Ownership and corporate governance in Finland: A review of development trends*

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Abstract

We review the evolution of Finnish ownership structures and corporate governance systems, focusing on large Finnish firms. We reflect Finnish patterns against the academic evidence on effectiveness of various ownership forms. In our view, the lack of controlling owners is a problem for the Finnish economy. As the Finnish regulation makes it difficult for management to establish a power base needed for long-term decision-making, dispersed ownership can lead to a power vacuum.

1. Introduction

In this paper, we analyze ownership structures and corporate governance systems of large Finnish firms, with a focus on the problems caused by the separation of ownership and control. We also propose adjustments to corporate governance systems that can alleviate some of the problems.

Recent literature indicates a large variation in ownership patterns and corporate governance systems across countries. Corporate governance systems tend to draw from the country's traditions and evolution of its business regulation. It is therefore not a surprise that global recommendations on corporate governance systems work poorly.

Regulation of corporate governance has become more globally aligned in recent years. Internationalization of financial markets and corporate ownership are driving this alignment. In Europe, the EU has naturally been a major factor in

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this development. Much of the global regulatory convergence has had the Anglo-American system as its model. In Europe, the regulatory change has brought European countries closer to the British system.

The US and the UK have a leading role in the financial markets, which explains the migration towards the Anglo-American governance system. Much of the top academic research also studies those markets. However, the premise of corporate governance system in the Anglo-American countries differs significantly from that in the rest of the world. In the Anglo-American countries, the corporate governance system is based on dispersed corporate ownership and managerial power, whereas controlling ownership is the norm in the continental Europe. In the U.S., management tends to possess control of corporations, while in the U.K., companies are often controlled by the board of directors, that is often relatively detached from shareholders. We argue that the Anglo-American regulatory framework works poorly in countries where management control is neither accepted nor possible. The Anglo-American influence has increased transparency, and power of minority shareholders.

In Finland, the corporate law provides the annual general meeting (AGM) with considerable powers over the corporation. Most importantly, the AGM can replace the board at any time. The board in its turn can replace the executive management of the firm. This means that the owner who controls the AGM also has the ultimate power over the corporation, and such a controlling owner plays an important role in corporate governance. Reforms that aim to mimic the Anglo-American model tend to limit controlling ownership, and in the Scandinavian setting, they run a risk of creating a power vacuums.

Sweden has a long tradition of controlling ownership of large firms. Within the "Swedish model" of management and control, firms are often controlled by a single owner, often an individual or a family. This single owner has the control of the AGM, and thus of the entire firm. The control rights are often obtained via a dual share class structure, where different share classes have different voting rights. The system with dual class shares continues to dominate among publicly-traded Swedish firms.

The "Swedish model" of controlling ownership has relevance for Finnish corporate governance. However, private controlling ownership does not have a similarly dominant role among publicly-traded firms in Finland, albeit passive blockholders exist. In practice, institutional investors exert some power in the Finnish firms by their activity in nominating directors for the corporate boards. In these situations, however, it is difficult to pinpoint a group that is in charge of the firm's future and longevity.

Government ownership continues to play an important role among publicly traded firms in Finland. Its importance has its historical roots. Many other aspects of the current ownership structure of Finnish firms depend on relatively recent developments. After the war, and up until the late 1980s, the two dominant bank spheres exerted power over a number of large Finnish firms. Their position resembled that of banks in Japanese keiretsus, and in the German main bank system. Control was exerted both through direct ownership, and through a network of cross-ownership within the bank's sphere. The banking crisis at the beginning of 1990s, paired with new regulations that limited direct share ownership by banks, forced banks to give up their power position. The resulting vacuum has since then been filled mainly by other types of Finnish institutional ownership. Meanwhile, policy efforts to encourage private Finnish ownership have been limited.

These historical events have shaped the Finnish corporate governance system to what it is today. In the reminder of this paper, we will analyze the evolution of the Finnish ownership structures and corporate governance systems against the backdrop of academic evidence regarding different ownership forms and their effectiveness.

2. The stock market and the role of publicly-listed firms in Finland

In the 1970s, the Finnish stock market was small and under-developed, and as already mentioned, the ownership structure of Finnish firms resembled that of a main bank system. The Finnish commercial banks each had their spheres, within which they exerted power, and provided both equity and debt financing (Korkeamäki, et al., 2013). The market was stagnant, and the strong insider influence further curbed the interest of minority investors to participate in the stock market. Finnish investors were not allowed to invest in foreign stocks, which paradoxically limited attractiveness of the Finnish market, as opportunities to diversify stock portfolios were limited (Hietala, 1989). Raising capital through the public stock market was not attractive either (Hyytinen, et al., 2003).

During the 1970s, the number of Finnish listed firms increased only from 43 to 49 (Korkeamäki, et al., 2013). The size of the stock market relative to GDP decreased through the decade, and at the end of the 1970s, stock market capitalization/GDP was below 10%, a level that is typical for an emerging country with underdeveloped stock markets.

The interest towards equity markets grew during the 1980s. The new Corporation Law of 1980 increased transparency, and the Finnish firms were also self-adjusting to attract financing. Many firms adopted international accounting standards, and thus reported dual accounting information to attract especially foreign investors (Hyytinen, et al., 2003; Kasanen, et al., 1996). New stock listings attracted a growing number of firms during the 1980s, as indicated by Figure 1. The late 1980s produced the first significant wave in Finnish IPO listings.

The Finnish stock market began to gain a meaningful role in corporate financing. Stock market capitalization/GDP increased in a ten-year period from 1985 to 1994 from 9.2% to 42.3%.[1] Restrictions for Finnish investors to invest in foreign stocks were lifted in 1986 (Hietala, 1989). The stock market boom reached the public awareness in part due to some newly-rich stock tycoons in the media spotlight. Interestingly, ownership on the Helsinki Stock Exchange became actually slightly more concentrated during the 1980s, with the average cash flow rights of the largest owner (three largest owners) increasing from 22% (36%) in 1980 to 28% (44%) in 1990 (Hyytinen, et al., 2003).

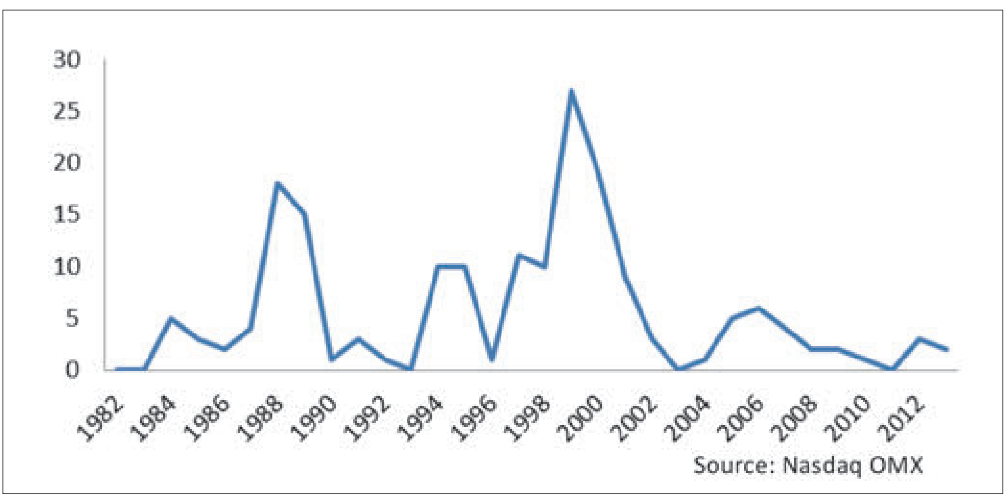

Figure 1: Finnish IPOs by year

[1] Sources: IFC Emerging market year book and OECD.

Explosive growth of the IT sector in Finland started to show on the stock market. Figure 2 depicts stock market development from the late 1980s to 2011 in comparison to the markets in Germany, the U.K., and Sweden. The U.K. and Sweden are often viewed as market-oriented economies, wheras Germany is viewed as a bank-oriented country, where public markets serve a less important role. Finland is at the level of Germany in the late 1980s and early 1990s, but in the late 1990s, the Finnish stock market capitalization over GDP exceeds that of the U.K. by a clear margin. More recently, Finland has returned back to the level of Germany.

Some studies have touted the Helsinki stock exchange as one of the world's most international exchanges due to the high level of foreign ownership. However, the historical statistics on foreign ownership of Finnish listed companies are biased due to a Nokia effect. At its height, Nokia stood for about 70% of the market capitalization of the Helsinki Stock Exchange, and the company's foreign ownership was around 90%. The Nokia effect is also evident in Figure 3, which indicates the Finnish stock market capitalization from 2000 to 2013. With Nokia included, the Finnish stock market has experienced a shrinking trend over the last decade, but even with Nokia excluded, the stock market has failed to grow during that time period.

While the Finnish stock market today is small relative to the size of the economy, publicly-listed firms play an important role in the Finnish economy. Pajarinen and Ylä-Anttila (2006) report that while only about 10% of the 500 largest firms in Finland are publicly listed, they stand for about half of sales, employment, assets, and investments in that group. Korkeamäki and Koskinen (2009) further note that in comparison to privately-held firms, publicly-listed firms tend to pay higher wages and provide for more employment growth. They suggest that publicly-listed firms gain a competitive advantage over private firms due to their easier access to capital.

The significant role of the publicly-traded firms in the Finnish economy has not decreased since the Pajarinen and Ylä-Anttila (2006) study. We observe more recent data from 2012 on the companies within the Talouselämä 500 dataset. In 2012, 76 of the 500 largest firms in Finland , or roughly 15% were publicly traded. As Figure 4 shows,

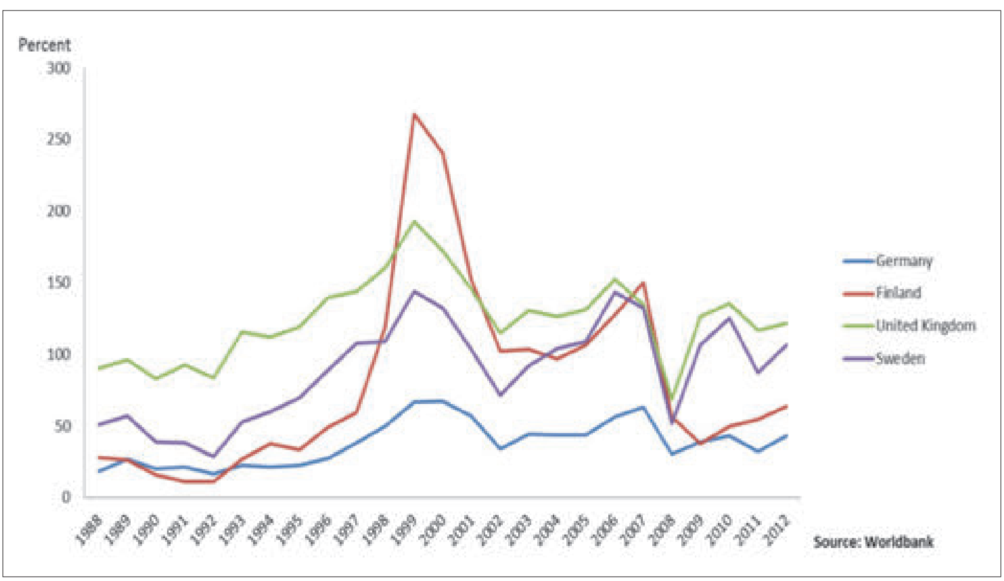

Figure 2: Market capitalization/GDP in Germany, Finland, UK, and Sweden.

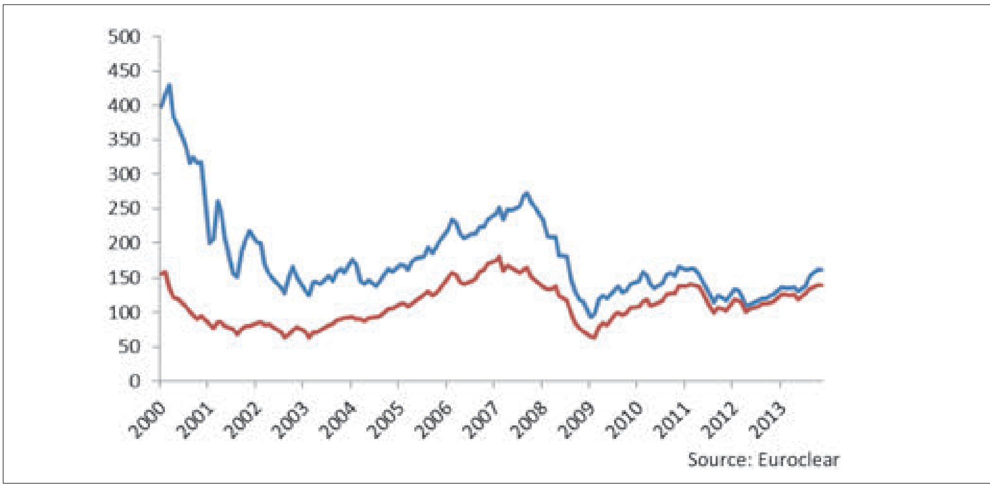

Figure 3: Finnish stock market capitalization with and without Nokia

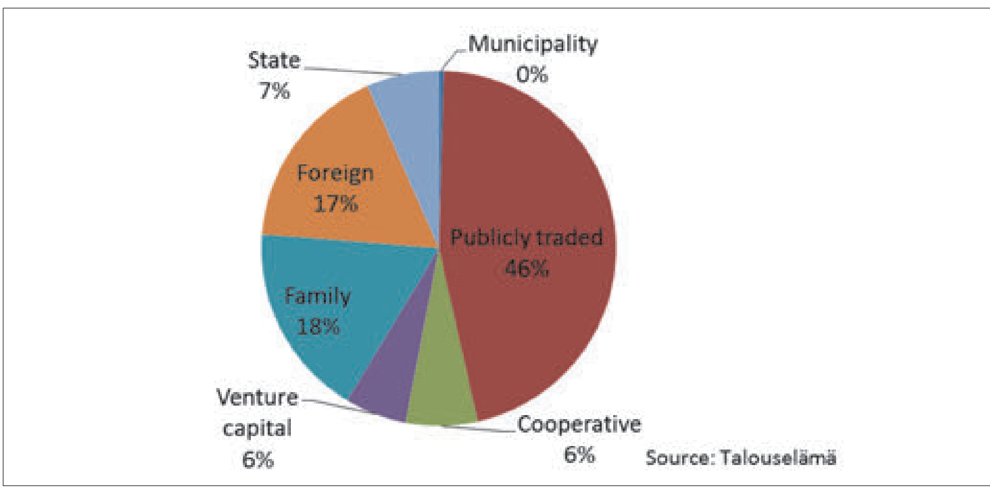

Figure 4: Share of employment among 500 largest Finnish firms in 2012 by ownership type

those firms stood for almost half of the total employment within the dataset, employing about 550.000 workers. It should also be noted that a significant number of publicly-traded firms are outside Talouselämä 500, as the Helsinki Stock Exchange had a total number of 125 firms listed at the end of 2012.

In recent years, the government has failed to introduce incentives to encourage participation in the stock market. On the contrary, reforms such as the re-introduction of double-taxation of dividends in 2004 have contributed to the continued small role of the stock market. Bank deposits continue to be the investment objective of choice for Finnish households, as indicated in Figure 5. About 12% of the household assets are directly invested in the Finnish stock market.

In a recent multi-country study, Rydqvist, et al. (2014) report that in Finland, less than 10% of the stock market value is held by households, which ranks Finland the third lowest among the 21 countries included in that study. Keloharju, et al. (2012) find that in 2008, about 13% of Finns owned stocks, with the median stock portfolio value at about

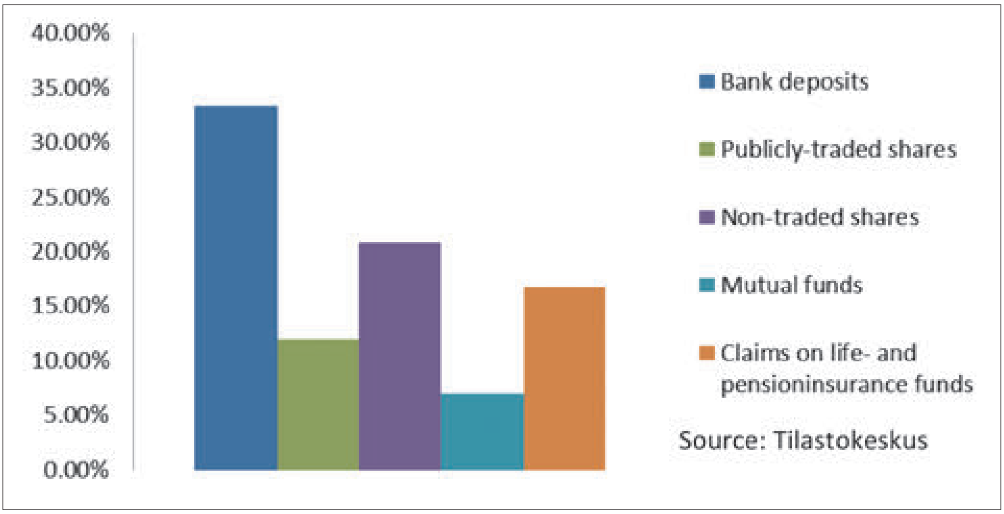

Figure 5: Distribution of Finnish household assets, third quarter of 2013

3.600 euros. Keloharju and Lehtinen (2015) report that in 2015, the popularity of stock ownership remains at 12.8%, with the median portfolio value at 4.200 euros. As the lack of capital continues to be a serious problem for Finnish firms, creating incentives to mobilize the capital on bank accounts should be one of the goals of the government.

Stock markets throughout the world benefit from home bias, as investors overweigh their home markets. Finnish companies have a competitive disadvantage, as they do not get the full benefits from home bias, as Finnish households remain circumspect of equity investments. The relative absence of households from the Finnish stock market also contributes to the local lack of liquidity, which in turn not only limits wider interest in Finnish listed firms, but also contributes to the poor attractiveness of being listed in Finland.

3. Evolution of the Finnish corporate governance system

As we mention above, the fast development of the stock market during the latter part of the 1980s was fueled by a wave of deregulations and shifts in tax policies. Vihriälä (1997) and Hyytinen, et al. (2003) describe regulatory changes relevant for banking and bank financing. The Finnish companies' ability to raise funds was enhanced with the deregulation process in the 1980s. In particular, new instruments, such as convertible bonds and loans with warrants were added to firms' tool boxes (Vaihekoski, 1997). Also, new types of intermediaries were introduced, which raised the number of potential participants in the local financial markets. For instance, mutual funds were introduced in 1989 (Korkeamäki and Smythe, 2004). The vast development of the financial markets during the period is indicated by the fact that the total value of financial assets in Finland increased from FIM 35 billion in 1970 to FIM 913 in 1995 an increase of about 2500 percent, or at a pace of roughly 24% per year. At the same time, the composition of financial assets developed so that the share of bank deposits shrunk from 81% to 39%, while the proportions of money market assets and bonds increased. The proportion of listed stocks was 12% in 1970, and 22% in 1995 (Vaihekoski, 1997).

Taxation of financial assets and their returns also underwent significant changes , especially in the early 1990s. Bank savings and government bonds had traditionally enjoyed a preferential tax treatment, as their interest was tax exempt. Dividend income was taxed at the investor's marginal tax rate, and stock transactions were subject to a

1.6% stamp tax, both of which further contributed to the unpopularity of the stock market. Finland introduced the avoir fiscal system in 1990. The system effectively abolished double taxation of corporate profits. Further in 1993, all capital income received equal treatment, as a flat 25% tax that was collected on income generated from financial markets and bank deposits alike. The avoir fiscal system has been since then recalled in 2004, and the current system resembles the so called traditional tax system, with double taxation of corporate profits (Korkeamäki, et al., 2010).

As mentioned, the Finnish corporate governance system was underdeveloped and opaque in the 1970s. The two bank spheres, the KOP-sphere and the SYP-sphere played an important role among large Finnish firms. According to Lantto (1990), the two groups stood out in their level of involvement and complexity. The next largest groups, in terms of the number of companies within the group, are the "Agricapital group" with OKO and Tapiola, the SKOP group, the "Labour sphere" with Elanto, Kansa, and STS, and lastly the "Public sphere" with government owned enterprises. Pohjola (1988) further notes that out of the top-20 industrial companies in 1986, 12 were controlled by a coalition that included either a bank, an insurance company or both. He also mentions that as suppliers of loan financing, banks exerted power beyond their voting power. Furthermore, Troberg (1992) states that in order to retain their power position over Finnish corporations, banks exerted their power also through lobbying activities. The power of banks may explain the seemingly odd finding in Mayer (1990), that while the Finnish tax system during his sample period (1970-1985) provided incentives for use of equity financing, the Finnish firms were nevertheless using mostly bank debt to finance their operations.

The KOP and SYP power spheres resembled the Japanese keiretsu system or the German mainbank system (Ihamuotila, 1994; Kasanen, et al., 1996; Hyytinen, et al., 2003). It is likely that the existance of these power spheres reduced small investors' interest in stock investments. The stock market was seen as an insider club, where small investors' concerns would weigh very little. Additionally, the fact that ownership was concentrated in few hands, the stock market was highly illiquid, which further reduced attractiveness of the stock market to small investors (Kasanen, et al., 1996). During the 1970s, about half of the firms listed on the Helsinki Stock Exchange had an owner with greater than 25% ownership share. About 20% of the firms had an owner with greater than 50% ownership share.[2]

Interestingly, Kuisma (2000) notes that the Finnish banks did not originally seek industrial power through their stock investments, but their equity investments were rather made in order to inject equity financing into ailing firms among the bank's industrial clients. With new equity issues, the banks would often retain the undersubscribed shares.

The Finnish banking crisis in the early 1990s disrupted the corporate governance system with bank-based power spheres. Banks faced liquidity problems, which forced them to liquidate some of their holdings, and at the end forced them to merge. Whereas KOP and SYP had been previously competing for power in the stock market, they now became one entity, which reconfigured the entire balance of power among large Finnish firms. Regulatory reforms also contributed to banks' reduced appetite for corporate equity on their balance sheets. Among them, the new Basel regulations assigned a high risk weight for equities, thus making it costly for banks to be stock holders. Banks' ownership of Finnish companies decreased throughout the 1990s, as indicated in Figure 6. The evidence on Finnish insurance companies follows a similar trend, as they have gradually reduced their percentage holdings of Finnish publicly traded shares from 9% in 1998 to less than 1.5% today[3]. Hyytinen, et al. (2003) note that the banking crisis instigated a process that moved Finland from the main-bank structure to a system where the stock market has an increasing influence.

2 Source: Annual editions of the Pörssitieto yearbook.
3 Source: Tilastokeskus.

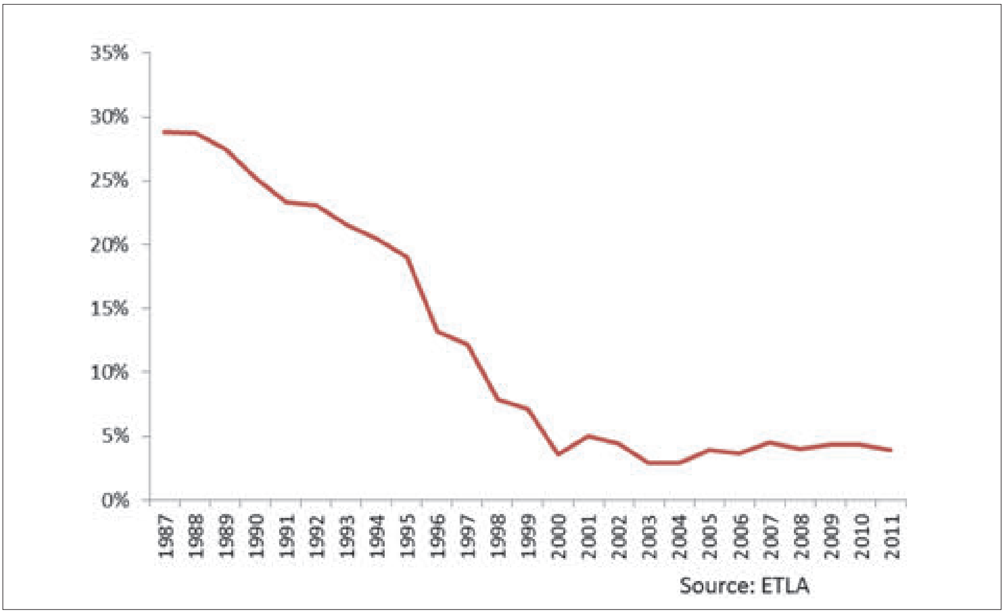

Figure 6: Ownership by commercial banks among Finnish listed firms

3.1. Controlling ownership in Finland

As mentioned above, in the 1970s, about 25% of the listed firms had a single owner with higher than 50% ownership share, and about half of them had the top owner with more than 25% ownership.[4] In 1995, the statistics remained surprisingly similar. This has two explanations. Firstly, the Finnish banking crisis caused restructurings in several listed firms, and in 1995, some of the listed firms were majority-owned by other companies as a result of mergers. Secondly, the number of listed firms had increased from below 50 in the 1970s to 73 in 1995, and the entrepreneur often retains the controlling share of a newly-listed firm. Still in 2005, about half of the listed firms had an owner with greater than 25% ownership (the number of listed firms had grown to 143), while the proportion of firms with a majority owner had decreased to about 18%. It is interesting to note that 10 of the 143 firms on the Helsinki Stock Exchange had the Finnish government as the top owner, whereas two of them (Telia Sonera and Nordea) had the Swedish government as the top owner.

4 In cases where cash flow rights differ from voting rights, these statistics are based on voting rights. The source for ownership information is various annual editions of Pörssitieto yearbook.

Despite the decreasing trend in controlling ownership, it has not completely disappeared from the Finnish economy. When we examine the 500 largest firms in 2012, contained in the Talouselämä 500 database, we can note that 122 or 24% of them are family firms. Even out of the 77 publicly-traded firms within the top-500, 17 (22%) are family firms.

3.2. Dual class shares and controlling ownerhship

The use of control via dual class shares was common in Finland earlier, but dual class shares have since then disappeared rapidly. In the early work, Rydqvist (1992) notes that 67% of the firms in the Helsinki stock exchange had dual share structures, setting Finland into the group for frequent dual class usage in his study. We observe more recent data for Sweden and Finland in Figure 7. While both countries have a strong history of dual class share structures, the period since the late 1990s shows that in Sweden, dual class shares remain

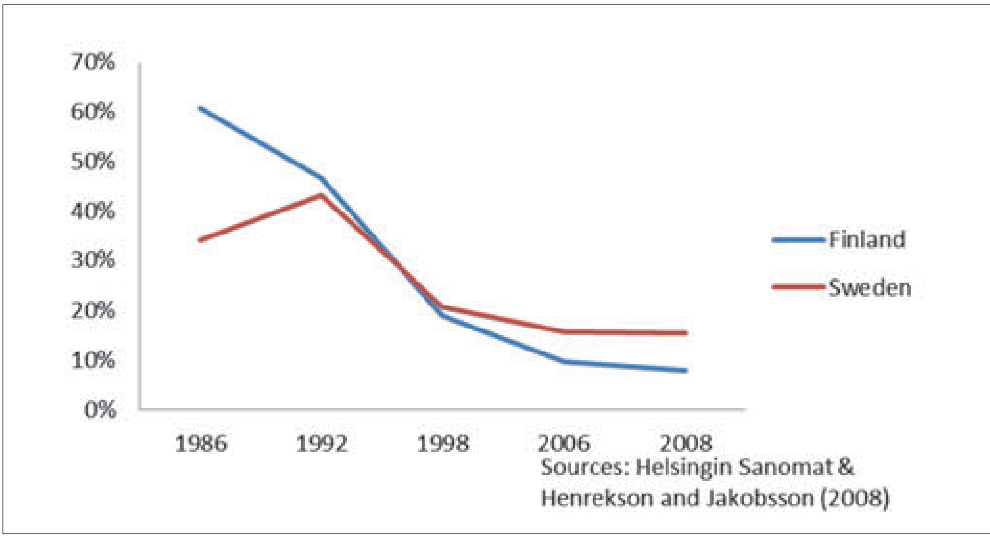

Figure 7: Percentage of listed firms with multiple share classes

almost twice as popular (46 firms or 15% in 2008) as they are in Finland (10 firms, 8%).

Previous studies confirm the decreasing trend in Figure 7. Faccio and Lang (2002) report that only 37.6% of the Finnish firms in their sample have dual class shares, whereas 66% of their Swedish sample have dual class shares. Also, Maury and Pajuste (2011) indicate that the proportion of dual class shares decreased in Finland from 45% in 1995 to 31% in 2005, whereas the same figures for Sweden are 61% and 50%.[5] Differences in the reported percentages between these studies and our Figure 7 are explained by the fact that we include all publicly-traded firms, whereas the prior studies use samples that are obtainable from commercial data vendors.

Nenova (2003) uses data from 1997 to study the market value of control blocks held via dual block shares. Interestingly, Finland is the only European country in her sample where the market value of the control block does not deviate from the class with lower voting rights. In other words, there is no extra value of control among Finnish firms with dual class shares. In summary, dual class shares have decreased in popularity in Finland, and even in firms where they are used, their higher voting power does not carry a value premium.

5 Holmén and Högfeldt (2004) note specifically that in Sweden, dual class shares are often used to obtain power to retain private benefits.

4. Different ownership models – What does research tell us?

In this section, we review academic evidence on the pros and cons of different types of ownership. We also make an effort to link the evidence to the practical issues related to the Finnish setting.

4.1. Institutions as controlling owners

For financial institutions, it comes natural to act as investors, rather than controlling owners. High net worth individuals and families are the typical controlling owners. Large pension funds are an example of the former, while investment companies represent the latter group. The Swedish "Industrivärlden" is an example of that group.

A large part of pension funds' assets are invested in fixed income products. Their stock holdings are highly diversified, both at home, and to an increasing extent abroad. They do not have any stock holdings that would give them a controlling role in the firm.

"Industrivärlden" is involved in a total of around ten firms, and the company has either a controlling stake, or it shares a controlling stake in each one of them. The holdings are diversified only to a degree that no individual asset can alone destroy the investment firm. When any of the firms in the portfolio experiences problems, a controlling owner typically works with the company to restructure it and help it through the difficult times, rather than liquidating its holdings.

Throughout the world, institutions tend to take the role of an investor, rather than that of a controlling owner. The main reason is arguably that it is costly to be a controlling owner. These costs can be estimated by observing the Stockholm Stock Exchange, and the so called "investment firm discount". The leading Swedish investment firms, including "Industrivärlden", are priced at 20–40% below the value of their holdings.

The costs of controlling ownership include the cost of active managerial involvement. While that cost may be relatively small, it needs to be considered, and covered by the dividend stream that comes from the firms in the portfolio. Thereby, a post that is relatively small in relation to portfolio firms' sales or value added can play a significant role on the investment firm.

Another cost for a controlling owner is related to both portfolio concentration, and illiquidity of the holdings. Lack of diversification comes with a cost. The fact that a controlling owner is locked in with her investment for a longer time period causes an additional cost. While these costs can be difficult to quantify, they are not trivial. The above-mentioned "investment firm discount" in Sweden reflects that. Given these costs, institutional investors have strong incentives to free ride and let others control the firm. Evidence from around the world indicates that institutional investors tend to "vote with their feet", rather than acting as controlling owners

Issues with insider trading further complicate institutional ownership. A direct involvement in the firm limits an investor's ability to trade the firm's shares. Thus, institutional investors are not able to follow their normal strategy of actively managing their holdings in case they get actively involved in the firm's management.

We are, of course, not suggesting that financial institutions completely lack value as shareholders of publicly-listed firms. For instance, Hansman & Krakman (2004) argue that the interests of institutional investors are often well-aligned with those of a typical investor. Compared to individual investors, institutions have superior analytical skills,[6] and that is what their customers essentially pay for. With their sheer size, institutional investors can also contribute to improved management of the firms in their portfolio. Hirschman (1970) shows that institutional investors have an effect on the firm's management through their trading activity. As significant players in the financial markets, institutions can have a disciplining role against both controlling owners and management of the firm.

Empirical studies confirm the positive effect of the presence of institutional investors on companies. The effect is, however, diminishing as the proportion of institutional investors' holdings grows (see Morck, et al., 1988; McConnell & Servaes, 1990; Pindado & de la Torre, 2006 and Miguel, et al., 2004).We should keep in mind that these studies are done in settings where either management control or a non-institutional controlling owner exists. They are therefore not directly applicable to the Finnish setting.

4.2. Foreign ownership

Foreign investors may either hold a proportion of shares of a Finnish publicly-traded company, or a Finnish company can become acquired by a foreign buyer. Foreign investors who make portfolio investments in the stock market are typically not controlling owners. Their effects on the firm thus remain relatively small. In some cases, foreign ownership may lead to international members on the corporate board. This has often positive consequences, as the board gains new insights and new types of competence.

In contrast, when Finnish company becomes a wholly-owned subsidiary of a foreign entity,

6 See e.g. Korkeamäki and Xu (2015) and cites therein.

the effects of foreign ownership are significant. Cross-border acquisitions tend to improve specialization. Finnish takeover targets are often bought by global players. Such acquisitions can lead to productivity gains and technology transfer, as the buyers bring their state of the art business models with them. A large empirical literature supports this. In other cases, the buyer may only be interested in the target's technology. This happens often in IT- and pharmaceutical industries. In such cases, the foreign buyer often contributes with its marketing resources, and with a structure that allows it to lever synergies and competitive advantages. As long as the target firm continues its activity in Finland, these advantages accrue to the local economy.

A number of empirical studies show that international acquisitions have a positive effect on target companies. These results are very consistent across different countries, even in Finland (Ylä-Anttila, et al., 2004). These studies often focus on profitability, but some also consider the effects on productivity and employment, which also tend to be positive. The common interpretation is that a foreign buyer contributes to the target firm's profitability. The alternative interpretation would be that foreign buyers are superior in finding profitable takeover targets. However, most studies acknowledge this potential problem, and account for it in their empirical design.

4.3. Government ownership

Government has played a historically important role in corporate ownership in Finland. In a study of 100 largest firms in 12 European countries, Pedersen and Thomsen (1997) find that Finnish government ownership is among the highest at 27.6%. They mention the late industrialization of Finland as a potential explanation. Faccio and Lang (2002) also present similar evidence. At 15.8%, the Finnish government ownership is the highest among their Western European sample countries.

Academic studies predominantly indicate that government ownership has adverse effects on corporate performance. Government owned firms are often cited for focusing on issues such as employment, rather than economic efficiency. Many studies also report that government-owned firms are poorly managed, as management recruitment is often politically motivated. Furthermore, media follows government-owned firms closely, which can lead to short-sighted decision making, as pressure to please the media and the electorate mounds among politicians. Government-ownership also distorts competition. A large company that has not only economic, but also political goals, tends to discourage other entrants from entering the industry. This easily leads to inefficient allocation of resources in an economy.

Dewenter and Malatesta (2001) conduct an in-depth international study of government-owned firms. Their results confirm the earlier findings of inefficiencies in the government-owned sector. However, they also find that in industries where they face stiffer competition, government-owned firms perform better. In a more recent study, Goldeng, et al. (2008) study the effects of competition in a large scale study of Norwegian government-owned firms. They find that in Norway, competition fails to increase efficiency among government-owned firms. The problems with governmental ownership are obviously relevant for Finland, given vast government holdings in the country.

4.4. Family ownership

Family firms have received ample research interest, especially since Anderson and Reeb's (2003) paper, where they report that in contrast to the popular view, family firms play an important role even among the largest U.S. firms. They find that 35% of S&P 500 firms can be classified as family firms. They also find family firms to outperform non-family firms, especially when family firms are run by a founder CEO. Villalonga and Amit (2006) report further support for the positive effect of the founder of a family firm being active either as the CEO or as the Chairman.

The effects of family ownership have also been studied in Finland. Tourunen (2009) reports that family firms play a smaller role in Finland than in other Western European countries. Pajarinen, et al. (2011) report that first generation family firms reacted more swiftly than other firms to the financial crisis in 2007–2009, by adjusting their labor force downwards. Pajarinen and Ylä-Anttila (2006) also find more fluctuation in the number of employees among family firms. This could be viewed as evidence of a concern for longevity of the firm, as family firms may be more willing to make painful cuts to their workforce in order to save the firm.

4.5. The role of Private Equity

Private equity firms invest in equity of both listed and unlisted firms. Through their investments, they gain the right to make decisions for the company (through voting rights attached to equity). Private Equity firms tend to specialize in investments into mature firms with stable cash flows. The transactions are called buyouts, and their goal is often to gain majority ownership. Private Equity investments have grown very fast in Sweden recently, making the country one of the European leaders in the field. The Finnish Private Equity industry is much less developed. In 2011–2012, the risk capital investments (pääomasijoitukset) in Finland were about 0.4% of the GDP, whereas in Sweden, they were 0.8% of the GDP (FVCA).

European Private Equity firms tend to follow the U.S. practice of making the acquisitions often through so called limited partnerships, where investors enjoy limited liability, whereas the PE-firm is the general partner with unlimited liability. The PE-firm is in charge of managing the fund, but typically contributes very little of the total capital (1–3%). Through the limited partnership structure, it is clear that the general partner takes the responsibility over the fund, but also that the limited partners have no say on the fund's investments. In other words, over 95% of the PE fund capital surrenders all control rights to the fund manager, the PE firm. In compensation for the risk that comes with unlimited liability, the PE firm takes a significant proportion of the profits.

The PE-firm's contract is designed to give powerful incentives for the firm. The incentives strengthen through the firm's use of financial leverage at the target companies, which forces them towards value-enhancing restructurings. The Private Equity model offers an elegant and effective solution to the problem with lack of controlling owners. The benefits of the PE model have been pointed out in several previous studies.[7]

The PE-model works best on companies that have the potential and the need for significant restructuring. In a more stable setting, the traditional models of corporate governance are likely to work better. Typically in the PE-model, firms with a good potential are bought from the stock market, restructured, and then listed back to the stock market. The PE-model can thus not function as a sole solution for the economy, but it rather requires that a well-functioning stock exchange with traditional corporate governance systems exists.

It needs to be noted that the PE-model has also received strong critique. Part of this critique is caused by the restructurings that are completed by the PE-firms. However, one can argue that often those changes were required, and that they had to be completed by someone else, were it not for the PE-firm. Even the most painful changes tend to have positive effects in the long run both for the company and for the economy. The critique related to taxational issues with the PE-firms is more problematic. The PE-funds are often domiciled in tax havens. It is also unclear whether the PE-company's profits (carried interest) should be taxed as capital income or ordinary income from a service. One would think that these problems can be solved without taking down the entire PE-model.

5. Conclusions and policy implications

Finland is currently facing a difficult economic situation. New investments and restructuring of

7 See e.g. Jensen (1989).

the business sector have important implications on how the Finnish economy recovers from the crisis. The crisis has exposed the problems that exist in corporate governance. We argue that those problems can present obstacles in the near future for the much needed restructuring of the Finnish economy.

Government-owned companies have a significant role in the Finnish economy. When external forces, such as changes in product markets, force firm to restructure its activities, management's inability to react and make decisions can aggravate an already difficult situation. With government-owned companies, restructurings can easily become parts of a political process, whereby the government can feel itself forced to resist restructurings due to issues related to regional politics or employment policy.

Innovations often instigate positive restructurings. However, the hierarchical decision making process in large companies can make it difficult to handle such adjustments within the company. Even when an innovation occurs within the firm, it may not fit with the company's strategic goals. The obvious solution to this problem is a spin-off or a sale of the innovation to another firm. Even this type of transactions can be more difficult to accomplish when the economic incentives are missing, which is often the case in government-owned firms.

Another notable characteristic for Finland is the gradual dismantling of the bank-based ownership system that was in place prior to the banking crisis in 1991, and the subsequent ownership vacuum. For a number of companies, it is unclear whether any group has a stable control over the firm.

Listed companies that face ambiguity regarding their control suffer from a different type of a problem. In the absence of a clear controlling owner, management finds it difficult to conduct a forward looking policy when it comes to extensive investment programs, large acquisitions, and divestments. This can lead to overly conservative policies, which fail to optimize the firm's long-term prospects. This can be a particularly serious problem during economy-wide shocks, when significant changes are needed at a number of firms.

However, for listed firms, several solutions exist. For instance, a company that fails to take advantage of its opportunities due to an overly conservative management becomes an ideal takeover target. An acquirer that can both take control, and have a plan for the firm's activities can spur growth within the company, and thus increase its value. Based on the Finnish debate, one might see foreign acquisitions as a problem. In our view, the problem is rather the lack of foreign acquisitions in Finland. Finland suffers from a historical and chronic lack of capital, and the Finnish business sector has substantial investment needs. Foreign buyers can be a solution to this problem.

Therefore, the interesting question in our view is, why does Finland fail to attract foreign investments? Finland continues to receive high rankings for its competitiveness and business climate. Such rankings tend to correlate with the country's attractiveness for foreign capital. However, this does not appear to be the case for Finland. One can speculate that the shortcomings of Finland, such as the distant geographical location, the peculiar language, and the small size of the domestic market are not fully captured by the international indices. Since Finland cannot affect its geographical location, its language, or even its local market size, the country would need to put even more effort on the factors that can be affected. Such factors include tax policies, employment policies, and immigration policies, to name few examples.

It is clear that increased inflow of foreign investments would be a good fit in a strategy to revitalize and restructure the Finnish economy. As we have noted, the academic literature is unanimous on the benefits of foreign acquisitions when it comes to business growth and profitability.

Foreign and domestic financial institutions combined stand for the majority of the capital invested in the Finnish stock market. Undoubtedly, they are the group with highest potential for additional investments. Despite the large current holdings, institutional investors do not seem overly interested in the Finnish stock market. As we saw earlier, the Finnish institutions have increased their holdings abroad, while their investments in the home country have remained steady. The inflows of foreign capital to the Finnish stock market have also dried in recent years.

At the same time, the existing institutional holdings may even amplify problems, as large institutional ownership shares contribute to ambiguity regarding the control of the company. We argue that this ambiguity contributes to weak development among a number of companies. We are describing a "catch 22" situation. Companies need more capital in order to grow and restructure. Institutions have the capital, but their increased ownership shares can potentially exacerbate problems with corporate governance. That might contribute to a decision to invest in countries where the issues related to control of the firm are more clear-cut.

International efforts to harmonize business regulations have viewed the Anglo-American system as the virtue. Within the EU, the British regulatory framework has been the model for new EU directives in the area. The British regulations tend to be critical on controlling ownership, which contributes to the near absence of controlling ownership of publicly listed firms there. However, in Great Britain, the corporate board has a number of legal rights to have power over the company. The point that someone needs to be in charge, driving a stable control, seems to have gone forgotten in other countries, including Finland.

It is logical that if controlling ownership is made difficult, management is allowed to gain control of the company. For Finland, we argue that the position of the controlling owners should be strengthened. Bengt Holmström wrote recently that Finland needs more people like Antti Herlin and Björn Wahlroos,[8] and we tend to agree with him. Improving the position of the controlling owners will, however, not be the universal solution to the problems we have discussed. Therefore, it is also worth considering giving management more rights, in line with the system in Great Britain. This would not make the annual general meeting meaningless, but it would allow management to compile relatively stable coalitions to back it up. Such coalitions could include both Finnish and foreign investors and institutions, and their existence would allow management to focus more on long term strategies than on quarterly results. This would further increase the interest in the Finnish stock market among long-term investors.

The Private Equity model can solve corporate governance problems in individual companies in an elegant way. The PE-model's goal is to create value in the company through restructuring. On the negative side, the powerful incentives built into the model have caused problems in some cases. Also, PE firms often receive critique around the world for their typically aggressive tax arrangements.

We have analyzed a narrow, yet crucial part of the Finnish economy. Given our limited scope, we do not have a comprehensive platform for a complete economic policy to help Finland out of the ongoing crisis. What we suggest here should be viewed as a part of a larger package of economic policy. We also want our report to generate constructive debate around the problems that we raise, which is a reason for us to avoid overly detailed policy suggestions, as such suggestions have a tendency to limit the scope of the ensuing debate.

However, our analysis can be viewed as guidance on the direction to which economic policy in the area should be headed. We think the *investing climate in Finland should be improved*. This is not a new issue, but Finland continues to lack its peers, including Sweden, in attractiveness. We also recommend *creating a long-term plan to reduce governmental ownership* in the Finnish business sector. We view the extensive government involvement in the business sector as an obstacle for dynamic development of the Finnish economy. The policymakers should also *try to solve control problems that large institutional ownership creates in publicly-traded companies*. The position of those owners who are actively involved in corporations should be strengthened, and the balance of power

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between the corporate management team and the annual general meeting should be reconsidered, to provide management with a more solid platform for long-term policies. Also, possibilities for encouraging increased involvement of Private Equity in restructuring of Finnish listed companies should be studied. Finally, *the stock market should be made more attractive for both firms and investors*. As we have pointed out throughout this report, a well-functioning stock market is a pre-requisite for a well-functioning corporate governance system. The current tax system contributes to the lack of dynamism on the Helsinki Stock Exchange. Changes in both taxation and pension policies could have large benefits for the Finnish stock market. Experiences from Sweden indicate that better incentives for household on the stock market improve market liquidity and also legitimacy of the stock market as an integrated part of the national economy.

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