



The ICA Publication Series

Competition after collapse

Report 2/2011

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Part I Conclusions

This part contains three sections: firstly, a description of the goal of the report and the events which led to the writing of the report; secondly, a summary of its substance; and finally, its principal conclusions.

1. Preamble

In November 2008, the Competition Authority issued an opinion directed at banks and government agencies on the importance of taking competition into account in decisions relating to the future of companies on competitive markets.¹ In the same month, the Authority published No 2/2008 – *Vigorous reconstruction – the opening of markets and strengthening of economic activities*, which pointed out the necessity of restarting dynamic development in the Icelandic economy in the wake of the collapse of the banking system. In the light of the above, it is very important to maintain and if necessary to promote and increase competition. The Competition Authority pointed out that competition is not a goal in itself, but rather a tool for increasing public welfare. Furthermore, competition leads to lower prices, creates jobs, contributes to economic progress and motivates businesses to do more for their customers.

The report on the dynamic development of markets contained 120 proposals for the opening up of markets. These proposals were presented to the government, municipal authorities and commercial enterprises. The report was subsequently followed up in December 2009 with a discussion paper on banks and the restructuring of companies.² The report contained a discussion of the 17 core views that the Competition Authority believes should be taken into consideration during the restructuring of commercial concerns.

Thirty-two months have elapsed since the collapse of the banks. As expected, this period has proved difficult. Households and companies have fought the consequences of a severely devalued króna and the collapse of the banks; the government has tackled the Treasury's problems in co-operation with the International Monetary Fund (IMF); the reorganisation of the banking system has proved complicated and time-consuming and reaching a settlement with the past is far from complete. Moreover, there is no unity as regards long-term or short-term national economic policies. Furthermore, Icelanders have experienced international disputes and natural disasters that have directed the world's attention to the country and its populace.

A dynamic and efficient business environment is a prerequisite for the economic wellbeing of Iceland. The business sector is the source and producer of value that pays the workforce's wages and provides government agencies with the capacity to maintain the infrastructure of the society. For this reason, the financial restructuring of companies is a key issue in the development of the economy.

¹ Opinion of the Competition Authority No 3/2008, *Decisions made by banks and government agencies regarding the future of companies in competitive markets*.

² See the Competition Authority's Report No 2/2009, *Banks and the restructuring of undertakings – policy formulation, December 2009*.

In this report, the Competition Authority intends to put forward its views on the status of the business sector and its restructuring, and on the competition on the markets. The goal is to encourage debate about solutions to the problem of restructuring companies and thereby to endeavour to speed up the necessary actions.

The report is based on the Competition Authority's investigation into the financial position and financial restructuring of 120 large companies in selected competitive markets (Part II). Moreover, the report reviews the financial position and development of business sectors since the collapse (Part II), assesses whether account has been taken of core views on the restructuring of companies (Part III) and describes the progress of the proposals for the opening up of markets that were put forward in the above report on this topic.

The report sets out the views of the companies from whom the Competition Authority sought an opinion in preparation of the report. In addition to written viewpoints submitted by companies, the Authority has had meetings with 70 representatives of companies, banks, consultants, experts and entities from within the government. Furthermore, the Competition Authority has obtained a range of views from the banks in connection with investigations into bank takeovers of commercial concerns. The report can be said to be a message to banks and government agencies concerning the restructuring of companies and competition on the market.

The report and the information obtained on the standing of individual companies will be of use to the Competition Authority in its monitoring of the banks' ownership of companies. The report will also be of use as a foundation for further work on cross-ownership ties and business conglomerates.

2. Summary

The collapse has had a considerable impact on competition in individual business sectors and on the competitive position of companies. Financial restructuring of companies, composition and bankruptcy lead to changes to the status of companies with respect to other companies in their field. This is inevitable. There is a pressing societal need to resolve the debt problems of viable companies as quickly as possible.

Banks control over 46% of ownership interests in companies, according to the Competition Authority's investigation of 120 large companies in selected competitive markets. These include companies in very poor financial shape which do not control their own fate. The share of individuals is 29%, that of resolution committees is 7%, that of pension funds is 7% and that of others is 11%. The ownership interest of banks was 68% when it was at its highest after the collapse. The situation, therefore, is poor although it is improving.

The financial position of just under half of the larger companies is very poor in the opinion of the Competition Authority, while a fifth of companies are in good condition. Just under a third of companies have completed their financial restructuring while the same proportion are of the opinion that they do not need restructuring.

The problems posed to the business sector can be traced back to the fact that the financial restructuring process of companies is too slow, its implementation is viewed with dissatisfaction and there is a lack of trust and transparency. Moreover, the financial position of many companies that have completed their financial restructuring remains poor.

There is a risk that competition will drop considerably in the long term due to lack of capital needed for new entities to enter the market. In addition, the strong position of companies in oligopolistic markets, who may be in a position to increase prices.

The system contains disincentives that delay the financial restructuring of companies. Without the correct incentives, the banks will retain companies for longer than can be considered beneficial to the national economy. A new temporary industry has been created, i.e. restructuring and sale of assets. The interest of the industry's employees in revenue generation and job security works against society's interest in a rapid resolution. The fear of making decisions and making mistakes is holding many people back under the present circumstances. The system does not reward those who take the initiative.

The demand for complete non-discrimination is one of the reasons that the process of corporate financial restructuring is taking so long. The problem is that perfect justice does not exist and that the definition of justice and non-discrimination is dependent on the position and opinion of the individual. No two restructuring processes in larger companies are the same. The banks need to have scope to make sensible decisions based on pre-defined rules.

The Competition Authority enjoins the banks to keep to already-designated deadlines for the sale of companies, and to clear indirect shareholdings in companies without undue delay. Furthermore, the Authority puts forward ideas that could assist in the resolution of this problem even though the ideas do not strictly come under the scope of the

Competition Authority. Moreover, the Competition Authority criticises the authorities for not having in general paid sufficient attention to actions to strengthen competition over the past few years. There are too many obstacles in the way of parties who wish to gain a foothold in competitive markets.

3. Conclusions

3.1. The problems posed to the economic sector and to competition

Resurrecting the Icelandic economy after its collapse is a demanding and complicated task. The losses suffered by Icelandic society and creditors were enormous, trust evaporated, and problems that appeared insurmountable were to be seen everywhere. Under no circumstances was it possible to assume that the resurrection would be smooth and that no-one would consider himself unfairly treated. Thankfully, many companies are in good shape and a number of growth areas have flourished after the collapse. The finances of many companies have improved over the past two years and many companies have undergone financial restructuring. Nevertheless, the status of the business sector is poorer than it needs to be at this point in time. There is good reason to respond to this fact. Disincentives must not lead to a long-term stagnation.

The problem facing the business sector is systemic and more deep-set than short-term statistics are able to reflect. In the opinion of the Competition Authority, the root of the problem can be traced back to three main issues.³

Firstly, the restructuring of the business sector is taking too long.⁴ The reasons for this are numerous and can be traced back to the banks, government agencies or systemic disincentives which are discussed in greater detail in Section 3.2. Among the larger companies in Iceland, a greater number have yet to complete their financial restructuring than have done so. In the presence of any uncertainty about their financial restructuring, companies are not capable of investing or making other major business decisions. The companies that are in better shape have very limited access to capital.

Secondly, there are many indications that those companies that have undergone financial restructuring have emerged too debt-ridden from such restructuring, particularly those who went at the early stages through the process with the banks. Thus the Competition Authority is of the opinion that the financial position of half the companies who have completed their financial restructuring is very poor. If important and viable companies are kept too leveraged it works against the economic recovery and also disrupts competition.

Thirdly, commercial companies are of the opinion that their competitive position is subject to a considerable uncertainty. Thus there is substantial dissatisfaction among companies as regards the financial restructuring, which they consider unfair, lacking in transparency and inefficient. Companies that carry little debt think that financial

³ Other economic factors, such as tax issues and foreign currency restrictions, may certainly cause uncertainty and lead to companies refraining from action. These aspects, however, are not directly within the scope of this report and are therefore not discussed here.

⁴ This view is also stated in the Central Bank of Iceland's report, *Financial Stability*, 1/2011.

prudence is held in low esteem, when they see debts resulting from the investments of their competitors being cancelled. Furthermore, information on the position of competitors is based on vague or unclear sources. Most of these companies have little trust toward the banks and the government agencies.⁵

Long-term uncertainty among a majority of companies leads to stagnation and ultimately to poorer living standards. As a consequence the competitiveness of the business sector will gradually decline and the will, ability and boldness of pioneers to advance on the market and create jobs will also decline. There is no doubt that a dynamic business sector, with an economical division of resources, access to funds for investment and few impediments to market access, is a necessary framework to create the dividends on which the welfare of Icelanders is based.

There is a risk that competition will decrease in Iceland in the long term. This is firstly due to limitations in the financing of new projects. This makes it difficult for pioneers to enter the market.⁶ It may be assumed that lack of capital is one of the largest barriers to enter markets in the current conditions. Another reason is that there is a risk that reductions in income along with financial difficulties will tempt many companies who hold a strong position in an oligopolistic market to take advantage of this position and raise prices. Companies may even be tempted to abuse their market dominant position or engage in illegal collusions for this purpose. The consequence is that the public and the economy suffer, e.g. due to the resulting increased inflation and poorer living standards.

3.2. Disincentives in the system

The banks are in a difficult position when it comes to the resurrection of the business sector. They maximise the value of their assets for their owners to the extent they consider it economical. This can, however, sap the energy of the banks' future customers. This is a sensitive situation that by its nature can lead to conflict.

The most pressing problem that must be addressed is first and foremost systemic. There is simply not enough incentive for the banks and other compulsory shareholders to complete the restructuring of companies and to quickly and securely sell the companies they possess. In this context, however, mention must be made of the fact that in some cases the banks have undertaken to sell companies within a particular deadline according to conditions set by the Competition Authority for the banks' takeover.⁷ Without an incentive to sell, there is all likelihood that the banks would own the companies for longer than can be considered economical for the economy as a whole. The sale would be delayed until the banks were certain that they could obtain a good price. This would mean that the sale of companies would not generally take place until the banks had

⁵ The survey carried out by MMR and Vidskiptabladid in 2011 among managers clearly shows the pessimism of company managers and their dissatisfaction with the way things are progressing. Thus approximately 70% of managers believe that morality, trust and transparency in the business sector are very poor or rather poor. Furthermore, 42.5% of managers believe that an unhealthy competitive environment is one the main threats posed to the operation of their company in the coming year. Only a downturn in domestic consumption was considered a greater threat than an unhealthy competitive environment. See Vidskiptabladid, 28 April 2011.

⁶ This applies first and foremost to the fact that traditional distribution routes of funds through the lending system are largely closed and access to finance through this system will be more difficult in the future than has previously been the case. On the other hand, the great interest shown toward offered companies indicates that investors are interested in investing in the business sector.

⁷ In this context, mention may also be made of the fact that Article 22 of Act No. 161/2002 on Financial Undertakings states that banks may only pursue activities other than further specified banking operations on a temporary basis and for the purpose of concluding transactions or reorganising the activities of customers.

made the company in question more sellable in their own view, i.e. by restructuring its operations and perhaps its mission.

There is international consensus that banks are not well suited to running businesses. This is because it may create a conflict of interests when banks provide financial services to business companies and own such companies at the same time. The necessary restructuring of companies is much more difficult and more sensitive if they are owned by a bank, for example, when it comes to changes in human resources. It is vital that banks allow other more suitable entities to restructure companies without undue delay.

However, the banks must be given reasonable scope to tidy up loose ends in the finances of companies taken over, before the companies are formally offered for sale. Financial restructuring is usually complicated and no two cases are alike. Various factors can increase the level of complication in the restructuring process, such as the number of claimants, guarantees between companies within groups and relations and contracts involving foreign trademarks. However, banks must also be required to work quickly and firmly in the financial restructuring of companies.

A large group of people is employed in cleaning up after the collapse, including those managing assets in resolution committees and banks and those who work in a range of expert related support services. There is no question that these jobs are temporary and that the people holding them will need to find new jobs once the clean-up process has been completed. There is a danger that the transfer to new and profitable jobs will take too long. People may get stuck in a comfort zone and learn to take advantage of this new unsustainable system. The same applies to various managers of companies who act as receivers for assets with other and lesser requirements than would be made to them under normal circumstances as managing directors of companies. If the problem becomes entrenched it will lead to reduced competitiveness in the business sector. This should not be taken as a criticism of the persons involved, nor is there any doubt as to their good intentions. Instead, attention is drawn to this systemic negative incentive and the importance of developing and applying positive and reasonable incentives and restraints to hasten the process.

In this context it should also be noted that the fear of making decisions and making mistakes is holding many people back under the present circumstances. The system does not reward those who take the initiative. This problem is endemic throughout the system. There is an instinctive tendency to restrict the authorisations of individual employees and loan committees in banks. Creditors and companies endeavour, during the financial restructuring of companies, to avoid the media spotlight and the blogosphere and the negative distractions and gossip considered to accompany such attention. It could be argued, however, that there would be less gossip and rumour, and greater trust, if the correct information was available and accessible.

In short, the main disincentives are as follows:

- 1) "Handling problem" (Moral hazard problem 1.) This is reflected in the fact that entities engaged in resolving problems receive a substantial income as a result and base their livelihood on this. Despite good intentions, their interest in revenue generation and job security works against society's interests in a rapid resolution. These entities are the resolution committees, employees in the banks' resolution processes, the employees of the companies in question, etc.

- 2) "Management problem" (Moral hazard problem II.) This relates to those who manage commercial companies under the control of banks becoming used to having the bank as the owner or sponsor and used to being free from the necessary discipline in decision making in the operation of the companies. It can also mean that managers of the companies do not have sufficient interests in ensuring that the operation is successful, as they may even intend to purchase the company themselves from the bank in question later on, for as low a price as possible.
- 3) "Owner problem". This relates to the banks' creditors having an interest in getting as much as possible out of claims lodged against the company. Such interests are, on their own, a normal part of a bank's operation, although this may have a negative impact if the short-term interest of the bank's owners in being reimbursed for losses overshadows the long-term interests of building and maintaining business relationships and thereby ensuring a sound foundation for business operations and a dynamic economy. There is a risk that too many claimants will take the short-term view in this sense although many are probably aware of the importance of not being too hard on future customers.
- 4) "*Decision-making problem*". This relates to the managers and employees of the banks seeking, in light of experience, to make every effort to avoid making mistakes and, at the same time, being constantly criticised for the decisions they make in the restructuring of companies. This also applies, in many respects, to decisions made by government agencies relating to the economic sector. Furthermore, the managements of banks had, at least in the beginning, a rather vague mandate for making decisions.
- 5) "*Fairness problem*". This relates to the powerful demand for fairness and non-discrimination in corporate financial restructuring. As is further described in Section 3.3, the emphasis on protecting companies from the negative consequences of removing the debts of competitors can delay and reduce the necessary clean-up of a company's debts.

The Competition Authority is of the opinion that these incentives must be addressed to prevent stagnation, such as occurred in Japan after their banking crisis in the 1990s. This decade has generally been called the "lost decade" in Japan. The problem was first and foremost that the banks did not foreclose on companies that defaulted on their loans or failed to embark on necessary restructuring. Instead, loan terms were extended and advances increased. Companies in this condition have been called zombie firms – that is, companies that are not only highly leveraged but also inefficient and uneconomical.⁸

3.3. Full non-discrimination cannot be ensured.

Among commercial enterprises, there is a loud demand that the financial restructuring of companies will be for fair and non-discriminatory. Demands thereto have also come from politicians. It is widely considered that non-discriminatory treatment regarding the resolution of debt issues has not been ensured, and that the restructuring process frequently leads to unfair conclusions. Companies carrying little debt, moreover, think that financial prudence is held in low esteem when they see debts resulting from the investments of competitors being cancelled. The expectations of debtors regarding

⁸ See e.g. Ahearne, Alan G. and Naoki Shinida: Zombie firms and economic stagnation in Japan, *International Economics and Economic Policy*, November 2005 and Dick K. Nanto, *The Global Financial Crisis: Lessons from Japan's Lost Decades of the 1990s*, Congressional Research Service, May 2009.

agreements with banks, however, are frequently based on an unrealistic view of their own position or rumours about solutions that other companies were granted.

It is understandable that managers of well-run companies who have exhibited caution and prudence in their management resent seeing banks writing off the debts of competitors who have been less careful. Regarding such aspects of fairness, one must bear in mind that there are pressing societal interests at stake and it is necessary that the debt problems of viable companies will be speedily and adequately dealt with. Generally speaking, it is to the advantage of consumers and the economy as a whole that banks write off debts or otherwise reduce the excessive debt burden of going concerns. The application of competition legislation should not prevent this.⁹

The Competition Authority has previously reiterated that the Competition Act and its application is not meant protect competitors, but rather to protect competition in general and the long-term interests of consumers and the general public. For example, the restructuring of companies in connection with composition, as provided for in law, commonly has a negative impact on the position of competitors due to increased competition from the restructured undertakings. This increased competition, on the other hand, generally has a positive effect for consumers.

Over-leveraged companies do not promote dynamic economic activity. The overall interests of society call for the effective financial restructuring of companies. The chain reaction launched by debt relief for one company with negative consequences for another competitor is therefore in many respects a necessary part in the rearrangement that has to take place, and, by the same token, will lead to new competitive challenges. At the same time, consumers are ensured gains from such competition in the form of lower prices and therefore there is less danger they will be made to suffer from insufficient competition between heavily leveraged companies.

In the same manner, the owners of companies undergoing restructuring will have to accept the loss of their ownership interest unless there are specific circumstances and arguments that recommend otherwise.¹⁰ The Competition Authority's investigation has shown that 70% of companies that have completed their financial restructuring have had a change in ownership.

The demand for fairness and non-discrimination is one of the reasons that the process of corporate financial restructuring is taking so long. Public debate places great emphasis on the necessity of non-discrimination and banks are frequently criticised when they complete the financial restructuring of a company. The problem is that it is very difficult to come to any conclusion about what fairness or justice really involves in this field, or how to achieve it. In this respect, it is important to understand that the definition of justice may depend upon the viewpoint and circumstances of each individual. Naturally, it is important that banks take account of the principle of equality in their work, but they must also consider the fact that no two companies are in exactly the same position. The owners and managers of companies are frequently faced with the choice of either to lose

⁹ As provided for in the Competition Authority's Discussion Paper No. 2/2009 on banks and the restructuring of undertakings. The Competition Appeals Committee, moreover, agrees with these views in Ruling No. 18/2009, *Síminn vs. the Competition Authority*.

¹⁰ Discussion Paper No. 2/2009, *Banks and the restructuring of undertakings*, discusses this issue in greater detail.

the company or renegotiate the debt. The banks must have the scope to take sensible decisions.

The Competition Authority, therefore, is not of the opinion that business enterprises in general should be protected from the negative consequences of debt relief that is granted to their competitors. Such debt relief can promote competition and thereby improve the general public's economic situation. Nevertheless, the resulting mistrust and dissatisfaction in the economic sector is a cause for grave concern. This mistrust can have a negative impact and indicates that the banks have not succeeded in providing satisfactory information on the actions they have taken and the reasons for them.

In this respect, it is vital that the banks are able to work according to an established and credible process presented to the business sector and government agencies. Thus the banks must, in their actions, minimise the risk that they, by improper and harmful means have an effect on the "natural selection" in the operation of companies. An example of this is the disappearance of a viable company from the market as a result of a clearly non-viable company having being kept alive. One way the banks can ensure this by being frank about the operation of companies that they have taken over and by setting them clear and reasonable profit objectives. The Competition Authority has sought to ensure this by imposing conditions on the banks' takeovers of companies.

3.4. The majority of larger enterprises are under the control of banks and resolution committees

The proportion of larger companies that are formally owned by individuals in important competitive markets has dropped from 85% in 2007 to 48% in 2011. This is the conclusion of the investigation performed by the Competition Authority into the financial position and financial restructuring of approximately 120 large companies, which together are responsible for almost half the operating income in the business sector. At the same time, bank ownership has grown from 2% to 17%; resolution committee and creditor ownership has grown from 0% to 12%; and pension fund ownership has grown from 2% to 9%.

The Competition Authority, however, feels that the above percentages do not provide a true picture of the dominant position held by the banks as regards ownership of business enterprises. The argument for this is first and foremost the fact that heavily-leveraged companies are subject to strict bank scrutiny, and the owners and managers of such a company typically cannot make decisions regarding the operation and future of the company by themselves.

For the purpose of determining the banks' controlling share in companies, the Competition Authority assessed the financial position of 120 companies and classified their position as "good", "poor or reasonable" and "very poor" based on specific criteria. The category "very poor" means that the management and formal owners of the companies in question do not have a full control of the management and policy formulation of the company without the involvement of banks. It should be noted, however, that it is not possible to conclude that all the companies assessed as being in a very poor financial position are under the control of a bank in the understanding of the Competition Act. However, the Competition Authority will investigate this matter further following the publication this report.

If companies in a poor financial position are added to the ownership interests of the banks, then the banks' share has risen from 24% in 2007 to 68% immediately after the collapse, although it has since decreased to 46%. The high percentage of bank ownership in 2007 is very interesting, as the opinion at that time was that the boom period in Iceland was at its peak and foreign debts had not increased due to the collapse of the exchange rate of the króna. The reason for this high proportion is that many Icelandic companies, both management companies as well as holding companies, had become extremely leveraged in 2007 and were therefore highly dependent upon creditors. The devaluation of the Icelandic króna in 2008 then made the situation worse.

The share owned by the banking system rose to 68% after the collapse. The collapse had an impact on the financial position of most of the companies in the country. The financial position of companies that were already in poor financial shape before the devaluation of the króna became hopeless, and the position of many companies that had previously been rated as having good or adequate prospects became doubtful after the collapse.

The proportion of bank ownership in larger companies nearly three years after the collapse reflects the current very severe state of the economy. In all fairness, the situation has improved significantly since the collapse, since many companies have completed their financial restructuring, while the financial position of others has improved as a result of better conditions, a tidying up of operations and the exchange rate appreciation of the króna.

The share of banks, resolution committees and pension funds in actual ownership of companies in important competitive markets is currently 60% in May of 2011 while the share of individuals is 29%.

The Competition Authority rates the financial position of almost half the companies in the investigation as extremely poor, nearly 30% as poor or fair and over 20% as good. About 20% of companies have maintained a good financial position from 2007 until 2010 and the same percentage of companies have had an extremely poor financial position throughout that period.

Just under a third of companies have completed their financial restructuring and the same proportion are of the opinion that they do not need restructuring. Over one third have not completed financial restructuring.

3.5. Banks and company restructuring

As mentioned before, the three banks, Arion Bank, Íslandsbanki and Landsbankinn, are in a difficult position. These banks own the largest proportion of claims lodged against the majority of companies in Iceland. In many cases these companies are unable to service their debt through the income generated from their operations. This is a delicate situation. Added to this is the understandable anger against the banks and against bankers because of the collapse which again will also reduce the self-confidence of the banks and slow down decision making. Outstanding court cases further add to the uncertainty and slow the restructuring process.¹¹

¹¹ It could be maintained that the banks were in fact unable to become involved in the restructuring of undertakings before 2010 due to various unresolved problems in the establishment of the new banks, such as

Hyper-cautiousness in the wake of a collapse resulting from recklessness is quite natural. The new banking system, however, needs to strike a balance in this matter. External incentives need to promote this balance as well. The banks, however, may be expected to be significantly more cautious than they were during the boom period prior to the collapse. In addition, the decision-making process will be slower, stricter rules will be in place for securing credit, there will be more sophisticated documentation and the monitoring of the performance of debtors will become stricter and more costly. Amendments to laws and regulations and the position of ministries and regulatory bodies all lean in the same direction. Future access to financial capital will obviously become more difficult and the terms will be worse than before. This may affect competition for the worse if less accessibility to financial capital makes the entry of new parties to the market more difficult or impossible; it will be for the better if improved procedures lead to an increase in trust, discipline and transparency.

It is the assessment of the Competition Authority that the banks must be encouraged to work against the negative incentives mentioned in this report and to work faster on the financial restructuring of companies. It is also possible that the banks will have to be subjected to discipline or that new regulations will have to be established in order to attain social objectives regarding the reorganisation of the business sector. In this context, one must simultaneously remember that the managers of any bank are required to take care of its interests and to maximise the value of its assets to the extent permitted by laws and regulations. In this respect it should also not be forgotten that the good financial position of the banking system is important for the future of the economy and for the financial stability of Iceland.

The three commercial banks have without exception reached a consensus with the Competition Authority in connection with the acquisition of leveraged companies and have built up a monitoring system in order to follow up on the instructions issued by the Competition Authority along with those which are indicated in the Authority's decisions. The Competition Authority believes this indicates that the managers of the said banks are aware of the competitive and social risks that their direct and indirect ownership of business enterprises creates for the economy and for the banks themselves. It is the finding of the Competition Authority in this report that the banks have generally been successful in meeting the conditions imposed, although there have been exceptions. A number of cases are under investigation by the Competition Authority regarding the conditions and their implementation.

3.6. The government must attend better to strengthening competition

Various entities have addressed opinions to the Competition Authority which heavily criticise the lack of morality in the business sector and the authorities' failure to act. In this respect, examples may include: companies that constantly change their ID number without comment or consequences; poor implementation of tendering processes; failure to return annual accounts to the Annual Accounts Register. Tax increases on the business sector were also mentioned.

management changes, court cases, etc., and that as a result, excellent progress has been made in the restructuring of companies since that time. The Competition Authority cannot agree that excellent progress has been made in the restructuring of undertakings. However, it is not always the fault of the banks in this respect. As stated in this section, there are a number of disincentives that are delaying the necessary financial restructuring.

The Competition Authority believes that the “prophecies of doom” as regards the direct intervention of the government into the restructuring of companies have not come true. Such interventions have been few – indeed far fewer than may have been expected when the collapse occurred.¹²

In the view of the Competition Authority, however, it would be very unfortunate if the authorities, the state or local government, unnecessarily limited competition through their actions or through inaction. The measures taken by government agencies during a period of economic depression have a considerable effect on the speed of economic recovery. Measures against some of the above complaints would facilitate a speedier economic recovery.

The Competition Authority has sent various opinions and recommendations to the government pointing out ways to remove competition obstacles and to create a better environment for competition. Unfortunately, government authorities have generally not paid sufficient attention over the past few years to suggestions intended to strengthen competition. It should be pointed out that the Competition Authority has issued appr. 40 recommendations to the authorities from the beginning of the year 2008. On the one hand the Authority has published eight formal recommendations, of which the relevant ministry or agency has fully complied with in two instances. On the other hand these recommendations are contained in report No. 2/2008 entitled, *Vigorous reconstruction – the opening of markets and strengthening of economic activities*. Of more the 30 recommendations, the Competition Authority is only aware of that the relevant ministry or agency has fully complied with the Authority’s recommendations in 15% of these instances.

Over the next few months, the Competition Authority will give a separate account of the manner in which government agencies have responded to these suggestions.

3.7. The importance of competition

The most prevalent opinions in current international discussions suggest that actions aimed at increasing competition help to speed up economic recovery. The solution to economic crises is thus not to reduce or relax the supervision of competition. These opinions have been expressed by the OECD and by competition authorities on both sides of the Atlantic. All agree that we must not repeat the mistakes of the U.S. authorities during the great depression of the 1920s when weakened competition law is said to have extended the depression by almost a decade, with the consequent harm to individual persons and companies.¹³

Since the collapse, all activities of the Competition Authority have been carried out with these points as guiding principles. The Competition Authority has endeavoured to present an explicit message with their resolutions on individual cases. The decisions by the

¹² Exceptions do exist, such as the assistance in the financial restructuring of Sjóvá as the government was of the opinion that the insurance company was systemically important. This financial assistance has been heavily criticized by competitors.

¹³ See e.g. the discussion of the effects of actions in the U.S. in Cole & Ohanian, *New Deal Policies and the Persistence of the Great Depression: A General Equilibrium Analysis*, *Journal of Political Economy*, 2004, vol. 112. See also the announcement issued by UCLA due to the publication of the article, dated 8 August 2004: “FDR’s policies prolonged Depression by 7 years, UCLA economists calculate”.

Authority, some of which involve high administrative fines, expressly indicate that it is impossible to tolerate illegal collusion, abuse of a market dominant position or competition restrictive mergers, and especially under the conditions currently prevailing. Moreover, the Competition Authority has sent a number of recommendations and opinions to government authorities for the purpose of facilitating competition.

In view of this, serious attention must be paid to the criticism stated in the opinions of companies, i.e. that the Competition Authority must speed up the processing of the cases submitted to the Authority and that market entities take for granted that the investigative process is a slow moving one.

The Competition Authority is ready to support the criticism that work must move more speedily with respect to investigations of competition violations. For example, many cases that began as dawn raids are currently under investigation. These cases are, by their nature, among some of the most important cases that the Authority handles, as the basis for the handling is a court order stating that it is necessary to impound the records of the companies in question. Moreover, account must be taken of the fact that investigations into cases are often complicated and their handling is subject to the strict requirements of the Administrative Procedures Act. It is important that companies do not adopt unrealistic expectations as regards the progress of case processing in complicated administrative issues.

Furthermore, the overall case load of the Competition Authority has increased by 30% since the collapse of the banks. The Competition Authority has requested a budget increase because of this, including a temporary budget allocation for the purpose of attending to urgent issues that are directly linked to the economic resurrection.

Part IV of this report contains the Competition Authority's status assessment of the progress of obstacles and their solution, as proposed in Report No. 2/2008 – *Vigorous reconstruction – the opening of markets and strengthening of economic activities*. The status is assessed in all the markets discussed in the report. Overall, it may be said that there have been some successes and that many projects have been moved in the right direction. Nevertheless, the apathy of many government agencies towards their own tasks is noticeable.

Although investigations of violations of the Competition Act are urgent, the role of the Competition Authority in educating and informing the market about competition laws and in following developments regarding competition practices and business practices in the Icelandic business sector is no less important. This report is also issued for that purpose. The report will support the Competition Authority's surveillance of banks and will be used for those relations. It is, moreover, a basis for further investigations by the Competition Authority into cross-ownership ties and business conglomerates. Furthermore, in connection with work on this report, companies have come forward with several suggestions regarding violations of the Competition Act that need to be further processed. Finally, this report will be useful for the Competition Authority's market analyses.

3.8. Proposals

The problems described above are recognised by most parties. Solutions to these problems are not obvious as they are systemic and relate to incentives and a way of thinking, along with the general admittance that progress and development are now necessary. The problem lies only partially with the banks, as has been described in this Section; however given the nature of the suggestions, they must be directed at them to a considerable extent, given that they hold the majority of claims on the companies.

In light of the conclusions of the report, the Competition Authority will focus on applying its monitoring authorisations to speed up this process. Three aspects must be mentioned in this context:

1. The actual extent of bank control of companies must be made known

It is vital that banks, without undue delay, make a decision as to whether to take over a company formally, adjust its debt position to its operating ability or initiate bankruptcy proceedings. Long-term indirect bank ownership of companies is unacceptable. In this context, banks must bear in mind that mergers, pursuant to the Competition Act, are not dependent on the formal takeover of the undertaking but rather whether an entity has in fact achieved control of it. Violations of the obligation to notify of mergers is subject to punishment according to the Competition Act.

The Competition Authority will, following the publication of this report, specifically examine whether companies considered to be in an very poor financial position are under the control of the banks. The banks will have to provide adequate explanations in each case in this respect.

2. Restrictions placed on direct ownership by means of deadlines

The Competition Authority has reached a consensus with the banks on companies that they take over, whereby the parties have agreed that the companies must be sold after a reasonable transitional period. The provisions state that the bank in question must sell the company as soon as possible and not later than at the end of a specified period of time. The general rule is that attempts must be made to sell the company as soon as possible even if a particular transition period is provided. At present, 25 agreements have been reached and 17 of these are currently active. It is vital that the banks keep to the selling deadlines that have been determined in the agreements with the Competition Authority and sell the companies under the market conditions applicable at that time. These conditions are intended to combat the disincentives described in Section 3.2.

3. Monitoring of profitability goals strengthened

The conditions that the Competition Authority has established for bank ownership of commercial enterprises state that companies are to be set reasonable profitability goals. This is important, among other things, to combat the disincentives described in Section 3.2, particularly those entitled "Management problem" and "Fairness problem". In the opinion of the Competition Authority, the banks' provision of information and follow-ups has generally been poor with regard to profitability goals. The Competition Authority will embark on investigations intended to improve the situation.

The Competition Authority also puts forward the following proposals which could help in resolving this matter.

4. *Banks and resolution committees are to systematically provide information on the restructuring of larger undertakings*

It is important that banks, and as appropriate, other entities involved in financial restructuring, formally publish the main aspects of the process. This also applies to the banks' resolution committees. The public establishment of clear phases in the work and regular provision of information is of particular importance. The banks have to some extent been involved in providing such information, although this has not drawn sufficient attention. There is good reason to strengthen such goal setting and provision of information even further.

5. *The banks must have better separation in their accounts between their permanent operation and the restructuring of companies*

The banks must provide clearer information on the effects of the financial restructuring of companies on profits, in excess of requirements in accounting standards. This places greater pressure to achieve operating efficiency which is not in place to the same extent at present due to the significant profits that resulted in the upgrade of loans purchased from the old banks. Regulatory entities should take particular note of this.

6. *The government is to formulate incentives that work with goals to speed up the resurrection.*

These could involve e.g. changes to the equity rules of banks to encourage them to speed up the sale of companies. Closer co-operation between the Competition Authority and the Financial Supervisory Authority on the sale of companies owned by the banks could also lead to this result. Stricter follow-up and penalties for failure to submit annual financial statements to the Annual Accounts Register could also be important.

7. *Government agencies should form a discussion forum with the banks and companies*

The Competition Authority believes that the government should invite public bodies, banks, resolution committees, pension funds and companies and their associations to a discussion forum to find solutions to the problems described herein and which could lead to economic stagnation.

