State and Local Government and the Formation of Green Banks

A PROPOSED FRAMEWORK FOR EQUITABLE AND ROBUST GREEN BANK DESIGN

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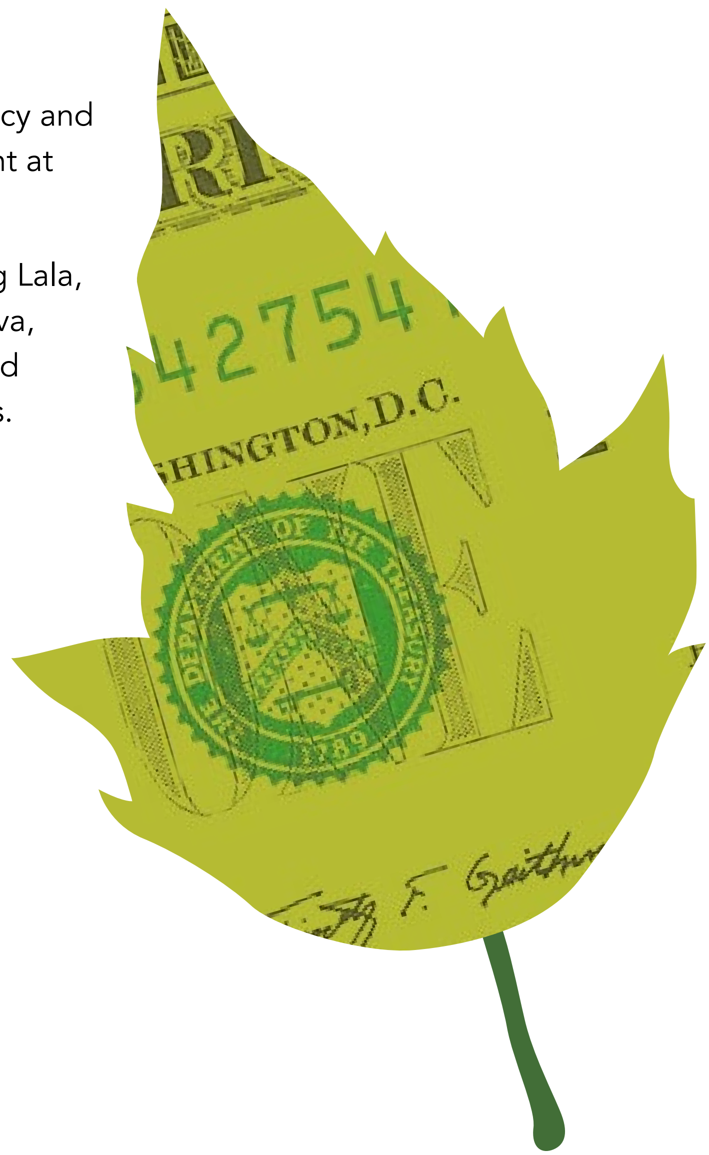
The authors are grateful to Brett Fleishman, Chirag Lala, Melanie Brusseler, Lenore Palladino, Saule Omarova, Yakov Feygin, Isabel Estevez, Johanna Bozuwa, and Patrick Bigger for their feedback and contributions.



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Executive Summary

State and local governments are key stakeholders in determining whether the Inflation Reduction Act is transformative for climate and industrial policy for years to come. One key provision is the Greenhouse Gas Reduction Fund, which provides $27 billion to support the proliferation of new and existing state green banks.

As the economic and financial impacts of climate change grow, it is crucial that state governments maximize the impact of this large, one-time injection of federal capital.

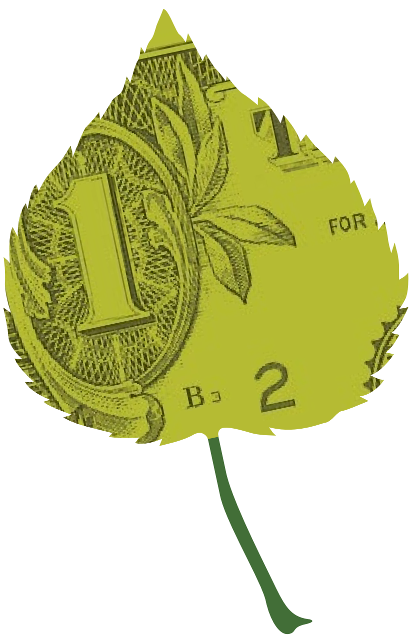
States should experiment with green bank models that are aimed at an ambitious investment strategy that will help them respond to the climate crisis in their state for many years to come. This is especially true during a period of divided government in Washington, with additional federal aid uncertain for the foreseeable future.

Building a diverse, inclusive, and accountable green bank that fosters multi-agency coordination toward a range of investment needs is imperative.

This memo will explain why, and make some recommendations for how green banks can be designed in a manner consistent with this vision.

Overview

The passage of the Inflation Reduction Act (IRA) has been hailed as the most significant piece of climate change legislation ever passed in the United States, as well as evidence of a "rebirth of industrial policy."[1] The Act foregrounds strategic public investment meant to transform how the country produces, transmits, and consumes energy by building public and private capacity in key sectors and coordination among them. It also invests in cleaning up industrial production in highly polluting sectors, like steel and cement, as well as in clean transportation, in natural infrastructure, and in repairing the harms to communities caused by pollution— investments that are projected to support 9 million jobs over the next decade.[2]



The extent to which the IRA is as revolutionary for climate and industrial policy as promised hinges on how state governments implement the legislation. Since it may be years before Congress takes action as robust as the IRA again, state governments must maximize the resources that the IRA has freed up in a manner that builds durable long term capacity. We recommend using IRA funds as seed capital for green banks that use proceeds from this short-term federal support to support a wider range of long-term investment needs, bringing in and coordinating various state agencies' work toward an overarching public investment strategy. Thus, states will be creating an independent tool that can conduct climate and industrial policy on a powerful scale, continuing to foster progress toward a clean energy transition and equitable economic growth even in the face of federal dysfunction.

This memo describes key considerations for building state capacity for green investment via a public green bank. By outlining a blueprint for how state and local governments can use IRA funds to establish investment vehicles that service long-term investment goals, we propose a model that will ensure that this historic injection of federal funds is made maximally useful.

[1] Vox, The rebirth of industrial policy, (Aug. 23, 2022).
[2] BlueGreen Alliance, 9 million jobs from climate action, (Aug. 2022).

Rather than simply supporting the financing of major clean energy projects, a state green bank designed along the lines that we propose will:

- fully embed economic development considerations into this clean energy transition;
- coordinate among various state agencies to meet economic development goals;
- prioritize support for the communities that are most vulnerable to climate catastrophe;
- facilitate a "just transition" for displaced fossil fuel workers;
- integrate state residents, consumers, and workers into the economic benefits of that transition;
- work across state regulatory, fiscal, and pension fund management offices to minimize the public's exposure to the financial stability risks of climate change;
- develop channels for private investment that support the green bank's public goals.

In sum, our proposed model for a public green bank will be a vehicle for state capacity building that takes substantial responsibility for addressing the climate crisis in the state where it is situated.

Background

Within the IRA is the Greenhouse Gas Reduction Fund (GHGRF), a $27 billion commitment to fund "green banks" and other investment vehicles. Though its mandate and grantmaking process is not yet final, the GHGRF offers the potential to catalyze state and local green investment by capitalizing green banks and other qualifying investment vehicles, which will then use the GHGRF money to support greenhouse gas mitigation projects in their regions.

The GHGRF has the potential to be transformative for the state public green bank landscape. According to the American Green Bank consortium, lending through green banks totaled $7 billion over the last decade-- equivalent to the amount of money that the GHGRF sets aside for direct grants to state and local governments alone. Quasi-public and non-profit organizations are eligible recipients of the remaining $20 billion in the GHGRF. The American Green Bank consortium's 2021 report also indicates that the largest green bank (Connecticut's) has supported about $312 million in investment.[3] Mindful of the fact that this federal money had the potential to supercharge what states were already doing with respect to green lending, the authors of the legislation that inspired the GHGRF included a provision for a "startup division" that would carry out technical assistance to encourage and support entities without a green bank to create one. It is critical that the spirit of this provision not be lost in implementation. States with existing green banks and states considering establishing new ones should seize this opportunity to use federal funds to maximize how effective and useful these bodies are. Technical capacity and commercial infrastructure should build over time as GHGRF fund recipients, including public and private investors, use recycled public investment funds to continue to further push public and private investment towards better environmental outcomes.

The passage of the GHGRF can be placed in the context of ongoing research and discussion over the best ways to organize public investment institutions. The coronavirus pandemic exposed significant weaknesses in public investment capacity in the US, including: strategic underinvestment in supply chains necessary for national security; weaknesses in the ability to effectively support (especially small) businesses at risk from the economic slowdown; lack of coordination between

[3] American Green Bank Consortium, Green Banks in the United States: 2021 U.S. Green Bank Annual Report, (May 2021).
[4] 117th Congress, S. 283, the National Climate Bank Act, (Feb. 8, 2021).

federal and state and local actors; and a dependence on market mechanisms and profit-maximizing actors that led to risks of excessive transaction costs and financial speculation. Professor Saule Omarova and others responded by exploring that idea of a US National Investment Authority (NIA) – a public investment bank with the capacity to invest strategically for public goals and to respond quickly and effectively to adverse shocks. Omarova's key insight is that public investment of sufficient scale and capacity, with clear goals and democratic oversight, can drive markets towards better outcomes.

As part of a series on the NIA and its potential solutions to long-term public investment needs, economist Lenore Palladino characterized climate change and financialization as "twin crises."[5] In this characterization, we can see two main advantages of a state-level NIA that takes the lead in overseeing climate and industrial policy within a state. By embedding economic and environmental justice principles within its mission, state green banks will empower states to conduct industrial policy of their own, addressing climate change and its economic inequities simultaneously without relying on the federal government alone for climate investment and, trade and labor policies. Moreover, by laying out a public mission and ensuring an inclusive and accountable governance structure, a well-designed state green bank will prevent pitfalls in which climate solutions are funded in a way that makes financialization worse, avoiding private market actors investments that excludes workers, retirees, and people of color from the transition's benefits.

Substantial capital from the GHGRF may be used to capitalize a national investment vehicle, but its effectiveness will depend on direction from state and local investors and coordination among them. Federal funds should encourage state and local government green bank design experimentation, competition, and collaboration.[1] Since federal support in the form of GHGRF funds holds the potential to be transformative for any and all state government investment vehicles, state governments should explore how they can design investment vehicles that maximize their utility over the long term. There's an urgent need to address essential questions about how state and local investment can be most effective, because the IRA offers a significant opportunity to (re)build public investment infrastructure.

[5] The American Prospect, Nicky Mac: A Public Option for worker's capital (Palladino), Dec. 2, 2020.

Note: The authors of the National Green Bank Act have advocated that the EPA set up a national non-profit financial institution to administer the GHGRF funds.

How to design a state green bank:

This memo focuses on a specific kind of institution – a state green bank – and explores key issues that will determine how well it meets its mandate. It focuses particularly on the idea of a public green bank – there is substantial momentum around the growth of both green and public banks, and a significant opportunity to bring these conversations together.

It treats five key issues, with recommendations for how to:

- Set the goals of a green bank
- Structure a green bank
- Govern a green bank
- Identify the investments opportunities for a green bank
- Measure the success of a green bank

To be clear, we recognize that public banks and green banks are not necessarily synonymous. The green bank design principles we enunciate in this paper apply to all public entities that qualify for GHGRF support, regardless of whether they are structured as a non-profit corporation or as a public financial institution that serves directly on behalf of a state or local government.

Important Green Bank Design Principles from the NIA Proposal to carry over to the state and local level:

PUBLIC STRUCTURE AND ACCOUNTABILITY

1

We recommend the establishment of a public bank wherever possible: Like the NIA's infrastructure bank, green banks can be most effective if they are serving as a source of ongoing low-cost financing toward a broader investment strategy. State banks should set up long-term investment strategies and be held accountable to them by the public through their elected officials. The proliferation of green banks and momentum toward establishment of public banks beyond the Bank of North Dakota should be in conversation with each other. In states like New Mexico that appear on the verge of setting up a public bank or California where a process for instituting public banks has recently been established, GHGRF funds can potentially serve as seed capital within a new public bank. In other places, existing state or local institutions could deploy GHGRF funds through existing public investment structures.[6]

BUILD CAPACITY FOR AN EXPANSIVE INVESTMENT STRATEGY

2

Under the NIA proposal, the first task of the new agency is to outline a comprehensive and ambitious national investment strategy that identifies the greatest areas of public investment needs across various segments of the economy, including housing, transportation, public health, community development, etc. This strategy is meant to be flexible and adaptable to circumstances, such that resources can be deployed to support vaccine development and deployment in the event of a pandemic, for example. This feature of the NIA should be replicated at the state level, so that federal GHGRF funds are deployed most effectively within a broad public investment framework within the context of integrated public investment strategies that include investments in housing, transportation, worker training, disaster relief, and so on.

[6] California Public Banking Alliance, California Public Banking Act: A Brief, (2019)

DECENTRALIZED, EQUITABLE, AND DIVERSE GOVERNANCE STRUCTURE

3

The NIA was meant to mitigate concerns about inequitable economic growth by mimicking the decentralized structure of the New Deal era Reconstruction Finance Corporation. The regional office feature of the NIA should be emulated at the state level. It is important that state green banks follow the NIA's requirement that green bank leaders are chosen through an open process that draws on expertise in a wide range of sectors and takes input from a diverse set of stakeholders and geographic regions. State green banks' governance should not be chosen by a single person, and their leadership should reflect strong gender, racial, socio-economic, and regional diversity, with a high degree of public transparency and accountability.

MULTI-AGENCY COORDINATION

4

As Saule Omarova has written, the NIA was envisioned as "a federal-level institutional platform for coordinating and amplifying climate-targeting action on multiple fronts," and "the primary federal authority in charge of coordinating and overseeing ongoing investments in critical public infrastructure and socially inclusive and environmentally sustainable economic growth."[7] State green banks must coordinate their planning and investments with other agencies to create comprehensive state goals for equitable economic growth. For example, Colorado's Office of Just Transition should be looped into the process for determining top priorities for the $8 billion in GHGRF funds that are designated for "low-income and disadvantaged communities." Similarly, it is important that recommendations made by California's Climate Insurance Working Group to "reduce climate-related risks to property" be incorporated into any work carried out by California's Climate Catalyst Fund at its Infrastructure Bank.

[7] Data for Progress, The Climate Case for a National Investment Authority (Omarova), Aug. 2020.

What kinds of goals should a state green bank target?

Green banks should integrate climate goals with economic development, economic equity, and environmental justice, rather than target decarbonization narrowly.

They have the potential to organize planning and investment around a low-carbon transition and climate resilience. They also can play a role in using public investment to address the social challenges that result from a low-carbon transition – they can be oriented towards a Just Transition. The GHGRF partially integrates environmental justice considerations in its mandate, through targeting of investments to low income communities. It also leaves enough flexibility to address environmental injustice by allowing for the targeting of toxic pollutant reductions in addition to GHG reductions.

State green banks can build on this by integrating strong labor and environmental justice standards with their decarbonization mandate. The jobs created by green bank investments should be good jobs, with provisions for prevailing wages, local hire, and responsible contracting policies. Investments in workforce training and apprenticeships should prioritize workers and communities who will bear the brunt of economic dislocation or who have carried the burdens of fossil fuel pollution. The green bank should prioritize historically marginalized communities when developing opportunities for future investment. These goals can be codified in the bank's governing documents.

In orienting its work around the Just Transition, the state green bank can take advantage of opportunities to achieve multiple public goals, and reinforce public support for the hard work of decarbonization.

How should a green bank be structured?

State green banks should be public institutions with a capital base where possible.

There are significant advantages to creating a public institution with sufficient scale and independence to shape the market --- such an institution can provide a center of gravity around which public and private capacity can develop. A state green bank with its own capital base can work with existing private financial institutions, especially those like community development lenders who invest in historically marginalized communities, to bring scale and technical capacity to institutions close to the ground. A green bank with its own equity base – capitalized in part with GHGRF funds – can be a long-term investor, potentially raising money by issuing its own debt.

States and localities have similar entities, such as state housing and finance agencies, or port authorities, that play important roles investing in public goals, and a state green bank could potentially be housed within such an entity or be an independent institution. There are significant advantages to a public institution – for accountability, for creditworthiness – rather than an independent nonprofit or for-profit bank. Among other benefits, the ability to issue bonds is itself an important way to shape market outcomes.

State green banks should build in-house technical as well as financial capacity.

In order to take advantage of the broad range of investments needed for a Just Transition, the bank can incorporate multiple lines of work, lending to green and community investment funds (both debt and equity), and directly to relevant projects and programs. Banks could also develop in-house capacity for equity investments.

Staffing should reflect the engineering and technical expertise necessary to evaluating green investments for their environmental and social outcomes, as well as the expertise necessary to engage with a broad range of worker, community, business, and financial stakeholders relevant to investing in a Just Transition. States should consciously partner with state public universities to draw on their research and expertise. Additionally, the bank should engage and reflect the work of financial officers and staff for municipalities throughout the state who are involved in putting out requests for proposals and procurement, since they will have the best understanding of infrastructure needs and economic development opportunities.

State green banks should establish a state investment strategy.

While many states set up some sort of "green bank" years prior to the passage of the IRA, GHGRF funds will in many cases supercharge the capacity of these entities. The IRA also instructs the GHGRF to support entities that "retain, manage, recycle, and monetize all repayments and other revenue received from fees, interest, repaid loans, and all other types of financial assistance provided using grant funds under this section to ensure continued operability." Thus, presented with a rare opportunity of substantial federal resources to support ongoing investment, state governments should put themselves in the best position to utilize revolving funds by setting an ambitious and far-ranging state investment strategy for the entity receiving these funds. Setting a state investment strategy that incorporates a green bank mandate can enable mutual support among green investments and those directed towards job training, disaster relief, housing, transportation, and a set of economically beneficial projects that extend beyond greenhouse gas emissions reductions.

Importantly, this should also enhance the infrastructure and resilience capacity of the state in a manner that is currently lacking. For example, at the end of 2020 Congress passed and FEMA has begun to stand up a STORM Act program that will help state and local governments with disaster relief, but the assistance does not have the same kind of technical capacity-building features that alternative legislation that was considered would have had. A smart state investment strategy will help to optimize the use of resources in the long run.

What kinds of investments should a state green bank make?

State green banks should have a range of flexible financial tools oriented around their environmental and social goals.

An essential role of public finance is to direct economic activity towards more useful social outcomes. Doing this requires acting differently from private finance. This can mean many things: building specific sectoral expertise and publishing research; linking public and private stakeholders more effectively; or creating consensus around investment goals and plans. But it can also mean targeting different kinds of financial returns.

State green banks do not need to maximize their short-term financial returns. On the contrary, patient long-term investment, and targeted returns set by investee needs, are tools that allow public investment institutions to directionally influence market activity. State banks can seek to cover operational expenses and recycle investments – the flexibility this provides allows for taking on more risk or accepting lower returns for investments of high social value, the basis of course for many public or mission-driven investment strategies. An independent, publicly controlled green bank is situated to tackle the difficult task of determining the appropriate rate of return based on the social value of their investments.

State green bank investments should have clear rules and mandates integrating environmental and social goals.

Without a clear set of environmental and social criteria for investment selection, and clear rules that set expectations for co-investors, investees, and the public at large, state green banks will give away key tools of influence in broader financial markets. This can include systems for the evaluation of the environmental, workforce and (disparate) community impacts of investments, and hard rules ensuring that public investments do not support negative outcomes such as increased carbon emissions, the degradation of workforce standards for inclusion, pay and benefits, and health and safety, or unjust distribution of the costs and benefits of investments and the work they engender.

State green banks should have established guardrails to prevent capture and rent-seeking.

The challenge is to make sure that any subsidies to investees in fact deliver on their promise, and are not captured for intermediary or investee benefit. State green banks will need clear guardrails to ensure that subsidies do not lead only to private benefit: for instance, recent federal programs have required companies receiving public dollars not to engage in share buybacks. More generally, the goal of green banks should not be to maximize the amount of private capital they leverage, but rather to optimize its investments and their catalytic effects towards public goals. The GHGRF has a number of associated subsidies, often tax expenditures, meant to catalyze private investment, and these necessarily run the risk of subsidizing financial intermediary activity without intended benefits. Green banks need accountability mechanisms based on public goals.

How should state green banks be governed?

State green banks should have governance designed for democratic accountability.

Public investment institutions create important possibilities for democratic accountability. The first place to do this is in the formal constitution of their boards. State green banks can have designated roles for important stakeholder groups, with designated seats for labor, environmental, and community advocates, and local and regional representation, to better meet their commitments to Just Transition.

State green banks should have robust transparency and reporting requirements.

State green banks should have reporting requirements to make their work regularly available to the public online, publish formal reporting on financial performance and progress towards public goals, and have regularly scheduled reports against goals made to elected officials. Green banks can play a particularly important role in analyzing investment performance and disseminating lessons learned over time, crucial elements for creating durable capacity for climate-related investment in both public and private sectors.

Recommended governance structure for a state green bank:

- 9 directors, serving staggered 10-year, non-renewable terms.
- Chair and Vice Chair are appointed by the governor, and can be removed through a 2/3rds vote of the legislature.
- All other directors are selected by a committee of state legislative leaders, consisting of 2 members of the majority party in each chamber and 1 member of the minority party in each chamber.
- All members are required have established expertise in finance, economics, law, environmental science, engineering, public administration, infrastructure projects, public health, or other relevant fields; and
- At least five of the members must have demonstrated experience with, and endorsement from labor organizations, non-profit organizations, and community advocacy groups, including environmental organizations. At least one of these members must be specifically designated by the labor community, and at least one must be designated by the environmental community.
- The members must represent the public, with consideration given to regional and geographic diversity, as well as racial and gender diversity. No more than 4/9 directors may reside in any particular geographic region of the state.
- At least three regional offices should be established as subsidiaries of the green bank, and at least one director must be selected from each region to represent each regional office.
- At least one member must represent the academic community, and must have an endorsement from the heads of public universities located in the state.
- At least one member must represent native and indigenous communities, and must have an endorsement from tribal governments.
- The board is required to submit an annual report to the state legislature, detailing the financial performance of the green bank, progress toward the green bank's investment objectives. The report should also include a thorough assessment of lending in low-and-moderate income communities, and progress toward racial and social equity goals. The chair is required to testify annually before the state legislature. Upon hearing this testimony, the state legislature is encouraged to issue recommendations to the board for improving the green bank's performance and progress toward its investment objectives.

Steps Towards a Public Green Bank

Together, the design questions above suggest a robust, durable public investment institution with a clear mission, substantial internal expertise and capacity, flexible financial strategies that prioritize public goals, and clear lines of public accountability.

States should review existing institutional design and capacity.

The IRA, and the GHGRF within it, offer an opportunity to take steps towards these goals. There are important existing state green banks and green investment funds whose capacity can be expanded with new investments and federal support. In other places, there are analogous public or quasi-public investment authorities that could perhaps house a green bank or whose experience can inform its design. In all places, there are a range of public, quasi-public, for-profit, and not-for-profit financial institutions with which a green bank will work to achieve its goals. A first step would be mapping these existing resources and the relationships among them, with particular attention to those institutions with existing climate expertise and those which invest in historically marginalized communities.

States should establish multi-sector commissions to encourage development of public green banks.

States can also organize multi-sector commissions that integrate labor, community, and public and private sector representatives to define the mission of a state green bank, address design questions, and build broad-based support for the institution and its mission. In effect, such a commission would model the kinds of governance and accountability that would then be built into a state green bank and inform its activities. There are examples of state and local work on the Just Transition and sustainability and resilience planning on which to draw.

Finally, states can use these experiences to inform the as yet undetermined path of the GHGRF itself, as well as the interface between the GHGRF, state and local green banks, and related federal, state, and local programs and policies.

Conclusion

Upon passage of the IRA, Rep. Debbie Dingell (D-MI), the author of the provisions that became the GHGRF, stressed that, "The impacts of climate change have created an emergency situation that poses a substantial danger to the health and safety of the American public, and the award and disbursement of the maximum amount of funds appropriated to the GHG Reduction Fund cannot be delayed."[8] Rep. Dingell is correct that the climate crisis poses an emergency that requires a swift and vigilant response from federal and state policymakers. It must be recognized, however, that an eleventh-hour breakthrough in negotiations allowed the IRA to become the largest-ever federal climate legislation after nearly two years of painstaking deliberations. Now, the prospect of another lengthy period of divided government at the federal level appears likely.

With this in mind, the public cannot afford to wait for the federal government to regularly provide clear direction and resources through legislation like the IRA.

The scope and breadth of the climate crisis, and its implications for our economy and financial system, demand creativity and innovation at the state and local level. Thus, state policymakers must respond to the emergency of the climate crisis and the IRA's rare injection of federal capital by creating enduring, long-term capacity-building vehicles that will enable the state to adapt to climate change and manage its economic ramifications for many years to come. Having established "why" we believe GHGRF funds should be used to capitalize state vehicles for long-term, capacity building toward a just transition and economic transformation, the authors are eager to work with state and local governments to explore "how" they can convert existing green banks into the type of bank we envision, or authorize new investment vehicles that serve these vital and wide-ranging functions.

[8] *Rep. Debbie Dingell, Remarks of the Honorable Debbie Dingell, (Aug. 12, 2022).*

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