KfW Development Bank

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Financing cities

Funds for sustainable urbanisation

Cities in emerging and developing countries face an enormous need for investment. The rapid urbanisation and population growth in urban areas will further increase these needs. Yet only with sufficient financial resources can cities provide their residents with an appropriate level of basic services and quality of life, and make their necessary contribution to fulfilling the global sustainability goals. Nonetheless, already today there is a more than USD 1 trillion shortfall each year for urban investments. The needs for the coming decades run into several trillion dollars. While the international donor community does indeed make a crucial contribution to financing urban development, even when coupled with other public funds it is unable to cover all of the needs. Further approaches are required to increase the revenues of cities and develop national financial markets for urban areas at the same time. Only by tapping into all potential sources can the financial gap be narrowed.

Context

In light of the global trend in urbanisation, global sustainability objectives can only be achieved with the cities. For this, they need access to financing, which is a huge challenge, because cities today are already often drastically underfinanced or even in debt. There are three potential sources of financing: own revenues, e.g. through taxes or fees, transfers by the national government, and debt financing.

Cities' own revenues are essential but generally not even sufficient to cover current spending. Transfers from national governments in emerging and developing countries are frequently not enough, not reliable, and their earmarked objectives do not always match urban priorities. Therefore, additional sources of financing are needed.

Many governments in emerging and developing countries are only just slowly beginning to implement legal framework conditions targeting fiscal decentralisation. Yet this is a fundamental requirement for cities to be able to collect their own revenues and use external sources of finance. What is also needed is an appropriate financial management. This includes transparent budgeting, meaning controls on spending, debt management, as well as the ability to deploy funds sustainably and prioritise expenditure. Only if these capacities are available do cities become creditworthy and attractive for external investors.

While guarantee mechanisms at national level or by development financiers can be used as alternatives, without a minimum degree of local management capacity they are insufficient. Cities can only draw financing from the capital markets or banks, through loans or bonds, if they have a suitable rating. This is a path that has so far been barred to most cities, especially small and medium-sized ones in emerging and developing countries. However, taking a look at the need for investment and the resources available on the financial

Source: KfW, Solveig Buhl.

markets makes it clear that this access can make a significant contribution to closing the infrastructure gap.

The KfW development approach

KfW uses different channels to finance cities and urban projects. In many cases the partner country is the recipient, generally represented by the Ministry of Finance. The Ministry channels the funds to (urban) executing agencies for specific purposes. Due to a lack of fiscal autonomy, weak capacities and insufficient creditworthiness, providing direct financing to cities will remain the exception in KfW promotional activities for the foreseeable future.

Financing through financial intermediaries such as funds or national development banks is also an option. These institutions receive funds from KfW and others, and forward them on to cities under appropriate conditions and with suitable quantities. This enables more funding to be drawn from the financial markets, mitigates the risk for external investors and also helps to develop urban capacities at the same time. Depending on the context, it also means certain investor groups and recipients (e.g. small / medium-sized cities) can be targeted and adapted methods of financing (loans / grants) provided.

As a link between the financial markets and structured finance, they tap into the potential for urban investments around the world.

Outlying district in a city in India. KfW Photo Archive / Bärbel Högner.

Financing cities, better financial markets

Just like in many other cities in India, the water supply in Tiruvannamalai with its 145,000 inhabitants is inadequate. Sometimes it is restricted to three hours per day, and there is no proper disposal of wastewater either. Through the Tamil Nadu Urban Development Fund (TNUDF), this small city – by Indian standards – has drawn a loan of EUR 6 million to renew its infrastructure.

On behalf of Germany’s Federal Ministry for Economic Cooperation and Development (BMZ), KfW Development Bank has financed the fund since 2008 with the sum of EUR 260 million to date. The TNUDF is the link between the Indian financial market and urban infrastructure projects in the Union Territory of Tamil Nadu in two ways. The municipalities are first provided with direct loans and grants for their infrastructure projects. Secondly, the cities are given the opportunity to issue their own bonds on the capital market by means of a special purpose vehicle.

To make the bonds more attractive, they are pooled together with others from small cities and issued as pooled bonds. This means that the funds from the Federal Ministry for Economic Cooperation and Development improve the credit rating of the bonds so that even small and medium-sized municipalities can autonomously finance themselves on the capital market. Consequently, local players gain their first experiences of the capital market and are supported in carrying out their own construction projects. All of these measures ultimately benefit the population, which not only enjoys an improved level of basic services, but also gains a better quality of life too.

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