

Access to private funding for the defence industry

Introduction

In its Conclusions of March 2022, the European Council announced that *“measures should be taken by the end of 2022 to promote and facilitate access to private funding for the defence industry, also by making best use of the possibilities offered by the European Investment Bank.”* This note sets out the European defence industry’s proposals for such measures.

State of play and challenges for industry

According to the experience of our member companies, the biggest challenge for the European defence industry in terms of accessing private funding¹ is currently that, due to ESG considerations, a significant portion of European equity and bond investors is refusing to invest in companies involved in defence activities.² Given its dynamic growth rate, ESG investment is expected to progressively dominate European equity and bond markets. This will result in defence and security related investments being in a fundamentally disadvantaged position relative to other investment sectors, as well as in respect of its key competitors based in other regions.

Since the Russian invasion of Ukraine, the formerly depressed share prices of European defence companies have recovered considerably. This situation, however, remains volatile and unpredictable. Several surveys³ show that very few investors have changed their defence exclusion policies despite the new geopolitical context. Indeed, a July 2022 Goldman Sachs analysis showed that ESG fund ownership of defence companies actually continued to decline between October 2021 and June 2022.⁴

This obvious reduction in the number of potential institutional and private investors has negative consequences not only on the valuation of listed companies, but also on the broader defence industrial ecosystem, including unlisted small and medium-size companies and start-ups. This is because the valuation of listed companies provides a benchmark for the whole industry in terms of multiples, and hence impacts the capacity to attract capital and talent to non-listed companies.

Recommendations

Against this background, ASD recommends 5 types of measures, which are outlined below:

1. A high-level cornerstone document issued by the EU, setting out key principles on how EU sustainable finance legislation is intended to be applied in order to ensure continued access to private funding for European defence companies;
2. Mainstreaming of defence industrial considerations in future sustainable finance initiatives;
3. Specific changes to sustainable finance regulation and general practice;
4. Political support actions by Member States and the European Commission;
5. Change in EIB lending policy.

¹ In this note, “defence companies” refer to companies whose sales to military customers represent more than 5% of total sales, as this is the threshold used by most investors who implement exclusions.

² According to a Barclays study based on Morningstar data, 20% of “Article 8” (SFDR) equity funds (that promote an environmental or social characteristic but do not have sustainable investment as their objective) and 40% of “Article 9” equity funds (that have sustainable investment as their objective) exclude companies involved in ‘military contracting’.

³ See for example Deutsche Bank, 29 March 2022, Jefferies, 14 April 2022, JP Morgan, 16 May 2022.

⁴ “A first look at ESG ownership changes amid macro turmoil”, Goldman Sachs research note, 12 July 2022.

1. A high-level cornerstone document issued by the EU, setting out key principles on how EU sustainable finance legislation is intended to be applied in order to ensure continued access to private funding for European defence companies

In its 15 February 2022 Communication, the European Commission stressed that *“it is [...] important to ensure that other horizontal policies, such as initiatives on sustainable finance, remain consistent with the European Union efforts to facilitate the European defence industry’s sufficient access to finance and investment.”*⁵

However, the existing EU regulatory framework for sustainable finance fails to properly reflect the vital contribution that the defence industry makes to the achievement of robust, long-term sustainability goals. Indeed, many investors often interpret the EU’s sustainable finance regulation as simply excluding defence companies. This creates a structural bias against the private funding of defence companies. These investors do acknowledge the crucial role of defence companies for European security but struggle to reconcile this reality with the sustainable finance regulation and guidelines. *“We believe that clarification from EU regulators on [whether EU Sustainable Finance Regulations prevent investors from investing in defence stocks] would be welcome, as interpretations vary”* (JP Morgan, March 2022).⁶

An appropriate measure to promote and facilitate private funding of defence industry would therefore be to adopt a high-level strategic cornerstone document that clarifies the intended application of sustainable finance regulation to defence companies. This document could take the form of a Joint Communication of the Commission and the High Representative and should be prepared in close cooperation with Member States and industry. It could explain the importance and the specific nature of defence companies⁷ and outline how the defence sector can address sustainability issues through a combination of Member States’ and industry initiatives.⁸ At the same time, such a document should also give guidance to investors and clarify that, to comply with EU sustainable finance legislation, investors should limit their exclusions to companies involved in the 4 categories of controversial weapons listed in the Commission Delegated Regulation 2022/1288 on technical standards that the Sustainable Finance Disclosure Regulation (SFDR) refers to⁹. Furthermore, the document should encourage investors to consider all defence exports as legitimate as long as they are approved in accordance with the export control policies of EU Member States.

Such a document would explain how the EU interprets the link between security and sustainability and frame the contribution of the EU defence industry to sustainability. This would serve as a reference for all EU sustainable finance policies and legislation and help investors to navigate EU regulatory requirements. In the medium term, this document could even become the basis for a defence sector-specific sustainability label.

⁵ “Commission contribution to European defence”, COM (2022) 60 final, 15 February 2022.

⁶ “Russia/Ukraine – Addressing ESG dilemmas in the Short, Medium & Long term”, JP Morgan research note, 2 March 2022.

⁷ The production and sale of defence products already receives a unique legal treatment in every Member State: national governments decide the features of the products to make, are the only allowed local buyers, and only authorize exports when they satisfy rigorous criteria and are aligned with their own policies.

⁸ For example, while defence companies can commit to reduce their operational CO₂ emissions (scope 1 and 2), the reduction of scope 3 CO₂ emissions depends to a large extent on technical and operational requirements defined by Member States.

⁹ The four categories are: Anti-personnel mines, cluster munitions, chemical weapons and biological weapons. These categories are also used in the EFRAG sustainability standards that the newly revised Corporate Sustainability Reporting Directive (CSRD) refers to. Lastly, they are also used by the Platform on Sustainable Finance to define “controversial weapons” in its draft report on Minimum Safeguards for the green taxonomy.

2. Mainstreaming defence industrial considerations in future sustainability initiatives

Given the multitude of initiatives related to sustainable finance, we believe that the Commission should develop a systematic approach to ensuring that these initiatives “*remain consistent with the European Union efforts to facilitate the European defence industry’s sufficient access to finance and investment.*”¹⁰ We suggest that such an approach should consist of three concrete measures:

- a. The effect on defence industry’s access to finance should become a criterion in every impact assessment accompanying new legislative initiatives related directly or indirectly to sustainable finance;
- b. A reference to the Communication of 15 February 2022 should be systematically included as a recital in every new legislative initiative related directly or indirectly to sustainable finance;
- c. Given its responsibility for the overall coherence of the Commission’s work, the Secretariat-General should ensure that all new policy or regulatory initiatives related directly or indirectly to sustainable finance abide by the above statement in the Communication of 15 February 2022, and that proposals a) and b) are fully implemented.

3. Specific changes to sustainable finance regulation and general practice

Notwithstanding the measures proposed in sections 1 and 2, the Commission and/or the relevant European supervisory authorities should rapidly provide clarifications on the following sustainable finance legislation, that is already existing or currently under preparation.

a. Sustainable Finance Disclosure Regulation: “principal adverse impact statements”

The Sustainable Finance Disclosure Regulation requires that asset managers disclose “Principal Adverse Impact statements” to show how their investment decisions may have adverse impacts on ESG factors relating to 1) climate and the environment, and 2) social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

We suggest that the Commission and/or the relevant European supervisory authorities issue guidelines to clarify that investing in European defence companies that are not involved in the 4 categories of controversial weapons referred to in the SFDR shall not be disclosed in such statements, since the primary purpose of these companies is to contribute to a resilient and secure European society. These guidelines could, for example, take the form of ESMA recommendations.

b. Defence activities and the EU environmental taxonomy

At present, defence activities are not covered by the EU environmental taxonomy. Since sustainable funds will increasingly base their investment decisions on alignment with this taxonomy, this situation will act as a headwind to investments in defence companies.

Since defence product specifications are defined by Member States based on trade-offs between operational performance and contribution to their own CO₂ reduction plans, defence companies would often not be in a position to comply with technical screening criteria designed for defence activities. This puts them at a structural competitive disadvantage on financial markets. To avoid this, in coherence with the cornerstone document proposed above, ASD suggests that asset

¹⁰ “Commission contribution to European defence”, COM (2022) 60 final, 15 February 2022, p.5.

managers are allowed to compute their taxonomy alignment percentages based on portfolio holdings excluding defence companies.¹¹

c. Minimum requirements for SFDR art. 8 classification shall not disadvantage defence companies

In order to reduce the risk of “greenwashing”¹², the Commission is currently discussing the definition of “minimum requirements” for funds to be eligible to article 8 classification. This regulation could introduce a new bias, implicit or explicit, against defence companies. To avoid this, European supervisory authorities should provide guidelines to clarify that the exclusion of defence companies cannot be one of these minimum requirements.

d. MIFID II “sustainability preferences”

Similarly, since 2 August 2022, investment product manufacturers and distributors have to consider customer sustainability preferences as part of their suitability assessment. European supervisory authorities should provide guidelines to investment product manufacturers and distributors with respect to the treatment of defence companies. In particular, questionnaires to determine sustainability preferences must not include questions that would then justify the decision to exclude defence companies from investment portfolios.

e. Defence exclusions as criteria for eco-labels

It is well documented that, for many investors, “the mandates set by labels drive restrictions.”¹³ *“The main driver for changes in [investor] ESG policies appears to be compliance with eco-labels and Article 8/9 guidelines, with 32% of respondents citing them as the most likely trigger for a change.”*¹⁴

The latest version of the draft Commission decision establishing criteria for an EU eco-label for retail financial products requires an exclusion of companies with more than 5% of turnover in defence. It also comes with a requirement for average taxonomy alignment levels above 50%, which would negatively impact defence companies (see point b). We understand that the EU ecolabel project is currently on hold. However, we reiterate our strongest rejection of systematic exclusions of defence companies in eco-labels for retail financial products, which obviously create a major hurdle to the Council’s aim of facilitating defence industry access to finance.

ASD also calls upon all Member States that already have national eco-labels to revise their policies accordingly and limit their exclusions to companies involved in the production and trade of controversial weapons identified in the SFDR.

4. Political support actions by the Union and its Member States

Until and even when regulatory bias is removed, ASD is concerned that asset managers may continue to implement defence industry exclusions, notably because of pressure from public opinion or dedicated investor requirements. This puts the European defence industry at a clear disadvantage

¹¹ For example, a portfolio made of 3 stock or bond holdings of same value, with respectively 80% alignment, 20% alignment, and a defence company (0% alignment), would have a taxonomy alignment percentage of 50% ($80\% \times \frac{1}{3} + 20\% \times \frac{1}{3} + 0\% \times \frac{1}{3}$) instead of 33% ($80\% \times \frac{1}{3} + 20\% \times \frac{1}{3} + 0\% \times \frac{1}{3}$).

¹² Since funds freely decide to take an SFDR classification, there is a risk that some funds take the article 8 label but do not really “promote environmental or social characteristics”.

¹³ “Will defence and nuclear pivot to ESG? Survey results”, Deutsche Bank note, 29 March 2022.

¹⁴ “ESG & Defense : feedback from our Investor survey”, Jefferies note, 14 April 2022.

against other sectors and defence companies headquartered outside Europe. On this basis, ASD recommends that the following further steps/initiatives are taken:

f. Step up actions to convince asset managers that the Union and its Member States support defence companies and are determined to ensure their access to private funding

ASD appreciates the messages that were included in the recent Commission Communication and European Council Conclusions. However, up until now European asset managers have not materially changed their stance. We therefore believe that both the Union and Member States should directly address the asset management community and call for a more nuanced approach towards defence companies. Ideally, this call would come from the highest political levels.

g. Make Government-controlled asset managers increase their investments in defence companies

A significant number of European equity and bond investors are government-controlled. Some of them have put in place systematic defence exclusions. Others have not been very active investing in European defence companies or still have margins to increase their investments in the sector.

As shareholders and owners, Member States could require these investors to remove the systematic defence exclusions where they exist, and/or urge them to increase their investments in European defence companies. Examples of such asset managers include:

- **France:** Caisse des dépôts, BPI France, La Banque Postale AM, RAFF
- **Germany:** asset managers owned by Landesbanken and Sparkassen (Deka Group, LBBW AM, Helaba, Warburg Invest, Bayern Invest...)
- **Italy:** Cassa Depositi and Prestiti
- **Netherlands:** APG AM, Pensioenfondsen Rail & OV, ABN Amro IS
- **Norway:** Norges bank IM, KLP
- **Sweden:** AP-Fonden 1 to 4

5. Change in EIB lending policy

At present, the EIB is only allowed to support dual-use projects. The bank's *Strategic European Security Initiative* intends to offer greater flexibility, but eligible projects will need to remain dual use and predominantly civilian. From ASD's perspective, a blanket exclusion of defence projects clearly contradicts the European Council's call to foster defence industry's access to private funding, including via the European investment Bank.

The March 2022 European Council explicitly referred to the ambition to make "best use of the possibilities offered by the European Investment Bank." ASD therefore calls again on Member States to change the EIB lending policy and eliminate the existing incongruous defence exclusion. Such a change would also serve as an important benchmark for national financial institutions and would therefore contribute considerably to boosting investments in the EU defence industry.

[signed by] Jan Pie, Secretary General of ASD
Brussels, 11 October 2022