

State Notes

TOPICS OF LEGISLATIVE INTEREST

Winter 2020



Banking Challenges for Michigan's Cannabis Industry **By Elizabeth Raczkowski, Fiscal Analyst**

Introduction

Michigan voters legalized medical marijuana in 2008 and recreational marijuana in 2018. However, marijuana's status as a Schedule I controlled substance at the Federal level means that states, the cannabis industry, and marijuana users face significant legal uncertainties. These include possible criminal charges under Federal law. Consequently, banks and other financial institutions largely have been reluctant to serve the cannabis industry, mainly because of the risk of money laundering charges and asset seizures and forfeitures. Marijuana businesses must deal almost exclusively in cash and assume significant costs and risks as a result. These cash-based transactions also pose a challenge for State and local governments seeking to track products, prevent crime, and collect tax revenue.

As of January 2020, marijuana is legal for medicinal purposes in thirty-three states and for recreational use in eleven states. Elected officials and administrators have supported efforts to pass Federal legislation that would protect financial institutions serving cannabis businesses in their states. States also have begun to explore alternative means of providing needed services to their expanding marijuana industries.

This paper provides an overview of this issue, which likely will become increasingly relevant in Michigan because of its recent legalization of recreational marijuana and the expected growth of its cannabis industry.

Scope of the Marijuana Industry: State and National Estimates

A white paper from the American Banking Association cites reports that project that the national legal marijuana industry will reach a size of \$25 billion in the next six years, up from over \$10 billion today.¹ The 2017 Marijuana Business Factbook estimated that the total economic impact of the industry could reach between \$47.6 billion and \$68.4 billion by 2021.²

There are no official national statistics regarding the number of people employed in the marijuana industry because of its Federal status. A March 2019 report estimated that about 64,000 new jobs related to cannabis were created in 2018 and employment in the industry is expected to grow. This report estimated the total number of jobs nationwide at about 296,000.³ In addition, peripheral jobs ranging from insurance agents to HVAC specialists are associated with the industry and may be affected by its growth.⁴ Estimates for the total number of individuals employed by the industry in Michigan are not available.

According to the Department of Licensing and Regulatory Affairs (LARA), Michigan is the second-largest marijuana market in the United States in terms of medical marijuana cardholders, with about 294,000 individuals registered. Medical marijuana sales from October 2018 to February 2019 totaled over \$57.5 million.⁵ In 2017, legal and illegal marijuana sales in Michigan were estimated to total between \$100 million and \$150 million.⁶ As of March 2019,



there were seventy-three medical marijuana provisioning centers located in Michigan. The statewide industry is expected to continue to grow.

The table below shows the estimated revenue for the excise tax and sales tax on marijuana. The challenges and inefficiencies of the cash-based system may result in lower-than-expected tax revenue because of the difficulty of tracking sales. Additionally, tracing cash transactions requires greater administrative expenditures on the part of the collecting agencies.

Projected Sales and Excise Tax Revenues (in millions)						
	<u>FY 2019-20</u>			<u>FY 2020-21</u>		
	Total	GF/GP	School Aid Fund	Total	GF/GP	School Aid Fund
Sales						
Recreational	59.0	9.8	43.3	86.0	14.3	63.1
Medical	19.0	3.2	13.9	19.5	3.2	14.3
Excise	<u>97.5</u>	<u>73.9</u>	<u>23.6</u>	<u>143.0</u>	<u>99.9</u>	<u>43.1</u>
Total	\$176.5	\$86.9	\$80.8	\$248.5	\$117.4	\$120.5

Source: January 2020 Consensus Revenue Estimates.

Risks for Financial Institutions

Banks that serve marijuana businesses may have their Federal charters revoked because of its Schedule I status. Meeting Federal banking requirements means collecting a substantial amount of information about customers served. Banks are expected to check for suspicious financial activities by their clients, a difficult requirement when dealing with an industry based upon the sale, cultivation, or processing of a product that is illegal under Federal law. Nevertheless, an increasing number of banking institutions nationwide have been willing to begin offering banking services including basic deposits, lending, and payment processing. Approximately 400 banks were thought to be serving cannabis business in 2017.⁷ The practical access that the average individual or business in the industry have to these institutions is unclear, particularly in Michigan.

Challenges for States, Local Governments, and Businesses

The cannabis industry's dependence on cash generally results in increased administrative workloads, higher processing costs, greater likelihood of being targeted for criminal activity, and poor documentation. These challenges frequently are interrelated and present serious risks to businesses, customers, financial institutions, and government agencies.

Cash-based businesses and their customers are frequent targets for theft,⁸ which can result in personal violence and property damage. Businesses may be forced to invest in greater security measures, which may erode profits. Theft prevention may be difficult to pursue because of the drug's illicit status; security services may be reluctant to serve marijuana businesses or marijuana businesses could be prevented from obtaining loans and equipment.⁹ However, some insurers do offer specialized insurance for the cannabis industry, covering all stages of



production, from cultivation to sale. Criminal activity also lowers property values and imposes greater costs on law enforcement at both the State and local level.

According to the *Detroit Metro Times*, 79% of Michigan's municipalities have elected to prohibit recreational marijuana sales within their jurisdictions. Local officials have cited uncertainty regarding the regulation of the industry as a significant reason for preventing or delaying recreational marijuana businesses in their communities. Officials also have voiced concerns that cash-system that retail locations must use could attract criminal activity.¹⁰ A number of these communities, including Detroit, have stated their intention to revisit the issue at a later date.¹¹

Day-to-day business activities, record keeping, access to insurance and loans, and tax preparation all are significantly more difficult without access to electronic fund transfers and the traditional financial documents produced by accredited institutions. In addition, cash-based businesses can more easily hide revenue and evade taxes.¹² State and local governments also must devote greater time and resources to collecting and processing taxes and other funds, such as application or licensing fees, when dealing with significant amounts of cash and less documentation.¹³

Voluntary Risk-Taking by Banks

As previously cited, about 400 banks and credit unions are thought to be offering services to marijuana businesses nationwide. These institutions have determined these activities to be an acceptable risk. In 2018, the Federal Reserve Bank of Kansas City extended a conditional master account to a Colorado credit union specifically focused on serving the marijuana industry. However, the agreement contained a requirement that the credit union agree not to provide services "to marijuana-related businesses" unless Federal law permits it.¹⁴ This raises questions about the full value of the authorization, although officials generally do not expect Federal regulators to pursue prosecution.¹⁵

Federal Action

The Secure and Fair Enforcement Banking Act (SAFE) has been introduced in both chambers of the U.S. Congress. The bill would allow financial institutions to provide services to businesses that handle marijuana-related funds without enforcement action by the Federal Deposit Insurance Corporation or the National Credit Union Administration.¹⁶ In addition, the current House version of the bill requires Federal regulators to report to Congress annually on the accessibility of financial institutions to minority- or women-owned marijuana businesses. The Act was passed by the United States House of Representatives in late-September 2019.

This legislation has been endorsed by numerous financial associations and state officials throughout the country.¹⁷ In May 2019, the Michigan House of Representatives passed House Resolution 101, which urged Congress to "enact legislation preventing federal regulators from sanctioning depository institutions for providing financial services to legitimate marijuana-related businesses in states where marijuana has been legalized". The resolution specifically references the SAFE Banking Act.¹⁸ A month later, Governor Whitmer cosigned a letter urging

the United States Congress to pass the Act. Eighteen other governors also have signed the document. Attorney General Nessel and the Department of Insurance and Financial Services (DIFS) Director Anita Fox also have signed letters asking Congress to address the issue.¹⁹

The Congressional Budget Office's cost estimate for the SAFE Banking Act suggests that the legislation ultimately would increase private sector costs but would result in increased revenues to the Federal government. Despite increased regulatory activity in the form of issuing guidelines and monitoring banks for compliance, the legislation also could result in additional or increased fees paid to Federal regulatory institutions.

It is unlikely the Act would have a significant direct impact on State revenues. Nevertheless, any resulting increase in business activity in the private sector could increase tax and application and licensing revenue, which would be offset partially by associated increases in regulatory activity.

State Actions

Guidance for Financial Institutions

The Department of Insurance and Financial Services issued a letter in December 2017 requiring State-chartered credit unions to complete a full risk evaluation if a marijuana business requested their services.²⁰ Previously, no guidance required an institution to complete such a review before denying service. This letter was rescinded by Letter 2018-CU-02 less than four months later because of a memorandum issued by the United States Attorney General Jeff Sessions,²¹ which reversed the Cole Memorandum. The Cole Memorandum encouraged U.S. Attorneys to exercise discretion when enforcing Federal marijuana laws in states with legal marijuana industries. In contrast to that document, the new directive advised Federal prosecutors to continue enforcing Federal laws and practices with respect to violations of the Controlled Substances Act.²²

Boilerplate language requiring DIFS to issue a new letter of guidance to financial institutions wishing to conduct business with the marijuana industry was included in the fiscal year 2019-20 DIFS appropriations bill, but was vetoed by the Governor.

State Banks

State-run banks have been proposed in several states, including Michigan (see previous section), Florida, New Jersey, and Colorado. Safe Harbor Private Banking, a division of a Colorado credit union, provides banking services to the cannabis industry in Colorado as well as other states. Use of this credit union is discussed in the next section.

A report prepared for the State of California that examined the possibility of creating a state-run bank for marijuana funds concluded that the creation of such a bank or credit union would still leave the state liable to the same problems that commercial banks face.²³ Banks that intend to serve the cannabis industry may face difficulties obtaining a master account with the Federal Reserve, meaning that the institution would not be able to perform key financial functions. Apart from the legal issues presented when handling financial transactions derived from

marijuana, any bank dealing primarily with the marijuana industry also could be judged to have too high an industry concentration risk by Federal regulators. The difficulty of connecting to national and international financial networks, the report concluded, poses a major obstacle even if a state-run institution were financially feasible. The risk appears to make further efforts to establish a state bank in California or elsewhere politically difficult.

Alternative Payment Systems

In June 2019, Nevada passed a bill authorizing its State Treasurer to develop a pilot program for a closed-loop marijuana banking system. Under this plan, marijuana businesses and customers convert cash into digital "tokens". These tokens could be used for cannabis-related transactions with commercial enterprises or the government, including paying taxes. The tokens then could be converted back to normal currency. The system is intended to be functional by July 2020, but it would be voluntary and businesses and customers could continue to complete transactions on a cash basis.²⁴

A similar system already is in use in Hawaii, California, and Colorado. CanPay is an app that functions similar to a debit card. Individuals can make purchases at cannabis and other cash-only businesses using the app on their own mobile phone or a retailer's computer terminal. As with a traditional debit card, the funds are deducted from a bank account. These transactions are done through banks that partner with the app and Safe Harbor Private Banking, a credit union based in Colorado. The money deducted from customers' accounts is sent to the credit union, where dispensaries have an account.²⁵

In addition to avoiding some of the pitfalls of customers and businesses handle large amounts of cash, each system also allows for more efficient and accurate record-keeping.

State Actions in Michigan

Legislative Action

Little legislative action has taken place on cannabis banking in Michigan. However, the issue has been examined by legislators apart from the recent House Resolution urging Federal action.

House Joint Resolution CC of 2018 would have amended the State Constitution to allow State funds to be deposited in the yet-to-be-established Community Bank of Michigan (see section "State Banks" below) with the intent that this bank be used for cannabis industry transactions. However, the resolution was introduced and referred to committee without further action. Six legislators cosponsored the bill.²⁶

In addition, Public Act 10 of 2018 revised the Medical Marijuana Facilities and Licensing Act in several ways, one of which was to specify that a certified public accountant or financial institution will not be penalized or prosecuted by the State for providing services to medical marijuana licensees.



Conclusion

Without Federal action, the financial obstacles facing the cannabis industry in Michigan and other states cannot be resolved. However, interim practices such as digital transactions (as in Hawaii) or digital currencies (as in Nevada) may allow smoother and more secure operations, which could help to reduce crime, lower administrative costs, and ensure better tax revenue collection.

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- ⁴ Note 1.
- ⁵ Michigan Marijuana Regulatory Agency Statistical Report: October 1, 2018 - March 31, 2019, Department of Licensing and Regulatory Affairs.
- ⁶ Note 2.
- ⁷ Note 2.
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- ²⁶ Michigan House of Representatives, House Joint Resolution CC of 2018