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EUROSTAT

Directorate D Government Finance Statistics (GFS)

Luxembourg,
ESTAT/D3/RJ/MA/GD/rf

Ms Katri Kaaja
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FINLAND

Subject: Bilateral advice on the sector classification of Finnfund

Reference: Your letter of 14 April 2023

Dear Ms Kaaja,

Thank you for your request for advice regarding the classification of Finnfund, received on 14 April 2023, and for the additional information about the general loss compensation mechanism you provided in January 2024. Having thoroughly examined the arguments of the Finnish statistical authorities and the relevant documentation, Eurostat is now prepared to express a view on this matter.

1. THE ACCOUNTING ISSUE FOR WHICH A CLARIFICATION IS REQUESTED

The matter under consideration is the sector classification of the Finnish Fund for Industrial Cooperation Ltd. ('*Teollisen yhteistyön rahasto Oy'*), known as Finnfund, that is currently classified as a public unit within the other financial intermediaries sub-sector (S.12501). Developments in recent years, encompassing both qualitative and quantitative aspects associated with Finnfund, prompted the Finnish statistical authorities to reassess the sector classification of this unit. Consequently, the Finnish statistical authorities have requested Eurostat's opinion on the appropriate sector classification of Finnfund.

Documentation provided

Statistics Finland submitted to Eurostat its analysis of the sector classification of the unit concerned. The submission included three key documents: (i) Statistics Finland's analysis of

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Finnfund's sector classification (Annex 1), (ii) an annex detailing the statistical impact on government debt and deficit upon a reclassification inside S.13 (Annex 2), and (iii) an annex concerning the liabilities of Finnfund (Annex 3). Additionally, separate information pertaining to the general loss compensation mechanism was also provided.

Description of the case

Finnfund, a development financing company, is predominantly owned by the Finnish Government, holding a 96.18% stake as of October 2023. The remaining ownership is divided between Finnvera, a state-owned financial corporation, with a 3.75% stake, and the Confederation of Finnish Industries EK (0.07%), a private business organisation. As of the end of 2022, the balance sheet value of Finnfund's investment assets stood at EUR 699 million. Undisbursed commitments stood at EUR 234 million and a further EUR 170 million of tied up funding is yet to pass the agreement stage. Finnfund typically takes around 20-30 new investment decisions annually, totalling approximately EUR 200-250 million.

As per the Act on Finnfund (291/1979), the unit's mandate is to promote societal and economic development in developing countries. This goal is primarily achieved through supplying long-term risk capital for private ventures in these countries, focusing on projects that might not be viable without its involvement. This support is extended in various forms, including equity capital, loans, and investments in private equity funds.

Although the Act on Finnfund states that the company's purpose is not to generate a profit for its shareholders, all Finnish state-owned companies must be self-sustaining in accordance with the state's ownership policy. This means that their operating income must be sufficient to cover the costs and risks of their activities. In addition, annual targets set by the Ministry for Foreign Affairs include an indicator regarding the return on equity on a five-year moving average basis.

Finnfund benefits from a 'general loss compensation' mechanism, where the State commits to compensate Finnfund for possible losses under the terms specified in the so-called 'commitment decision'. In addition, Finnfund has access to a specific government loss compensation mechanism called 'special risk financing instrument', under which the State undertakes to compensate Finnfund for around 50 % of credit and investment losses on specific high-risk projects.

The Board of Directors at Finnfund is composed of eight members. Among these, presently, one is appointed from the Ministry for Foreign Affairs, another from the Ministry of Finance, and a third from Finnvera Plc, which is entirely state-owned. The selection of the Board members, including the Chairman and Vice Chairman, is conducted annually by the Annual General Meeting. The Board holds the responsibility for guiding the strategic direction of the company and making decisions related to its business operations. When it comes to finalizing investment decisions, these are either made by the Board of Directors or, in some instances, by the managing director. Additionally, there is a Supervisor Board comprising twelve members, predominantly from the Parliament, who are also elected by the Annual General Meeting for a term of three years.

The Finnish Ministry for Foreign Affairs provides strategic guidance to Finnfund and sets policy goals through an annual document known as the 'government ownership steering memorandum'.

Finally, Finnfund has significantly expanded its activities in recent years through annual capital injections (EUR 10 million a year in recent years, and 50 million in 2020), through large State loans (EUR 130 million in 2016, increased to EUR 260 million in 2020 and to

EUR 340 million in 2021) and through repeated increases of the ceilings of the 'special risk financing instrument' (EUR 150 million currently, from EUR 50 million initially in 2012, increased to 75 million in 2018).

Availability of national accounting analysis

Statistics Finland, after conducting its analysis, concluded that Finnfund "*can be reclassified as a captive financial institution in sector S.13 (General government). Due to the constraints on the operations and based on the risk criterion, the unit is not considered an independent captive financial institution or a financial intermediary.*" Statistics Finland also noted that "*a captive financial institution can only be classified as an independent unit in the financial sector S.12 if it can produce the market output normally expected of a business entity*".

2. METHODOLOGICAL ANALYSIS AND CLARIFICATION BY EUROSTAT

Applicable accounting rules

The relevant accounting rules for this case can be found in the following sections of ESA 2010 and the Manual on Government Deficit and Debt 2022:

ESA 2010 Chapter 2 - Classification of Units:

- Paragraph 2.12, on the definition of institutional units.
- Paragraphs 2.21-2.23, focusing on Captive Financial Institutions.
- Paragraph 2.27, discussing Special Purpose Entities (SPEs) related to general government.
- Paragraphs 2.56 and 2.57, dealing with financial intermediation.
- Paragraphs 2.98-2.99, covering Captive Financial Institutions and Money Lenders.

ESA 2010 Chapter 20 - Government Accounts:

- Paragraphs 20.24 to 20.28, describing the criteria for identifying the purchasers of outputs from public producers.
- Paragraphs 20.32 to 20.34, on financial intermediation in the context of government accounts.
- Paragraph 20.204, addressing fiscal operations conducted by government and financed through standard budgetary procedures.

Manual on Government Deficit and Debt (MGDD) 2022:

- Chapter 1.6.6 provides additional guidance on classifying entities that exhibit characteristics of captive financial institutions.

Methodological analysis by Eurostat

Finnfund as an institutional unit

Finnfund is a public entity engaged in financial operations and seemingly meets the criteria of an institutional unit as outlined in ESA 2010 paragraph 2.12. This assessment is based on its capacity to independently own goods and assets, its ability in making economic decisions and conducting economic activities for which it is responsible and accountable at law, its authority to incur liabilities, undertake obligations, commitments and enter into contracts, and its capacity to prepare a complete set of accounts.

Finnfund reaches its specific investment decisions independently from the government. While the Ministry of Foreign Affairs provides a fairly strict framework within which

Finnfund operates, the entity nonetheless chooses the projects and sets up the characteristics of its financing instruments (interest, length of investment, etc) based on each client individually and under the supervision of its Board of Directors.

Finnfund as a financial intermediary

The principal function of financial intermediation is to bring together a large number of savers and borrowers, each with different requirements in terms of liquidity and risk, such that transformation occurs, thus implying that the intermediary puts itself at risk. Financial intermediation is indeed defined under ESA 2010 as an activity "*in which units acquire financial assets and at the same time incur liabilities on their own account by engaging in financial transactions on the market. The assets and liabilities of financial intermediaries are transformed or repacked in relation to, for example, maturity, scale, risk etc. in the financial intermediation process*" (see ESA 2.56).

An essential aspect of financial intermediation is to be performed "*on the market*" (also referred as "*open market*" see ESA 2.55, 2.64, 2.98), implying that the operations of the unit should not be confined to a limited number of entities or transactions, but should involve "*acquiring assets and incurring liabilities with the general public or specified and relatively large sub-groups thereof*" (ESA 2.61).[1] This applies both to its assets and its liabilities, encompassing sources of financing.

On the asset side, defining an open market in the context of foreign economic aid presents challenges. It's hard to determine if financial actors are willing to engage in similar transactions under the same conditions, especially since such investments are seldom traded in secondary markets and given the concessional content of large fractions of its assets (see below).

On the liability side, however, Finnfund's reliance on government support is clear. The organization primarily uses government-provided convertible loans and regular capital injections for funding. Finnfund's balance sheet shows that government funding - through share capital and loans - accounts for approximately 80% of its total liabilities. This indicates that the vast majority of Finnfund's funding does not come from open market activities.

Finnfund functions more similarly to a financial captive, depending on a restricted set of funding sources and transactions. This is in contrast to a traditional financial intermediary, which typically engages in a broad spectrum of market activities on the open market with a variety of funding sources.

Finnfund as a captive financial institution

The concept of captive financial institutions concerns entities that: a) are apparently institutional units, and b) while seemingly engaging in some financial activities, e.g., holding significant assets or liabilities, are not meeting the definition of a financial intermediary, because they are transacting on neither their asset nor their liability sides with the public at large (ESA 2.98).

[1] ESA 2.62 foresees exceptions, although they are not applicable to the case under review: "*Exceptions to the general limitation of financial intermediation to financial transactions on the market may exist. Examples are municipal credit and savings banks, which rely on the municipality involved, or financial lease corporations that depend on a parent group of companies for acquiring funds or investing funds. Their lending or their acceptance of savings shall be independent of the municipality involved or the parent group, respectively, in classifying them as financial intermediaries*".

As discussed in the previous section, Finnfund exhibits traits that align it with the characteristics of a captive financial institution, to the extent that its activity is essentially financial while not meeting the financial intermediary definition. Finnfund is reporting the financial assets and associated liabilities on its own balance sheet, and as such cannot be seen as a financial auxiliary (S.126).

ESA 2.20 stipulates that "*captive financial institutions (...) with no independence of action are allocated to the sector of their controlling body.*" In contrast, captive financial institutions that are deemed 'independent' (i.e., from their parents) are to be classified in the dedicated S.127 sub-sector (ESA 2.98).

Further on, ESA 2.22 indicates that "*the degree of independence from its parent may be demonstrated by exercising some substantive control over its assets and liabilities to the extent of carrying the risks and reaping the rewards associated with the assets and liabilities. Such units are classified in the financial corporations sector.*"

ESA 2010 thus foresees that 'independence' is demonstrated (in this specific case of captives) by exercising substantive control over ones' balance sheet so that the entity actually carries the risks and reaps the rewards associated with its own assets and liabilities.

As will be described in more detail below, the combination of the 'general loss compensation mechanism' and the 'special risk financing instrument' de facto guarantees a significant part of Finnfund assets. On the liability side, funding is mostly from government, and Finnfund even benefits from a mechanism that automatically converts a large government loan into equity whenever its equity ratio falls below 10%. Finnfund is thus rather close to meet the direct condition set by ESA 2010 for dependent captives – with government rather than Finnfund carrying the risks associated with its assets and liabilities.

The MGDD 2022 chapter 1.6.6 complements the prescription in ESA 2.22 in order to provide practical guidance to compilers to decide when certain public captive financial institutions with similar functions do not act independently from government.

According to the *MGDD Chapter 1.6.6* paragraph 59, three criteria must be simultaneously analysed in order to conclude that certain government-controlled unit engaged in financial activities would have the features of a dependent captive, and as such should be classified in S.13: *"1. the unit would carry out a limited range of activities in narrow conditions set by government (in the framework of public policy objectives), 2. government influence or constraints would be evidenced simultaneously on both: assets' side and liabilities' side of the unit, and 3. the unit would not behave like a "normal" commercial entity (e.g., no expectation of a market rate of return on equity)."*

a) Finnfund's range of activities

Finnfund is one the instruments of Finland's foreign development policy. Each year, the Foreign Ministry issues a 'government ownership steering memorandum' that outlines Finnfund's development policy objectives and operational targets, including detailed quantitative ones. While Finnfund maintains a large degree of autonomy in its day-to-day operations, it is nonetheless required to pursue the goals set by the government, adhering to specific limitations and guidelines. Finnfund is directed to concentrate its efforts on low and lower-middle-income countries or countries in fragile situations where alternative risk capital is very limited (except from other foreign development agencies). Furthermore, it is instructed to focus on particular sectors such as renewable energy, sustainable forestry, food security, manufacturing, and innovative growth sectors, aligning its investments with strategic areas of development deemed important by the Finnish government. Finally, the set of detailed quantitative objectives to be met appears fairly constraining (see Annual Report 2022, page 28), if not putting a question mark on the autonomy of decision of the unit.

As such, Finnfund has no room of manoeuvre to exit from or enter in new activities, as a response to market forces. It cannot contract or expand its activity based on profitability considerations, such that it would be debatable to conclude that its activity is market in the ESA 2010 meaning (i.e., with economically significant pricing).

Should the Finnish government issue direct instructions for specific interventions, Finnfund's scope of activities would become even more constrained. Although the Finnish statistical authorities have not documented instances of this nature,[2] it is nonetheless important to recognize that a significant portion of Finnfund's annual disbursements is explicitly classified as Official Development Aid (ODA)[3] by the Finnish State. This classification underscores Finnfund's role in contributing to Finland's foreign development objectives, thus highlighting the potential for its activities to be controlled or directly influenced by governmental policy directives. It is also documenting that a significant share of Finnfund activity is concessional.

Table 1 - Finnfund annual disbursements

	EUR m	*2014*	*2015*	*2016*	*2017*	*2018*	*2019*	*2020*	*2021*	*2022*
A	ODA disbursements	40	26	23	28	44	53	79	45	45
B	Total disbursements	73	77	81	114	135	125	149	144	110
	A/B	54%	34%	28%	24%	32%	42%	53%	31%	41%

Source: Ministry of Foreign Affairs and Finnfund's Annual Reports

Finnfund also publishes the detailed list of its investments, very transparently, which facilitates the scrutiny that befits a government agency, but quite unlike the usual practices of commercial banks. It is noted that Finnfund is not a credit institution as referred to in the Act on Credit Institutions (610/2014), nor does it use the income statement and balance sheet models intended for credit institutions (annual Report 2022 page 98).

b) Government influence on Finnfund's assets and liabilities

Finnfund benefits since 1987 from a 'general loss compensation' mechanism, under which the Finnish State pledges to cover potential losses Finnfund might incur in its lending and guarantee operations. This coverage extends to losses and impairments on loans or equity investments, or on guarantees granted, as well as any foreign exchange losses incurred from foreign credit taken by the company, all according to specifications laid out in the 'commitment decision'. A joint opposition of the representatives of the State at the board of directors would apparently be enough to prevent enclosing a capital project under the commitment. According to the Finnish statistical authorities, the total investments and credits eligible for this general loss compensation mechanism amounted to EUR 168 million at the end of 2021. According to the Ministry of Foreign Affairs, no compensation has been paid to

[2] However, on a case-by-case basis Finnfund still asks the Ministry's position on politically important decisions, such as investments in certain countries, cooperation agreements with the authorities of other countries and investments in sensitive sectors, for example peat production or small hydropower plants. See report 3/2023 of the Finnish National Audit Office.

[3] Official development assistance (ODA), defined by the OECD, refers to government aid that promotes and specifically targets the economic development and welfare of developing countries. To qualify as ODA, the flows have to be i. Provided by official agencies, including state and local governments, or by their executive agencies; and ii. Concessional (i.e., grants and soft loans) and administered with the promotion of the economic development and welfare of developing countries as the main objective.

Finnfund by the Finnish State since 1993 however, when the commitment was last revised – given that compensation is due only after the reserves of Finnfund have been fully consumed.

Finnfund also benefits from a targeted government loss compensation mechanism called 'special risk financing instrument', which has a total allocation of EUR 150 million. This mechanism is designed to cover up to 50 % of credit and investment losses on projects that are deemed too risky for Finnfund's standard financing criteria.[4] By the end of 2022, projects with a combined value of EUR 271 million were under the protection of this mechanism, and the Finnish State is responsible for covering 49% of the associated risks, translating to a contingent liability of EUR 132 million. This arrangement underscores government's commitment to supporting Finnfund in taking on high-risk projects that align with its foreign developmental goals, by providing a financial safety net for half of the potential losses incurred.

When the general loss compensation mechanism and the special risk financing instrument are considered together, the Finnish State's guarantees seemingly provide coverage for Finnfund assets totalling approximately EUR 300 million. This represents about 43% of the total investments managed by Finnfund.

Combined with the significant constrains imposed by the 'government ownership steering memorandum' described above, both the 'general loss compensation' and the 'special risk financing instrument' provide altogether nonnegligible influence by the State on the assets side of the unit.

On Finnfund's liabilities side, the government funding through share capital and loans accounts for approximately 75% of its total liabilities. This figure includes government's convertible loans, granted in 2016 and 2019 for a total amount of EUR 340 million (44% of Finnfund's total liabilities as of 2022). These loans are eligible for conversion into share capital under specific conditions. The government possesses the authority to trigger this conversion, either wholly or partially.[5] Nevertheless, with the government already holding almost complete ownership of Finnfund, any conversion of these loans into equity would not impact the government's ownership proportion. This arrangement implies government fully assumes in advance the risk associated with non-repayment of the loans.

c) Finnfund expectation for market returns

The Act on Finnfund states that the unit's purpose is not to generate a profit for its shareholders and cannot distribute dividends (nor return capital through share buybacks). However, the Ministry for Foreign Affairs holds the expectation that Finnfund, like all Finnish state-owned entities, should be self-sustaining and generate sufficient operating income to cover the costs and risks of its activities. The Ministry has set an annual target return on equity, using a five-year moving average. In 2022, Finnfund reported a return on equity of -3.0% however, falling short of the 2% target. The National Audit Office has noted that Finnfund has not achieved its target in this respect since 2011.

This implies both an expected and a realised rate of return significantly below market rates of return on equity investment, presumably reflecting a significant concessional content of

[4] Those rated as C, CC or CCC in Finnfund's risk classification.
[5] The State is entitled to convert the 2016 loan either entirely or partly as Finnfund's share capital, whereas the 2019 loan will be automatically converted in full into share capital in the company if the company's equity ratio falls to 10 %.

Finnfund assets, despite having access to fairly cheap funding from government and also being exempt from income tax (under the Act on Income tax 1535/1992).

Government makes regular annual capital injections into Finnfund without requesting dividends. Typically, these injections amount to EUR 10 million annually, with an exception in 2020 when the contribution surged to EUR 50 million. Additionally, as it was mentioned in previous sections, government provided two long-term convertible bonds to Finnfund. These hybrid loans were granted for a period of 40 years, with a 10-year instalment free period and an interest rate of 0.5% for the first five years. After this period, the Finnish State is entitled to adjust the interest rate if it so desires.

The examination of past financing sources raises doubts about Finnfund's ability to sustain its operations independently of government assistance. Looking forward, we note that a 2023 audit by the Finnish National Audit Office[6] highlights uncertainties regarding the future funding sources of Finnfund. The audit could not determine the planned extent of increased funding from the Finnish State, nor could it clarify whether there is an expectation for Finnfund to eventually operate without the need for annual capital injections from the government.

3. CONCLUSION

Finnfund does not operate as a financial intermediary, because it does not primarily acquire its financial assets and incur its financial liabilities on the open market, with the public at large. Its operations are instead more characteristic of captive financial institutions, more of the dependent captive kind, given that government exerts considerable control over its range of activities (through the constraints created by the detailed targets sets by the annual 'government ownership steering memorandum', through the mechanism of 'special risk financing instrument' and to some degree by the 'general loss compensation', and having in mind that a significant part of Finnfund disbursements are classified as ODA) and given that Finnfund does not put itself meaningfully at risk for a sufficient part of its assets and liabilities. A significant portion of Finnfund's resources is dedicated to executing government functions within the realm of foreign economic aid.

By the end of 2022, the government had guaranteed 43% of Finnfund's investments and provided over 80% of its balance sheet financing through equity or hybrid loans.

Finnfund acts differently from private financial institutions since its mandate is not to generate profit or distribute dividends. The tasks carried out by Finnfund are mostly done in the context of public policy objectives regarding foreign development, without the expectation of a market rate of return, effectively representing an efficient alternative to government performing the tasks directly.

Finally, Finnfund can hardly be seen as a market producer (e.g., as seller of financial services) given the extent of its concessional activity and given that Finnfund cannot expand or contract its activity based on profitability consideration (thus failing the economic significant price criteria).

Eurostat thus agrees with the analysis of Statistics Finland in that Finnfund is a borderline case that should be classified within the general government sector (S.13) on the basis of the elements mentioned above.

4. PROCEDURE

[6] Report 3/2023 of the Finnish National Audit Office.

This view of Eurostat is based on the information provided by the Finnish authorities. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information presented, Eurostat reserves the right to reconsider its view. In this context, we would like to remind you that Eurostat is committed to adopt a fully transparent framework for its decisions on debt and deficit matters in line with Council Regulation 479/2009, as amended, and the note on ex-ante advice, which has been presented to the CMFB and cleared by the Commission and the EFC.

Eurostat is therefore publishing all official methodological advice (ex-ante and ex-post) given to Member States on its website.

Yours sincerely,

(e-Signed)

Rasa Jurkoniene

Acting Director