

Unclassified

DAF/COMP/AR(2011)7



Organisation de Coopération et de Développement Économiques
Organisation for Economic Co-operation and Development

24-Jun-2011

English - Or. English

Directorate for Financial and Enterprise Affairs
COMPETITION COMMITTEE

DAF/COMP/AR(2011)7
Unclassified

ANNUAL REPORT ON COMPETITION POLICY DEVELOPMENTS IN ICELAND

-- 2010 --

This report is submitted by Iceland to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 29-30 June 2011.

English - Or. English

JT03304541

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1. Executive Summary

1. The Icelandic Competition Authority (ICA) lays strong emphasis on using the means at its disposal to help speed up the economic recovery in the aftermath of the banking collapse in Iceland in the autumn of 2008.

2. Under current economic circumstances, there are signs of increased concentration in important markets. It must also be deemed more likely that firms will abuse their dominant position on the market or collude illegally with their competitors, as companies can seek such solutions to address their financial difficulties.

3. The ICA has sought to send a clear message through its enforcement of competition law. Since the beginning of 2010 the ICA has fined 10 companies a total of approximately 7.6 m EUR for collusion or abuse of a dominant position. From the beginning of 2010 to the present date (June 22, 2011) the ICA has intervened in 20 mergers, where conditions have been imposed (see chapter 2).

4. 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. These companies earn almost half the total operating income earned 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%.

5. The financial position of just under half of the larger companies dealt with in the report is very poor in the opinion of the ICA, while a fifth of companies are in good condition. A little less than one third of the companies have completed their financial restructuring while approximately the same proportion of the companies are of the opinion that they do not need restructuring.

6. The problems posed to the business sector can be traced back to the fact that the financial restructuring process of companies is too slow and the system contains disincentives that delay the financial restructuring of companies. These problems are addressed in the aforementioned report (see chapter 3).

7. One of the factors that will play a key role in the reconstruction of the Icelandic business sector is the manner in which financial activities are conducted in Iceland. In April 2011 the ICA issued a consultation paper on competition on the banking market. There the ICA puts forward the view that policy formulation for the financial markets must prevent homogeneity in structure and mentality and must create an environment for an active market and innovation in the sector. The ICA is wary of larger commercial banks merging between themselves or buying or taking over smaller financial undertakings and of creating a comfortable market with two or three large banks that are free from the risk of external competition. This type of market would generally be detrimental to the public and the business sector (see chapter 4).

2. Enforcement of competition laws and policies in times of crisis

2.1 Abstract

8. The ICA considers vigorous enforcement of competition laws to be the proper reaction to financial crises, and has acted accordingly. Competition rules are particularly important in an economic recession or a depression, as actions aimed at increasing competition help speed up economic recovery.

9. As a result of the financial crisis many companies have had to withstand considerable contraction in demand for their products and contraction in income. Under these circumstances, increased concentration on the market is likely. It is also more likely that firms will be tempted to abuse their dominant position on the market or to collude illegally with their competitors. Under such circumstances, the harm is often transferred from the respective companies to their clients, and frequently onwards to the consumers.

10. The emphasis and actions of the ICA takes the aforementioned scenario into account. Currently, the ICA lays strong emphasis on using the means at its disposal to help speed up the economic recovery. With this in mind, the Authority has enforced competition law with the intention of sending a clear message along the following lines:

11. Firstly, mergers that restrain competition will and must be counteracted in every possible way. Since the beginning of 2008, the Competition Authority has annulled/prevented 4 mergers and imposed conditions on a further 31.

12. Secondly, no tolerance will be shown for companies or associations of undertakings that enter into illegal collusion. The same applies to cases when companies abuse their dominant position on the market. The ICA has dealt with many cases of this type in recent years. Since the beginning of 2008, 21 companies have been fined a total of 19,2 million Euros because of collusion or abuse of a dominant position.

13. Fourthly, authorities, the State or local government, should avoid any unnecessary limitations to competition through their actions or lack thereof. The measures taken by the authorities during an economic crisis can have a considerable effect on the speed of economic recovery. The ICA has addressed various formal opinions to the authorities containing requests concerning a number of competition related matters. An opinion that the ICA addressed to the Prime Minister at the end of 2009 is one example. It contained a recommendation that the Prime Minister should promote that the authorities implement a standard competition assessment in connection with the drafting and passing of legislation and administrative rules and orders.

14. The ICA published 38 decisions on its website in 2010. During the year the ICA worked on approximately 280 cases. Of these, approximately 150 cases were still under investigation at year-end 2010. Never before have so many cases been processed by the Authority at the same time. The ICA has carried out six dawn raids from the beginning of 2010 to present date.

2.2 Fines imposed

15. Since the beginning of 2010 the ICA has fined 10 companies a total of approximately 7.6 m EUR. Five of these companies took part in agreements or concerted practices between the largest grocery retailer (Hagar) and meat processors in connection with the retail pricing of meat products. Two of the companies were fined for abusing their dominant position. One of the two leading pharmacy retailers in Iceland was fined for actions aimed at hindering the entry by a new firm into the market. Earlier this year, Vifilfell, the Icelandic bottler for Coca Cola, was fined for abusing its dominant position in connection with extensive exclusionary agreements with retailers and restaurants in Iceland.

16. Further information on fines imposed by the ICA can be found in the following table:

Table 1: Fines imposed by the ICA since beginning of 2010 to present time

	Decision	Company	Nature of infringement	Fines (EUR)*	Appeals Committee
1	11/2011	Vifilfell hf. (beverages, Coca-Cola)	Abuse of a dominant position	1.611.000	Under appeal
2	33//2010	Hagar hf. (retail, groceries)	Collusion	1.763.000	Not appealed
3	33/2010	Sláturfélag Suðurlands svf. og Reykjagarður hf. (food)	Collusion	294.000	Not appealed
4	33/2010	Kaupfélag Skagfirðinga (food)	Collusion	261.000	Not appealed
5	33/2010	Norðlenska hf. (food)	Collusion	196.000	Not appealed
6	33/2010	Kjarnafæði hf. (food)	Collusion	131.000	Not appealed
7	30/2010	Ívar ehf.	Violation of prohibition to implement merger	78.000	Not appealed
8	27/2010	SART (Assotiation for electric industries)	Collusion	26.000	Not appealed
9	Settlement	Skipti/Síminn hf. (telecom)	Collusion	2.542.000	Not appealed
10	4/2010	Lyf og heilsa hf. (pharmacy)	Abuse of a dominant position	746.000	574.000
*(Euros at time of decision)				7.648.000	

2.3 Merger interventions – a tool to speed up economic recovery

17. In 2009 the ICA 26 formal decisions regarding mergers as compared with 20 decisions on mergers in 2009. In the first half of 2011 the ICA has made around 15 merger decisions. From the beginning of 2010 to present date the ICA has intervened in 20 mergers by imposing conditions.

18. Most of these merger cases are cases of banks taking over commercial undertakings. As explained above, many commercial undertakings have had to withstand considerable contraction in demand for their products and contraction in income as a result of the financial crisis. Many companies were also heavily in debt before the onset of the crisis. The three banks that were established on the ruins of the collapsed banks have directly or indirectly become owners of many of these companies, because of their financial situation resulting from the crisis.

19. The ICA has subsequently established detailed conditions for the banks' ownership of these companies, in order to ensure that the ownership does not lead to harmful disruptions to competition as a result of the unusual circumstances now present in the Icelandic economy. In other words, the role of banks as owners of commercial companies fits poorly with the role which the banks traditionally have of providing financial services to such companies. These conditions are described in detail in the ICA's 2009 annual on competition policy developments in Iceland (DAF/COMP(2010)12/11).

20. Further information on merger interventions by the ICA can be found in the following table:

Table 2: Merger interventions since the beginning of 2010 to present date

	Decision	Mergers	Conclusion
1	20/2011	Arion banki's and Búvellir's (holding company) takeover of Hagar hf. (groceries, retailer)	Conditions imposed on merger
2	18/2011	Landsbanki's (Regin, holding company) takeover of Laugahús ehf. (real estate management)	Conditions imposed on merger
3	17/2011	Landsbanki's takeover of Pizza Pizza ehf. (food/restaurant)	Conditions imposed on merger
4	16/2010	Arion banki's takeover of Fram Foods hf. (fish export)	Conditions imposed on merger
5	12/2011	Arion banki's takeover of G-7 (real estate management)	Conditions imposed on merger
6	8/2011	Íslandsbanki's and Glitnir's (resolution committee) takeover of Bláfugl (Bluebird Cargo)	Conditions imposed on merger
7	7/2011	Arion banki's takeover of Sigurplast (plastic materials/packaging)	Conditions imposed on merger
8	5/2011	Landsbanki's takeover of Björgun (building materials)	Conditions imposed on merger
9	1/2011	FSÍ (Holding company owned by Landsbanki and largest pension funds) takeover of Vestia (holding company for a few significant commercial undertakings)	Conditions imposed on merger
10	36/2010	Byr's (resolution committee) takeover of Byr bank (savings bank)	Conditions imposed on merger
11	32/2010	Landsbanki's takeover of Límtré Vírnet (building materials)	Conditions imposed on merger
12	31/2010	Arion banki's takeover of B.M.Vallá (building materials, concrete)	Conditions imposed on merger
13	22/2010	Íslandsbanki's takeover of Eik Properties (real estate management)	Conditions imposed on merger
14	21/2010	Arion banki's takeover of Þyrping (real estate management)	Conditions imposed on merger
15	20/2010	Landsbanki's (Vestia, holding company) takeover of Plastprent hf. (plastic materials)	Conditions imposed on merger
16	19/2010	Landsbanki's, (Regin, holding company) takeover of Fasteignafélag Íslands (real estate management)	Conditions imposed on merger
17	15/2010	Íslandsbanki's, Landsbanki's and Arion banki's (banks) joint takeover of Reitir (real estate management)	Conditions imposed on merger
18	16/2010	Íslandsbanki's (bank) takeover of Bevis (car rental)	Conditions imposed on merger
19	10/2010	Landsbanki's (banki) takeover of Húsasmidjan (hardware stores)	Conditions imposed on merger
20	8/2010	Íslandsbanki's (bank) takeover of B&L and IH (car dealership)	Conditions imposed on merger
21	6/2010	Arion banki's (bank) takeover of Hagar (retailer)	Conditions imposed on merger
22	7/2010	Landsbanki's (bank) takeover of Teymi (telecom. and IT)	Conditions imposed on merger

3. Competition conditions after the collapse.

3.1 The ICA issues a report on "Competition after the collapse"

21. In June 2011, the ICA issued a detailed report under the heading "*Competition after the collapse*". The report is based on the ICA's investigation into the financial position and financial restructuring of 120 large companies in selected competitive markets. Moreover, the report reviews the financial position and development of business sectors since the collapse, assesses whether account has been taken of competition policy in the restructuring of companies and gives a status-report on a plan to open up markets that the ICA put forward in November 2008, shortly after the banking collapse.

22. The ICA's emphasis, put forward in the report, is based on the fact that a dynamic and efficient business environment is a prerequisite for the wellbeing of the Icelandic economy. 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.

23. In the report, the ICA expresses 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.

24. The report also describes the views and opinions stated by the companies from whom the ICA sought responses when the report was prepared. In addition to written viewpoints submitted by companies, the Authority had meetings with 70 representatives of companies, banks, consultants, experts and entities from within the government. Furthermore, the ICA 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.

25. The report and the information obtained on the standing of individual companies will be of use to the ICA 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.

3.2 ICA's main conclusions as regards competition conditions in Iceland

26. The report reviews the difficult conditions facing the Icelandic economy and the competition policy conditions since the collapse of the Icelandic banks in October 2008. 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 the society seems not to have reached a settlement with the past. Moreover, there is no unity as regards long-term or short-term national economic policies. Furthermore, Icelanders have experienced international disputes and natural disasters.

27. The main conclusions of the report are the following:

28. 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.

29. 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 earned almost half the total operating income earned 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%.

30. The financial position of a little less than half of the number of the larger companies is very poor in the opinion of the ICA, while a fifth of the companies are in a good condition. A little less than one third of the companies have completed their financial restructuring while the same proportion of the companies are of the opinion that they do not need restructuring.

31. 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.

32. There is a risk that competition in many markets 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, lead to higher prices.

33. The system contains disincentives that delay the financial restructuring of companies. Without the correct incentives, the banks will retain companies for a longer period than can be considered beneficial to the national economy. A new and temporary industry has been created, i.e. an industry that deals with the restructuring and the sale of assets. The employees in this industry have an interest in their own revenue generation and job security. This 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.

34. 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.

35. The ICA 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 ICA. Moreover, the ICA 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 markets.

4. The future structure of banking market

4.1 Consultation paper on competition on the banking market.

36. One of the factors that will play a key role in the resurrection of the Icelandic business sector is the manner in which financial activities are conducted in Iceland. Active competition on the financial market is particularly important for both the business sector and consumers. Active competition supports job creation, industrial development and the competitiveness of Icelandic companies.

37. In April 2011 the ICA issued a consultation paper on competition on the banking market. By this the Competition Authority wishes to encourage financial undertakings and the authorities to pay attention to competition issues in policy formulations for the financial market, as well as to present its views on bank mergers.

38. There have been sweeping changes to the scope and nature of banking operations in Iceland following the collapse of the banks. Icelandic banks now operate almost exclusively in the domestic market and their operations cannot as yet be considered to be conventional commercial banking activities. The banks have been reorganising their lending portfolios, work that will form a considerable proportion of their activities over the next few years. At the same time, there are fewer profit opportunities in the market, tasks involving the financial restructuring of management companies are labour intensive and the authorities are making increased demands on the banks as a result of the collapse.

39. Participants in the financial market and the authorities have for the past few months been formulating policies for the future in light of the new economic reality. These parties, including the three commercial banks that took over the activities of the fallen banks in Iceland, i.e. Arion Bank hf., Íslandsbanki hf. and NBI hf., have been contemplating the option of merging banks on the Icelandic market. The ICA's consultation paper includes a preliminary response to such a development.

4.2 ICA's conclusions as regards competition in the banking market

40. The ICA believes that policy formulation for the financial markets must prevent tendencies for homogeneity in structure and mentality in the sector. It is also necessary to create an environment for an active market and innovation in the sector. The ICA is wary of larger commercial banks buying or taking over smaller financial undertakings and of creating a comfortable market with two or three large banks that are free from the risk of external competition. This type of market is generally detrimental to the public and the business sector.

41. The principal conclusions of the consultation paper are as follows:

42. Concentration on the banking market has increased substantially since 2008, with reductions in the number of financial undertakings and with the larger banks taking over deposits in savings banks. The calculated Herfindahl-Hirschman Index (HHI) is just under 2,700 points at present. Before the collapse, the Index did not reach 2,000 points. Such a great concentration creates the risk of competition restrictions involving the co-ordinated behaviour of competitors.

43. There are considerable entry barriers to the banking market, and it is difficult for consumers to switch banks. The ICA is of the opinion that advantage should be taken of the present opportunities that have arisen from the reshuffling since the financial collapse to make entry to the banking market easier and to decrease the cost for customers of switching between banks. This will increase competition and enable smaller competitors to grow stronger.

44. The banking system is too expensive given its current scope, and rationalisation is therefore necessary. The operating costs of Arion Bank, Íslandsbanki and Landsbankinn rose by ISK 7.5bn between 2009 and 2010, or by approximately 12% in real terms. The number of employees increased by 200 over the same period.

45. Rationalisation must be achieved by means other than by mergers that harm competition. The ICA is of the opinion that extremely serious competition problems can result from the merger of commercial banks, at least in the instances where one or more of the larger banks is party to such merger. In this respect, it is right to point out that the rationalisation that is projected to result from a merger is a hypothetical rationalisation and not a certainty. The majority of papers that have been written about bank mergers indicate that they tend to lead to insignificant rationalisations.

46. It is vital to keep in mind that circumstances on financial markets can change quickly, as experience has shown. The financial market is subject to a great deal of uncertainty. It is not known when capital controls will be lifted. Moreover, the financial strength of the banks is not yet known. Furthermore, there is the possibility of radical changes on arrangement of monetary issues that can change the market completely.

5. Changes to Competition Laws and Policies

47. The Competition Act was initially adopted in 1993. The Act was to a certain extent based upon the Agreement on the European Economic Area. The Act has been amended a number of times since that in light of the experience and in light of further legislation trends within the European Economic Area.

48. The Competition Act was amended in the spring of 2011. The three main changes were the following:

- The Competition Authority was given the powers to take action against any situation or behaviour that restricts competition even though that behaviour does not violate the prohibition rules in the competition act by itself. The amendment gives the Competition Authority options similar to those found for instance in the UK. Remedies on the form of divestiture are included.
- The ICA was enabled to bring rulings of the Appeals Committee before the courts. Before this amendment only those who opposed the ICA before the Appeals Committee could bring a case before the courts.
- Those who bring cases to the Appeals Committee have to pay a moderate fee.
- A moderate merger notification fee was introduced for the first time.

49. This amendment gives the ICA new remedies and also demonstrates an important recognition of the fact that competition restraints do not always stem from violations of prohibition rules. The changes and the reasoning behind them clearly show that the legislators are of the opinion that the encouragement of competition will promote a speedier economic recovery. The changes are intended to promote those improvements.

50. The new provision therefore supports the prohibition rules in the competition act. By it the ICA is better able to ensure that the public and the commercial sector do not suffer because of conduct or circumstances on the market that limit competition. The fundamental concept is that no company in an important market should have an irreversible right to benefit from profits deriving from a monopolistic situation of that company.

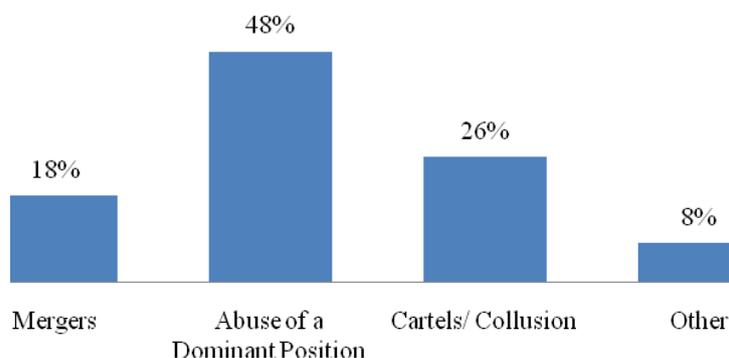
51. The ICA is currently preparing the general application of the new provision. As with other interventions by the ICA, the application of this provision will be tested before the Competition Appeals Committee and before the courts.

6. Resources of the Competition Authority

52. The ICA is funded through the state budget. The ICA's budget for 2011 amounts to approx. 1.9 m. EUR. The employees of the ICA at year-end 2010 were 24.

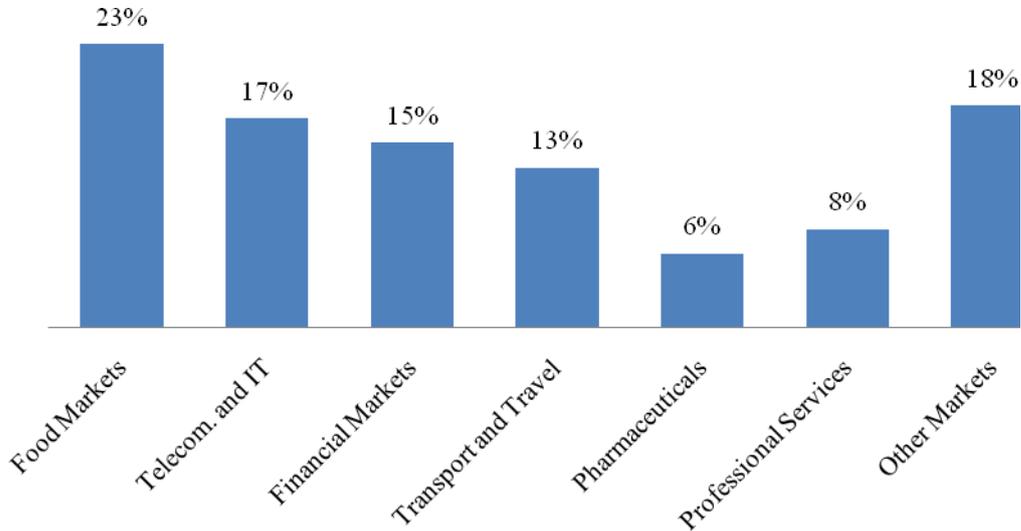
53. As shown in illustration 1, cases dealing with possible abuse of a dominant position are a significant part of the ICA's work.

Illustration 1: Allocation of resources in 2009 – types of work



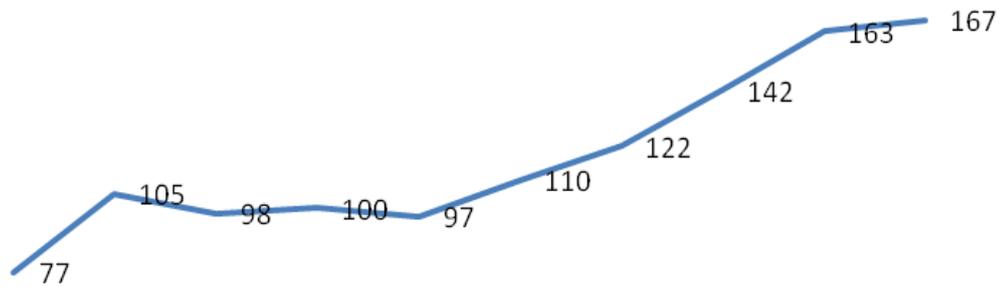
54. As showed in Illustration 2, cases related to food markets are at the top of the ICA’s agenda.

Illustration 2: Allocation of resources in 2009 - markets



55. The economic crisis in Iceland has had a profound impact on the ICA’s work. The number of cases have risen considerably since the banking collapse, as shown on illustration 3.

Illustration 3: Quarterly number of cases in process



Autumn 2006 Spring 2007 Autumn 2007 Spring 2008 Autumn 2008 Spring 2009 Autumn 2009 Spring 2010 Autumn 2010 Spring 2011