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Developing interest:

The future of Urban Development Funds in the UK

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Executive Summary

The old model of regeneration funding that supported investment in many of our cities before the start of the recession is no longer viable. Private sector banks and other investors have a much weaker appetite for risk, while the public policy goal to reduce the deficit means that there is much less money for state-led regeneration. This means that other models are required to support investment in our cities.

Urban Development Funds (UDFs) have the potential to be one of these models. Nine of these funds already exist in the UK, currently underpinned by JESSICA monies from the European Regional Development Fund (ERDF).

The creation of these funds has been a success in itself. But their impact has not been maximised because of three overarching issues; **inflexibility created by the design of current regulatory framework;** a **lack of investment-ready projects;** and a **lack of coverage across UK cities.**

The change in the economic development landscape in England presents an opportunity to build upon and refine how UDFs work in the UK to increase the amount of investment in our cities. Previously UDFs were set up on regional boundaries, reflecting the geographical remit of the now defunct Regional Development Agencies. Their abolition, and the creation of Local Enterprise Partnerships, allows policy makers to rethink the geography in which UDFs operate. This opportunity to expand the coverage should also be used to reduce the inflexibility in the system, particularly around regulations on eligible products and commercial returns, which has reduced the appetite to invest.

This report calls for the creation of a 'Fund of Funds' model at a national level which would oversee a number of sub-national UDFs serving individual or groups of cities. Such a set up would allow more cities to access UDF finance to support the growth of their economies.

"The change in the economic development landscape in England presents an opportunity to build upon and refine how UDFs work in the UK"

Introduction

Our cities are the driving force of the UK's economy. They account for 53 per cent of businesses, 58 per cent of jobs and 60 per cent of output.[1] As such national economic policy should support economic expansion in our cities to support overall economic growth.

To support their growth, continued investment will be required in these cities. But the way in which this investment will be made in the future is likely to be very different to the model used in the recent past – the old approach of relying on investment from commercial banks topped up with public subsidy which was used in the 1990s and 2000s is no longer feasible in most instances.

"The reduction in appetite for risk as a result of the economic downturn means that commercial banks are unlikely to enter the development market again"

The shift in the investment landscape is happening for two principal reasons. Firstly, the reduction in appetite for risk as a result of the economic downturn means that commercial banks are unlikely to enter the development market again in many areas of the UK without greater certainty about sufficient future returns. Secondly, the stated public policy goal of reducing the Government's deficit has constrained the amount of public expenditure directly available from Government for the regeneration of cities.

To respond to this new landscape any new models of investment are likely to be based around Financial Instruments (FIs) that use loans, equity or guarantees in an attempt to recycle scarce public money to support investment on a commercial rather than grant basis. This means that projects must be able to generate a financial return.

One example of a FI is an Urban Development Fund (UDF). In total there are nine UDFs currently in operation in the UK which match JESSICA monies from the European Regional Development Fund with other public and private sector funding. Examples are the Evergreen Fund in the North West of England and the SPRUCE fund, which covers part of Scotland.

While the creation of the nine funds marks a success in itself, the impact to date of UDFs in the UK has been limited by three main problems. The first is **the inflexibility created by the design of the current regulatory framework.** The second is **the lack of investment-ready projects to invest in.** And the third is **their lack of coverage across UK cities.** The patchwork nature of the existing UDFs limits the access to UDF investment for over half of the UK's cities.

The beginning of a new funding period for ERDF, which runs from 2014 to 2020 (and will likely place much greater emphasis on the role of FIs, coupled with the reduced appetite for risk in the private sector, a new spending review period in the UK and the abolition of the Regional Development Agencies (which were previously responsible for UDFs in England) offers an opportunity to redefine the structure and coverage of UDFs in the UK.[2]

This report sets out policy recommendations for changes that should be made to reflect the lessons learned from current UDFs. In particular it calls for a new National UDF Programme that brings together the current JESSICA-based UDFs in England

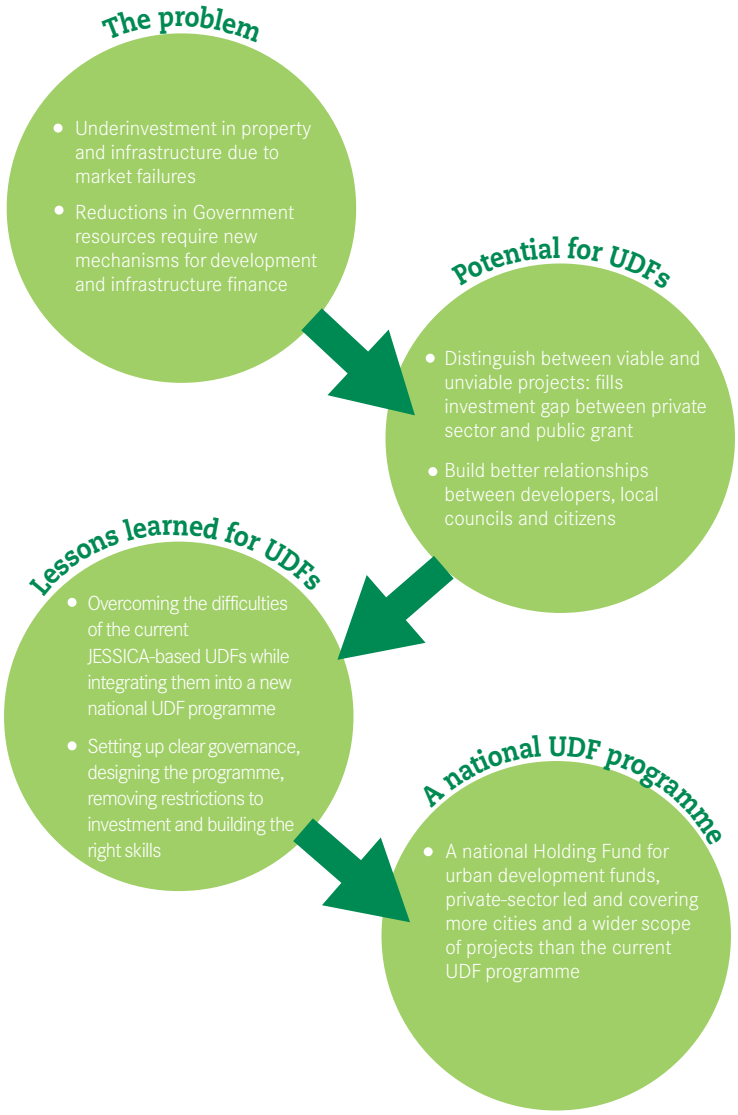
1. Centre for Cities (2013), *Cities Outlook 2013*, London: Centre for Cities. Cities are defined as Primary Urban Areas. See www.centreforcities.org/puas for more information.
2. The Heseltine Review also offers the opportunity to refine how UK public sector finance is used in UDFs.

and new UDFs, funded either through European or UK Government monies, to support a wider range of cities and projects across the UK.

The report is set out as follows. Section 2 looks at the nature of demand for investment and supply of investment funds across a selection of cities; Section 3 reviews the models available to encourage investment; Section 4 looks at specific issues around the current set up of UDFs; Section 5 proposes a new model for UDFs to address issues of coverage and Section 6 concludes. Figure 1 outlines the report structure.

"This report calls for a new National UDF Programme"

Figure 1: Report structure



Investing in our cities

Demand for investment in our cities

Many cities across the UK received large scale investment in regeneration in the two decades before the downturn, with London and the Core Cities in particular seeing large investment in their city centres.[3] At the economy's peak in 2008, the top 100 regeneration projects as identified by trade journal *Regeneration and Renewal* were valued at £87 billion.[4]

Despite the large amount of money invested in the 1990s and 2000s, demand for city centre related development in particular remains high. Centre for Cities' analysis of individual proposals across 35 cities and their associated Local Enterprise Partnerships (LEPs) across England during the course of this research revealed city centre redevelopment to make up the largest share of proposed investment (40 per cent of all allocated investment). [5]

"Many cities across the UK received large scale investment in regeneration in the two decades before the downturn"

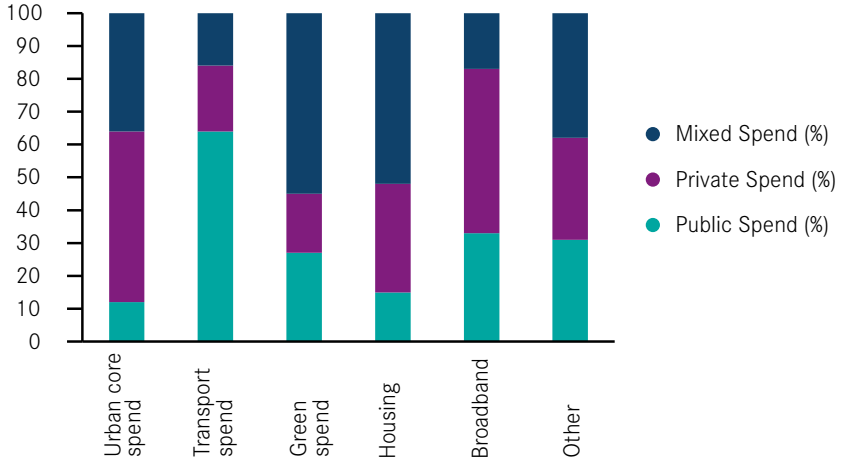
The 35 cities cover a range of geographies, sizes and economic performance based on the Centre for Cities' Private Sector Cities Index. [6] Whilst this analysis is neither comprehensive nor conclusive[7] it does provide an illustration of the nature of demand for investment in UK cities. The viability of these projects varies from project to project, and Appendix 3 discusses market testing undertaken with developers on the projects identified. A summary of this development pipeline is attached in Appendix 1, and the key findings include:

City developments

- The 35 cities have made public information available on £75 billion of project investment at various stages of advancement. Some projects are still on the drawing board with no funding committed, others are proceeding, and the remaining are stalled or cancelled.
- Around £12 billion (16 per cent) of the projects do not provide details on the investment opportunity beyond headline figures.
- Excluding the unallocated figure, priority projects include: urban core developments (city centre retail and housing) which make up around 43 per cent of the pipeline; housing (22 per cent); and transport (19 per cent).
- Green investment is only around seven per cent of the sample pipeline, and this number is driven by a few large projects in Birmingham and Coventry.
- Information on the breakdown of funding between the public and private sectors is not always clear. Figure 2 gives an indicative split of investment by project theme. City Centre redevelopment has the highest percentage of private sector involvement, while transport projects have the highest percentage of proposed or actual public sector investment.

3. For example, the privately funded Liverpool One development cost a reported £1 billion. Source: http://www.grosvenor.com/Portfolio/Liverpool+ONE.+Liverpool.htm accessed 14th February 2013.
4. Special Report: The Top 100 Regeneration Projects. Regeneration and Renewal. Friday, 07 March 2008 http://www.regen.net/news/788823/
5. Research was conducted between August and September 2012.
6. Webber C & Swinney P (2010), *Private sector cities: A new geography of opportunity*, London: Centre for Cities
7. For example commercial sensitivity means that it would not be possible to get a comprehensive picture of project pipelines in cities.

Figure 2: Breakdown of indicative investment pipeline by the public and private sector



Source: Centre for Cities research

"LEPs have more of a focus on smaller projects and transport infrastructure, which together makes up about 40 per cent of their investments"

LEP developments

The overall identified spend of LEPs at £190 million is much smaller than that of cities. Amongst the LEPs sampled, around half of funding has either not yet been allocated or details have not been released.[8]

Excluding the unallocated figures, LEPs have more of a focus on smaller projects and transport infrastructure, which together makes up about 40 per cent of their investments. However, the greatest proportion of LEP development investments is primarily out of town business parks.

The impact of the economic downturn on investment

The viability of all projects has reduced since the onset of and fall out from the financial crisis. This has occurred for two reasons. Firstly, an increase in risk resulting from a reduction in demand and restriction of the supply of credit has discouraged private sector investment. Secondly, the large planned reduction in public sector expenditure has reduced the ability of the public sector to make investments.

Private sector lenders are exposed to bad commercial real estate debt

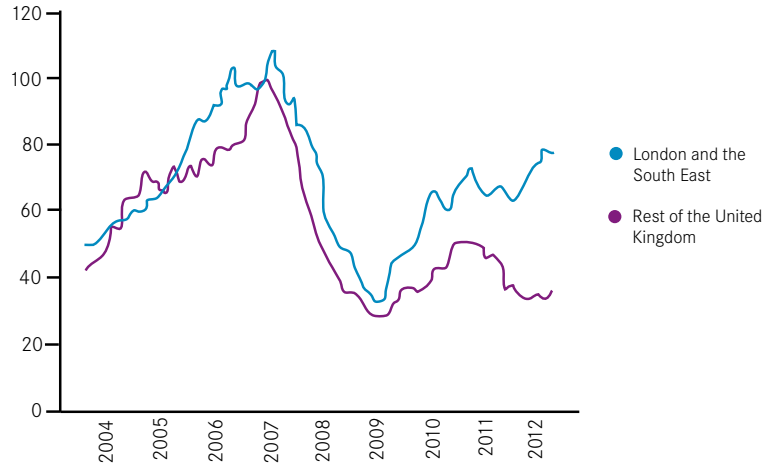
The impact of the financial crisis has left lenders (and banks in particular) exposed to bad debt on commercial property. Loans on commercial real estate account for just under 50 per cent of all UK corporate lending and according to the Bank of England "accounted for a large proportion of the major UK banks' losses on UK lending during the [financial] crisis."[9]

And further losses could yet be incurred. Of the £204 billion of commercial property loans held by UK banks, £90 billion had a loan to value ratio above 70 per cent, the traditional threshold for lending on commercial property. Given that much of this debt is to be refinanced in the coming years, the banks will have to take further losses unless there is a sharp rise in property prices.[10]

This exposure has significantly reduced their appetite to make investments in commercial property. And as Figure 3 shows, while transactions are still occurring across the country, the reduced investment has been most acutely seen outside of London and the South East where commercial real estate transactions are still 60 per cent below their 2007 peak.

8. A higher total is likely to have been allocated internally but this information has not been made publicly available.
9. Bank of England (2012), *Financial Stability Report November 2012*, London: Bank of England
10. De Montfort University (2012), *The Commercial Property Lending Market Research Report - Mid Year 2012*, Leicester: De Montfort University

Figure 3: UK Commercial real estate transaction volumes



Source: Bank of England. Indices: 12 months to end of June 2007 = 100

"The public sector is increasingly looking to earn a return from, rather than subsidise, investment"

The public sector is increasingly looking to earn a return from, rather than subsidise, investment

This reduction in private sector appetite has come at a time when the public sector has also seen a reduction in budgets available to support development. The Chancellor has set out plans to reduce public sector net borrowing from 9.6 per cent of GDP in 2009/10 to 1.7 per cent of GDP in 2017/18.[11] The announcement in the 2013 Budget on 'Help to Buy' illustrates the wish in government to fund some growth-related activity through co-investment rather than subsidy, where the tax payer becomes a co-investor and the exchequer earns a return.[12]

This approach has two main benefits. Firstly it aims to use the reduced money available for investment to go further by matching it to finance from other sources. Secondly the gross cost of co-investment instruments is not counted on the public sector balance sheet. This means that only the expected loss of the investment – i.e. the difference between money lent and money repaid - contributes to public sector net borrowing, rather than the total investment.[13]

These two factors mean that the way in which this investment will be made will need to look very different to the most popular model used in the recent past – the old approach of relying on investment from commercial banks topped up with public subsidy which was used in the 1990s and 2000s is no longer feasible in most cases. This has implications for how the public and private sectors go about making investments in the future:

- Given the constraints on budgets the **public sector** has the requirement to reduce up-front costs and lever in a greater degree of private investment through the public money that is available.
- Given the increase in risk and associated financing costs seen since 2007, any **private sector** investment that aims to fulfil a public policy goal now needs the public sector to take action to ensure returns are sufficiently certain and of a level that make projects viable.

Any model proposed to facilitate investment in our cities must look to satisfy both of these criteria.

11. HM Treasury (2012), *Autumn Statement 2012*, London: The Stationery Office
12. HM Treasury (2013), *Budget 2013*, London: The Stationery Office. Also, Chapter 2 of the Autumn Statement 2012 sets out the use of several instruments. See HM Treasury (2012), *Autumn Statement 2012*, London: The Stationery Office
13. HM Treasury (2012), *Consolidated Budgeting Guidance from 2012-13*, London: The Stationery Office

Models to finance urban development

To support future investment, a model is required that de-risks investments for the private sector but does not require full subsidy from the public sector. This section proposes UDFs as a potential solution to these two main drags on investment.

Potential approaches to investment

The use of investment tools over subsidy is not a new practice for the public sector – public-private partnerships are a good example of this.[14] But the emphasis on the use of this approach is likely to be increased given the need to reduce the deficit – a subsidy increases the amount of public debt, whereas any return on investment instead contributes to its reduction. There are three main areas where these tools are currently being used under the guidance of the Coalition Government:

"To support future investment a model is required that de-risks investments for the private sector"

- **Direct loan/equity:** Loan or equity made by the public sector to the private sector. Housing has been a particular target for this approach under the current Government through Get Britain Building and FirstBuy. The Public Works Loan Board is a longstanding example of such an approach, which loans money to public sector entities.
- **De-risking:** Guarantees by the public sector to underwrite any investment made by the private sector. Infrastructure investment has been a key target of this, with the Government announcing in 2012 that it will underwrite up to £40 billion of infrastructure investment.[15] More recently it has also offered £10 billion in guarantees for property investors in the private rented and affordable housing sectors.[16]
- **Co-investment:** Funds matching public and private monies to make investments in economic development. Examples of these are the English Cities Fund and UDFs that currently exist in parts of the UK.

Whilst all have a role to play in supporting investment, in many instances a co-investment approach would be more appropriate for urban development than the other approaches above for the following reasons:

- **Direct loan/equity:** Does not necessarily leverage in private sector funding and lacks commercial guidance and expertise. Unlike a UDF it also does not recycle funds to use in further investment in the same area. So although the public sector takes on less risk, it also sees a lower return.
- **De-risking:** For non-standardised products, as is common in urban development, this approach has historically required the public sector to guarantee each individual loan (as opposed to an overarching guarantee), increasing the administrative burden of such a process.[17]

UDFs are a co-investment model that have been created to match European funding from the JESSICA programme to UK public and private sector investment. But whilst there are nine UDFs operating across the UK currently, the model remains underutilised. The rest of this paper explores how UDFs could play an increasing role in financing urban development in the UK.

14. OECD (2003), *Private Finance and Economic Development*, OECD: Paris
15. Infrastructure plan: UK to guarantee investments, BBC, 18th July 2012. See http://www.bbc.co.uk/news/business-18880354, accessed on 12 February 2012
16. DCLG (2013). Next steps for £10 billion housing guarantees. https://www.gov.uk/government/news/next-steps-for-10-billion-housing-guarantees
17. Whilst guarantees can be used to de-risk projects within a UDF, this would require a State Aid approval.

What is a UDF?

A UDF is a long-term fund, typically with a horizon of up to 15-20 years.[18] It is usually initiated by the public sector with an initial equity stake but managed at arm's length by a private sector fund manager, charged with attracting further private sector investment.[19] The goal of the fund is to support investment in private sector projects that support defined public policy objectives. The crucial difference to more traditional public sector investment is that it must also provide a financial return to investors – **the Fund must be commercially focused rather than being grant based**. Capital receipts are then recycled into further projects until the closure of the fund.

"A UDF is a long-term fund, typically with a horizon of up to 15-20 years"

The key distinctions of a UDF compared to more traditional public sector investment are that:

- There is a clear demarcation between the role of the public sector (setting the fund's public policy objectives, influencing or setting the investment strategy and providing an equity stake) and the fund manager (making investment decisions).
- Investment decisions are made on the basis of achieving a financial return (rather than political considerations and optimism bias which can sometimes be seen in public sector decision making[20]).
- Its portfolio approach to development allows it to spread risk and enables smaller scale projects to be funded through institutional investment.
- Limited public sector investment is stretched further through the addition of private sector investment and the recyclable nature of the investment returns.

And the key distinctions of a UDF compared to a private sector commercial property or infrastructure fund are that:

- Projects are likely to be higher risk than the developments that usually attract private sector investment.
- UDFs can also offer junior debt or equity.
- To address market failure the objectives of an investment will include social returns and well as a commercial return.
- There is the possibility of borrowers being able to take repayment holidays,[21] offering subcommercial rates, longer tenures and first loss protection.

Being distinct from more tradional public and private sector investment models means that the structure of UDFs in the UK should be characterised by the following:

- **Funding is provided as a loan or equity, not a grant**. As will be discussed below, a common theme that emerged from our interviews is that many local authorities assume UDF funding to be a grant in the mould of economic development funding in the past. This has caused some issues in project pipeline development. The requirement to make a return on investment underpins the whole UDF model, and so projects must be on the brink of commercial viability in order to realise this return.

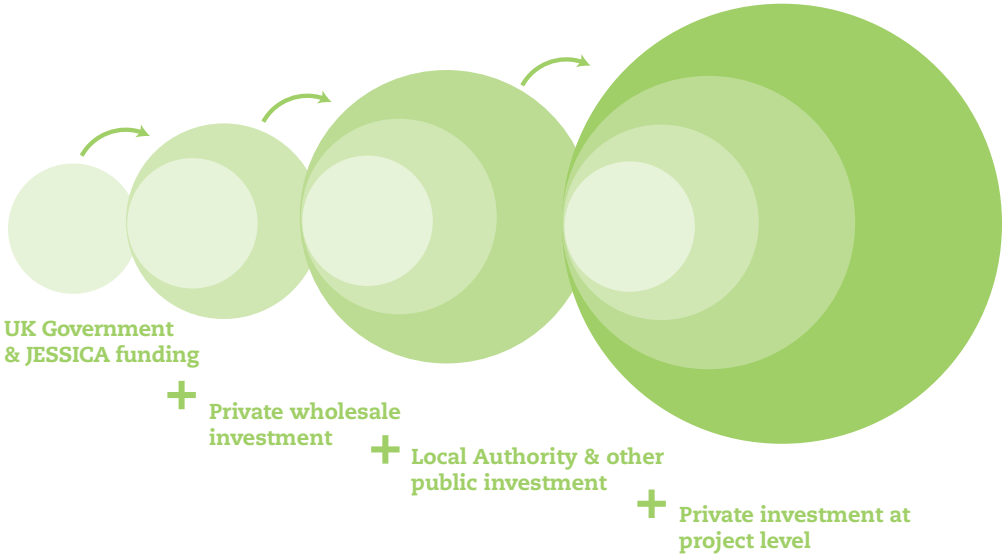
18. Current UK funds have lives of 10-12 years. Extending this time horizon could increase the life of funds and increase the number of projects funded.
19. Private sector fund managers also bring in private sector expertise, credibility, independence, commercial deal structuring, and among other benefits.
20. Flyvbjerg B, Bruzelius N & Rothengatter W (2003), *Mega Projects and Risk: An Anatomy of Ambition*. London, Cambridge University Press
21. EIB (undated), *UDF Selection for the JESSICA Holding Funds in the North West Region of England IR – 887 Questions and Answers*, EIB: Luxembourg

- **Debt is off the public sector balance sheet**. The public policy goal of reducing the deficit means that debt must be off the balance sheet. In turn, this means that UDFs must not be owned by any one local authority and ideally should be private sector led. But there still is a very clear role for the public sector – it must provide guidance in order to ensure that projects selected align to stated public policy objectives.
- **UDFs should 'stretch' the market in order to achieve public policy goals and support economic growth.** Although the commercial focus of projects is crucial, the role of UDFs is not to replace the market but to augment the number of viable investments within cities.

"UDFs should 'stretch' the market in order to achieve public policy goals and support economic growth"

A further aim of the UDF model is to lever in private sector investment to stretch the impact that public sector investment has. Figure 4 illustrates how co-investment has worked to date in the UDF model. The original JESSICA investment is matched with private sector money from institutional investors, such as the EIB, local authority and other public body monies at the Holding Fund level (see Box 1). Further private sector money is then matched at the project specific level, multiplying the size of the original JESSICA monies available.

Figure 4: Co-investment in the UDF model

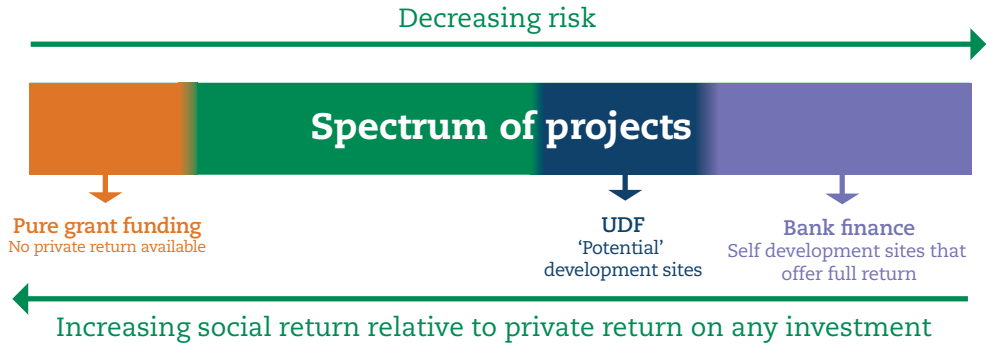


What does a UDF invest in?

UDFs operate in a very specific space. As Figure 5 illustrates, a UDF seeks to provide finance to projects on the margins of commercial development that would not otherwise go ahead under fully commercial conditions. But as noted above, it does not primarily provide grant funding of commercially unviable projects.[22] As such, the Fund Managers are expected to have the mindset and strategy of an investor (i.e. to be commercially disciplined) while investing in projects that private sector financiers would not ordinarily consider.

"A UDF seeks to provide finance to projects on the margins of commercial development"

Figure 5: Indicative spectrum of investment projects



Source: Centre for Cities interviews
Note: Other sources of funding, such as the Public Works Loan Board, have not been included on this illustrative diagram for simplicity.

Figure 6 sets out the reasons why projects may require public sector intervention, categorising market failure at a national, city-region and project level. It also categorises market failures according to whether they are structural (permanent) or cyclical (move with the economic cycle) in nature. This is an important distinction to make – UDFs operating in the UK were designed before the onset of the economic downturn. The resultant change in appetite for risk from banks and other investors and developers as a result of the downturn has potentially altered the range of projects that are eligible for UDF investment, and this is something that should be considered in any future refinements of how the UK's UDFs operate.

22. Grant funding can be used in conjunction with the UDF loan or equity arrangement.

"To date, UDFs in the UK have used ERDF and national match funding, in the form of JESSICA, to support investment in development projects"

Figure 6: Types of market failure

	Structural	Cyclical
National	• Regulatory uncertainty (DCLG)	• Legal and regulatory changes lead to information asymmetry: adaptation to Localism Act, National Planning Policy Framework, changes to environmental subsidies, Enterprise Zones and Local Government Finance Bill
City-Region	• Poor pipeline development • Lack of 'promotion' • Political uncertainty • Access to capital	• Access to capital (city-level)
Project	• Lack of competition between developers • Lack of demand • Politics of planning (principle-agent problem) • Externalities of development • Co-ordination failures around land ownership • Urban blight	• Access to capital (project-specific)

Source: Centre for Cities interviews

Box 1: The structure of a UDF

To date, UDFs in the UK have used ERDF and national match funding, in the form of JESSICA, to support investment in development projects. The JESSICA funds are complemented by further public sector and private sector funds to reach the full financial need of the development.

A Holding Fund is often used to hold the JESSICA funds and other public sector resources, which are then distributed to specific projects via one or more UDFs and matched with more public and private resources. Holding Funds have been used in three instances in the UK; in London, the North West of England and Scotland. In all three cases the EIB acts as the Holding Fund Manager. Holding Fund operations are overseen by Investment Boards, which can include public sector representatives and independent private experts. The Holding Funds's management provides technical assistance and assists in the structuring, development, and monitoring of business strategies for potential UDFs.[23]

Each UDF is run by a Fund Manager (a single institution or consortium of partners), usually regulated by the FSA, who has wide ranging responsibilities. A Fund Manager will often help determine which projects are potential UDF projects, manage legal and financial due diligence for each project, contract projects and subsequently monitor project performance. Thus, the Fund Manager needs to be a facilitator and a scrutinizer, a financier and legal entity, and private-sector oriented while also being public sector-minded.

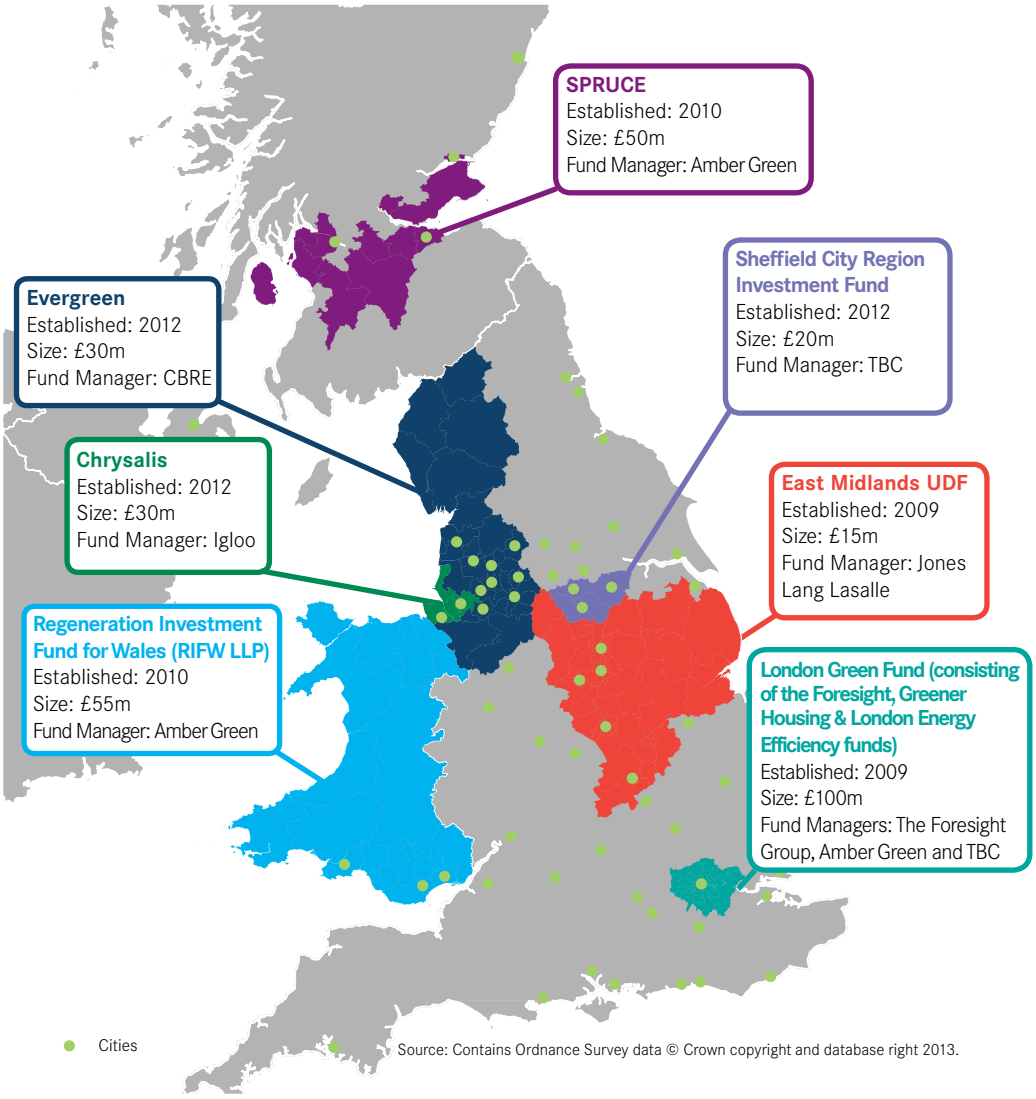
23. Kreuz C (2010), *JESSICA – UDF Typologies and Governance Structures in the context of JESSICA implementation*, Luxembourg: EIB

Current UDFs in the United Kingdom

To date there are nine UDFs operating in the UK, all of which use JESSICA funding. In London investment has focused on waste and energy efficiency, while the North West's Evergreen Fund has focused on business space. But while the establishment of these funds has been a success in itself, there are three main problems with the progress that they have made to date. The first is **the design of current regulatory framework**. The second is the **lack of investment-ready projects**. And the third is the UDF's **lack of coverage across UK cities**, which limits access to UDF investment.

"In London investment has focused on waste and energy efficiency, while the North West's Evergreen Fund has focused on business space"

Figure 7: Urban Development Funds in the UK



The first two problems have combined to limit the amount of investment to date from the UK's allocation of JESSICA. Of the 12 areas[24] across the UK that had the option to use some of their grant resources via the JESSICA UDF mechanism for the 2007-13 funding period, only six have drawn down funding to allocate to individual UDFs. And of the regions that have drawn down money, only a small proportion of this money has actually been committed to projects to date – in part as a result of the time taken to establish the funds and in part because of the restrictions that are attached to the money. There has been some improvement more recently - one Fund Manager covering the Scottish, Welsh and London Funds has lent over £40 million to the end of 2012 (see Box 2 for a discussion on the London Green Fund) – but the availability of investment-ready projects continues to be an issue. Section 4 looks at this in more detail.

24. These areas are the former Regional Development Agency regions plus Wales, Scotland and Northern Ireland.

Box 2: London Green Fund

The London Green Fund is the Holding Fund that oversees the three UDFs that operate in the city:

- The **Foresight Environmental Fund,** managed by the Foresight Group, focuses on turning waste into energy, recycling and sustainable infrastructure. It invests by providing equity and was launched in March 2011. Of a total size of £60 million, so far it has invested £17.5 million in the building of an organic waste facility in Barking and Dagenham.
- The **London Energy Efficiency Fund** is the second UDF under the Green Fund. Established in August 2011 and managed by Amber Infrastructure, its aim is to invest £100 million in the retrofitting of public and voluntary sector buildings such as universities, hospitals and schools to make energy efficiencies. This investment will mainly be done through debt financing and it has so far invested £19.8 million in an arts facility.
- The **Greener Housing Fund** will invest in improving energy efficiency in social housing in the capital. To be officially launched imminently, it benefits from complementary finance of £400 million from the EIB.

"The existing Funds cover around 44 per cent of the UK's total business stock and less than half of the UK's cities"

The slow speed of investment is compounded by the incomplete geographic coverage of UDFs, as shown in Figure 7. The existing Funds cover around 44 per cent of the UK's total business stock and less than half of the UK's cities. And, of the largest cities, Leeds, Bristol, Birmingham and Newcastle do not have access to JESSICA funding.

This is a problem for two reasons. Firstly, the patchy coverage of UDFs to date means that the majority of the UK's cities do not have access to this instrument to finance investment in their economies. Secondly there is an issue about the types of cities covered. While some large cities such as London, Manchester and Liverpool have funds in place, the coverage of smaller cities in particular is much more limited. Previous work by Centre for Cities[25] has shown that there is an institutional blindness in the UK's development industry which means that it rarely looks beyond the largest urban areas in the UK to carry out development. Currently the UDF structure in England largely re-inforces this blindness rather than looking to counteract it.

Examples of such cities with potential for investment but which are currently being overlooked include some of England's 'mid-sized' cities, such as Sunderland and Coventry. Research by Centre for Cities[26] showed that these cities experienced strong private sector jobs growth in the decade prior to the recession that began in 2008. But the underperformance of their city centres threatens their future growth prospects and some form of public investment is likely to be required to support a strengthening of their city centre economies.

To allow UDFs to play a greater role in supporting investment in our cities, both of these issues – patchy coverage and the types of cities covered – will need to be addressed. Doing so will help support economic growth at a local and national level.

The rest of this paper will investigate why these two issues have arisen and will make policy recommendations as to how they can be overcome.

25. Sarling J, Swinney P & Coupar K (2012), *Making the Grade: The impact of office development on employment & city economies*, London: Centre for Cities
26. Swinney P & Carter A (2012), *Hidden potential: Fulfilling the economic potential of mid-sized cities*, London: Centre for Cities

Learning the lessons of UDFs

The difficulty in making investments, mainly driven by regulations attached to JESSICA monies, has been a key issue surrounding the creation of JESSICA-funded UDFs in the UK. Drawing on interviews with developers, fund managers, investors, local authorities and central government, this section identifies six elements of the current programme design which should be improved in order to attract a greater amount of private sector investment into UK cities through the use of UDFs. As a point of reference Box 3 sets out what investors require from Financial Instruments such as UDFs.

"The difficulty in making investments, mainly driven by regulations attached to JESSICA monies, has been a key issue surrounding the creation of JESSICA-funded UDFs in the UK"

Box 3: The requirements of investors

- **Governance:** Investors want a clear understanding of the governance arrangements and who ultimately makes the investment decisions for the Fund. They are wary of decisions which seem to be made by the public sector, and will look to the presence of commercial fund managers with a good reputation and proven track record.
- **Clear objectives:** Investors want to see clear strategic objectives set for any Fund so that they have a clear understanding of the type of projects which will be invested in. This enables them to quantify the financial risks associated with the Fund.
- **Scale:** Investors want the Fund to be on a sufficient scale as they typically make substantial investments and often look for others to invest too. They also want the Fund to have a large portfolio of investment projects to spread risk.
- **Expected returns:** Investors want a clear understanding of the expected returns from the Fund and the timeframe for these returns. This enables them to consider the balance between risk and return within the context of their wider investment strategy.
- **Liquidity:** Investors want to know the extent investment can be readily redeemed from the Fund as part of their wider investment strategy.
- **Transparency:** Investors want clear on-going information about the performance of the Fund in a comparable form to other investment information.

Figure 8 organises these six lessons learned into three groups: design; skills and expertise; and investment restrictions. Addressing these six lessons learned will improve the ability of the existing UK UDFs to make investments in UK cities.

Figure 8: Lessons learned from the structure of existing UDFs

Design	Skills & Expertise	Investment restrictions
Clarity of rules & regulations	Pipeline development for Government & Fund Managers	Investment restrictions
Size of UDFs	Switching from a grant mindset	Risk & reward structures

"Both the European Commission and DCLG should look to simplify the process of applying for and using funding from UDFs"

Design

1. *Clarity of rules and regulations*

UDFs often cite the difficulty in understanding, interpreting and coordinating the rules around the Funds made by DCLG and the European Commission. This uncertainty means that some UDFs operate under different rules (or a different understanding of the rules), which causes confusion among the Funds, investors and developers.

One example where there is particular confusion concerns the use of recycled funds. The interpretation of what rules apply to recycled funds varies between the UDFs and influences the way they structure and market their Fund. It has also caused delay in establishing the UDF in some cases, as rules around recycling the monies influences the legal and financial design of the UDF.

Another example has been around the translation of ERDF grant regulations into debt, equity and guarantee arrangements that are acceptable to private sector fund managers. Many of the regulations were not updated upon the creation of UDFs to reflect the differing nature of a commercial loan to a grant. And translating these rules was a factor in the time it has taken to establish UDFS that are now in operation.

Recommendations:

- Both the European Commission and DCLG should look to simplify the process of applying for and using funding from UDFs.
- Rules and regulations should be interpreted and consistently enforced across the UDFs by the European Commission and DCLG, simplifying the conditions attached to JESSICA and UK Government monies and clarifying their implications at the beginning of the new funding period.
- DCLG should seek to reduce duplication between funds and encourage efficiencies by creating a platform to share lessons learned between UDFs.

2. *Size*

The small scale (in terms of money and geography) of current UDFs limits the size of projects that they can invest in. This means that many of the schemes identified in Section 2, particularly those based around city centre development, could not be supported by a UDF in their current format. The small scale also limits the attractiveness of UDFs to potential fund managers.

The overall size of the UDF limits the size of the individual investments it makes. The rule of thumb among current UDFs is to have no more than 20 per cent of their total funds in any one project; if one project fails, the UDF will still be operational with 80 per cent of their resources. Most UDFs typically invest between 20 and 30 per cent of the total project cost. In some cases this can be as large as 50-60 per cent.

"The overall size of the UDF limits the size of the individual investments it makes"

This means that if a UDF wanted to invest in a project of some scale and impact to a city–say £100 million – the Fund would need to have access to total monies of between £100 million and £150 million (see Box 4). At a minimum, UDFs should be able to invest in individual projects worth around £40 million, meaning the Funds would need to be operating with a total pot of at least £60 million in order to diversify their portfolios. This is much larger than most of the current UDFs, as shown in Figure 7.

Box 4: Example of how project type and size determines scale of UDFs

UDF minimum size determined by scale of projects

	Ideal Size	Minimum Size
Project cost:	£100m	£40m
UDF contribution (30%):	£30m	£12m
Max contribution as % of total UDF:	20%	20%
Minimum size of UDF:	£150m	£60m

Larger UDFs may also be able to attract both a greater number and better quality of Fund Managers, which is important as they play a critical role in project pipeline development. As such a larger sized UDFs would likely increase the pool and quality of potential Fund managers.

"From our perspective as a commercial fund manager, £50m+ is where you want to be." Interviewee quote

Recommendations:

- The Government should increase the size of funding that it commits to UDFs to increase their scale. This could be done by reassigning current funds for economic development, such as the Regional Growth Fund, to UDFs.
- DCLG should consider assigning a greater proportion of ERDF for the 2014-2020 period as JESSICA money to increase the contribution that ERDF makes to UDFs in the UK .

Skills and expertise

3. *Pipeline development*

A successful UDF requires a pipeline of viable projects to fund. But experiences of the UDFs to date suggest that developing such a pipeline has been more difficult than first envisaged.

Interviewees suggested that this had occurred for two reasons. Firstly, the increasingly limited capacity of local authorities meant that project development had fallen on Fund Managers. In many instances the Fund Managers were involved relatively late in individual project development, resulting in wasted effort and resources. Earlier involvement would have reduced the time taken to secure development as advice around issues such as de-risking projects would have speeded up the process.

Secondly there has not been a long list of 'oven-ready' projects to finance. For many of the projects that have been considered by UDFs, the Fund Managers have had to invest time to bring them to a position where they become viable investment prospects. This further type of cost is likely to act as an additional barrier to bringing a development forward.

"There has not been a long list of 'oven-ready' projects to finance"

These two factors are likely to have limited the development of projects for investment. This suggests that resources for pipeline development can not come from the Fund Managers alone if investment by UDFs is to be increased.

"There could be a TA pot to provide grant or commissions studies on behalf of projects to help them come to market. It's a lot of work to find out what is viable and what is not." Interviewee quote

"The first and foremost challenge is developing the project pipeline–finding the projects to invest in." Interviewee quote

"In some cases (noting not in Evergreen) fund managers are involved too late in the process. If they were involved earlier then derisking advice could be given and projects could go ahead earlier." Interviewee quote

"Many projects brought forward are not finance ready and require work." Interviewee quote

Recommendations:

- Technical Assistance should be provided to Fund Managers to support pipeline development and to offset the reduction in capacity in local authorties to encourage the progression of a greater number of projects. This should take the form of grant funding, and the requirement for this to be match funded (as is currently the case) should be reviewed.
- In order to create the right incentive structure, any Technical Assistance funding should only be fully paid on projects that attract investment from a UDF or alternative funder. This could take the form of an initial payment of 20 per cent with the remaining 80 per cent paid upon investment. The funding should be assigned to the UDF level and managed by the advisory committee, with the fund manager applying to the committee to get access to the fund on a project-by-project basis.

4. *Mindset of grants over investment*

Some UDF managers perceive local authorities as having an entrenched expectation of grant funding and as lacking a clear understanding of the enhanced benefits of the UDF model (mainly recycling of funds and greater partnership working).[27] This is regarded as having had an impact on the types of projects that local authorities have attempted to bring forward, some of which have been unsuitable for UDF investment.

27. A similar finding was found in Tyler P (2012), *Expert evaluation network delivering policy analysis on the performance of Cohesion policy 2007-2013 Year 2 – 2012, Task 1: Financial engineering, United Kingdom,* Brussels: European Commission

"One of the core challenges of working with local government is to get them to change their mindset from grant and being a client to investment and being a partner." Interviewee quote

Recommendation:

- The Holding Fund should provide technical assistance and resource materials to Fund Managers to explain the benefits of UDFs compared to grants, as well as the ways in which local authorities are expected to act differently (e.g., risk sharing).

Investment restrictions

5. *Investment restrictions*

"The Holding Fund should provide technical assistance and resource materials to Fund Managers"

UDFs funded by JESSICA are specific and rigid in the types of projects they can invest in. Restrictions from the European Commission, DCLG[28] and in some cases the UDFs themselves limit the type of projects and the scale of projects suitable for UDFs. This limits the pool of projects that Fund Managers can choose from.

A good example is in the East Midlands, where money has been designated to fund hi-tech, high-growth SME space only.[29] This further limits the number of suitable projects to invest in on the indicative spectrum of investment shown in Figure 4 above.

The exclusion of the construction of housing in particular from ERDF funding has been a frustration for those working with UDFs.[30] A lack of housing in the UK, particularly in some areas, is a big challenge to the national economy.[31] The inability to tackle this limits the impact that JESSICA can have on the UK's urban economies.

"It's remarkably difficult to lend money because of the economic climate. The more flexible you can be in terms of putting the money where it should go, the better. Try not to create silos and restrictions that keep money from being spent where it could really be used." Interviewee quote

Recommendations:

- A greater amount of flexibility around the use of funding should be introducted to the UDF model. To do this, the European Commission and DCLG should set out guiding principles for investment, rather than hard rules.
- Government monies could provide match funding for the UDF which can be spent outside the ERDF eligible areas and can be invested alongside ERDF projects within the Fund.
- UDFs should avoid putting further restrictions on how the UDF money is used beyond those applied to the Holding Fund. Any further restrictions that are applied by the Operational Programme of a UDFs should align with local economic conditions.
- The European Commission should remove the restrictions of the types of projects that UDFs can invest in, particularly housing.

6. *Risk and reward structures*

The future development of UDFs should look to create a more advantageous risk and reward structure for the public and private sectors alike. For example, riskier projects with high social reward may warrant the use of public finance to provide 'first loss'

28. As the UK's managing authority for JESSICA monies.
29. This focus was based on the priorities of the 2007-2013 ERDF programme, established with grant funding in mind and not necessarily reflective of the current economic climate.
30. It is worth noting here that energy efficiency programmes on social housing are not excluded because the focus is on the energy efficiency goals rather than the housing stock. E.g. London
31.Centre for Cities (2013), *Cities Outlook 2013,* London: Centre for Cities

protection to private investors, reducing their risk and providing the incentive to support a project with lower, but more certain returns.

State Aid is a particular example of this. UDFs that are able to benefit from State Aid approval, such as the Chrysalis and Evergreen funds, have a greater degree of flexibility because the approval increases the number of projects that they can potentially fund. This approval enables the two UDFs to make sub-commercial investment options, where certain conditions are met.

One option would be to secure State Aid approval for all UDF projects that operate within the UK. This could reduce both the time and cost associated with the application process and the risks associated with operating without an approval. There would still be a requirement to commercially appraise developments in this approach – the State Aid notification for the North West, for example, requires an appraisal to identify the funding gap of a particular scheme. But it would also potentially allow the fund to de-risk an investment, making it more attractive to the private sector.

"Government should look to streamline and clarify the State Aid approval process for UDFs"

This would remove the pari passu–or 'equal footing'–split of returns between private and public funding, to be used where appropriate. Interviewees suggested that a change in this rule would increase the spectrum of projects that private investors would seek to invest in, as illustrated in Figure 5. This would mean, however, that either UDF or public sector funds would need to take the brunt of any financial difficulties, while private investors would be granted 'first loss protection'.

"The State Aid notification gives greater flexibility around eligible projects". Interviewee quote

Recommendations:

- The European Commission and DCLG should review the requirement to have a 50:50 payback of returns on all projects, specifically looking at the viability of having a sliding scale of payback between funders to reflect the risk of a project. Wider ERDF or UK Government monies should be considered to fund the grant element of an investment.
- Government should look to streamline and clarify the State Aid approval process for UDFs.
- Government should also consider extending the North West State Aid approval to all UDFs which seek it, given the projects meet due diligence requirements. If demand is strong a UK wide State Aid notification should be considered.

Case Studies: Understanding the requirement for UDFs across cities

A combination of these issues has had or would have implications for operation of UDFs across the UK's city economies. To illustrate why we need the proposed changes to UDFs set out above, five case studies on individual cities are presented below to illustrate their specific challenges and opportunities. These cities were selected according to their size and location and the strength of their economies.

Manchester

Manchester is the UK's third largest city economy. This scale has allowed it to set up the Evergreen Fund, which covers Cheshire, Lancashire and Cumbria as well as Greater Manchester itself. In total 5.7 million people live in, and 25,000 businesses operate within, this area.

The creation of the UDF has been built on long running relationships between the local authorities within Greater Manchester. Staff of the investment teams of Greater Manchester's local authorities also work part time for the Association of Greater Manchester Authorities to determine key investment projects for the city region. This pooling of resources increases the capacity within local government to support the fund.

Despite the long term working relationships between the Greater Manchester local authorities it still took three years for the fund to make its first investment, compared to under two years for the Welsh UDF.[32] Complications around the interpretation of rules written for grants but applied in a co-investment framework, particularly with the matching of development sites to projects, were a main factor. These delays have not been unique to the North West – there was a lag of almost two and a half years between the creation of the London Green Fund and its first investment by one of its UDFs.[33]

"The creation of the UDF has been built on long running relationships between the local authorities within Greater Manchester"

The fund has now announced its first two investments. The first is the Soapworks development at Salford Quays, a £6m investment which will convert the former Colgate-Palmolive factory into office space. The second is the Citylabs development, a £4.75m investment that will create office and laboratory space.

Demand for investment within the Fund's geographical area is strongest in Manchester city centre, where there is also a depth of viable developments. But demand for and supply of development projects elsewhere is weaker. Here the Fund's State Aid notification has become important in increasing the pool of viable projects which, without the notification, would not be taken forward.

Birmingham

Being the second largest city in the UK, Birmingham has the scale to support its own UDF. With major city-centre redevelopment underway, including an Enterprise Zone, unlike Manchester plans to create a UDF have not been taken forward.

Birmingham launched its 'Big City Plan' in 2010 with the ambition of transforming the city centre by targeting redevelopment of five key areas. The Enterprise Zone Initiative is being used as a catalyst to drive forward the delivery of the Big City Plan. This Plan aims to make major improvements to the walkability, public transport and residential and commercial offer in the city centre. But while in theory a UDF would have been suitable to help finance these improvements, several issues with the structure of a potential UDF meant that they have not proceeded with the creation of a UDF to date.

With over £1 billion in public monies being invested through the Big City Plan, the £20 million proposed UDF was regarded as a small piece of the puzzle. Given its size, the relative effort required to get the UDF up and running needed to be small as well. However, UDFs have had large up-front resource and time costs. The city-region fund would require collaboration from neighbouring authorities, strict procurement processes, a low borrowing rate, learning new regulatory and financial structures, and new relationships with Government and private sector in order to proceed with the UDF. Greater scale to the fund – in both monetary and geographic size – could have helped tip the scales in favour of bringing a UDF forward.

32. The North West Holding Fund was set up in November 2009 and the Evergreen Fund announced its first investment in December 2012.
33. European Association for Information on Local Development (2012), JESSICA in London: the London Green Fund, Brussels: European Association for Information on Local Development

Birmingham offers a very important lesson for the wider adoption of UDFs in the UK. The city has an appetite for working with the private sector, for taking on some risk and investing in its economic growth. However, the relationship between scale of the UDF and return on institutional investment of time, resources, and learning must prove worthwhile. A larger scale UDF and a clearer, simpler system with more technical assistance could redefine the use of UDFs in the UK.

Milton Keynes

Milton Keynes has been one of the UK's strongest performing cities in recent years. The pro-development stance of the city, coupled with strong private sector demand, has allowed it to expand quickly; its number of private sector jobs increased by 24 per cent between 1998 and 2008, and its population increased by 17 per cent between 2001 and 2011.

"Private sector demand is such that funding is available to support development within Milton Keynes"

To date Milton Keynes has not explored the possibility of using finance from a UDF, but the local authority notes that it could be used in the future to support economic growth. Given the requirement for a UDF to be of sufficient scale, the city's involvement should be as part of a UDF with a wider remit. On its own, Milton Keynes has a population of 249,000, much smaller than the 5.7 million people that live within the geographic remit of the Evergreen Fund, for example.

Private sector demand is such that funding is available to support development within Milton Keynes; notwithstanding the impact of the economic downturn the city's strong economic performance makes it an attractive proposition to the private sector. But there is a market failure in the provision of up front financing of housing-led projects. Developer appetite to bear the up-front costs of development is weak, while the local authority is not in a position to bridge this gap. Housing developments on greenfield land, for example, typically require infrastructure investment of £20-30 million per 1,000 dwellings.

Traditionally the Public Works Loan Board (PWLB) has been used by local authorities to finance such investment when it has been public sector led. Although likely to be more expensive, UDF lending would be off the public sector balance sheet and would provide the opportunity to give more certainty by forward fixing the interest rate on repayments.

In order to continue its recent expansion, sites on the periphery of Milton Keynes will need to be developed as the city looks to expand. The problem, however, is that under current rules the city would not be able to finance its housing expansion through a UDF because the financing of housing is not allowed under JESSICA rules. Without change this would limit the role that a UDF could play in supporting the continued expansion of one of the UK's strongest performing cities.

Barnsley

Barnsley, like many of its neighbours in South Yorkshire, performed more weakly than many cities in the decade before the current downturn. In part this is because it has continued to grapple with the impact of deindustrialisation on its economy – as late as 1980 it was still home to 15 coal mines, none of which are open today. This rapid shift in the structure of its economy has meant that land remediation has been a big part of the overall investment in the city in recent years, which is not only capital intensive but requires grant funding and takes many years to complete.

Scale is not an issue for Barnsley. Despite only having a population of 231,000, its location within the Sheffield City Region means that it falls within the geographical remit

of the Sheffield City Region Investment Fund (SCRIF) UDF. Reflecting the balance of demand for land within Barnsley before the onset of the downturn, the sites earmarked to be considered for funding from the SCRIF are out of town sites with good access to main trunk roads or the M1 motorway. The current plan for these sites is for them to be occupied by manufacturing, distribution and logistics companies, following on from the decision of companies such as ASOS to locate within the city.

The problem that such sites are likely to face, in the short term at least, is one of demand. The appetite for developers to take on risk is weak, and so investment is likely to require some degree of de-risking, not only to deal with the cyclical issues of demand but also to deal with longer term structural issues that result from the capital investment required to continue to deal with issues such as land remediation. For this to occur, the current pari-passu requirement on returns from investment would need to be reviewed.

"A UDF could benefit Southampton by aiding the Council in building stronger public-private relationships"

Southampton

Southampton performed relatively strongly in the decade before the recession – it was assessed as being among the top cities in the Centre for Cities' Private Sector Cities classification. The city is not currently part of a UDF but would be interested in pursuing finance from a UDF in the future to support its plans to redevelop its city centre.

In the past, Southampton has had a reputation with some developers for being closed off to new investors and too inwardly focused. Thus, the city experienced under-investment given the opportunities available because there was simply not the quantity and clarity of information developers needed.

Efforts of both the Council and Business Solent – a business-led group supporting economic growth in the area – have since worked to raise the profile of the city and are promoting the opportunities available there, especially focused on the City Centre Masterplan, which has given more certainty to developers. Being more open to public-private working and marketing the opportunities of the city is an important by-product of the partnership working seen in UDFs.

A UDF could benefit Southampton by aiding the Council in building stronger public-private relationships, focusing the development pipeline around the city's strengths in its universities and role as a regional centre in the South East for example. Infrastructure investments around the Eastern Docks and Southampton Central Station have the potential to unlock growth in those areas. According to stakeholders the city has made good progress in attracting new investors, including a partnership between Lloyds Register and the University of Southampton. This could tackle the city-wide challenges of providing the information and relationships needed to bring development forward on larger projects, raising the profile of the city as a whole and reducing the risk associated with lack of information about local markets.

These case studies illustrate how issues around pipeline development and investment differ across cities. The next section looks at how a re-design of the structure of UDFs in the UK could address these challenges, increase the creation of UDFs and result in increasing investment in our cities.

An improved model for urban finance

The previous chapter outlined specific recommendations to improve the current UDF system in the UK. But even with the proposed changes, UDFs would still lack the geographic scope and financial scale to attract and mobilise private investment to drive change in many UK cities.

This section sets out why and how the current UDF programme could be strengthened by:

- A national Holding Fund which acts as a 'Funder of Funds', with several place-based UDFS operating beneath it
- A technical assistance programme to reduce lead-in time for new UDF investment

"Since the formation of UDFs in the UK, major political and economic changes have altered the landscape in which they operate"

A moving target: changes since the original conception of UDFs

Since the formation of UDFs in the UK, major political and economic changes have altered the landscape in which they operate. These shifts bring to light areas where a national UDF programme should adapt to the new environment.

Change in administrative structure. Previous JESSICA funding has been administered at a regional level through the Regional Development Agencies in England.[34] Since the abolition of the RDAs, the responsibility for JESSICA has been assumed by central Government (DCLG).

The change in the structure of economic development in England presents an opportunity to rethink how UDFs operate in order to support city growth. Regional geographies were, on the whole, an administrative construct and often bore little relationship to the economic geography of UK cities. As a result, the coverage of JESSICA was not tailored to cities, despite them being its main focus. With the removal of the regional tier, greater thought should be given to city characteristics and location when creating new UDFs.

Economic change. UDFs began during a time of economic buoyancy. The scope of projects they fund and the market failures they address has shifted in the current economic climate. In a stronger economy, UDFs can more easily focus on kick-starting local regeneration efforts by dealing with site-specific challenges rather than wider-scale and cyclical issues.

As shown in the case studies, the onset of the economic downturn has meant that cyclical as well as structural market failures currently hinder investment. While finance is short in most cities outside of London, wider structural issues about investor confidence and market appetite in medium and smaller cities has expanded the scope of need for UDFs as well.

Increased localism. Lessons learned from the current Funds found that Fund Managers and Agents should operate as closely to the Fund's location as possible. Local market knowledge and relationships with local government and businesses are key elements to a Fund's success.

Evidence from the House of Commons reiterates the findings from our interviews. ERDF teams located in the area in which the Fund operates means they can offer better support and advice to businesses. In addition, The Greater Manchester Combined Authority commented that: "Having the DCLG team based in the region offers significant added

34. The devolved administrations have responsibility for administering JESSICA in Scotland, Wales and Northern Ireland.

value and understanding to the holistic economic development of the city region"[35] Thus, each city involved in the national UDF programme should have local representation, either with local government representation in the UDF or with agents who represent them and know the market.

Proposed basic structure of the Holding Fund and Urban Development Funds

Structure

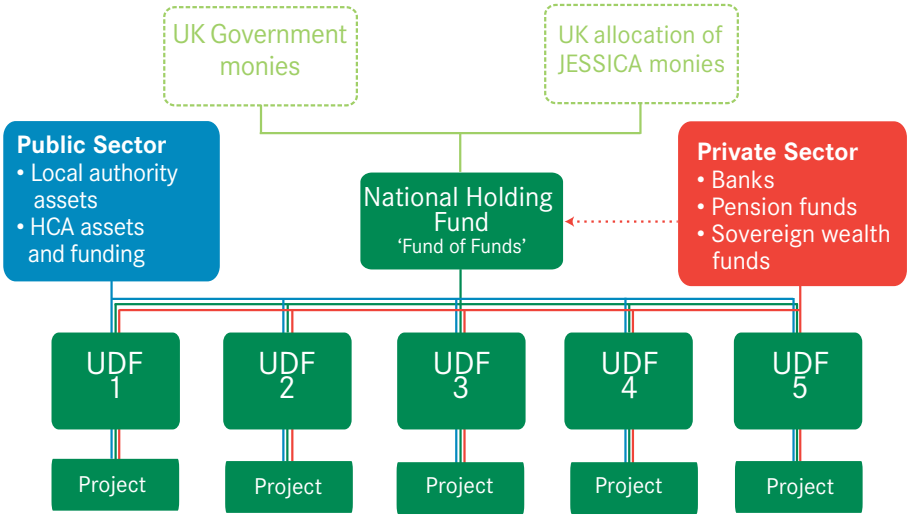
The structure of a national UDF programme should reflect the lessons learned from the experience of existing UDFs as well as changes in the administrative and economic landscape in the UK. The Holding Fund should use both ERDF and central Government funding to bring scale to the UDFs so they can increase their impact.

"The structure of a national UDF programme should reflect the lessons learned from the experience of existing UDFs"

Figure 9 sets out what the structure of UDFs could look like during the next round of ERDF funding (beginning in 2014). A national UDF programme would use a National Holding Fund to act as a 'Fund of Funds.' It would combine funding from JESSICA and UK Government would be managed by DCLG in partnership with the European Investment Bank. However, to remove the restrictions discussed in the previous section that JESSICA monies apply to investments UDFs could operate without the UK's allocation of JESSICA.

A further advantage of creating a 'Fund of Funds' is its scale. As was the case with Fund Managers of individual UDFs, private institutional investors also require an investment of a large enought scale to be attractive. The creation of a National Holding Fund would be of the required scale to provide the opportunity to lever in institutional inbvestment into UDFs.

Figure 9: Potential structure of future UDF funding in the UK



A number of Funds could sit under the Holding Fund, with money allocated to them according to a clear and established set of criteria and supporting funding agreements. To complement the existing UDFs currently in operation, each UDF in Figure 9 would represent a city or group of cities depending on their scale. In addition to the UDFs already in place,[36] two further types of city Funds could be created:

- Individual **City-region** Funds for the remaining Core Cities, i.e. those cities with economies that are large and strong enough to warrant a fund, but that do not currently have a UDF, such as Leeds and Bristol.

35. Communities and Local Government Committee - Second Report, European Regional Development Fund. The published report was ordered by the House of Commons to be printed 4 July 2012. http://www.publications.parliament.uk/pa/cm201213/cmselect/cmcomloc/81/8102.htm
36. Given the time taken to set these funds up, as illustrated in the Manchester case study, these existing funds should sit alongside the new UDFs created rather than being subsumed by them.

- **Multi-city /LEP** Funds for those cities that do not have sufficient scale to support a UDF on their own, and a pooling of areas allows a UDF to better spread risk.[37] Examples of such groups could be 'mid-sized' cities such as Sunderland, Coventry, Derby and Swindon that share similar economic characteristics, or City Deal Wave 2 Cities.

Each UDF would be managed by a Fund Manager. This Fund Manager would use Agents in the field who would work with local partners to help develop the project pipeline, liaise with potential investors, and work through proposals for UDF funding. The Fund Manager would then assess the project's business case, determine the funding and finance required and contract with the project. Box 5 illustrates the project investment process.

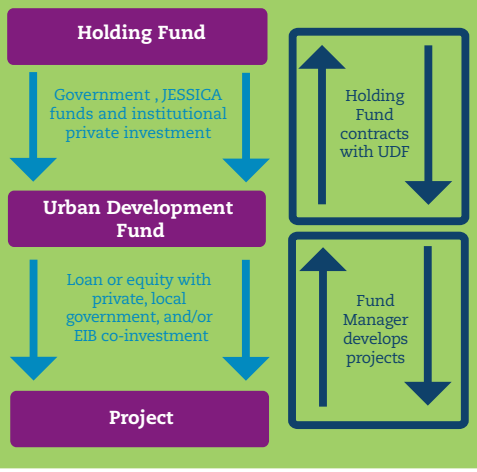
"The typical process for developing a UDF project is reliant on the work of the Fund Managers at inception and completion"

Box 5: An illustration of the project investment process

The typical process for developing a UDF project is reliant on the work of the Fund Managers or Agents at inception and completion of the project. The typical process is as follows:

1. Agents and Fund Managers collaborate, using their local and sector-specific knowledge to determine which projects are good candidates for the UDF.
2. Fund Managers:
   - check project eligibility against investment strategy including outputs and ERDF-eligible expenditure (if applicable);
   - seek initial approval at Board or investment committee level;
   - develop a business case based on the market failure;
   - provide evidence of local government and private sector funding;
   - define what Holding Fund resources are needed;
   - perform due-diligence; and
   - seek final board approval
3. The UDF matches National Holding Fund monies with UDF and project-specific investments to finalise the finance or equity model for the project.
4. Final funding is allocated via the UDF to finance the project.
5. The project is monitored.
6. Repayments and profits are passed back to the UDF which allocate them to their respective parties within the Holding Fund and public-private partners.

Figure 10: Typical development of a UDF project



37. This scale should be determined by the number of investment projects available for a fund of size £60 million to diversify its portfolio. A fund of this minimum size accords with money allocated to enterprise zones as part of the Government's wider £474 million Local Infrastructure Fund announced in the 2012 Autumn Statement.

Funding

Monies within the national UDF programme could be matched or invested at different levels. Money from the ERDF 2014-2020 Programme would be put into the National Holding Fund, and could be match-funded with Government programmes, such as the money currently assigned to the Regional Growth Fund and Growing Places Fund. National public funding would be matched at this level for management efficiencies and could be earmarked (as necessary) to comply with any legislative rules and regulations. Box 6 discusses the challenges of match funding.

Other investors may choose to invest at the UDF or project level. Local government money could be invested at the UDF or project level, depending on what would maximise leverage, management of risk and where appetite lies. Public investment could include local authority and HCA assets.[38] Finally, to maximise the leveraging of private sector money, matching should be done at the project level – interviews suggested that it had been much easier to attract private sector investment to a specific project than to a UDF.

"Monies within the national UDF programme could be matched or invested at different levels"

Box 6: Challenges of match-funding

UDFs have a dual challenge of securing match funding for those funds which utilise JESSICA and finding ways to make Government funding complementary to UDFs. To deal with these challenges will require strategic structuring of funding at the national and local levels, to ensure match funding can be delivered, enabling the UK and its cities to make the most of European funds. Upfront match-funding from Government is the easiest and most-certain way to ensure the most is made of ERDF available to the UK. While this challenge does not apply to all funds within the national UDF programme, learning the lessons from attempting to piecemeal match RDA funding to the current UDFs is essential for capitalising on European funding.

One solution to providing match funding has come in the form of using Government's schemes already in place. Most prominently, Regional Growth Fund (RGF) monies have been proposed as a means to match ERDF. But this has been met with challenges in both purpose and logistics. RGF is aimed at providing money to specific firms for boosting employment growth, while JESSICA's focus on creating new spaces (floorspace and refurbishment) means that the job-creation benefits of these projects do not match with BIS objectives for funding. Where the objectives do meet, the implementation and decision delays of RGF have made using it in time to invest in JESSICA projects impossible. In addition, decision making processes for ERDF projects are made locally based on local priorities, while RGF is decided by central Government based largely on national objectives.

To improve the flexibility of UDFs, restrictions attached to money currently assigned to policies such as RGF should be removed.

38. We note here that using land as match funding is more complicated that using money.

Governance

The governance structure of the Holding Fund and new UDFs should reflect the strengths of those Holding Funds and UDFs already in place. The main lessons learned from the current UDF programme include:

- Importance of public-private partnerships which are privately-led
- Clear channels of communication and divisions of responsibility
- Minimised restrictions on UDF lending decisions, both at the Holding Fund and UDF levels
- Transparent means of applying to the UDF

"Public-private partnership governance structures are the foundation of UDF success in the UK"

Public-private partnership governance structures are the foundation of UDF success in the UK. Tensions between the two parties' objectives (socio-economic versus financial returns) create an environment that helps ensure UDFs are operating in the right space on the spectrum of viability. Public-private boards should ideally have a private sector majority (e.g., 3-2 split on a five person board) to ensure investment credibility, off balance sheet treatment and to keep the private sector engaged. Public-private working is essential at both the Holding Fund and UDF levels.

There are several options for the model of governance of the Holding Fund. These range from a public corporation model, similar to that of Network Rail, through to an advisory board, similar to that overseeing the Regional Growth Fund. Whichever model is chosen, ensuring a strong commercial influence over the Holding Fund's strategy and decision making will be crucial to the success of the model.

Clear delineation of responsibility, powers and communication channels should be outlined. A common structure for the management and communication among UDFs and between them and the Holding Fund will assist in efficient and effective management of the Funds. Outlining these structures in the Funding Agreements between project managers, Fund Managers and the Holding Fund should be mandatory.

The UDFs should operate under a devolved management structure. Outside of legislative, regulatory and essential economic guidelines, Fund Managers should be able to 'get on with it.' This means that there should be no additional restrictions on what projects UDFs can invest in outside of the current ERDF guidance, and Fund Managers should be able to make strategic investment decisions on a commercial basis, not on the basis of political considerations.

But there should be a common governance framework across the National Holding Fund and UDFs. While some specific differences to reflect local variation may be necessary, a common approach will make it easier for private sector investors to understand how the UDFs operate. Navigating the UDF system for the first time imposes time and resource cost on investors, developers and public sector partners. The extent to which that learning process can be minimised through a common framework should be explored. Box 7 illustrates the governance structure of Merseyside's Chrysalis Fund.

Box 7: Governance in the Chrysalis Fund

The Chrysalis Fund demonstrates the benefits of public-private partnership working for UDFs. The Fund is owned by IRL investments and is governed by the Chrysalis Board of Directors made up of private partners and public representatives with the balance of power held by the private sector. This ensures that, even though the Fund invests in projects with more socio-economic return, they are guided by commercial principles.

Board Members	Votes
Igloo: Igloo, GVA, Royal Bank of Canada	3
Liverpool City Region Cabinet representative	1
Public sector representative	1
Independent Chair	0

This corporate governance model, with independent fund management, makes the UDF a separate private legal entity. Together, Igloo manages the UDF, with each private sector member covering the remit of their expertise. GVA is the agent, which finds opportunities and helps develop the pipeline. Royal Bank of Canada acts as credit advisors, providing an opinion on credit scoring and how to structure the deal. Igloo structures the loans, with compliance managed by Mazars as required.

"The National Holding Fund should be in charge of determining preliminary allocations of funds to the local UDFs"

Financial structure

The National Holding Fund should support and oversee the performance of local UDFs. Where existing UDFs have prescribed mechanisms of receiving ERDF monies, they should continue in that manner. Where new funds are created, the allocations to UDFs should be agreed by the Holding Fund Board against pre-approved allocations made by Government (including ERDF allocations made at LEP level). With each UDF given an indicative budget, actual monies would move from the Holding Fund to the UDF in bundles as projects are approved, funded and contractual milestones achieved. This ensures that money at the Holding Fund level is flexible enough to adapt to changing needs of cities and UDFs, and the Holding Fund can reallocate monies as necessary.

Money within the Holding Fund should be flexible and commutable between UDFs at set periods of time. Funds should be earmarked for UDFs at the outset of each funding period. This provides an indication to the scale of the Fund and allows the Fund Managers to plan the project pipeline accordingly. However, ideally the money should not be ring-fenced; rather, they should be able to be moved between funds as needs or progress changes.[39]

For transparency, UDFs should develop a common framework for assessing the allocation of their funds. A uniform framework for assessing projects and fund allocation would ensure that the best projects within each UDF will go forward. This would also promote the use of best practice and equitable distribution of resources based on financial and social returns rather than politics.

39. To give Fund Managers certainty over the size of the investment pot an allocation could be inserted into the contract between the UDF and the Holding Fund with the understanding that this money may be moved to another UDF in the case of an underspend. Local conditions should also be taken into consideration here. Those places with weaker demand may require a greater amount of time to develop viable projects, and so project pipeline should be considered before any money is reassigned.

Integration of Funds: A national programme for urban investment

A national UDF programme should provide a common funding and finance framework for unlocking key growth projects in cities across the UK. By developing a new national system of UDFs, Government could realise some very important advantages:

- Build on the lessons learned and infrastructure developed in the current ERDF funding period.
- Make the most of EU JESSICA funding, ensuring match-funding is coordinated early on.
- Make greater use of scarce public money by shifting the focus from grant-focused funding to a combination of public-and private funding in a time of austerity.
- Provide a framework for attracting additional funding and finance from the EIB, central Government, local government and private partners. This model allows the public sector to retain a role in setting investment priorities and developing projects despite the greater commercial focus.
- Develop a programme that can support projects across those cities which need UDF-style finance the most, increasing the geographic coverage of the Funds. This could also provide the opportunity to expand the coverage of the existing State Aid approal for the North West Holding Fund, increasing flexibility of public sector investment.
- Create efficiencies of managing UDFs across the country through common legal, financial and governance frameworks.
- Unlock growth in UK cities by overcoming market failures, supporting growth of their economies and in turn the national economy.

"A national UDF programme should provide a common funding and finance framework for unlocking key growth projects in cities"

Conclusion

The large reduction in the availability of finance for investment in our cities poses a challenge to their future growth prospects. Urban Development Funds provide a model that addresses the requirement of the public sector to take a more commercially focused approach to investment while encouraging private sector investment in our cities. But while the UDFs currently in operation provide a framework to build upon, their difficulties in finding investment-ready projects and lack of geographic coverage have limited their impact to date.

In order to get the design of a national UDF programme right, lessons learned from experienced UDFs should be carried forward. Providing clarity within the governance structure, offering scale to the Funds, allowing flexibility around investment and allocating time and assistance to pipeline development are among the main areas identified in this work to improve the performance of UDFs. Expanding the coverage of the current UDF programme will also allow all cities to access UDFs to support future investment in their economies.

"Urban Development Funds provide a model that addresses the requirement of the public sector to take a more commercially focused approach to investment "

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