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Banking on Cannabis

Navigating the Shoals of Cannabis Banking Regulations

November 2017

Executive Summary

Twenty-nine states and the District of Columbia have passed laws legalizing marijuana for medicinal, recreational, or dual permissions, yet marijuana remains classified as a Schedule 1 narcotic. Therefore, federally chartered and insured financial institutions have generally refrained from transacting business with any known entity that derives its revenues from cannabis related activities. As the industry continues to evolve, the clear and present risk of transacting business in "cash only" continues to supervene as many businesses are not able to accept debit or credit cards, write checks nor make (or receive) payments electronically. These limitations plague not only entities that "touch the plant" but also ancillary businesses and service providers.

Simply, this means that, as long as the Drug Enforcement Agency (DEA) effectively defines the federal legality of marijuana, all cannabis related enterprises are compelled to transact sales and the disbursement of operating expenses by means of cash or nontraditional payments. This transaction model poses an inherent risk to investing in the cannabis industry. Additionally, these enterprises are forced to operate under adverse taxing regulations (most notably the inability to deduct most business expenses from revenues). Consequently, businesses find it difficult or impossible to obtain financing as their capital needs must be either self funded or raised privately. We note, too, that these legal restrictions also extend by implication, to non US banking institutions -- American banks have signaled that they would stop doing business with foreign counterparts if they are found to be providing services to marijuana businesses.

Investors continue to be concerned that their interests may not only remain vulnerable to existing legal impediments, but also that they could face an additional threat if the federal government were to claim superseding law enforcement jurisdiction over state mandates.

We believe that until such time as the federal government ends prohibition or passes legislation to change existing laws that the cannabis industry will be impelled to seek out temporary solutions to facilitate banking transactions. It is hoped that some of these work-arounds will be suited for longer term viability and will (or continue to) stand the tests of regulatory scrutiny.

Accordingly, there will remain some level of ambiguity as to whether a true cannabis banking solution exists in the marketplace today. There is no one answer and we think there will continue to be a patchwork of alternative offerings. Some of the conclusions drawn from our analysis of the cannabis banking environment are:

- The implementation of California's recreational use market in January 2018 could increase the amount of cash collected (at retail) to approximately $5.2B ($6.2B+ including sales tax collections). With other new state markets planned for 2018, we estimate total legal marijuana retail revenues of approximately $12.1B ($ 14.5B+ including sales tax). Unlike sales consummated through the black market, the legal retail channels contains an added element of risk – a known address where a cash transaction occurs (i.e. dispensary) underscoring a significant concern to public safety. The State is exploring all possibilities for a practical solution including the establishment of a state owned bank, solely for cannabis businesses.

- We reiterate our view that all 50 states and D.C. will have implemented a medical only or a fully legal market by 2021 which could achieve approximately $30 B ($36 B with sales tax collections) in retail revenues. The magnitude of these projections underscores the potential public safety threat that looms on a national level should no action be taken to remedy the restrictive nature of the current banking environment. We further suggest that the potential loss of tax revenues (possibility of unreported revenues) and the lost opportunity for banks in such a cash only environment will also drive the call for new federal legislation.

- We estimate that approximately 5% of all financial institutions are on record with the U.S. Treasury Department's Financial Crimes Enforcement Network (FinCen) as having established a relationship with a known Marijuana Related Businesses (MRB's) though only about 1% are actively servicing these businesses. In addition many more state licensed enterprises (which we cannot quantify) have been able to maintain a deposit account with a bank or credit union (and merchant account with a payment processor) by concealing the true nature of their business activities. Consequently, there are frequent occurrences of account closures that appear to be systemic throughout the cannabis ecosystem.

- Approximately 35% of the cash collected by Colorado's dispensaries are deposited into just one credit union which accounts for only ~1.5% of the total credit union assets in Colorado -- it is plausible that other states could exhibit similar levels of concentration risk. To ease the concerns of other financial institutions that seek to onboard and maintain new cannabis clients, several FinTech/RegTech solutions are emerging that seemingly are compliant with all regulatory requirements (achieved from either a software interface and/or the outsourcing of personnel). The land grab is significant (>7,000 financial institutions in the U.S.) and the successful rollout of these alternatives will likely mitigate one aspect of the risk unique to cannabis investing.

- We are cautious on the use of Cryptocurrencies as a viable banking solution. Its questionable ability to pass regulatory scrutiny due to its inherent complexity and limited transparency remains a major stumbling block.

- As we indicated in our last report, we anticipate the possibility of a friendlier cannabis banking environment under the Trump Administration, which has expressed its intent to further deregulate the banking industry in ways that could minimize, if not eliminate, the compliance burden associated with Sarbanes Oxley. As a possible consequence, this event could potentially effect a redeployment of internal resources (within a bank/credit union) to focus on cannabis (we note that since Trump took office, a bill has been presented in both the House and Senate which effectively could eliminate or minimize some of the cost burdens associated with Sarbanes Oxley).

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