Future of London: Policy in Focus
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Capital Momentum:
Can new funding sources help sustain capital investment in regeneration?

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Can new funding sources, such as pension funds or municipal bonds, help us sustain capital investment in infrastructure and regeneration during a time of national fiscal consolidation? Here, Tom Symons of the New Local Government Network, considers the merits of linking pension funds to infrastructure investments, and what implications this approach could have in a London context.

Introduction

The Budget 2010 confirmed that capital investment will halve from 2009 levels by 2014. This amounts to a huge challenge for England's myriad infrastructural weaknesses and needs. While it is important for the budget deficit to be tamed, it is also important that England has a network of modern infrastructure capable of supporting long-term economic growth.

The New Local Government Network has been working in recent years to resolve this conundrum. Central to this work has been a belief that while there may be limited capacity within central government over this parliament, local government should grasp the opportunity to harness innovation and actively drive new investment independently of the centre. In our recent report, Capital Momentum, in conjunction with the Northern Way we examined one strand of this challenge by assessing whether there is viability and benefit in releasing new sources of funding, and if so what the vehicles needed to do this could look like.

Shifting Responsibility for Capital Investment

It is becoming increasingly clear that responsibility for capital investment will be held not by central government, but by local authorities, sub-national collaborations and the private sector. The budget offered a degree of hope to the sector in the form of a commitment to sustain development and bring in more private capital, but expanding investment beyond the shrinking capital grant given by the centre will be determined by the ingenuity of councils and their partners. Promisingly, there have been hints of a more decentralised capital finance system. The announcement by Deputy Prime Minister Nick Clegg that councils will be given Tax Increment Financing-style borrowing freedoms by 2013 has been almost unanimously welcomed and could symbolise the beginning of a more independent and innovative municipal finance landscape.

There have also been warning signs. The £6bn of in-year cuts announced in Summer 2010 highlighted transport, housing, regeneration and schools as particularly vulnerable areas of capital investment. There is likely to be a considerable short-fall in these areas as well as others following October's Comprehensive Spending Review. The early signals from the Comprehensive Spending Review process are that housing and regeneration will be a major source of consolidation. In addition, as all local authority borrowing is consolidated onto the national balance sheet it is conceivable that the current latitude extended towards local authority borrowing may be reined in. This would further limit the availability of capital to invest in infrastructure development making momentum harder to sustain. The Budget 2010 has also made clear that private capital should be the preferred route for new investment, with public funding used only where it not possible to do this. Combined with recent changes to lending patterns in the banking sector, this has prompted much speculation about alternative ways of raising finance for infrastructure.

In Capital Momentum three new sources of capital are examined; municipal bonds, local authority reserves and investments and local government pension funds. Through our research, pension funds emerged as the option with most immediate potential. Municipal bonds may bring in considerable benefits in project finance rigour and financial over-sight, but currently are beset by unfavourable comparisons in lending conditions with the Public Works Loan Board. Perhaps more promisingly, local authorities continue to hold sizeable investments, estimated to be roughly £30bn. There would be various complex dynamics to work through, not least the need for high liquidity for local authority deposits, but this remains a plausible avenue for future capital finance. But it was the option of injecting local authority pension funds to vital infrastructure schemes that was felt to yield greatest potential. Just 1% of this would bring in close to £1bn of funding for flagging infrastructure schemes.

Linking Pension Funds to Infrastructure Investment

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

This is not to ignore that there are a number of objections to using pension funds for infrastructure finance. The risk-return profile is often considered to be inadequately balanced. There could be an inherent conflict of interest problem if the investment was made wholly in the same locality as the pension fund. There are also concerns about political risks, future regulatory or legislative reform and unrealistically high entry prices.

The solution must lie in the creation of an investment vehicle that can neutralise these objections. Superannuation fund investment in infrastructure typically involves the formation of infrastructure funds. These use pension fund investment to finance projects, paying a return to the pension funds and any other investors that is generated through use of the infrastructure asset. Therefore to make this an option viable in reality, the vehicle must address the three major elements of the investment decision; the philosophical, the structural and the economic. In other words, the vehicle needs to;

- change the mind-set of LGPS fund managers to want to invest
- provide a mechanism that can diffuse risk sufficiently and remove the conflict of interest objection

- provide a rate of return that is optimal for the pension fund's investment strategy

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

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

Which schemes would be most suitable?

Not all infrastructure entails the same degree of risk. There is a risk-return spectrum that exists within the infrastructure asset class that covers both different types of infrastructure and stages of infrastructure development. For instance, a post-construction school has a far lower volatility and return profile than a pre-construction airport or transport facility. Economic infrastructure entails demand and technological risks that are far less prevalent in social infrastructure, particularly where this has been procured by a public sector client. Infrastructure funds offer a rate of return commensurate to this risk level, ranging from approximately 15% for some types of construction stage economic infrastructure, to approximately 7% for operational social infrastructure. The decision must ultimately come down to a consideration of the return that is required by the investor and the risk they are willing to accept for this. This makes it important that any investment vehicle designed for pension funds can reflect the needs of its investors.

Our research recognised the inherent need for the various interests involved to be suitably aligned. This in itself presents the key to turning this concept into a reality for infrastructure investment. There is a need for a serious dialogue between local authorities and pension funds to establish the appetite for investment in schemes across a sub-national geography. Assuming there is interest, work needs to begin on establishing the areas in which interests can align. It may be necessary to appoint a fund manager to create a vehicle that can connect these two ambitions. With the right will from all parties this is a concept that could make a significant difference to plans for new infrastructure.

Implications for London

In a London context this could present several considerations. London is distinct from the rest of the country in its resumption of statutory sub-national architecture. An arrangement through the GLA could present one way of organising an investment vehicle. This would present questions however of the links down to local authorities and the scope they would have to bring their individual projects into the fold. There are also pre-existing organised collaborations in place, such as London Councils, which could present a means of aggregation that would retain a greater level of control. In addition, there remain question marks over whether London authorities will be able to enter into Local Enterprise Partnerships.

Should they be able to these would certainly provide a strong economic case for aggregated infrastructure schemes that could be made attractive to pension funds. It is also worth noting that negotiation with local government pension funds may be easier in London as the majority of London authorities' funds are managed by the London Pension Fund Authority, the largest in the country. With just one investor's requirements to tailor the investment option to, this could present one of the more straightforward negotiation processes.

Conclusion

It is clear that public funding for capital works, in its traditional forms, will not be sufficient to finance all economically viable schemes over the next 5 years. This is combined with a firm commitment from central government to promote localism and hand councils the powers and flexibilities they need to respond to local needs. This should offer scope for local authorities to intervene and activate economic development independently of central government. Realising the potential offered by new sources of capital must first and foremost begin with a proactive stance from local authorities and the relevant stakeholders. But in addition to this, we recognise that this would be better facilitated by a more permissive local financial landscape for local authorities.

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To read the full report visit: http://www.nlgn.org.uk/public/2010/capital-momentum-financing-options-for-locally-driven-capital-investment/