Regent Bank has been around for over a century — founded in 1898 in Nowata, Oklahoma, a small town at the intersection of two highways in the northeast quadrant of the state. Yet, it wasn't until 2008 that the now Tulsa-based subsidiary of Regent Capital Corp. really started to grow. It crossed $100 million in assets that year, $200 million by the end of 2014, and today, its balance sheet boasts $874 million in assets.

The principal challenge with rapid growth in banking, beyond credit quality, of course, isn't on the asset side of the balance sheet. It's on the liability side. It takes inventory to grow. And in banking, deposits are inventory.

That's what led Regent to marijuana.

In 2018, the bank hired Keri Cain, who previously served as a director of store operations for clothing retailer Gap. She was tasked with investigating the feasibility of banking marijuana-related businesses, a cash-based trade that had historically been excluded from traditional banking services.

"We're talking billions and billions of dollars in this industry," Cain says. "Today, in Oklahoma, it's easily a billion dollars. In the next three to five years, it's going to be a $35 billion industry across the U.S., according to projections. And a lot of that is unbanked. It's the Wild West of Weed."

Regent started small, with just eight clients in its pilot program. But after proving the concept out, Cain was given the green light to expand. "Today, we've got hundreds of cannabis accounts, and I've got a team of three folks who report to me," says Cain, the BSA director of special programs for the bank. "We're going gangbusters."

As more states legalize the sale of marijuana, the appeal of banking the industry grows. As of June 22, 36 states and the District of Columbia have passed legislation allowing medical use, while 18 and D.C. have passed laws regulating cannabis for recreational use, according to the National Conference of State Legislatures. Legal sales across the U.S. hit a record $17.5 billion in 2020, according to a report published by BDSA, a cannabis sales data platform. But the question of whether to do it isn't only about legality; it's also about financial viability. Is the strenuous compliance burden associated with serving the industry counterbalanced by wider profit margins? That's what banks are trying to figure out.

The rules governing marijuana banking represent a legal no-man's-land between federal and state law.

"The product is illegal at the federal level, and there are rules around anti-money laundering that we need to pay attention to," explains Stacey Litke, director of banking compliance oversight at Green Check Verified, a financial technology company that helps banks serve the industry. "But the FinCEN guidance, as provided, clearly states that financial institutions can bank the industry and be transparent about it, because FinCEN wants the information."

Litke is referring to guidance issued by the Financial Crimes Enforcement Network in 2014 that laid out a framework for how banks can comply with U.S. Department of Justice guidance issued the prior year by then-Deputy Attorney General James Cole. The so-called Cole Memo acknowledges the illegality of producing, possessing and distributing marijuana under the Controlled Substances Act. Given the fact that several states had fully or partially decriminalized cannabis, the memo explained that the Justice Department would exercise discretion in prosecuting marijuana-related cases.

It lays out eight priorities that inform its exercise of discretion. These include preventing the distribution of marijuana to minors, preventing revenue from the sale of marijuana from going to criminal enterprises, and preventing the diversion of marijuana from states where it is legal into states where it remains illegal. So long as these priorities aren't defied, federal law enforcement officials will defer to state laws governing cannabis.

The FinCEN guidance reconciles this by imposing heightened due diligence expectations on banks that serve the industry. It lays out seven expectations, including the duties to verify that the businesses are licensed to sell marijuana, monitor publicly available sources for adverse information about the businesses and related parties, and conduct ongoing due diligence to ensure the businesses remain compliant with state laws.

FinCEN also articulates a three-part framework for filing suspicious activity reports, or SARs, related to marijuana-related transactions. If a transaction seems to contravene a Cole Memo priority or violate state law, a bank should file a "Marijuana Priority" SAR. Alternatively, if the transaction doesn't appear to violate the guidance, then the institution should file a "Marijuana Limited" SAR. Finally, if a bank terminates a relationship with a marijuana-related business to maintain an effective anti-money laundering compliance program, then it should file a "Marijuana Termination" SAR.

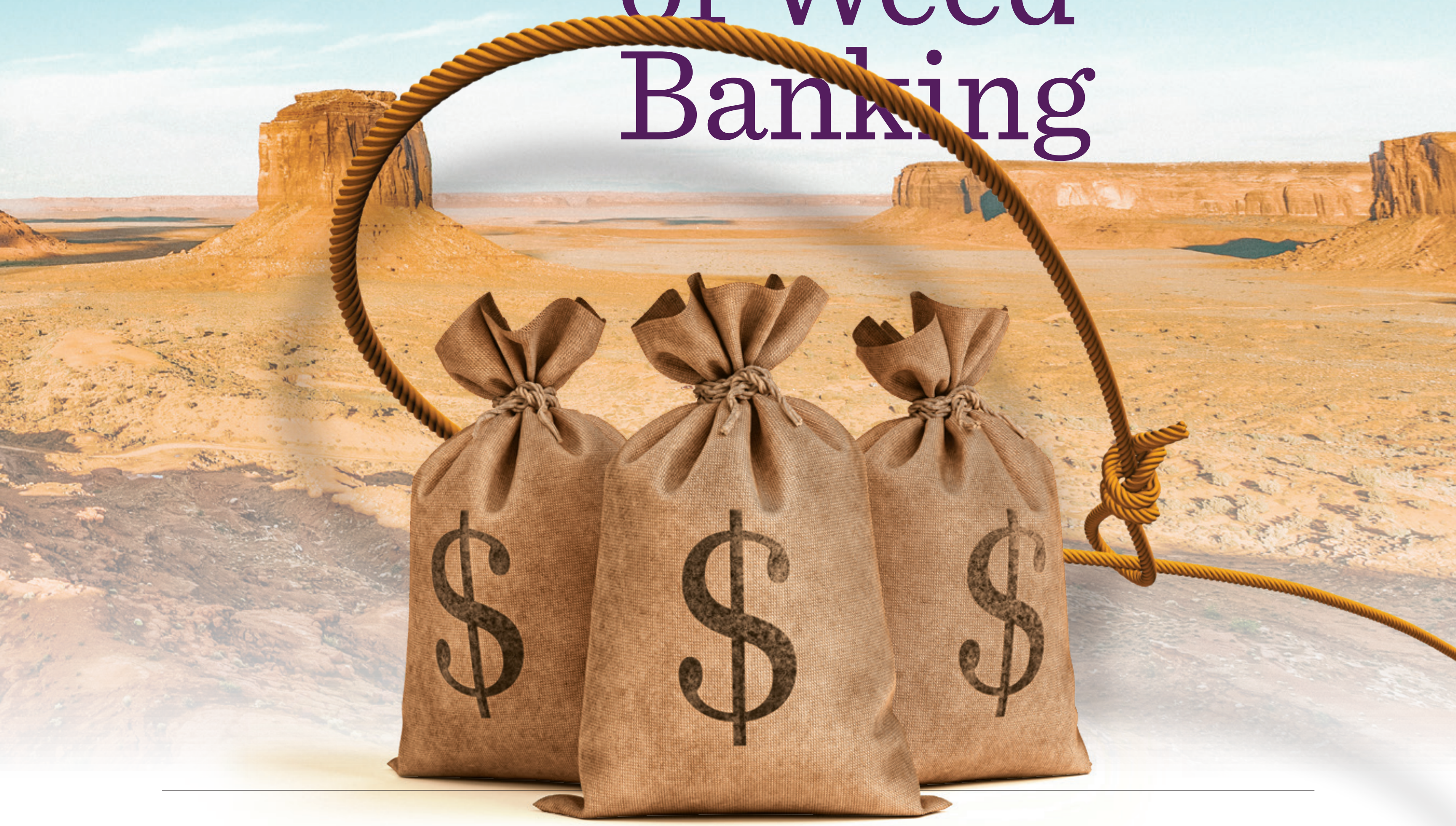
As of Dec. 31, 2020, FinCEN had received a total of 170,975 such SARs since releasing the guidance in 2014. Three quarters were “Marijuana Limited” SARs, approximately 22% were so-called “Marijuana Termination” SARs, and approximately 7% were “Marijuana Priority” SARs.

Yet, despite regulators’ permissive approach, as of the first quarter of 2021, just 515 banks and 169 credit unions, or less than 7% of the combined population of institutions, report actively banking the industry, according to FinCEN. This is in part because many financial institutions don’t actively screen their customer base for marijuana-related businesses, says Steve Kemmerling, CEO of CRB Monitor, which helps banks identify, on-board and monitor cannabis-related relationships. But the more fundamental issue, Kemmerling continues, is that most banks would simply prefer to avoid the added compliance burden.

Advancing the Frontier of Weed Banking

More and more banks are onboarding marijuana-related business clients. Does the strategy offer a way to earn outsized profits?

BY **JOHN J. MAXFIELD**



Valley National Bancorp offers a counterpoint to any presumption that only banks willing to play fast and loose with risk management have ventured into this legal no-man's-land.

The $41 billion bank based in New York City is the biggest bank to venture publicly into the space, according to Kevin Hart, CEO of Green Check Verified. Since Valley National's founding in 1927, it has never reported a quarterly loss. That's an impressive feat given that it weathered the Great Depression, the inflation-induced crises of the 1980s and 90s, and the financial crisis of 2007-08.

A group of executives at the bank, including its director of enterprise risk management, had been following the marijuana industry for years, weighing the costs and benefits of banking it. One of the initial appeals was fee revenue, though it was less about how much Valley National could earn and rather how much other financial institutions were charging.

"When I first started looking at this business, we were gathering statements from other banks and looking at fees," recalls Rick Kraemer, chief financial services officer at Valley National who leads its marijuana banking program. "What really became apparent was that while some of the fees from other institutions were what I would phrase as being egregious, what was even more egregious were the transport fees."

Valley National saw this as an opportunity.

It partners with a third-party transport provider who is either following the bank into new territories or, in some cases, preparing preemptively for Valley National to enter a new geography. The two companies agreed that they'll treat the marijuana industry like any other industry from a pricing perspective. Whereas a typical marijuana business will pay anywhere from 1.5 to 2 times the typical rate for transport fees, Kraemer explains, Valley National's customers pay no more than 1.1 times the going rate. (Valley National also charges cannabis customers a minimum monthly account fee of $1,000 per dispensary.)

"The partner that we've chosen and have expanded with is in non-cannabis industries as well," Kraemer says. "But there's an opportunity for them and for us to scale together, and I think they recognize that there's obviously a strong legislative tailwind to this."

Yet, while fees were the initial draw, that isn't where Valley National sees the longer-term opportunity. "We had a conversation early on about fees and realized, 'At some point, the value within these businesses aren't the fees that are being charged right now,'" Kraemer recalls. "Because that is going to be commoditized and eroded. Ultimately, the value, at least from my perspective, is in large-scale deposits, corporate relationships and a strong, core-funded balance sheet."

In 2020, six years after New York legalized medical marijuana and one year before it followed suit with recreational cannabis, Valley National rolled out a pilot program to serve a handful of large, vertically integrated, multistate operators. The size of the clients offered scale while the vertical integration provided a controlled environment, enabling Valley National to track deposited funds from seed to sale, so to speak, simplifying the process from a Bank Secrecy Act/anti-money laundering perspective.

The pilot program, which lasted six months, proved to be a success. Now Valley National is focused on onboarding new customers and scaling the program. "As we exit our pilot phase, we are positioned to capitalize on growth in the cannabis space as legislative support continues to build momentum," noted chief financial officer Michael Hagedorn on the bank's first quarter 2021 conference call.

Later during the same call, Valley National's CEO Ira Robbins characterized the scale of the opportunity as tremendous. "We think overall that the industry is something that will drive performance at Valley well above peers, and we think we're going to be first in it from any size perspective."

The reason more banks don't get involved in the marijuana industry has less to do with the legality, it seems, and more to do with the burden of compliance.

Southwest Capital Bank, a $397 million, family-owned subsidiary of Las Vegas Bancorp. based in Albuquerque, New Mexico, started serving the industry in 2014. Over the next three years, propelled by the inflow of deposits, the bank grew on average by more than 10% a year. Today, Southwest Capital banks more than 90% of the marijuana industry in New Mexico, according to Lonnie Talbert, the bank's president and chief operating officer.

In 2020, Southwest Capital processed

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Lonnie Talbert
President and chief operating officer of Southwest Capital Bank

> "Today, we've got hundreds of cannabis accounts, and I've got a team of three folks who report to me. We're going gangbusters."

Keri Cain
BSA director of special programs at Regent Bank

$197 million in marijuana-related deposit inflows. Talbert won't say how much the bank charges, for competitive reasons, but it's a formula they came up with to give cannabis clients a measure of predictability around costs while giving the bank predictability around revenue.

"We were the first entrant into the market, and we've been in the longest," Talbert says. "We've invested the most. We've gone through the most pain and suffering. And we've developed what I believe to be a best-in-class product in terms of the way we do it."

To Talbert's point about pain and suffering, it hasn't been entirely smooth sailing for Southwest Capital. On Dec. 6, 2018, it signed a consent order with the Federal Deposit Insurance Corp. and the New Mexico Financial Institutions Division requiring the bank to beef up its internal controls involving the Bank Secrecy Act and anti-money laundering laws.

"This is entirely related to high-risk accounts of a specific industry," its then-CEO Greg Levenson told the Albuquerque Business First publication in June 2019. (Levenson's family has owned and operated the bank for three generations.)

The consent order required Southwest Capital to submit a BSA compliance plan, appoint a designated BSA officer and develop internal controls for identifying suspicious transactions. It also required the bank to request permission before paying a dividend as well as to ensure that "each member of management shall possess qualifications and experience commensurate with his or her duties and responsibilities."

A little over a year after the consent order, in February 2020, the bank promoted Talbert to president and named a new executive chairman, who had previously been CEO of Century Bank, a $1.2 billion bank based in Santa Fe. And two months after that, in April 2020, another former Century Bank executive, Chesley "Chez" Steel, was named CEO of Southwest Capital.

Still, the order didn't instruct Southwest Capital to exit the marijuana banking business; the bank just needed to fix the BSA/AML issues. In essence, the FinCEN guidance for banking cannabis businesses has been interpreted to require a bank to understand the origins of not just every deposit transaction that comes into the bank itself, but of every transaction completed by the marijuana businesses — every retail sale, every wholesale purchase, every time money goes in or out of the business. "We have to track everything related to the account," Talbert notes. "We have to know all of it."

Southwest Capital has since developed a system that does just that. It now has six employees in its compliance department, including a designated BSA officer, all of whom were hired in the wake of the 2018 consent order.

The bank is also in the process of vetting third-party fintech companies, such as Green Check Verified, to streamline the compliance process. Green Check is one of a handful of technology companies launched in recent years to help banks shoulder the otherwise cumbersome due diligence process involved with monitoring every transaction completed by a cannabis client. (Regent Bank and Valley National already use its services.)

It's only by leveraging technology, every banker interviewed for this article acknowledges, that a bank can serve the marijuana industry in an economically rational way. An automated program like Green Check's will consume 10% to 15% of a bank's cannabis-related revenue in terms of expenses, notes Green Check's Litke. But if a bank does compliance manually, the figure goes up to 20% to 25%.

The banking industry offers few avenues to differentiate one institution from another. There are approximately 10,000 banks and credit unions spread across the country, all of which are buying and selling the same thing — money. In such a competitive and commoditized environment, finding a niche is one of the only ways to gain an edge.

Is the marijuana industry one such niche? That remains to be seen. The heavy compliance burden combined with the increased commoditization of the cannabis industry itself will eventually compress margins in both markets. But if a handful of financial institutions like Regent, Valley National and Southwest Capital can come to dominate the space, it does seem to position them to earn outsized profits. **|BD|**

John J. Maxfield is a Portland, Oregon-based financial writer.