The Challenge of Cannabis Deposits
Is there another way?

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Introduction

Lack of access to banking services threaten to cripple the cannabis industry in the state of California, and elsewhere. Briefly, the fundamental problem is that, while cannabis is now legal according to California state law, it remains illegal to grow and sell under federal law. This is problematic because all banks, including state-chartered banks, are subject to federal banking and money-laundering laws, most notably the Bank Secrecy Act and the Anti-Money Laundering regulations (BSA/AML). Under Obama, the Department of Justice (DOJ) and the Financial Crimes Enforcement Network (FINCEN) both issued guidances that would allow financial institutions to negotiate a delicate path between state and federal laws, but the Sessions DOJ revoked its guidance letter. Technically, the FINCEN guidance remains unrevoked, but is of uncertain value under the current administration.

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The situation has left cannabis growers and dispensaries in an awkward situation, forced to manage a huge business on an entirely cash basis. This is inconvenient for customers, for the dispensaries who have to pay employees and payroll taxes, and for the governments collecting the taxes. In addition to the inconvenience, there is the public safety issue of moving around and storing large piles of cash and the vulnerability of the various parties to theft and fraud.

In addition, another point that has perhaps failed to receive enough attention is that the underground and cash-only nature of the cannabis industry means there is a large amount of wealth stashed away, hidden not only from the authorities, but from the local economy. Getting that wealth into the banking system will make it available to be used for social needs in the affected communities, and could have tremendous economic development benefits, especially for rural economies.

The challenge of cannabis deposits

Designing a solution to the challenge of cannabis banking must anticipate two significant challenges that threaten to undermine its operation before it even begins. One possible solution is a state-run public bank, that would accept cannabis deposits and use its status as a state institution as a form of shield against federal laws. This has been considered by the commission convened by the state Treasurer, who put out a report on the subject in December 2018.

The fundamental idea is sound, in theory. Sadly, legal issues are often not settled on the basis of sound theory. A state bank focused on managing cash deposits from the cannabis industry would not necessarily insulate the financial institution against federal legal and regulatory enforcement or political harassment, both of which must be anticipated in the current political climate. Second, the establishment of a public bank may fail to generate the necessary political will if its projected legal, management, and administrative costs outweigh the additional revenue it would create.

As with any new policy initiative, the legislators and executives who establish a public bank cannot discount the legal risk to its creation, even in the presence of compelling legal arguments to support it. On the contrary, opening a public bank to address the issue of banking Marijuana-Based Enterprises (MBEs) would be a direct confrontation to the federal government and its banking and law enforcement power. There is no reason to expect the federal government would back down and decline to challenge the bank's establishment, in courts or in administrative and regulatory forums. Compelling legal arguments only acquire the force of law after being tested in courts, which takes time. Though the state might eventually prevail against such challenges, there would be months or years lost when the bank would remain unable to address the problems for which it was created.

The second challenge relates to overhead. An institution completely independent of existing banks and banking networks would incur tremendous administrative overhead simply to collect cash from all over a state as large as California. Nor is it completely clear that commercial banks would not come to regard transfers from a cannabis bank as tainted and avoid accepting them. This would not only defeat the purpose of the public bank, but would force it into having to provide much of the management infrastructure itself, along with more expensive consumer services, and result in an expensive and unwieldy structure.

Unfortunately, both of these outcomes — the twin possibilities of being tied up in court for years, and the chance that transfers from the public bank will appear as tainted as the original deposits — are determined by the actions of players outside the scope of any bank. There is no way to predict with any confidence what they will do, and thus the bank will be at risk from inception. The amount of work, not to mention capital, that would be put at risk is large, and the downside risk is not only the loss of the time and effort invested but also the time wasted while cannabis businesses continue to be inconvenienced by the situation. For these and other reasons, the concept was rejected by the Treasury commission.

The promise of tradable tax credits

A public bank designed to manage liquidity for a system of tradable tax credits — rather than cash deposits — could simultaneously address the legal and financial challenges described above. With this design, cannabis and its proceeds would be effectively and legally separated from the banking. Such a system could be operated at a low overhead and still provide access to most of the important banking services to the cannabis sector. Furthermore, it could provide capital for important local public finance needs. Crucially, such a system could be started relatively quickly and safely compared to the regulatory hurdles facing the establishment of a federally-regulated bank.

Such a system could be organized as a unified entity, or as a network of smaller entities. Because BSA/AML compliance could be easier to manage at a local level, consider for the sake of discussion a network of independent public-run funds. In order to make the deposit base large enough at least to partially defray the BSA/AML compliance costs, the scale of a county or large city would seem seem appropriate. In the discussion that follows, we will refer to these as "county banks," for convenience.

Design features

Such a system would work like this: a citizen or business could purchase from their local tax assessor's office a discounted credit toward the payment of future taxes. Perhaps such a person might be a cannabis dispensary paying their taxes and taking a credit as the change, but it also might be anyone interested in prepaying their taxes at a slight discount. The assessor's office would use the cash to purchase short-term securities, whose ownership would be transferred to the county public bank. The bank would register the credit on a statewide ledger and hold the securities, or redeem them to invest in some other way in anticipation of the credit's redemption.

The tax credits are tradable, and would thus be redeemable at any business that owes tax to the same municipality or county. For example a bank could use the credits to pay the property taxes on mortgages with escrow accounts, or a merchant could use them to pay sales tax. The county bank's role would be to facilitate their liquidity in the local area, by opening tax credit accounts for banks and businesses who wish to buy credits, and to reimburse the city or county when the credits were used to pay a tax bill. It could also facilitate the redemption of credits as a broker with a connection to the county treasurer.

With a unified statewide ledger of credit ownership, the tax credits can be used for transaction processing via specialized payment applications. A cannabis dispensary, for example, might conduct all its business in tax credits, having its customers secure credits to make purchases and leaving the redemption of the credits to the employees and suppliers it pays. Because the credits are not directly linked to cannabis business, purchase and redemption should not be a significant difficulty. Because the use and redemption of the credits is by entities with validated accounts at each bank, BSA/AML compliance will be feasible to maintain.

Establishment of such a system would be able to rely heavily on cash payment arrangements already largely in place, currently used by MBEs to pay their taxes. Little or no new physical infrastructure would thus be required. The state's responsibility would be to establish the electronic tax credit ledger, and perhaps a special series of inflation-protected bonds that could be used by the county banks as a default investment, comparable to using SLGS for tax-exempt bond proceeds. The banks would require a small initial investment to create liquidity of the tax credits, but it would not be at risk and could be returned once enough credits were sold. The major cost would be administering the account management and compliance costs, some of which could be borne by fees levied on bank customers, and some of which might be defrayed by investment of the collected taxes. To the extent the business of these banks can be expanded, the costs would go down.

For the MBEs, such a system would not solve all their banking problems, but could provide a relief from many. The county banks would be able to offer transaction accounts denominated in tax credits, and could arrange electronic payment systems for consumer sales. Payments to employees and vendors could be made with credits, and because the credits are not for cannabis alone, the recipients would find it relatively easy to convert the credits to dollars. Alternatively, they could use accounts at the county banks for their own needs as well. The system would thus offer MBEs many of the conveniences of modern banking services.

In addition to easing the cash management burden of MBEs, the approach would generate a stock of funds a bank could invest. Because the banks' liabilities would be relatively predictable, it would be reasonable for some of the assets to be made available for investment at 1-2 year terms, for example as bridge financing for infrastructure projects or affordable housing development. Because these are future tax revenue, security would be paramount and the amounts available to lend would be modest. Since the banks' liabilities would have a matching term, a bank charter would not be required, at least at first. The inventory of bonds would also position the county banks to expand their services in the future. For example, the bonds could provide collateral for municipal deposits should one of the county banks seek a banking charter in order to offer cash management services to local governments. Because the original business of the banks will likely not cover the costs of compliance or management, there will be some incentive to expand into other business lines to ease the cost to customers of the bank services.

Though they could be sold at a slight discount, to account for inflation, the credits themselves would not bear interest. Tradable tax credits have not in the past been deemed to be regulated securities by the SEC. Without significant regulatory hurdles, a system like this could be started quickly and inexpensively. A system that encompassed a network of county banks could also be rolled out county by county, allowing it to be deployed first in the areas that need it the most. The result would be the mobilization of significant amounts of cash currently outside the banking sector and not actively circulating in the local economy. This would allow for a real increase in the effective supply of money in the local economy.

This is obviously not a solution to the problem, which will not be solved without federal legalization of cannabis or federal legislation shielding financial institutions that serve the cannabis industry. But the system proposed here offers a significant improvement over having the industry operate predominantly in cash, with only sporadic banking access: a better point on the continuum than where we are now.

To a certain extent, a system of tax credit banks could even serve as a transition solution in the short term. After all, a fair amount of the reluctance to offering banking services to MBEs has been overcome in other states. Solutions for banking this cash exist, though many banks find the solutions to be more onerous than is worth the extra deposits. However, an MBE with an existing banking relationship with the county bank, with demonstrated compliance with BSA/AML rules, will be easier for a traditional bank to contemplate making a customer, though obviously this will depend on developments in Washington. The county banks could thus not only provide better access to banking services, but facilitate a transition to even more access by helping MBEs acquire access to full bank services.

Tax credit circulation

Tradable tax credits are themselves widely used around the country. Affordable housing developers, for example, use credits issued by the federal government, and also by many states, to subsidize construction. Their tradable nature means that developers can liquidate credits even without an offsetting tax liability. In addition to housing construction, tradable state tax credits exist for historic preservation, film production, job development, worker training, brownfield remediation, renewable energy, and even brewery investment (in New York).

Such a system of tradable tax credits could be compared to another currency, though one intended to complement the national currency, not supplant it. There are a number of such currencies in use around the world, as well as several examples of tradable credits in the United States that are quite similar in nature. Virtually all these complementary currencies have been summoned into existence by one or another impediment to business, such as MBEs face in California. In Switzerland, a system called the WIR Franc was developed in 1934 to ease the crippling credit shortage of the time. Backed by the assets of the businesses that participate in it, it became an important part of the Swiss economy. It is run by the independent WIR Bank, which manages the ledger and liquidity and offers bank accounts and transaction services exclusively in WIR Francs. Today, over $2 billion in transactions takes place each year in the currency, among 60,000 Swiss businesses. Interestingly, the volume of transactions tends to be counter-cyclical, creating a certain amount of economic stability across swings in the business cycle. The RES Bank, a similar effort in Belgium, was founded in 1996, where there are approximately 5,000 participating small and medium size businesses doing about 40 million euros worth of business each year.

In several states of Brazil, a Dutch research and development NGO called Social Trade Organization (STRO) helped establish a Commercial Credit Circuit (C3), a form of currency backed by outstanding purchase orders from the big customers of small business. Again, the currency arose out of the demand for credit in a market starved of liquidity, in this case by the sluggish payment systems of those big players, such as the Brazilian government. Today the C3 market in Brazil is several million dollars per year. The system has spread to Uruguay, which has put the national government behind this alternative currency. These currencies, like the WIR Franc and RES, are all electronic, with payment cards for consumers and bank accounts like any other. Similar smaller networks exist today in El Salvador, Honduras, and Japan among others.

Such arrangements are not even unusual in the US. Tradable renewable energy credits (RECs) were introduced years ago to enhance the value of renewable energy installations. These are widely traded now, and there are entities serving as brokers to make that market. The pollution credits used to address acid rain played a similar, though much more limited, role, and several states around the country use transferable development rights to influence land development decisions.

California, of course, has its own experience with alternate currencies, during the budget fiasco of a decade ago, when the state's registered warrants became a vehicle for getting past a budget deadlock between governor and legislature. These warrants were deemed to be regulated securities by the SEC and became much more of a regulatory issue than was anticipated, with thousands of people unknowingly violating securities law. But with planning and careful regulatory scrutiny, and with the county banks to provide a modest amount of market oversight, the credits can remain a safe vehicle for consumers and businesses.

REC trading, and tax credits as well, have been hampered by the lack of a market player whose role is to maintain liquidity, and some of these markets have seen significant swings in value as a result. With the existence of county banks in the mix and with the acceptance of the credits by the taxing authority, the credits can remain liquid, with a relatively stable value.

These currencies were created to address real economic issues, and were adapted to the specific problems they were designed to address. Alternate currencies are often derided as the province of dreamers, but these currencies are practical solutions to real problems. The state of California faces a very different set of problems from pre-war Switzerland or 21st century Brazil, but it is possible that a similar solution could address them equally well.

Inter-government exchange

Tax credits are credits against taxes due a particular government. An MBE that purchases credits from one county but needs to pay a supplier in another county would need the confidence that the supplier would be able to liquidate the tax credit upon receipt. There are two options available, to make the tax credits specific to a particular county or city, and to make them general, redeemable by any participating county or city. In the first case, the holder of the credits would have the responsibility of repatriating them to the issuing government, and in the second, the network would assume the responsibility.

Assume that the credits are specific to a government and an MBE in Mendocino County needs to pay a supplier in Sonoma. There are many banks in one county who would be easily able to liquidate a credit in the other, so it would likely not be an inconvenience for the supplier. To the extent that such a structure discourages an MBE from using a distant supplier for goods or services, this is not necessarily a negative outcome. Keeping dollars confined to the local economy can be a valuable boost to local fortunes.

Alternatively, the credit system can be arranged so that they are generally usable in whatever counties establish county banks. In this case, the ledger system would be used to reconcile the credit accounts so that a dollar credit issued by Mendocino and accepted in Sonoma would see the corresponding dollar transferred from the Mendocino fund to the Sonoma fund. This would be less likely to keep dollars as closely confined as if the credits were not exchangeable, but it would be likely to leave the entire system somewhat more liquid.

In the end, this is a policy choice to be made upon establishment and there are pluses and minuses in both directions.

Business

Using the tax credit ledger, county banks can provide limited transaction account services for customers, including cannabis businesses. Though they would not be able to offer full integration into the national banking network, they could offer a variety of basic banking services denominated in tax credits, including transaction accounts and electronic payments. With cooperating banks, employee paychecks could be direct-deposited. Payroll deductions for federal and state taxes could be managed, as well. It would perhaps even be possible to offer limited short-term credit services, such as overdraft protection or modest business lines of credit.

This is not a structure that can readily provide long-term credit for MBEs, but it is not unreasonable to imagine it could offer short-term collateralized loans for planting, or bridge finance for grow development. The loudest demands for banking services to MBEs have been about basic services and integration into the financial network, and this route could provide much of that: account management, payroll services, transaction processing, and electronic payments. And it would have the effect of reducing the amounts of cash necessary to keep around an MBE, improving public safety.

Beyond that, it is worth considering the range of appropriate investments for the county banks. Ultimately, they will oversee an accumulation of capital in prepaid taxes. From a fiduciary perspective, as well as a responsible management perspective, it would make sense to invest those funds in a way that might defray the costs of some of the account management services, or to provide benefits to the member municipalities. There would potentially be some benefit to county banks operating with a banking charter, though the basic benefit of the bank would not depend on it.

Ultimately, tax credit accounts such as are described here, are not a substitute for a real business transaction account and its access to payment processors and other business services. But the path outlined here offers no obvious legal hurdles, a degree of regulatory certainty, and has some positive additional features. It is not a perfect solution, but a perfect solution is likely not achievable without substantial risk to state resources, time and effort as well as money. This solution, though imperfect, is achievable at low risk and would still be a substantial improvement over the status quo.

Discussions of banking and government must at some point discuss security and deposit insurance. For the activities described here, the county banks would not require deposit insurance, as they would be invested in fairly liquid bonds. If the banks were to expand their lending activities from simple bond purchases, they could be required to provide collateral, though the requirement might depend on interpretation of the relevant California laws.

The “deposits” of tax credits would not require deposit insurance, nor would it likely be available. The county banks would not necessarily be involved in lending them, except possibly to the small extent implied by offering overdraft insurance or modest short-term credit lines. A county bank could choose to extend those services only to its customers willing to provide collateral in cash.

Governance

The county banks described here could be founded not as regulated banks, but as simple bond funds. They would require regulatory oversight, as any financial institution should, but the basic operation would involve liabilities that match the terms of the assets, so in a technical sense would not be banking.

These county banks could be constituted as simple arms of the relevant counties, but it might be desirable instead to create them as institutions owned mutually by the governments to whom they owe the prepaid taxes. This would be comparable to an ordinary mutual bank, where ownership belongs to the holders of a certain class of liabilities. The Federal Home Loan Bank and the Federal Reserve, are constituted in this fashion, as a network of mutually-owned institutions. This would allow the county banks to be distributed according to the volume of business — which is not likely to respect county and city boundaries — and allow both cities and counties to participate in them.

Under such a structure, the owning governments would control appointments to the board of directors, who would control management of the bank itself. The banks’ independence would provide several benefits, such as preventing the governments from appropriating future tax receipts in advance.

Any financial institution, including this network of county banks, requires strong and independent oversight. If the tax credits are interchangeable among municipalities (a policy decision with advantages and disadvantages) existing California law would bring them under the oversight of state regulators under the Money Transmission Act. Even if they are not interchangeable, it would be appropriate to seek to undergo that regulation voluntarily, while preparing a longer application for a charter under state banking regulations, in order to begin with financial oversight.

The county banks would begin as fairly specialized institutions, managing tax credit accounts for a range of consumers and businesses, and investing the proceeds of prepaid taxes. There are management and fiduciary reasons why they might wish more variety in their investments than would be possible as simple bond funds, and policy reasons to do more with those funds than simply save them. It would, be relatively straightforward to expand the design of the county banks to have a wider brief, and let them offer account management services to municipalities, for example, or to offer loans for important public policy goals, such as housing or clean energy development. Some of these wider briefs would require the bank to seek a charter and doing so would be a natural way to grow the capacity of the county banks. A charter would allow a larger range of investment options for the deposited funds, and could offer the opportunity to earn enough income to defray the management and compliance costs. In the process it could provide a valuable asset to the county's governments, perhaps as a component of their cash management and investment strategy.

Crucially, however, the activities involved in managing tax credit liquidity and the statewide ledger would not require a bank charter, and most of these decisions can reasonably be left in the hands of the governing bodies of the county banks, to pursue or not, as their appetite suggests. A distributed model like this would encourage a certain amount of experiment, and the different county banks could learn from one another as they jointly develop best practices.

Public financial institutions

Since the financial crisis of 2007-09, there has been a resurgence of interest in the concept of a public-owned and controlled financial institutions. Common in other countries, they are somewhat unusual in the United States, though this appears to have more to do with cultural and economic happenstance than anything else. The US has, for example, a state-owned bank, in North Dakota, that has been quietly tending to that state's economic fortunes for a century. In 2014, Vermont established a quasi-bank program whereby a percentage of the state's cash balance is loaned for short terms to several state agencies who make long-term investments and loans. In structure this is very like a bank, though without the charter and official acknowledgment. In 2016, a public-owned bank was founded in American Samoa, an island too small to be of interest as a branch location for the big corporate banks. And as of the fall of 2019, public banks are legal in California.

Banks are not the only public-owned financial institutions out there. An interesting development grew out of the Obama Build America bond program, where municipalities organized by the National League of Cities, created a mutual bond insurer called Build America Mutual. This is a municipally-owned bond insurance company that functions to to improve the ratings of bonds issued by its members.

In Rhode Island, the Interlocal Trust is a mutually-owned insurance company, providing liability, property, and workers' compensation to its member cities and towns. It began as a buyers' co-op, but has expanded to underwrite some of its business. It has been highly successful over its 33 years of operation, and now covers virtually all of the state except the capital city. It recently expanded its services to provide health insurance to its members' employees. Similar insurance co-ops exist in other states, though not all of them do their own underwriting.

In many ways, the cannabis issue is a perfect example of the need for this kind of action. In other states, credit unions and small banks have concluded that it is important to their communities to service the cannabis industry, despite the regulatory risk. Notable among them is the Partner Colorado Credit

Union, a small institution in Denver. But those institutions are small. There and in other states, including California, private banks have largely left an important community need unmet, creating hardship for businesses, personal risk for employees, and a drag on the local economies. It is only natural that government step in to fill an important role.

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