The Financial Crisis and Competition in Retrospect

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A deep financial crisis has wide-ranging repercussions. A country that develops a bubble economy that ends with a banking crisis will experience considerable swings in asset prices and the flow of capital, wreaking havoc in balance sheets all over the corporate and even household sector. It will also almost certainly adversely affect public finances but I will not dwell on that side of the story here.

Such an economic roller-coaster ride can have a significant impact on competition in the private sector, in particular if it leads to a dramatic reorganization, financial or operational of many companies.

Looking back at what has transpired in Iceland in recent years provides some vivid examples of this. I have had the privilege of a front-row seat as that story has unfolded and hope I can share some of the lessons with you today. Although some of the developments in Iceland were unique to this country the lessons that can be drawn should be of wider interest.

Pre-crisis I was an academic economist and the chairman of Iceland’s competition authority. Right after the collapse of the financial sector I joined the cabinet as one of two ministers from outside the political

arena. I served for a little under two years, first as Minister of Business Affairs and subsequently Minister of Economic Affairs. My portfolio in both ministries included competition and the financial sector. After leaving the Ministry I am back in academia and consult for the Competition Authority.

The global financial crisis struck Iceland especially hard. The Icelandic asset price bubble was larger than most, especially in the stock market. It was fuelled by a massive inflow of capital that was primarily used to finance highly leveraged purchases of shares or whole companies inside and outside Iceland.

The pre-crisis developments included substantial structural changes in Iceland's private sector. It saw the rise of sprawling business groups or conglomerates as tycoons used borrowed funds to finance acquisitions of just about anything they could get their hands on, companies, private jets, real estate. The list even includes a couple of British football teams. Each business group would have close ties to at least one financial institution, a bank or an insurance company, or even both. The reason simply being that that is were the money is.

This development was a considerable headache from a competition viewpoint. Concentration of many industries increased and all sorts of ties developed between related and unrelated companies due to the ever-increasing complexity and size of the conglomerates. Ownership ties were often opaque, with various holding companies playing a large role, often based in jurisdictions noted for secrecy and low taxes.

It should be noted that historically the Icelandic economy has been plagued by a lack of competition in many industries, in particular those that principally cater to the local population and have little or no foreign competition. The retail sector is a case in point.

With a population of only 330 thousand and an annual GDP of approximately 14 billion euros the Icelandic market is so small that in many sectors it will only sustain a handful of companies. Two to four companies compete – or so we hope – in many sectors. These companies are usually also substantially smaller than comparable companies in the neighbouring countries and suffer from a lack of scalar economies.

The empire building of the bubble era made all of this worse, if anything. There was a flurry of takeovers and highly leveraged buyouts.

When the inflow of capital stopped, asset prices plummeted and all of these empires collapsed. That was a large, even the pivotal, factor in bringing down the banking system in October 2008.

This was a disastrous turn of events by any measure. Assets that had been worth several times Iceland's GDP on paper essentially vanished, leading to massive losses by creditors and shareholders inside and outside Iceland. The currency lost half its nominal value. Corporate and household balance sheets were in tatters all over Iceland.

The Competition Authority in Iceland faced a monumental challenge: How could it deal with all of the competition issues that the turmoil created – allowing those entrusted with sorting out the mess to do what was needed while trying to ensure that a healthier private sector emerged after the reorganization? What was wanted was a corporate sector that was not plagued by the problems of the conglomerate era and benefitted from as much competition as possible despite the constraints imposed by the small size of the local economy.

All of this re-organization, financial and operational, had to take place without the operations of the companies stopping. Despite seemingly hopeless finances they had to go on producing goods and services, meeting their payroll, paying suppliers etc. Otherwise the Icelandic economy would grind to a halt.

A typical operating company would in many cases have a reasonable business plan and operations and was led by a decent management team. It was however carrying a mountain of debt that it had no realistic chance of servicing. Often its owner was a holding company that was itself dealing with far too much debt and no viable business plan. The operating company had to have its finances reorganized and its operations modified to reflect a changed economic environment. At some point a new owner had to be found.

Usually this process would be controlled by each company's creditors, most often one of Iceland's new banks. The new banks had

been set up virtually overnight in October 2008 to take over the domestic operations of their insolvent predecessors. The new banks' balance sheets included a mountain of toxic assets but their liability side reflected this so they had room to maneuver. Most importantly they had the necessary ability to write-off loans down to levels that were reasonable relative to the capacity of the debtor to service them.

The Competition Authority did not control this monumental reorganization of a large proportion of Iceland's corporate sector but it could and did influence it in many ways.

One important step taken by the Authority was to issue guidelines on how financial institutions could reorganize companies that became their wards due to financial difficulties. The process was to be as fair as possible, comply with the legislation on competition, and preferring outcomes that were considered healthy from a competition viewpoint. Financial institutions were strongly encouraged to try to the extent possible to take the impact on competition into account when reorganizing companies. Barriers to entry would hopefully be lowered, rather than raised. The report of the Nordic Competition Authorities on Competition and Crisis that was issued in 2009 was very helpful in this work.

One very real threat here was that banks that were reorganizing many companies would try to set up structures that discouraged competition. The reason being that the ability to extract monopoly rent would be seen as likely to increase the value of the shares of the

companies when these were sold after the reorganization, increasing the recovery for the banks.

Another very real threat was that a financial institution that was involved in the reorganization and operations of many companies would encourage these companies to trade with each other rather than competitors. One practical question was whether the same teams or individuals were working on behalf of a bank on the reorganization of more than one company in the same industry.

The underlying problem is the perceived trade-off between robust and healthy competition on the one hand and profits or shareholder value on the other hand.

From the viewpoint of the economy as a whole setting up unhealthy corporate structures that are in one way or another sheltered from competition is the equivalent of peeing in your shoes to warm your toes, to use a common Icelandic saying. It may provide some short-term relief but the effect quickly wears off and in the long run you will regret it.

This dilemma is of course not unique to Iceland. In a financial crisis when the solvency of companies and financial institutions is threatened it can be tempting to try to elevate profits by sacrificing competition. Throw a little monopoly rent into the mix. The benefits may seem obvious while the cost is less transparent and spread thinly all over the economy.

An example of this would be allowing a merger or even collusion that reduces competition and would not pass muster under normal circumstances. The pressure to allow this may not only come from the private sector, it can very well come from politicians. It can even come from other regulators fearing for the solvency of their wards.

Indeed this is usually seen as one of the factors that contributed to the great depression of the 1930’s. With prices and company profits falling, collusion to raise prices was considered justifiable by many.

The Icelandic Competition Authority also used every opportunity to try to influence decisions of the executive or legislative branches of Iceland’s government that had an impact on competition. The parliament did make several changes to the legal code that were important. This included adding a new tool to the arsenal of Iceland’s Competition Authority that allows it to require structural changes in companies under certain strict conditions.

Given the extra-ordinary circumstances that the Icelandic economy was experiencing in the period after 2008 unusual or even unorthodox measures were sometimes called for. This included allowing financial institutions to collaborate on some projects that would almost certainly have been frowned upon from a competition viewpoint under more normal circumstances.

This collaboration included setting up common guidelines for dealing with the financial reorganization of households and small and medium sized companies. None of the exemptions were permanent.

They were all narrow and allowed collaboration or synchronization when dealing with a specific non-recurring problem. The issue of household debt was especially thorny so it was seen as vitally important that different banks would to the extent possible all treat heavily indebted households in a similar manner.

The Competition Authority also faced a flood of merger cases, usually because a company had become the ward of a bank while its finances were being reorganized. This of course added considerably to the workload but also sometimes provided a welcome tool for the Authority to encourage competition. It could impose conditions when allowing such mergers. This was done in several important cases.

Now, in 2015, the dust has settled. The reorganization of the Icelandic economy took several years but it is now essentially completed. The new banks' balance sheets still have some dodgy or non-performing loans from the household or corporate sectors but the numbers are starting to resemble what can be considered normal.

From a competition viewpoint considerable progress has been made. Most companies are now operating under reasonable conditions. They are not the ward of a financial institution although they of course rely on the financial system for their financing. The conglomerates and various holding companies that emerged during the bubble era are almost all gone.

Many companies however are rather weak financially. They have little equity and their owners are often also rather weak, not able to support e.g. a major investment or expansion of operations. One worry is that the companies may be too weak in some cases to compete aggressively for e.g. market share. If all competitors in an industry are struggling financially it is easy to see how they could end up with a relatively cosy arrangement where all have high margins and relatively steady market shares, not really competing on price.

The main exception to the lack of financial strength by company owners is Iceland's pension funds. Despite having suffered a heavy blow in the crisis they have very substantial assets, valued at 21 billion euros or a little over one and a half year's GDP. Combined, they are by far Iceland's largest investor and own an alarmingly high proportion of most types of listed assets in Iceland. Most importantly this includes listed shares.

The stock market was essentially wiped out in the crash, losing 98% of its nominal value and even more when inflation is taken into account, but has been making a gradual comeback.

With most local investors having suffered heavy losses during the crisis and practically no inflow of funds from foreign investors the market is dominated by the only entities still standing, namely the pension funds. That is not a very welcome development for various reasons, including that this leads to a concentrated ownership structure of individual companies and sometimes even the same or closely related investors holding shares in two or more competitors.

The lifting of the capital controls that are still in place, seven years after the onset of the crisis, can be expected to help in this respect. It will allow the pension funds to resume investing abroad and hopefully encourage foreign investors to invest again in Icelandic assets, including shares.

So, how have we fared? Has the Icelandic economy emerged in better health post-crisis? Is it structurally sound or have we just been peeing in our shoes?

The signals are mixed. Economic recovery is certainly well under way with most macroeconomic variables looking quite healthy. GDP has been growing at a reasonable pace and unemployment falling since 2010. There is a substantial current account surplus; the government's budget is close to balance and debt levels have come down all over the economy.

The export industries emerged by and large unscathed from the crisis and have been doing well for the most part, helped by the collapse of the currency. The low price of aluminium in world markets is the only major grievance for exports. Despite that export revenues have grown at a rapid pace, especially due to a boom in tourism.

The ownership and financial structure of most companies is certainly far healthier than during the bubble era or at the onset of the crisis.

That said, the Achilles heal of the economy is still there. Companies that primarily compete in the local market and are sheltered from imports are still generally facing little competition and suffering from inefficient scale. That has not really changed.

Does that mean that a golden opportunity to reorganize Iceland's corporate sector to make it more competitive was wasted? Perhaps to some degree but I expect that level-headed analysis will show that the underlying problems are so endemic that it takes more than one deep crisis to get rid of them.

I have always been fond of Schumpeter's idea of creative destruction. To make something new and better you have to destroy what was there before. A crisis like the one Iceland has experienced certainly led to a lot of destruction. In particular it destroyed almost all of the country's financial institutions and the conglomerates that Iceland's tycoons had built on such shaky foundations during the bubble era.

We have not rebuilt any of that. The new banks may have an uncanny resemblance to their predecessors when you take a superficial look at their domestic operations but there are very important differences, in their structure and the legal and supervisory environment that they face. The conglomerates we certainly hope are gone for good.

To fundamentally change the level of competition between Icelandic companies and allow them to operate closer to efficient scale will be much harder. In essence that calls for closer integration of the

Icelandic economy with that of our neighbouring countries – the Nordic countries of course being crucial here. Icelandic companies that face tough competition from foreign imports – or compete abroad themselves – are far more likely to be at the cutting edge technologically, quality and productivity wise than those that have the luxury of only having to deal with limited local competition.

So, the Icelandic Competition Authority will never run out of important tasks. Indeed, the work of few if any competition authorities in our part of the world is as crucial for the local economy as that of the Icelandic Authority.