Conclusions and recommendations of the National Audit Office

Finnfund's investment activities and risk management

Finnfund (Finnish Fund for Industrial Cooperation Ltd) is an almost wholly state-owned finance company, which carries out the specific development policy task assigned to it. The purpose of the company is to promote the economic and social development of its target countries. The company performs this task by offering private companies in developing countries equity risk financing, long-term investment loans, mezzanine financing and special competence related to investments. Finnfund's funding comes from the State of Finland, the private capital market, and the return on its investments. Finnfund makes annually around 20–30 new investments, totalling approximately EUR 200–250 million. At the end of 2021, the balance sheet value of its investment assets amounted to EUR 657 million.

Finnfund has expanded its activities in recent years, and the expansion will continue. For this reason, the audit examined the possibilities of the investment activities to achieve the objectives set for them and whether the objectives have been achieved. It is also important to examine whether the company's risk management is sufficient so that the investment activities do not cause avoidable costs and risks to the state. The audit also examined how the ownership steering by the Ministry for Foreign Affairs has promoted the company's objectives and risk management.

The companies financed by Finnfund aim at financially profitable business

Finnfund's statutory task of is to promote the economic and social development of developing countries. The Ministry for Foreign Affairs, which is responsible for Finnfund's ownership steering, has also set a target for financial returns on the activities. Finnfund has not achieved this target since 2011, even though it has mainly reported profits. However, financial profitability plays a major role in Finnfund's investment activities, as most of the companies financed by it primarily seek financial profits. Desired development impacts are considered to arise when a project meets the requirements set for the location, sector and sustainability of Finnfund's investment destinations.

The ex-ante assessment of Finnfund's development impacts has improved in recent years. The significance of development impacts in the making of project decisions should be further strengthened. The investment sums have grown as Finnfund’s funding has increased. Larger investments have been justified by the greater development impacts following the greater amount of money invested. Finnfund pursues large projects, but in the selection of investment destinations, it should pay special attention not only to the size but also to other features of the companies to be financed. When making the selection, Finnfund should carefully assess the risks and potential development impacts of the investment destination and the relationship between these.

Finnfund monitors the development impacts of its investment activities mainly through quantitative statistics on the activities of the financed companies. Monitoring of the development impacts of its investment activities in the target society is very limited. In its regular monitoring, Finnfund assesses, for example, the number of investments, the number of financed companies, the return on investments, and the share of operating expenditure. In addition, it assesses the share of climate projects and low- and medium-income countries in its investment decisions, the number of jobs in the financed companies and the share of women employed in them. More comprehensive sector-specific assessments of the development impacts have also been made, and Finnfund has strived to improve the assessment and measurement of the development impacts of its investment activities. Finnfund must continue the development work to make it possible to better assess whether it has succeeded in the task assigned to it.

Finnfund has not set itself clear strategic development impact targets describing the development the company wants to achieve. Consequently, the company's reporting on its development impacts remains disconnected and does not systematically describe the company's operational performance in relation to the targets set. The company mainly describes the methods by which it aims to promote development. In addition, the company has defined theories of change for its main sectors to describe the ways in which investments affect the target country and community. However, theories of change are not objectives. The company has not considered it appropriate to set objectives, such as job creation or increased tax revenue, and measuring the development impacts has proved to be difficult. Furthermore, the Ministry for Foreign Affairs has not demanded in its ownership steering that the company should set strategic objectives for its development impacts. However, in view of the accomplishment of the task set by the ownership steering and the assessment of Finnfund's operations, it would be justified to specify the objectives.

Finnfund assesses risks comprehensively before making an investment decision, but insufficient information may weaken the assessments

The objectives set by the state's ownership steering steer Finnfund's investments in risky investment destinations. Finnfund has a systematic investment process, where the investment destinations are assessed from the perspectives of both financial and other risks. An assessment made prior to the investment decision may remain incomplete in the case of fund investments, as it is not necessarily known at the time of the decision making in which projects the financing will ultimately end up when invested by the fund.

In Finnfund's investment process, well-established actors have the best opportunities to obtain a financing agreement with the company. This is due to the requirements Finnfund sets for its investment destinations as well as the channels through which Finnfund is looking for investment destinations. Potential investment destinations come largely from a stakeholder network, and it may be difficult for local enterprises operating in developing countries to join this network. The company must also have some resources to be able to meet Finnfund's sustainability requirements. Therefore, local enterprises seldom have an opportunity to conclude a financing agreement with Finnfund.

Finnfund monitors investment risks both on a project-by-project basis and at portfolio level. Risk management has defined different target distributions and restrictions for Finnfund's investment portfolio in order to diversify and manage risks. The restrictions include, for example, country-specific limits set for the portfolio and a target distribution for the financing instruments. Finnfund finances projects through different investment instruments. They differ as regards the risks they involve and Finnfund’s opportunities to influence the activities of the financed company. Finnfund has fewer opportunities to participate in the companies’ activities in the case of companies funded by a loan instrument than in the case of those funded by equity financing. In the latter ones, Finnfund is usually given a seat in the company's board of directors. As Finnfund is a minority shareholder in the companies, its possibilities to have influence in the boards of directors may be limited.

Ownership steering should set limits on Finnfund's funding and take into account the risks caused by the ownership to the state

The Ministry for Foreign Affairs steers Finnfund's activities primarily through an Ownership Steering Memorandum. The Memorandum sets the objectives and defines the principles for Finnfund's activities. Both the Ministry for Foreign Affairs and Finnfund find the division of labour between the owner and the company clear and effective. The ownership steering focuses on the setting of objectives and on assessing their achievement. In addition to this, the ownership steering should pay attention to the financial and other risks caused by Finnfund's activities to the state and to any liabilities – even hidden ones – arising from them. For example, it would be good to assess the liabilities arising from the policy line set out in Sanna Marin's Government Programme on ensuring that sufficient resources are budgeted for Finnfund.

Finnfund has been financed annually by the state through equity financing and sometimes also through loans. No strategy has been prepared in the ownership steering as to the extent to which the state funding of Finnfund can be or is intended to be increased. The Ministry for Foreign Affairs should form a view on the instruments through which Finnfund can be funded and on the maximum amount by which it can be funded.

Funding Finnfund outside the spending limits may result in favouring its activities over other measures aiming at development impacts

The state has funded Finnfund through convertible bonds that have been treated in the state budget as financial investments. Finnfund has thus been granted funding outside the central government spending limits. The justification for this is that the funds are assumed to be returned to the state. According to the terms and conditions of the convertible bonds, the state has the right to convert the loan either fully or partially into Finnfund's share capital if it so wishes. Loan financing falls outside the spending limits, whereas equity financing falls within them, which may lead to favouring loan financing. As convertible bond financing falls outside the spending limits, Finnfund's loan financing is not necessarily compared with the financing of such corresponding policy measures aiming at development impacts that are financed within the spending limits. Although loan financing outside the spending limits affects the central government finances, its amount or adjustment is not limited by the expenditure objective. Funding outside the spending limits should be justified particularly carefully, and different ways of achieving the objective should be compared genuinely in the justification.

Recommendations of the National Audit Office

Based on the audit, the National Audit Office recommends that the Ministry of Finance should

1. assess the financial and other risks caused by Finnfund's investment activities to the state and the liabilities that may arise from them.
2. specify the situations in which Finnfund needs or does not need additional state funding as well as an appropriate maximum to Finnfund's state funding.
3. specify the special task assigned to Finnfund in its ownership steering and define the development impacts primarily aimed at through Finnfund's investment activities. The Ministry for Foreign Affairs should also ensure that the reporting, impact assessment and monitoring of Finnfund's development impacts are developed in parallel with the company's strategic impact targets.