

90 Day Note

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Testing Your Balance Sheet's Capacity to Weather the Pandemic and Embrace New Opportunities

By: Martina Dowidchuk, Senior Consultant and Director of Management Services

As we adjust to the new reality and navigate through the immediate operational challenges, long-term planning comes back into focus. What is the bank's balance sheet capacity to weather the economic downturn, absorb the potential losses, and leverage the existing resources to support households and businesses affected by the pandemic?

Community banks, with their relationship-based business models, are uniquely positioned to support their markets by using their in-depth knowledge of the local economies and the borrowers' unique situations to provide timely and individualized assistance for impacted customers. This is an opportunity to facilitate a return to economic stability and be the source of information and communication, but also to enhance customer relationships and trust over the long term.

Unlike during the 2008 financial crisis, most banks have stronger risk infrastructure, larger capital buffers, and higher liquidity reserves. How long the existing safeguards will last depends on the length and severity of the downturn. As we continue to work surrounded by an array of unknowns, there are planning steps that can be taken now to get in front of problems and position the bank to leverage its strengths to support the local communities and shareholders.

Capital Plan Review – How much capital can be deployed into new credits? How much stress can we absorb?

Considering the abrupt economic changes, the bank's risk-specific minimum capital level requirements should be revised to reflect the likely changes in the levels and direction of credit risk, interest rate risk, liquidity risk, and others. The recently issued regulatory statement relaxing capital requirements includes modifications related to the amount of retained income available for distribution, allowing banking organizations to dip into their capital buffers and to continue lending without facing abrupt regulatory restrictions. Institution-specific capital adequacy calculations can also provide a basis for the decision whether or not to opt in to using the community bank leverage ratio, which has been temporarily reduced from 9 percent to an 8 percent minimum threshold.

Stress testing the capital against credit losses, adverse interest rate environment, and other earnings challenges can help identify potential vulnerabilities and allow management to proactively prepare and protect the bank from losing its well-capitalized status should the simulated stress scenarios unfold. The sooner the problems are identified, the more flexibility you have in developing a solution. Every bank should have an up-to-date capital contingency plan to be implemented if the capital levels approach the minimums needed for a well-capitalized bank designation.

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The review of the minimum capital requirements and the stress tests can provide valuable insights regarding not only the bank's ability to survive a recession, but also to estimate the amount of "excess" capital that can be used to support additional lending. Many banks can justify lower capital requirements once they customize the capital adequacy calculations to their specific risk profiles. If additional asset growth can be supported from the capital perspective, the plan should be further evaluated from the liquidity standpoint.

Liquidity Plan Review – Are the existing liquidity reserves sufficient to support additional loan growth and the potential funding pressures?

Liquidity plan review needs to go hand in hand with capital planning. While most community banks have strong liquidity positions, the scale and speed of the coronavirus shock have raised concerns that credit drawdowns, sudden declines in revenues, and a higher potential for credit issues will strain bank balance sheets. Funding pressures may be building because of uncertainty about the amount of damage that the coronavirus might cause. Banks may be experiencing deposit drains from customers experiencing financial hardship or seeing withdrawals driven by fear. On the other hand, the volatility of the stock market and the uncertainty may drive the "flight to safety" and increases in bank deposits.

Changes in the business strategies and the results of the capital stress tests should be incorporated in the liquidity plan and the projected cash flows should be stress tested. Banks need to plan for ways to meet their funding needs under stressed conditions. The simulations should cover both short-term and prolonged stress events using a combination of stress constraints that are severe enough to highlight potential vulnerabilities of the bank from the liquidity perspective. The analysis should show the impact on both the on-balance sheet liquidity and the contingent liquidity, while taking into consideration changes in the available collateral, collateral requirements, limitations on access to unsecured funds or brokered deposits, policy limits on the use of wholesale funding, and other relevant stress factors.

Credit Risk Assessments – What is the loan loss potential?

Credit risk has the highest weight among the risk factors affecting capital and it is the biggest unknown in today's environment. The assessments will need to shift to be more forward looking rather than solely relying on past performance. The stress tests will be most useful when customized to reflect the characteristics particular to the institution and its market area. Banks need to understand which segments of their portfolio will be the most affected and perform targeted assessments of the potential fallout, along with the review of other segments that may have had weaker risk profiles before the pandemic, higher concentrations of credit, or those segments that are significant to the overall business strategy. The estimates might be a moving target in the foreseeable future; however, once the framework is set up, the analyses can be regularly repeated to determine the current impact. The results of these credit risk assessments will provide a valuable input for fine-tuning the capital plan and assessing adequacy of liquidity reserves, as well as for formulating strategies for working with the affected borrowers and extending new credit.

Measuring Impact of Plans

As we face abrupt changes in the strategic focus, taking the time to diagnose strengths and weaknesses, to understand the range of possible outcomes of the new business strategies, and to line up contingency plans ready to be invoked as the picture gets clearer is a worthwhile exercise. Young & Associates, Inc. remains committed to assist you in every step of the planning process. Our modeling and stress testing tools will allow you to generate valuable support information for your decision making, ensure regulatory compliance, and be proactive in addressing potential problems and positioning for new opportunities. For more information, contact Martina Dowidchuk at mdowidchuk@younginc.com or 330.422.3449. □



Strategic Planning for 2021

By: *Bob Viering, Senior Consultant and Director of Lending*

Young & Associates, Inc. is a leader in assisting financial institutions to move successfully through the strategic planning process. We remain flexible to your bank's specific needs, and work with you to create a vision with a focus on both your short- and long-term future.

Pre-Planning – Where are We Today?

At Young & Associates, Inc., our approach to strategic planning is individualized for your bank. Prior to your planning session, we feel it is important to get to know your bank. We do this by sitting down with your management team, discussing the biggest issues facing your organization, and reviewing your results and progress from your prior strategic plan. Next we send out a confidential questionnaire to both directors and senior officers to determine if there are specific issues of importance that need to be addressed. Based on your assessment of your bank's direction and the results of the questionnaire, we will work with you to craft an agenda that is specific to your bank. The pre-planning session and analysis is geared to answering the question: where are we now?

Planning Session – Where do We Want to Be?

On the day of your planning session, we spend time discussing what is going on in the banking world and the analysis of the pre-planning work so everyone is on the same page about where we are today. This may include updating your SWOT analysis. We focus on a critical piece of the planning session, which is to answer: where do we want to be? Young & Associates will facilitate the discussion and use our years of real-world experience to help you craft a plan that reflects your vision. The goal is to have a vision of where you want your organization to be next year, in five years, or ten years down the road, and determine what it will take to get there. Strategy is about making choices about who you want to serve, how you plan to serve them, and often just as important, who you are not going to serve.

Plan Execution – How will We Get There?

The goal at the end of the day is to have an agreed direction for your bank and the strategies/goals you will use to get there. Finally, we discuss the most important item of all planning: execution. The best plan in the world won't get you anywhere without a plan for how you will execute your plan, who is responsible for each goal you set, a timeline for completion, and periodic updates on the progress of your plan.

Written Strategic Plan

After the planning session, we will take the information about your goals and strategies and, with the assistance of your CFO, craft a financial plan that reflects your future direction. Our financial modeling tools allow us to show the impact of various "what-if" business scenarios, whether it is an alternative/stressed budget, impact of alternative strategies on the bottom line, capital, shareholder value, liquidity etc. All of the above are then included in your written strategic plan that we complete for you.

Why Young & Associates, Inc.?

Our consultants working on strategic planning are former CEOs and senior executives that were responsible for planning in their own banks so we know the realities of running your bank every day, along with the need to balance your time with executing your plan.

For more information, contact Bob Viering:

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Phone: 330.422.3476. □

Other Planning Services

- IT Strategic Planning
- Capital Planning and Capital Contingency Plans
- Liquidity Planning
- Budgeting



- **Liquidity Review**
- **IRR Review**
- **Compliance Review**
- **Loan Review**
- **Appraisal Review**
- **CRE Stress Testing**
- **Residential Mortgage QC Review**
- **IT Audit**
- **Internal Audit**



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Off-Site Reviews, Virtual/Teleconference Training, and Management Consulting Support

Young & Associates, Inc. remains committed to keeping our employees, clients, and partners safe and healthy during the COVID-19 pandemic. During this difficult and unprecedented time, we have continued to successfully leverage technology to fulfill our commitments to our clients and partners through secure remote access for reviews, virtual/teleconference training, and other management consulting support.

Young & Associates' commitment to virtual/teleconference training and remote access reviews date back well over five years. We see this ability as a win-win for everyone – the review and training get completed in a timely manner and the bank avoids paying any travel expenses. Concerned about security, please be assured that we use the latest secure technology.

We remain committed to helping our clients with all areas of their operations through off-site reviews and providing the most current regulatory updates through our virtual/teleconferencing training.

Contact one of our consultants today for more information about our off-site reviews or virtual/teleconferencing training:

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Young & Associates, Inc.'s consultants provide a level of expertise gathered over 42 years. In our consulting engagements, we closely monitor the regulatory environment and best practices in the industry, develop customized solutions for our clients' needs, and prepare detailed and timely audit reports to ease implementation moving forward. With backgrounds and experience in virtually all areas of the financial services industry, our consultants bring a broad knowledge base to each client relationship. Many of our consultants and trainers have come to the company directly from positions in financial institutions or regulatory agencies where they worked to resolve many of the issues that our clients face daily.

We look forward to working with you as you work to obtain your goals in 2021 and beyond. □

Work from Home Policy – \$195

Written to include both long-term and emergency situations for bank employees working at home or in a remote location, and addresses the determination and availability of employees, productivity issues, home office and equipment assessment, remote access considerations, safeguarding information, monitoring, and reimbursement considerations. A short-term telecommuting agreement is included.

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Dealing with Pandemic Disruption – and What Happens Next

By: Bill Elliott, CRCM, Senior Consultant and Director of Compliance Education, and William J. Showalter, CRCM, CRP, Senior Consultant

For years banks have had pandemic policies, and have done some level of testing, but never really thought the day would come when it would represent more than another examiner-required policy. Then came COVID-19, and in a matter of days, the world changed.

Managing Bank Policies and Procedures

When we teach in live seminars, we always ask, “How many of you believe that your policies are up to date?” That always gets some hands, but not 100 percent of attendees. Then we ask, “How many of you believe that your procedures are up to date?” Seldom does anyone raise their hand. These two situations are revealing.

Keeping policies current is the easier of the two. But many banks rubber stamp policies that could be much more effective. If it is a Regulation B policy, it usually follows the regulation and indicates that the bank intends to comply. That is fine for that type of policy. But other policies, notably operations and loan policies, need to do more than restate a regulation – they need to be a document that can be read and used. And, a pandemic policy needs to cover a wide range of subjects and issues.

It might be time to review these types of policies and add significant language as to how you will address situations such as we have experienced – lobbies closed or restricted, limited staff, staff working from home, and the same job to be completed. At a minimum, these policies should address:

- How jobs are done in an off-site world
- How electronic solutions are to be used
- Safeguards that must be used to protect customer data
- What types of paper documents can be used “at home” by staff working off site
- Proper disposal and the safekeeping of any documents that are off site
- Other protections, such as how the computers being used at home are protected from intrusion

With a little brainstorming, we are sure that you can add to this list.

Procedures are more difficult to maintain. A consultant from our company was recently in a bank and was examining procedures. Most of the procedures could be summed up as “Bill takes care of that.” As long as Bill is there, things probably work well. But if Bill is out sick, is working from home, on vacation, or no longer there, how does someone accomplish the task?

Procedures are always changing. It is far too easy to tell the three people that need to know about the change and then make a mental note to “update the procedures someday.” That elusive “someday” often never materializes. We believe that each bank should have a formal procedures review at least annually, and for some areas, maybe more often. For many banks, the inadequate procedure manuals that they have will not offer sufficient information for anyone to complete a task correctly. And with the staff more scattered, this can really complicate the situation.

The Future

Many banks have switched to imaging all files and documents. The banks that have made that decision generally are in a little better shape for off-site work, as it is easier to send employees home and still get the work done in a timely manner. If your bank has not made the transition to electronic files,

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Customizable Bank Policies

- Work from Home - \$195
- Pandemic - \$195
- Marijuana/Cannabis and MRB - \$275
- Marijuana Business and MRB Lending - \$275
- Flood - \$225
- Cybersecurity - \$200

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this may be your cue to consider the advantages of this technology. We have talked to numerous banks recently that in the past have said “NEVER” to imaging only to discover that “never” may not have been the right answer.

As the world becomes more electronic, and the cost of maintaining offices and buildings continues to increase, this may also be a time to reconsider the locations from which employees work. This may be especially critical if your brick and mortar buildings are getting close to capacity. Many tasks, with the right policies, procedures, equipment, and software, can easily be done from home, saving wear and tear on your building, perhaps reducing occupancy costs, and maybe, as a side benefit, resulting in happier and more productive employees.

Of course, everyone working from home is not going to be effective for banks. But it can be a great tool. For instance, you have a long-term excellent employee who does a job that could be done from home. While they are currently working in the office, their spouse gets transferred 300 miles away. In the past, that probably meant a resignation. But, properly managed, there may be no reason why you could not retain that employee by just letting them work from home – even if that home is not local.

The authors of this article are most aware of compliance officers. Over the last several years, we have seen more and more situations where compliance officers work from home, with some compliance officers going south for the winter and continue to work remotely, etc. In our company, none of our compliance consultants work in our office, even in “normal” times.

Conclusion

So we encourage you to reimagine the bank – to the extent possible. Face-to-face customer contact employees need to be local, but much or the rest of the staff may not really need to be “in the building,” at least not every day. We encourage you to use this mind set for the future – and let it help your bank thrive.

For more information, contact Bill Elliott, Director of Compliance Education, at bille@younginc.com or 330.422.3450, or William Showalter at wshowalter@younginc.com or 330.422.3473. □

Handle ARM Adjustments with Care

By William J. Showalter, CRCM, CRP, Senior Consultant

Adjustable-rate mortgages (ARM) have not been much of an issue for many banks and thrifts in recent years since fixed rates have been so low. But they are still an important tool for serving those customers who cannot meet the secondary market qualifications applied to most fixed-rate loans. And, many institutions have a portfolio of existing ARM loans that they service. One potential complication for some lenders is the impending discontinuance of the LIBOR index, requiring them to find another comparable index for their ARMs.

ARMs were in the spotlight over 10 years ago because of problems in the subprime market. Many subprime products have variable interest rates, which shift the interest rate risk from lender to borrower. Besides the issues raised then over putting borrowers into inappropriate products, there also are concerns over errors in ARM rate changes.

Do an internet search for “ARM errors” or similar terms and you will come up with numerous firms offering loan audit and information services to borrowers. These firms tell borrowers that their companies can correct ARM errors, bring loans into compliance, and get the borrower a mortgage refund.

Background

The initial furor over these mistakes arose over a report on ARM adjustment errors prepared by a former Federal Savings and Loan Insurance Corporation employee in 1989. His assertions sent a tremor through the mortgage

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industry. The report concluded that miscalculations in periodic adjustments to rates on ARM instruments resulted in significant overcharges. He found ARM adjustment errors in about 50 percent of the loans he sampled. From these results, he estimated the potential overcharges to be up to \$15 billion for ARMs nationwide at the time. This figure has been estimated as high as \$50-60 billion in recent years.

The controversy was further stoked by a study from the Government Accountability Office (GAO) released in September 1991 which found between 20 and 25 percent of the ARM loans at the time contained interest rate errors. Such errors occurred when the related mortgage servicer selected the incorrect index date, used an incorrect margin, or ignored interest rate change caps.

The damaging studies kept coming. In July 1994, Consumer Loan Advocates, a non-profit mortgage auditing firm announced that as many as 18 percent of ARMs had errors costing the borrower more than \$5,000 in interest overcharges. And, another government study in December 1995 concluded that 50 to 60 percent of all ARMs contained an error regarding the variable interest rate charged to the homeowner. The study estimated the total amount of interest overcharged to borrowers was in excess of \$8 billion. Inadequate computer programs, incorrect completion of documents, and calculation errors were cited as the major causes of interest rate overcharges.

Even though no other government studies have been conducted into ARM interest overcharges to date, the potential issue continues to simmer below the surface and lenders need to be vigilant so that it does not erupt into a veritable supervolcano of enforcement actions and lawsuits.

Types of Errors

The kinds of errors lenders are said to make in implementing ARM rate and payment adjustments run the gamut from calculation mistakes to carelessness, including:

- Mistakes in original loan set up/data input
- Miscalculation of payment amount
- Improper allocation of payments between interest and principal (amortization)
- Use of the wrong index
- Selection of incorrect index value
- Application of incorrect interest rate caps
- Failure to adjust in some years
- Use of incorrect margins
- Improper rounding methods (e.g., rounding up instead of rounding to the nearest $\frac{1}{8}$ th of 1 percent)
- Math mistakes causing an incorrect rate
- Use of incorrect loan balance

Banking regulators point out that these errors may be considered breaches of contract and could expose the financial institution to legal action.

Extent of Errors

Since ARMs involve changing index values periodically and oftentimes complex computer calculations, they seem to attract human and software errors. Mortgage audit firms point out that leading publications such as *The Wall Street Journal*, *MONEY*, *Forbes*, and *Newsweek* have warned borrowers about miscalculations occurring in up to 50 percent of ARMs.

The firms get borrowers' attention by pointing to figures of lender overcharges and borrower refunds like these:

- Average borrower refund of over \$1,500

"The calculation of ARM rate changes is a complex process and errors can occur in a variety of ways. Add to this the fact that many lenders offer, and servicers support, a variety of ARM products with different rate adjustment intervals, indices, margins, and other terms."



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- 21 percent of refunds ranging from \$3,500 to \$10,000
- 13 percent of errors exceeding \$10,000

Reasons for Errors

The calculation of ARM rate changes is a complex process and errors can occur in a variety of ways. Add to this the fact that many lenders offer, and servicers support, a variety of ARM products with different rate adjustment intervals, indices, margins, and other terms. Another potential complicating factor is the widespread practice of transferring loan servicing, presenting another opportunity for human mistakes and software mismatches to cause errors.

In addition, some of the mortgage audit firms assert that ARM rate and payment adjustment errors have been linked to:

- Lack of training, supervision, and experience of loan servicing personnel
- Simple human error
- Computer data entry or software errors
- Clerical or calculation errors
- Fraud
- Sale or transfer of the loan to a different company
- Rider, handwritten changes, or other irregularities in the note
- Very complex calculations, use of an unusual index, or interest rate
- Dissolution or merger of the original loan institution

How to Avoid These Problems

The federal banking supervisors began encouraging financial institutions back in 1991 to perform reviews of their adjustable-rate loan systems to ensure that interest rate information is correctly ascertained and administered, and that rates are adjusted properly.

Banks and thrifts should have effective internal controls and procedures in place to ensure that all adjustments are made according to the terms of the underlying contracts and that complete, timely, and accurate adjustment notices are provided to borrowers. Also, a system for the ongoing testing of adjustments should be in place to ensure that adjustments continue to be made correctly.

A critical component of any successful loan servicing program, including correctly implementing rate and payment adjustments, is a thorough training regime for lending personnel involved in the process. Those involved must be given the appropriate tools – including knowledge – to succeed in their jobs.

Any review of ARM adjustments should include documentation indicating the basis for interest rate adjustments made to a lender's ARM loans, showing whether changes have been made consistent with the underlying contracts.

If a lender finds that it has made errors in the adjustments for interest rates which have resulted in interest overcharges on ARMs, the supervisory agencies expect that you will have in place a system to correct the overcharges and properly credit the borrower's account for any interest overcharges. In general, undercharges cannot be collected from borrowers.

Young & Associates, Inc. offers a variety of compliance management and review services that are proven effective for institutions of all types and sizes. For more information on this topic or how Young & Associates, Inc. can assist your institution, contact Bill Showalter at wshowalter@younginc.com or 330.422.3473. □

Compliance Update Newsletter - \$249

Monthly newsletter that provides a thorough compliance review and covers developments that affect the industry.

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Work from Home Policy (#337) – \$195

Written to include both long-term and emergency situations for bank employees working at home or in a remote location, and addresses the determination and availability of employees, productivity issues, home office and equipment assessment, remote access considerations, safeguarding information, monitoring, and reimbursement considerations. A short-term telecommuting agreement is included.

Marijuana/Cannabis and MRB Policy (#331) – \$275

This policy establishes the responsibilities and requirements for conducting banking activities for legal marijuana and cannabis businesses, including those Tier 2 and Tier 3 businesses that have a secondary or tertiary relationship with marijuana related businesses.

Marijuana Business and MRB Lending Policy (#333) – \$275

Establishes a prudent framework for financial institutions to responsibly conduct business with legal marijuana/cannabis businesses in their communities while acknowledging and mitigating the legal and regulatory risks posed by doing so. The policy can be customized to fit the institution's risk profile and line of business strategy and assures lending, compliance, and BSA/AML staff have access to necessary information that addresses the many marijuana/cannabis issues that must be understood, documented, and monitored. Includes a Due Diligence Checklist.

Marijuana Policy Combo (#334) – \$495 *Save \$55*

Liquidity Toolkit (#273) – \$1,500

Includes:

- **Liquidity Cash Flow Planning Model (#271):** Forecast funding sources, funding needs, and cash flow gaps. Monitor availability of contingent liquidity. Monitor funding concentrations and dynamic cash flow ratios. Perform liquidity stress testing and multiple-scenario what-if analyses.
- **Liquidity Contingency Funding Plan (#272):** Delineates strategies and actions addressing potential liquidity shortfalls in emergency situations. Includes identification of stress events, stress levels, early warning indicators, parameters for liquidity stress testing, sources of funds and funding strategies, lines of responsibility and communication, as well as a detailed crisis action plan.
- **Liquidity Management Policy (#096):** Customizable policy designed to ensure that the bank is managed to provide an adequate level of liquidity to meet both predicted and unexpected cash needs while maintaining a planned net interest margin.

System Requirements: Microsoft® Word 2007 and Excel 2007 or higher

Capital Planning System

Assess capital adequacy in relation to your bank's overall risk and develop a customized capital plan for maintaining appropriate capital levels in all economic environments.

Allows you to:

Develop a base case scenario in which minimum capital adequacy standards are established.

Identify and evaluate risk for your bank. Parameters in this analysis have been field-tested in our work with banks over the years and closely resemble adequacy standards established in consent orders.

Stress test capital by loan classification (as recommended by the FDIC and OCC).

Perform contingency planning for stressed events. All assumptions are stressed to determine the amount of capital needed and possibilities for increasing capital are examined.

Generate your capital plan in as little as 1 day. Data from the Microsoft® Excel spreadsheets can be easily transferred directly into a Word document that can be customized to fit the unique circumstances at your bank.

First Year License Fee (#304) – \$1,095

Update/Annual License (#306) – \$495

System Requirements: Microsoft® Excel 2007 or higher

Completing the New Uniform Residential Mortgage Loan Application – Webinar and Manual

New and informative webinar and manual to assist your lenders in preparing and completing the new application, required by March 1, 2021. Includes a 55-minute webinar and manual that provide step-by-step instructions for completing the new mortgage application, including special instructions for collecting Government Monitoring Information for both HMDA and Non-HMDA banks. Both the webinar and manual can be used throughout the bank.

- **Limited Access (#335) – \$175:** Will allow you to train your current staff. Includes the manual and access to the webinar for your institution until April 1, 2021. (Note: If the regulators make changes to the application form prior to April 1, 2021, we will update the webinar and manual to accommodate these changes.)
- **Unlimited Access (#336) – \$275:** Will allow you to train your current and future staff with no time restriction. Includes the manual and access to the webinar for your institution for an unlimited period. (Note: If the regulators make changes to the application form within the next 3 years (through July 2023), we will update the webinar and manual to accommodate these changes.)

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