Sieps
Swedish Institute for European Policy Studies

European Policy Analysis
FEBRUARY · ISSUE 2013:2epa

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The creation of an internal market for mortgage loans: A never ending story?

Abstract
This article summarizes previous and current attempts of the European Union to create a common legal framework for mortgage credit contracts. In this context the author describes the reasons for regulating mortgage credit at the EU level and shows that, previously, the goal was to achieve an internal market and cross-border activities for banks and consumers. However, due to the current financial crisis, which had its origin in the malfunction of some national mortgage markets, the political reasoning shifted towards achieving a high level of consumer protection, safeguarding mortgage markets and hence preventing a second mortgage crisis.

The author also outlines the approach of the United States. He summarizes the changes of the Dodd-Frank Act for the American mortgage market and compares it with the proposed EU legislation. Furthermore, a short survey of other legal proposals in Germany, United Kingdom, Sweden and Spain provides evidence that, while several governments were very active in the area of mortgage credit regulation, their actions were not coordinated. The author argues that one effect of these uncoordinated legal activities is that national legal activity will create further obstacles for the internal market for mortgage loans, despite the attempts to harmonize the rules for mortgage credit.

1 Introduction

On the first of January 2013, Europe will celebrate the 20th birthday of the European Internal Market. However, it seems as if the EU policy makers have forgotten this special anniversary. Other topics are dominating the agenda of the EU right now: The EU is struggling to find a coherent answer to the present financial and sovereign debt crisis. The regulation of the financial service industry is currently being looked into by the European Council and the European Commission. The implementation of more robust rules on capital requirements and the transposition of the Basel III agreement into EU law has been the main priority recently. Among the politically more sensitive issues are the political wish to establish a Banking Union, a single supervisory system for all credit institutions in

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the eurozone, common rules for the deposit guarantee scheme and a European wide regulatory framework for the restructuring and winding up of credit institutions.

In these busy times for EU lawmakers, the reasons and the origins of the current financial crisis are often forgotten. Mortgage credit underwriting practices in the US, UK, Ireland and Spain, poorly regulated intermediaries, securitization practices and bundled 'toxic' products, which have also affected credit institutions around the globe, were major causes of the current crisis.

However, housing finance systems within Europe are very diverse. There are huge differences in home ownership rates, real estate markets, housing prices, refinancing structures and national policies supporting consumers to acquire their own home across Europe. The size of the mortgage market, in comparison to the national GDP range in the EU, ranges from the Netherlands at 107.1 per cent GDP to the UK at 85 per cent to Romania at 5.6 per cent.[1]

This article summarizes the attempts over the last three decades of EU law makers to create an internal market for mortgage credit loans within the EU, under the influence of different motives due to the respective political and economic circumstances. Particular emphasize will be put on the recent proposal for a Directive on credit agreements relating to residential property.[2]

The article will also provide a short overview of the attempts of some EU Member States and the US to provide a legal answer to the national mortgage markets and compare the differences of the chosen approaches by some countries and their effect The key question here is whether the measures taken will be enough to prevent a future crisis.

2 Obstacles for a specific European internal market for mortgage credits

The key underlying feature of a credit agreement is money, which can easily be transferred electronically across borders, but the main features of a credit agreement are legal conditions. These conditions are different in any jurisdiction. A loan agreement, which has the purpose of financing real estate, is also connected to the law of the *'lex rei sitae'*. This means that the contracts dealing with the obligations between two parties also have to reflect the laws of the country where the property is located. In particular, the rules for securing foreclosure rights need to be observed. However, the main obstacle within the internal market for these legal contracts as products can be found in the European Private International Law.[3] The choice of law in cross border contracts is only possible if the essential consumer protection rules of the consumer's country of residence are respected.

This means that a creditor has to adjust a loan and the security contract to the law of the consumer residence, which makes it virtually impossible to offer mortgage loans or consumer loans on a cross-border basis, since national rules concerning consumer protection for credits are still very diverse. Therefore the EU has been working on harmonizing consumer and mortgage credit law. In the area of consumer credit, we already have three European Directives regulating the level of consumer protection for these kinds of loans.[4] But according to the latest report of the European Parliament, cross-border consumer credits accounts for less than 2 per cent of the total credit market and roughly 20 per cent of the loans in question are taken out online.[5]

The reason for this poorly developed consumer credit market is probably that Member States are still able to maintain national rules which are not regulated within the Directives. Also, some rules of the Consumer Credit Directive are not even fully harmonized as they grant Member States the freedom to implement these rules differently according to the national legal context.[6] This will not change with the currently debated Mortgage Credit Directive, since it regulates only a certain minimum level of consumer protection in the area of mortgage credit. Different member States implement these rules differently which leaves many legal parts of a mortgage credit contract unregulated at the EU level.

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1 EMF Hypostat 2012
2 COM(2011)142 from 31.03.2012
3 As previously regulated in the Convention on the law applicable to contractual obligations (Rome Convention) from 1 April 1991 regulated in Art. 4 par. 2 and now stipulated in Art. 6 par. 2 of the Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I) [Official Journal L 177 of 4.7.2008]
4 Which means credits for consumption purpose not for housing
5 Report on the implementation of the Consumer Credit Directive 2008/48/EC, IMCO_PR(2012)489471
6 Consumer Credit Directive 2008/48/EC

3 Previous attempts to regulate EU mortgage credit markets

In 1984, the European Commission published its first working paper on the freedom of establishment and freedom to provide services in the area of mortgage credit. In December 1984, the European Commission published its proposal for the first Mortgage Credit Directive.[7] However, the majority of Member States at that time were convinced that minimum harmonization seems to be necessary for mutual recognition. In 1986 a number of debates on the proposals of the Mortgage Credit Directive started within national Parliaments, but they were no longer being pursued by the European Commission.

In addition, the so called Cecchini Report[8] of 1988 assessed the costs and benefits of an integrated EC internal market for the European Commission. The Cecchini Report was based on the fact that a variety of products in each Member State should be maintained in order to guarantee a well-functioning internal market. As the Member states' support for regulating mortgage credit on the basis of mutual recognition was not very strong, the proposed mortgage Credit Directive was withdrawn by the European Commission in 1995.

After many years of silence, in 1997 Commission started negotiations between the consumer organizations and European credit sector federations in order to elaborate a voluntary Code of Conduct for pre-contractual information. The European Banking Federations and the Consumer Organizations signed the so called European Agreement on a Voluntary Code of Conduct on Pre-Contractual Information for Home Loans (2001). The main element of this Code was the elaboration of a pre-contractual information sheet with EU-wide harmonized information standards, as well as the design of general information concerning the variety of mortgage and housing loans. These two information elements should enable the consumer to compare offers on a cross border basis and to enable him to make an informed choice before signing a mortgage credit contract.

Reasons for the current proposal to regulate EU mortgage credits before the crisis

After many years of consultation,[9] a Green Paper,[10] a White Paper[11] and several studies,[12] the European Commission proposed the so called Proposal for a Directive on credit agreements relating to residential property. The European Commission was of the opinion that a competitive and an efficient mortgage market could contribute to the growth of the EU's economy. This could be achieved by removing the obstacles in the mortgage market in other Member States, completing relevant markets, enhancing product variety and strengthening price convergence, thereby creating a functional European internal market for mortgage credit.

In a study for the European Commission, consultants assessed the benefits of an integrated market for mortgage credits. They predicted that the GDP of the EU would grow until the year 2015 by 0.7 per cent and that private consumption would stimulate the growth of this GDP by 0.5 per cent.[13] This cost-benefit analysis was based on perceptions of the Anglo-American markets. Shortly before the outbreak of the crisis, these consultants proposed to introduce higher loan-to-value (LTV) ratios,[14] to establish a framework for subprime lending all over the EU and to encourage higher volume of lending by strengthening securitization as a source of lending.

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7 Proposal for a Council Directive on the freedom of establishment and the free supply of services in the field of mortgage credit, COM 84 730 final

8 Cecchini Paolo, The European Challenge 1992, The Benefits of a Single Market, 1988

9 Report on the Integration of the EU Mortgage Credit Markets from 13.12.2004 or the so called Mortgage Industry and Consumer Dialogue (MICEG) and the Mortgage Funding Expert Group (MFEG) from 22.12.2006

10 Green Paper on Mortgage Credit in the EU, COM(2005)327 from 19.07.2005

11 White Paper on the Integration of EU Mortgage Credit Markets COM(2007)807 from 18.12.2007

12 Study on consumer testing of a possible new format and content for the European Standardized Information Sheet (ESIS) on home loans from October 2009, Study of the role and regulation of non-credit institutions in EU mortgage market from 2.12.2008, Study on equity release schemes in the EU from 18.03.2009, Study on the costs and benefits of different policy options for mortgage credit from 31.03.2012

13 Study by London Economics for European Commission, DG Internal Market, The Costs and Benefits of Integration of EU Mortgage Markets, August 2005, p. 93

14 The loan-to-value (LTV) ratio is a financial and legal term in order to define the relationship between the loan amount and the real value of a the real estate, which is usually not always the purchase price.

Justification for the Mortgage Credit Directive after the crisis

Before the crisis, there was also a political wish to include certain market segments and grant them access to mortgage credits. Therefore, funding structures became more innovative; unlimited securitization and selling claims to investors seemed to raise the possibility of getting enough funding to grant new loans to customers, who would not pass any average creditworthiness test.

All this proved to be the perfect recipe for a crisis. When property prices fell, consumers were not able to pay back their loans and creditors could not foreclose on the secured property with prices they expected. Moreover, banks became bankrupt, refinancing agencies in the US went into public ownership and shock waves hit European investors since the securitized claims were worthless. What followed was mistrust of banks in Europe. In some places the retail mortgage market was hit as well, but for different reasons.

The current proposal is, according to the EU law makers, an appropriate answer to the financial crisis. The proposed Directive contains measures focusing on the process leading to the signing of mortgage credit agreements, such as advertising, information provision, creditworthiness assessment, advice and measures providing for a sound regulatory framework for the market actors involved in the granting of credit. Hence, the European Commission justifies this Directive as the answer of EU politicians to the subprime crisis in the United Kingdom and in Ireland, problems with foreign currency lending in Romania, Austria and Hungary as well as the general banking crisis and the oversupply of housing and lending in Spain.

4 Content of the proposal for a Directive on credit agreements relating to residential property

The proposed Directive on credit agreements relating to residential property is based on the competence of the EU to establish and guarantee the functioning of the internal market.[15] According to this, the representatives of the Parliament and the Council have the right to co-decide on amendments for this proposed Directive.

The main elements of the political consensus among the politicians are:

- Increased financial education,
- Business conduct standards,
- Rules for pre-contractual information and reflection periods,
- Creditworthiness assessment of potential borrowers, property valuation,
- The duty of creditors or intermediaries to explain the credit contract or grant advice to the consumer,
- Early repayment rules,
- The definition of the annual percentage rate of charge,
- Rules on product tying, qualification standards for creditors and employees but also for tied intermediaries and brokers.

Financial education

The EU identifies the financial illiteracy of consumers as one of today's main problems. Therefore new principles on financial education have been included, according to which the Member States, together with stakeholders, have to devote more attention to financial education and the creation of information documents for first time property buyers. [16] These documents should also include information regarding further assistance provided by consumer organizations and national supervisory bodies. Member States have to ensure that at the national level, measures will be in place to support the education of consumers in relation to responsible borrowing and debt management. Stakeholders at the national level should be involved in the design and development of these measures. The credit sector associations, together with consumer organizations and the regulator, will develop and draft new brochures in the future in order to fulfill these obligations.

General rules on the conduct of business

The EU Commission proposes general rules of business conduct in order to guarantee that creditors and intermediaries perform their business towards their customers with a high level of ethical and moral standards.

These general rules for the conduct of business by mortgage lenders have been amended by Parliament, so that creditors and credit intermediaries do not always have to act in the best interests of the consumer, but

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[15] Art. 114 par. 1 TFEU

[16] Art. 4a of the proposed Directive after the ECON vote, Doc No. A7-0202/2012

merely have to consider those interests.[17] Consumer representatives would argue that this outcome will result in less consumer protection. They would prefer the approach of the EU Commission, which derives from the conduct of business rules of the so called MiFID Directive in the sense that creditors always have to act in the interest of the consumer.[18] The Parliament also obliges the Member States to ensure that the remuneration structure for creditors' staff and for credit intermediaries should have no impact on their ability to give objective advice or an objective recommendation.[19]

Pre-contractual information obligations and reflection period

In order to prevent consumers taking hasty decisions, the EU Commission proposes a standardized pre-contractual information sheet and suggests a period of reflection; i.e. a cooling off period for the consumer in the pre-contractual phase. Following the ECON vote, there is now to be a standard pre-contractual information sheet for housing and mortgage loans Europe-wide.[20] This should allow consumers to compare credit offers from lenders all around Europe.

With regard to the reflection period, the consumer must in all cases have 14 days to compare offers.[21] Member States can then regulate whether this period is granted as a 14-day pre-contractual period for reflection or as a 14-day withdrawal period following the conclusion of the contract. The pre-contractual period for reflection is to ensure that the creditor's offer remains valid for at least 14 days.

Finally, Parliament's compromise will ensure that a consumer is sufficiently informed with the timely handover of the pre-contractual information sheet. Member States can keep their own legal approach to a pre-contractual cooling off-period or a withdrawal period after the conclusion of the contract. The results are the same in both situations.

Creditworthiness assessment

The mortgage crisis proved that the creditworthiness checks of some creditors were not carried out sufficiently. In the subprime segment in some markets (UK, US) intermediaries and lenders based their lending decisions solely on their hopes of increasing property prices. Securitization as a funding tool for these loans also increased the risk appetite for subprime lenders, since the risk of default has been sold to the investor.

Therefore the EU had the intention to regulate mandatory standards for credit worthiness checks within the Mortgage Credit Directive, even though EU banking supervisory standards already exist.[22] The duty of creditworthiness assessment still exists and the borrower's expenses are to be considered and where appropriate, databases can be consulted. If the credit application is rejected on the basis of consultation of a database, the creditor must inform the consumer immediately and without charge of the result of such consultations and of the particulars of the database consulted.[23]

Property valuation

The European Commission was well aware of the fact that developing property valuation standards at that point would have been too early.[24] Therefore the Commission refrained from proposing any European standard for property valuation. The Commission also did not propose any European wide standard for loan-to-value, or loan-to-income limits, as proposed by the Financial Stability Board.[25]

The new rule now provides only that Member States shall ensure that sound valuation practices be applied in accordance with international standards and methods. The importance of sound regulation and oversight of appraisers is also recognized. Member States must supply the corresponding specifications regarding property valuation and ensure that the valuation can be carried out by appraisers employed by the creditor or appoint

17 Art. 5 of the proposed Directive after the ECON vote, Doc No. A7-0202/2012
18 Markets in Financial Instruments Directive 2004/39/EC, Art. 19 par. 1
19 Art. 5 (2b) of the proposed Directive after the ECON vote, Doc No. A7-0202/2012
20 The ECON Committee rejected an amendment, which had the support of the British Members of the European Parliament, which would have allowed Member States the possibility of providing information sheets other than the European Standardized Information Sheet (ESIS).
21 Art. 9a par. 3 of the proposed Directive after the ECON vote, Doc No. A7-0202/2012
22 Banking Directive 2006/48/EC
23 Art. 9 par. 2 of the Consumer Credit Directive 2008/48/EC
24 Commission staff working document, National measures and practices to avoid foreclosure procedures for residential mortgage loans SEC(2011) 357 final, from, 31.3.2011
25 Principles for Sound Residential Mortgage Underwriting Practices from the Financial Stability Board (FSB) dated 18.04.2012

external appraisers. This valuation must be documented and retained by the credit institution. The European Banking Authority (EBA) will now have to lay down corresponding European wide supervisory standards in this respect.

Advice and obligation to provide explanations
The EU lawmakers realized that pre-contractual information may not be enough to protect consumers when they take one of their most important decisions of their financial life. Under the influence and experience of the crisis, the EU Commission had great sympathy with the approach of mandatory advice and explanation duties for creditors. Inspired by the British standards for responsible lending,[26] the Commission proposed European wide rules for advising customers.

It is now stipulated that the consumer must be informed in advance as to whether or not advice is provided. Creditors and tied intermediaries then only have to recommend the most suitable product in their product range, whereas brokers and intermediaries, who are not tied, are required to examine a sufficiently large number of products available on the market.[27] If any advice is provided, the result of this advice must be supplied to the consumer in a sustainable medium.

Member States are required to prohibit the use of the terms 'advice', 'adviser', 'independent adviser', etc. if the broker or intermediary receives commission from the creditor.[28] As a result of this, the first step has been taken at EU level towards creating fee-only financial advisers.

The obligations to provide explanations of the pre-contractual information and linked transactions, provided for by the European Commission,[29] is now consistent with the wording of the Consumer Credit Directive. Creditors and, where applicable, credit intermediaries now have to provide adequate explanations of the proposed credit agreement and any ancillary service to the consumer. This is in order to place the consumers in a position to enable them to assess whether the proposed credit agreements and ancillary services are adapted to their needs and to their financial situation. These explanations include pre-contractual information, including the ESIS, the essential characteristics of the products proposed and the specific effects they may have on the consumer. They should also include the consequences of payment default by the consumer and, where ancillary services are bundled with a credit agreement, whether each component can be terminated separately and the conditions for doing so.[30]

Credit intermediaries
The EU realized that, in certain markets, the credit intermediaries with their remuneration practices or with their ability to conduct an abusive creditworthiness assessment on behalf of the lender provided one of the reasons for the mortgage crisis.[31] Furthermore, there were no uniform rules at a European level for mortgage credit intermediaries.[32] Therefore, the EU Commission proposes, in addition to fulfilling the credit intermediaries' general obligations, to provide information concerning their status and for whom they are acting, as in the Insurance Mediation Directive.[33] Credit intermediaries who are not tied, and brokers, must provide information on remuneration paid by the creditor.[34] In sufficient time before the conclusion of a contract on the provision of services by a credit intermediary he or she must now provide the consumer with specific information. The Directive also regulates the minimum qualification requirements that the intermediary needs to fulfill in the future. The details will be regulated by the relevant Member State. The Directive also foresees that intermediaries will be registered in a national intermediary register and supervised by national authorities. In order to start a business as an intermediary, he or she must file the register application according to national law and must prove that he or she has signed an indemnity insurance agreement or has a comparable guarantee. The intermediary must also provide the qualification certificate or proof of his professional experience and evidence of his good reputation.[35]

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26 See for example the British Banking Code from 1992, or the Responsible Lending Standards from the British Office of Fair Trading from 2009
27 Art. 17 par. 3 (b) and (c) of the proposed Directive after the ECON vote, Doc No. A7-0202/2012
28 Art. 17 par. 4 of the proposed Directive after the ECON vote, Doc No. A7-0202/2012
29 Art. 11 Commission's proposal for a Directive on credit agreement relating to residential property, COM/2011/0142 final
30 Art. 11 of the proposed Directive after the ECON vote, Doc No. A7-0202/2012
31 United Kingdom, Ireland, The Netherlands
32 Unlike in the insurance intermediation or the intermediation of financial instruments business
33 Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on insurance mediation
34 Art. 10 of the proposed Directive after the ECON vote, Doc No. A7-0202/2012
35 Art. 19 of the proposed Directive after the ECON vote, Doc No. A7-0202/2012

Early repayment
One of the major issues for creditors and consumer representatives at EU level has been the rules on the right to repay a loan earlier and the limits on early repayment compensation. Some EU Members States recognize a right to repay early and limit the compensation for early repayment to a certain amount of the outstanding debt or a certain limit with regard to the interest rate. Other countries do not oblige creditors to accept the early repayment of a loan and if creditors accept the early repayment of a fixed interest rate credit agreement, they have a right to compensation.[36]

According to the vote of the ECON Committee, the consumer is, in principle, granted the right to repay early in whole or in part.[37] In such cases, creditors may not impose any penalties, but are granted a right to compensation. However, Member States may restrict the right of early repayment of credit with long term fixed interest rate agreements.[38] The compensation of the creditor may not exceed the economic loss. The consumer must be informed in a transparent manner and before the conclusion of the agreement about the method used to calculate the compensation for early repayment or the corresponding amount of the compensation for early repayment. Member States are authorized to introduce or maintain corresponding restrictions on the compensation for early repayment.[39]

Annual percentage rate of charge
One of the main elements for regulating credit law is the setting up of uniform standards in order to calculate the price of the loan - the interest rate. In order to enable consumers to compare loan interest rates, the Commission has proposed a uniform mathematical formula. According to the Commission, all costs of the credit should be included in this calculation. As an example, in the case of variable interest agreements, the creditor must inform the consumer of the highest and lowest interest rates that have applied during the previous 20 years. In the case of foreign currency loans, it is necessary in addition – also according to the proposal of the Green members of the Parliament – to indicate an interest rate which includes a possible depreciation of the national currency of 20 per cent in comparison to the currency of the loan agreement.

Variable-interest rate agreements and foreign currency loans
In the context of the current foreign currency lending crisis in some EU Member States, the members of the European Parliament brought forward some measures in order to protect consumers. The European Commission identified foreign currency lending as an activity requiring consumer protection but had not proposed any measures. The Parliament has been much more ambitious.

The ECON Committee has therefore also drawn up a new article on variable-interest rate agreements and foreign currency loans, which entitles the consumer, under certain conditions, to change the currency.[40] In the case of variable rate loans, new information obligations have been introduced in relation to the consumer. For example, the reference interest rate of the past 14 years must be made available by the lender.

Product tying
The EU Commission did not propose any legal restriction on the tying or bundling of other banking products with the mortgage credit agreement, but for the first time ever the European Parliament now proposes rules on the prohibition of certain cross-selling practices in relation to mortgage credit. Product tying in the context of this Directive means the offering of one or more ancillary services with the credit agreement in a package where the credit agreement is not made available to the consumer separately.[41]

The European Commission believes that certain forms of cross-selling practices or products, namely tying practices, where two or more financial services are sold together in a package and at least one of those services or products is not available separately, can distort competition and negatively affect consumers' mobility between providers and their ability to make informed choices.

Evaluation of the outcome of the Parliament vote

In some ways, it can be argued that the Commission's proposal has been superficial and has not really focused on the lessons of the subprime crisis. For example, the

36 Art. 488 par. 1 no 2 of the German BGB
37 Art. 18 par. 1 of the proposed Directive after the ECON vote, Doc No. A7-0202/2012
38 Art. 18 par. 3 of the proposed Directive after the ECON vote, Doc No. A7-0202/2012
39 Art. 18 par. 4 of the proposed Directive after the ECON vote, Doc No. A7-0202/2012
40 Art. 18a of the proposed Directive after the ECON vote, Doc No. A7-0202/2012
41 Art. 3 rd) of the proposed Directive after the ECON vote, Doc No. A7-0202/2012

Commission never dealt with necessary consumer protection in the area of foreign currency lending. Also the main drivers for reckless lending, funding via securitization only, have not dealt with the Commission's proposal. Instead the Commission tried to impose creditor duties similar to a guardianship towards the consumer.

After long and intensive debates the Parliament took a different approach and found an equilibrium between consumer protection and market realities. Credit intermediaries will soon be regulated similar to the insurance intermediaries with a certain level of qualification, knowledge, duties to disclose their fees and provision. Consumers will get better informed before signing a mortgage credit contract and therefore can take an informed discussion. For the first time ever, foreign currency lending will also be regulated at the EU level. The valuation of the property and the creditworthiness assessment will make credit decisions more sustainable. EBA will be mandated to further develop issues like loan-to-value or loan-to-income-limits and will draft certain standards on property valuation and elaborate common standards on responsible lending.[42]

The discussions to prevent the next mortgage crisis within the EU are not yet over. In fact, they have only just started.

Next steps

The next step within the so called co-decision procedure is for the European Parliament, the European Commission and Council to agree on compromise wordings in order to prevent a painful second reading. In the EU jargon, the means of finding a compromise are called trilog meetings. These informal meetings take place behind closed doors until a compromise is found. These trilog meetings have been invented by the EU institutions without any justification under the EU treaty in order to prevent a second reading which, to be successful, requires the Parliament to have an absolute majority of their Members. This is often difficult to organize.

According to the timetable of the European Parliament, the vote in the plenary is scheduled for the 21 May 2013, which means that this Directive could then be published in the official journal of the EU by early 2013. However, according to other priorities in the regulation of the banking area, the negotiations between Parliament, the Council and the Commission have been postponed several times. The Member States will have two years to transpose these rules into national law, probably until spring 2015.

Coming back to the 20th birthday of the Internal Market, this Directive aims to harmonize some consumer protection rules, but leaves Member States with wide discretion to implement this on national level, so that in the end, Europe will not necessarily have unified rules on EU level and cross border contracts will need to be adjusted to national consumer protection laws.

An internal market for mortgage loans becomes more and more unlikely since several EU Member States have opted to regulate the national home loan market in different ways. The diversity of rules has therefore increased, especially in the few last years. But the main reason for regulating mortgage credit has changed. The creation of an internal market is not the main target anymore. What EU lawmakers have in mind right now is increasing of consumer protection and the prevention of the next mortgage crisis.

5 Regulation of mortgage credit in other jurisdictions

Not only has the EU been very active recently in the area of mortgage credit legislation, but other EU Member States have also adopted rules for mortgage credits as an answer to the current crisis. The **Swedish** Banking Supervisor (Finansinspektionen), for example, decided to issue general guidelines limiting the size of loans which are secured with a mortgage. These loan-to-value-limits (LTV) entered into force on 1 October 2010 and prescribed that a loan collateralized by a home may not exceed 85 per cent of the market value of the real estate.[43] Recently, an expert group from the **Finnish** Ministry of Finance suggested to the Finnish Financial Supervisory Authority (FIVA) that creditors should be prohibited from granting loans which are over 80 per cent of loan-to-value ratio.[44] In **Germany** similar rules exist for Housing

42 In November 2012 EBA sent a questionnaire to national supervisors "EBA survey on national responsible lending measures and FSB mortgage underwriting principles and measures in place to assist borrowers in payment difficulties in the mortgage market"

43 Report of the Swedish Finansinspektionen, The Swedish Mortgage Market from 13.03.2012, p. 4

44 Macroprudential Regulation and Supervision of the Financial Market/Report by the Working Group, 32/2012 from 6.11.2012

Savings Institutions (Bausparkassen) which are only entitled to grant loans with a LTV of 80 per cent.[45] Banks in Germany which wish to refinance their mortgage credit with 'Pfandbriefe' (German covered bonds) even have to observe an LTV-limit of 60 per cent.[46]

The **Spanish** government recently reformed certain rules concerning the foreclosure of secured property in the light of the current crisis. According to a Royal Decree, from spring 2012 different mechanisms have been introduced in order to allow the restructuring of the mortgage debts of debtors who are suffering from specific financial difficulties.[47] This Decree foresees the possibility of re-arranging the payment obligations and attempts to increase the flexibility of foreclosures of *'right in rem'* guarantees. A further reform of the Spanish mortgage market was introduced in November 2012.[48] It included specific measures for setting a certain limited time limit, such as the immediate cessation of evictions for a period of two years for all households which were in a specifically vulnerable position.

In the **United Kingdom,** the British Banking Supervisor (FSA) started already in October 2009 with a massive consultation process on the reform of the mortgage market. The consultation document of October 2009 covered a wide range of topics and proposals to avoid situations such as those experienced by British consumers during the financial market crisis. In this paper, the FSA designated two key objectives for the mortgage market: that the mortgage market should be sustainable for all participants and that the regulatory regime in this respect must be predictable, clear and transparent and that the mortgage market should stay flexible for consumers and should offer a wide range of products corresponding to the needs and wishes of various consumer types.

After almost four years of consultation, the FSA finally published its final rules for the mortgage credit market in October 2012.[49] The main elements of these new rules were the provisions for the so called affordability assessment as well as an interest rate stress test, assuring that consumers would be able to repay the mortgage. The new British rules will shift more responsibility to British mortgage lenders in order to prevent consumers signing credit contracts they would not be able to pay back. After a long debate the British supervisor opted to continue to allow "interest rate only loans" but introduced an obligation for borrowers to guarantee that they clearly understood this loan contract and prove that they have a credit repayment strategy. The FSA made clear that the lender is not responsible for the performance of the repayment strategy.

Would the EU Mortgage Credit Directive have an impact on these markets?

The question for lawmakers should be; would the implemented Mortgage Credit Directive have prevented the crisis? If one assesses the above mentioned national measures for these relevant mortgage markets one could have doubts.

National law makers tend to address the specific problems and malfunctions in the market. The EU has a more global perspective and does not take individual mortgage markets with their different funding structures or real estate markets into account. National governments can be more efficient and impose measures such as LTV limits as in Sweden. However, the EU Commission is well aware that setting up LTV limits can endanger certain markets, in which property prices are high and consumers usually have no own savings. The EU would also have difficulties in proposing uniform LTV limits for all 27 Member States.

Setting up pre-contractual reflection periods could slow down hasty property markets or exclude certain consumers from the market. European rules on preventing creditors foreclosing on secured properties would be contradictory to European Banking Supervisory rules, which oblige creditors to always have recoverable securities. In the area of mandatory information disclosure, the EU and the UK for example have similar intentions. It is very likely that the existence of better informed consumers will be essential for preventing further over-indebtedness. In the end, however, it is still the consumer who should take the decision to buy the real estate or not.

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45 Art. 7 par.1 German Bausparkassen Act
46 Art. 14 of the German Pfandbrief Act
47 Royal Decree Law 6/2012, of March 9, on urgent measures to protect mortgage debtors without resources (the "RDL 6/2012") which came into force on March 10, 2012
48 Royal Decree 27/2012 on urgent measures to reinforce the protection of mortgage debtors from 15.11.2012
49 FSA: PS 12/16 Mortgage Market Review: Feedback on CP11/31 and final rules from 25 October 2012

One thing is clear. Proposing a European Directive for mortgage credit in order to create an internal market, where lenders and consumers can take advantage of offers and shop around, will not work, until the Directives can be harmonized enough to create a certain minimum level of consumer protection and Member States can regulate their market on their own. However, it was probably necessary to react, as some national governments did, in order to heal the malfunctions of their own mortgage markets.

6 The US mortgage reform - a copy from the EU?

In the **US**, the famous Dodd-Frank Act,[50] with its 1601 articles, changed the legal landscape for mortgage lenders and consumers. This federal law was intended to be the US federal legislators' response to the subprime mortgage and financial sector crisis in the United States.[51]

The Act changes the existing regulatory structure, creating a host of new agencies on a federal level and increasing the oversight of specific companies and financial institutions regarded as systemic risks. It tightens the regulations relating to credit rating agencies, equity, and deposit insurance, introduces restrictions on mergers and acquisitions of depository institutions, establishes standards for mortgage lending, deals with financial remuneration of heads of institutions, and regulates hedge funds and the minerals trade. It also includes extraterritorial provisions aimed at combating corruption.

In total, the Act contains more than 400 statutory authorizations for subordinate federal authorities in order to develop regulations and standards. Title XIV, which deals with mortgage lending, is called the Mortgage Reform and Anti-Predatory Lending Act. The regulations apply to all mortgage creditors, but specific provisions were introduced for three types of mortgage credit agreement: higher-risk mortgages, qualified mortgages,[52] and high-cost mortgages.[53]

New duties for lenders and brokers

These provisions of the Dodd-Frank Act have implications for mortgage brokers and creditors, who must comply with mortgage lending standards. The Act also prohibits certain lending practices, imposes restrictions on the payment of certain types of compensation to intermediaries, obliges the creditor or originator to comply with information and disclosure requirements, limits early repayment penalties, and establishes professional standards for appraisers.

In addition to the duties imposed by otherwise applicable provisions of the law relating to compliance with consumer protection legislation, each mortgage originator must be registered and licensed as a mortgage originator in accordance with the applicable state or federal law. [54]

Limits for the remuneration

The Act states that, for any residential mortgage loan, no mortgage originator may receive from any person, and no person shall pay to a mortgage originator, directly or indirectly, compensation that varies based on the terms of the loan.[55] These anti-steering provisions are intended to prevent mortgage intermediaries from recommending loans based on the amount of compensation (i.e. fees) they receive.[56]

Furthermore, the originator may henceforth receive compensation from one party only.[57] Similarly, the European Commission proposed that the staff of credit intermediaries possess an appropriate level of knowledge and competence.[58]

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50 Dodd-Frank Wall Street and Consumer Protection Act" in force since 21 July 2010

51 Previously, federal regulations on mortgage lending were mainly contained in the Truth in Lending Act (1968) and the Home Mortgage Disclosure Act (1975) Mortgage Reform and Anti-Predatory Lending Act. (2007)

52 Section 1414 Dodd-Frank

53 Section 1431 Dodd-Frank

54 The term used in Section 1401 (2), i.e. "originator", is much broader in scope that the term "creditor".

55 Section 1403 Dodd-Frank

56 Article 5(2) of the European Commission's proposal for a Directive on credit agreements relating to residential property contains a similar provision: the manner in which credit intermediaries are remunerated must not impede compliance, by the creditor and credit intermediary, with the obligation to act in accordance with the best interests of the consumer.

57 Section 1403 (4) Dodd-Frank

58 Article 6 of the European Commission' s proposal for a Directive on credit agreements relating to residential property

In the Dodd-Frank Act, a distinction is made, for the first time, between two categories of mortgage; the aim being to provide the credit industry with incentives for responsible lending. To that end, mortgages are classed as either 'qualified' or 'not qualified'. As an incentive to provide qualified mortgages, Section 941 of the Act amends Section 15G of the Securities Exchange Act so that these loans can be securitized to 100 percent. The retention of not less than five percent of the credit risk by the securitizer applies only to any asset that is not a qualified residential mortgage. In contrast, European law contains a requirement for the retention of randomly selected exposures, equivalent to no less than 5 percent of the nominal amount of the securitized exposures, in all cases, irrespective of "quality".[59] In both jurisdictions law makers realize that securitization and reckless, underlying, underwriting standards can present a great risk to overall financial stability.

Therefore on both sides of the Atlantic mortgage lenders need to take on more responsibility, if they fund their mortgage credit contracts by securitizing their claims, so that they can at least partially cover the potential losses of the transaction.

Early repayment rules under US law

The Dodd-Frank Act also changed the rules on compensation for early repayment for mortgage credits. Section 1414 (3) deals with penalties for the early repayment of qualified mortgages. During a one-year period beginning from the date the loan is consummated, the prepayment penalty may not exceed an amount equal to 3 percent of the outstanding balance of the loan. During the second year, the prepayment penalty may not exceed an amount equal to 2 percent of the outstanding balance on the loan. After the end of a three-year period, no prepayment penalty may be imposed on a qualified mortgage.

Particular standards of information and disclosure apply to mortgages with negative amortizations, which occur when the loan payment for any period is less than the interest charged over that period, so that the outstanding balance of the loan increases. The creditor must provide the consumer with a statement that the pending transaction will or may, as the case may be, result in negative amortization, and an explanation of what negative amortization means must be provided to the consumer. No creditor may extend credit that results in negative amortization unless these requirements are met.[60] The European counterpart, the Mortgage Credit Directive, does not deal at all with regulating the amortization of loans. European lenders will only be obliged to explain the relevant amortization structure within the pre-contractual information sheet.

Disclosure

According to the new rules concerning disclosure requirements the creditor is required during the contract period to transmit certain information to the obligor for each billing cycle.[61]

The Bureau of Consumer Financial Protection is charged with developing a standard form for the disclosures required. Analogous to the European Commission's proposal for the mortgage credit Directive,[62] US law requires[63] that the creditor gives certain warnings to the consumer.[64]

The Dodd-Frank Act also introduces amendments to the Truth in Lending Act, stating that no creditor may propose an offer for a residential mortgage loan unless the creditor makes a reasonable determination in good faith that the consumer has a reasonable ability to repay the loan.[65] This determination should include consideration of factors such as the consumer's credit history, their current and expected income, their debt-to-income ratio, their employment status, and their other financial resources.

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59 Article 122 a) of Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions inserted by Directive 2009/111/EC of 17 November 2009 Directive 2006/48/EC

60 Section 1414 (2) f) Dodd-Frank

61 Section 1420 Dodd-Frank

62 Article 9 (Pre-contractual information) of the European Commission's proposal for the mortgage credit Directive on credit agreements relating to residential property

63 Section 129B of the Truth in Lending Act

64 "You are not required to complete this agreement merely because you have received these disclosures or have signed a loan application." Or: "If you obtain this loan, the lender will have a mortgage on your home. You could lose your home, and any money you have put into it, if you do not meet your obligations under the loan."

65 Section 1411 Dodd-Frank

Article 14 of the European Commission's proposal for the so called Mortgage Credit Directive contains a similar provision related to the obligation to assess the creditworthiness of a consumer. If the assessment of the consumer's creditworthiness results in a negative prospect of his ability to repay the credit, the creditor is obliged to refuse the credit.

The Act also contains a requirement for the creditor to provide a written notice to the consumer describing the protection provided by the anti-deficiency law and the significance for the consumer of this legislation.[66] The creditor must disclose to the borrower the creditor's policy regarding the acceptance of partial payments and how such payments will be applied.[67] During the one-month period that ends six months before the date on which the interest rate adjusts or resets, the creditor must provide the borrower with information about the index or formula used in making adjustments to or resetting the interest rate, a good faith estimate of the amount of the monthly payment that will apply after the date of the adjustment or reset, and a list of alternatives consumers may pursue.[68]

New regime for subprime credits under US law

An entire subsection of the Dodd-Frank Act deals with what were previously known in the EU as 'subprime mortgages'.[69] Reflecting the higher risk associated with lending to less creditworthy borrowers, resulting in higher rates of interest therefore being charged, these are termed in the Dodd-Frank Act 'high-cost mortgages'. The Act defines this as meaning a consumer credit transaction in which, in the case of a credit transaction secured by a first mortgage on the consumer's principal dwelling, the annual percentage rate will exceed the average prime offer rate by more than 6.5 percentage points. In the case of a subordinate or junior mortgage on the consumer's principal dwelling, the annual percentage rate at consummation of the transaction will exceed the average prime offer rate by more than 8.5 percentage points. The Bureau of Consumer Financial Protection is authorized to increase or reduce the interest rate differentials for this group.[70]

A creditor may not charge a consumer any fee to modify, renew, extend, or amend a high-cost mortgage, to defer any payment due under the terms of the mortgage, or charge a fee for a monthly statement. Nor may the creditor extend credit to a consumer under a high-cost mortgage without first receiving certification that the consumer has received counseling on the advisability of the mortgage.[71]

Compared to the EU, the Mortgage Credit Directive does not make any distinction between the available mortgage credits for average consumers or for subprime customers.

7 Conclusion

This comparison of the extensive Dodd-Frank Act with existing European legislation and legislative proposals currently under discussion shows that legislators on both sides of the Atlantic draw inspiration from each other and are involved in proposing and adopting sometimes identical provisions, despite the disparities in contexts. It is by no means the case that European lawmakers copy US ideas; on the contrary, some regulatory concepts which originate in Europe can also be found in US law. The reason for these parallel legal reforms around the globe is the commitment of the political leader of the G20 States and their political wish to guarantee a more stable legal and financial environment for banks and prevent further banking crisis.

What is striking, however, is that the European law and the relevant reforms in some EU Member States pertaining to the regulation of the financial markets are far more detailed and progressive than US federal law.

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66 Section 1414 (3) g) Dodd-Frank

67 Section 1414 (3) h) Dodd-Frank

68 Section 1418 Dodd-Frank, amending the relevant Section 128 of the Truth in Lending Act. Since the introduction of the Risk Limitation Act (Risikobegrenzungsgesetz) of 12 August 2008, German law, for example, states in Section 492a of the German Civil Code: "If a fixed interest rate is agreed in the loan contract, and if the fixing of interest ends prior to the time determined for repayment, the lender shall inform the borrower at the latest three months prior to the end of the fixing of interest whether he is willing to reach a new agreement as regards interest and if so, on what terms."

69 Sections 1431-1440 Dodd-Frank deals with high-cost mortgages.

70 Section 1431 (1) Dodd-Frank

71 Section 1433 u) Dodd-Frank

Will these measures prevent the next mortgage crisis?

Law makers tend to react and fix problems in order to prevent specific malfunctions in the market happening again. If the legislation is well targeted, the same problem might not occur a second time. Hence, the main task of the legislator is to identify problems in order to solve them.

This summary of some legislative proposals shows that the malfunctions of some national markets have been identified differently, but that the chosen legal measures are quite similar. This includes the British, US and EU approaches to information disclosure for mortgage credit contracts or the common approaches in the US and the EU concerning the mandatory retention of 5 per cent of the credit risk by the securitizer on its own balance sheet. As a summary, one can observe that consumers will be better protected and better informed. Some mortgage products will disappear, such as the UK's so called self-certified loans, or foreign currency mortgages in Eastern Europe and for some consumers it will be harder to find an individual mortgage credit product.

There is a danger that uncoordinated national mortgage market reforms will again contradict the goal of the EU and its currently debated Mortgage Credit Directive in order to create an internal market for these loans. It will probably be even harder, after the crisis, to offer and demand cross border loans within the EU.

Therefore, it seems very unlikely that the EU Mortgage Credit Directive will have a substantial effect, at least for the integration of EU mortgage markets. One major effect of the crisis can already be observed; the pull-out of certain retail-orientated foreign banks. One of the side effects of these European political compromises in this field will be that the intended harmonization of laws and rules will only happen in the area of disclosure, meaning the rules concerning the information requirements in the advertisement and pre-contractual phase. Consumers in future may take a more informed choice, if they read and understand the newly introduced information.

Although the definition of the Annual Percentage Rate of Charge (APRC) is harmonized, the price of a loan will not be comparable in the future since different local or national costs need to be included in the APRC such as e.g. national stamp duties, different fees for registering the land charge, mandatory insurance fees and so on. The European mortgage market will therefore not develop into a more integrated internal market. Hence, the loan product which is still a legal contract will not be traded across borders easier, since it will still need adjustments that are costly for creditors.

Furthermore, consumers will not shop around in the EU and search for the best mortgage credit offer. Not only do we still have 11 currencies but banks will also refuse serving customers in a foreign legal jurisdiction. On the other hand, creditors can open branches and subsidiaries in other EU member States and under national offer law mortgage credit products. However, credit institutions do not need the mortgage credit Directive for such common practice to take place.

The assumption that the implemented mortgage credit Directive will make mortgage markets safer and more resilient to crisis is probably no more than political wishful thinking, so as to justify these legal changes. Subprime lending, reckless securitization practices, mortgage insurance, foreign currency lending, high LTV loans will still be possible.

However, one positive side effect of this Directive will be that consumer protection within Europe will be higher. This is one of the main goals of the European Union. According to Art 169 of the Lisbon Treaty, the European Union also has to promote the interests of consumers and ensure a high level of consumer protection. Therefore the Union will contribute to protecting the health, safety and economic interests of consumers, as well as promoting their rights to information, education and to organise themselves in order to safeguard their interests. Thus, one can conclude that the EU has at least completed this mission in the area of mortgage credit.

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