advancing with ESIF financial instruments

Stocktaking study on financial instruments by sector

Progress to date, market needs and implications for financial instruments

The use of financial instruments in the 'urban development and transport' sector

Synthesis

European Commission

European Investment Bank
The EU bank

DISCLAIMER

More than 70% of European citizens live in urban areas and this is set to increase in the future. This makes European cities a critical place to stimulate growth and innovation. Over the last decade, **urban policy has been increasingly prioritised by the European Union** (EU), resulting in the development of an Urban Agenda for the EU, which aims to provide an integrated and coordinated approach to deal with the urban dimension of EU and national policies/legislations.

Whilst urban development has not been explicitly prioritised in Regional Development and Cohesion Policy during the 2014-2020 programming period among the eleven Thematic Objectives (TOs) defined in the Common Provisions Regulation (CPR), **more than half the European Regional Development Fund** (ERDF) **resources have been dedicated to investments in urban areas as defined in the Cohesion Policy**[1].

In the 2021-2027 programming period, much more explicit emphasis on urban investment activity is envisaged: a new objective 'Europe closer to citizens – sustainable and integrated development of urban, rural and coastal areas through local initiatives' is proposed among the five main policy goals. This Policy Objective will focus on the support of locally-led development strategies and sustainable urban development across the EU[2].

1. ESIF investments and the use of financial instruments

About **EUR 64 billion of ESIF** (European Structural and Investment Funds) **funding is planned to support urban development related activities** during the 2014-2020 programming period. Investment in the sector typically comprises support for transport infrastructure (including sustainable transport) and investment in social, health and educational infrastructure. However, only EUR 385 million of the overall ESIF investment has been specifically devoted to financial instruments in the sector. Only five Member States (MS) were using ERDF and Cohesion Fund (CF) funding for specific financial instruments in the sector as of 31 December 2017; namely: Italy, Poland, Portugal, Slovenia and Slovakia[3]. However, the financial instrument amounts above should be viewed as only part of the overall picture, as in some MS, other activities which may take place in an urban environment, for example energy efficiency in public buildings, may be classified under TO 4.

Nevertheless, based on the relatively low allocations to specific urban financial instruments reported, it appears that **the lessons learnt and the positive experience acquired with the JESSICA initiatives** (Joint European Support for Sustainable Investment in City Areas) during the 2007-2013 programming period **have not necessarily motivated other MS to develop similar dedicated urban financial instruments**. **The development of financial instruments in the urban development and transport** (UDT) **sector consequently seems very specific to some MS, despite very large amounts of ERDF/CF funding available in total in all MS in the sector**.

1 Guidance for Member States on Integrated Sustainable Urban Development (Article 7 ERDF Regulation), European Commission, 2016.
2 Please see: https://ec.europa.eu/regional_policy/en/2021_2027/.
3 The cut-off date of the data analysed in the stocktaking study conducted by *fi-compass* was 31 December 2017. The quantitative data analysis performed in the study consisted in using the financial data that Member States regularly send to the European Commission for monitoring/reporting purposes in relation to the implementation of their Operational Programmes.
Since 31 December 2017, other Member States have developed financial instruments in the UDT sector, such as Bulgaria. This indicates that developing financial instruments in this sector may have taken some time to the managing authorities but also that relevance for such type of financing/support is perceived by managing authorities and sectoral stakeholders, for the current programming period and the next.

Within the urban financial instruments reported, the main form of finance chosen by the managing authorities is loans, and the limited amounts devoted to financial instruments in the sector indicate that grant financing is also still needed and relevant for UDT projects. In terms of differences reported amongst MS:

- The case of Slovakia appears quite unique. While loans are the form of finance preferred by all other four MS using urban-based financial instruments, Slovakia decided to use 92.2% of its ERDF/CF funding under the form of (quasi-)equity financing in the UDT sector. Slovakia has also prioritised investment in the UDT sector overall, with an allocation of 25.6% of the overall amount allocated to financial instruments.
- Portugal is also different since it also uses its ERDF/CF funding as a guarantee product, and for subsidy/technical support in relation to its financial instruments (in addition to loans)[4]. This indicates that – as for other sectors – in the UDT sector, various financial products provided through financial instruments may add value.

2. Market opportunities

In 2017, the European Investment Bank (EIB) undertook an investment survey to track investment activities, needs and barriers in relation to municipal, urban and infrastructure investments. As part of the survey, 555 municipalities across Europe were interviewed, with 48% reporting that their urban interventions and related investment had increased over recent years (2012-2017). In relation to investment gaps reported by municipalities, the survey highlighted the highest gaps in housing (45% of municipalities), urban transport and ICT (Information and Communication Technologies) infrastructure (around 30% of municipalities). Such gaps were more acutely felt where there are municipal budgetary constraints, both in relation to the resulting competing demands for scarce municipal resources and also overall investment challenges brought about by borrowing limitations. It should be noted that such constraints can also lead to the favouring of grant based solutions.

The large investment needs of the sector, as evidenced by the large proportion of urban based activity supported by the existing ESIF Programmes during the 2014-2020 period, the level of investment activity reported by municipalities through the EIB survey and the experience gained through the implementation of the previous JESSICA programme demonstrate a significant opportunity for the increased use of financial instruments in the urban sector.

In addition to offering attractive long-term and low-cost financing conditions, **financial instruments can play a key role in offering and facilitating more innovative financing mechanisms, which can crowd in private sector investment and offer off balance sheet solutions**. These solutions can make better use of relatively scarce public sector investment and borrowing capacities. Financing solutions such as Public Private Partnerships (PPPs) and Energy Performance Contracting (EPCs) not only have the potential to introduce balance sheet benefits, but the involvement of the private sector can also improve the viability of urban development projects and provide a level of market orientated investment which in turn encourages other private sector investment and improves the overall quality and financial sustainability of the investment programmes subsequently realised.

4 It is to be noted that since 31 December 2017, the Portuguese financial instruments For the UDT sector provided under the IFFRU Fund-of-Funds (*'Instrumento Financeiro para a Reabilitação e Revitalização Urbanas'* – Financial instruments for urban rehabilitation and revitalisation 2020) have been particularly successful, especially the loan instruments. Please see the *fi-compass* case study developed on IFRRU: https://www.fi-compass.eu/publication/case-studies/financial-instruments-urban-development-portugal-ifrru-2020-case-study.

3. Barriers

The main challenges for financing the UDT sector are:

- The **domination of grants** in the sector is a significant, if not **the most significant**, barrier. In addition to often crowding out the potential for financial instruments, by offering grant resources to projects with repayable and/or cost saving components, the availability of grants and specifically the timing of grant calls often artificially shape the preparation of urban development projects and limit the resulting project pipeline available for non-grant based support. This encourages short-term reactive approaches to the development of individual projects to meet the requirements of the grant call in question, as opposed to sound long-term investment planning. **Long-term strategic investment planning is essential** in realising successful integrated and sustainable urban development.
- Linked to the above point, **public authorities often face capacity challenges** which prevent them from dedicating sufficient resources to adequately plan, develop and implement appropriate development strategies and investment programmes which could support financial instruments. In many instances, financial instruments could adequately address the long-term investment needs of the projects in question, releasing grant funds for those projects which need to address more acute market failures. Financing options are not however given adequate consideration in the project development process. **There is a need for greater awareness of the benefits of financial instruments amongst all public authorities**.
- **Integrated urban development activity, by its very nature, can often involve multiple different components, with a range of end uses, borrowers and resulting in differing financing needs**. This can introduce complexities which require specialist advice and input in order to structure appropriate solutions, including financing structures and address issues such as State aid. There is however a **limited amount of financial advisory support available**, with many existing technical assistance programmes geared towards supporting the absorption of available grant funds.
- **Municipal borrowing constraints** also remain a key challenge, which can dissuade some public authorities from developing solutions which would involve them incurring debt. This, in turn, also encourages grant based approaches.
- From a financial instrument implementation perspective, **the lack of direct prioritisation of urban development among the Operational Programmes during the 2014-2020 programming period** resulted in the scattering of urban interventions and related allocations among multiple objectives, which made it difficult to create dedicated financial instruments in the sector.
- **State aid can also add further complications**. Article 16 of the General Block Exemption Regulation limits the provision of aid to projects included in assisted areas. In some cases, urban development plans span assisted and un-assisted areas, which can limit the delivery of a holistic approach.
- The **lack of standards and common regulations for innovative transport solutions** introduces a level of uncertainty which both reduces the size of the potential investment pipeline and dissuades investors in the sector.

4. Potential for the use of financial instruments for urban development and transport

There is strong potential for financial instruments in the UDT sector. Financial instruments can provide critical mass to enable municipalities and projects which are too small in their own right to secure sufficiently attractive financing, by acting as aggregation mechanisms. Financial instruments can **offer improved financing conditions – often longer term and lower cost finance**, this financing can be combined with grants to both address viability issues and provide additional project development and implementation capacity. Financial instruments can also **provide innovative off balance sheet solutions** which can address some of the issues associated with municipal borrowing constraints. More specifically, financial instruments can provide value added in this sector by:

- **Delivering a combined financing solution/one stop shop approach** that would include, both, Technical Assistance/advisory support in order to address some of the pipeline maturity and public sector capacity issues identified, as well as capital grants to address viability issues, such as for brownfield sites and/or heritage buildings. In that vein, attractive repayable financing and Technical Assistance can be provided together to accelerate the development of mature project pipelines.
- **Encouraging more sophisticated financing solutions**, such as the use of PPPs and EPCs – limiting the need to rely on the public sector balance sheet and securing private sector leverage.
- **Providing long-term and low-cost financing solutions** for municipally sponsored projects which have long payback periods and cost sensitive business models.
- **Offering subordinated debt and equity solutions** for higher risk private sector led solutions, including the development of brownfield sites and redevelopment of commercial business premises.

5. Key enabling factors for the use of financial instruments

Feedback from stakeholders highlighted the following key factors:

- **Raising awareness of/promoting combination solutions**. The CPR proposal for the 2021-2027 programming period greatly facilitates the use of combination structures and will enable financial instruments to offer combined financing solutions. This will help to target the use of grant in support of a financial instrument in question and help to avoid issues associated with crowding out. The ability to more easily combine a financial instrument with Technical Assistance type support will also help to address some of the pipeline maturity issues that are often reported by stakeholders.
- **Designing financial instrument friendly Operational Programmes**. Allocations for financial instruments in this sector should be concentrated within the same Operational Programme and priority theme, in order to provide the necessary critical mass for financial instruments and avoid the need for multiple different reporting records. Grant support for the sector should also be very tightly defined to ensure it is targeted in areas where financial instruments and combined financial instruments are not appropriate solutions to help limit issues of crowding out.

- **Providing Technical Assistance**. Access to Technical Assistance can both improve the quality of the underlying project pipeline and also accelerate the deployment of financial instruments overall. In the UDT sector, Technical Assistance should support the development of awareness raising activities targeted at public and private final recipients to ensure they understand the type of projects that would be suited to financial instrument support and the related benefits. This will help to ensure that projects are structured at an early stage so that they are capable of accommodating repayable forms of investment. Technical Assistance should also be used to invest in the development of the project pipeline itself and, where needed, in the enhancement of the delivery capacity of urban authorities through project implementation units.

Financial instruments have a clear role to play in supporting investment in the urban environment. A proven track record already exists through the previous JESSICA model. The inclusion of an urban thematic priority and new possibilities to combine grant and financial instruments in the 2021-2027 programming period, should address some of the key issues experienced in the current programme. Combined financing solutions under financial instruments rules, that include both a repayable component and a grant element, reinforced by dedicated Technical Assistance, can support a range of public and private sector sponsored urban investment activities. **Raising awareness of the new regulatory possibilities is considered to be key in encouraging greater allocations to financial instruments in this sector in the 2021-2027 Operational Programmes**.

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