CATAPULT
Future Cities

# URBAN INNOVATION AND INVESTMENT

## The Role of International Financial Institutions and Development Banks

## ACKNOWLEDGEMENTS

The Business of Cities Ltd. was commissioned by Future Cities Catapult to produce a report to act as a background note for a gathering of International Financial Institutions and Development Banks to discuss the future of urban investments and urban innovation.

The genesis for this report began in late 2013 after an initial consultation to identify the IFIs which have specific focus on the urban agenda or have innovative financing mechanisms to support urban investments. Subsequently, this report was then stimulated by three overarching questions:

- How has the engagement of IFIs with cities emerged and evolved over time with respect to urban investments?
- What are the priorities of IFIs today in terms of providing financial and other solutions for urban innovation globally, and how are these priorities likely to change in the near future?
- Is there a common agenda among IFIs around integrated urban development, and is there an appetite to undertake new forms of partnership and financial instruments to support urban innovation?

The IFI-specific case studies that accompany this report were produced following an initial discussion with representatives within each of the institutions to establish the appropriate urban specialist. Subsequently, there was a series of in-depth face-to-face or telephone interviews with a total of 21 representatives across 11 of the 13 institutions. We wish to express our gratitude to the following individuals for their time in engaging with us and for the substantive written feedback:

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The series of one-hour interviews, combined with the cycles of communication and feedback they prompted, has informed the evolution, update, and revision of the 13 IFI case studies. These cases provided the basis for understanding the distinctive character and contribution of each IFI's urban agenda, which was circulated to the IFI's respective urban departments for peer review. The case studies' findings underpin this synthesis report, which summarises the most important elements of the IFIs urban investment activities and the role of IFIs moving into the future.

In March 2014, a two-day symposium was held in London to discuss the future priorities and opportunities in urban investment. Future Cities Catapult would like to thank **Simon Mills** and the City of London Corporation for hosting the roundtable discussion, and the Right Honourable Alderman **Fiona Woolf**, 686th Lord Mayor of London, for giving the keynote speech.

In September and October 2014 all of the initial case studies were reviewed, revised, updated and are presented here in a finalised form. These case studies are accurate as of October 2014 and can be found as an Annex as individual case studies on https://futurecities.catapult.org.uk.

This report was researched and written by **Greg Clark**, Chairman, and **Tim Moonen**, Director of Research and Urban Strategy, at The Business of Cities Ltd.

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The Business of Cities Ltd is an intelligence and strategy firm based in London, that observes and reports on global trends and changes in cities, leadership, and development. It provides an independent source of intelligence and expertise on cities, globalisation, and reform. With experience engaging with over 120 cities, it supports public and private sector leaderships and strategic agendas for cities, firms, and inter-governmental organisations.

## PROLOGUE

International Financial Institutions and Development Banks, collectively known as IFIs, operating at international, regional, and national levels, provide a critical nexus between the public policy goals of governments and the capital markets that allocate financial resources on a global scale.

For fifty years, IFIs have provided large-scale finance to urban development and infrastructure projects. This critical branch of development policies worldwide has been the structuring of financial packages using sound banking principles underpinned by state guarantees and technical assistance. Over the past decades, these financial institutions have evolved, each with distinctive priorities and ways of working, but all reinforced by the role of governments acting to support the sourcing of capital and to guide the way that capital is used to catalyse desired investments.

The repercussions of the global financial crisis, coupled with the mega-trends impacting cities - urbanisation, demographic shifts, resource depletion and climate change - have prompted IFIs to pave the way for more innovative and joined-up urban solutions. At the same time, IFIs recognise that finance alone cannot solve these complex urban challenges, and that capacity-building, knowledge-sharing, institution-building, and wider governance support will be equally important. This is especially true in cities, which share ambitions to become more productive, resilient and fit for the future, but with very different institutional frameworks and policy levers.

This report therefore seeks to synthesise how IFIs are responding with respect to urban investment and innovation, and map the current thinking of IFIs towards a more joined-up approach on city systems.

### Summary Points:

- **IFIs are a significant global resource for capital mobilisation and blended finance in support of urban development**. Finance from IFIs takes the form either of (i) sovereign loans to governments to capitalise urban programmes or to on-lend to municipal and metropolitan governments; (ii) lending to businesses or PPP mechanisms to provide key services; (iii) direct lending to municipal governments or funds; or (iv) capitalisation of syndicates to convene investment partnerships. There is also an increase in 'non-debt' forms of financing, especially the growth of various kinds of grants and equity finance initiatives. IFIs typically earmark 10-15% of their total portfolio for 'urban' programmes, but much more of their financing benefits cities directly through investment in infrastructure, housing, health care, energy and utilities, waste and water, business and industry.

- **IFIs are critical development partners of cities, supplying invaluable technical and knowledge support**. This takes the form of technical assistance programmes to support cities in structuring viable investment propositions effectively, capacity-building for national and sub-national institutions, and on-going assessment and peer-to-peer learning. IFIs now also help to shape the national development process, provide tailored solutions, support under-equipped smaller cities, offer project credibility, and train municipalities and civil society.

- **Partnerships with different types of cities are a growing feature of IFIs' practice.** Many have developed their own city partnership programmes around themes of competitiveness, sustainability, or good governance. The willingness and readiness of cities to participate in IFIs-funded initiatives depends on their size, scale, borrowing powers, bankability, regulatory climate, leadership and national political relationships. In recent years, IFIs have become active partners with emerging megacities, cities vulnerable to climate change, high growth competitive middleweight cities, and challenged cities in the vicinity of larger hubs.

- **IFIs are incorporating integrated multi-sector and 'city systems' thinking into their approach to cities**. Their initiatives since 2008 acknowledge that cities are positive for economic development and competitiveness. Therefore, the quality and design of urban systems, management and governance have a real impact on sustainability and liveability, making cities better equipped for the future. The recent step-change in IFIs' commitment in promoting and financing integrated city systems is linked to mega-trends including rapid urbanisation, climate change and demographic shifts, all of which put strain on existing public infrastructure.

- **For IFIs, urban innovation means the next threshold of priorities in a context of step-by-step development**. The recent phase of innovation for IFIs in the urban arena includes support for metropolitanisation processes, smarter investment in infrastructure, promotion of long-term and resilience thinking, empowerment of city management systems, help to shape national urban policies, adaptation of financing instruments to support combined approaches and life cycle financing, and the mobilisation of citizens around investment needs.

- **Few cities in the regions in which IFIs operate are very far down the path towards the 'holy grail' of comprehensively integrated city systems.** Indeed there are very few cities anywhere in the world for which this is a near reality. For IFIs, urban innovation 'on the ground' involves incremental steps towards the end goal of efficient and sustainable cities. Upgraded urban infrastructure - water supply, sanitation, urban transport, and solid waste management – is still viewed as pivotal to the economic growth potential of cities in low and middle income countries.

- **IFIs identify key barriers to urban innovation**. These barriers include siloed sector-specific rigidities, hostility to planning-led approaches, short political cycles, fragmented governance, and a lack of experience with diverse financial instruments, and limited local capacity to maintain and re-finance systems.

IFIs are dynamic organisations committed to finding ways to collaborate and partner to promote the urban agendas. No doubt, the role of IFIs and their influence will continue to evolve in the medium-term future. Whilst finance will be critical in shaping the urban future, so will new sustainable business models, innovative financial instruments, and partnerships, with IFIs at the forefront of these changes.

# CONTENTS

# 1. INTRODUCTION

This report examines the role that multilateral development banks, development banks, and bilateral development finance institutions (together known as International Financial Institutions, or IFIs[1]) play in financing and shaping urban development and investment across the world.

By way of introduction, IFIs are public sector development banks and development finance institutions that are owned by one or more national governments. The fundamental role of IFIs is to provide long-term large-scale development finance to meet national or international economic, developmental, and social priorities.  The provision of finance from IFIs can be provided to governments, to large and small-medium enterprises (SMEs), or to other financial intermediaries that can 'on-lend' or structure the use of the capital.

The size, influence and operational flexibility of IFIs make these financial institutions one of the most interesting and important branches of global public policy. Collectively, IFIs provide significant capital mobilisation, and knowledge on institution-building, policy development and the blending of financial instruments for investing in urban development.[1]

There are several ways to classify IFIs based on size of ownership and/or membership, source of capital, and nature of development targets. One way to categorise IFIs is as follows:

- **Multilateral development banks (MDBs).** MDBs are created by multiple countries for the purpose of development in both Organisation for Economic Co-operation and Development (OECD) and non-OECD countries. The capital is provided through multi-year donor cycles agreed amongst the member nations. MDBs fund operating costs from money earned on non-concessional loans to borrowers, with the loans themselves offered by borrowing money from international capital markets. MDB's main responsibility is to finance projects through a combination of grants and long-term loans at or below market rates. MDBs tend to have a separate Board of Governors and Board of Directors that represent members in decision-making.

- **Regional and sub-regional multilateral development banks.** Membership of regional and sub-regional banks is usually limited to borrowing nations in the local region, for example, Southern Africa or East Africa, with a small number of exceptions. Lending is typically made possible by borrowing on international capital markets, for which members effectively share repayment responsibility, thereby spreading the risks. These regional banks tend to be more flexible because the decision-making committee generally consist of national ministers rather than separate boards. Together, the members are able to borrow at competitive rates as a collective in pursuit of local development goals.

- **Bilateral development banks, development finance institutions, and agencies.** These financial institutions are established by one OECD country to help finance development projects with partner non-OECD countries or support with the

[1] Hereafter the 13 institutions covered in this report will be referred to, for sake of brevity, as IFIs. The distinctions between the different types of institution are detailed later in the introduction.

partner country's private sector development. As national organisations, these institutions are, in effect, a branch of national development policy and their activity takes the form of bilateral partnerships and projects, with public or private sector partners.

The 13 IFIs involved in this report include the following institutions, categorised by MDBs, regional and/or sub-regional development banks, and bilateral institutions:

## Multilateral Development Banks:

- With 54 African and 25 non-African member countries, the **African Development Bank (AfDB)** celebrated 50 years of operation in 2014. To date, AfDB achieved total loan and grant distributions of over $100bn,[2] nearly all agreed with sovereign partners. AfDB expanded rapidly since the early 2000s with an approved annual spending of nearly $7bn across 300 projects in 2013.[3] Whilst AfDB does not have a dedicated urban sector, however, there is much focus within their portfolio on infrastructure, transport, ICT and social development, all which are critical to cities. More recently, AfDB has ramped up its effort in mobilising the private sector in large African cities, as well as enhancing local finance capacity, both in which has been aided by improved access to data and statistics.

- Headquartered in Manila, the **Asian Development Bank (ADB)** will be celebrating its 50th anniversary and has operations across the Asia-Pacific region, which is managed through five sub-regional departments as well as private sector and knowledge management arms. The ADB, whose largest shareholders are Japan and the United States, approves financing of over $20bn annually, prioritising energy, finance, transport and ICT. Approximately, 10% of its total investment portfolio is earmarked for urban programmes. ADB's 2020 Strategy aims to make Asia's cities become more liveable through a combination of project funding and financial and technical instruments to catalyse private sector and capital market finance.

- The **Council of Europe Development Bank (CEB)** is a small IFI whose objectives, lending priorities and strategy are overseen by the Council of Europe's Administrative Council. Headquartered in Paris, the CEB has a small 150-person staff but comprises 40 European member state shareholders. CEB's main goal is to finance long-term social projects to achieve social integration and robust environmental protection in Western and Eastern Europe, using funds raised on capital markets. Due to its small, centralised structure, the CEB operates a more adaptable approach than its larger peers. Key priorities include social housing, urban renewal, energy efficiency and human capital development.

- The **European Bank of Reconstruction and Development (EBRD)** is one of the youngest IFIs established in 1991 to assist the economic transition in Eastern Europe and Central Asia. Headquartered in London, AAA-rated EBRD is owned by 64 national governments, including much of the OECD. The focus of its €40bn portfolio is to re-stimulate markets by lending to businesses and local financial institutions, or by offering long-term credit to governments and utilities. EBRD's urban lending is overseen and administered by the Municipal and Environmental Infrastructure (MEI) department, which lends over €500m across around 40 urban projects annually, much of which are loans to city (sub-sovereign) government partners for both water/wastewater improvement and low-carbon transport and energy solutions.

- The **European Investment Bank (EIB)** is the EU's long-term lending bank which broadens the EU's financing base for key investments. The five largest EU countries - Spain, Italy, UK, France, Germany – are its major subscribers and account for two-thirds of EIB loans. Since the 1980s, EIB has become an experienced and proficient financer of major stand-alone urban infrastructure projects. Of EIB's €50-70bn of annual lending, more than 10% is allocated to specific urban projects, although, indirect investment in the urban sector probably exceeds 40% of its portfolio, whilst it also provides significant technical and institutional support.

- **The Inter-American Development Bank (IaDB)** is a critical partner for many of Latin America's countries and cities. The AAA-rated IaDB is headquartered in Washington DC, and in addition to its country offices it has a strong presence in Madrid and Tokyo. IaDB approves over $10bn annually, and oversees more than 600 active projects. IaDB is looking to refine its strategic focus towards lower income countries and the private sector. Mexico, Brazil and Argentina are principal beneficiaries of the IaDB's lending, but more than 20 nations receive over $100m worth of investment each year. Urban projects are on the rise since 2007, whilst a separate Board-approved Emerging and Sustainable Cities Initiative aims to support the infrastructure and governance needs of the region's medium-sized cities.

- The **Islamic Development Bank (IsDB)** is a South-South multilateral development finance institution established in 1975 with the purpose of fostering economic development and social progress of its 56 member countries and Muslim communities. Saudi Arabia is the Bank's largest shareholder, followed by Libya, Iran and Nigeria. IsDB has a number of regional offices, including in Rabat to Kuala Lumpur. The IsDB uses Shariah-compliant financing instruments and approved a record $5bn of project operations for 2013-14, whilst enlisting new co-financing partners to achieve its goals. IsDB's Urban Development and Services Division was created in 2009 which sits within the Infrastructure Department and has a growing $2.5bn portfolio that largely focuses on water and sanitation projects.

- The **World Bank** is the oldest of the IFIs in this report, and historically the largest aggregate lender, with over $60bn of total annual commitments in 2014. Based in Washington DC, the Bank's major arm, the International Bank for Reconstruction and Development (IBRD), specialises in low-cost, stable lending to middle income creditworthy countries, with funding raised through bond issues in international capital markets. The concessional arm, International Development Association (IDA), provides 20-40 year debt at concessional rates to the poorest countries. The World Bank possesses unsurpassed global knowledge and experience, and continues to increase its urban portfolio – its $4.5bn of annual urban development lending is around double the pre-crisis volume.

## Regional/Sub-Regional Development Banks:

- **CAF - Development Bank of Latin America** (formerly Corporación Andina de Fomento) is the largest development bank and multilateral financer of infrastructure in Latin America. Headquartered in Caracas and with majority regional control, CAF has grown rapidly since the mid-2000s and commits nearly $12bn of annual lending, 80% of which is sovereign risk. CAF's major focus is to finance infrastructure projects that can help re-balance the region's growth model away from commodities and towards higher value knowledge sectors. Known for its flexible and risk-tolerant approach to lending delivery, CAF leads a 'Ciudades con Futuro' (Cities with Future) programme that provides investment and technical assistance with large and medium-sized cities in pursuit of more joined-up sustainable development.

- The **Development Bank of Southern Africa (DBSA)** is a development finance institution wholly-owned by the South African government. Since the democratic transition, DBSA's main goal has been to invest counter-cyclically into social service delivery and economic capacity. With a growing track record and creditability, DBSA has been able to borrow more from capital markets, and it has thereby grown its assets ten-fold over the past two decades. In 2013, DBSA underwent strategic overhaul, and now concentrates on infrastructure investment in South Africa on mainly municipalities, state-owned enterprises and Public Private Partnerships (PPPs). DBSA also supports the design and construction of key projects in the education, health and housing sectors on behalf of various government departments. In addition, it supports state-owned entities and PPPs outside South Africa, and of the $1.2bn of 2013/14 disbursements in infrastructure projects, more than a quarter applies to the wider region.

## Bilateral Institutions:

- The **Agence Française de Développement (AFD)** is a public non-profit institution headquartered in Paris. AFD is pivotal to France's international aid and development system, with a wide network of 70 offices and over 500 employees. The AFD approves over €7bn of investment annually, of which around 15% is supported by the French government. Over 15% of AFD loans are to non-sovereign partners, whilst its private sector lending subsidiary PROPARCO also has a $4bn investment portfolio. The AFD's priority region is sub-Saharan Africa, but over the past decade it has expanded its scope into the large non-OECD nations. AFD's new strategic plan develops a distinct lending approach to each region and advocates a new era of partnership with other IFIs and non-government bodies.

- **CDC Group (formerly the Commonwealth Development Corporation)** is a UK development finance institution, owned by the UK Department for International Development (DfID), but operates independently under the supervision of a board of directors. With total assets in excess of £2.5bn, CDC is self-funding and deploys profits from existing investments to finance its activities. CDC is the only IFIs in this study that invests exclusively in private enterprise – both directly and through intermediaries.

CDC's mission is to support the building of businesses throughout Africa and South Asia and job creation in some of the world's poorest places. In 2012, CDC underwent a strategic realignment to diversify beyond private equity funds, and now also provides direct equity and debt for expanding businesses across multiple sectors with a focus on agribusiness, financial services, manufacturing, infrastructure, health and education.

- **KfW Development Bank** is an integral part of the KfW Group and carries out Germany's financial co-operation with non-OECD countries on behalf of Germany. Headquartered in Frankfurt with about 70 local offices, KfW cooperates with partners around the world to establish a country and case-specific programme for reform and lending. Alongside KfW Development Bank, two subsidiaries KfW IPEX-Bank and DEG also have commitments abroad, with KfW IPEX-Bank active in international project and export finance and DEG provides financing and consulting to companies investing in non-OECD countries. Together, KfW Group committed over €6bn in 2012 annually, about a quarter of which is funded from the German government budget.

## Figure 1: IFIs – At a Glance

| | Year Est. | Members (non-regional) | Head Office | Priority regions | Credit rating[4] | Sectors |
|---|---|---|---|---|---|---|
| African Development Bank (AfDB) | 1964 | 53 (24) | Abidjan | Africa | AAA | Energy, Transport |
| Asian Development Bank (ADB) | 1966 | 48 (19) | Manila | Asia-Pacific | AAA | Transport, ICT, Energy, Finance, Trade |
| Agence Française de Développement (AFD) | 1941 | 1 | Paris | Sub-Saharan Africa, MENA | AA | Transport, Water, Urban Development, Energy |
| Development Bank of Latin America (CAF) | 1968 | 18 (2) | Caracas | Latin America | AA- | Transport, Energy, Water, Social Services |
| CDC Group | 1948 | 1 | London | Sub-Saharan Africa, South Asia | - | Financial services, manufacturing, business services |
| Council of Europe Development Bank (CEB) | 1956 | 40 | Paris | Europe | AA+ | Skills, Urban renewal, Health, Housing |
| Development Bank of Southern Africa (DBSA) | 1983 | 1 | Midrand, SA | Southern Africa | BBB | Energy, Roads, Sanitation, Water, ICT |
| European Bank for Reconstruction and Development (EBRD) | 1991 | 35 (29) | London | Eastern Europe, Caucasus, MENA | AAA | Environmental infrastructure, transport, SMEs |
| European Investment Bank (EIB) | 1958 | 27 | Luxembourg | Europe, Global | AAA | Transport, Industry, Services, Water, Urban |
| Inter-American Development Bank (IaDB) | 1959 | 26 (22) | Washington DC | Latin America | AAA | Productive infrastructure, Education, Energy |
| Islamic Development Bank (IsDB) | 1975 | 56 | Jeddah | Asia, MENA, Sub-Saharan Africa | AAA | Transport, Energy, Finance, Agriculture, Health |
| KfW | 1948 | 1 | Frankfurt | Global | AAA | Infrastructure, Environment, Entrepreneurial investments |
| World Bank | 1944 | 188 | Washington DC | Global | AAA | Governance, Energy, Transport, Health |

The majority of aforementioned 13 IFIs continue to loan (and sometimes grant) primarily to sovereign (and occasionally sub-sovereign) government recipients because of strict requirements for sovereign guarantees. In terms of private sector activities, the MDBs created by wealthy nations to serve the less developed nations, either have a private sector lending arm (such as the World Bank's International Finance Corporation, or IFC), or increasingly lend to private sector firms or commercial banks.

The sub-regional development banks, such as DBSA, created within lower income regions to serve local needs also intend to expand private lending, but in practice sovereign relationships tend to dominant because of the riskier and less mature markets in these lower income regions. Meanwhilst the bilateral development banks have specialised private finance arms, such as the DfID's CDC, AFD's PROPARCO and KfW's DEG.

IFIs vary considerably in terms of their financial power and lending capability. Among the IFIs, five now have subscribed capital in excess of $100bn as a result of multiple cycles of recapitalisation. At the opposite end of the scale, CDC is the smallest capital provider in this report, whilst the CEB lends the least amongst the 13 IFIs involved in this report. It should be noted that lending does, however, tend to vary year-on-year by as much as 25% due to different climatic factors.

Whilst the 13 IFIs covered in this report vary in size, ownership, legal status, purpose, and commercial orientation, perhaps the most significant variation are their respective scope and remit, and their focus on the private sector. Figure 2 is a mapping of the 13 IFIs against these two aforementioned factors.

## Figure 2: Typology of IFIs


Although the differences between institutions are manifold, it is important to bear in mind that IFIs are dynamic organisations that will continue to evolve and adapt to address mega-trends impacting cities and nations.

## 1.1 EVOLUTION OF IFIS: FIFTY YEARS OF LENDING

Whilst lending practices vary from institution to institution, over their relatively short history there has been a clear progression in how IFIs approach city funding. A review of the 13 IFIs and their respective approaches to urban investment reveals three distinct, yet overlapping phases:

- 1950s to 1980s: Urban Investment Experimentation
- 1980s to 2000s: The Rise of Urban Specific Policies
- 2000s to the Present: Towards an Integrated Approach

### 1950s to 1980s: Urban Investment Experimentation

Majority of IFIs in this report were established in the post-World War II era with specific directives to help reduce poverty and address rural economic development challenges in lieu of private financial investment. Many of which made their first investments into cities in the 1960s and 1970s as stand-alone initiatives to address basic infrastructure limitations, such as water supply, sanitation, and inter-city roads and funded in the form of credit lines to local banks. Often these investments were not made with a specific urban mind-set, but to support with poverty alleviation initiatives.

The 1980s witnessed a broad evolution in IFIs' approaches to cities. Practitioners observed that the existing policy and institutional frameworks were not maximising the effectiveness of the project investments. Instead of financing one-off projects, IFIs began to recognise challenges of urban management amid rising slum dwelling across many cities across the developing world. This prompted a more sustained phase of policy and advisory cooperation with country governments to build up capacity, with equal emphasis on macro-economic reform that would encourage the private sector to participate in urban services. Some IFIs opted to forego direct financing of urban infrastructure from the presumption that the private sector could fill the gap.

Urban development grew incrementally as a proportion of IFIs investment over this time period. However, concerns about fragmentation of investment continued to persist. During this period, IFIs tended to view rapid growth in cities as part of the problem instead of harnessing the potential that cities can offer.

### 1980s to 2000: The Rise of Urban-Specific IFIs Policies

In late 1980s and early 2000s, IFIs began to develop Bank-wide urban strategies that would underpin a more consistent engagement with cities. Major initiatives were launched, for example in 1999 (ADB) and 2000 (World Bank) that for the first time attempt to focus on citywide development that spans the physical environment, infrastructure, finance, institutions, and social sectors.

These strategies were accompanied by rising individual loans to projects as well as the total loan volumes. During this period, there was greater outreach to cities governments through intermediary approaches in order to help more cities to develop systems for project financing. Important networks such as the Cities Alliance, Cities Development in Asia and the South African Cities Network emerged to propel these agendas, which were endorsed and supported by IFIs and other bilateral donor organisations.

Although the World Bank established its own Urban Division in 1972 via the IBRD, it was not until the early 2000s that many IFIs followed suit and established an urban-specific division. These urban divisions were created to sit differently within each IFIs organisational structure, with varying powers and capabilities. Where there were stand-alone urban departments, these IFIs appear to be empowered to focus on innovation, replicability and scalability, and multi-cycle public-private co-operation.

One of the limitations during this period was a tendency towards a one-size-fits-all set of solutions which was too inflexible to fit the complex needs of cities in different political contexts. Many projects proved unsuccessful due to a lack of systems created on the ground within and between municipalities and utilities, which made implementation ineffective. Despite the rise in project numbers and investment, technological and institutional conservatism within urban sectors of IFIs constrained the impact on urban systems.[5]

## 2000s to the Present: Towards an Integrated Approach

Since the global financial crisis in 2008, most IFIs have substantially increased their commitments to urban agendas. Regional development banks in Latin America, Asia and Africa have played a counter-cyclical role in scaling up lending operations to cities as debt financing from commercial banks declined dramatically due to the capital adequacy requirements.[6] In the post financial crisis era, IFIs are increasingly acknowledging that cities are a permanent and positive feature of globalisation, and that the quality and design of urban systems, densities, management and governance have a real impact on economic development. Most IFIs have learnt from their previous experiences that key targets cannot be fully achieved without a multi-dimensional and multi-sector approach which takes seriously how cities are institutionally configured and fiscally empowered.

Presently, due to the considerable wealth and knowledge in urban financing, IFIs have also been a major source of technical advice, for example, helping to establish data-led urban observatories and actively assisting governments to make cities more institutionally effective, investment ready and business friendly. This period has also seen much more knowledge-sharing take place between IFIs and between other organisations on understanding the complexity of urban agglomeration, cluster-building, value chains and productivity.

National governments are increasingly recognising the important role that cities play in achieving economic development goals, and have begun to invest and shape urban development in cities. In parallel, many of the largest Western financial institutions are no longer the largest global lenders or investors. Large middle income countries are increasingly able to tap global capital markets directly, as evident by the establishment of the New Development Bank[2] (previously known as the BRICS Development Bank) in 2013.

[2] The New Development Bank (NDB) is a multilateral development bank operated by the BRICS states (Brazil, Russia, India, China and South Africa) to foster greater financial and development cooperation among the five emerging markets. It was agreed by the BRICS leaders at the 5th BRICS Summit held in Durban, South Africa in March 2013.

## 1.2 THE ROLE OF IFIS IN URBAN DEVELOPMENT

Although IFIs vary in regional focus, IFIs all share a common characteristics in that each IFI is a highly-rated credit worthy raiser, usually AAA in most cases but not all. As such, IFIs can borrow on the international capital markets at competitive rates as they are underpinned by sovereign guarantees and complemented with sound banking practices. As many IFIs receive financial support from their shareholders, IFIs tend to have a loan portfolio with strong capital adequacy, liquidity and asset quality. The relatively low risk profile of IFIs allows them to offer:

- Direct sovereign loans to borrowing end-customer states (sometimes called 'retail' operations) and/or
- Lending to private banks and other financial partners which then on-lend to end-customers (called 'wholesale' operations).

In both these cases, IFIs' lending has been offered at rates that are rarely achievable with commercial loans in the recipient countries. Because of this, many IFIs have been able to catalyse long-term infrastructure finance, including in cities to help draw in private capital into long-term projects in locations and sectors where the market perceives higher risks.

Although sovereign guaranteed debt finance is the dominant form of lending, many IFIs have also developed new instruments to address urban development and investment challenges. In some cases IFIs have evolved to directly supply capital to municipal governments, without a state guarantee. They have also developed investment mechanisms such as municipal funds, risk-sharing facilities, or specialised financial instruments that support urban development rather than national development processes.

IFIs' medium-term strategies have now focused their partnership with municipal governments as a building block to shape urban development, in tandem with an enhanced private sector which offers the entrepreneurial impetus to supply urban services and to scale-up urban innovation.

The pace of urban investments has picked up in nearly all cases. It is estimated that total annual direct urban lending between all 13 institutions is $25-30bn, with as much as a further $100bn spent indirectly by their other lending programmes. Today, IFIs typically earmark 10-15% of their total portfolio for urban programmes, but much more besides is earmarked for infrastructure whose impact is often most felt in cities. By some estimates, as much as 60% of total IFIs lending has an impression on city capacity or services.

In addition to this diverse supply of capital, IFIs have increasingly become development partners of cities, and to national governments that seek to steer urban development. IFIs are now invaluable source of knowledge, technical assistance and capacity-building for urban strategy and projects. As such, IFIs' value-added has shifted from direct capital support towards a broad set of interventions that aim to foster and stimulate development cycles, the investment market, and to build capacity for sustainable investment and development in cities.

**Figure 3: Lending by IFIs in 2012-2013**

| | Credit rating[7] | Authorised Capital ($bn)[8] | Subscribed capital ($bn)[9] | Annually approved lending operations ($bn)[10] |
|---|---|---|---|---|
| AfDB | AAA | 103 | 100 | 2.8 |
| ADB | AAA | 164 | 163 | 21 |
| AFD | AA | - | - | 9.2 |
| CAF | AA- | 10 | 6.3 | 12 |
| CDC | - | - | - | 0.3 |
| CEB | AA+ | - | 5.5 | 2.4 |
| DBSA | BBB | 0.5 | - | 1.7 |
| EBRD | AAA | 41 | 40 | 11 |
| EIB | AAA | - | 323 | 96 |
| IaDB | AAA | 171 | 145 | 14 |
| IsDB | AAA | 153 | 77 | 5.1 |
| KfW | AAA | - | - | 8.5[11] |
| World Bank | AAA | 278 | 223 | 66 |

The involvement of IFIs in urban development and urban investment also include:

- **Helping to shape the national development process** to support preferred outcomes, and in so doing makes projects more bankable and sustainable. Through their country offices, IFIs are now active partners in helping to set the development agenda with national governments in areas such as climate change, housing and public transport, with urban development a central part of the overall agenda. Examples include ADB's strategic advisory role on Kazakhstan and Uzbekistan urban development up to 2040, and KfW's partner country agreement with Bangladesh which has paved the way for a new urban climate change adaptation programme. As such IFIs are engaging much more closely and systematically with the agenda of national governments and the capability of their systems to respond to new urban economic and social realities.

- **Providing tailored solutions** as IFIs have become experts at understanding which methods - technological, institutional and organisational – work successfully in different contexts. After a period of 'one-size-fits-all' approaches to urban development, IFIs now have the breadth and depth of knowledge to adopt and adapt innovations inspired elsewhere.

- **Engaging with small or medium-sized cities where demand or proficiency is lower** where IFIs interventions increasingly recognise the role that competitive 'middleweight' cities (250,000 to 5 million in population) will play in emerging regions, as the layer beneath the global megacities. The middleweight cities are where much future growth will take place if their environment and functionality can be kept superior to the sprawling gateway megacities. The smaller governance maze in these cities means IFIs recognise an opportunity to make a more visible impact on their systems and to show others what can be achieved in terms of urban sustainability.

- **Offering credibility and transparency to projects** in order to retain their attractive credit ratings, and use their capital wisely, IFIs have to undertake comprehensive due diligence for the investments and loans that they make. One important side effect of this is that when a recognised and reputable IFIs invests in (or lends to) a project, other investors (including other IFIs but not limited to them) will be attracted to the same project or opportunity. The IFIs' willingness to lend acts as an important 'market signal' to other investors that the opportunity has been carefully appraised and that a leading international lender has confidence in its bankability.

- **Training municipalities and civil society** through training and learning programmes. This is in part because they have reach across many locations and are well placed to identify good practices, standards, and practices that can be codified, taught, and illustrated. In addition, IFIs are aware of the challenges that developmental projects and programmes bring and can address them directly in training. Finally, there are important training needs arising directly from the systems and protocols that they use, and these can be trained best by the IFIs themselves.

## 1.3 ORGANISING FOR URBAN INVESTMENTS WITHIN IFIS

The evolving policy frameworks within these institutions can sometimes make it difficult for IFIs to define and formalise a coherent approach towards the urban agenda. Several of the IFIs are undergoing, or have recently undergone, a period of restructuring which has impacts on key urban sectors. For instance, some institutions are either moving towards centralisation of their previous regional teams (eg. KfW), re-adjusting which sector urban development now sits within (eg. World Bank), or streamlining as part of a growth strategy overhaul in order to expand urban development impact (eg. DBSA). Such re-adjustments not only reflect political priorities, but also the inherent often experimental and uneven terrain of integrating urban development expertise with regional operations. Urban experts are embedded across the organisations, whether in operational teams, knowledge advisory centres, or in R&D roles at the level of corporate strategy.

Because of the way the larger IFIs have evolved over the past fifty years, there is not a single internal 'birds-eye-view' of all the urban investments and activities that take place under their umbrella. Urban divisions do not typically have the size or influence to shape the priority or cohesiveness of operations in different sectors of an institution. Although between 40-70% of total IFI lending is in urban areas, only around a third of this spend is typically overseen by the urban division.[12] Multi-year IFI-wide strategies often detail the key principles which all divisions adhere to, but each division may have space to act creatively within these bounds.

## Figure 4: IFIs' Estimated Urban Spending and Division Responsibilities

| | Own urban division? | Department overseeing urban agenda | Direct urban lending p.a. ($bn)[♭] | Estimated additional indirect urban lending p.a. ($bn)[13] |
|---|---|---|---|---|
| **AfDB** | No | Operations in Infrastructure, Private Sector and Regional Integration (OIVP) | 0 | 2 |
| **ADB** | Yes | Five sub-regional divisions: Urban Development and Water Division (Southeast Asia, South Asia, Central and West Asia); Urban and Social Sectors Division (East Asia); Urban, Social Development and Public Management Division (Pacific); & Private Sector Operations Department | 1.9 | 10-12 |
| **AFD** | Yes | Local Authorities and Urban Development (CLD) | 3.2 | 5 |
| **CAF** | No | Office of the Vice President of Infrastructure; (Office of the VP of Social and Environmental Development; Office of the VP of Development Strategies and Public Policy) | 0.5 | 4-6 |
| **CDC** | No | Development Impact | 0 | 0.1 |
| **CEB** | Yes | Housing and Urban Development | 0 | 1 |
| **DBSA** | Yes | South Africa Financing Division | 0.1 | 1 |
| **EBRD** | Yes | Municipal and Environmental Infrastructure | 0.8 | 3-4 |
| **EIB** | Yes | Regional and Urban Development | 13 | 20-30 |
| **IaDB** | Yes | Urban Development and Housing; Fiscal and Municipal Management Division within Institutions for Development Department | 0.5 | 8-9 |
| **IsDB** | Yes | Urban Development & Services Division, Infrastructure Department | 0.8 | 1.5-2.5 |
| **KfW** | No | Sector Policy Unit | 4^ | - |
| **World Bank** | Yes | Urban, Rural and Social Development | 4.1 | 10-15 |

These figures are based on 2013 financial figures. Where currency is not US dollars, we used average exchange rate for the period, $1.3/€ and $1.6/£. Figures should be treated as an approximate guide.

[♭]In a small number of cases, named urban lending is counted within broader categories of investment. The amounts included here are, in lieu of finer-grained figures, the whole category.

^ KfW figures incorporate direct and indirect lending (approximately €3bn in total in 2013)

# 2. ACTIVITIES AND TYPES OF LENDING BY IFIS

Many IFIs already have a dedicated urban investment strategy, typically earmarking 10-15% of their portfolio to dedicated cities programmes. Even without an established urban agenda, IFIs still provide financing – to housing, health care, energy and more – that has a huge impact on cities. Regardless of their explicit or implicit interest in cities, IFIs provide financing to city infrastructure projects in numerous ways. This chapter focuses on the type of lending offered by IFIs as well as a discussion on risk mitigation activities.

## 2.1 STIMULATING THE FLOW OF FINANCE

This section outlines the type of lending offered by IFIs:

- **Affordable debt capital to states.** Many of the IFIs continue to be bound to sovereign guarantees on any loans at the urban level because of credit rating and guarantees requirements. In these cases, the IFIs allocate loan financing to the national government, on the basis of an agreement to provide for disbursement to local authorities according to specified conditions. It is common for project ownership to be delegated to the city authority whilst the funds are managed by the central government.

  Cities in low-income countries often receive non-repayable grants via their national governments. In the case of cities in creditworthy middle income countries, IFIs offer a wide range of sovereign loans that tend to be tailor made for each project. Loans typically are repayable over a 10-20 year period with variable interest rates. However, in a small number of cases project loans can exceed 20 years. When these loans are agreed at the state level, on-lending add-ons from financial intermediaries can raise the repayment rate.

  In some cases, IFIs will agree a strategy with a partner country that will involve a series of targets that has positive impact on cities to help achieve the partner country's economic development goals. This is a common way that KfW, IaDB and ADB, for example, all operate.

- **Municipal governments.** Several IFIs are working hard to offer non-sovereign loans directly to municipalities, as IFIs-city partnerships are in principle considered the most effective way of building trust, delivering demand-driven infrastructure and avoiding burdensome procedures.

  Municipal lending can also take form by helping local banks take and manage municipal credit risk, or by creating intermediary municipal development funds. These can be applied with smaller and mid-sized cities, which otherwise lack the capacity to pursue major infrastructure projects because of limited access to commercial bank funding. Often such intermediated loans are combined with local capacity building programmes for both the borrowing entity and/or the city government.

  However, there are challenges associated with municipal lending. Direct municipal loans have become harder to assemble since the global financial crisis, which is why IFIs such as the ADB has seen their direct non-sovereign lending fall by over 10% since 2008. For most IFIs, non-sovereign lending is relatively low compared to the overall lending portfolio, as only 4% and 20% of the largest cities in non-OECD countries are creditworthy in the international financial markets and local markets, respectively.[14] Even when IFIs agree financing at the country level, their project relationships will typically be formed at the city government or utility level as these entities usually are most responsible for implementation. This means that IFIs generally develop a wide range of negotiated relationships with city actors, which once forged, pave the way for a sequence of projects that fit a more planning-led approach, and take into account a municipality's fiscal potential.

### Box 1: The EBRD's Municipal Lending Strategy

The EBRD is one of the leading IFIs in terms of harnessing the direct municipal lending market. Almost 60% of its €500m annual investment is directed to local (sub-sovereign) government partners, either as corporate loans to municipal utilities or as direct municipal loans. This is the result of mature country relationships and dialogues that have permitted the evolution first to sub-national or municipal utility level and now to municipal entities.

EBRD's urban loans have a 12-18 year time-frame, depending on the asset being financed, which is relatively longer than EBRD's non-urban investments. EBRD invests in many local currencies, most typically in Hungary, Poland and Kazakhstan. Municipalities as clients face a choice of whether to agree loans in local currency or euros; there is less risk when using local currency, but they can experience the challenge of higher or unstable interest rates. EBRD offers both debt and equity, but in practice only 10% of projects are equity-based. In these cases, average equity return has typically been 10-15%.

EBRD acknowledges that assembling the right investment package for a municipal project is often very challenging. Its focus is to arrange and deliver projects that impact as closely as possible on local citizens, rather than through top-down decisions that determine city involvement on the basis of eligibility. EBRD is currently exploring opportunities for multiple municipalities to syndicate to reduce loan prices and achieve effective economies of scale, as has occurred in France and elsewhere.

- **Private sector lending - SMEs**. IFIs cooperate with a broad range of financial intermediaries, including commercial banks, micro-credit providers, leasing and guarantee firms, and private equity funds. Some IFIs have a separate arm that supervises private sector development and corporate financing in non-OECD cities. Often these IFIs will work in localities where there is little public sector capacity and where private sector industrial and financial services are critical to urban economic growth.

  MDBs have considerable experience in supporting micro-enterprises and SMEs in recipient countries. SMEs are viewed as critical providers of entrepreneurship, innovation, and job creation in under-developed urban markets. MDBs in particular have made efforts to widen the range of their products to help meet SME financing needs, including progress micro-loans and risk-sharing instruments for R&D innovation.[15]

  Private sector-oriented teams within IFIs commonly use conventional debt, mezzanine debt and equity and mezzanine capital. Usually their repayment periods are shorter (6-14 years) and interest rates higher than sovereign loans, although they still tend be more cost effective than private equity firms.

**Box 2: The Importance of the Framework Loan to the EIB's integrated Urban Investments**

Within the urban sector, and specifically integrated urban development, the Framework Loan is the most important financial instrument at the EIB, as well as at the CEB and EBRD. The use of this flexible instrument began with Italian cities in the 1990s, and within the EU27 has grown from less than 1% of EIB operations 15 years ago to nearly 20% today, with the average loan worth over €200m.

The Framework Loan is effectively a line of credit afforded to municipalities that supports the funding of eligible projects in each city's capital programme. It allows the EIB to cover a portfolio of projects across multiple sectors, by authorising the counterpart city or region to manage the allocation and disbursement of funds. It does not fully define all operations at the point of the appraisal. Only projects worth over €50m are subject to separate and full appraisal. At the EIB, multi-sector programmes that are urban in nature and managed by a municipal authority are appraised by the Bank's spatial development division, MRU (Municipal and Regional Unit).

Framework Loans create leverage by blending with national, regional or EU grant or loan funding. In allowing the funding of a package of investments they can overcome barriers related to project size, enabling the EIB to reach out to smaller city transport, telecommunications, water, and human capital and infrastructure schemes. These have been especially popular in new European member states, but less influential in countries where local authorities face considerable borrowing restrictions, such as the UK, where cities still often rely on Public Works Loan Board funds.

The compilation of a Framework Loan has a higher project management burden for the IFIs than other loans. In the case of the EIB, it first requires the Bank to get to grips with the local or regional programme and its possible sub-projects. Later the Bank must check that sub-project allocations are viable and fit within the total agreed loan volume. Although the EIB and other IFIs seek to streamline this workload by improving partner competence to predict and manage allocation requests, the loan arrangement has ultimately been successful in cities such as Warsaw and Hamburg. The Framework Loan, in tandem with Structural Programme Loans, are set to become an even more important part of the EIB's urban lending in the years to come.

- **Private sector lending - Public-Private Partnerships (PPPs).** PPPs form an important part of the urban investment package. Many have PPP-specific departments to manage the role of the private sector in municipal service delivery, which tend to vary from city to city. PPPs can vary from basic service contracts with limited asset ownership, to mature fee-based build-operate-transfer (BOT) projects where the private sector has full responsibility for a project's operations and investment.

  PPPs are not yet used as a matter of course in all IFIs development contexts. However, since 2011 a range of new strategies led by national governments with support from IFIs have appeared to strengthen the financial viability of PPPs in African, Asian and Latin American cities. IFIs support recipient countries and cities with strengthening the financial viability of PPPs in a number of ways, including:

  - help make the case for improvements to the national legal and regulatory framework, as well as the political and business environment, to demonstrate the city or country is 'PPP-ready'.
  - build an understanding of the PPP process within the city or municipal government, including aspects of risk allocation and incentive structures.

- play an advisory and a brokerage role on individual PPP projects, identifying potential equity investors and technical partners, developing clear project specifications, and making them bankable by forging robust relationships.
- help link remuneration to functional 'outcomes-based' performance rather than simply financial performance.
- lead the structuring, negotiation and implementation to ensure that the PPPs meet local industry best practices.

### Box 3: CAF's Flexible Lending Terms

CAF has developed as Latin America's major financer partly because its governance structure has fewer stages to delivery and favours greater risk appetite. Ministers of Finance sit directly on the Board which means there are fewer rules in relation to consultants and procurement, and fewer complications over construction and lending. Rather than formal conditionality, the Bank prefers responsible and rigorous evaluation for high-demand (rather than speculative) projects.

Ministers are very responsive to country requirements, and tend to err on the side of greater technical assistance rather than cancelling a project. The simple and agile channels for agreement means is not unusual for a project to take just three months from inception to delivery. This speed is attractive to loan-seekers despite the slightly higher rates of lending.

CAF's loan delivery structure also means private sector loan recipients are relatively high, at 18% of total by volume. Despite some arrears with private-sector loans, which has resulted in restructuring and write-offs, CAF's member countries continue to afford it preferred creditor treatment, and it retains a higher rating than any other Latin American issuer.

Additionally, IFIs also seeks to stimulate the flow of finance by working in close partnership with the following entities:

- **Local or regional banks.** In some cases, IFIs also provide financing mechanisms in sectors such as urban housing could involve a concessional loan to a national bank that then refinances local banks and housing finance companies. Local banks are then entitled to issue loans to city buyers of housing.

- **Sovereign wealth funds (SWFs).** SWFs are increasingly active in investing in urban development and infrastructure as an economic and diplomatic tool. For example, the $5bn China-Africa Development Fund (CAD Fund) has been operational since 2007 as a subsidiary of the China Development Bank. The CAD Fund seeks to build capacity in African economies by targeting infrastructure including urban electricity, water supply, affordable housing and industrial parks.[16] In partnership with IFIs, SWFs can promote investments across several urban sectors, including infrastructure, hospitality, water and transport, as well as high-growth companies.

  Other active SWFs in urban development include: Norway's Norfund, Qatar Investment Authority, Abu Dhabi Investment Authority and Angola's Fundo Soberano Angolano. IFIs are also beginning to provide assistance to newly active funds in terms of building transparency and risk management.

### Box 4: Supporting Private Sector-Led Infrastructure in Dakar

The AfDB's recent lending in Dakar is emblematic of its existing approach to developing Africa's largest cities. Since 2009 it has approved four major infrastructure projects involving the private sector in and around the Senegalese capital; the expansion of the Dakar container terminal; Sendou power plant; the 32km Dakar-Diamniadio toll highway; and a new Blaise Diagne International Airport. These four projects constituted total investment of €1.3bn, and in 2013 began to come online. The Bank provided financing worth €185m, and acted as Mandated Lead Arranger (MLA) on three of the four projects, thereby facilitating a further €326m of senior debt for other IFIs including the World Bank and AFD.

The AfDB has played an important role both as an adviser and a broker role in these projects, which have been among the first of their size in Africa to attract private investment. Patient local capacity and relationship building has helped make projects bankable. The Bank has helped ensure the agreements meet industry best practices.

In 2009 a Senegalese subsidiary of public infrastructure specialist Eiffage was awarded a 30-year contract to operate the toll highway. For this project alone, from a total cost of €375m the AfDB provided a preferential non-sovereign loan of €12m over a 15-year term, including a grace period of five years, as well as an additional credit facility of €1.5m. In addition to the non-sovereign finance package, the Bank also provided a €51m sovereign loan to the Senegalese Government.

- **Ethical and social investment.** There is growing interest from large multinational corporations to invest in inclusive economic and social development in cities. For example, in 2013 Goldman Sachs launched a $250m social impact fund with returns indexed to the success of projects in American cities, whilst Morgan Stanley has established the Morgan Stanley Institute for Sustainable Investing with an aspiration for $10bn of client funds.17 Due to the wealth of knowledge stemming from managing complex urban investments, IFIs such as the ADB have started to offer technical assistance to interested investors. This is due to the wide recognition that the new investment supply system since the financial crisis can offer different forms of co-investment and collaboration to solve shared concerns.

A summary of urban-specific lending trends within IFIs is outlined below:

## Figure 5: Trends in Sub-Sovereign and Private Sector Lending for Cities[18]

| | Sub-sovereign lending | Private sector lending | Urban lending patterns observations |
|---|---|---|---|
| AfDB | Working on practical approaches but very little activity as yet. | 10% of total, often urban transport, power and clean technology. Forecasts rapid growth up to 2017. | Almost exclusively with sovereign partners, 5-20 year loans. |
| ADB | Fairly limited and cautious, but favours quasi-independent municipal credit institutions, credit enhancement mechanisms and special purpose vehicles | Now much more open to private sector partnership. Managed through a separate Private Sector Operations Department (PSOD). A new Office of Public Private Partnership (OPPP) supports work in this area since September 2014 –e.g. independent Transaction Advisory Services (TAS) to government Clients/agencies. | Favours tapping domestic credit markets. New urban trust funds under the Urban Financing Partnership Facility (UFPF), which invest co-financing into integrated multi-sector approaches. |
| AFD | Active in direct financial support in €10-50m projects, especially when linked to capacity building (e.g. South African cities and Kayseri, Turkey). | Managed through PROPARCO, €870m annual disbursements in infrastructure and finance, 10% equity.19 | Supports direct city lending wherever possible, using PEFA assessment tool. City contracts, municipal funds and capacity grants used regularly. |
| CAF | Very limited: most cities must go to central authorities to obtain credits, guarantees or other financial facilities. Affected by weak credit histories and fractious political relationships. | Mostly overseen by Office of the Vice President of Infrastructure. Half goes to financial institutions. Most impacts on cities in Brazil, Colombia and Peru. 20 | Mostly long-term sovereign commercial or working capital loans, 12-20 years |
| CDC | None | Africa Funds and Asia Funds teams provide equity capital in 10+2 year funds through intermediary fund managers. Equity team offers equity capital directly, £20m+ for infrastructure projects. Debt and financial institutions team provides capital to corporates and financial institutions. | Adaptive, case-by-case market-led approach in challenged cities. Majority of current portfolio in funds, but now provides debt and equity directly to businesses and financial institutions. |
| CEB | Participates in JESSICA initiatives. | Limited private sector activity. Approximately 20% of total loan portfolio is with specialised on-public financial institutions. | Primarily grants long-term that enable part-financing of viable projects. Interest rate subsidies, sometimes granted for high-impact projects. |
| DBSA | Over a third of loan book is with local govt. Initially top-tier metros, now smaller too. 15-18 year municipal loans to fund city's capital expenditure programme across a range of sectors. | Limited due to issues of project bankability, but expanding. Quarter of loan book is with private sector intermediaries. | Prioritises infrastructure finance, by supporting municipal lending, infrastructure plans of state-owned enterprises, regional lending and funding for PPPs. |
| EBRD | Extensive, 60% of urban investment. 15-18 year | 1/3 of MEI investment, much in 18+ year PPPs (often BOTs), | Gradual, tailored and flexible approach. Uses debt, |

| | | | |
|---|---|---|---|
| | loan time frames, in local currency or euros. 10% equity based. Exploring opportunities for multiple municipalities to syndicate to reduce loan prices. | to experienced providers to deliver key public services, when risk-appropriate. Often arranges syndicated loans. | equity and guarantees to first national, then sub-national and private firms and utilities. Typical 35% co-financing share. |
| EIB | Engaged with 300 urban areas up to 2020. Framework Loans are key for large integrated investments. Financial instruments help some cities access EU Structural Funds for their own capital investment programmes. | JEREMIE allows EU Structural Funds to finance SMEs flexibly and sustainably. Support for utilities, public transportation providers, social housing associations, etc. | Specialises in assembling large long-term loans to municipalities and private sector. Increasingly co-invests with other IFIs partners (WB, KfW, EBRD, and DBSA). |
| IaDB | Urban development financing for eligible cities involves 20 year-loans, interest rate based on LIBOR, and counterpart funding of 30-60%. | Diversifying investments to private sector clients via PPPs and commercial bank financing. Multilateral Investment Fund, offers grants and investments. | Limited case-by-case experience of financing municipal investments. 80% of lending co-ordinated with sovereign governments. |
| IsDB | Municipalities not yet allowed to receive direct financial support. | PPPs with wastewater firms and utilities to embed technology solutions. | Mostly finances at the national level. Financing of city projects begins with municipality-led feasibility study and project design, followed by Bank help for city government systems and bankability. Sharia-compliant methods mean financial operations must be asset-based. |
| KfW | No sub-sovereign lending because of the requirements of a strong credit rating, securities and guarantees. Does engage directly with cities (e.g. Bangladesh) or with states/provinces (e.g. India), but depends on overarching sovereign agreement. | Managed through DEG, €1.3bn annual lending, uses combination of long-term conventional debt, mezzanine debt and equity and mezzanine capital. KfW Development Bank sometimes lends to utilities in PPPs. | KfW money for cities is channelled through central government institutions, except for highly commercial private sector projects. Blends EU and German federal budget funds with its own loans. |
| World Bank | Limited but much new activity. Initiative to help African cities tackle fiscal challenges to catalyse investments. Schemes to establish intra-government transfer sharing and untied revenue sharing with central govt. | Wide range of guarantees to private debt to attract lenders. IFC's subnational finance programme offers >$5m investments, up to 50% project cost, 5-17 year maturities. | Bound by sovereign guarantee requirement, but regularly offers cities intermediary lending facilities, such as municipal development funds. |

## 2.2 RISK MITIGATION AND EXPERTISE POOLING: PARTNERSHIPS AND SYNDICATIONS

Due to the complex organisational relationships and the desire to spread risk, multi-lateral partnerships are critical for lending to urban projects. Multi-IFIs co-financing and partnership is becoming the norm of IFIs lending practice. In some cases, this multi-IFI partnership accounts for nearly half of total resource deployment in cities. Partnerships seek to tackle urban under-investment, offer skills transfer and best practice knowledge exchange. Shared financing, co-ordination and project leadership are viewed by IFIs representatives as essential to improving efficiency and capacity in cities with relatively little long-term project management experience. Examples of such partnerships include:

- **Regional bank partnerships:** IFIs with overlapping regional specialisms often partner with other regional development banks in order to avoid duplication and pool their city relationships for maximum development effect. For example, in 2013 EBRD and KfW signed a partnership agreement for a €100m infrastructure fund for cities in the Western Balkans to enhance its direct municipal lending market and making city services more efficient. As such, this funding agreement will help local banks manage municipal credit risk.

- **Inter-regional partnerships**: Inter-regional partnership between IFIs have been increasingly important to raise impact. In the past several years, there has been an increase of activities in Latin America and Asia from European-based IFIs. For instance, KfW and the EU have recently partnered with CAF to share technical assistance for its *Ciudades con Futuro* scheme, and supported IADB's Clean Technology Fund to invest in Mexico's urban housing sector.[21]

- **IFIs-country donor partnerships**: IFIs-country relationships can be leveraged to help co-ordinate new resources for urban investment, often to bridge important financing gaps and help integrate and accelerate intra-bank disbursal processes. In 2010, ADB established a partnership fund called the Urban Financing Partnership Facility (UFPF) to support investment in urban development and infrastructure projects through co-financing mechanisms. The Swedish government was the first to contribute to UFPF via an initial subscription and additional guarantee facility. Beneficiaries include the Mongolian capital of Ulan Bator. Additionally, ADB is working towards a partnership strategy with China working in the urban and social sectors, focusing on the economic benefits of inter-city mobility.

# 3. CURRENT AND EMERGING PRACTICES IN URBAN INVESTMENT

Nearly all the IFIs examined in this report are focused on the preparation of cities for economic and population growth, and on minimising the adverse impacts of urbanisation and climate change. Recognising the realities of growth amongst developing cities, IFIs observe that many cities in the developing world have grown to become chaotic, congested, polluted, and inefficient with poor quality of life, weak financial powers, and inadequate urban infrastructure.

IFIs recognise that enhanced urban infrastructure in terms of water supply, sanitation, urban transport, and solid waste management is critical to realising the economic growth potential of cities in low and middle income countries. Towards this end, IFIs have helped to create a robust body of research that shows that economic growth in cities is closely correlated with transformative investments in urban infrastructure to cope with fast population growth.[22]

## 3.1 INVESTMENTS IN KEY SECTORS

The main sectors IFIs invest in include, and often overlaps:

- **Water.** Water comprises one of the largest proportions of urban investment within IFIs, especially in those operating in the poorest countries such as the AfDB, AFD and KfW. Many low-income cities lose millions of litres of water daily due to poor maintenance of water systems, whilst in middle income countries coverage in much higher but systems are aging and require upgrading. IFIs such as the ADB and EBRD emphasise on creating demand-oriented efficiencies through more private sector utility involvement that ensure full cost recovery, and the sensible use of regulatory reform, tariffs and metering. Others, such as the ADB, also argue that water, energy and food systems have to be more tightly linked to reflect their mutual interdependence.[23]

- **Solid waste and wastewater**. Municipal solid waste – generated by residents, businesses and institutions - is both a key service and an economic sector in non-OECD cities, providing up to 5% of urban jobs.[24] Municipal waste is estimated to double by 2030 due to rapid urbanisation Opportunities to engage the private sector around recycling under a system of government organisation are being explored, for example by AFD's private PROPARCO arm.

- **Sustainable transport.** Majority of IFIs are committed to increasing public transport usage, and managing land-use in order to facilitate transport-oriented development. At the Rio+20 United Nations Conference on Sustainable Development in June 2012, eight IFIs delivered the joint statement "Commitment to Sustainable Transport", forecasting more than $175bn of loans and grants for sustainable transport in non-OECD countries over the coming decade.25

  Most identify congestion and a culture of car-dependency as major barriers to competitiveness. High-capacity, low-cost public transport systems are widely viewed as the most achievable way of integrating the peripheral urban poor into the economic fabric of the city. Bus Rapid Transit (BRT) systems are therefore popular solution especially in smaller or medium-sized cities because implementing a BRT system is relatively inexpensive which can be assembled either individually or through joint ventures. Technologies that improve the organisational structure of traffic management are highly desirable, as are parking system and multi-modal solutions to cater for large incoming daily populations.

IFIs increasingly try to invest in integrated transport solutions by financing projects that form part of an agreed broader regional transport plan. For example, the World Bank's IFC, AFD and the EBRD have all supported the Izmir metropolitan region by financing its €100m+ Sea Transportation Project as part of the city's 2030 transport master plan. The project will relieve saturated ground transport and contribute to denser and better distributed public transport network across both sides of the city's bay.

However, whilst there is political will for major investments in transport infrastructure, particularly "smart" transport project, financing is challenging due to the associated construction risk.

### Box 5: Islamic Development Bank's Wastewater Investment

The IsDB's water and sanitation lending now exceeds $1bn after arranging a significant new influx of money from stakeholders and investors (including a recent successful $1.5bn sukuk issuance) to help expand beyond conventional stand-alone water and wastewater projects and towards more intelligent systems.

An increase of 200m urban dwellers in member countries has been a major driver behind the sanitation and waste disposal sector funding need. Within this sector the Bank focuses on urban infrastructure development and fostering the capacity of urban utilities and municipalities. The majority of the Bank's commitments to the sector use the Istisna'a (Sharia'ah mode of financing), where it pays for the construction of assets under an agreement to later transfer ownership for an agreed fee.

The IsDB's most significant urban market by far has been the Iranian wastewater sector, where a lack of other international lending options due to sanctions has made investment difficult. The Western Tehran Sanitation Project involves the construction of a huge wastewater plant to serve around a million people in the western part of the capital.

Although the Bank's activity has mostly been led by the need for human impact, environmentally efficient and integrated management is also now a priority. Sanitation is now widely coupled with water supply interventions, and other systems linkages are sought. The Bank raised $730m in 2001 with the establishment of the IDB Infrastructure Fund I and more recently launched IDB Infrastructure Fund II in June 2014 to raise $2bn for all Member Countries.

- **Energy**. IFIs widely promote energy efficiency and renewable energy in cities with lending in this sector growing at a rate of 25% per annum. The objective of these energy efficiency initiatives is to reduce energy output, provide access to energy for all citizens, and create the right framework of reforms and incentives to mobilise a capable private sector. Public lighting and reliable electric power are two of the areas with most loan activity. KfW Bankengruppe (including its domestic business) is the biggest urban clean energy lender of the 13 IFIs, with EIB and World Bank also growing their investments.[26]

  District Heating (DH) systems are one of the important low-cost and environmentally friendly heating solutions in cities. For the EBRD and ADB, DH are priorities in cities with mid-to-high density to achieve considerable reduction in heat loss, CO2 emissions and coal usage. Chinese and former Soviet cities are the largest DH markets, with coverage at only 30-40%, compared to 60% in Europe.[27] EBRD identified over 10,000 cities in Russia and Eastern Europe in need of DH retrofitting, but financial positions for many municipal utilities are weak and there is a limited competitive market.

Both the EBRD and ADB provide considerable technical assistance and regulatory system reform advocacy in this area. Efficient billing and metering is also being pursued. IFIs involvement in this area is critical in providing political and regulatory assurance to private investors, and attracting new investors to unlock the flow of finance. For example, ADB acted as the transaction advisor for Ulaanbaatar's $1.3bn district heating plant, with a concession agreement with private sector sponsors signed in June 2014.

### Box 6: Sustainable Development in Zenata, Greater Casablanca

Zenata is an ambitious project to build Africa's first eco-city and one of 15 new cities being planned by the Moroccan Government. In 2013, project financing for the first phase of the 18 square kilometre master-planned urban area was signed by the French President and the King of Morocco. AFD, in collaboration with the EIB, has committed €300m in long-term investment, with an additional €30m EU technical cooperation and investment grant. AFD's contribution is over 14 years while the EIB is lending over 20 years.

Zenata is the centrepiece of a strategic plan to reduce socio-economic inequality between the East and West of Greater Casablanca, and to boost the city's international profile as a modernising centre committed to fighting congestion and sprawl. Zenata itself is slated to become home to 400,000 people and 130,000 jobs. Its water, waste and public transport services are to be integrated, and nearly a third of its area will be designed as green space or green corridors.

This project has been made possible by strong relationships between participating IFIs, local governments and regional investors. The borrower/developer is owned by CDG, a Moroccan state-owned financial institution able to provide local technical and financial expertise.

- **Housing**. Energy efficient within social housing is a priority in many IFIs. In many non-OECD cities, housing accounts for over half of urban growth and over a quarter of total electricity use. In order to accelerate the building of sustainable housing, IFIs help nations or cities package incentives with smarter designs and/or innovative technologies that can achieve measurable performance across the 'whole-house'. IFIs also help finance the costs of embedding energy-efficient measures into citywide or region-wide housing programmes through special earmarked initiatives, such as the IADB's Clean Technology Fund.

  IFIs are entering new markets to address the housing challenges. In 2013, the EIB agreed to provide €15m to specialist development finance institution, Shelter Afrique, which will in turn fund SMEs involved in eligible housing estate projects in Kenya and Rwanda with subsidised interest rate loans. This housing investment, which cannot exceed 60% of the cost of any individual project, will be integrated with community infrastructure and water, power and road services. This is a milestone for the EIB, marking its first investment in the African urban housing market.[28]

**Figure 6: Sector Engagement of IFIs in Urban Areas**

| | Solid waste/ wastewater | Energy, Power, District Heating | Water supply | Public transport | Green Infrastructure | Disaster management/ resilience | Inclusion | ICT/ Broadband | Health, Education | SMEs, entrepreneurs | Clusters, skills, R&D | Housing | Governance and Management | Urban renewal |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **AfDB** | | * | ** | * | * | * | * | ** | ** | ** | | | * | |
| **ADB** | * | * | * | ** | ** | * | ** | | | | ** | | | * |
| **AFD** | ** | * | * | ** | | | * | | | | | ** | * | ** |
| **CAF** | * | * | * | ** | | ** | ** | * | | * | ** | * | ** | |
| **CDC** | * | * | * | * | | | | * | * | * | | * | | |
| **CEB** | | * | | * | * | | * | | ** | * | * | ** | | ** |
| **DBSA** | * | ** | * | ** | * | | * | * | * | | | | | |
| **EBRD** | ** | ** | ** | ** | ** | * | * | * | * | ** | | | ** | ** |
| **EIB** | * | ** | | ** | * | * | * | * | | ** | * | * | | ** |
| **IaDB** | * | * | * | ** | * | ** | | | | | | ** | ** | |
| **IsDB** | *** | *** | *** | ** | | * | * | * | ** | ** | | ** | | * |
| **KfW** | * | *** | *** | * | ** | ** | * | | ** | ** | | ** | * | |
| **World Bank** | * | * | * | * | | ** | * | * | * | * | ** | * | *** | |

In addition to the aforementioned key sectors, IFIs also has vested interested in social elements of development, resilience-proofing cities, and economic competitiveness. As such, IFIs are engaged in investing in activities that yield positive social, economic, and environmental outcomes, including:

- **Inclusion.** IFIs also help to manage the strains that migration puts on education, health, and housing systems. This requires a combination of infrastructure and housing development, but also strengthened community services and livelihood development solutions. Because of the preference to fund larger projects, inclusivity projects often involve high capacity transport that prioritises gender access, tied in to economic development mechanisms to build human capital and job creation.

- **Climate change resilience.** IFIs are rapidly scaling up their investment in cities' capacity to mitigate and adapt to climate change. This involves a combination of protective measures to prevent damage from flooding, drought or sea-level rises, and proactive measures to support low-carbon cities. The ADB's 'green cities' pillar of its

2020 strategy, for example, channels investment into green infrastructure programmes that involve considerable retrofitting and infrastructure re-use.

- **Cluster support.** IFIs consider clusters as central to improving urban competitiveness and reducing unemployment levels. Many IFIs intervene not only in terms of providing infrastructure, but also in helping develop R&D and fostering regional co-operation to maximise cluster effects.

### Box 7: Asian Development Bank's City Cluster Economic Development agenda

For the last seven years, the Asian Development Bank's Urban Community of Practice has helped grow the institution's knowledge of Asian cities' agglomeration, productivity and potential for higher-value economic growth. Its work has established that large Asian cities are centres of clustered industrial activity with potential to offer wider growth opportunities for SMEs within a more sustainable pattern of development.

ADB has initiated a City Cluster Economic Development (CCED) methodology to better support the planning, development, and management of integrated multi-sector projects for fostering clusters in cities. This involves a seven-step approach to assessing a city's economic environment and competitive drivers.

The Bank recognises that such cluster projects necessarily require multi-layered changes – to supply chain capacity, skills, R&D, specialised finance - that take longer to complete than physical infrastructure projects, and therefore are not best coordinated through the public sector. The Bank therefore works with industry task forces in South Asian cities that can draw up feasible and bankable projects, and is looking for other kinds of public and private partnership. The Bank's knowledge institute has also recently created a training manual for Eco-Industrial Clusters to build capacity to implement cluster programmes in a more sustainable framework.

As part of the CCED programme, in 2013 the ADB agreed a Rs 140bn loan with India's Karnataka state government to develop eight city clusters in the Bangalore metropolitan region, where the population is forecast to reach 18m by 2030. The loan comprises 2/3 of the total investment (1/3 by the government). The cluster project will be implemented up to 2018, and includes a commuter rail system and a ring road project connecting each of the clusters, to help decongest the city. Because the areas included in the project fall under different local planning authorities, an integrated planning programme has been proposed for the entire region, covering all clusters.

The Bangalore projects also incorporates a $1.3m technical assistance fund. This fund sees the Bank conduct economic and sector analyses in Bangalore, prepare prefeasibility studies for the priority clusters, and conduct detailed feasibility studies for two clusters to be financed under the first tranche of money. For this project, the Bank has sought to engage with consulting firms with multi- cross-sectoral experience, requiring four international experts for a total of 18-33 person-months. The consulting firms have been tasked with preparing a quantitative city competitiveness assessment, a sector road map to guide the overall investment, and ultimately an economic development plan for City Cluster Development.

## 3.2 PARTICIPATION OF CITIES IN IFIS-FINANCED PROJECTS

Despite some perceptions to the contrary, IFIs do not have the authority to impose particular solutions on cities in partner countries. The role of IFIs is much more as providers that respond to urban requirements, and partner with cities to grow knowledge and fill financing gaps. IFIs however are still much more likely to be involved in project financing than in comprehensive development strategy making. There are a number of key factors which affect cities' ability, willingness and preparedness to participate in IFIs-funded initiatives. Among these include:

- **Size and scale**. The success of larger cities at the heart of national and regional systems is critical to the success of smaller centres. The concentration of skills, as well as interest from public and private sector means that cities can advocate more effectively for investments, including those part-funded by IFIs. Larger cities are also a priority for IFIs strategies that acknowledge the potential of agglomeration.

- **Borrowing powers**. For cities to take part directly in arrangements with cross-border investment institutions, project propositions must be bankable – that is, with sufficiently sizeable and stable revenues to ensure dependability and profitability. Cities must also present a robust pipeline of financially viable propositions and opportunities that meet the specific process, asset, scale, and risk management requirements of institutional investors. As such cities must also possess the development and technical capacity to mount its own programme of development and redevelopment.

- **Climatic and regulatory factors.** Nationally-determined frameworks around business regulation, tax, property rights protection and incentives, all affect the capability of IFIs to invest in cities and city businesses. National legislatures set the tone for market dynamics and sector prioritisation over many electoral cycles, which form part of a complex set of risk and reward appraisals that all investors must undertake.

- **Leadership and national political relationships**. In many countries where there is still strong political centralisation, the potential for cities to become actively involved with IFIs on their own terms is largely determined by national political relationships. Mayors may often play an important role in delivering local public services, but the capacity to develop the fiscal space for co-financing can boil down to cities' lobbying capacity in the capital, and even the rapport with national party leaders.

## Figure 7: IFIs' Relationships with Cities[3]

| IFIs/DB | Example cities | Countries |
|---|---|---|
| AfDB | Abuja, Accra, Dakar, Fez, Nairobi | South Africa, Morocco, Tunisia, Gabon |
| ADB | Fuzhou, Hunan, Jiangxi, Kerala, Kolkata, Shanghai, Ulan Bator | Bangladesh, China, Georgia, India, Indonesia, Philippines |
| AFD | Abidjan, Beijing, Cape Town, Casablanca, Curitiba, Douala, Medellin, Tunis | Brazil, Chad, Colombia, Ghana, Morocco |
| CAF | Fortaleza, Guayaquil, Lima, Loja, Panama City | Dominican Republic, Ecuador, Panama, Peru, Venezuela |
| CDC | Chennai, Hyderabad, Kolkata, Nairobi | India, Kenya, Nigeria, Tanzania |
| CEB | | Belgium, Germany, Hungary, Moldova, Serbia, Spain |
| DBSA | Cape Town, Ekurheleni, Mbombela, Mpumalanga, Tshwane. | Mozambique, South Africa, Zambia, Zimbabwe |
| EBRD | Almaty, Burgas, Bursa, Lviv, Skopje, Warsaw, Wroclaw | Bosnia-Herzegovina, Kazakhstan, Russia, Ukraine, Tajikistan |
| EIB | Barcelona, Liverpool, Madrid, Rome, Rotterdam, Seville, Sofia, Warsaw | France, Germany, Italy, Poland, Spain, UK |
| IaDB | Asunción, Montego Bay, Montevideo, Port-of-Spain, San Jose | Argentina, Brazil, Colombia, Mexico, Peru |
| IsDB | Nouakchott, Tripoli (Lebanon), Tunis | Indonesia, Lebanon, Tunisia |
| KfW | | Bangladesh, Brazil, China, India, Kenya, Peru |
| World Bank | Durres, Gaziantep, Ho Chi Minh City, Istanbul, Lima, Johannesburg | Most countries in Africa, Asia and Latin America |

With these factors in mind, a number of different types of city are being targeted for IFIs investment in the current cycle:

- **Emerging megacities:** IFIs are active in large Asian and African mega cities in major infrastructure projects including: rail, bus transport and road projects, often through co-financing schemes that involve multiple IFIs and local commercial bank. Recent cities to sign major transport deals include: in Asia, Ho Chi Minh City, Jaipur, Ahmedabad, Bangkok, Jakarta and Guangzhou; and in Africa, Dakar, Nairobi, Accra and Abuja.[29] One example is the $1.9 bn construction project of the Metro Line 2 in Ho Chi Minh City, co-financed by KfW, ADB and EIB, with each IFIs helping to finance rolling stock, electro-mechanical equipment, project design and construction supervision. Subsequently, financing for Metro Line 5 has been agreed with the ADB and EIB, with the IFIs providing $500m and €150m respectively.[30]

[3] Prominent cities and countries with whom IFIs have established investment relationships, either formally or on a single project basis

- **Cities vulnerable to climate change:** More investments have been diverted to vulnerable urban areas to make them more resilient-proof, particularly in megacities. Majority of beneficiary cities are located in South Asia to improve long-term environmental resilience through improved infrastructure. These funds target water supply, sewerage, solid waste management, water drainage and slum development projects.

  The ADB, DfID and the Rockefeller Foundation are partnering together to support 25 secondary cities in South and South East Asia to protect the urban poor from climate change as part of a Managing Climate Risks for the Urban Poor project. This programme is financed from the Urban Climate Change Resilience Trust Fund (UCCRTF), administered by the ADB.

- **High growth competitive middleweight cities**: Focus on middleweight cities is a priority for IFIs as a potential way to relieve the burden from the congested megacities and supporting these cities to become more liveable international growth areas.

  In Latin America, both CAF's 'Ciudades con Futuro' and the IaDB's Emerging Sustainable Cities Initiative (ESCI) target future areas of growth for investments in business hubs, transport and infrastructure as well as long-term urban planning support. The IADB's ESCI was set up as a special programme, separate from but in close co-ordination with the urban development and infrastructure departments. ESCI seeks to help the region's 140 growing medium-sized cities make more informed planning decisions and take fast actions towards smart urban development. This set of middleweight cities were targeted because they are the locus of much of the growth in the region, because of their potential to become quality of life leaders, and because the impact of intervention is easier to achieve and detect. Projects range from urban renewal, to traffic management, transport, and water access.

  In Asia, the ADB's 2020 Urban Plan also earmarks this group of cities for priority investment.

- **Challenged cities in vicinity of larger hubs:** Second and third tier cities in low-income countries often lack the capacity to attract private investments. As such, a number of IFIs are concentrating on these poorer cities to boost their competitiveness. Typical investments tend to focus on their logistical capacity in order to participate in wider national or regional supply chains, as well as core infrastructure and services. EBRD is very active with these cities, whilst the Pragma Fund II, in which CDC is a participant also finances SMEs in India's second and third tier cities, focusing on healthcare, logistics and entertainment services.

# 4. IFI'S PERSPECTIVES ON URBAN INTEGRATION

There has been a step-change in IFIs' commitment in promoting and financing integrated urban planning and city system building since 2010 due to the mega trends impacting cities – urbanisation, demographic shifts, resource depletion and climate change. These trends have prompted for more innovative solutions to financing large-scale and/or integrated urban infrastructure projects.

Furthermore, the focus on urban integration has also accelerated because the global financial slowdown has triggered an awareness that responsibility for economic and infrastructural development can often be dealt with most effectively at the local level. In parallel, broader sources of investment capital globally have led IFIs to refine their roles in development finance.

However, very few cities are far down the path towards the desired goal of holistic integrated urban systems, and the financing arrangements for such transformation are very much embryonic, at best. Whilst some IFIs are more forward-thinking than others, there is a shared understanding that urban innovation 'on the ground' involves incremental steps towards the end goal of efficient and sustainable cities.

**Box 8: IFIs and New Thinking on Systems of Cities**

The new wave of IFIs thinking about cities began in 2009 with the World Bank's World Development Report (WDR) and its ten-year Urban and Local Government Strategy. The WDR provided a major boost to the urban sector by putting the case against the distribution of economic activity away from urban centres. It represented a paradigm shift in calling for a proactive rather than reactive stance to urbanisation and the realities of economic geography, which sees rewards accrue to dense and well-connected places.

The Bank's 2009 Urban Strategy, which began the Decade of the City, brought the concept of 'systems of cities' to the centre of the global debate. The Bank has found the concept a compelling way to define inter-relationships of different parts into a larger integrated whole. In particular, systems of cities refers to the way urban economies specialise and complement each other within a region or country. It identified national systems of cities as usually featuring large diverse post-industrial(ising) cities, secondary specialised and industrial cities, and smaller towns, all participating in an inter-dependent arrangement. One of the central pillars of the Bank's new urban policy is to build institutional capacity across these national city systems.

The World Bank's Urbanisation Reviews have since offered a framework for city leaders to make tough development choices by providing diagnostic means to identify policy distortions, market failures and investment priorities. These Reviews have already taken place in countries such as Brazil, China, Colombia, India, Indonesia and Vietnam. At the same time the Cities Support Project has worked in a number of countries - including Benin and Uganda - to scale up access to urban services and improve urban management in selected cities.

## 4.1 DRIVERS FOR URBAN INTEGRATION

IFIs have a long-standing history of engaging with ideas and challenges around complex systems integration at the city level. IFIs agree that city system integration is critical to successful urban management and urban outcomes in the future. Many identify systems thinking as denoting urban approaches that are "planning-led" rather than ad-hoc, random, or de-contextualised from broader strategies. Urban systems also require consideration of how a city is part of a wider system of cities at the national and even regional level. City systems approach takes a holistic view the system as a whole within countries, and supporting arrangements for top-down strategic management combined with bottom-up experience, agility, information and data. It also encompasses integrated urban mobility across an urban area is important to economic development, whilst also combating climate change. In practice, IFIs see this form of integration could be achievable through transit-oriented urban development and mass transit, for instance.

IFIs recognise that integrated urban development cannot be achieved just by an effective master planning document alone, but that it needs decision-making processes that collectively add up to a coherent approach for the city or region. The consensus appears to be that some significant changes in thinking are required for the cities of the future to prosper. These include:

- **Effective governance for city systems**. IFIs agree that governance is a central pillar of achieving integrated urban development. In most areas where IFIs are active, systems of governance remain too disintegrated and disconnected to achieve coherent strategic planning.[4] A lack of strong governance means that cities lack strategic planning authorities with meaningful powers to bring together strategic systems.

- **Decentralised Finance.** Several officials also pointed out the importance that systems are flexible and decentralised in order to be more fluid and responsive to address specific needs. Singapore, for example, effectively combines strategic centralisation with local management flexibility to focus interconnectedness of multiple systems, from road pricing to water catchment and food security.

  Equally a lack of fiscal decentralisation has prevented cities and municipalities from being able to invest in joined-up solutions or from becoming able to use their balance sheets for loan agreements with IFIs or other investors. In non-OECD countries, subnational taxes still account for only about 11-12% of total government taxes, and subnational expenditures just 15-16% of total spending. These figures are approximately half that founds in OECD countries.[31]

- **Citizen engagement.** The mobilisation of citizens around investment needs is identified by several IFIs as critical to implanting the right kinds of services and infrastructures at the urban level. New experiences of ICT systems to enable citizen feedback, GPS mapping, and other technologies are viewed as important in providing services to improve participation and responsiveness. Conventional top-down approaches should be complemented with bottom-up knowledge transfer through citizen engagement -- with a genuine commitment to improve quality of life.

[4] Governance tends to be found in five main forms: (i) consolidated single tier governments; (ii) fragmented one-tier governance (e.g. Houston); (iii) two-tier models – city and municipalities (London); (iv) Voluntary inter-municipal co-operation (Vancouver, Bologna); (v) Single purpose authorities, focusing on delivery of one agenda such as culture, environment or transport.

### Box 9: CAF's Step Change Towards Integrated Urban Development

Since 2011, CAF – Development Bank of Latin America has pursued an initiative to grow its partnerships on long-term urban development, entitled 'Ciudades con Futuro', or Cities with a Future. This scheme was recently approved internally and launched across Latin America, promoting solutions to managing forecast urban population growth.

The principle behind Ciudades con Futuro is that the urbanising Latin America will soon consist of a few consolidated megacities and a new generation of medium-sized cities. These competitive 'middleweight' cities are seen as potential models of sustainability, innovation and design and are expected to offer an increasingly appealing alternative for companies and qualified workers. The Ciudades con Futuro agenda helps these cities undertake the patient learning curve towards understanding the ingredients necessary for successful long-term development.

The four main areas of the programme are inclusive urban development, economic competitiveness, future-proof cities, and local governance capacity. Cities which make progress on all these agendas are described as future "intelligent cities", for whom big data and open data will be central the interoperable system. Given limited resources and the need for local consensus in a fragile and dispersed governance context, the programme anticipates that the main initial impact will be faster uptake and delivery of standard systems such as BRT, traffic management and parking management, with more combined investments following on.

## 4.2 OVERCOMING CHALLENGES WITH URBAN INTEGRATION

IFIs recognise the importance of increasing integration of urban systems of services and have detailed knowledge and understanding of the multiple barriers that cities face in taking such approaches. Some of these challenges include:

- **Overcoming siloed sector-specific rigidities**. IFIs representatives have commented on the difficulty in overcoming sector thinking among national and urban officials. Existing political and financing processes within IFIs and their stakeholder bodies make it much easier to organise and agree a loan for a single new road, metro line, or power station than to package more co-ordinated mixed investments. The long-inscribed organisational divisions between transport, housing, energy and other sectors tend to thwart broader approaches towards sustainability. Internal reform is sometimes more oriented towards making territorial development more sector-aligned than the other way round.

- **Hostility to planning-led approaches**. The liberalisation of city governance in many parts of the world has seen resistance grow to public sector-led planning, which some IFIs argue has held back more integrated thinking. The scale and pace of development in non-OECD cities, alongside the contraction of many OECD cities, has brought unexpected economic and spatial changes that require more integrated strategic thinking. Furthermore, the potential of technology and IT to offer smart solutions to urban challenges (e.g. road pricing, smart metering) has surged so quickly that the entrenched opposition to citywide system planning now seems outmoded.

- **Lack of experience and capacity with diverse financial instruments**. Many IFIs that have established urban project divisions have yet to translate funding commitments into a steady supply of concrete integrated projects. This is partly a product of the weak lending environment after the global downturn. It is also a result of the difficulty of compiling loans when dealing with an integrated set of projects. IFIs rely on experienced loan officers to blend instruments in order to provide a package of lending. Familiarity with how to use instruments such as framework loans to financial advantage can be a necessity for making urban innovation a bankable proposition.

- **Limited local capacity to maintain and re-finance systems**. Several IFIs, including KfW and EIB explained that technological innovations must be operationally maintained by the city government or utility after construction. The entity in charge must be capable of continuing to generate fees, pay for repairs and ensuring the legal framework is adequate and adaptable, with rules enforced and stipulations implemented in practice. Innovative urban solutions must therefore be accompanied by collaboration and information sharing to support local authorities.

- **Short political cycles**. Major infrastructure or systems projects demand careful composition. This process can be very slow, meaning that the window of political opportunity risks could be missed if new leaderships and new priorities emerge. By the time pre-authorisation for a project is agreed, a city leadership may have changed and the momentum and appetite can dissolve. More than one IFIs representative commented on the need to prepare projects that can be executed very quickly once the political apparatus lines up in favour of it.

- **Generating consensus within fragmented governance.** The approval and implementation of technology-based urban projects require consensus among many political communities in a given area. In cities where a strong local democratic voice exists, for example in Latin America, there is often controversy surrounding disruptive projects that makes them politically unfeasible.

- **Over-reliance on national governments and transfer payments.** Project financing for key city projects is often held back by poor political and even personal relationships between central governments and city governments. Lending restrictions mean the majority of IFIs urban innovation projects still need the endorsement and guarantee of central government, with only the largest cities in each region tending to possess more fiscal flexibility. Programmes of financial intermediation that involve central government are often at risk of political bias, misallocation, and mixing of multiple objectives beyond the strict lending criteria.

## 4.3 PROGRESS TOWARDS CITY SYSTEM INTEGRATION

IFIs are increasingly incorporating aspects of urban innovation, integrated multi-sector development, and ‘city systems’ thinking, in their approach to cities in their target regions. The aspiration towards efficient joined-up infrastructure systems is widespread in a range of different development contexts.

## Examples from IFIs

The overall impression so far is that IFIs have not got very far in their quest for integrated urban development, but that considerable progress is now being made. Three examples of how IFIs are beginning to take a city systems approach are illustrated below:

- **Islamic Development Bank (IsDB) -** Integrated urban development, infrastructure, and municipal utility are three core themes of IsDB's newly created urban division. Working with municipalities on their development plans, IsDB aims to provide holistic infrastructure development approach. The concept of integrated development at the Bank emerged from proposals made by municipalities with whom it had existing water project partnerships to join up systems to incorporate wastewater and other systems such as electricity and public lighting. As well as helping cities to devise combined project frameworks, it also builds capacity for cities and their private sectors to take more responsibility in terms of service delivery across these systems.

- **Agence Française de Développement** – The French development agency, ADF, has substituted an integrated urban vision for its traditional sectoral approach describing it as "more restrictive and does not create true regional coherence." AFD partners with local authorities to promote a sustainable city model based on four key area: (i) quality safe housing, (ii) access to the essential services of water, sanitation, lighting and waste management; (iii) urban mobility and (iv) economic vitality and local employment.

- **Asian Development Bank (ADB) -** ADB's country partnership agreements often aim to create an integrated urban planning and management system for cities. The intention is for city planning departments to factor climate change mitigation and adaptation into the vision, construction and management of urban infrastructure. Often these agendas are enabled or stimulated by national development plans that focus seriously on urbanisation. In most cases, such as Indonesia, integrated planning is still at an early stage and first involves the creation of multi-stakeholder city working groups within or adjacent to local governments, in order to be responsive to local needs.

In many of these cases, achieving integrated city systems depends firstly on smarter clients rather than smarter technology. These relationships can, over time, ensure the efficient use of scarce funds, improved services, and responsive user-centric technology.

## Examples from Cities

There are at least three cycles that cities must undertake in order for their development to become integrated, planning-led and systems-led:

- Phase 1: The acquisition and installation of basic infrastructure systems which cover the whole city as a functional unit.
- Phase 2: Once systems are in place, the experimentation with combining systems, such as housing and land-use, as a means to attract investment and improve efficiency.

- Phase 3: Integrated city systems, solutions achieved through smart systems in tandem with good government.

The majority of cities with whom IFIs have relationships with are either in the middle of phase 1 or about to transition into phase 2. Among the hundreds of cities with which they partner, only a few stand out for being clearly in the midst of phase 2, with sights on phase 3. These cities have strong political will, execution capability, and some fiscal autonomy to create their own arrangements with IFIs and others. There are only a handful of such cities across the world that have managed successfully to create, in tandem with IFIs investment, a continual cycle of incremental projects in city services and city systems, which has prepared them for more advanced initiatives. Successful examples include:

**Africa:**

- **Johannesburg** and **Cape Town** are Africa's pioneers at rolling out first phase innovations such as cleaner energy, public lighting, and other quality of life improvements, and showcase their improvements across the continent. There is a strong impulse from IFIs lending to achieve further progress in energy and SMEs in the current decade.

- **Nairobi** has been one of the more successful African city participants in a range of IFIs-funded transport and infrastructure projects, and its 2030 metropolitan vision has unified actors around integrated and planned development.

**Latin America:**

- **Panama City**, **Quito, Bogota** and **Sao Paulo** have created more fiscal capability to receive direct or indirect lending, which has enabled them to part-finance new metro systems and other important infrastructure with IFIs help.

**Asia:**

- **Jakarta:** after many years of poor planning**,** stricter planning compliance, tighter traffic management, and a more pro-public transport approach have helped Jakarta deliver important projects, including a series of bus, rail and light rail systems. The city also has a more integrated approach to environmental management - integrated regional flood control, sanitation and waste. The World Bank, ADB and KfW are all active in the city. Elsewhere, **Manila**, **Bangkok**, and **Mumbai** have all started to develop integrated approaches, in positive working relationship with one or more IFIs.

## 5. LOOKING AHEAD: THE ROLE OF IFIS AND URBAN INNOVATION

The IFIs do not have a settled leadership position on urban innovation. Many of them see the value of embedding urban innovation and wish to be engaged in shaping the future agenda for urban innovation.

Following the World Bank's lead, other IFIs have taken initiatives to accelerate the pace of urban innovation by working with targeted groups of cities within national or regional systems. A recent example of this is the IADB's Emerging and Sustainable Cities Initiative, which seeks to help over 30 secondary cities in Latin America develop deliverable action plans for their medium-term development, using diagnostic tools developed with McKinsey & Co. These kinds of engagement constitute a step-change in the way IFIs help to guide metropolitan development, management and finance.

At the same time, IFIs often prioritise cities where the needs are most acute, or where there is a substantial deficit in an individual system such as transport, water, waste management, or housing, and their immediate aim is to bridge that deficit. From the reviews and initial consultation, a range of different illustrations of how IFIs innovate in the urban arena is possible. Among the possibilities includes:

- **Investing in managed urbanisation as a path to sustainable development.** IFIs now recognise that, far from being a problem, urbanisation is a process that can itself give rise to innovations in housing, healthcare, and education in cities as well as giving them access to work and income opportunities that are not available in rural areas. Despite the impact of urbanisation being unequal, the main innovation is to view urbanisation as a positive process with potential beneficial effects if it can be managed and shaped. Metropolitanisation in the more developed countries also offers the same potential and is embraced by the IFIs. Thus, IFIs have spent much attention supporting the active planning and management of urbanisation and metropolitanisation.

- **Smart investment in infrastructure.** Recent cost estimates of the infrastructure needs in non-OECD nations and its cities are enormous. The scale of investment required is well beyond the combined capacity of government finances and lending alternatives. Therefore, cities must be supported to use existing infrastructure more efficiently, and develop the most effective way to achieve development outcomes without huge spending on assets.

- **Promotion of long-term thinking and planning about urban development.** IFIs are active promoters of integrated long-term strategic planning for cities and metropolitan areas in Latin America, Africa, and South Asia. The World Bank Institute (WBI), for example, until recently supported a world-wide metropolitan strategic planning laboratory and other IFIs such as the ADB are also engaged in knowledge-sharing about future cities.

- **Evolving and empowering city management systems.** The decentralisation of municipal services is an important form of innovation that IFIs seek to assist in. This involves IFIs partnering with cities to strengthen systems and take more responsibility in service delivery.

The AFD, for example, has pioneered a PEFA (Public Expenditure Financial Accountability) study on the City of Dakar, the first of its kind in an African city. PEFA forms part of a financial management capacity building programme with the Senegalese city's councillors and administrative teams. PEFA identified shortcomings in municipal management and set the platform for a new plan developed in consultation with the City and the World Bank, which also includes training for city government employees.[32]

- **Promoting integration at the national level**. Many IFIs are moving away from providing site-specific services that mend visible housing or infrastructure problems, and instead are focusing on national policies that can prepare cities for change. Adjustments to national land and housing regulations, for example, can assist cities in managing rapid influx of migrants or organising affordable housing. This reflects a recognition that effective policies can be linked to investments.

- **Promoting urban and metropolitan resilience.** IFIs increasingly seek to draw on statistics and data to back up interventions and investment decisions that are best for the city in the long-term.

- **Supporting private sector leadership and commercial urban services**. Whilst real estate firms have been the most active in realising the opportunities of integrated development, IFIs observe that other firms in sectors such as engineering and financial services are becoming more involved in these agendas.

- **Financial innovation for urban challenges.** Several IFIs have sought to adapt existing financing instruments to support more innovative approaches. These include for example combining energy efficiency with housing renewal, or transportation systems with land-use planning.

- **User-focused approach.** IFIs are handling urban problems and solutions in a more iterative way. They seek to learn quickly from failure and facilitate shared decision-making rather than deliver top down verdicts about city challenges.

## Box 10: Key Quotes

*"The private sector is a mainstay of innovation going forward to meet the growing demand for smarter and green cities, and for managing environmental and natural hazards. The main hurdles in city PPPs are political will and the governance capacity. These are the challenges for achieving productive engagement with the private sector."*

**Idrissa Dia, Islamic Development Bank**

*"Systems thinking means thinking about the system as a whole – cities within regions and regions within countries. What is needed is a system of governance that allows interaction between top-down strategic planning and bottom-up thinking and data-led information"*

**Brian Field, European Investment Bank**

*"The question we have realised we have to ask is what kind of connectivity do we need before even thinking of smart cities? Mayors often don't comprehend the use of applying new technologies. They lack the knowledge that for apps to function you need a certain threshold of broadband width, fibre optic, internet penetration, radar sensors and so on. They go ahead and buy from technology vendors that can't run because a lack of diagnosis of what is possible. All cities need basic connectivity, a minimum threshold towards transitioning towards smart cities."*

**Ellis Juan, Inter-American Development Bank**

*"Innovation in cities means iterating, putting the user at the centre as part of shared decision-making. Cities need a model to engage with citizens around investment in order to put in the right kind of services and infrastructure. Simple methods of ICT citizen feedback to improve participation can help cities respond effectively. In many of our contexts innovation does not yet mean sensors everywhere, but instead means helping cities use technology to provide services to respond and react better."*

**Abha Joshi-Ghani, World Bank**

## 5.1 INCREMENTAL INNOVATION

Future innovation depends upon each city's position on the development curve. What counts as an easy solution in one city can be a highly complex, costly or intractable solution in another. In many non-OECD cities, for example, the establishment of reliable drinking water infrastructure represents important incremental urban innovation that requires an unprecedented degree of joined-up thinking. In each case, innovation refers to the next stage, or next threshold of priorities in a context of a step-by-step development strategy.

This means that the approach to designing city solutions and systems must proceed carefully based on individual city's starting point. If understood in a narrow sense, smart city solutions cannot be immediately applied to many non-OECD cities. That said, there are major opportunities for ICT or new technology to become part of city systems, products and services.

For non-OECD cities, innovations include, but not limiting to: minimising urban sprawl, improving traffic management, reducing pollution, increasing recycling and reuse, mapping urban slums, promoting education awareness, and developing new building materials.

### Box 11: Unlocking Public Finance to Spur Development Momentum

One creative response by IFIs to the assembly of urban lending has been Urban Development Funds that blend public grants with more traditional loans and associated funding instruments. Since 2007, the EC's JESSICA initiative intended to help cities access EU Structural Funds to help kick-start 'sub-commercial' development projects where private lenders view investment as too risky. It uses Structural Fund (mainly European Regional Development Fund) support with a view to creating not one-off grants, but a locally controlled, self-sustaining investment fund using returns generated from the project.

The EIB manages JESSICA Holding Funds on behalf of nine member states, amounting to €1.8bn. Although deployment of these funds for actual projects was originally relatively slow, significant progress is now being made with a number of new projects recently breaking ground. Participating countries include Spain, UK, Italy, Poland, Bulgaria and Czech Republic – involving cities such as Seville, Sofia, Rotterdam, Warsaw and Liverpool – with approximately €1.5bn committed to Urban Development Funds investing in over 40 projects.

By providing evergreen (incremental) mezzanine risk capital, JESSICA was intended to provide additional help to local authorities keep up their economic development momentum. After a difficult incubation period, the programme is now beginning to make the case for the benefits of integrated investments. Local authorities have also realised the benefits of co-operating to attract project finance, and are starting to embrace the discipline that private funds bring to projects.[1]

Cities in more advanced regions have a pace of change that is relatively slower than cities in emerging markets. The latter's core urban systems have a degree of stability and permanence which means that the rate of transformative process innovation is slowing down. In emerging cities, the rate of uptake of new systems and technologies is more rapid, as many of these systems are either incomplete or entirely absent, whilst the built urban fabric is in greater flux. In these cities, the progress from lower income to upper middle income status is taking place over a much shorter time period, in sometimes as little as 25-30 years, compared to over a century in most Western cities. As the life cycle for urban development has become much shorter, many cities in poorer countries are undergoing very rapid cycles of innovation, with the solutions embedded now creating a path dependency for the innovations that are possible in the future.

Both rich and poor cities share urban innovations. Whilst wealthier cities have shared and implemented concepts such as the congestion charge, data-led crime prevention and multi-modal ticketing, poorer cities have learnt from each other's experiences in low-cost innovations such as bus-rapid transport (BRT), healthcare systems and slum mapping. Lower-cost solutions may often be more replicable because their agreement often comes with fewer political and financial costs. However, exchanges of good urban practices need to be always informed by a clear understanding of the different institutional, regulatory, and fiscal systems that are their context.

Over the next decade IFIs and Development Banks will continue to promote and develop their work for and with cities. As specialist financial institutions, IFIs will further develop their financial instruments, policy advice, and capacity building and knowledge exchanges in the urban arena. Their dynamism will be an important part of the wider adaptation of pro-urbanisation policies and frameworks at the inter-governmental level. IFIs and Development Banks will likely come to be seen as critical players in this generational shift, as the established lenders evolve and new banks emerge. This will foster a rich environment for exchange and collaboration as well as benchmarking and evaluation.

## ABBREVIATIONS

| | |
|---|---|
| **ADB** | Asian Development Bank |
| **AFD** | Agence Française de Développement |
| **AfDB** | African Development Bank |
| **BOT** | Build-Operate-Transfer |
| **BRT** | Bus Rapid Transit |
| **CAD** | China-Africa Development Fund |
| **CAF** | Development Bank of Latin America |
| **CCED** | City Cluster Economic Development |
| **CDC** | CDC Group |
| **CEB** | Council of Europe Development Bank |
| **DBSA** | Development Bank of Southern Africa |
| **DfID** | UK Department for International Development |
| **DH** | District Heating |
| **EBRD** | European Bank for Reconstruction and Development |
| **EIB** | European Investment Bank |
| **ESCI** | Emerging Sustainable Cities Initiative |
| **IaDB** | Inter-American Development Bank |
| **IBRD** | International Bank for Reconstruction and Development |
| **ICT** | Information Communication Technology |
| **IDA** | International Development Agency |
| **IFC** | International Finance Corporation |
| **IFIs** | International Financial Institution |
| **IsDB** | Islamic Development Bank |
| **MDB** | Multi-lateral Development Banks |
| **NDB** | New Development Bank (BRICs) |
| **OECD** | Organisation for Economic Cooperation and Development |
| **PPP** | Public Private Partnership |
| **SME** | Small and Medium Enterprise |
| **SWF** | Sovereign Wealth Funds |
| **UCCRTF** | Urban Climate Change Resilience Trust Fund |
| **UFPF** | Urban Financing Partnership Facility |

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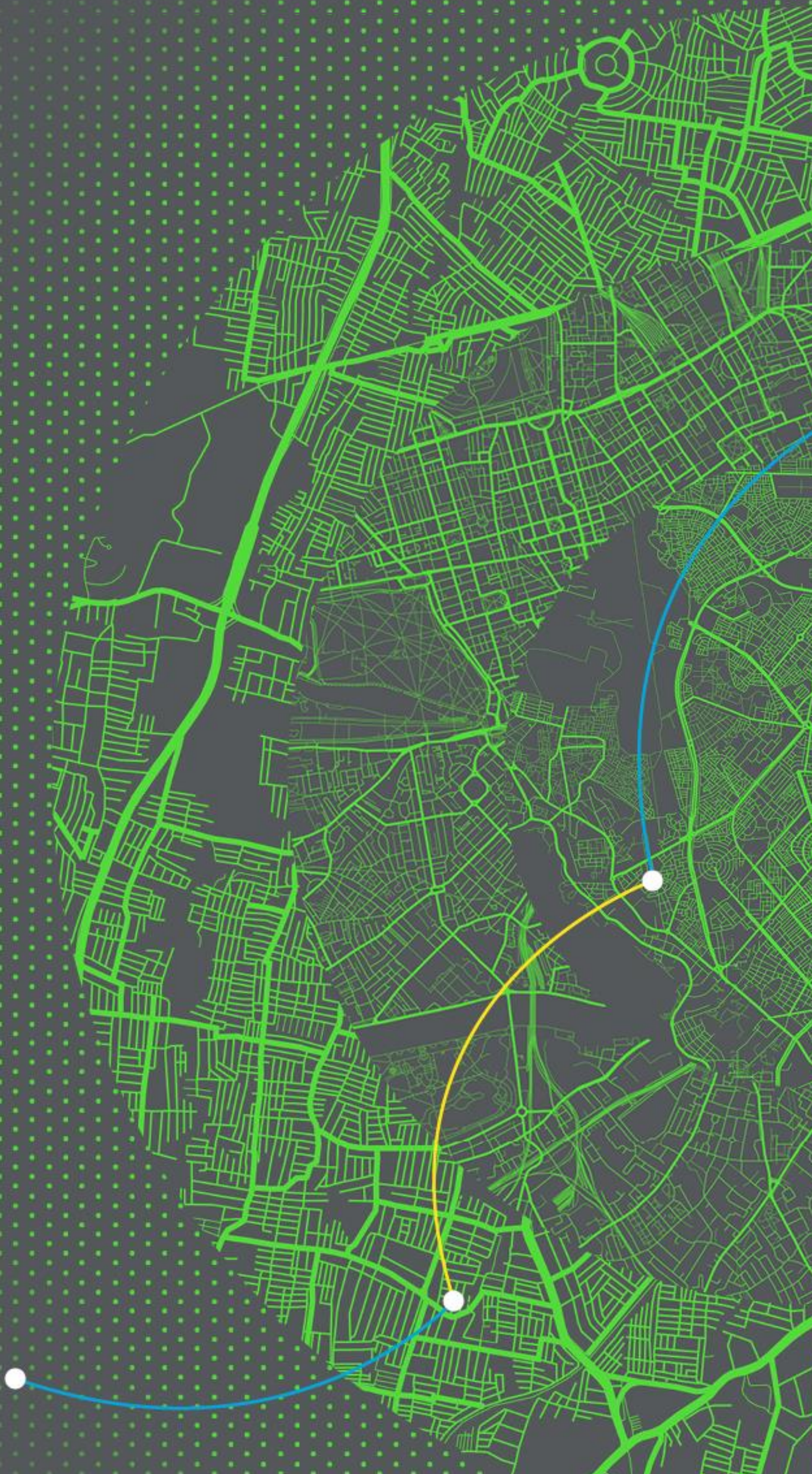

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