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Cannabis Lending Guide

Lending has emerged as an important component of cannabis banking programs. By understanding the risks and taking the appropriate measures to mitigate them, bankers can make informed decisions about lending to cannabis-related businesses.



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Cannabis Lending Guide

Growing public acceptance of cannabis and state-level legalization momentum has contributed to the rapid growth of the cannabis market.

According to a research report conducted by New Frontier Data, the U.S. cannabis industry is projected to generate sales of $72 billion per year by 2030. The economic opportunities are significant, and while the risks of banking this industry are complex, a growing number of banks and credit unions are entering this line of business, creating increased competition.

Lending has emerged as an important component of a cannabis banking program, for both bankers who are new to the industry and those with significant cannabis banking experience. Cannabis-related businesses (CRBs) are actively seeking bank lending, from real estate loans to equipment financing, while bankers are increasingly viewing the cannabis industry as a prime source of new earning assets and a way to gain additional yield.

Lending to this industry, however, is not without its challenges. It's important for bankers to be grounded in the credit and compliance fundamentals of these businesses including an in-depth cash flow analysis, licensing, and thorough due diligence on cannabis-related collateral. By understanding the risks and taking the appropriate measures to mitigate them, bankers can make informed lending decisions.

This Cannabis Lending Guide is designed to help bankers understand the nuances of lending to the cannabis industry and the risks associated with cannabis operators and cannabis-related collateral.

> "A financial institution's existing traditional commercial lending program can be extended to the cannabis banking space using almost the same criteria that it would evaluate any other loan."
>
> 
> **Tony Repanich**
> **President and CEO**
> Shield Compliance

1. BSA/AML RISKS ASSOCIATED WITH CANNABIS LENDING

Implementing a compliant cannabis banking program requires considerable planning and an understanding of all potential risk areas. The guidance offered by FinCEN outlines how to manage some of the BSA/AML compliance risks, but there are additional underlying risks associated with the cannabis industry because of how it has evolved. These risks are related to the industry's high cash concentration, the abundance of legacy cash, the potential for bad actors to try to attach themselves to legal businesses, and the ongoing strength of the illicit market.

> "Having control over the entire customer relationship is the best way for financial institutions to monitor the borrower's cash flow for BSA/AML purposes."
>
> **Scott Moskol, Partner**
> Burns & Levinson

DOWNLOAD

The Shield Compliance
Cannabis Banking Playbook

For more information about the BSA/AML risks of cannabis banking and how to implement a compliant cannabis banking program, please download the Shield Compliance Cannabis Banking Playbook.

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Whether you are taking a CRB as a deposit and loan client or as a loan-only client, enhanced BSA/AML procedures and KYC due diligence will need to be conducted to ensure funds coming into the FI are from legal sources. Having control over the entire relationship is the best way to monitor cash for BSA/AML purposes and manage compliance risks, which aligns well with the relationship-driven culture of many community banks and credit unions. If you are not the primary depository, you will need to have controls in place to make sure that you understand the source of repayment coming from a qualified cannabis deposit account outside of your financial institution. Lastly, depending on who the primary borrower is, an investor or ancillary company versus a plant-touching entity, ongoing SAR filing may also be required.

> "If a financial institution is of sufficient size, has the balance sheet for it, and has commercial lending, it can lend for the cannabis industry."
>
> **Katrina Skinner, General Counsel & Chief Banking Officer**
> Simplifya

2. DIRECT AND INDIRECT LOANS

There are many ways to lend to the cannabis industry. One approach is to lend directly to plant-touching cannabis operators (Direct Lending). You may also choose to lend to a landlord, investor, or other Tier-Two ancillary company (Indirect Lending). In some cases, direct lending could be considered somewhat less risky from a BSA/AML and credit risk underwriting perspective because the FI typically has immediate oversight of the flow of cash. However, some FIs may feel there is less reputational and credit risk associated with indirect lending. Regardless, both types of lending must carry their own set of conditions. In the event of failure, the FI must be clear about how it will protect its position and how might that differ from any ordinary commercial loan that it would make.

Direct Lending. A direct loan is offered directly to a cannabis business or an individual involved in the cannabis industry. Direct loans can be made in the form of term loans, real estate debt, lines of credit, or other loan products. Direct loans often come with higher interest rates and more restrictive loan terms than those offered to traditional borrowers, due to the increased legal and regulatory risks associated with the cannabis industry.

Indirect Lending. An indirect loan is offered to a borrower that is not directly involved in the cannabis industry, but the loan proceeds are used to finance cannabis-related activities or payments from plant-touching entities are used to repay the loan. This type of loan is typically used to provide real estate acquisition capital, finance equipment purchases, or refinance existing real estate debt for a business that provides goods or services to the cannabis industry, such as a landlord renting to a cannabis business.

While much of the underwriting is similar to loans outside of the cannabis industry, the underwriting of these credits requires additional information about the collateral and related parties. Further, while the cost of these loans to the borrower is generally lower than those made directly to the cannabis industry, lenders are earning a premium on these loans.

NEW LENDER CHECKLIST

If you currently serve CRBs, consider the impact of lending to your cannabis banking program.

Create a cannabis lending team that is comprised of internal team members and external experts.

Assess the strengths and weaknesses of your existing commercial lending program.

Identify which loan products or services can be extended to the cannabis industry.

Evaluate ways you can create compliance efficiencies using automated solutions, including those designed to support banking CRBs.

Modify your risk assessment and internal policies to account for the BSA/AML, credit, and reputational risks associated with the cannabis industry.

Determine your position on lending to entities that do not bank with your financial institution.

Set policy on lending thresholds based on how much exposure you want to this industry as a percentage of capital. This could include setting limits on loans to a single entity.

Establish requirements for guarantors or secondary sources of repayment.

Define your exit strategy.

3. CREDIT RISKS ASSOCIATED WITH CANNABIS-RELATED BUSINESSES

For most FIs, the criteria used to evaluate traditional commercial loans can be applied to cannabis-related applicants. However, there are several unique credit risks associated with cannabis-related businesses and cannabis-related collateral that lenders should consider when evaluating loan applications from the cannabis industry. Some of these risks include:

- **Legal and regulatory risks.** The legal landscape for cannabis is constantly changing, making it difficult for lenders to assess the risk of a loan default. For example, a change to licensing provisions in a given state may dramatically change the competitive environment for an operator. Moreover, some states restrict what can be taken as collateral. For example, some states explicitly prohibit taking a lien on the cannabis licenses.
- **Limited financial and operating history.** Many cannabis businesses are relatively new and do not have a long financial or operating history, which can make it difficult for lenders to assess the creditworthiness of the borrower.

> "Until the dust settles on federal legalization, cannabis is going to be considered higher risk just by virtue of being a newer industry and because there is still a lot of black-market activity that wants to find its way into the banking system."
>
> **Katrina Skinner, General Counsel & Chief Banking Officer**
> Simplifya

- **High operating costs and tax obligations.** Cannabis businesses often have high operating costs, such as expensive equipment, high energy costs, and regulatory compliance requirements, which can increase the risk of loan default. They also face a much higher tax obligation than traditional businesses because Section 280E of the Internal Revenue Code prohibits them from deducting certain expenses. 280E represents two potential risks to lenders: The CRB may have access to less cash to service loans, and, if a CRB is too aggressive in its 280E calculations, it could be subject to future tax liens. FIs may need to adjust their debt coverage ratios to account for these risks.

RESOURCES FOR LENDERS

Burns & Levinson LLP
www.burnslev.com

The Burns & Levinson Cannabis Business & Law Advisory team advises clients seeking to navigate the legal and business framework surrounding the cannabis industry. The team offers a full scope of services including: cannabis business formation, licensure, legal and regulatory compliance; corporate structuring, joint ventures, mergers and acquisitions, fund formation, debt and equity financing, real estate acquisitions and leasing, labor and employment issues, intellectual property protection, 280E taxation issues as well as, if necessary, litigation services.

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- **Limited liquidity.** Cannabis businesses may have limited liquidity, which can make it difficult for them to make loan payments in the event of unexpected financial difficulties or seek refinancing opportunities of defaulted or matured debt.

- **Lack of bankruptcy protection.** While a borrower declaring bankruptcy is generally viewed as undesirable by financial institutions, bankruptcy courts can create an orderly process for liquidation or repayment. However, bankruptcy protection is a federal proceeding denied to cannabis companies under current law. In place of bankruptcy, state law will prevail. The orderly dissolution of licensed cannabis operations, including provisions for receivership, varies greatly by state.

- **Seizure of collateral.** The ongoing conflict between state and federal law on cannabis makes the seizure of collateral very tricky. For example, a building purchased through the sale of cannabis, could be viewed as legal under state law, but it could also be at risk of being seized by law enforcement as cannabis is still illegal at the federal level. Courts have generally protected landlords as it pertains to legal cannabis operations, however this risk still exists. Lenders should consider implementing a strong guarantor strategy and cross-collateralize with non-cannabis assets when possible to mitigate this risk.

Qualified experts and experienced legal counsel are indispensable assets to commercial lenders as they evaluate these, and other credit risks associated with cannabis lending.

> "If you are an experienced commercial lender, you can apply your existing knowledge and skillset to extend lending to the segment of the cannabis industry that best aligns with your expertise."
>
> Cami Cantrell
> Executive Vice President, Payments & Strategic Alliances
> Shield Compliance

RESOURCES FOR LENDERS

Simplifya
www.simplifya.com

Simplifya is the leading regulatory and operational compliance software platform for the cannabis industry. Its portfolio of products includes Self-Audit/Standard Operating Procedure templates to help manage and maintain compliance, a cannabis license verification service, and Simplifya Market Guide, an automated solution providing regulatory overviews and market information for all 50 states on topics such as banking and lending, tax structure and rates, requirements for investors, insurance guidelines, license types and structures, supply chain dynamics, governing law, policy movement, and other insights.

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4. UNDERSTANDING CANNABIS-RELATED COLLATERAL

Different types of cannabis-related collateral have varying levels of risk. For example, real estate may be considered lower risk than inventory or cash. Bankers should be aware of the specific type of cannabis-related collateral they are evaluating and be familiar with the methods used to value these assets.

- **Acceptable collateral.** Acceptable collateral may vary depending on the lender and its underwriting policies and the specific loan product. Some common types of collateral that may be acceptable for cannabis industry loans include:



Real estate: Lenders may accept property such as land or buildings as collateral for a loan. This can include the property on which the cannabis business operates or other real estate assets owned by the borrower.



Equipment: Lenders may also accept equipment used in the cannabis business as collateral, such as cultivation or processing equipment.



Inventory: In some very limited cases, lenders might include inventory, such as cannabis products or raw materials, as collateral for a loan.



Accounts receivable: Lenders may also consider accepting accounts receivable, such as money owed to the cannabis business by customers, as collateral.



Licenses: Cannabis licenses are extremely valuable, but unlike property that can be re-leased or subsequently sold, there may be little to no value in the FI taking a lien on a cannabis license. In some states, taking a license as collateral is restricted or prohibited. Moreover, the process of transferring a license varies state by state and is often cumberson and time-consuming.



Personal assets: Some lenders may also require the principals to pledge personal assets as collateral for a loan or provide a personal guarantee.

- **Valuing collateral.** FIs must determine how to value the collateral associated with a CRB to determine how much money it should lend against such collateral. In the case of a real estate loan, for example, the FI must consider the risk if the borrower defaults. Should it value the collateral property on a sales approach versus a more conservative "going dark" approach? Lenders should be familiar with the methods used to value cannabis-related assets, work with qualified and experienced appraisers, and understand the potential for fluctuations in value due to changes in laws, regulations, or market conditions.

- **Perfecting collateral.** FIs must understand if their state's regulatory framework allows them to take the operator's license as collateral, regardless if underwriting does not include the value of the license and how to secure their interest in such collateral.

5. MITIGATING CREDIT RISK WITH BSA/AML DATA

In an environment where the cannabis industry is facing increased competition and shrinking margins, loan covenants and effective portfolio management allows FIs to identify problem credits early and take action to limit exposure. The information and processes required to monitor BSA/AML risk can provide valuable insights to lenders. Consider the following:



- **Underwriting Information.** Collecting and reviewing initial due diligence for depository accounts and the extension of credit provides valuable insights about cannabis-related business customers and ensures that financial service providers know their customers. In fact, lenders working with CRB borrowers likely know their clients better than traditional borrowers. These insights help lenders evaluate whether borrowers are, in fact, creditworthy.



- **Sales Data.** Collecting and regularly monitoring sales data from state seed-to-sale tracking systems provides FIs with valid, up-to-date information about a CRB's total sales activity. Anomalies or significant changes in sales activity could indicate deterioration in revenue generation.



- **Financial Statement Data.** Interim financial data can provide insights into margin compression, cash reserves, accounts receivable aging, and other changes in financial condition which may impair the borrower's ability to repay.

Purpose-built BSA/AML compliance solutions with activity alerts, automated report filing, and rich data analysis simplifies the collection of ongoing due diligence requirements by the BSA team and provide additional insights for credit portfolio managers without requiring extra work by the borrower.

6. UNIQUE LENDING CONDITIONS



- **Lack of credit enhancements (e.g., SBA, USDA).** While most potential CRB borrowers are small businesses or startups, due to the federal illegality of cannabis, certain credit enhancements normally available to small businesses cannot be accessed by cannabis operators or its lenders. For example, many FIs are able to provide loans to startups or other high-risk borrowers through the SBA loan program, but cannabis businesses are excluded.



- **Adjusting for the green premium on collateral values.** When underwriting a loan, especially a cannabis loan which will generally be secured by hard assets, such as real estate or equipment, lenders need to ensure they hire appraisers with specific industry experience. Additionally, lenders taking a conservative approach will generally value the real estate on a going dark basis as opposed to a completed or built-out and operational facility.



- **Ability to take licenses as collateral.** Each state has its own regulatory framework that provides what cannabis-related assets the lender can or cannot take as security for its loan. In some states, a lender can have a lien on the cannabis license. In other states, the lien is only valid after some notice is provided to the cannabis regulators or the law explicitly prohibits the lender from taking a lien on the license. In all states allowing a lien, a lender cannot take control or ownership of a license (or exercise its secured party rights and sell the license to an unvetted third party) without the ultimate entity or person that would own or control that license being approved by the state (and sometimes local) regulators—a process that is lengthy and costly, with no assurances that a license transfer will be granted.



- **Title insurance and settlement services.** Lenders should ensure their closing attorneys are authorized (and willing) to write title policies by title insurers that will cover loans in which the borrower is a CRB or the collateral is being used for cannabis-related operations. Although not all title insurers are willing to write such policies due to cannabis' federal illegality, the number of insurers willing to do so has increased in recent years.



- **Collateral insurance.** Generally, the suite of insurance coverages that a lender would expect any of its borrowers to have (e.g., property, general liability, business interruption, D&O, umbrella, etc.) are now available for purchase by CRBs and the policies are written by reputable carriers. Some experienced cannabis insurance brokers will work with lenders to evaluate if their borrowers have adequate insurance.



- **In lieu of bankruptcy, business dissolution and protection of creditors.** Because CRBs are unable to access the protections of the federal bankruptcy code, lenders may seek instead to protect and enforce their secured creditor rights via state court receiverships and in some instances/in some states, friendly Article 9 sales or ABCs (Assignment for Benefit of Creditors). In certain states, cannabis receiverships may have additional requirements and/or limit individuals who can serve as receivers.

7. ALTERNATIVE LENDING OPPORTUNITIES

Aside from direct or indirect lending to the cannabis industry, there are alternative lending opportunities that enable FIs to generate income and serve the community without having primary responsibility for the loans. Here are a few examples of these types of financing opportunities:

- **Participation Loans.** Participation loans are loans made by multiple lenders to a single borrower. There are several advantages to this type of loan. For FIs just starting to dip their toe in the cannabis industry, this is a way for them to get educated and learn from more experienced bankers. For others, it's a way to participate in lending to the industry without being directly responsible for the CRB relationship, including underwriting, ongoing monitoring, and enforcement, if required. Additionally, loan participation can serve as an important part of an exit strategy.

- **Warehouse Lines.** A warehouse line allows FIs to lend money to a non-regulated financial player like a fund, with the fund making the loan to the borrower. While the fund typically gets the loan origination and other fees, it allows the FI to be involved with the cannabis industry without taking on the risk.

- **Commercial Property Assessed Clean Energy (C-PACE) Loans.** C-PACE is a financing program that allows property owners to invest in energy-efficient upgrades for their buildings through a special assessment on their property, and is an attractive financing solution for mortgage lenders to attract new or retain existing customers. The use of C-PACE for cannabis-related properties is limited to states that have passed legislation allowing local municipalities to provide this funding tool. For more information, please see C-PACE – A Competitive Funding Source for the Cannabis Industry.

Cannabis Banking, Simplified.

Earn the benefits a compliant cannabis lending program with the help of the purpose-built BSA/AML platform for cannabis compliance. **Schedule a Demo →**

THE SHIELD COMPLIANCE PLATFORM

shield data hub

The Shield Data Hub simplifies and improves compliance and reporting requirements and is instrumental in allowing financial institutions to maintain high levels of due diligence within their organizations.

shield assure

Shield Assure automates BSA/AML compliance management processes, including case management, detailed reporting, and automated government filing of Suspicious Activity Reports (SARs).

shield engage

Shield Engage facilitates the new client application and underwriting process by offering a simple and secure customer experience tailored to meet the compliance demands of cannabis industry banking partners.

shield transact

Shield Transact enables compliant cashless payment solutions to reduce cash transaction dependency.

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ABOUT THE AUTHORS



Tony Repanich

President & CEO, Shield Compliance

Tony leads day-to-day operations and is the company's principal product architect. Having served as a senior executive at a Washington State-based community bank for over 20 years, Tony has in-depth knowledge of the banking industry and the regulatory and compliance requirements for high-risk industries. Today he brings that knowledge to financial institutions serving and considering serving the legal cannabis industry.



Cami Cantrell

Executive Vice President, Payments & Strategic Alliances, Shield Compliance

Cami has over two decades of experience in product and business development roles in the banking industry and corporate world. She specializes in developing deal structures and third-party risk management programs that assist financial institutions with oversight of payments products delivered through fintech partnerships. Prior to joining Shield, Cami was an executive at an Illinois state-based community bank where she led sponsor bank programs.



Katrina Skinner

General Counsel & Chief Banking Officer, Simplify

In her role at Simplifya, Katrina helps create and implement automated regulatory compliance solutions for licensed cannabis operators. Prior to joining Simplifya, LLC, she was a partner in Burns & Levinson's Cannabis Business & Law Advisory practices. She has been advising financial institutions serving the legal cannabis industry since 2015, and was also named by the National Law Journal as a Trailblazer in Cannabis Law for cannabis banking. Katrina continues to advise financial institutions, licensed cannabis operators, and fintech companies, developing and offering unique solutions through her firm Choice Law, pllc and as of counsel to Burns & Levinson.



Scott Moskol

Partner, Burns & Levinson

Scott is a partner and co-chair of Burns & Levinson's Financial Restructuring & Distressed Transactions and Cannabis Business & Law Advisory practices, and a member of the Corporate and Finance practices. He has developed a national platform representing and counseling clients with respect to all legal issues that may arise in restructurings, workouts, bankruptcies, receiverships, and other insolvency-related matters both in the cannabis and non-cannabis industries. Scott was named by the National Law Journal to its inaguaral list of Trailblazers in Cannabis Law.

Scott's practice also consists of advising clients concerning the purchase and/or sale of distressed assets, companies, and loan portfolios. He also represents clients for financings and lending transactions, as well as general corporate matters, sometimes serving as outside general counsel.