The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Act) will have wide-ranging impact on anyone providing retail financial services in the United States. Dodd-Frank creates a new independent regulator and supervisor, the Consumer Financial Protection Bureau (CFPB), housed at the Federal Reserve. The CFPB will have the authority to promulgate rules designed to ensure that US consumers receive clear, accurate information to help them evaluate mortgages, credit cards, and other financial products, and to protect them from hidden fees, abusive terms, and deceptive practices.

Further, to control certain mortgage industry practices that Congress considered as abuses contributing to the 2007–09 financial crisis, the Act contains a series of mortgage reforms administered by the CFPB and others that cut across various aspects of the mortgage origination and servicing businesses. The stated purpose of the Act’s mortgage sections is to assure that consumers are offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay the loans and that are understandable and not unfair, deceptive, or abusive. Additionally, the Act requires the Government Accountability Office to conduct certain studies that could result in additional legislative or regulatory initiatives, and establishes a new Office of Housing Counseling within the Department of Housing and Urban Development.

The CFPB will consolidate many of the consumer protection responsibilities previously handled by the Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision, Federal Deposit Insurance Corporation, Federal Reserve, National Credit Union Administration, Department of Housing and Urban Development, and Federal Trade Commission.

This A Closer Look provides an initial perspective on the impact some of these considerations may have on consumer and mortgage banking.
The CFPB will enhance supervision and regulation of consumer compliance. Even for banks, which are already subject to consumer compliance examination by a legacy regulator, a newly created regulator with a specific emphasis on consumer protection as its core mission represents a significant change in emphasis, and will likely result in greater compliance control requirements.

For nonbanks, the scope of the impending change may be more dramatic, potentially forcing re-evaluation of corporate strategy and affiliation. Some of these nonbank lenders who are bank affiliates may increasingly weigh the option of remaining outside of a banking chartered entity, while independent, nonbank lenders may increasingly reconsider the benefits of bank affiliation either through de novo charter, acquisition, or sale.

How is the CFPB organized?

The CFPB’s structure includes the following features:

- Rather than being a stand-alone agency, it is part of the Federal Reserve System
- It is led by a director and deputy director, selected by the president, and confirmed by the Senate
- Rules issued by the CFPB are in some cases subject to veto by the Financial Oversight Stability Board
- Several of its departments are mandated by Dodd-Frank, including (i) community affairs, to study and provide technical assistance regarding provision of financial products and services to underserved communities; (ii) consumer complaints; (iii) Office of Fair Lending and Equal Opportunity; (iv) the Office of Financial Literacy; and (v) the Office of Financial Protection for Older Americans
- Consumer protection functions will be transferred from existing agencies to the CFPB within 12 to 18 months after enactment
- It will lack authority to enforce the Community Reinvestment Act; that authority remains with legacy supervisory agencies

The organization of the CFPB will likely dictate the way examinations are conducted. Firms should assure that they are organized in a way that is familiar to the bureau and responsive to its demands. Some firms are already naming a compliance officer to cover each CFPB department.

Firms covered by the CFPB

The list of businesses subject to CFPB supervision is long, and there are important exceptions. In general the following are covered:

- Banks, thrifts, and credit unions
- Finance companies
- Payday lenders
- Pawn shops
- Currency exchanges
- Retail stores offering in-house credit or deferred payments
- Mortgage loan servicers
- Mortgage loan brokers
- Check guaranty services
- Consumer credit reporting agencies
- Debt collectors
- Real estate settlement companies
- Credit counsellors and debt settlement, negotiation, or mortgage relief service providers
- Money transmitters and wire transmitters
- Money services businesses
- Financial data processors
The CFPB will examine all mortgage-related businesses (such as lenders, servicers, and mortgage brokers) and large nonbank financial companies (such as large payday lenders, debt collectors, and consumer reporting agencies).

For banks and credit unions already subject to consumer compliance examination by existing regulatory agencies, the story is a bit different. The CFPB has the authority to examine and enforce regulations for banks and credit unions with greater than $10 billion in assets—a group that represents more than 70% of total US banking assets.

We anticipate that the scheduling of CFPB examinations will be risk-focused, but it is too early know how often any particular type of firm will be examined.

Banks and credit unions with assets below $10 billion will continue to have compliance examinations performed by their current supervisor. However, the CFPB would have authority to participate in exams conducted by another supervisor and provide input on the scope and conduct of the exam as well as the content of the exam report and the exam rating. A key concern going forward will be considering whether the CFPB’s lack of examination authority over smaller institutions will add a large institution bias to its rule-making.

Impact of Dodd-Frank on state regulation of consumer financial services activities

Dodd-Frank does change federal preemption of state law, but the extent of that change is not yet fully understood. Before Dodd-Frank, the OCC automatically preempted all state laws that “obstructed” or “impaired” national bank operations. By contrast, the Dodd-Frank approach:

- Revokes the OCC’s ability to automatically preempt state “consumer financial laws” and adds a tougher preemption standard for state consumer financial laws. If the law is not a “consumer financial law,” prior OCC preemption rules apply. The definition of “consumer financial law” in Dodd-Frank is unclear, and is likely to be defined by courts of law.
- Gives the OCC the ability to consider consumer finance preemption issues on a case-by-case basis and may only deem state laws preempted if such laws “discriminate” against nationally chartered banks or if, under the Barnett decision, they prevent or significantly interfere with the exercise by a national bank or federal thrift of its powers.
- Allows national banks and thrifts to continue to export the highest rate of interest “allowed by the laws of the State, territory, or district where the bank is located.”
- Specifically weakens the traditionally stronger federal thrift preemption to eliminate gaps between federal thrift and national bank preemption.
- Could change the status of previous preemption rulings by the OCC, many of which may be destined to be worked out in court. Though not certain at this time, prior OTS preemption rules are likely void, but thrifts will be able to rely on OCC preemption rulings.
- Allows state attorneys general to sue to enforce federal rules promulgated by the CFPB. However, it prohibits class action lawsuits.

Another important change is Dodd-Frank’s application of state consumer protection law to affiliates and subsidiaries of national banks. Nothing is preempted if it is not in the bank. The provisions of the Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act) that do not require employees of bank operating subsidiaries to obtain state licenses is unchanged. However, given that operating subsidiaries no longer benefit from preemption, states may now choose to require such registration.
In our experience, some bank compliance programs are not as effective as they could be in dealing with state banking laws. Institutions should consider building out matrices of applicable state laws and regulations that mirror the programs they have—or should have—for federal laws and regulations. Matrices should cite the law, regulation, affected business unit, products, applicable policy, procedure, controls, party with oversight responsibility, and compliance monitoring and testing process.

**Changes Dodd-Frank makes to mortgage origination**

Dodd-Frank includes Title XIV, the Mortgage Reform and Anti-Predatory Lending Act. This act makes broad changes to US mortgage origination, including:

- Prohibiting originators from receiving compensation that varies based on the terms of the loan
- Requiring reasonable ability to repay the loan, and that credit decisions be based on verified financial resources
- Limiting pre-payment penalties
- Adding new disclosures and limitations

Many of these sweeping changes were long expected in the mortgage markets and some were even previewed in Federal Reserve Board regulations. Nonetheless, it is clear that Dodd-Frank makes fundamental changes to the way consumers and lenders interact. In perspective, Dodd-Frank seems to favor simple and straightforward mortgage products. This preference is evident not only in the origination provisions, but also in the inclusion of enhanced monetary damages, new defenses in foreclosure, and added risk retention requirements for non-vanilla products.

The highlights of these sweeping changes to mortgage origination are outlined below. In the coming weeks we will publish guidance to further assist in operationalizing these changes.

**Restrictions imposed on compensation of mortgage originators**

Dodd-Frank attempts to prevent mortgage originators from steering consumers into inappropriate loan products by restricting the manner in which mortgage originators earn their compensation. The Act’s general rule is that no mortgage originator shall receive compensation that varies based on terms of the loan other than the amount of principal. Thus, the Act will prohibit “yield-spread premiums” and other forms of compensation that, in the past, may have provided an incentive to promote certain mortgage loans.

Dodd-Frank restricts, but does not prohibit, mortgage originators from receiving compensation from a party other than the consumer. Such compensation is allowed only if:

- The originator does not receive any compensation directly from the consumer
- The consumer does not pay fees (such as discount points, origination points, etc.) other than bona fide third-party charges not retained by the originator, creditor, or affiliate of the creditor or originator

These provisions are designated to come under the purview of the CFPB; however, many of the regulations under Title XIV will be written by the Federal Reserve Board. These regulations will be critical, because the Dodd-Frank definition of “mortgage originator” is very broad.

Similar to the rule-making under the SAFE Act, affected firms should be highly engaged in the rule-making through the public comment process regarding the definition of “mortgage originator,” because of its broad potential impact. Already it is clear that many in the industry would prefer that “compensation” restrictions, and the scope of their compliance programs, be limited to persons whose compensation comes from mortgage origination, rather than including a wider pool of bank employees who otherwise interact with the customer.
Institutions are advised to identify and consider all forms of compensation received from consumers or paid to originators. Despite the above restrictions, certain types of other mortgage originator compensation options remain. For example, the Act permits (i) compensation to a lender from a secondary market for sale of consummated loan, and (ii) volume-based incentive payments to mortgage originators (i.e., payments based on the number of loans originated within a specified period).

**Impact of Dodd-Frank on underwriting standards**

**Prohibiting steering to products which the consumer cannot reasonably repay.** In addition to restructuring originators’ compensation, Dodd-Frank also explicitly prohibits mortgage originators from steering any consumer into a mortgage loan that they cannot reasonably repay, or that has predatory characteristics or effects such as equity stripping, excessive fees, or other abusive terms.

Further, the Act prohibits mortgage originators from steering a consumer away from a loan for which they are qualified into a mortgage loan that is not a “qualified” residential mortgage loan.

A “qualified mortgage” is a mortgage loan:

- In which regular, periodic payments do not result in an increase of the principal balance or allow the consumer to defer repayment of principal
- That does not contain a balloon payment that is more than twice as large as the average of earlier payments (the Federal Reserve Board may prescribe certain narrow exceptions for balloon loans)
- In which the income and financial resources of the consumer are verified and documented
- That is either a fully amortizing fixed-rate loan or an adjustable-rate mortgage that is underwritten based upon the maximum rate permitted during the first five years and on a fully amortizing schedule thereafter, including all applicable taxes, insurance, and assessments
- That complies with debt-to-income underwriting guidelines established by the Federal Reserve Board
- In which total points and fees (excluding third-party charges) do not exceed 3% of the total loan amount
- Whose loan term does not exceed 30 years

The Act provides an allowance for discount points for the purpose of the 3% limit by excluding from the calculation of total points and fees 2 points for loans with interest rates that do not exceed the average prime rate by more than 1%, or 1 point for loans with interest rates that do not exceed the average prime rate by more than 2%. Further, the Act requires the Federal Reserve Board to draft regulations that will allow lenders who extend smaller loans to presume compliance with these restrictions on points and fees.

Firms should immediately assure that they have systems and controls in place to identify and distinguish between qualified and non-qualified mortgages.

**Key CFPB regulations to define terms such as “excessive” and “abusive” are forthcoming.** However, it is important to recognize right away that violations of these provisions will be costly, and risk mitigation activities should commence. Cost will stem not only from CFPB administrative action, but also from the Act’s provision that mortgage originators in violation will be privately liable. Potential liability will equal the greater of a consumer’s actual damages or three times the amount of compensation gained from the subject transaction, plus the consumer’s costs to bring an action, including attorneys’ fees. Further, violations can also be raised as a defense to recoupment or set-off in foreclosure. This applies without regard to state statutes of limitation.

**Verification and documentation.** In general, the Act requires mortgage originators only to make loans upon a reasonable and good-faith determination, based on verified and documented information, that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan according to its terms, along with all applicable taxes, insurance (including mortgage guarantee insurance), and assessments. The mortgage originator must make this determination based on the combined required payments of all of the consumer’s loans secured by the same dwelling. The mortgage originator’s determination must include
consideration of the consumer’s credit history, current income, expected income, current obligations, debt-to-income ratio or the residual income after paying all non-mortgage obligations, employment status, and other financial resources other than equity in the dwelling. The payments that the mortgage originator uses to make this determination must be based on a schedule that fully amortizes the loan. The Act prescribes the documentation necessary to verify a consumer’s income as an IRS Form W-2, tax returns, payroll receipts, financial institution records, or other third-party documents.

There is an exemption to the income verification requirement of the Act for loans made, guaranteed, or insured by the Department of Housing and Urban Development, Department of Veterans Affairs, Department of Agriculture, and the Rural Housing Service. That exemption is for loans that are refinancing under a streamlined refinancing program under the following conditions:

- The consumer is not 30 days or more past due on their existing mortgage loan
- The refinancing does not increase the principal balance outstanding, except for the amount of allowable fees and charges under the program
- Total points and fees do not exceed 3% of the total new loan amount
- The interest rate on the new loan is lower than the interest rate on the original loan
- The new loan is fully amortizing
- The new loan does not contain a balloon payment

As with the restrictions on steering noted above, the failure to determine ability to repay may be raised as a defense by recoupment or set-off in foreclosure. However, the Act includes a safe harbor granting lenders a “presumption of compliance” if the loan is a qualified mortgage, as defined in the section above.

The Act also prescribes underwriting requirements for what it deems to be “non-standard” loans. These non-standard loans include variable-rate loans with deferral of principal or interest, and interest-only loans. For these types of loans, the Act explicitly prescribes that the determination of a consumer’s ability to repay must be based upon payments that would be required to fully amortize the loans by their stated maturity.

These provisions will likely require changes to most firms’ credit and underwriting policies and procedures. Until (and perhaps after) implementing regulations are drafted, new product approvals may be more complex. Firms should begin to investigate changes to processes and systems that may be necessary to implement controls to assure compliance.

Also, firms should consider the impact of Dodd-Frank on refinancing processes, as the Act appears to favor the refinancing of hybrid loans into standard loans. For such loans, to be further defined in regulations, mortgage originators may take into their underwriting consideration additional facts such as the consumer’s good standing on his or her existing loan, and whether the refinancing would prevent a default under the existing loan that may occur upon an upcoming reset. A lender may also offer rate discounts and other favorable terms that would be available to new customers with high credit ratings.

Also of note, this type of mortgage market regulation appears to be increasingly present globally. On July 13, 2010, the UK’s Financial Services Authority issued proposed rules that include (i) imposing affordability tests for all mortgages and making lenders ultimately responsible for assessing a consumer’s ability to repay; (ii) requiring verification of borrowers’ income in every case to prevent over-inflation of income and to prevent mortgage fraud; and, (iii) extra protection for vulnerable customers with a credit-impaired history.1

Appraisal reforms

“Higher-risk” mortgages. The Act requires a written appraisal for “higher-risk” mortgages and places specific requirements on those appraisals. For the purpose of these requirements, a higher-risk mortgage is not a qualified mortgage (as defined for purposes of underwriting standards) and has an annual percentage rate that exceeds the average prime rate offered by at least 1.5 percentage points for conforming loans, or by at

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least 2.5 percentage points for non-conforming loans. The appraisal must be performed by a licensed or certified appraiser who must physically visit the interior of the property.

If a higher-risk mortgage is for the purpose of financing the purchase of a residence within 180 days of when the seller purchased the property, and if the current price is higher than that for which the seller acquired the property, the Act requires a second appraisal from a different certified or licensed appraiser. That second appraisal must include an analysis of the difference in sale prices, changes in market conditions, and any improvements made to the property between the previous sale and the current sale. The cost of the second appraisal must not be charged to the loan applicant.

At the time of the initial application, creditors must disclose to consumers that the appraisal is for the sole use of the creditor, and that the consumer may choose to have a separate appraisal for their own use at their own expense. At least three days prior to closing, creditors must provide a copy of each appraisal, required for higher-risk mortgages, to the loan applicant.

Appraiser independence and portability. The Act also amends the Truth in Lending Act to require that appraisers be independent, and precludes anyone from attempting to influence an appraised value to be based on anything other than the independent judgment of the appraiser. Mortgage lenders who have a reasonable basis to believe that an appraiser has violated standards, laws, or ethics are required under the Act to report that appraiser to the respective state appraiser licensing agency.

The Act also explicitly prohibits broker price opinions from serving as the primary basis to determine the value of a residential property when securing a mortgage loan for the purpose of purchasing that property.

If a mortgage lender knows at or before closing that the appraiser violated the independence standards of the Act, that mortgage lender shall not extend credit based on that appraisal unless the lender documents that the creditor acted with reasonable diligence to determine that the appraised value does not materially misstate the value of the dwelling.

The Act also permits federal banking regulatory agencies to issue regulations that provide for the portability of appraisal reports between lenders for the purpose of mortgage credit on one- to four-unit properties.

Until Dodd-Frank regulations are written, some uncertainty remains for lenders who require the use of appraisal management companies.

Dodd-Frank creates new appraisal independence standards that are similar to (and replace) the current Home Valuation Code of Conduct (“HVCC”). The HVCC was brought into being in 2009 by Fannie Mae, Freddie Mac, and the Federal Housing Finance Agency. The HVCC’s main purpose was to protect appraisers and the quality of appraisals from undue influence and conflicts of interest. Some in the mortgage industry considered the HVCC to favor having appraisal management companies’ act as a buffer between appraisers and lenders, and some in the industry believe this led to reduced profits for appraisers, and threatened to lower appraisal quality.

Like the HVCC, Dodd-Frank will prohibit influencing of the judgment of an appraiser through collusion, coercion, bribery, etc. Unlike the HVCC, Dodd-Frank allows Fannie Mae and Freddie Mac to accept any appraisal report completed by an appraiser selected or paid by a mortgage loan originator. The bill also includes provisions that require lenders and their agents to pay customary and reasonable market rates for appraisals, and subjects appraisal management companies to registration and state and federal oversight. The amount that is customary and reasonable is to be supported by government agency fee schedule, academic studies, or independent private sector surveys.

Until rules are written, however, it is unclear whether lenders can rely exclusively on appraisal management companies’.

Automated valuation models. With regard to automated valuation models (“AVMs”), the Act requires the federal banking regulatory agencies, in consultation with the Appraisal Subcommittee of the Federal Financial Institutions Examination Council and the Appraisal Standards Board of the Appraisal Foundation, to issue regulations to implement quality control standards.
Prepayment penalties. For the purpose of prepayment penalties, the Act distinguishes between “qualified” and “non-qualified” mortgages. The Act defines “qualified” mortgages for this purpose as follows:

- Not an adjustable-rate loan, or
- Does not have an annual percentage rate that exceeds the average prime offer rate by:
  - 1.5% for conforming loans
  - 2.5% for non-conforming loans
  - 3.5% for subordinate lien loans

If a mortgage loan is not a qualified mortgage for this purpose, it may not contain a prepayment penalty.

If a mortgage loan is a qualified mortgage for this purpose, it may only contain a prepayment penalty that does not exceed the following limitations:

- During the first year of the loan, 3% of the outstanding balance of the loan
- During the second year of the loan, 2% of the outstanding balance of the loan
- During the third year of the loan, 1% of the outstanding balance of the loan
- Thereafter, the mortgage may not contain a prepayment penalty

Mortgage originators may not offer a consumer a loan with a prepayment penalty without also offering a loan without a prepayment penalty.

Other Dodd-Frank mortgage reforms

Interest rate reset notice. Requires creditors to notify consumers at least six months before the interest rate on a hybrid adjustable-rate mortgage is scheduled to reset.

Escrows. Requires escrows for taxes and insurance for certain mortgages (including those exceeding specified interest rate thresholds).

Broader HOEPA coverage. More loans will receive the protections for high-cost mortgages under the Home Ownership and Equity Protection Act of 1994 (HOEPA).

Regulations. Requires final regulations for most of the foregoing mortgage protections within 18 months of enactment.

New disclosures. Establishes new disclosure requirements regarding adjustable-rate mortgage loans, escrow payments, partial payments, fees and settlement charges, negative amortization, and anti-deficiency protection provisions.


Duty of care. Requires mortgage originators to be qualified and (when required) licensed and registered, and include on all loan documents an identifier provided by Nationwide Mortgage Licensing System and Registry.

Customer interactions. Prohibits servicers from (i) obtaining force-placed insurance unless there is reasonable basis to believe borrower has failed to comply; (ii) charging fees for valid qualified written requests; (iii) failing to take timely action to respond to borrower’s requests to correct errors; (iv) failing to
respond within 10 days to requests from borrower for information about owner/assignee of loan; and (v) failing to comply with any other obligation required by the CFPB.

A plan for action

Given the context of the strengthened supervision mandated in other sections of Dodd-Frank, financial institutions must adapt quickly to a steep learning curve. The penalties for non-compliance are stiff. Regulators can impose a variety of informal or formal enforcement remedies that can restrict an organization’s growth and halt strategic plans until control structures and risk management programs meet agency expectations. Such disruptions can negatively impact key revenue streams. Moreover, remediation efforts can be complex and competitively damaging, potentially embedding high remediation costs in processes long after the problems are corrected. Regulators may also require organizations to increase capital, curtail lending, or sell assets. Financial holding companies whose depository institution subsidiaries are not rated as “well managed” may lose their financial holding company status, preventing them from continuing to own insurance, securities, or other financial affiliates.

How can financial institutions successfully manage this transition? The answer is threefold. First, be prepared. Develop a proactive plan to honestly and critically assess the structure and performance of your consumer compliance program. This will indicate that your organization is ready for enhanced oversight, and could lessen the risk of remedial actions. This type of review has to be bold, venturing beyond your auditors’ or examiners’ previous parameters and leaving nothing to chance. The review should be enterprise-wide and structured to include all elements of existing regulatory guidance, but structured to reflect the administrative scope of CFPB.

Second, rather than a piecemeal approach to remediation of issues, focus on developing a compliance risk framework that is woven into the company’s cultural fabric in order to maintain the long-term safety and soundness of the organization and promote compliance as a customary course of business. This cultural make-over should also follow the organizational lines of the CFPB, perhaps necessitating new officers, roles, and control structures.

Third, read ahead. Actual implementation of the provisions and requirements of Dodd-Frank will depend upon the transfer of responsibilities to the CFPB and the issuance of regulations. This timeline could take up to a maximum of three and a half years. Companies should actively engage in the regulation-setting process by keeping abreast of developing regulations and providing formal comments on proposed regulations. Although this may seem like a lengthy timeline, companies will need to begin planning now for the structural changes to their businesses that the Act will require.
While Dodd-Frank will have significant impact on consumer and mortgage banking operations, many implementation issues are currently unclear and are subject to the SEC and other agencies’ rulemaking processes and various statutorily directed studies. PwC will continue to monitor those developments and provide you with updates, which will be available at www.pwcregulatory.com.

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