Rebuilding the Icelandic Equity Market

Speech given by Pall Hardarson, President NASDAQ OMX Iceland, at the Better Finance Conference "Back to Basics – Economies before, during and after the crisis" at Harpa Conference Center, Reykjavik, Iceland, June 27, 2014

Ladies and gentlemen,

It is an honor to be invited to speak here today. The topic is one that is close to my heart – the rebuilding of the Icelandic stock market. As you are aware, the stock market took a severe blow in the wake of the collapse of the Icelandic banks in October 2008. In fact, I am not aware of any stock market that was harder hit during the global financial crisis. As you can imagine, rebuilding is in many ways a challenging task complicated by the legacy of the banking collapse and the magnitude of the blow investors received. Trust is the most important pillar of a well-functioning market and that virtually disappeared overnight in October 2008. Measures to rebuild the stock market are, therefore, inseparable from measures to ensure a trustworthy market environment. In what follows, I will give an overview of measures that have been taken to strengthen the market framework in the wake of the crash and discuss additional measures we at NASDAQ OMX Iceland have argued for. I will also attempt to give you a sense of where we are at in our efforts, the status of the stock market recovery and future prospects.

The collapse of the Icelandic financial system and its consequences differ at least in two respects from previous economic events of significance in recent Icelandic history. Firstly, the scale of the loss suffered is unprecedented. Iceland experienced the sharpest drop in per capita GDP and national income since the Second World War, with the former dropping more than 11% and the latter 27%

from peak to trough. The shareholders of the three big Icelandic banks lost around USD 13 billion (using the market cap at mid-year 2008 as a reference point) or around 2/3 of Iceland‘s GDP. Even these losses pale in comparison with those endured by the creditors of the banks, estimated to be in excess of USD 60 billion or four-fold Iceland‘s GDP. Secondly, this calamity was man-made, and for the most part made in Iceland. Whereas, one can argue that the international financial crisis had an impact and may have affected the timing of the crisis, reckless behavior by the Icelandic banks themselves was primarily responsible for their downfall. Many businesses and households had also left themselves extremely vulnerable to shocks as they were highly leveraged. Many also carried large debts in foreign currency even if their revenue stream was primarily in Icelandic krona. The high leverage and currency mismatch greatly aggravated the impact of the collapse on the economy.

The crisis raised fundamental questions, many of which revolve around the legal framework governing the banks and the securities market, role and accountability of auditors, surveillance and, of course, corporate governance. The crash of the stock market has also led some to question the viability of public companies in Iceland.

The success or failure of the public company model of capitalism has some potentially important implications. If we fail, firms‘ access to capital will be more restricted and expensive than it otherwise would be. Access to capital is, ultimately, an engine of economic growth. But the implications for capitalism are more far reaching. The public company model gives ordinary people an opportunity to take on a role in the operation of our economy, otherwise left to the privileged elite or the state. It gives the public a voice. Furthermore, the rules public companies play by foster transparency in the operations of businesses. Failing to adopt measures to restore faith in the functioning of the securities market is therefore not an option.

To restore trust a joint effort by the authorities and all market participants is required. Important measures have been taken on several fronts in recent years to this end. Below I will outline those I consider of greatest significance.

Parliament revised several laws in response to the banking collapse. The legislative response has only to a very limited degree been directed at the legislation governing the securities market directly. The securities market legislation is for the most part based on EU directives and will, hence, follow the revisions taking place in Europe that aim to further increase transparency and improve financial stability. However, as the experience in Iceland shows, legislation other than that pertaining directly to securities markets can have a crucial impact on the functioning of these markets.

Most significantly, changes were made to the laws on financial undertakings. Among other things, the revision explicitly makes it illegal for banks and financial firms to extend loans against a collateral in their own shares. This activity was quite common leading up to the collapse of the banks, resulting in inflated measures of banks‘ equity and artificial support of the banks‘ stock prices. Further restrictions were made on loans to large shareholders, board members, management and key employees. The changes to the law also limit the term of auditors to five years and forbids them to perform other services for the financial undertakings in question.

The following legislative changes are also worth noting:

- By changes to the law on securities trading, the takeover threshold was lowered from 40% to 30% to limit the room of large shareholders to manouvre.
- Class action suits were made possible by changes to the code on civil procedure.

- Also, changes were made to the law on limited liability companies to strengthen minority rights.

The financial crisis shed light on the importance of good corporate governance. Corporate governance was not high on the list of executives‘ priorities prior to the banking collapse, with, to be fair, some notable exceptions. The Icelandic corporate governance guidelines were first published in 2004, with minor revisions in 2005. In 2009, however, the Guidelines were extensively revised. The revision was a call to action „to reclaim lost goodwill and to build up credibility in the business sector“ as stated in the foreword to the Guidelines. Additional and more detailed provisions were added in relation to most aspects of corporate governance, including internal control and risk management, independence of directors, the role of the Chairman of the Board, remuneration policy and disclosure of information. A section on ethics and social responsibility was also added. In February 2012 the fourth edition of the Guidelines was published, with fairly minor revisions from the previous edition.

The corporate governance guidelines in Iceland are published by the Iceland Chamber of Commerce, NASDAQ OMX Iceland and the Confederation of Icelandic Employers. To further encourage compliance with best governance practices these parties together with the Center of Corporate Governance at the University of Iceland decided in February 2011 to enable companies to have their corporate governance practices certified by the Center of Corporate Governance following an audit by auditors or other qualified experts. Ten companies have been certified so far.

The diversity of boards and management has received special attention in Iceland following the crash, and for a good reason. Many have convincingly argued that a lack of diversity played a role in the collapse. Many of Iceland‘s biggest companies indeed followed a similar path. High leverage and fast growth were the name of the game among these companies, many of which were led by thirty-something, relatively inexperienced male CEOs. In the spring of 2008 9 out of 10 board members of listed Icelandic companies were male. The stock market, that a few years earlier had been a home to many diverse companies, was by 2008 dominated by financial companies, that comprised about 80% of total market capitalization.

The corporate governance guidelines emphasize the importance of diverse board members with „ a wide range of capabilities, experience and knowledge.“ It is hard to argue that CEO and board profiles in Iceland in 2008 were the result of a careful process purely based on these considerations. In March 2010, Parliament enacted changes to the law on limited liability companies which came into effect September 1, 2013 and that stipulate that the representation of each sex on the board of limited liability companies with more than 50 employees shall be no lower than 40%. Prior to the enactment of this law, business leaders in Iceland had recognized the need for greater gender balance on boards and rising female board representation pointed to a significant shift in attitudes. By mid 2012 around a third of board members of listed Icelandic companies were female. Currently, women represent 44% of board members of Icelandic companies listed on NASDAQ OMX Iceland. The corresponding average for EU‘s largest listed companies is 18%.

While the lack of women representation on boards prior to the banking collapse raises questions as to whether board selection in Iceland was generally based on purely professional considerations, greater gender balance on company boards does not guarantee professionalism. Neither does gender imbalance on individual boards necessarily point to weaknesses in the composition of the board. And good corporate governance need not either be perfectly correlated with good looking corporate governance statements. Had one invested just prior to the stock market crash in Iceland in a portfolio containing the four companies that came unscathed from the collapse, Marel, Össur, HB Grandi and Hampiðjan, one would have nearly tripled one‘s investment by now. Yet, the gender ratios on the boards of these companies differed in no way from those of listed companies at large. Also, two of these companies, HB Grandi and Hampiðjan, were listed on First North Iceland and, therefore, not subject to the „comply or explain“ declaration regarding corporate governance unlike companies on the Main Market.

By pointing this out I am in no way trying to diminish the importance of gender diversity or good corporate governance codes. However, one should not view them as „cure-alls“. Ultimately, a multitude of factors need to be in place to create vibrant and healthy stock market culture. And emphasis on good corporate governance – good guidelines and measures of real compliance – can be useful tools in creating the desired culture. But more is needed, all links in the chain need to be strong. All market participants, companies and their employees, auditors, law and rule setting institutions, surveillance authorities, analysts, media and shareholders, need to play their part. And we shouldn‘t underestimate the part the „informal surveillance“ of market participants can play in creating a sound marketplace. A recent study on all reported fraud cases in large U.S. companies between 1996 and 2004 (Dyck, Morse and Zingales (2009)) found that fraud detection relies to a great degree on players such as employees, the media, analysts, industry regulators and short sellers.

NASDAQ OMX Iceland has actively promoted measures to create a best-in-class stock market framework in Iceland. As I mentioned previously, we were engaged in the revision of the corporate governance code and corporate governance certification. We have been proponents of greater diversity on company boards of both listed and unlisted companies.

We have put heavy emphasis on education. We have made a special effort in reaching out to a diverse group of private investors. We have also approached companies and advisors to a greater degree than before. With easy access to cheap bank debt financing in the first years of this century people largely forgot about the critical role the stock market plays in raising capital for economic growth. Considering the relatively great fluctuations in macroeconomic activity historically, healthy equity ratios are even more important here in Iceland than in most other countries.

Our surveillance activities have also to an increasing extent been geared towards education and preventive measures, through active communication with issuers and traders alike. We have also put added emphasis on the analysis of long-term trading patterns and strengthened our cooperation with the Icelandic Financial Supervisory Authority (IFSA).

In all our operations we benefit greatly from being part of the NASDAQ OMX Group. Systems, rules and practices are largely harmonized across the NASDAQ OMX Nordic markets. As an exchange we can therefore offer best-in-class market framework.

In spite of important steps taken by the authorities and market participants to strengthen the financial market in Iceland in recent years, we believe additional measures are necessary to support a healthy stock market, a stock market fully serving its purpose as a transformative force that helps companies grow and the economy to prosper. And we have argued for such measures.

On top of the list is the swift abolition of capital controls. By locking in domestic capital (and legacy foreign capital entering Iceland prior to the collapse in 2008) the controls increase the risk of asset price bubbles. There is also great reluctance by foreign capital to enter the Icelandic market under capital controls, even if there are formally no restrictions on the inflows and outflows relating to new foreign investment. This lack of participation by foreign investors weakens the market, although, perversely, may to some extent counteract the threat of price bubbles created by the locked-in domestic capital. The capital controls also practically eliminate the possibility for Icelandic companies to raise capital domestically for expansion abroad. In the last few years several companies have decided against listing for this reason. Under the current circumstances, the stock market is only able to fully support companies that intend to use funds domestically. This situation is reflected in the listings we have had in recent years, which have been dominated by some of Iceland‘s leading domestic service companies. Therefore, the capital controls are already causing damage to the stock market in addition to interfering with normal price formation. They must go!

Apart from the abolition of capital controls, perhaps the most important issue left unaddressed by the legislature relates to securities lending and short-selling. Facilitation of short-selling prior to the crash could have illuminated the weaknesses in the system and slowed down or even halted the expansion of the banks at an earlier stage. While securities trading legislation in Iceland imposes no restrictions on short-selling as such, in practice short selling is greatly limited by the fact that pension funds are, by law, not allowed to lend securities. The scope of mutual funds to lend securities also needs to be broadened.

In addition to the above, the Icelandic government can have a great influence on the development of the stock market in the coming years via other measures. First, it must pursue policy that supports macroeconomic stability. There are positive signs in this regard as we are eyeing a balanced budget this year and the government has presented a bill that would, if passed into law, put great restrictions on its ability to run deficits over an extended period of time, while retaining some flexibility to meet fluctuations in demand in the short run.

Secondly, it must work hard on restoring Iceland‘s reputation, which was tarnished by the collapse of the banking system. This can best be done by emphasizing sound and predictable operating environment for businesses, while also highlighting the many exciting opportunities facing those doing business in Iceland. Thirdly, listing companies in the government‘s ownership would have direct positive impact on the stock market. Listing Iceland‘s largest bank, Landsbankinn, would be a great first step and, in fact, the Minister of Finance and Economics has already expressed the government‘s intention to list the bank as early as in 2015. Listing Iceland‘s largest energy company, Landsvirkjun, would represent a significant second step. These companies would be likely to draw the attention of international investors, thus boosting the stock market as a financing venue for Icelandic companies. These actions would enhance liquidity and, together with the proposed legislative measures discussed earlier, contribute to the development of a sound stock market.

Above, I have outlined measures already taken and further actions needed to support our rebuilding efforts. On the whole the rebuilding effort is going well to date, although we risk running out of steam if the capital controls are not soon greatly relaxed or abolished. The first post-crash listing materialized in December of 2011, when Iceland‘s leading retailer, Hagar, was listed. Since, additional seven companies have listed bringing the number of listed companies to 17. The growing stock market capitalization also illustrates the recovery. In March 2009, market capitalization was at a low point, at 1.1 billion euros, or 12% of GDP. It has more than tripled and is currently around 3.8 billion euros or about a third of Iceland‘s GDP. However, we are far off levels commonly seen in other countries and further still from the levels seen in Iceland prior to the crash. In five years, we believe it is reasonable to aim for roughly doubling of market capitalization, to around 70% of GDP and 30 to 40 listed companies.

NASDAQ OMX Iceland has articulated its vision of a stock market representing the diverse set of industries making up the Icelandic economy, including our thriving export industries tourism, energy and fisheries. Whether this vision can be realized will very much depend on the path of public policy. In the near term, we can expect a similar pattern of listings as in the past three years, with some of our leading domestic service companies expected to list in the coming 12-18 months. I am also optimistic Landsbankinn will be listed in 2015 giving the market a significant boost. Should the capital controls be substantially relaxed, we will likely see some of Iceland‘s most exciting innovation companies opt to list and expand from their base in Iceland. However, if the capital controls remain in place, the picture looks drastically different. Many of these companies may seek to relocate abroad and some of our largest listed companies could consider that as well.

Despite undeniable challenges, I remain optimistic. My optimism is based on generally sound and improving economic fundamentals. The economy is growing at around 3% at an annual rate, with most economists expecting even stronger growth in the years to come. We have enjoyed current account surplus in recent years and data indicates that the nation‘s underlying debt position is quite manageable and even favorable in historical context. This gives us a strong platform to move forward, get rid of the capital controls and attract international investors.

Additionally, NASDAQ OMX Iceland envisions a broader role for the Exchange than it has had in the past decade. The stock exchange was founded in 1985 and in 1991 the first company was listed. By 2000 the number of companies had grown to 75. Some of these companies were quite small. We had more than twenty fisheries companies listed, more than any other exchange in the world. Now, there is only one listed fisheries company. Easy access to debt financing in the early years of this century and merger activity among listed firms led to a sharp reduction in the number of listed firms. By 2007 there were only 30 companies listed. At the same time, the listed companies were on average many times bigger than they had been around the turn of the century. The concept of the stock exchange as a platform to help small companies grow got lost. Small companies in Iceland generally don‘t consider listing as a viable means for financing and advisors generally don‘t think small companies are fit for listing. As a result, companies, investors and the economy as a whole suffer. We are working hard on changing this perception. We are nurturing our relationship with small and medium sized companies and engaging in an active dialogue with advisors. We have pointed to the role NASDAQ OMX is playing in the Nordics in helping small companies grow via the First North market. We have expanded the scope of activities in relation to SMEs. For example, we recently brought together investors and some of Iceland‘s most interesting innovation companies in an event held here in Harpa. We have also argued for changes to the legislative framework which we think will help these companies list and gain access to financing. In particular, we have argued for changes to the legislation on pension funds that would enable them to invest to a greater degree in small and medium sized companies listed on multilateral trading facilities (MTFs) such as our First North market. These changes together with other supporting actions could be a gamechanger for the financing of SMEs in Iceland. Currently, we are also engaging market participants and other stakeholders in a project we term the „IPO taskforce“. The goal of this work is to pinpoint and generate widespread support for concrete actions that would make it more attractive for companies to list and finance themselves through the securities market. I predict these efforts will bear fruit and that our role in helping Iceland‘s most exciting innovation companies grow will be a big part of our story told ten years from now.