projects are not abandoned part way through, or fail to even be started in the first place. Where there is the opportunity to utilise new sources of finance to save projects these must be taken advantage of, as it is clear that in this difficult financial situation the government is no longer able to guarantee the necessary support for projects.

## 2 *Local authority borrowing freedoms*

Where there is constraint within central government preventing investment in capital works, alternatives exist for local government to act independently of the centre to sustain investment. By using the prudential borrowing powers enshrined by the Local Government Act (2003) councils are able to raise debt from any source provided that it is affordable, sustainable and prudent. The prudential borrowing regime replaced a system of formal credit controls, by which central government had explicit power to limit local authority capital investment, and provides councils with a more permissive landscape to operate within. The local economic impetus required to continue vital infrastructure investment will be dependent on the ability of local authorities to borrow freely and independently of central government.

**Figure 1** Expenditure financed by prudential borrowing and total capital expenditure



Source: CLG *Local Government Financial Statistics England No. 19 & 20* (2009, 2010)

As figure 1 shows prudential borrowing has been growing as a percentage of total capital spend by local authorities since its introduction in 2003. In 2008/09 it accounted for 21.64 per cent of all capital expenditure, up from 13.4 per cent in 2004/05.<sup>10</sup> This demonstrates the growing independence and maturity of local authorities, as well as the changing profile of infrastructure investment.

The Public Works Loan Board (PWLB) is part of the Government's Debt Management Office (DMO) and functions as a lender of last resort to local authorities. Its interest rates are determined by the DMO on behalf of HM Treasury. It on-lends from UK Government via the National Loans Fund, at approximately 0.2 per cent over the yield on a UK gilt. This provides the cheapest form of debt available to local authorities. The PWLB states in its lending conditions that it aims to meet the borrowing requirements of local authorities up to their legal borrowing limits.<sup>11</sup>

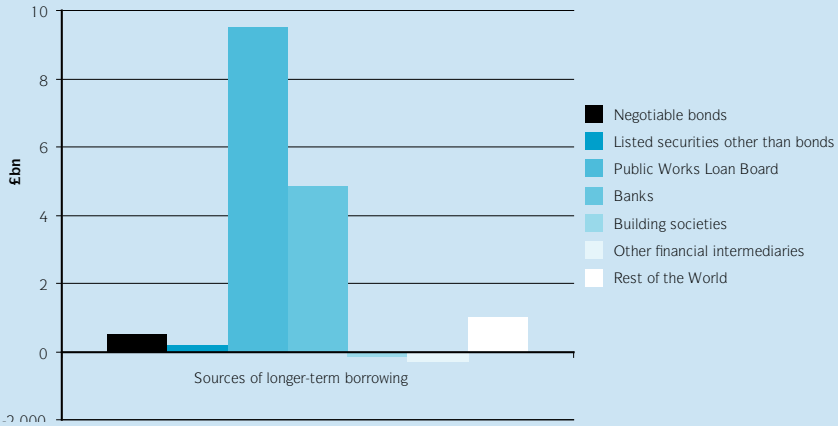
Figure 2 on the following page demonstrates that the PWLB is the primary source of borrowing by local authorities, accounting for £9.5bn between 2004-2009 and representing 59.6 per cent of the total amount borrowed. Borrowing from banks accounted for £4.5bn, 30.7 per cent of the £14.7bn borrowed in total. The PWLB has therefore been the preferred source of borrowing, but is by no means the only source. This indicates that there are a range of factors to be considered by local authorities when accessing borrowing, of which interest rate is an important but not sole factor. Local authorities also wish to have a diverse portfolio of debt, avoiding reliance on any single source of borrowing.

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**10** CLG *Local Government Financial Statistics England No.20 2010* (2010) - N.B Forecast figures for 2009/10 are from *Local Government Financial Statistics England No. 19* (2009)

**11** UK DMO PWLB lending conditions (26th April 2010) - <http://www.dmo.gov.uk/documentview.aspx?docname=pwlbircular144.pdf&page=>

**Figure 2** Sources of local authority long-term borrowing for capital expenditure 2004/5 -2008/09



Source: CLG *Local Government Financial Statistics England No.20* (2010)

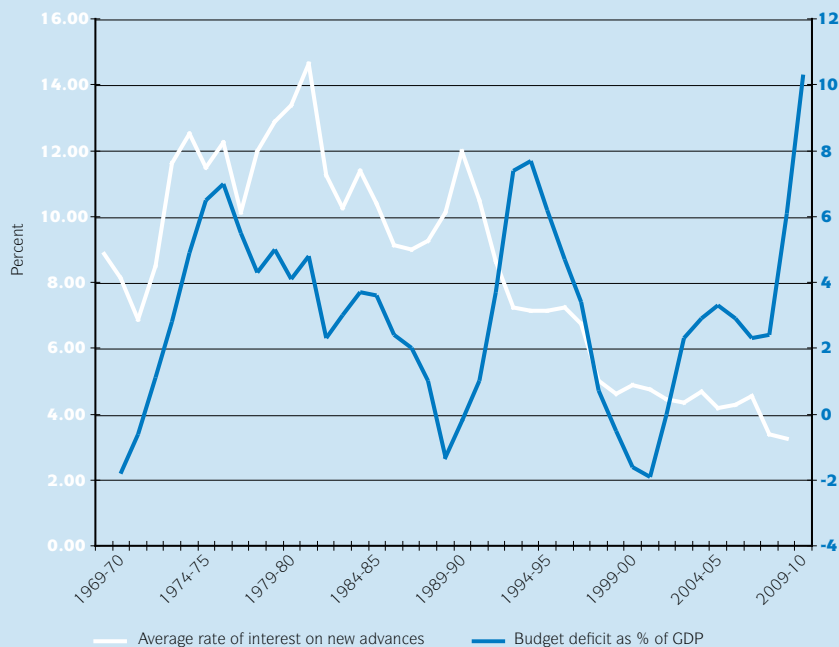
As its lending conditions imply, there is no limit on the amount that can be borrowed from the PWLB by local authorities, other than that which is specified within their prudential borrowing limits. The diversification of debt is therefore an indication that even though the PWLB represents the cheapest form of debt, there may be other sources of debt that are preferable to it in certain circumstances. For instance debt can only be taken from the PWLB on a fixed-rate basis, which may not be preferable for local authorities if rates are particularly high at the time of borrowing and expected to decrease in the short to medium term.

### The future of local authority borrowing

During times of fiscal consolidation national governments typically try to limit activities that add strain to the national balance sheet. Local authority borrowing for capital projects is a contributor to the balance sheet, and has previously been targeted by central government when working to tame a budget deficit. As figure 3 shows, between 1975-90, the lending conditions offered by the PWLB were high, almost always above 10 per cent. This

coincided with a period in which central government made specific and concerted attempts to curb its budget deficit. A key strand of this strategy was controlling expenditure by local authorities.<sup>12</sup> Since 1990, after sustained decreases in the budget deficit, the PWLB has gone on to lend at much more favourable rates, to the benefit of local investment.

**Figure 3** Graph showing average yearly interest rates on new advance loans from the PWLB with the annual budget deficit as a per cent of GDP



Source: PWLB *Amounts outstanding and rates* (2010), HM Treasury *Public Sector Finances Databank* (27 May 2010)

It is conceivable that local authority borrowing could be targeted in the lifetime of this parliament. This could be done either through a national cap on all borrowing by local authorities, as legislated for in the 2003 Local

**12** Gordon, Travers and Whitehead, *Local Authorities and the Downturn: a review of issues, experience and options* (2008) p. 2-3

Government Act, or via harsher lending conditions at the Public Works Loans Board (PWLB). The Budget 2010 revealed that “to ensure the fiscal risks around local authority borrowing decisions are better understood, the Government will monitor lending from the Public Works Loans Board more closely”<sup>13</sup>. It is reasonable that the Government needs to have a greater understanding of when finances borrowed from the PWLB will be spent in order to make fiscal forecasting more accurate. However, it would be a regressive step if the closer monitoring was to lead to adverse changes in lending conditions to local authorities, bearing mind the intrinsically prudential nature of this borrowing.

A restriction by central government of local government’s borrowing freedom, in addition to the halving of capital grant, would be highly detrimental to capital investment needs in local communities.

**Recommendation:** *central government must commit formally to the protection of local authority borrowing freedoms*

The primary objective of this report is therefore to argue for the current borrowing freedoms enjoyed by local authorities, as a minimum, should be protected. In *Capital Contingencies* we argued that in constructing a new fiscal framework, the Government should take account of the inherently prudential nature of local authority borrowing. The argument that it would not be economically sound for Government to reduce its national debt by limiting local authority borrowing that funds productive investment and creates an economic return is restated here. The Government must make provision within its new fiscal framework to protect local authority borrowing. This would give councils greater assurance over their future capital investment plans, and would not block projects with high economic viability from proceeding.

Over the coming years local authority borrowing will be integral to efforts to sustain capital investment. There is potential that the PWLB may not be able to lend either as freely or as generously over the coming years. This may require councils to diversify their borrowing even further. It is therefore worthwhile to investigate whether there exist alternative sources of finance that present local authorities with an enhanced selection of borrowing options than currently exists.

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<sup>13</sup> HM Treasury *The Budget 2010* (June 2010)

### 3 *Municipal bonds*

The concept of municipal bond issuance has pertinence both historically, within the UK, and comparatively across local government finance frameworks in other developed economies. Bond finance is one of the principal methods of funding infrastructure in countries such as the US, the Netherlands and Sweden, but as a financing tool for local authorities has lain dormant in the UK for the past two decades. Bonds therefore present a logical starting point for consideration of different sources of capital for local authorities in the UK, should changes in borrowing conditions outlined in the previous chapter necessitate alternative options. NLGN has previously identified a number of the benefits, and challenges, stemming from municipal bond issuance. This provided the context for the research seminar discussion about the viability of bonds and how they might be made a realistic policy option for local authorities.

The seminar discussion focussed on three main strands of discussion;

- What is the value of issuing bonds when debt can be accessed more cheaply at the PWLB? What would be the benefit?
- Which types of project would be most suitable for bond finance?
- How could the costs be brought down to make this a more viable option?

#### **Why use bonds when local authorities can go to the PWLB?**

*“We should focus on the practical elements of discussion. My authority borrowed about £80 million in the summer from the PWLB, with differing rates, differing maturity, very good rates and it was very easy to do. If we are going into issuing bonds ... there has to be a significant win.”*

#### **Seminar participant**

In a time of fiscal constraint the cost of debt must be a primary consideration, and if this was the only or over-riding factor the PWLB represents the most cost-effective option for local authorities. It would not

be sound economics to advise borrowing at a more expensive rate than is necessary without there being a compelling financial argument in its favour.

*“The discipline < of bond issuance > is one of the advantages that you could argue you don’t necessarily get in the prudential borrowing because you’re not tested.”* **Seminar Participant**

*“You have certainly got to raise a lot of money < for certain projects > and the attraction < of bonds > is not just the discipline to think through ‘what is the optimal project’, it’s to de-risk it to the maximum extent, in other words to think through as the Germans do about how we can accelerate the rate of building. When we compare British schemes to continental schemes you find that they have a 3-5 times faster speed so you are getting the money repaid much quicker.”* **Seminar participant**

The research seminar identified a number of benefits of bond issuance, and these principally related to the scrutiny and over-sight that is offered by the process of raising the debt through market operations rather than the PWLB. Running a credit rating, and asking investors to make a decision about the credit worthiness of an offering, exposes an organisation to external scrutiny which forces greater discipline on project selection and execution. It places a necessity for there to be certainty on the capacity of the organisation and the quality of the project to keep a revenue stream to service the bond, as well as able to make repayment of the bond at the maturity date. Such disciplines will in theory make over-runs and over-spends less likely, in addition to weeding out any projects that are not completely essential. In an ideal world these are disciplines that should not be contingent on the way the debt is raised, and enhanced project management capacity within local government should be targeted in any circumstance. However, there was consensus that these are the benefits offered by bond issuance that are not forthcoming when borrowing from the PWLB. In addition to benefits of discipline, there is a broader political appeal presented by bonds in their symbolism of independence.

The table below shows the average costs of borrowing from the PWLB, compared with the costs of some recent bond issuances by public institutions, as a means of demonstrating how much more expensive bond finance may be as a form of debt. It shows that TfL bond issuance has a yield typically between 0.29-0.38 per cent over the rate of interest of borrowing

from the PWLB. Network Rail, a public sector organisation that is Triple A rated, due to the explicit financial guarantee offered by the Secretary of State for Transport, has issued bonds that have been between 0.09 and 1.26 per cent over the cost of borrowing from the PWLB. As TfL and Network Rail both have high credit ratings, it would seem likely that local authorities would not be able to issue bonds any more cheaply than this. Housing associations, which are without a guarantee of government backing, have issued bonds to invest in new housing. RSLs are typically rated AA- and have offered yields on bonds of 6-7 per cent, roughly 1.5-2 per cent over the interest rate from borrowing at the PWLB. Though RSLs are not able to borrow from the PWLB, this provides an informative comparison and reflection of the different market conditions post-2008 which local authorities may also have to contend with if issuing bonds.

Issuer	Bond Value (m)	Length (years)	Year	Credit Rating - S&P	Credit Rating - Moody's	Coupon/ Yield (%)	PWLB equivalent (%)	Difference
Imperial College	£50	30	2002/03	Private placement	Private placement	5.39	4.43	0.96
TfL	£200	30	2004/05	AA		5	4.69	0.31
Network Rail	Avg of total issuance		2004/05	AAA	Aaa	4.78	4.69	0.09
Network Rail	Avg of total issuance		2005/06	AAA	Aaa	4.82	4.19	0.63
Network Rail	Avg of total issuance		2006/07	AAA	Aaa	4.85	4.29	0.56
Imperial University	£50	50	2006/07	Private placement	Private placement	4.84	4.29	0.55
TfL	£200	25/36	2006/07 – Dec.	AA		4.6 / 4.5	4.29	0.31/0.21
TfL	£200	25	2006/07 – Mar.	AA		4.5	4.29	0.21
Network Rail	Avg of total issuance		2007/08	AAA	Aaa	4.93	4.55	0.38
Network Rail	Avg of total issuance		2008/09	AAA	Aaa	4.63	3.37	1.26
Circle Anglia Housing Association	£275	30	2008/09	N/R	Aa3	7.25	4.45	2.8

<b>The Housing Finance Corporation Funding No1.</b>	£80	27	2008/09	AA-	N/R	5.96	4.45	1.51
<b>Affinity Sutton</b>	£250	30	2008/09	N/R	Aa2	5.98	4.45	1.53
<b>PfP Homes</b>	£180	15	2008/09	AA-	Aa2	6.92	4.2	2.72
<b>Sanctuary</b>	£200	30	2008/09	AA-	Aa2	6.64	4.45	2.19
<b>London and Quadrant Housing Association</b>	£300	30	2009/10	AA-	Aa2	5.55	4.4	1.15
<b>The Housing Finance Corporation Funding No2.</b>	£191	30	2009/10	A+	N/R	6.35	4.4	1.96
<b>Sovereign Housing Capital</b>	£175	30	2009/10	AA-	Aa2	5.71	4.4	1.31
<b>Gen Finance ii PLC</b>	£250	30	2009/10	N/R	A1	6.06	4.4	1.66
	*Average yearly rate of interest on all loans							

In addition to these increased costs of debt, issuing bonds entails fees and other costs that are not incurred when borrowing from the PWLB or directly from a bank. These include the maintenance of a credit rating with at least one agency, costing approximately £25,000-50,000 per year per agency, and the costs involved with issuing a bond to the markets, due diligence and attracting buyers, approximately £500,000-1,000,000 per issuance. As a percentage of a total bond issuance of for instance £200m these are relatively small figures, but still represent large sums of money when there is a squeeze on all areas of council finance.

It is therefore a decision to be taken locally by councils about which source of finance best suits their needs. At present, despite their benefits, with the costs of issuance and the increased costs of debt unavoidable, bonds may be considered unaffordable by councils making significant spending reductions in other areas. Repayment of borrowing forms part of the local government revenue budget, and competes with expenditure on other service areas.

Each percentage point in debt costs over that of the PWLB therefore has an opportunity cost of that money not being spent on adult social care, waste disposal or road gritting, for example.

A more independent financial settlement for local authorities, as has been advocated in the past in, for instance, the Lyons Review, may make the concept of bonds more relevant. Such a direct relationship with financial markets and self-determined borrowing would represent a degree of maturity and independence currently not enjoyed by English local authorities, removing the otherwise implicit central government influence.

### **Future Circumstances**

While it seems clear that as things currently stand, with the PWLB still able to fund freely and cheaply, municipal bonds may not be viable as a source of borrowing for the majority of local authorities, there are identifiable scenarios by which there may be more justified usage. The PWLB could become a less favourable source of finance for two reasons:

- the interest rate is effectively controlled by HM Treasury, who may force the rates up in an attempt to further curb the strain on the UK's net cash requirement and reduce the budget deficit.
- the PWLB is no longer able to meet the full financing requirements of local authorities

In addition, there may be a strand of this discussion that remains relevant despite some of the challenges outlined above. There is the possibilities for schemes that have strong revenue generating potential to be funded via bonds that are issued through joint venture companies. If the requisite risk share can be achieved this may take the investment 'off balance sheet'.

It is the case that in some instances it is desirable to de-politicise investment decisions so that their viability can be based predominantly on sound economic analysis. Where there is pressure on governments to decrease capital expenditure this may prevent even the soundest investment opportunities from going ahead. In these instances it may be beneficial if the scheme can be taken 'off-balance sheet' to enable it to continue. Bonds issued by joint venture companies may therefore provide a mechanism for

doing this, provided that the vehicle is 50:50 deadlocked with no overall public share of ownership.

In light of these potential circumstances, some of the more practical aspects of bond issuance are worth exploring.

### **Types of project most suitable**

The constrained nature of public finances in the short-to-medium term, and the slightly more expensive form of debt, makes projects with a clearly derivable revenue stream more applicable to the process of bond issuance. The seminar found a degree of consensus that efforts to increase the use of renewable energy and decrease the centralisation of energy and power generation, for instance the Renewal Energy Strategy (2009) - by implication creating a role for local authorities - could also be a way for councils to isolate revenue streams that help pay for projects. Combined Heat and Power generators, for example, would enable local authorities to trade surplus heat to local citizens or businesses, as a form of income generation. Such projects may also benefit from government subsidy or other legislation designed to address the lack of cost competitiveness of local energy generation. This area was identified as being particularly receptive to the process of bond issuance.

It was also noted that affordable housing built by Residential Social Landlords (RSLs) has been an area dominated in recent years by bond issuance. The combination of large projects, creating a market-ready scale, with stable, assured income streams and government subsidy or funding has provided an environment in which bond finance has been one of the primary methods of finance for RSLs (see for instance London and Quadrant, Circle Anglia and Affinity Sutton). With a commitment from the Housing minister Grant Shapps in June 2010 to continue consultation on housing finance reform, with the intention that local authorities would then be in a position that enables them to build social housing on a large scale, this is another area of interest for councils, should there be changes in borrowing conditions at the PWLB.

### **Reducing the costs of debt**

As one of the principal objections to the use of bonds is the increased costs, there was discussion in the research seminar about whether there might be reasonable ways of reducing these costs. It is highly unlikely that, even with a

Triple A rating, the coupon or yield on the bond could ever be as low as the cost of borrowing from the PWLB, but there may be ways of reducing some of the other costs associated with an issuance.

Maintaining a credit rating costs approximately £25,000-£50,000 per year per agency. In the case of TfL, two credit ratings are maintained. While there is implicitly government backing of local government, would it be possible to establish irrevocably the credit rating of local authorities so that this is an expense local authorities would be freed from? The Local Government Act (2003) states that, in the event of a default on payment:

*(7) The High Court may confer on a receiver appointed under subsection (5) any powers which the local authority has in relation to:*

- (a) collecting, receiving or recovering the revenues of the local authority,*
- (b) issuing levies or precepts, or*
- (c) setting, collecting or recovering council tax.*

This explicit guarantee for lenders to local authorities could be interpreted as a substitute for a credit rating. It ensures that no lender to a local authority would be unable to recover their money, and if necessary would be given access to council tax income to complete repayment of the principal. If bonds were to be pursued on a reasonable scale by a number of authorities, it would be valuable to establish definitively, through open discourse with all relevant parties, whether this legislation would act as a legitimate substitute for a credit rating.

A repercussion of this could be a limit on the size of bond that a local authority is able to issue. The sums to be considered in the event of default could be so high that they effectively put a local authority out of business. TfL has been able to issue bonds of £200m on three occasions, but in the absence of similarly sized operating budgets local authorities may have to contemplate smaller issuances or aggregated issuance.

### **Aggregated issuance**

It is conceivable that bond issuance would only be viable if done on a large enough scale. Aggregation would enable collections of authorities to pool their borrowing and issue a bond jointly. This would enable them to issue

a bond of sufficient size to attract market interest, while still borrowing in proportions that do not threaten the council's overall financial position. There are conceivable methods of doing this, for instance across a Local Enterprise Partnership. In the longer term it would be beneficial for large groupings of local authorities to look into the viability of aggregated issuance as a model of funding future economic development.

**Recommendation:** *Groupings of local authorities, operating at a sub-regional level, or through the Core Cities Group or LGA, should investigate the longer term viability of developing a model through which bond finance could be used as an additional new and cost effective instrument for raising new capital finance.*

There is much cross-over between this and with the discussion that follows in the next chapter about pension fund investment. For further discussion of aggregation across different spatial levels, see p. 16 onwards.

## Conclusion

Bonds represent an option that does not currently have sufficient viability where the PWLB still operates with generous lending terms. Though there exists some interest in revenue-generating projects that may be suitable for public-private, off-balance sheet, joint ventures, the overall analysis is that the price of issuing a bond is currently prohibitively high.

The conditions that would make municipal bond issuance viable are therefore:

- parity in lending conditions between PWLB and bond issuance. Either through harsher lending conditions or lower limits at the PWLB, or through more favourable conditions at the PWLB
- establishment of inherent credit worthiness of local authorities, perhaps without the need for a credit rating
- a sustainable income stream

A future scenario that sees councils given greater financial independence might also entail the use of municipal bonds. There may be many benefits that are realisable from this approach, but before this there would need to be a different financial relationship arranged between central and local government.

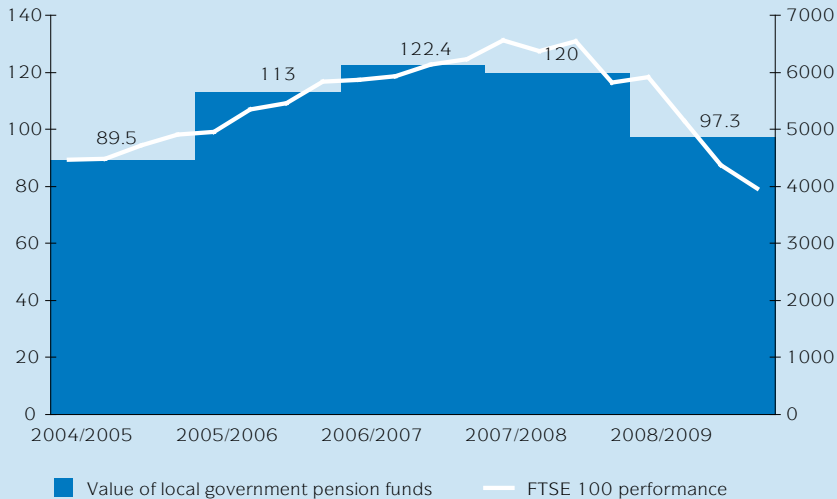
## 4 *Pension funds*

### Introduction

**Pension funds are increasingly seen by some as a solution to potential capital funding constraints in local government. Linking pension funds to infrastructure investment is now considered in some quarters to be a ‘win-win’ scenario, pairing neatly aligned interests and in the process promoting wider social benefits. Pension funds are long-term investment vehicles comprising a diverse range of assets. Infrastructure requires investors willing to take a long-term-view and stable returns that lie between equities and fixed income investment. In addition, it is an alignment that produces wider benefits through its implicit support for local public works, leading to job creation and economic stimulus. At present there is limited opportunity for this to happen. The question is what is required for local authority pension schemes to support local infrastructure while also gaining a return that can assist a pension fund in reducing its deficit?**

The recent volatility in the equities market has reinforced the need for pension funds to have diversified portfolios. The graph below demonstrates the extreme fluctuations witnessed in share prices over the past 5 years. With the majority of pension funds invested in equities, every fluctuation has a corresponding impact on the asset value of the scheme and by extension its ability to meet its liabilities. The value of the LGPS has risen and fallen in accordance with this. The travails of the BP share price in 2010 and subsequent uncertainty over dividend payouts is a further example of the unsuitability of pension fund investments being so dominated by this asset class. Infrastructure theoretically provides a logical counterpoint to the fluctuations experienced with equities. Though equities are also a long-term investment, their short-term volatility can make the actuarial assessment of pension fund deficits look unnecessarily severe, and there would be great benefit in having a portfolio that is subject to less volatility.

**Figure 4** FTSE 100 performance compared to the value of local government pension funds 2004-2009<sup>14</sup>



Moving towards a higher allocation of funds into the infrastructure asset class has been the subject of considerable focus in recent years, with politicians and senior industry figures arguing the necessity for pension funds to play a key role in local infrastructure finance while Government is unable to fund future infrastructure expenditure fully. Reducing the national budget deficit will have clear implications for the ability of central government to undertake capital spending. In addition, the capacity within the banking sector to lend to infrastructure projects is likely to be curtailed by a requirement to have higher capital ratios. This has led to the Chief Executive of Infrastructure UK, James Stewart, to call for the creation of a “new financial instrument” for pension funds to invest in strategic infrastructure, such as energy projects, waste, transport and communications.<sup>15</sup>

<sup>14</sup> FTSE 100 data: <http://www.wrenresearch.com.au/downloads/>

LGPS data: CLG - *Local Government Pension Scheme Funds England* (2009)

<sup>15</sup> Nicholas Timmins, Pension funds recruited for capital projects, *Financial Times* (January 25th, 2010) - <http://www.ft.com/cms/s/0/696c74b6-0a19-11df-8b23-00144feabdc0.html>

Opportunities already exist for pension funds to invest in private sector-run infrastructure funds, utilised by both public and private sector pension funds. These are typically funds aggregating infrastructure projects from around the world and there is limited scope to target this investment at specific localities. However, there is currently no mechanism for local government pension funds to invest directly in pooled infrastructure provided by English local authorities and related sub-regional and regional agencies. In March 2010, just 0.7 per cent of the UK's total pension fund assets were invested in infrastructure, indicating the lack of attractive investment opportunities for superannuation funds and the scale of untapped potential that exists.<sup>16</sup>

Several funds in charge of council pension schemes, such as Kent County Council and the London Borough of Ealing, have recently issued mandates to invest in infrastructure funds, indicating that there is growing appetite for the infrastructure asset class within the LGPS. A direct link back to the promotion of economic growth within a particular funds locality adds further rationale and likelihood that with the correct offer investment could occur. At the end of the financial year 2008/09 the LGPS had total assets of £97bn. Just 1 per cent of this would be close to £1bn and would provide considerable financial weight to infrastructure schemes under threat from spending cuts. The question our research focussed on was how could this 1 per cent be linked up with the infrastructure plans of local authorities?

### **What would be needed to bring in 1 per cent of the total LGPS?**

The research seminar found consensus that the logic behind superannuation fund investment in infrastructure as part of diversified investment portfolio was sound. This is not to argue that infrastructure presents a risk-free route to investment returns and there was acceptance that the fiduciary responsibility of pension fund managers and the management of conflicts of interest were the principal concerns. These notwithstanding, no legislative or regulatory hurdle could be identified that would prevent investment by the LGPS in local capital projects. It was reasoned that this is a combination that has not occurred in the past because up until 2010 there has been no pressing need for it to happen, and many of the immediate objections, such as the potential conflict of interest, appear too difficult to reconcile. The

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<sup>16</sup> Investment and Pensions Europe, *UK Government Targets pensions for infrastructure funding* 15<sup>th</sup> March 2010 - [http://www.ipe.com/news/uk-govt-targets-pensions-for-infrastructure-funding\\_34386.php](http://www.ipe.com/news/uk-govt-targets-pensions-for-infrastructure-funding_34386.php)

imperative for Government to reduce the national budget deficit while also supporting capital investment may now provide this impetus.

Translating the theory of the pension fund-infrastructure finance link into reality offers a number of tensions that must be worked through for this to be a viable option. There are a number of objections to the idea,

- the risk-return profile is not adequately balanced
- local investment presents a 'conflict of interest' problem
- pension fund investment is illiquid
- political risks through potential regulatory or legislative reform
- unrealistic entry prices

The first two of these objections are the most fundamental, and without resolution this option would struggle to become viable. There was consensus that pension fund investment requires a suitable investment vehicle to channel it. The architecture of this investment vehicle is felt to be the answer to many of the objections encountered, and the two major challenges of risk/return profile and conflict of interest. To make this into an option that can happen in reality, the vehicle must address the three major elements of the investment decision; the philosophical, the structural and the economic. In other words, the vehicle needs to;

- change the mind-set of LGPS fund managers so that investment and infrastructure is seen as desirable.
- provide a mechanism that can diffuse risk sufficiently and remove the conflict of interest objection
- provide a rate of return that is optimal for the pension funds investment strategy

### **Creating an investment vehicle that can remove barriers**

Superannuation fund investment in infrastructure globally typically involves the formation of infrastructure funds. These use pension fund investment to finance projects, paying a return to the pension funds and any other

investors that is generated through use of the infrastructure asset. Our research seminar indicated that this would be the most practicable approach for local authorities to take in the UK. The vehicle must be capable of packaging a number of schemes into one fund, spreading the risk of the projects evenly and presenting fund managers with a product with a reduced risk profile than that possessed by a single project. The investment opportunity must also be of sufficient size to make it a viable proposition. In addition to due diligence costs, pension funds may have quotas about the minimum percentage of assets they are willing to invest, requiring the offer to be able to match this. The first question to answer therefore must be; what is the correct geography to both minimise risk and present a scale conducive to investment?

### **Finding the right geography and size/scale**

The investment opportunity must be substantial enough to tempt pension funds in, while also remaining small enough for all of the investments to be directed at local infrastructure creation. Recent mandates from some local authority pension schemes provide indication of the amount funds may be willing to invest. Kent County Council's £2.2bn scheme proposed putting £50m into infrastructure funds, or roughly 2 per cent of the total fund value. Similarly, LB Newham issued a mandate to invest £30m of the funds assets into the infrastructure class. For larger schemes 1-2 per cent of total assets may be a viable option, for smaller schemes the percentage may need to be slightly higher. A mandate of £50m from a larger scheme may be enough for an infrastructure fund to operate with, but this may be the bare minimum and may not enable diversification of investment options. Alternatively the fund could look for similar investments from other funds to create a fund of over £100m, enough to invest in a range of different projects.

Finding the correct geography to fit this scale, while also ensuring there is an adequate diversification of infrastructure schemes to reduce risk, is a major challenge for the infrastructure vehicle to address. It may be that the differing needs or requirements of pension funds, coupled with the differing infrastructure plans of particular spatial areas, means that there are multiple geographies at which this could work. The fundamental requirements of the vehicles operational geography are that it can:

- aggregate schemes together into a sufficiently large investment opportunity
- find enough schemes to diversify and minimise risk
- retain a guaranteed link back to the localities of the pension funds
- provide some degree of local control

The table below weighs up the advantages and disadvantages of some of the potential geographies the investment vehicle could operate at. There may also be additional collaborations possible, for instance if the Core Cities group were to put their infrastructure plans together into a single investment vehicle.

Tier/geography	Advantages	Disadvantages
<b>Local</b>	<ul style="list-style-type: none"> <li>• social responsibility through direct link to promotion of local economy</li> </ul>	<ul style="list-style-type: none"> <li>• conflict of interest</li> <li>• higher risk</li> <li>• greater return needed</li> <li>• difficult to reach correct scale</li> </ul>
<b>Sub-regional / City-region</b>	<ul style="list-style-type: none"> <li>• geographic alignment with many pension funds, especially metropolitan counties</li> <li>• risk diversification without losing local connection</li> <li>• collaboration possible through existing architecture of MAAs/LEPs, ITAs</li> </ul>	<ul style="list-style-type: none"> <li>• scale may still be too small depending on the size of the sub-region and the nature of the investment</li> </ul>
<b>Regional</b>	<ul style="list-style-type: none"> <li>• reaching correct scale easier</li> <li>• existing regional architecture could be used to facilitate</li> <li>• diverse range of schemes available to reduce risk</li> </ul>	<ul style="list-style-type: none"> <li>• harder to secure collaboration</li> </ul>

<b>National</b>	<ul style="list-style-type: none"> <li>• risk spreading through diversification</li> <li>• lower return possible</li> <li>• large funding possibility</li> </ul>	<ul style="list-style-type: none"> <li>• loss of control through central government involvement</li> <li>• difficult to ensure investment is returned as local benefit</li> </ul>
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Attempting to create an infrastructure vehicle at a local level encounters major conflict of interest problems that can only be resolved by enlarging the geography of the vehicle. Similarly, it is far harder to create the correct scale at a purely local level and difficult to find enough schemes to spread the risk out. The local level does not appear to present a feasible geography at which to design an infrastructure fund. At the other end of the spectrum, a national-scale infrastructure fund would avoid these problems but presents its own difficulties. A fundamental principle from the local authority perspective is to ensure that there is some economic benefit to the locality of the pension fund. A national vehicle would fail to guarantee this connection is made. There is also a risk that control is lost by local authorities through a national vehicle. As much of this discourse centres on local economic activism that is responsive to divergent geographic needs, a national fund may not have sufficient flexibility to meet these needs. The local and national level are the more problematic geographic scales for the investment vehicle to operate at.

The sub-regional tier may present opportunities to build on much of the collaboration that has occurred over the past decade. Sub-regional collaboration is designed to reflect the functional economic geography of people's work, consumption and travel patterns. It follows that some infrastructure investment, for instance in transport or housing, is also conducted at this level. The sub-regional tier may present an appropriate geography for an investment vehicle. Along with the formation of MAAs, metropolitan areas also have Integrated Transport Authorities (ITAs) which operate at the same tier and co-ordinate transport investment. In some parts of the country, these organisational geographies are matched by pension funds, for instance in the metropolitan counties. It could therefore be apposite, for example, the South Yorkshire pension fund to direct investment into a vehicle that operates at the same tier, providing finance for the South

Yorkshire ITA. Alternatively, MAAs or ITAs could collaborate to draw in funding from a vehicle that operates across multiple sub regions.

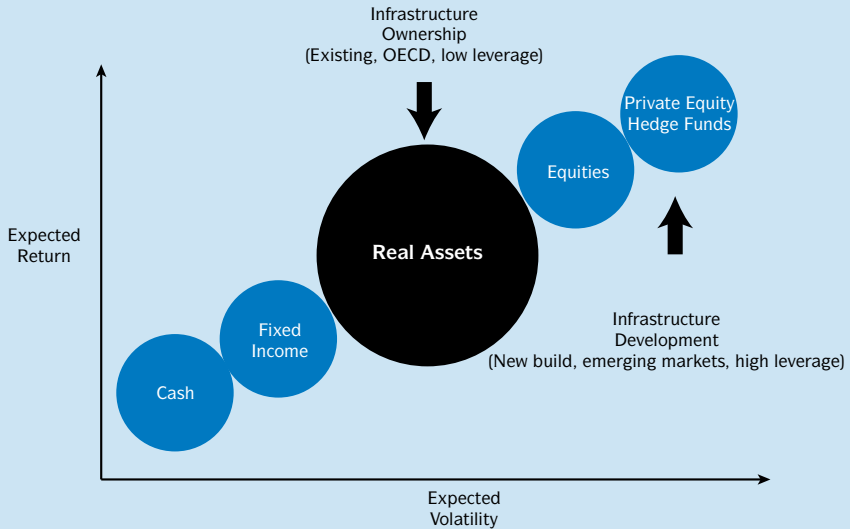
The role of the regional tier is in transition and is more likely to continue to play an important role in the North where the legitimacy and rationale for regional working is more accepted. It appears certain that whatever the future form of regional organisation, the same capital funding levels of the past decade will not be available. It may however have a role in co-ordinating infrastructure investment, perhaps being an effective means of generating the critical mass to bring new innovations to fruition. The regional tier would be large enough to produce the correct scale of offer, and would be capable of bringing in enough schemes to diversify investment and spread risks. If local authorities and sub-regions were sold on the idea, there could be real potential for the regional tier to provide the correct geography.

It is likely that there are multiple geographies at which an infrastructure fund could operate. The differing investment mandates of each pension fund makes it probable that the solution is in bespoke schemes, created through collaboration with the pension funds so that they are fully reflective of their needs.

### **Which types of project would be most suitable?**

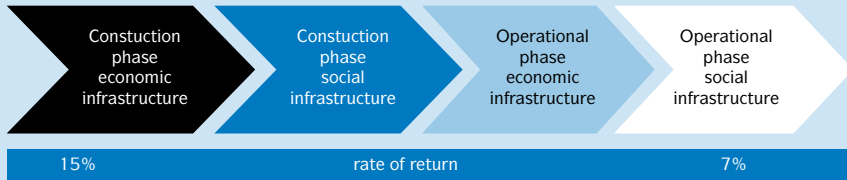
The premise behind pension funds investing in infrastructure is that in addition to economic return there is an element of social responsibility. This leads to a question of which projects should be provided, as the social responsibility aspect is an inherently normative judgement. Therefore a fundamental consideration must be that the projects being invested in are broadly aligned with the interests of pension funds.

The general theory of infrastructure as an asset class is that it resides between equities and fixed income on a risk-return spectrum. As the diagram below demonstrates, post-construction infrastructure in developed economies has a slightly higher volatility or risk than bonds, but also a higher expected return. Similarly, it is less risky than equities but also carries less return.

**Figure 5** Infrastructure risk/reward profile

Source: Inderst, G. "Pension Fund Investment in Infrastructure", *OECD Working Papers on Insurance and Private Pensions* (2009)

However, not all infrastructure entails the same degree of risk. There is a risk-return spectrum that exists within the infrastructure asset class that covers both different types of infrastructure and stages of infrastructure development. For instance, a post-construction school has a far lower volatility and return profile than a pre-construction airport or transport facility. Economic infrastructure entails demand and technological risks that are far less prevalent in social infrastructure, particularly where this has been procured by a public sector client. Infrastructure funds offer a rate of return commensurate to this risk level, ranging from approximately 15 per cent for some types of construction stage economic infrastructure, to approximately 7 per cent for operational social infrastructure.

**Figure 6** Phases of Infrastructure creation risk-return spectrum

The decision must ultimately boil down to a consideration of the return that is required by the investor and the risk they are willing to accept for this. This makes it important that any investment vehicle designed for pension funds can reflect the needs of its investors. A sub-regional or regional infrastructure fund would only operate successfully if it was providing a type of infrastructure that was desired in that sub-region and which was also within the risk-reward profile of the pension funds in question. It is clear that any investment vehicle would need, as a minimum, a dialogue with pension fund managers prior to its creation, or alternatively an explicit mandate created by the pension fund managers. This could occur if pension funds were to collaborate, decide on the type of infrastructure they would like to invest in and then start a new company to take it forward. They could then appoint a fund manager to run the fund as they would like, investing in infrastructure that meets all their objectives; economic contribution to local areas and an acceptable risk-return profile.

To generate a return for the fund the projects invested in require a sustainable revenue stream. This adds a further consideration about the type of project that would be most suitable. Typically infrastructure funds have a preference for PFI/PPP type assets because of their contracted usage and guaranteed payments from the public sector. Social infrastructure assets that have been conventionally procured, i.e. where the asset is owned by the public sector, may not present the same potential for return. Conversely, economic infrastructure, particularly where that involves an element of user charging may provide a return whether the asset is owned publicly or privately.

## Making it happen – a chicken and egg problem?

This chapter has recognised the inherent need for the various interests involved to be suitably aligned. This in itself presents the key to turning this concept into a reality for infrastructure investment. The research seminar identified that there may be an appetite within pension funds to invest in a pooled local infrastructure fund, but up to this point no suitable offer has been presented to them. However, the onus is not necessarily solely on local authorities or MAAs or the regional tier to create a vehicle to present to pension funds. The vehicle can only reflect the investment needs of the pension fund if it is designed in collaboration with it. Much of the technical detail of the fund - i.e. whether it is listed or not, the type of project invested in, the legal structure, the liquidity of the investment, ultimately can only be decided by the pension fund managers and infrastructure fund in dialogue with one another. There are multiple ways of structuring the vehicle, and different structures would suit different needs.

Much of the challenge centres on finding the correct balance between multiple variables, and this balance will fall in different places for different pension funds. It is likely that the most appropriate investment vehicle is a bespoke creation designed around the infrastructure needs of a specified geographic area, most probably regional or sub-regional, and its equivalent pension funds.

This is by no means a panacea for all local infrastructure needs. Great care must be taken to ensure that the projects are an appropriate match for the investment needs of a pension fund. Similarly, pension funds must ensure that investing in the fund would be aligned with their fiduciary responsibility to find the best returns for their members across a diversified asset portfolio. Translating this into reality will require action on behalf of pension funds and the public bodies responsible for infrastructure investment in their locality. In addition, it may be necessary for concerns about the risk of this form of investment to be assuaged by commitment from central government to support the principle of investing superannuation fund assets in local infrastructure funds.

**Recommendation:** *a steering group should be convened to establish the appetite within the Local Government Pension Scheme funds for investing in local, sub-regional and regional infrastructure investment. The steering*

*group should outline the key priorities and requirements of the pension funds that are interested in this opportunity.*

The steering group should drive the agenda forward. This could be a role for CIPFA, or the Local Authority Pension Fund Forum, to fulfil. The steering group should focus on assessing whether there are combinations of geography, scale and projects that would create the correct balance of risk and return for local authority pension funds. Assuming the concept is viewed as a viability, the steering group should assist with the collaboration of pension funds and local authorities to decide on the most suitable projects for investment.

**Recommendation:** *Assuming there is sufficient will, serious dialogue with pension fund managers should be undertaken by local authorities, working at an appropriate local, sub-regional or regional scale, to determine the investment vehicle needed to attract pension investment.*

Following this, agreement can be reached on the type of investment opportunity the pension funds are looking for, and the projects the local authorities require financing. Work can then commence to appoint a fund manager to create a vehicle that can connect these two ambitions. Where there appears to be a genuine possibility for an investment vehicle to develop discussion may be needed about appointing a fund manager to take over the responsibility for creating the vehicle.

## 5 *Local authority reserves and investments*

Previous work by NLGN has highlighted the potential for large sums held in reserves and investments to be utilised for infrastructure finance.<sup>17</sup> Much of this work centred on the possibility of a local authority mutual fund that would take deposits from local authorities, offering a healthy rate of return, and using these deposits to provide project finance. This could provide local authorities with a higher rate of return than is being obtained at the Debt Management Office, the traditional safe haven for local authority reserves and investments. In common with the concept of an infrastructure fund for pension funds, this vehicle could provide socially beneficial finance for local infrastructure where there is a funding gap. These ideas have been taken forward by the LGA and the results of some of these early developments is discussed later in this chapter.

There is a distinction between local authority reserves and investments. Reserves typically refer to money that is being held by the council either for a particular reason or for contingency purposes. As such, the majority of reserves are 'allocated', making them unsuitable for a mutual fund type vehicle that may not provide sufficient liquidity for money that is needed imminently. Unallocated reserves are held for a variety of reasons. Work by the LGA and CLIP<sup>18</sup> has highlighted some of the purposes unallocated reserves are held for;

- already identified capital expenditure
- service developments, e.g. in highway maintenance, winter maintenance, older people's and children's services, supporting people services
- insurance payments
- pay equalisation
- redundancy costs

Many local authorities have been required to access their reserves over recent years for these reasons, and as such the level of reserves is reducing.

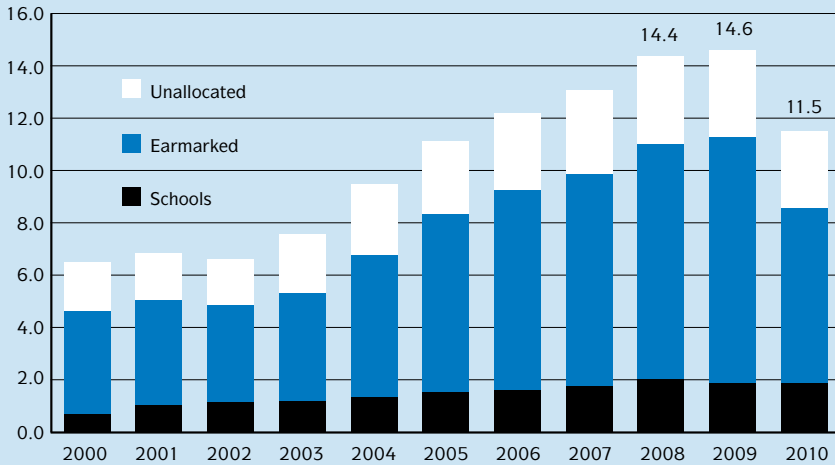
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<sup>17</sup> Chris Leslie, *Investing Together: the case for a local authority mutual fund* (NLGN, 2008)

<sup>18</sup> Central and Local Government Information Partnership - [www.clip.local.gov.uk/](http://www.clip.local.gov.uk/)

The imminent financial squeeze will place further demand on reserves these levels and it seems unlikely there is much scope for them to be put towards other uses, such as a mutual fund.

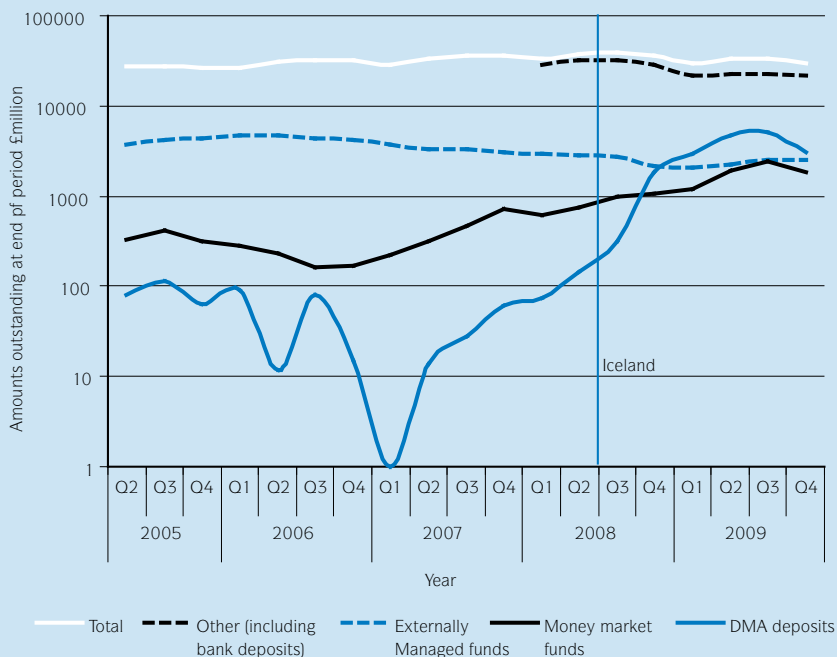
**Figure 7** Local authority reserves at 1 April from 2000 to 2010<sup>19</sup>



Cash investments are approximately double the level of reserves and present a more viable source of infrastructure investment. Some of the £30bn plus of investments are being held as a cash balance but have already been earmarked for capital expenditure. In addition, following the Icelandic banking crisis there are now lower returns on offer for commercial deposit holdings. This has removed the incentive for councils to invest their cash balances whilst simultaneously borrowing from cheaper sources for capital purposes. Therefore there has been a recent reduction in the level of investments held as these have been used directly for capital expenditure. These factors considered, there still remains scope for investments to be directed towards infrastructure. Following the Icelandic banking collapse there has been a recent surge to hold these investments these investments at

the Debt Management Office, which typically offers very low rates of return. Though there are now far more stringent attitudes to risk throughout local government, an investment vehicle that could offer higher rates, with similar liquidity, would in theory be attractive to local authorities.

**Figure 8** Local government investments 2005-2009 - logarithmic scale <sup>20, 21</sup>



Our research seminar established some of the fundamental features that a vehicle would have to possess;

- high liquidity
- competitive rates of return
- a high credit rating

**20** Office of National Statistics, *Financial Statistics No. 578 June 2010* (2010)

**21** Graph shows a logarithmic scale on Y-axis.

The creation of an investment vehicle that can be credit rated, and offers local authorities a short-term haven for money for between 3-6 months could be the basic architecture of such a vehicle. At present, councils are often getting very low rates of interest, in some instances at the DMO. If there was something that offered short term deposits with high liquidity, it could be a desirable option for a number of authorities. Local authorities currently place a sizeable proportion of the investments in building societies, which are often not highly credit rated, but which are local and therefore fulfil criteria relating to socially beneficial investment. It was stated in the research seminar that local authorities sometimes struggle to find appropriate destinations for their deposits, with some banks intermittently not accepting deposits. In such an instance a vehicle that could take these deposits, using them to finance infrastructure, but with high liquidity, could be a genuinely attractive proposition for local authorities.

It is likely that the solution to the liquidity problem lies in the scale of the vehicle. A vehicle that covers all or close to all of the country may provide the requisite scale to ensure that a 'run on the fund' is not experienced. In June 2010 it was announced that following initial work between the LGA and NLGN, with a range of industry experts, CCLA proposed a Public Sector Deposit Fund (PSDF), which essentially would be a money market fund for local authority investments. It is estimated that this fund could grow to be worth £4.5bn.<sup>22</sup> We welcome the creation of this fund and would urge the fund's managers to consider the potential for investment in local infrastructure creation, possibly through a similar vehicle to that proposed earlier in this paper for pension funds. If it is possible to allocate a proportion of this fund to infrastructure investment and retain the required liquidity it could present a form of investment for local authorities that produces healthy rates of returns whilst also supporting local economic development.

**Recommendation:** *That the PSDF gives active and serious consideration to the potential for the fund to invest in local infrastructure projects.*

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<sup>22</sup> Municipal Journal, Members could advise new town hall fund (24<sup>th</sup> June 2010)

## 6 *Applications of new funding sources*

**This paper has dealt primarily with how new sources of capital could be released. In this final chapter one possible application of new capital sources is considered as an example of how they might fit within emerging financial delivery models. It would be relatively straightforward for the new capital sources outlined earlier to be applied to traditional infrastructure finance techniques. However these new sources of capital may also be applicable to some new innovations in capital finance policy.**

### **Tax Increment Financing and Accelerated Development Zones**

An ADZ scheme allows the highest tier of authority in a local area certain financial freedoms to pursue targeted economic stimulus. This is enabled by the Central government approval for the relevant authorities to ‘ring-fence’ any increases in business rates as a result of the development, which is then used to pay for the borrowing that has under-pinned the investment. ADZs can be used for large projects which are dependent on the provision of enabling infrastructure.

The borrowing for an ADZ scheme could be raised through any of the sources of capital identified in this project. A vehicle that has attracted pension fund investment could be used to drive the funding of the scheme, paying back a return based on the generation of new business rate income. Similarly, bond finance could be used to borrow for the initial investment, with the ADZ providing the long-term stable revenue stream needed to repay the bond investors. There is clearly the potential for new sources of finance to underpin innovative financial delivery models as well as traditional ones.

A major hurdle for ADZ schemes is the need for central government’s approval and granting of access to increased business rate income. It is a welcome step that the Budget commits to “consider the most appropriate framework of incentives for local authorities to support growth, including exploring options for business rate and council tax incentives, which would allow local authorities to reinvest the benefits of growth into local communities”.<sup>23</sup>

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**23** HM Treasury, *The 2010 Budget* (June 2010)

**Recommendation:** *We would urge the Government to consider Accelerated Development Zones and Tax Incremental Finance as part of this framework, and capital investment as a component of the concept of growth. Having access to such financing methods would give local authorities vital flexibility and the agility to sustain investment.*

## *Conclusion*

**The 2010 Budget has laid out in stark terms the challenges ahead for local authorities. But it has also offered a sliver of hope for infrastructure investment, through commitment within central government to protect and sustain capital investment over the course of this parliament, a time in which a historic budget deficit is set to be eliminated. However, it is clear that public funding for capital works, in its traditional forms, will not be sufficient to finance all economically viable schemes. This is combined with a firm commitment from central government to promote localism and hand councils the powers and flexibilities they need to respond to local needs. This should offer scope for local authorities to intervene and activate economic development independently of central government.**

This report has focussed on one strand of the challenges ahead; how can we find new sources of capital to sustain the necessary investment? Though finding new sources of capital does not come without its difficulties, we believe that there exists huge potential for pension funds to meet some of the infrastructure finance gap. There are also conceivable circumstances and parameters in which municipal bonds and the £30bn of council investments could be channelled into promoting local economic development.

Realising this potential must first and foremost begin with a proactive stance from local authorities and the relevant stakeholders. But in addition, we recognise that this would be better facilitated by a more permissive local financial landscape for local authorities. Local authorities will be vital in supporting growth in our communities over the coming years, and we hope that this report will have added new insights to an important aspect of this challenge.

## **Appendix 1** *Methodology*

Three research seminars were held to investigate the viability of three new sources of capital identified in Capital Contingencies. These were roundtable discussions with local government finance professionals from the public and private sector. In addition to our research seminars several short interviews with Local Authority Finance Directors were carried out. Follow-up research to explore specific areas where greater insight and expertise was required was conducted after the research seminars.

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## *The Northern Way*

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**Britain has substantial capital investment needs, yet there are plans to decrease public sector net investment by 50% by 2014. While it is important that the nation's budget deficit is brought under control, it is also important that it has a network of infrastructure capable of supporting long-term economic growth. Finding a solution to this conundrum is a worthy policy goal and this report examines whether releasing new sources of capital, which can help enable local authorities to sustain investment, might be part of its resolution.**

In the 2009 report *Capital Contingencies*, NLGN argued that while there may be limited capacity within central government during this period, delivery of new or improved infrastructure will be partly dependent on local authorities' ability to continue investment independently of the centre.

In this follow-up research new mechanisms for raising capital are explored in greater depth. The report aims to establish whether these are viable options for local authorities, and if so what the investment vehicles should look like to enable this.