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Ownership and governance of large Finnish firms

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Abstract

In this report, we study the ownership structure of large Finnish firms. We make an overview of the evolution of corporate ownership in Finland from the 1970s to today, and contrast the Finnish setting to international patterns of ownership. Factors that make the Finnish ownership field different from most Western countries include large government involvement, and a significant role of co-operatives. We also note that while the role of local banks was very significant, it diminished quickly upon the Finnish banking crisis in the early 1990s, and subsequent regulatory changes. The disappearance of banks as owners seems to have resulted in a power vacuum in Finnish listed firms. While the general lack of capital seems to plague the Finnish corporate sector, we note a specific need for anchor owners, in other words owners who hold a significant proportion of the firm's shares, and who are actively involved in the firm and can thus be seen as owners, instead of merely as investors.

Among our policy implications, we see a need for an improved investing climate in Finland. The goal should be to make Finnish firms attractive in the eyes of both domestic and foreign investors. The government's large role as owner should, in our view, be reduced. However, changes in government's role need to be viewed as a long term goal, as hasty actions are likely to cause severe side effects. From the point of economic efficiency, the co-operative form is not optimal for a dynamic, integrated, and fast-changing world. Supporting migration from co-operatives to corporations should thus be considered. Institutions play a large role in corporate ownership throughout the world. We argue that the model of dispersed ownership and large institutional ownership with no active voice works less well in Finland, compared to the Anglo-American countries. Finland should consider ways in which the power of the corporate management team could be solidified, for management to have a better footing to pursue long term policies. Finally, the Finnish stock market needs to be made more attractive. A wider participation in the stock market would have wide spread positive effects to the economy.

Keywords
Ownership, corporate governance, financial markets, finance, investment

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FOREWORD

The Economic Council, and the public debate in general, has recently drawn increased attention to the significance of business ownership structures from the viewpoint of economic growth and employment. The discussion has focused on the effects of foreign ownership, on the decline of the relative position of the stock exchange, and on the State's role as an owner. The linkages of Finnish businesses with international value chains have placed spotlight on the national origin of ownership: the distribution of profits and value added to different countries is partly based on the headquarters' location which, for its part, is linked with ownership.

Spurred by these topical and partly unaddressed questions, the Economic Council commissioned in spring 2014 a report from Adjunct Professor Ulf Jakobsson and Professor Timo Korkeamäki on business ownership and ownership steering in Finland. As Ulf Jakobsson has only recently conducted similar research in Sweden, it was considered useful to carry out the project in the form of Finnish-Swedish cooperation. The now published final report provides a compact overview of the evolution of Finnish ownership from the 1970s until today, together with an analysis of the situation in light of latest research results. The report attaches particular attention on how ownership patterns affect companies' planning horizon, investments and ability to regenerate themselves. One of the key observations is that the Finnish businesses lack strong, long-term controlling ownership which would ensure opportunities for sensible development. The authors discuss and propose various alternatives to resolve the problem.

The interim report was submitted to the Economic Council in June 2014. The preparation of the project has benefited from the dialogue on ownership issues in a group led by Prime Minister Jyrki Katainen and consisting of a number of Finnish decision-makers and experts. An expert seminar was held in August 2014 bringing together Chairman of the Board Pekka Ala-Pietilä (Solidium), Chairman of the Board of Directors Anne Berner (Vallila Interior), Managing Director Marika af Enehjelm (Finnish Venture Capital Association), Vice Chairman of the Board Jussi Herlin (Kone Corporation), Director Seija Ilmakunnas (Labour Institute for Economic Research), President and CEO Sari Lounasmeri (Finnish Foundation for Share Promotion), CEO Timo Löyttyniemi (The State Pension Fund), Managing Director Matti Vanhanen (Finnish Family Firms Association), Director General Juhana Vartiainen (Government Institute for Economic Research) and President and CEO Matti Vuoria (Varma Mutual Pension Insurance Company). On behalf of the Secretariat of the Economic Council, I wish to thank everyone for their comments and participation. However, the seminar participants are not in any respect responsible for the contents of the final report. Finally, my warm thanks to the authors of the report for their valuable work which will hopefully encourage discussion and provide kindling for necessary reforms in this extremely important sector of economic activity.

Helsinki 18 December 2014

Pekka Sinko
General Secretary of Economic Council

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1 INTRODUCTION

Finland is currently going through some difficult economic challenges. There are many reasons behind these difficulties. Among the most important reasons are the structural changes in the forest industry, the downfall of the previously successful technology sector, and the general loss of cost-competitiveness.

Both in Finland and Sweden, the issues related to cost-competitiveness have been traditionally solved with currency devaluations. However, due to the Euro-membership, this option is not available for Finland, which heightens the need for adjustments within the Finnish economy in the medium term. This needed realignment will place demands upon all areas of the Finnish economy. The ability to adjust depends on a number of factors. Among them is the corporate governance mechanism, especially among the large Finnish firms. The current crisis has by no means been caused by failures in corporate governance. However, the crisis has brought weaknesses in the Finnish corporate governance practices to daylight. Well-functioning corporate governance systems have become much more important due to the ongoing economic crisis.

The main purpose of this study is to analyze the corporate governance system of large Finnish firms. Especially among publicly-traded companies the separation of ownership and control has the highest potential to cause problems. We tackle the question of which corporate governance systems need to be adjusted in Finland, and how.

The questions about corporate governance of large publicly-traded firms are not unique to Finland. Rather, a number of developed countries face similar challenges. The role of large firms has changed markedly in the last couple of decades, and with all the changes in the global economy, the old way of corporate governance has become questioned. Many of the new challenges are involved with new forms of corporate ownership. Globalization has spurred international ownership in firms. Also, institutional investors such as pension funds and insurance companies have become major players in corporate ownership. Institutional investors differ from the traditional controlling corporate owners in that for them, corporate ownership has mainly one goal, and that is return on investment. We will return to this theme later in this report.

Recent literature on corporate governance indicates a large variation in corporate governance systems and practices across countries. The corporate governance system in place in a given country is to a large degree path dependent, and based on the country's traditions and development. Laws and regulations on corporate governance are affected not only by the country's traditions, but also by how the rest of the business sector is regulated. It is therefore not a surprise that global recommendations on corporate governance systems tend to work poorly.

Despite this incomparability across countries, regulation of corporate governance has become more and more aligned in recent years. Internationalization of financial markets and corporate ownership are among likely causes to this alignment. It seems natural that regulations are made more aligned, in order to support further internationalization. In Europe, the EU has naturally played a major role in aligning regulation. The global alignment of regulation has, to a large degree, had the Anglo-American system as its model, and in

Europe much of the regulatory change has brought rules in European countries closer to the British system.

The likely cause for movement towards the Anglo-American system is the leading role that those countries have in the world financial markets. A very large part of the top academic research also both comes from those countries, and is based on those markets. However, the premise of corporate governance system in the Anglo-American countries is quite different from that in the rest of the world, for instance in Finland and Sweden. In the Anglo-American countries, the corporate governance system is based on dispersed corporate ownership and managerial leadership, rather than controlling ownership, which 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 many times relatively detached from shareholders. We argue that the regulatory framework that is in place in the Anglo-American countries works poorly in countries where management control is neither accepted nor possible.

While the Anglo-American influence has had a positive effect on the Scandinavian markets via increased transparency, and to some extent via increased power for minority shareholders, it has as indicated contributed to problems in corporate governance. The regulatory framework is fairly similar in Sweden and Finland, due to both the common origin of the law in our countries, and the cooperation in regulatory reforms between the countries. Most importantly, from the corporate governance viewpoint, the corporate law in both countries provides the corporate annual general meeting (AGM) with considerable powers over the corporation. Most important is that AGM can in both countries 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.

Naturally, if no individual owner is willing or able to take on the role of controlling owner, the company is without control.(“herrelöst = isännätön”). In the Anglo-American setting, either the company’s board of directors or its management would have the control, and in fact this is the normal situation there. In contrast, in Finland and Sweden, neither the board nor the management has the legal powers to take such control. There is no legal entitlement for board or management to act on their own in questions related to ownership and control. Therefore, in practice, management control is not an option for Finnish and Swedish firms.

The Anglo-American regulatory framework that rests upon dispersed ownership and management control thus makes a poor fit within the Scandinavian corporate governance system. The 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 vacuum for the local firms.

Sweden has a long tradition of controlling ownership of large firms. It is thus motivated to speak of a “Swedish model” of management and control of large publicly-traded companies. Within that model, it is typical for a firm to be 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. Despite internationalization and growing institutional ownership, the system with dual class shares continues to dominate among publicly-traded Swedish firms. However, in the long run, sustainability of the system faces questions in Sweden, as indicated by Henrekson and Jakobsson (2012).

The "Swedish model" of controlling ownership has relevance for Finnish corporate governance as well. However, private controlling ownership does not have a similarly dominant role among publicly-traded firms in Finland. In Finland, government ownership plays an important role. Furthermore, a number of Finnish firms do not have any clear controlling owner. In practice, institutional investors exert some power in the Finnish firms by their activity in nominating directors for the corporate boards.

The high level of government ownership is based on history. Many other aspects of the current ownership structure of Finnish firms depend on relatively recent developments. After the war, and up until the beginning of the 1990s, the two dominant bank spheres exerted power over a large number of Finnish publicly-traded firms. Their position was not unlike the position that the banks have traditionally had both in the 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 banks' sphere.

The banking crisis that hit Finland 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 Finnish institutional ownership. There has not been any visible effort of encouraging private Finnish ownership during the period. Instead, we have witnessed developments such as a significant reduction in the number of firms with dual class shares.

It seems that both politicians and the Finnish public have missed the fundamental change that occurred in the Finnish corporate governance system as the banks' power diminished. There are many potential reasons to this. One is that the networks that formed the basis for the "main bank model" have to some extent remained, while the banks' ownership itself declined. Another potential reason for why the development was overlooked is that the exceptional success of Nokia as publicly-traded company with dispersed ownership somehow masked the long term trend that happened in corporate governance in Finland.

As already mentioned, very few Finnish listed firms currently have a controlling owner. A significant proportion of the market has either the Finnish government or financial institutions as main owners. In such situation, it is difficult to pinpoint a group that is in charge of the firm's future and longevity. We believe that this is not a good basis for forward-looking and innovative plans in these firms. We will return to this issue later in this report.

Our analysis of the situation that we describe above will take the following form:

Since our main focus is on the publicly-traded firms in Finland, a natural starting point is to describe the role of publicly-traded firms in the Finnish economy. We do this in Chapter 2. In Chapter 3, we describe the evolution of Finnish corporate governance and corporate ownership in the most recent decades. During this period, there have been a number of significant changes that affect Finnish corporate governance. Financial deregulation, increased international economic integration/globalization, and also internationalization of corporate ownership are among those changes. Since all these changes are interconnected, it is natural to present the Finnish development against an international background. The similarities between Finland and Sweden in areas such as industrial structure and legal tradition, paired with the interconnectedness of the two neighboring economies, motivates comparisons in developments between Finland and Sweden.

A direct empirical examination of different corporate governance systems and their effectiveness in Finland is beyond the scope of this study. We therefore tackle the question from the basis of existing literature. Corporate governance is an internationally very well-studied area, which allows us to draw from a large number of prior studies. Some areas, such as international ownership, have also been extensively studied in the Finnish context. We make conclusions based on these prior studies in Chapter 4.

As we mention above, a large number of authors consider the Anglo-American market setting, and many of them make comparisons between companies that have block holders and thereby a controlling owner, and those that have dispersed ownership. Since management control is less feasible in Finland due to the reasons that we state above, these comparisons are of a limited value to us. However, in the longer run, where changes in the regulatory framework are possible, they are more relevant and interesting from the Finnish perspective. An important observation to make from the comparative studies concerning ownership in the Anglo-American context is that those studies quite often assume that there are existing parties that have the direct control of the corporation. For instance, the effects of institutional ownership are often studied based on the premise that either management control or control by other controlling owners exists. Nevertheless, we will also discuss the implications for institutional investors as controlling owners in Chapter 4.

Our study is mainly focused on publicly-traded firms. Listed firms play an important role in the Finnish economy, and any problems in their governance can be studied within that group. Of course, an alternative positive outcome from the viewpoint of the Finnish economy would be that growth occurs outside the range of publicly-traded firms. This is why we also consider models that are not limited to publicly-traded firms, also in Chapter 4. The discussion will be based on the ownership structures that are present and relevant in the Finnish economy. Government-owned and publicly-owned firms play an important role, both within the Helsinki Stock Exchange, and outside it. Co-operatives are by some measures more important in Finland than in any other industrialized country in the world, and they of course operate outside the stock exchange. International ownership has gained importance around the world, and Finland is not an exception. Foreign ownership of publicly-traded firms tends to be relatively passive, so that foreign owners most often decide to “vote with their feet”, rather than actively managing the firms that they own. Meanwhile, a number of Finnish firms have gone private, as a foreign buyer has emerged and taken the firm out of the exchange. Such firms have thus become subsidiaries of large firms, headquartered outside Finland. This development, and its implications, is also discussed in Chapter 4. There we also discuss the potential for Private Equity to be an actor in the sphere of large Finnish firms.

There are two questions that we consider as central to our theme. The first is the shortage of active controlling owners in Finland. The second is related to the growing internationalization of Finnish firms. We discuss both of these questions also in Chapter 4.

Finally, Chapter 5 contains the policy implications of our analysis.

2 THE ROLE OF PUBLICLY-LISTED FIRMS IN THE FINNISH ECONOMY

In this chapter, we discuss the role of the stock market and listed firms in the Finnish economy. We trace back the stock market development from the 1970s to today, and offer some insights into the stock market's role today.

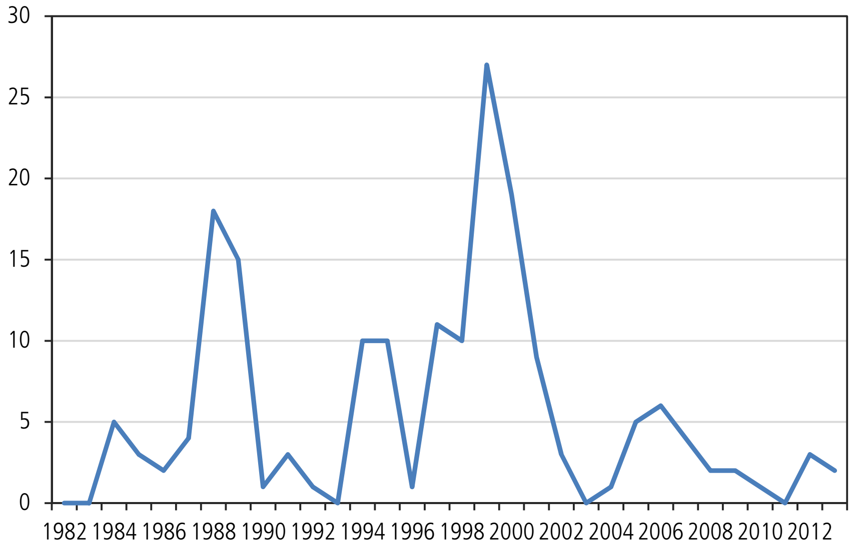
In the 1970s, the Finnish stock market was small and under-developed, and the ownership structure of Finnish firms resembled that of a main bank system. Namely, the Finnish commercial banks each had their spheres, within which they exerted power, and provided both equity and debt financing (Korkeamäki, et al., 2013). The market was stagnant, and the strong insider influence affected willingness of minority investors to participate in the stock market. Finnish investors were not allowed to invest in foreign stocks, which paradoxically reduced their willingness to invest in the home market as well, due to their inability to diversify their portfolios (Hietala, 1989). It seems that much of the negative attitudes that exist towards the stock market in Finland still today can be traced back to the 1970s and the influence of insiders and banks that was in place at that time. The stock market was not an attractive venue for raising capital either. The regulatory framework and the tax system at the time favored heavily the bank-based debt financing (Hyytinen, et al., 2003).

During the entire 1970s, the number of firms listed on the Helsinki Stock Exchange increased 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. Poor business habits and social norms continued to keep the interest in corporate ownership via publicly-traded shares low.

The 1980s saw a rapid expansion in interest for equity ownership in Finnish firms. The regulatory framework had been renewed with the new Corporation Law in 1980 to increase transparency, and the Finnish firms were also self-adjusting to attract financing for their growth. For instance, it became common to adopt international accounting standards and thus to report dual accounting information to attract especially foreign investors (Hyytinen, et al., 2003; Kasanen, et al., 1996). After the stagnant 1970s, the stock market was living boom years, especially in the late 1980s. The rally was partially instigated by abundant financing from the Finnish banks that were aggressively competing for market shares in lending (Vihriälä, 1997).

New stock listings attracted a growing number of firms during the 1980s, as indicated by Figure 1. Recall that from 1970 to 1979, the number of firms listed on the Helsinki Stock Exchange had grown by only six firms. The late 1980s produced the first significant wave in Finnish IPO listings. The second wave occurred during the IT-bubble years around the turn of the millenium. It is interesting to note that in general, in comparison to larger equity markets, these Finnish IPO waves have come with a lag - a year or two after IPO waves in the U.S. market.

Figure 1 Finnish IPOs by year in 1982-2013.



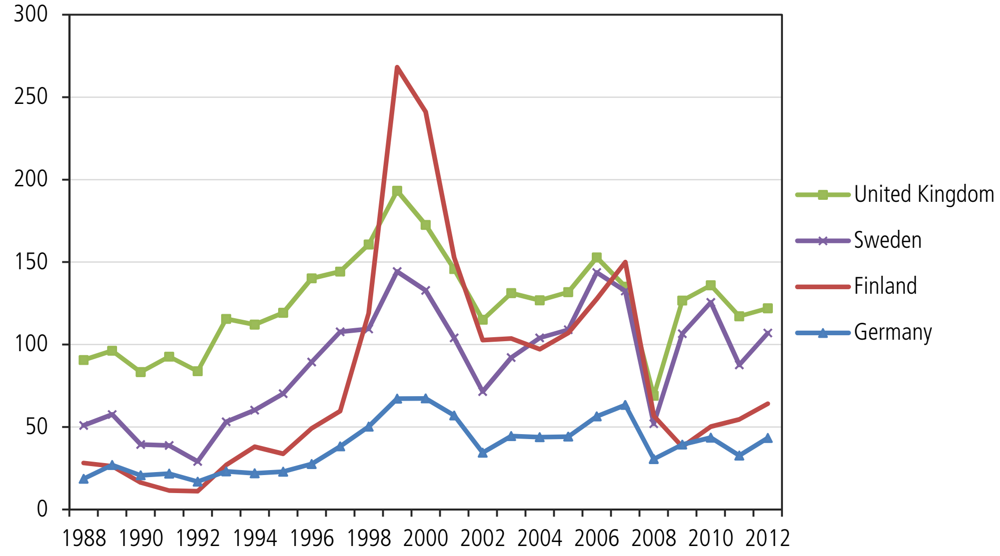
Source: Nasdaq OMX.

The Finnish stock market began to grow towards having a meaningful role in corporate financing, and this happened already before the boom years for Nokia, which we will discuss later. Stock market capitalization/GDP increased in a ten-year period from 1985 to 1994 from 9.2% to 42.3% (During the same time period, the same figure for Sweden grew from 29.6% to 72.1%).[1] The above-mentioned restriction for Finnish investors to invest in foreign stocks was also lifted in 1986 (Hietala, 1989). The stock market boom reached at least the awareness of most Finns in part due to some newly-rich stock tycoons that reached the media spotlight. Interestingly, ownership on the Helsinki Stock Exchange became actually slightly more concentrated in the Finnish stock market 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).

Nokia and the explosive growth of the IT sector in Finland began to play a significant role in the growth of the stock market. This is evident from Figure 2, which depicts stock market development from the late 1980s to 2011. The Figure also provides a comparison to the markets in Germany, the U.K., and Sweden. The figure reports stock market capitalization over GDP, which is a widely used measure of stock market development. Among our comparison markets, 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. The effects of Nokia and the IT-bubble on the Finnish stock market are evident from the graph. Finland is at the level of Germany in the late 1980s and early 1990s, but then in the late 1990s, the Finnish stock market capitalization over GDP exceeds that of the U.K. by a clear margin. In the most recent years in the graph, Finland has returned back to the level of Germany.

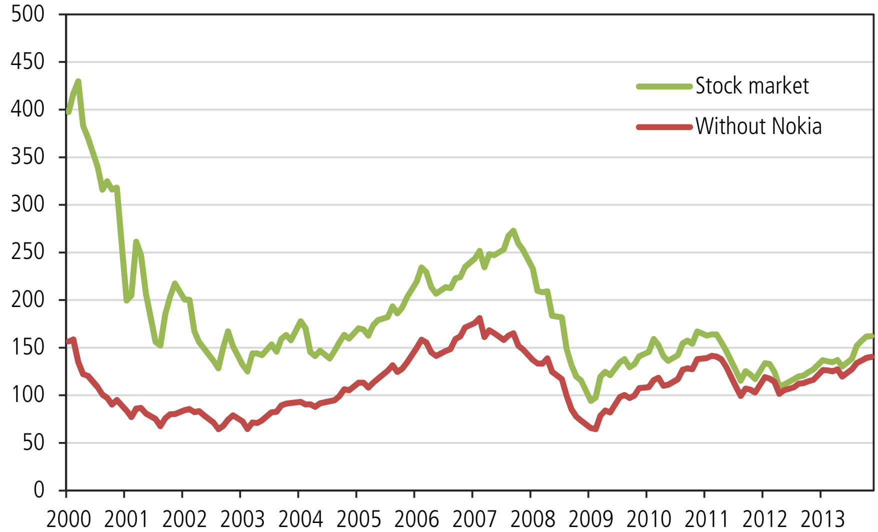
[1] Sources: IFC Emerging market year book and OECD.

Figure 2 Market capitalization/GDP in Germany, Finland, UK, and Sweden in 1988-2012.



Some previous studies have touted the Helsinki stock exchange as one of the most international exchanges in the world due to the high level of foreign ownership. However, the historical statistics on foreign ownership of Finnish listed companies are heavily biased due to Nokia's effect on the aggregate figures. 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 strong effect of Nokia on the aggregate market statistics 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.

Figure 3 Finnish stock market capitalization with and without Nokia in 2000-2013.

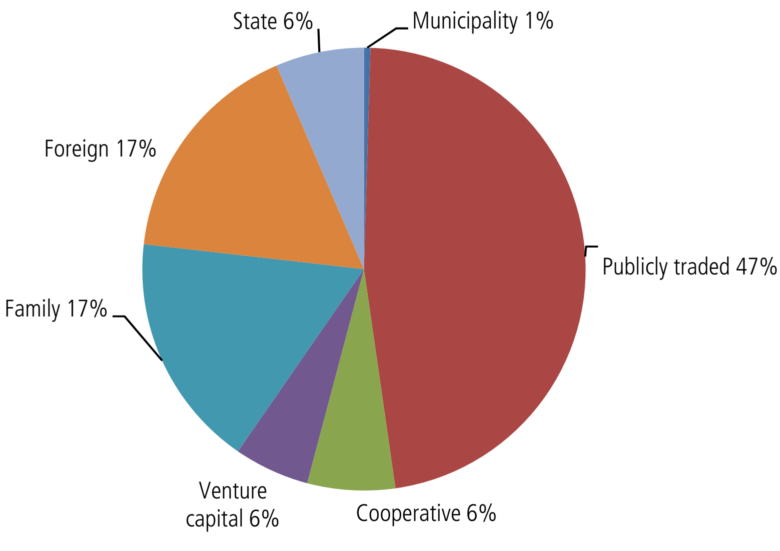


Source: Euroclear.

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. In other words, the publicly listed firms in the Top-500 group are relatively large, and they thus have a high impact on the Finnish economy. Korkeamäki and Koskinen (2009) confirm Pajarinen and Ylä-Anttila findings, and also 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, 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. While we discuss the role of publicly-traded firms in this Chapter, we will cover the other significant ownership types in Figure 4, namely Family-, Foreign-, State-, and Venture capital-owned firms and Co-operatives later in Chapter 3.

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

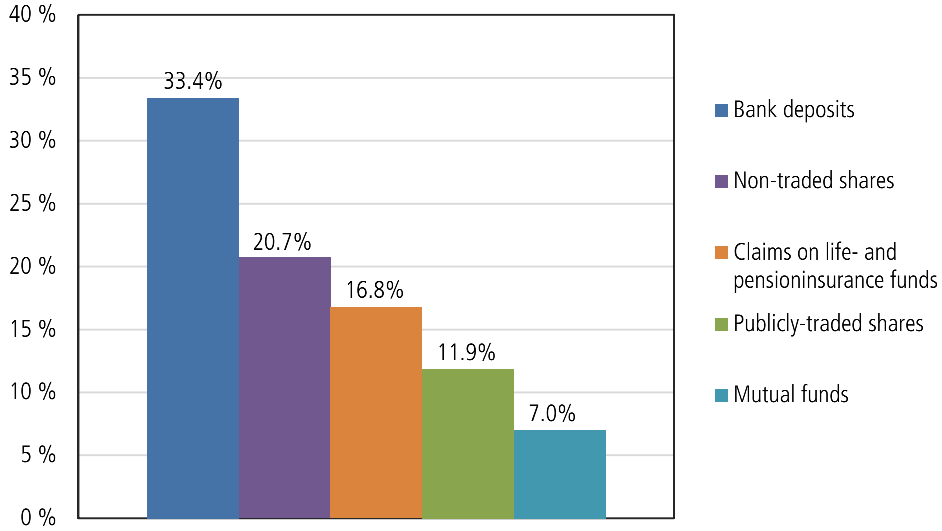


Source: Talouselämä.

The Finnish tax system, with a preferential treatment for dividend income from privately-held firms has been often mentioned as a significant threshold for firms to publicly list their shares. The traditionally negative sentiment towards stock investments, paired with the strong position that the Finnish banks have had on the local financial markets, have contributed to the small size and the illiquidity of the local stock market (Korkeamäki and Koskinen, 2009). In recent years, the government has failed to introduce incentives to encourage private citizens' investments in the stock market. On the contrary, reforms such as the re-introduction of double-taxation of dividens in 2004 have supported continued the small role of the stock market in the Finnish economy, and also to dominance of bank deposits as the investment objective of choice for Finnish households. Figure 5 indicates the large proportion of capital that is currently in bank deposits. About 12% of the household assets are invested in the Finnish stock market. While both mutual fund investments and pension fund assets also include investments into the Finnish stock market, the part of those investments that is allocated to Finland is fairly small, as we will discuss later.

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. In this respect, Finland is the third lowest among the 21 countries included in the Rydqvist, et al. (2014) study. Keloharju, et al. (2012) find that in 2008, about 13% of Finns owned stocks, with the median stock portfolio value at about 3.600 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.

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



Source: Statistics Finland.

Stock markets throughout the world benefit from so called home bias, as local investors are more likely to make investments within their home country than abroad. Finnish companies have a competitive disadvantage, as they do not get the full benefits from home bias, since Finnish households remain circumspect of equity investments. The relative absence of households from the Finnish stock market contributes to the local lack of liquidity, which in turn not only limits wider interest in firms listed on the Helsinki Stock Exchange, but it also contributes to the poor attractiveness of being listed in Finland.

3 EVOLUTION OF THE FINNISH CORPORATE GOVERNANCE SYSTEM

As discussed in the previous chapter, following the stale 1970s, the 1980s, and particularly the latter part of that decade, saw a fast development of the Finnish financial markets. This development was fueled by a wave of deregulations and shifts in tax policies. In this chapter, we describe the most significant of those changes, and their implications on the corporate governance in Finland. The implications for controlling ownership is one of our focal points, and we will discuss the role of financial institutions in shaping corporate governance systems and the Finnish stock market in this chapter. We will also review the evolution of other important ownership types from the 1970s to today.

Vihriälä (1997) and Hyytinen, et al. (2003) describe regulatory changes relevant for banking and bank financing. Among them, the banks were allowed to get involved in foreign exchange markets starting from 1980, when they were allowed to cover commercial forward positions. Deregulation of the domestic lending market began in 1983, when the lending rate regulation was first relaxed. Lending rate regulation was subsequently abolished in 1986. At the same time, borrowing in foreign denominations was allowed first for companies in 1986, and then also for households in 1991. The previously tight capital controls were also relaxed gradually from the 1980s (Vaihekoski, 1997).

The Finnish companies' ability to raise funds was also 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 during the early part of the decade (Vaihekoski, 1997). Also, new intermediaries were introduced to the market, which raised interest and in 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 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 company profits. This was followed in 1993 by setting all capital income on the same footing through introduction of 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, where corporate profits are first taxed at the corporate level, and then the recipients of those profits pay another tax on the dividends they receive (Korkeamäki, et al., 2010).

Another significant development on market regulation is the allowance of cross border investments, both foreign ownership of Finnish firms, and Finnish investments in foreign assets. These changes and their consequences will be discussed in the next sub-chapter.

As we mention in the previous chapter, 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 both within the stock exchange and among firms outside the exchange. Banks had historically held a significant power position on the Finnish corporate ownership scene. Lantto (1990) describes the largest holding groups and ”power spheres” in the Finnish market. Two groups stand out in their level of involvement and complexity, and those are the KOP-Pohjola sphere, and the SYP-Teva sphere. 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 what their voting power in the Finnish companies would indicate.

As we will discuss later, banks are not optimal controlling shareholders. As lenders, they tend to have a restricted view on corporate risk taking, and they thus think more like bondholders than like shareholders. In comparison to the Finnish setting, Pohjola (1988) notes that at the time, Swedish banks were ”not normally allowed to own shares in industrial companies”, and that insurance companies in Sweden faced a regulatory limit of 5% ownership in industrial companies.

In the case of KOP and SYP, their 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, and those hands were keen on retaining their power and not selling their shares, 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]

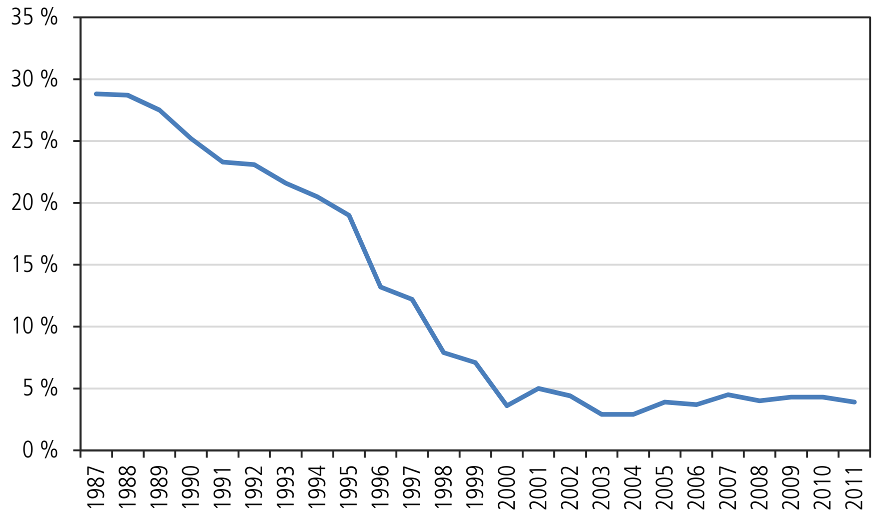
Interestingly, Kuisma (2000) notes that the Finnish banks did not originally seek industrial power through their stock investments, but their equity investments were rather made in order to inject equity financing into ailing firms among the bank's industrial clients. With new equity issues, the banks would often retain the undersubscribed shares. On the other hand, banks did not necessarily even need equity stakes to exert power in the Finnish firms at the time. As already mentioned above, the firms suffered from a serious lack of capital, and with the seriously under-developed financial markets, banks were the only supplier of that scarce resource. Regardless of whether the banks reached their power position deliberately or by default, they were not shy to use that position. The top line management at both SYP and KOP were actively involved in a high multiple of corporate boards. Furthermore, Troberg (1992) states that in order to retain their power position over Finnish corporations, banks

[2] Source: Annual editions of the Pörssitieto yearbook.

were exerting their power on law-making 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) gave strong incentives for use of equity financing, the Finnish firms were nevertheless using mostly bank debt to finance their operations.

It was not until the Finnish banking crisis in the early 1990s when the corporate governance system with bank-based power spheres was disrupted. On one hand, banks faced liquidity problems, which not only forced them to liquidate some of their holdings, but also at the end forced them to mergers. Whereas KOP and SYP had been previously competing for power in the stock market, they now became one entity, which thereby 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 very 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.

Figure 6 Ownership by commercial banks among Finnish listed firms in 1987-2011.



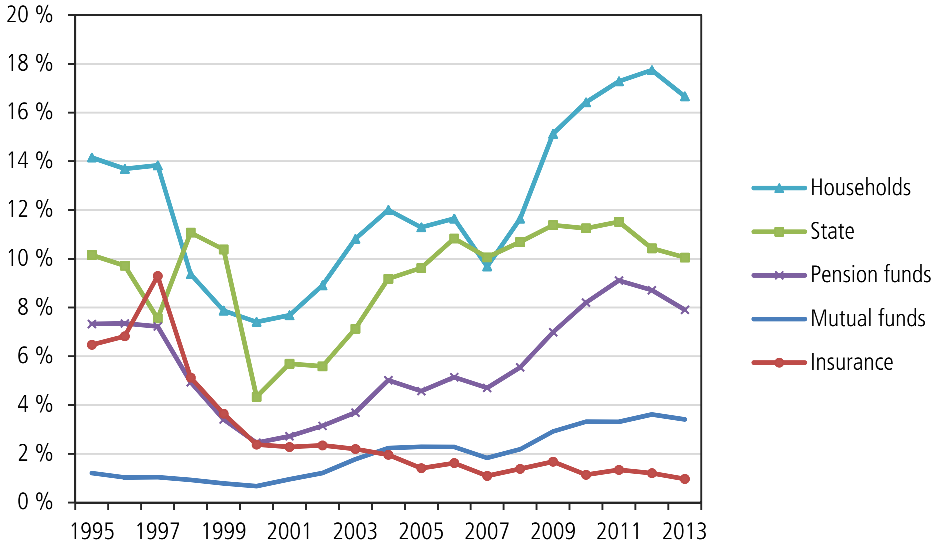
Source: ETLA.

If the ownership by Finnish banks was reduced as sharply as Figure 6 indicates, who were the new owners, to fill the ownership vacuum? We observe ownership patterns by various groups of owners in Figure 7. No clear patterns emerge for most of the groups represented in the figure. The exceptions are the above-noted insurance companies, that have steadily reduced their proportional ownership, and mutual funds that have been growing their proportion. Korkeamäki and Smythe (2004) note that the Finnish mutual fund market was the fastest growing in Europe from 1996 to 2000. However, we should keep in mind that mutual funds were introduced in Finland only in 1989, and therefore the growth started from very low levels. Even today, mutual funds remain a fairly small factor in the Finnish stock market, with their holdings at less than 4% of the total market value in 2013.

[3] Source: Statistics Finland.

It should be noted however, that Figure 7 is somewhat misleading, since the size of the Finnish market has also contracted severely since the IT-boom, so that the market size in 2013 is less than half of that in 1999. We showed this earlier in Figure 3 in Chapter 2. If we were to observe the absolute amounts of investment instead of percentage shares, the total investment in the Finnish stock market has grown from 1999 to 2013 for only two of the groups represented in Figure 7, namely mutual funds (by 88% during the 14-year period), and pension funds (by 0.4%). All other groups show significant declines in the value of their holdings during that time period.

Figure 7 Ownership of listed Finnish firms by ownership category in 1995-2013.

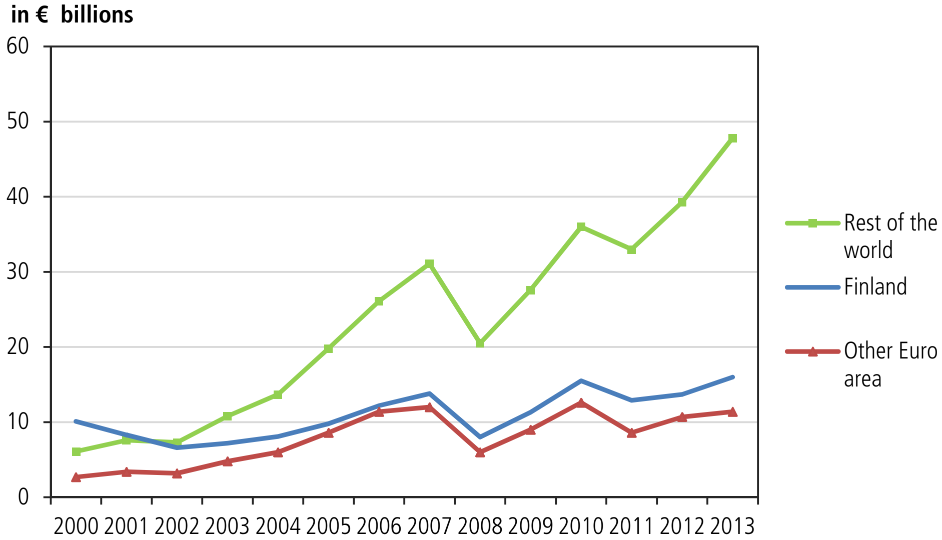


Source: Statistics Finland.

Rydqvist, et al. (2014) include Finland as one of their sample countries as they study the evolution of stock ownership for a longer time period in an international sample. They note a decreasing trend in households' proportion of stock ownership in Finland from 1950s to 2005. They also report a trend towards more indirect ownership via institutions but that trend does not appear to be as strong in Finland as it is in the other countries they observe. Another obvious ownership type to fill the ownership vacuum left after the Finnish banks, especially in the latter part of the 1990s, is foreign owners. We will return to their ownership patterns and implications shortly.

Pension funds that manage the law-mandated pension investments are a sizeable domestic player on the Finnish stock market, with their holdings reaching roughly 10% of the market capitalization, as shown in Figure 7. However, pension funds cannot and should not take an all too active ownership role in the companies they own, as their objective should be strongly focused on portfolio risk and return. In Figure 8, the equity investments of the Finnish pension alliances are broken down by their location. As the figure indicates (and as was already noted above), their investments to the home country publicly-traded stock market have barely grown since 2000, whereas investments to the Euro area have increased in a somewhat faster pace, and the investments to the rest of the world have increased very fast. In percentage terms, in 2000, the largest part (53.4%) of the pension funds' equity investments were in Finland, whereas in 2013, only 21.3% of the funds' equity investments are in Finland. Between 2000 and 2013, the equity investments by pension funds have increased by a total of 56.3 billion euros. Out of that amount, 10% have gone to Finnish equities, while 74% have gone outside the euro area. It is understandable that Finnish pension funds seek high returns and diversification benefits globally, but from the ownership perspective, they seem to be contributing to the lack of interest in ownership of Finnish firms.

Figure 8 Equity Investments by Finnish Pension Alliances in 2000-2013.



Source: TELA.

International ownership

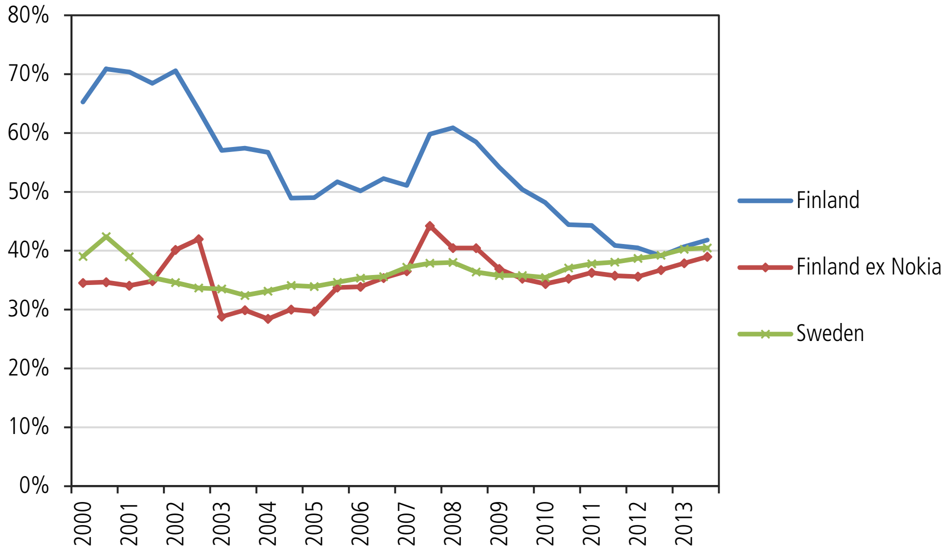
Prior to 1986, foreign ownership was possible only in special cases. Foreign investors were allowed to own shares in companies that were established by foreigners.[4] Also, up to 20% foreign ownership was possible via unrestricted shares. However, foreigners were in general unattracted by Finnish companies prior to the IT-boom, and the rise of Nokia. Vaihekoski (1997) dates the beginning of the internationalization process of the Finnish equity market to 1984, and he suggests that it was the increased foreign interest in Finnish stocks that instigated the subsequent changes. The deregulation started with abolishment of the aforementioned 1.6 percent stamp tax for those stock transactions that occurred between foreign parties, in 1984. In 1986, Finnish investors were allowed to invest in foreign assets, and in 1987, the limit on the unrestricted share capital was increased to 40%, as long as their voting power remained below 20%. Finally, in 1993, all restrictions on foreign ownership were removed.

After deregulation of foreign ownership in 1993, the effects of foreign ownership have received some research attention in Finland, especially in research institutions focusing on policy relevant research. The deregulation of foreign ownership coincides with an overall globalization trend, and therefore it is difficult to disentangle the effects of deregulation from the growing integration of Finland with the rest of the world. As a sign of overall globalization, Väyrynen (1999) reports that the Finnish exports/GDP grew from 18% in the 1980s to 40% in 1998.

4 Ford was listed on the Helsinki Stock Exchange already in the 1970s, with foreign ownership reported at above 70% during the entire decade.

Foreign ownership on the Helsinki Stock Exchange increased very rapidly during the latter part of the 1990s, mostly thanks to Nokia's rise to become the world leader in the cellular phone industry. In Figure 9, we compare foreign ownership of publicly-traded companies in Finland and Sweden from 2000 to today, and note that while the Finnish aggregate foreign ownership reaches 70% in the early 2000s, leaving Nokia out of the comparison makes foreign ownership in Finland very close to that in Sweden. Earlier data, as reported in Puttonen (2004), Vaihekoski (1997), and Henrekson and Jakobsson (2008) indicate a fairly similar earlier development of foreign ownership of listed firms between Finland and Sweden. Through the early 1990s, foreign ownership was below 10% of the market value, and around 1992, it rose rapidly to the 30%-40% level where it has remained since then.

Figure 9 Foreign ownership in 2000-2013.

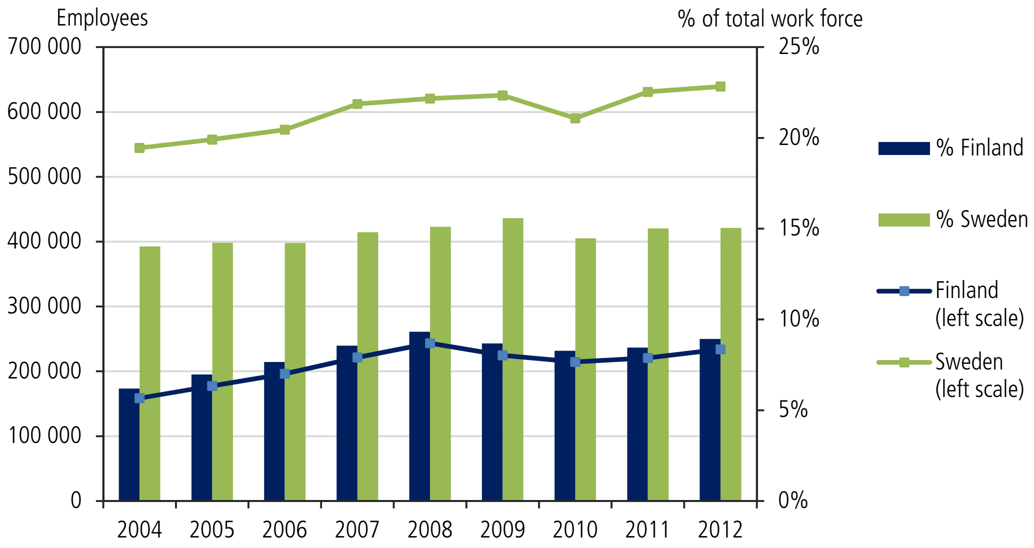


Sources: Euroclear and SCB.

While foreign ownership of listed firms is at a similar level between Finland (ex Nokia) and Sweden, the foreign interest in unlisted firms and Finnish subsidiaries remains relatively low. Väyrynen (1999) notes that in 1996, the FDI stock in Finland was about 50 billion markkas, which was among the lowest among the OECD countries. Even more recently, Finland pales in comparison to Sweden when it comes to attractiveness to foreign capital. In 2011, the FDI to Finland was less than 20% of the same figure for Sweden.

Figure 10 provides further evidence of the relative importance of foreign-owned entities in Sweden and Finland. As the figure indicates, foreign-owned entities employ roughly three times as many employees in Sweden as in Finland, and their corresponding proportion of the total work force in Sweden is around 15%, whereas that figure for Finland is well below 10%.

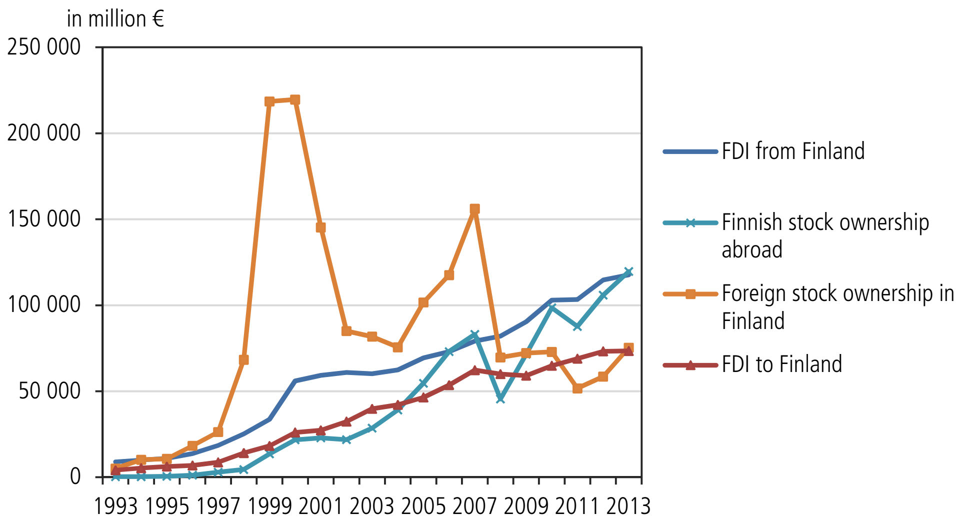
Figure 10 Employment in Foreign-Owned Firms in Finland and Sweden in 2004-2012.



Sources: Statistics Finland and SCB.

In Figure 11, we look at both stock ownership and FDI to and from Finland. While the foreign stock ownership graph is again heavily influenced by Nokia and fluctuations of its stock price, it is interesting to note that Finnish stock holdings abroad have been steadily increasing, and they have been higher than foreign stock ownership in Finland since 2008. In other words, Finland has become a net investor, so that investments (both FDI and equity market) from Finland exceed investments in Finland, made by foreigners. The stock market development to some extent matches the prediction by Väyrynen (1999). He notes that while the statistics back in 1999 indicated Finland as a net winner from globalization, he predicted that the birth of the euro area will have particularly the Finnish institutional investors seeking diversification benefits outside the Finnish market.

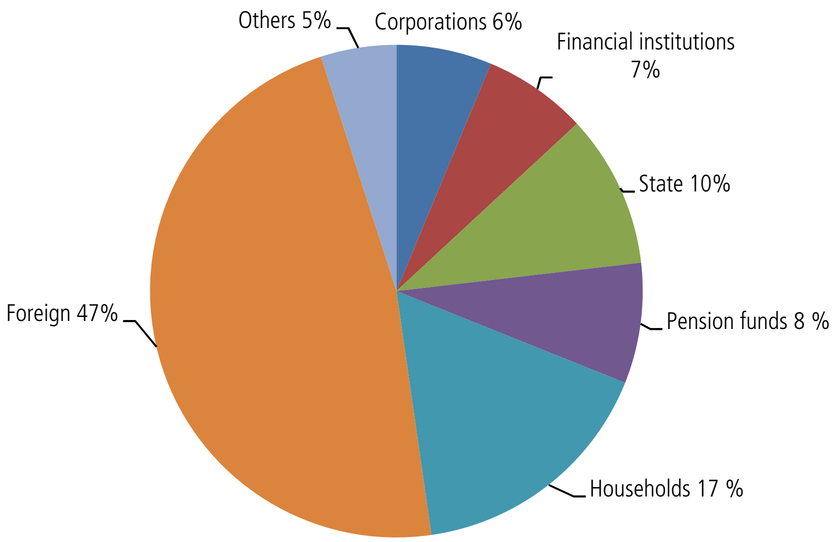
Figure 11 Inbound and Outbound Investments to and from Finland in 1993-2013.



Source: Statistics Finland.

The developments described both in this Chapter and in Chapter 2 have obviously had a significant effect on the evolution of ownership patterns on the companies listed on the Helsinki Stock Exchange. In Figure 12, we present the breakdown of ownership of listed companies in Finland. The data for the figure come from Rahoitustilinpito by Statistics Finland.

Figure 12 Ownership of Finnish listed firms in 2013.



Controlling ownership in Finland

In terms of block ownership, controlling ownership has slowly dissipated from the Helsinki Stock Exchange. 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.[5] 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 and fusions. Secondly, the number of listed firms had increased from below 50 in the 1970s to 73 in 1995, and newly-listed firms often tend to have the entrepreneur remaining as a controlling owner. 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. We will return to government ownership later in this chapter.

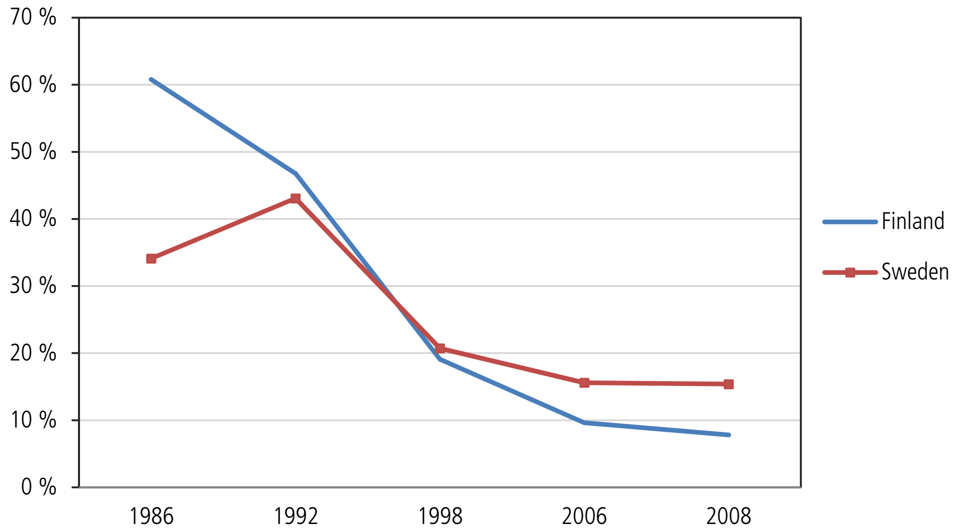
Despite the decreasing trend in controlling ownership, it has not completely disappeared from the Finnish economy. When we examine the 500 largest firms in 2012, contained in the Talouselämä 500 database, we can note that 122 or 24% of them are family firms. Even out of the 77 publicly-traded firms within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

[5] 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.

Dual class shares and controlling ownerhship

The use of control via dual class shares was earlier commonplace in Finland, but dual class shares have since then disappeared rapidly from the Finnish stock market. 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, along with Denmark and Sweden, where 75% of the firms had dual class shares. We observe more recent data for Sweden and Finland in Figure 13. 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 almost twice as popular (46 firms or 15% in 2008) as they are in Finland (10 firms, 8%).

Figure 13 Percentage of listed firms with multiple share classes.



Sources: Helsingin Sanomat and Henrekson & Jakobsson (2008).

Previous studies confirm the decreasing trend visible in Figure 13, 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%.[6] Differences in the reported percentages between these studies and our Figure 13 are explained by the fact that we include all publicly-traded firms in both countries, whereas the academic journal articles tend to be based on a sample that is 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 one of the European countries 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.

6 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?

As we have seen, a wide variety of different ownership models and corporate governance systems exist, both in Finland and in other industrialized countries. In this chapter, we will review the research evidence on the effectiveness of those different models. Our aim is not to conduct a complete review of the abundant research on the field, but we rather present our view of what is known in light of previous studies, with a focus on those studies that we see as the most important. We also bring into our discussion studies that are specific to the Finnish setting, whenever applicable. However, most of the theoretical studies and empirical evidence covered in this chapter come from abroad.

The main topic of this study is the corporate governance of publicly-listed Finnish firms. However, we will consider ownership types and forms in a more general way, while emphasizing issues relevant to large firms.

There is an important distinction among shareholders of publicly-traded firms between investors and controlling owners. The business idea of an investor is typically to use statistical tools to optimize the trade-off between risk and return within her investment portfolio. This is done by choosing investment objects based on characteristics such as expected returns, volatility, and correlation with the existing portfolio. Large investors possess a large number of various instruments to manage risks within their portfolios. It is natural for those investors to make both investment and liquidation decisions on an ongoing basis. A controlling owner has a very different business idea, based on investments in a limited number of companies, or perhaps just one company. A controlling owner owns a significant proportion of the firm’s shares, and she seeks to establish control over the firm. The control is then used to enhance the value of the firm by direct involvement in the firm’s strategic decisions. We will distinguish between controlling owners and investors throughout this chapter, as the two groups have very different implications upon corporate governance of the firm.

Listed firms – controlling ownership versus management control

In a simplified setting, listed firms can be divided into two main types – those with dispersed ownership, where management can practically control the company, and those where owners exist with ownership proportions that are sufficiently large to allow them to control the firm. In the academic literature, these are referred to as insider and outsider systems, or systems based on controlling ownership versus market-based systems. In the insider system, stock ownership is typically concentrated so that a block holder exists. These larger stock holders are directly represented in the corporate board, which monitors the executive team. There are also cases when the controlling owner functions as the CEO of the firm.

In the outsider system, stock ownership is dispersed, and owners exert power by electing members to the board, and by voting on concrete proposals from the management. By its right to submit proxies for shareholder voting, management can be viewed as having control over the company. Also importantly, management can play an active role in the selection of new board members. Management can thereby compile votes for their candidates. A stable system of management control requires that the law provides management with this type of rights and privileges.

The Anglo-American systems are the clearest examples of the outsider system, while the insider system dominates most of the rest of the world. The insider system has strong traditions and a powerful position in the Continental Europe (see Barca and Becht, 2001). The insider system also describes well the system in Sweden, and to some extent also that in Finland, while in Finland's case, the classification is slightly less obvious than for Sweden.

It is important to distinguish between voting rights and cash flow rights of a stock holding when analyzing controlling ownership. Cash flow rights tend to go proportionally hand in hand with the investment made by the shareholder. The same is not necessarily true for voting rights. The voting rights of an owner can deviate from her cash flow rights due to various methods. The most obvious one is a system with multiple share classes. Burkart and Lee (2008) point out that a decision regarding separation of cash flow rights from voting rights presents a trade-off between controlling ownership and managerial power within the firm.

Another method to increase voting rights of a certain holding is to use a pyramidal ownership structure. Multiple share classes and pyramidal ownership structures are often used simultaneously in firms. Pyramidal ownership structure is used in some cases in Sweden, while in Finland it is a very unusual form of ownership (Faccio and Lang, 2002) A third method, which has become very uncommon in Scandinavian countries, is cross ownership.[7] Through these methods, controlling owners have been able to retain their strong control positions. In Sweden, this has lead to ownership structures that are extremely stable in an international comparison. As we have seen earlier in this report, the same cannot be said for Finland. The controlling ownership system that was dominated by the bank spheres in Finland began to erode as the banking crisis hit in the early 1990s, and the power vacuum that was left behind them has not been filled by other controlling owner groups.

The usual explanation for international differences in ownership concentration and use of methods to gain control lies on the legal protection of minority shareholders (LaPorta, et al., 1997). In order to minimize the risk of management taking undue advantage of the company's assets, the investors obtain powerful control rights by having considerable ownership blocks and voting blocks in the companies. To protect their control positions, the influential block holders have defended the use of the above-mentioned methods to retain power, such as multiple share classes. This has lead to such methods becoming the norm in certain national ownership systems (LaPorta, et al., 2000). The size of the country's stock market, which depends on institutional factors such as the setup of the local pension system, has also an effect on the national regulation concerning controlling ownership. The local norms on controlling ownership thus tend to be based on the local evolution of the markets. It is possible that attempts to change these systems and norms via international regulation weaken the local corporate governance system (Burkart and Lee, 2008).

Since the local corporate governance system is deeply rooted in the country's history and business climate, it is difficult to determine which system is the best from either the corporate or the economic viewpoint. The academic research in the area is dominated by professors in American universities. In the U.S., the local system with dispersed ownership and management control was for long viewed as the superior solution. Influenced by Berle and Means (1932), and their analysis of corporate governance, the local system was seen as the natural choice in a well-functioning market economy. Given this view, the finance

[7] For a review of these methods from a Swedish perspective, see Henrekson and Jakobsson (2008).

literature tends to see any deviations from the system of dispersed ownership and managerial control as signs of existing barriers for a well-functioning market. Presence of controlling ownership is often connected to lacking protection of minority shareholders, and to a setting where controlling owners are in various ways able to transfer wealth from minority owners to themselves.

The academic finance field viewed it as a path-breaking finding, when XXXX discovered that outside the Anglo-American world, controlling ownership is the dominant model of corporate governance. It appears that this “finding” has lead to a more developed view on controlling ownership within the academic literature. More recent studies, such as Giles, XXXX, also indicate that even with controlling ownership as the dominant corporate governance system, it is possible to safeguard minority shareholder protection at a reasonable level. Enron-type scandals have also shown that minority shareholders’ legal protection is not perfect in the Anglo-American system either. Very recently, John Key (2013) points out in his report on the Brittish listed firms that the Brittish system suffers from serious problems.

While the academic literature seems to have reached a consensus that no ownership system dominates globally, Carlin and Mayer (2000) present arguments that different ownership forms and corporate governance systems are better suited for different types of industrial activity. Concentrated ownership and clear owner control works, in their view, better in activities that require committed investors with long-term goals, whereas dispersed ownership better serves activities with shorter investment horizons and a need for flexibility. They point out the need for matching between the owners’ expected influence period, and the period within which firm projects are realized.

A short period of influence, or a lack of consistent control in relation to the realization period for projects can lead to fewer long-term investments by the firm. On the other hand, an overly long period of influence and lack of dynamic control can lead to diminished pressure for management to adjust to the changing environment. Controlling owners, and management in firms with concentrated ownership can retain control for a long period. In companies with dispersed ownership, management needs to be reactive to more varying influences. Management control can therefore be more advantageous in companies with shorter investment horizons, while controlling ownership may better suit industries with long-term commitments and long-drawn realization periods (Haldane, 2011).

As we mentioned earlier, stable management control is not practically possible in Sweden or Finland. The countries’ regulatory framework does not allow management to counter shareholders at the general meeting. Since a general meeting can be summoned at any time, management without support from a controlling owner can be dethroned as soon as a larger set of owners want to do it. Thus, nothing stops hedge funds or activist funds from rearranging the corporate management system. Without support from a controlling owner, management is not able to run the company in a stable way towards long term goals. As a consequence, companies without controlling owners can be characterized as being without a master.

Institutions as controlling owners

For financial institutions such as insurance companies, pension funds, and mutual funds[8], it comes natural to act as investors, rather than controlling owners. Wealthy individuals and families are the typical controlling owners. In Sweden, pension funds (”AP-fonder”) are an example of the former, while investment companies such as ”Industrivärlden” represent the latter group.

A large part of the assets of “AP-fonder” are invested in bonds. Their stock holdings are spread over hundreds of firms, both in Sweden and 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 shares a controlling stake with another shareholder in each one of them. The holdings are diversified only to a degree that no individual asset can alone destroy the company. Should the outlook at any of the firms in the portfolio deteriorate, it is obvious that an investor would sell her shares. However, a controlling owner is typically forced to work with the company to restructure it and help it through the difficult times.

Throughout the world, institutions tend to take the role of an investor, rather than that of a controlling owner. There are several good reasons for this. 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 the assets in their portfolios.

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 due to both concentration of her holdings, and the illiquid nature of them. The portfolio theory indicates that an investor can enhance her expected returns for a given risk level through diversification. Lack of diversification in the portfolio of a controlling owner thus 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. Institutional investors have therefore strong incentives to let others control the firm, and to free ride on the effort of those in control.

Institutional ownership is also complicated due to issues with insider trading. 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.

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[8] Our focus is on these three types of institutional investors.

In summary, institutional investors with diversified holdings have very limited incentives to act as controlling owners. It is therefore not surprising that evidence from around the world indicates that institutional investors tend to "vote with their feet", rather than acting as controlling owners. The low incentives also make them poor candidates for controlling owners.

It is important to point out that we are not suggesting that financial institutions are not valuable as shareholders to publicly-listed firms. For instance, Hansman and Krakman (2004), in their well-known article, argue for a global trend towards having shareholder value as a goal for corporate management. Their argumentation builds upon the growing importance of institutional ownership throughout the world. According to Hansman and Krakman, the interests of institutional investors are often well-aligned with those of a typical investor. Through their investments, institutions contribute to shareholder value being a legitimate goal for the corporation, and thus, their presence supports share ownership at the general level.

Institutional investors have superior ability to obtain, analyse, and absorb corporate information, which gives them an advantage over a typical private investor. The customers of institutional investors actually pay for this informational value. The informational advantage has given arise to the term "informed investors". 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, the institutions can have a disciplining role against both controlling owners and management of the firm. This obviously rests on the assumption that a controlling owner or management with control exists.

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). Even these studies are done in settings where either management control or a non-institutional controlling owner exists.None of the studies above have a direct connection to the Finnish setting. As we will discuss, Finland has a special situation where in many publicly-traded companies, no controlling owner exists.

International ownership

Two types of foreign ownership are relevant for large firms. Foreign investors may either hold a proportion of shares of a publicly-traded company, or a Finnish company can become acquired by a foreign buyer, in which case the company is taken out of public trading. In the latter case, the company typically becomes a wholly-owned subsidiary of a foreign corporation. While the Finnish company disappears from the stock exchange, the foreign buyer can be publicly-traded at some foreign exchange.

In the case of the foreign investor holding shares of the Finnish publicly-traded company, the foreign owner is typically not a controlling owner. The effects of its ownership remain thus relatively small. The shares are mostly seen as a portfolio investment, and the investor is a passive owner. 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, for a Finnish company that becomes a wholly-owned subsidiary of a foreign entity, the effects of foreign ownership are significant. From profitability viewpoint, the expectations are positive for a number of reasons. Cross-border acquisitions tend to improve specialization. Those Finnish firms that buy foreign entities tend to be in leading positions in their field. Similarly, Finnish takeover targets are often bought by leading foreign firms. Thereby, acquisitions can lead to productivity gains, as the buyers bring their state of the art business models with them.

In a more concrete sense, multinational enterprises tend to have high research intensity, which creates opportunities for technology transfer from the buyer to the target firm. 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, it can be expected that the foreign buyer contributes with its marketing resources, and with a structure that allows it to lever synergies and competitive advantages elsewhere within the firm. As long as the target firm continues its local activity, these advantages accrue to the local economy. We will return to the question about moving the activity out of the country later. It is also important to remember that the owners of the target firm receive a payment for their ownership share in the company. This obviously generates opportunities for new investments.

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 the financial results of the company, but some also consider the effects on productivity and employment, which also tend to be positive. The direction of causality can be difficult to determine in studies of the effects of foreign ownership. The common interpretation, and the one we share, 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.

Many of the studies concerning international acquisitions overlook the fact that with an acquisition, many of the strategic functions, and thus often the most human capital intensive activity of the company may move out of the country. While most of the studies that we cite show clearly that companies do not tend to move their productive activity out of the country after an acquisition by a foreign entity, it is likely that some of the top level functions, such as the headquarters and the R&D activity are moved abroad. The Swedish pharmaceutical industry has followed this pattern. We will re-visit this theme from the Finnish viewpoint in the next chapter.

Government ownership

As mentioned above, government has played a historically important role in corporate ownership in Finland. In a study of 12 European countries by Pedersen and Thomsen (1997), Finnish government ownership is among the highest at 27.6%. They include 100 largest firms in each country into their study. Pedersen and Thomsen (1997) mention the late industrialization of Finland as a potential reason for high government ownership. Faccio and Lang (2002) also present similar evidence regarding Finnish government ownership. At 15.8%, the Finnish government ownership is the highest among their Western European sample countries.

Academic studies on government ownership find fairly unanimously government ownership to have detrimental effects. Government owned firms are often cited for making inefficient use of labor, in other words focusing on employment rather than economic efficiency. Many studies also report that government-owned firms are poorly managed, when compared to the private sector. One particular problem in management tends to be politically motivated managerial recruitment. Dewenter and Malatesta (2001) question some of these stylized facts, and 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 seems to do little to increase efficiency among government-owned firms.

The problems with governmental ownership are obviously relevant for Finland, as government ownership is wide-spread into several sectors of the Finnish economy. Media follows these government-owned firms with a keen interest, and any troubles in those firms become very quickly political, even if the government's initial goal is to insulate business firms from political decision-making. This can lead to short-sighted decision making that is done in order to please the media and the electorate, rather than thinking of the long-term viability of the business. Recent cases in companies such as Talvivaara and Finnair serve as examples of this.

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 leads easily to less than perfect allocation of resources.

Family ownership

Family firms have received ample research interest in the academic journals, especially since 2003, when Anderson and Reeb (2003) first of all poited out that in contrast to popular view, family firms are an important group even among the largest U.S. firms. They studied the firms in the S&P 500 index, and found that 35% of them can be classified as family owned. They found family firms to outperform non-family firms. They found further positive effects among family firms that are run by a founder CEO. Villalonga and Amit (2006) find further support for the positive effect of the founder of a family firm being active either as the CEO or as the Chairman of the board.

The effects of family ownership have also been studied in the Finnish context. Ali-Yrkkö, et al. (2007) explore the effects of family ownership on globalization. According to their findings, family ownership does not appear to affect the likelihood to move operations abroad. Tourunen (2009) reports that family firms play a smaller role in the Finnish economy, when compared to other Western European countries. Pajarinen, et al. (2011) study how different ownership types affect stability of employment, focusing particularly on fluctuations during the financial crisis, from 2007 to 2009. The only ownership group with statistically significant results in their study is the first generation family firms, who cut down their number employees more than other ownership groups. In an earlier study, 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.

Co-operative ownership form

As Figure 4 in Chapter 2 showed, co-operatives play a significant role in the Finnish economy. The co-operative form is common in all Scandinavian countries, but indeed, Finland is the top nation in the world by some measures of co-operative activity. Pellervo.fi reports that 84% of Finns are members in at least one co-operative. According to Jones and Kalmi (2009), co-operative turnover/GDP reached 24% in Finland, which was a clear number one among their sample countries. The second-highest figure was 19% for Switzerland. Most of the academic literature views the co-operative form as a solution to otherwise underdeveloped markets, both in financing, but in particular in product markets (Holmström, 1999; Nilsson, 2001). Given the historical lack of capital in the Finnish economy, paired with the distant location and isolated product markets, it is perhaps not surprising that Finland has developed into a hot bed of co-operatives.

Skurnik and Egerström (2007) claim in their article entitled ”How cooperatives serve as globalisation insurance”, that cooperatives have contributed to a new structure on the Finnish economy. The pressure from globalization has lead to development of an internationally focused part of the economy. That part includes industries such as IT and forestry. The part calls ”the Global Pole”, and it is characterized by export-oriented firms with internationalized activities on a global scale. The corporate form is the dominant business form in that part. Skurnik and Egerström (2007)call the other part ”the Finn Pole”. That part of theeconomy is focused on the home market, and the cooperative form dominates. As the title of their paper suggests, the business form contributes to the sector’s protected status. The division reminds of the old division into competitive and protected sectors of the Nordic economies.

Holmström (1999) points out the limitations of the cooperative business form. In the cooperative business form, both ownership and decision-making are communal. Such model works best if the owners share common goals and interests. Thecooperative form functions best when members are tied to the activities of the firm. In such cases, a corporate governance system that is based on voice rather than exit can function well. A typical type of cooperatives throughout the world is thus mutual insurance companies. Holmström mentions also electric utilities in areas with low population. In such areas, electricity customers typically had no other choices, which is why cooperatives were common.

The developments during the last decades, with market deregulation and improvements in electronic communication, have lead to a situation where the requirements for well-functioning cooperatives fulfills in fewer and fewer markets. This is also true for the markets that we in the Nordic countries earlier viewed as protected.

Research also shows that any changes in the market environment are likely to cause frictions among the co-operative owners. The academic literature offers a public listing at that point as a solution, as the value of the ownership shares of those owners who want to leave the co-operative is viewed as one of the key problems with the co-operative business form. It is also notable that in co-operatives, the agency problems that are well known and documented on the corporate side are exacerbated, as ownership is extremely dispersed by design. This is a particular problem for co-operatives that generate profits and free cash flow.

The role of Private Equity

A stock investor receives no guaranteed return on her investment, even though the risk of an equity investment is higher than that of a lending arrangement. For an investor to take the risks involved in equity investments, the expected return has to be higher than what the same investor could get from the firm as interest for a loan.

Private equity firms make equity investments in both listed and unlisted firms. Through their investments, private equity firms retain a contract on the residual rights upon the firm, which gives them the right to returns on their investment, the right to make decisions for the company (through voting rights attached to equity), and the right to sell the holdings further to a third party.

Both in Finland and Sweden, a large part of these “risk capital” investments focus on unlisted firms. In fact, risk capital works in diverse segments, defined by the development face that they focus their investments on. The field can be roughly divided into three segments: The early phase, the growth phase, and the re-structuring of mature firms. Venture Capital deals with firms in the early phase. Investments are made into relatively young firms that have high growth prospects, but suffer from a lack of capital.

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. Since our main focus in this study is on large firms with a stock exchange connection, our discussion on risk capital will focus on Private Equity firms.

Private Equity investments have grown very fast in Sweden during the last few years, and Sweden is one of the leading countries in Europe in the area. The Finnish Private Equity industry is not very well known yet, but it is growing, albeit much behind Sweden. 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).

Private Equity firms in Europe (including Sweden and Finland) tend to follow the U.S. practice of making the acquisitions often through so called limited partnerships. In this type of partnerships, 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. However, the profits are shared to a certain point based on the invested capital.

In other words, in PE-funds, 97-99% of the capital surrenders all control rights to the fund manager, the PE firm. In compensation for the unlimited liability, the PE firm takes a significant proportion of the profits, typically 20% of those exceeding a certain level.

The funds that are set up as limited partnerships have a limited life span, but it often stretches over several years, typically from 6 to 10 years. PE-firms typically make their acquisitions in one of the following ways: (i) purchase of a publicly-listed firm that is then taken private. (ii) purchase of parts of a larger company (divisions or subsidiaries) (iii) purchase of unlisted firms. The business idea is to restructure the target company, and then liquidate it for profit. The engagement with a company thus typically ends in an exit. The exit can take place either via re-listing to the stock exchange, or via a sale to another buyer, either an industrial buyer or another PE-firm. The fund's main income source is expected to be the value gain caused by the re-structuring of the firm.

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 restructuring.

One of the main problems in many of the world's stock exchanges today is, that institutions that are the largest owners of listed companies are neither willing nor appropriate to act as controlling owners of the firms. The Private Equity model offers an elegant and effective solution to this problem. The investors that supply the capital in Private Equity funds are typically institutions, either domestic or foreign. They delegate the control function to the PE-firm, that has clear and strong incentives to develop the companies that the fund owns in a way that is beneficial to all investors. These benefits have been pointed out in several previous studies. Michael Jensen was one of the early advocates of the model, and his words have been well-cited.[9]

The PE-model should not been seen as the universal model of corporate governance. The model works obviously 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 on 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.

We have discussed the problems with institutional ownership in Finland, and in particular the lack of controlling ownership in the country. Given that the PE-industry in Finland remains small, it would seem that the industry faces significant growth prospects in the country.

[9] See Jensen (1989).

5 CONCLUSIONS

In the introduction, we noted that Finland faces a difficult economic situation. New investments and restructuring of the Finnish business sector have important implications on how the Finnish economy recovers from the crisis. Finland is, in many ways, well equipped for a positive restructuring of the economy. The whole world, including Sweden, admires the Finnish educational system. In international rankings, Finland tends to be rated very high for its competitiveness.

This report is not a study of the entire Finnish economy. Our goal has been to analyze corporate governance systems and ownership structure on the Finnish business sector. The crisis has exposed the problems that exist in this area. We argue that problems in the area of corporate governance can present obstacles in the near future for the much needed restructuring of the Finnish economy.

Both government-owned companies and cooperatives have a significant role in the Finnish economy. As we mentioned earlier, by an international comparison, Finland can be seen as a world leader in both areas. 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 on the Finnish stock exchange. For a number of companies, it is unclear whether any group has a stable control over the firm.

All these circumstances can reduce the economy's ability to adjust. For cooperatives and government-owned companies, the distance to the market is the main problem. As we noted in Chapter 4, cooperative business form is an optimal choice for certain market situations and industries. The large volume of activity amongst cooperatives in Finland suggests that much of their current activity lies outside that optimal range. As Holmström (1999) underlines, development of the markets, and advancements in communication technology should be expected to narrow the area where cooperatives offer a competitive solution. In our view, much of what applies to cooperatives is also relevant for government owned firms.

Bengt Holmström has, in several papers, highlighted the role of the stock market in economic restructuring. Deregulation of the financial markets, and development of new communication technology have increased the comparative advantage of the stock market, and thus increased advantages of being publicly listed. The market provides information on the value of the firm. It makes selling companies or their parts easier, as an informed and publicly available opinion of their value exists. This type of activity is more difficult among cooperatives and government-owned firms, even if the latter may be publicly-listed. We return to the division made in Chapter 4, between the “Finn Pole” and the “Global Pole”, where for instance cooperatives would be placed in the former group. As mentioned, the protected zone where cooperatives are optimal should be shrinking, given new technology and more integrated markets. What was previously called the protected sector among the Scandinavian economies barely exists today, even as a term. With this background, we see it obvious that the pressure for the cooperatives to restructure their activity will increase in the coming years.

Upon a need for corporate restructuring, the nature of managerial decision making required at the company has typically changed from its historical level, and become more challenging. Management's inability to react and make decisions can therefore aggravate an already difficult situation at the firm. With state run 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 a company, it may make a poor 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 in a government owned company or a cooperative, in comparison to a firm that is closer to the market place.

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, in case the company is not currently taking full advantage of its opportunities due to an overly conservative management, the company 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. This will obviously make the acquisition a profitable one.

A such acquirer can be:

- A Finnish potential controlling owner with sufficient wealth
- Another Finnish firm
- A foreign buyer
- A Private Equity fund.

The first alternative is most unlikely. The second alternative is obviously in many cases a possibility. The most likely candidate in today's environment is the third alternative. Foreign firms have been active in the M&A market in all Scandinavian countries recently. When a foreign firm buys a Finnish firm, it becomes a subsidiary of the foreign firm, and it will disappear from the Helsinki Stock Exchange. The Private Equity alternative has not been historically very common in Finland, but as we mentioned earlier, the Private Equity industry is growing in Finland. We will return to the Private Equity alternative later.

Restructurings through foreign acquisitions?

We discussed above the potential role of foreign buyers in the needed restructuring of the Finnish economy. Based on the Finnish debate, it may seem that foreign acquisitions are a problem for Finland. In our view, the problem is rather the lack of foreign acquisitions in Finland. Firstly, Finland suffers from a historical and chronic lack of capital, and the Finnish business sector has substantial investment needs. Even the Finnish companies seem to be keener on investing abroad than in the home country. As Figure 10 in Chapter 3 indicated, the presence of foreign companies, and their contribution to business activity and employment, is significantly larger in Sweden than in Finland.

Therefore, the interesting question in our view is, why does Finland fail to attract foreign investments? The above-mentioned rankings on competitiveness and business climate tend to correlate with the country's attractiveness for foreign capital. Given the high rankings of Finland, one would therefore think that the country would be an appealing investment objective for foreign investors. This does not appear to be the case.

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 that we mentioned. 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. More solid recommendations in these topics would require more thorough research into them, which falls outside the scope of our current study.

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

A more difficult question to address in the academic studies is, what happens to the firm's strategic functions when it is bought by a foreign buyer. A foreign acquisition tends to automatically move the corporate headquarters out of the country, as the Finnish takeover target becomes a subsidiary of a foreign firm after the transaction. Research shows also that many strategic functions of the firm, such as R&D tend to be located near the headquarters. In Sweden, the pharmaceutical sector serves as an example of this. The debate around Pfizer's relatively recent bid on Astra Zeneca highlights that foreign acquisitions can also present threats. The main threat in the long run would be that a country that focuses on attracting foreign acquirers will experience drainage of human capital intensive activity, and become a location for more basic level production.

On the other hand, countries such as Ireland and Singapore have very successfully followed the strategy of attracting foreign investment. For Finland, an economic policy that focusses on attracting foreign investments would need to have a special emphasis on factors that are attractive for human capital intensive activity.

Institutions and control problems

If we include both foreign and domestic financial institutions, they 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, we have argued that those institutional holdings that do exist, are actually creating problems, as large institutional ownership shares contribute to ambiguity regarding the control of the company. We further argue that this ambiguity contributes to weak development among a number of companies. We are describing a "catch 22". 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 than in Finland.

Institutions taking an active role in corporate governance has been voiced as a solution to the problem, both in Sweden and in Finland. In Chapter 4, we have argued that this is a poor solution. However, a couple of alternative potential solutions, which are not mutually exclusive, exist.

- *Provide management with a legal platform to gain corporate control*. As we mentioned earlier, the 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. The point that someone needs to be in charge, driving a stable control, seems to have gone forgotten in other countries, notably in Sweden and Finland. In Great Britain, the corporate board has a number of legal rights to have power over the company. These include rights to present proxies for the general meeting, and to name candidates for board membership. In practice, this often leads to the board naming its own members.

The British system functions in a less than ideal fashion. The Kay commission reported on its problems recently.[10] It is, however, logical that if controlling ownership is made difficult, management is allowed to gain control of the company. For both Finland and Sweden, we argue that the position of the controlling owners should be strengthened. Bengt Holmström wrote last spring, that Finland needs more people like Antti Herlin and Björn Wahlroos,[11] 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.

- *Private Equity (PE)*. The Private Equity model can solve the corporate governance in individual companies in an elegant way. As we described in Chapter 4, PE investors are typically financial institutions, such as pension funds. Once they have made their investment, they give up, for the lifetime of the PE fund, the control and the voting rights that their investment would entitle them to, had they invested directly in the company. The PE-model's goal is to create value in the company through restructuring. The favorable aspects of the PE-model have lead Michael Jensen, the guru on agency issues in corporate finance, to express enthusiasm over its prospects. On the negative side, the powerful incentives built into the model have caused problems in some cases. Also, various very involved tax arrangements are an integral part of PE-funds' activity. These factors are problematic if PE-funds were to be seen as a solution for the Finnish economic recovery.

[10] John Kay (2013).

[11] Helsingin Sanomat, 13.4.2014.

Policy implications

In this report, we have analyzed a narrow, yet important 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 have summarized our potential policy implications into five suggestions, as follows.

1. *Improve investing climate in Finland*, and make Finland more attractive to foreign investors. International studies suggest that Finland has an attractive investment climate. However, the ultimate test is to observe the actual extent of foreign investments in the country, and Finland does not do well in this test. A good starting point for an action plan in this area would be to conduct more involved studies into attractiveness of the Finnish investing climate to foreign investors, with the specific research question of how that attractiveness could be improved, specifically in human capital intensive areas. We have mentioned the Worldbank's ongoing research program on ”The ease of doing business”. The Swedish government has commissioned the Worldbank team behind the research program to conduct an in-depth study on the Swedish corporate setting and investment climate. A similar initiative from the Finnish government could provide a fruitful starting point for formulating a policy to improve attractiveness of Finland as a country to invest in.

2. *Create 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. We have also pointed out that government ownership can, in the medium term, impede restructuring of the Finnish economy. Existing literature supports our view unanimously. Obviously, the long term plan needs to be planned carefully. We do not recommend a sudden liquidation of government holdings, but rather a smooth transition towards a more normalized status. On a shorter perspective, an existing long term plan could clarify the view that government ownership is a "part of the problem, not part of the solution". This can help the government in choosing alternative ways for restructuring of the economy, instead of looking at possibly increased government interests as a solution.

3. *Support transformation of cooperative companies towards other business forms*, such as corporations. We have highlighted problems with the cooperative business form, and argued that the strong position of cooperatives in the Finnish economy contributes to challenges regarding restructuring of the economy. We do not see a forced transformation of cooperatives through law changes as a solution. Instead, the government could take action to ease changes that cooperatives can make, as they either face problems, or themselves become interested in a change.

4. *Try to solve control problems that large institutional ownership in publicly-traded companies creates*. We have discussed in-depth the potential lack of control in companies with sizeable institutional ownership. We have also drafted three ways to help ease these problems. Firstly, the position of those owners who are actively involved in corporations should be strengthened. Secondly, adjusting the balance of power 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. Thirdly, possibilities for encouraging increased involvement of Private Equity in restructuring of Finnish listed companies should be studied.

5. *Make the stock market 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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