Armament Industry European Research Group

ARTICULATING ESG CRITERIA AND THE FINANCING OF THE EDTIB: A PROSPECTIVE VIEW

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The Armament Industry European Research Group (Ares Group) was created in 2016 by The French Institute for International and Strategic Affairs (IRIS), who coordinates the Group. The aim of the Ares Group, a high-level network of security and defence specialists across Europe, is to provide a forum to the European armament community, bringing together top defence industrial policy specialists, to encourage fresh strategic thinking in the field, develop innovative policy proposals and conduct studies for public and private actors.

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ABSTRACT

The war in Ukraine has highlighted the lack of investment in European defence by EU countries since the end of the Cold War. Awareness is real, as shown by the commitments of most countries to significantly increase their military spending in the months and years to come. The European institutions have also taken a stand on several occasions in favour of strengthening Europe's defence capabilities. A solid and dynamic defence industry is an essential instrument for this reinforcement. Then, Europeans must guarantee EDTIB companies a secure and long-lasting access to the necessary funding, while the dialogue between defence industry and financial players has often appeared complicated.

There are many reasons to explain this situation, some relating to the specific characteristics of the defence industry (classic risks of an industrial and innovative activity to which are added specificities linked to the production of weapons and to the poor reputation of the sector) but also to recent changes in financial markets (inflation of compliance requirements around the fight against corruption, money laundering, etc., increasing consideration of extra-financial criteria in risk management coupled with a difficulty in assessing the risk associated with defence activities due to a certain lack of knowledge of the sector).

This paper presents these different aspects that complicate the relationship between defence companies and financial players. It opens ways to remedy these difficulties and build a solid and productive dialogue while the war in Ukraine and the needs for military equipment to defend European countries certainly constitute new opportunities to rethink this relationship.

Keywords: Financing EDTIB / Extra-financial criteria / ESG/ Defence and sustainability

INTRODUCTION

Over the last thirty years, the defence industry has undergone major changes linked to the end of the Cold War and to strategic, economic, and technological "revolutions”. New threats and overseas operations have had decisive consequences for armies, requiring new capabilities and armaments (the Revolution in Military Affairs). The defence industry had to adapt and invest in new equipment programmes while Peace Dividends led to the reduction of defence spending. At the same time, the globalisation of the World economy increased competition, and the deregulation facilitated industrial consolidations even in the defence sector. New players such as banks or investment funds invested in defence companies.

However, the war in Ukraine has highlighted the lack of means dedicated by EU countries to their defence and arms production since the end of the Cold War. This current war is also pushing to accelerate arms production to replenish the stocks depleted by arms deliveries to Ukraine. It thus poses with new acuity the issue of the financing of the arms industry.

This observation comes at a time when European defence industries are facing certain difficulties in their access to financing. In a position paper published by the European Aerospace and Defence Industries Association (ASD) in October 2021, the association defended the idea that "Defence is a crucial component of security, and security is the precondition for any sustainability", and expressed concern about the stigmatisation of this activity and the risks this entailed in terms of access to financing for European companies[1]. These difficulties are directly connected to the very nature of this industrial activity whose risks can be difficult to grasp for non-specialist financial players. They also result from changes in the financial markets themselves with the proliferation of compliance rules and the rise of extra-financial criteria in the evaluation of investments.

If the war in Ukraine puts the importance of the EDTIB for security in Europe back on the agenda, it may create an opportunity for defence companies to deepen their dialogue with financial players. To do so, it is necessary to properly identify and understand the issues and challenges of such a dialogue both at the level of each investor and at a national or community level. This is what this policy paper on “Articulating ESG Criteria and the Financing of the EDTIB: A Prospective View” proposes. First, it explains the implications of the increasing consideration of extra-financial factors such as ESG, for example, on investment choices and their consequences for the defence industry. It then highlights in a second step the fact that other factors more specific to this activity than ESG criteria can also explain the difficulties

[1] ASD Considerations on Sustainability and the European Defence Industry, ASD Position Paper, 6 October 2021.

encountered by defence companies in their relationship with financial players. Finally, in a third step, it questions how defence players in Europe can strengthen this dialogue and convince investors of the interest to support the ramp-up of armament production in Europe.

IMPLICATIONS OF THE INCREASING CONSIDERATION OF EXTRA-FINANCIAL CRITERIA FOR THE DEFENCE INDUSTRY

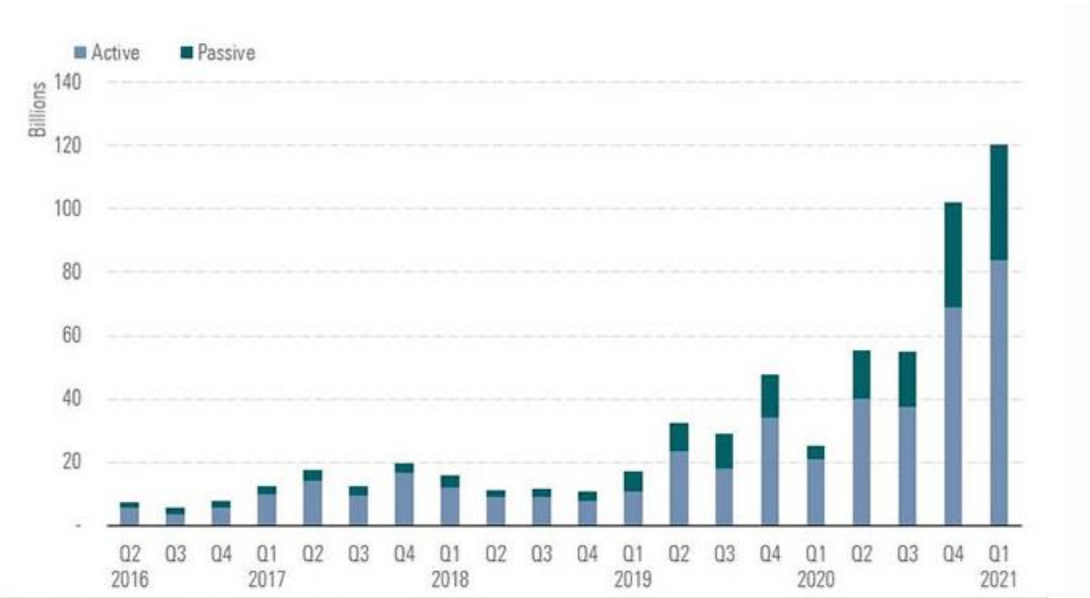
The main mission of the finance sector is to finance economies and therefore to meet the financing needs of companies, states, and individuals. For this activity to be sustainable, the financial actors must ensure that the loans granted will be reimbursed, their investments will bring a suitable return, etc. They must therefore know how to assess the risk of each of their actions, the financial decision falling within an opportunity/risk trade-off judged to be positive. Traditionally, this risk assessment and therefore the decision to invest or not were essentially based on financial criteria such as income or turnover, financial strength, prospects for return on investment. Since the ‘70s and particularly after the 2008 crisis or in the framework of the Paris Climate agreement in 2015, more and more bankers and funds began to take extra-financial criteria into account to assess risk, as in the case of ethical finance.

A growing consideration of extra-financial factors by financial markets

Ethical finance was in the 18th century one of the first movements to integrate extra-financial criteria, in this case ethical criteria. It has its origins in religious philanthropic movements such as the Quakers in the United Kingdom. This religious commitment continued in contemporary times with the launch in 1971 of the Pax World Fund in the United States by two Methodist pastors, Luther Tyson and Jack Corbett, and in France of the Faim et Développement mutual fund in 1983 by the Catholic Committee against Hunger and for Development (CCFD) in collaboration with the French Crédit Coopératif.

Since the ‘70s, several factors contributed to broaden the extra-financial criteria considered by investors, going beyond ethical issues alone. At the beginning of the ‘90s for example, the awareness that global warming called into question our model of intensive growth based on waste and mass consumption. It led to the creation of green funds to finance activities that contribute to the fight against climate change. Socially responsible investment integrates ESG criteria, while solidarity finance more specifically integrates social criteria linked to activities considered to be socially useful. The European Union has also been one of the first institutions to push investors towards more sustainable finance with several initiatives such as the green taxonomy, the Corporate Sustainability Reporting Directive (CSRD)[2], or the recent proposal for a Directive on Corporate sustainability due diligence[3].

Graph 1: Quarterly European Sustainable Fund Flows (EUR Billion)



Source: Morningstar Direct, Manager Research. Data as of March 2021

However, before the crisis of 2008, the share of these investments remained limited (less than 3% of total assets). The change came from the financial crisis in 2008 when the demand of small shareholders for ethical investments met the desire of banks and funds to restore their image[4]. It has since experienced strong growth, representing today nearly 30% of financial assets in Europe and the United States. The Eurosif 2021 report estimates that in 2050, half of investments could be classified in this category[5]. The Global Sustainable Investment Alliance estimates that in 2020 responsible investments have reached $35,3 billion, an increase of

[2] Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting (Text with EEA relevance). Available on: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32022L2464

[3] Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937, COM/2022/71 final. Available on: https://commission.europa.eu/publications/proposal-directive-corporate-sustainability-due-diligence-and-annex_en

[4] Cuénoud, T. (2013). "L'impact de la crise financière sur la finance responsable en France, vers une structuration plus durable du secteur ?", *Vie & sciences de l'entreprise*, 195 - 196, (3), 13-32. Available on: https://www.cairn.info/revue-vie-et-sciences-de-l-entreprise-2013-3-page-13.htm

[5] European Sustainable Investment Forum, *Fostering Investor Impact, Placing it at the heart of sustainable finance*, Ninth Eurosif SRI Report, 2021. Available on: https://www.eurosif.org/wp-content/uploads/2021/11/2021-Eurosif-Report-Fostering-investor-impact.pdf

more than 15% in 2 years[6] and will represent 36% of investments (compared to 33% in 2018). The United States and Europe account for 80% of ESG funds, but the growth of this type of finance is particularly strong in Canada (+48% between 2018 and 2020).

Yet a wide, vague and variable-geometry scope of extra-financial criteria

Extra-financial criteria respond to a need to reduce uncertainty in the economic competition. In recent years, investors have shown a growing interest in ESG, underlining a desire to have a positive impact on society and a reduction in long-term risk exposure[7].

However, these criteria are interpreted and calibrated in a variable way depending on the players and their interests. If the definition of extra-financial criteria such as ESG ones remains unclear and divergent depending on the institution that transposes it, it is because they are still poorly defined and by nature more qualitative than financial criteria and indicators. They rely on a certain number of international instruments ranging from the Universal Charter of Human Rights to the OECD's guidelines for multinational companies[8], the United Nations' Sustainable Development Goals (SDGs), and the ILO conventions. Consequently, their definition suffers from a deficient regulatory framework and a lack of harmonisation of concepts and definitions used by financial players. Financial actors take advantage of these gaps to set up indicators adapted to the objectives or interests they pursue, to their own agenda.

The European taxonomy aims to harmonise the scope of these criteria. Adopted in June 2020, it remains focused on the environmental issue for the time being, but a social taxonomy project could be added to it with the ambition of classifying economic activities according to social criteria such as the respect of the conventions of the International Labour Organisation or human rights. These initiatives are a priori welcome because they aim to provide a better framework, greater visibility, and transparency for companies. However, while the green taxonomy should have a limited impact on the evaluation of the defence industry by financial institutions, the social taxonomy presents much greater risks of exclusion and may create major difficulties for defence companies.

[6] Global Sustainable Investment Alliance (2020), *Global Sustainable Investment Review 2020*. Available on: http://www.gsi-alliance.org/wp-content/uploads/2021/08/GSIR-20201.pdf

[7] Martellini L., Le Sourd V. (2020), "ESG; What Are Investors' Expectations?" EDHECVOX. Available on: https://www.edhec.edu/fr/recherche-et-faculte/edhec-vox/esg-quelles-sont-les-attentes-des-investisseurs

[8] OECD (2011), *Guidelines for Multinational Enterprises*. Available on : https://www.oecd.org/fr/investissement/mne/2011102-fr.pdf

Implication of the increased consideration of non-financial criteria for the defence industry

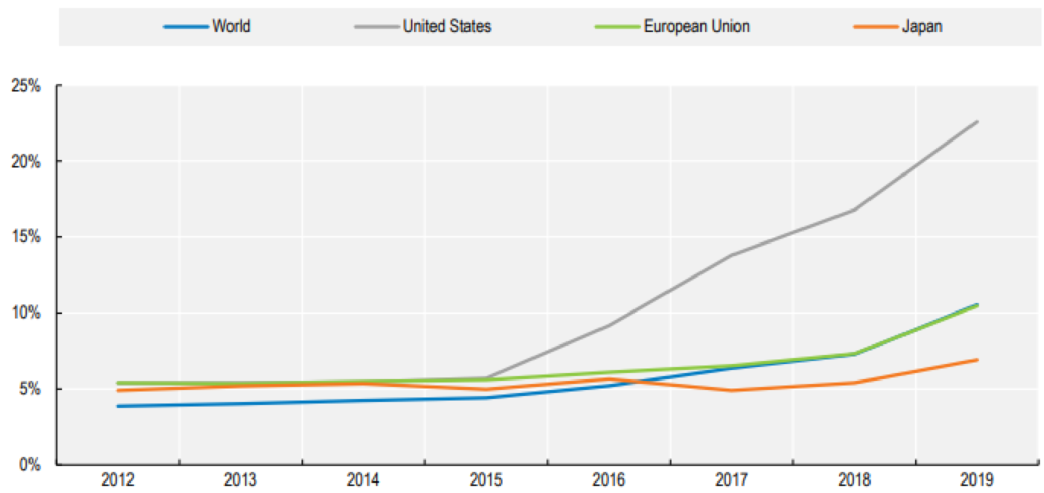
The rise of ethical and responsible finance over the last few years has been undeniable. In recent years, it has even been coupled with an inflation of rules in Europe (taxonomy, due diligence) and norms in financial markets (labels and standards). Investors have become increasingly demanding in terms of ESG criteria. It can be argued that even if banks and pension funds apply ESG criteria to some of their funds, they do not apply those criteria to their other funds. So technically, defence companies can still access funding even if they are excluded from ESG funds. The reality appears to be more complex.

Firstly, extra-financial criteria are more and more considered in investors' decisions, which significantly reduces the funds available for assets that do not meet the extra-financial standards set by investors in a crowding-out effect. Let us take the example of the European Sustainable Finance Disclosure Regulation (SFDR)[9]. This regulation requires asset managers to provide information on the ESG risks of their investments as well as the impact on society and on the planet. Funds are sorted into three categories depending on their sustainability objective: Article 6 which includes all funds, Article 8 for funds that promote environmental or social characteristics, and Article 9 for funds that have a sustainable investment objective. Article 8 and Article 9 funds will be asked to provide more detailed ESG information, as set out below. Four months after the implementation of the regulation, the Morningstar website observed a significant rise in funds relating to Articles 8 and 9. Of the 210 funds launched, 48% were classified as Articles 8 or 9. The website explained that "fund companies are feeling commercial pressure to have as many funds as possible that meet minimum requirements. Many distributors and purchasers of funds across Europe have stated that they will only consider funds in the Article 8 and 9 categories in the future"[10].

[9] Regulation (EU) 2019/2088 of the European Parliament and the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector. Available on: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2088&from=fr

[10] Hortense Bioy, "SFDR Four Months On", *Morning Star*, August 3, 2021. Available on: https://www.morningstar.co.uk/uk/news/214207/sfdr-four-months-on.aspx

Graph 2: Share of market coverage by ESG scoring companies by region, 2012-2019



Note: Calculated as the number of public companies with an ESG score over the total number of public companies, in each year for the different areas.
Source: Refinitiv, OECD calculations

Secondly, to respect extra-financial criteria, some investors are quick to exclude more and more sectors from their portfolios. Arms production is one such sector, along with coal, oil, tobacco, and pornography. Exclusion consists of refusing to invest in companies or to include an asset in a fund when a significant part of its activity is connected to unwanted productions or sales such as drugs, alcohol, tobacco or pornography. Weapons are frequently listed too. Some investors have adopted a zero-tolerance policy, excluding all companies producing or exporting weapons, and others define a limit above which they refuse to invest. For the Bayerische Landesbank for example, the limit is set at 20%, and for the Belgian label "Toward sustainability", at 5%.

Most of the time, the exclusions are related to controversial weapons, but not always. In Europe, controversial weapons were the most common exclusion in 2017 (63% of exclusions) according to the Eurosif report[11]. Companies who design, manufacture, or market controversial weapons are excluded from the portfolio of investors. Weapons listed as controversial are anti-personnel mines, cluster munitions, depleted uranium, and chemical and biological weapons. Controversial weapons are generally considered to be those whose production, sale, or proliferation are strictly regulated and prohibited by international treaties or agreements[12] ratified by EU States. But since 3 European countries (Malta, Ireland, and

[11] European Sustainable Investment Forum (2018), *European SRI Study 2018*, 2018. Available on: https://cupdf.com/document/european-sri-study-2018.html?page=1

[12] The case of the conventions prohibiting chemical or biological weapons or the prohibition of the use, stockpiling, production and transfer of anti-personnel mines (Ottawa Convention) and cluster munitions (Oslo Convention).

Austria) have signed the Treaty on the Prohibition of Nuclear Weapons (TPNW), banks from these countries (or not) may decide to also ban nuclear weapons[13].

However, exclusions defined by the banks are not limited to controversial weapons. Norway's largest pension fund, KLP, announced in 2019 that it would divest from certain companies on the grounds of their direct or indirect involvement in weapons manufacturing. The title of the document published to list these exclusions seems to suggest that they will only concern controversial weapons[14], but upon reading it, we see that the exclusions are much broader and companies like Rolls Royce Holding, Dassault Systems, and Thales were on the list. The definition of controversial weapons given by the report is very vague: "KLP shall not invest in companies that produce weapons that violate fundamental humanitarian principles through their normal use". The German Bayerische Landesbank, announced at the beginning of 2021 that it would no longer invest in the defence sector[15]. This announcement was all the more surprising not only because this bank is located in Bavaria, a region where defence activities are important (Airbus or Hensoldt), but also because it is a regional public bank. It was not only a poor signal for private banks, but it also reflects the challenges that the development of responsible finance poses to defence companies today.

BEYOND NON-FINANCIAL CRITERIA, FINANCIAL PLAYERS' RELUCTANCE TO FUND ARMS INDUSTRY

Candriam, a pioneer in sustainable investment which manages over €590 billion in financial assets, argued that it was extremely difficult to reconcile investment in the defence sector with sustainable investment. BNP Paribas also explains on its website that "While BNP Paribas recognises the right of countries to defend themselves and protect their national security, the Group acknowledges that the defence and security sector presents specific risks related to (1) the status of certain weapons and equipment, (2) their potential end use, and (3) the risk of corruption and diversion. Potential irresponsible end-use of military, security or police equipment is a key issue in this sector. For this reason, certain countries are subject to

[13] ICAN, "$63 billion drop in investments: New report shows impact of nuclear weapons ban treaty on nuclear weapons business", November 11, 2021. Available on: https://www.icanw.org/63_billion_usd_drop_in_nuclear_weapons_investments

[14] KLP, "Decision to exclude companies that produce controversial weapons", November 2021. Available on: https://www.klp.no/en/corporate-responsibility-and-responsible-investments/exclusion-and-dialogue/Decision%20to%20exclude%20companies%20that%20produce%20controversial%20weapons.pdf

[15] Hollinger P., "EU risks its own security by branding defence industry socially harmful", *Financial Times*, December 1, 2021. Available on: https://www.ft.com/content/31933a53-c5ad-4633-826c-adc945f62207

international monitoring, international sanctions or specific embargoes on trade in weapons or internal repression equipment."[16]

The reluctance of financial players to finance defence industries is much broader than just the compatibility of this activity with ESG criteria. It is directly connected to the characteristic of arms production, but also to the reputation of the sector, and it seems to reflect in reality a lack of knowledge and therefor a difficulty in assessing its opportunity and risks.

Producing military equipment, an industrial activity requiring significant and risky financing

The funding of defence production is affected by the very nature of this activity. In economics, any "deviation" from the competition is qualified as a market imperfection[17]. Modigliani Miller's theorem (1958) explains that "the existence of markets' imperfections affects the cost of financing. However, defence markets are, in many respects, far from being perfect competition and free markets".

The defence market is first and foremost a monopsony dominated by one main client, the state, but it is also characterised by the presence of large companies with real market power compared to smaller companies[18]. States are also regulators of the sector, imposing strict rules to producers and controlling their export markets. The financial actors could consider that this state control is a guarantee, limiting the risks. On the contrary, they most often believe that it reduces the leeway and consequently the opportunities of companies[19]. Similarly, the transfer and acquisition of all or part of the capital of a company are almost systematically subject to state control, as these companies hold critical and sovereign skills, know-how and technologies. As these rules on foreign investments were strongly reinforced all over Europe[20] recently, they can be perceived as a potential difficulty and therefore a risk for investors when they wish to resell their assets.

[16] BNP Paribas, Defence & security sector policy, CSR, 2017. Available on: https://group.bnpparibas/uploads/file/csr_sector_policy_defence_final_2017_en_v_3.pdf

[17] The reference in this area is pure and perfect competition, which is characterised by perfect information, the atomicity of suppliers and demanders, the absence of barriers to market entry or exit and the uniformity of products.

[18] Depeyre C., Dumez H., "The role of architectural players in coopetition: the case of the US defence industry", in Yami, S., Le Roy F., *Coopetition: Winning strategies for the 21st century*. Cheltenham, UK - Northampton, 2010, MA, pp.124-140

[19] Interview conducted with a mid-sized French company in April 2021

[20] European Commission, *Commission staff working document on Foreign Direct Investment in the EU*, following up on the Commission Communication "Welcoming Foreign Direct Investment while Protecting Essential Interests", 13 September 2017 and 13 March 2019

Moreover, and as for all industrial companies, the production requires heavy and long-term investments, generating important fixed costs (need for highly qualified personnel and investments in R&D[21]) and strong uncertainty and risks. Their high technological intensity improves the risks of failure and loss. It is not specific to defence activities and a lot of industries report their difficulties to find funding, but in the case of the defence industry, these risks are amplified by political and strategic uncertainties. Consequently, access to financing can be more difficult and costly while companies need money to pay wages, equipment, etc., but the returns may not be available for years.

Indeed, questions about governance and lack of transparency are often quoted by investors as reasons for their reluctance to invest in these companies. A study published in November 2021 by the NGO Transparency International estimated that 62% of the countries in the world present high risks of corruption in the field of defence and security, and that only 12% of defence companies had implemented strong and convincing measures to fight corruption[22]. However, these characteristics are inherent to the very activity of arms production. The lack of transparency is linked to the imperative of defence secrecy (contracts, technology and know-how, etc.), but in return this lack of information adds an additional difficulty in assessing the interest and sustainability of such investments.

Coupled with the specificities of arms production, such as longer and riskier arms programmes than other types of industrial projects, or the nature of the industry's "customers", this does not reassure investors either. The "country" risk is indeed real (insolvency or destabilisation of states, social movements, economic or financial crises). It is potentially even more important as the purchase of weapons reflects a need for security and defence, and therefore often the existence of threats and/or a significant risk that the situation may change unfavourably (authoritarian drift of the purchasing state, deterioration of the local political, economic or social situation, etc.). Moreover, defence companies, unlike most other companies, do not always have a choice of customers. States impose on them, for political and strategic reasons, to sell to certain countries. Thus, even if at the time of the investment the company may be in line with the criteria and imperatives imposed by the bankers to agree to finance or guarantee an export, there is no guarantee that the situation will not deteriorate, putting these same bankers at odds with their own rules of compliance (in the case of sanctions pronounced against the purchasing country and subsequent to the export).

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[21] An investment in R&D is particularly risky because if it does not lead to a result, it leads to a pure and simple loss of the money invested without any compensation.

[22] Transparency International, "62% of countries at high risk of defence and security corruption, index reveals", November 16, 2021. Available on: https://www.transparency.org/en/press/62-per-cent-countries-at-high-risk-of-defence-and-security-corruption

A relationship also complicated by financial players under increasing pressure and a misunderstanding of this activity

The exclusion of weapons production and more broadly of defence companies by certain investment funds appears to be a dogmatic posture. This can be explained by several factors such as reputational risk or a poor knowledge of this industry and its specificities. For example, the Lazard Frères Gestion fund explains in its ESG policy that it reserves the right to exclude certain sectors, without justification, including gambling, pornography, and weapons.

To their credit, these financial players also must deal with various kinds of pressure, such as contradictory aspirations of individual shareholders who wish for peace and security but push asset managers to stop financing arms production. The extraterritoriality of American compliance rules (corruption, sanctions, export controls) encourages them to over-comply in front of the risks of prosecution by the American authorities (fines imposed in recent years[23], but also the threat of losing their licence in the United States which remains the world's leading economy and financial centre). For these institutions and for these reasons, scrupulous compliance with American rules is therefore a question of survival against which support for a particular project carries little weight. Finally, in a world where information and misinformation circulate quickly, reputational risks are amplified, putting these financial players under pressure, and NGOs are very active in denouncing the sale of arms[24].

Consequently, beyond investments in defence companies, financial actors may be reluctant to finance and ensure the export of armaments as it is increasingly contested. Accusations of human rights violations in the context of the war between Saudi Arabia and Yemen have, for example, increased the reputational risk taken by banks that would support exports to belligerents. The condemnation of a certain number of them in recent years by the American justice system, or the activism of certain NGOs against the production of arms has led to an even greater appreciation of this risk.

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[23] Raymond N., "BNP Paribas sentenced in $8.9 billion accord over sanctions violations", *Reuters*, May 1, 2015. Available on: https://www.reuters.com/article/us-bnp-paribas-settlement-sentencing-idUSKBN0NM41K20150501

[24] This is the case of the report published in March 2022 by the European Network Against the Arms Trade (ENAAT and Stop Wapenhandel and Transnational Institute (TNI), *Fanning the Flames - How European Union is fuelling a new arms race*. Available on: https://enaat.org/wp-content/uploads/2022/03/FanningtheFlames.pdf. As well as a note published by Amnesty International in 2019, *Outsourcing Responsibility HR policies in the Defence Sector*. Available on: https://www.amnesty.org/en/documents/act30/0893/2019/en/

ADDRESSING THE CHALLENGES OF SUSTAINABLE FINANCE, A KEY FINANCING ISSUE FOR THE EDTIB'S FUTURE

Since the start of the war in Ukraine, the debate on the "sustainability" of arms production has resumed within the investment community.[25] In February 2022, the BDSV called for armaments to be considered as a durable good as a prerequisite for peace and security. The Swedish SEB Investment Management has just reversed its decision to exclude weapons from its investment universe. They now consider that “investing in the defence industry is important to defend democracy, freedom, stability and human rights”. Kiran Aziz, head of responsible investments at the Norwegian pension fund KLP, said he could invest in arms manufacturers only if they can prove that their products “are not used in illegal conflicts”.[26]

However, the possibility to control the use of weapons is questioned by other investors such as Jon Hale, director of sustainability research at Morningstar[27], or Herve Guez, CIO of Mirova, a French sustainable asset manager who explains: “weapons manufacturers do not have the means to choose their customers and refuse contracts with undemocratic regimes”. One can also question the real reasons for a return to grace of investments in the defence sector, but the significant revaluation of defence companies since the beginning of the conflict (which is also a sign of this return to grace) or the growing need for armaments constitute strong incentives.

However, the war in Ukraine, through the insufficient means dedicated to the defence and security of Europe that it highlights, is a real opportunity to renew the dialogue between financial players and the defence industry.

The factors and arguments that deterred financial actors from investing in defence have not disappeared with the war in Ukraine and at the same time, defence companies have long been committed to more sustainable approaches. The fight against corruption is a good example of the complexity of this dialogue. It has intensified in the early 2000s, after the US and European countries signed the OECD anti-bribery convention requiring them to strengthen their regulations, but also after several scandals involving defence companies and proving the capacity of this sector to improve its processes. However, and as we have already noted previously, corruption remains a frequent argument for investors to explain their caution in

[25] Eccles R.G., “Vladimir Putin’s Contribution To ESG Investing”, *Forbes*, March 6, 2022. Available on: https://www.forbes.com/sites/bobeccles/2022/03/06/vladimir-putins-contribution-to-esg-investing/?sh=40d817bd7f93

[26] “ESG Managers Skewer ‘Ridiculous’ Idea of Embracing Arms Stocks”, *BQ Prime*. Available on: https://www.bqprime.com/business/esg-managers-skewer-ridiculous-idea-of-embracing-arms-stocks

[27] Smith O., “We said farewell to arms in ESG, let's not u-turn”, *Morningstar*, March 4, 2022. Available on: https://www.morningstar.com.au/insights/funds/219403/we-said-farewell-to-arms-in-esg-lets-not-uturn

investing in this sector, proving that efforts of companies to improve the dialogue with financial players will not be sufficient. Public authorities must also become aware of the challenges and commit themselves. To do so, the European Commission and governments will have to find a way to reconcile the challenges of sustainable finance and European security, and to put in place instruments and incentives that make investors reconsider EDTIB funding as a safe and sustainable investment. In a joint declaration published at the end of the 2022 European summit held in Versailles, the European states placed the need to strengthen defence capabilities at the top of the three priorities of the 27, ahead of reducing energy dependence and strengthening the European economy. The declaration stated on page 3: "We therefore agreed to: increase substantially defence expenditures, with a significant share for investment". More recently, in its proposal for the reform of the Stability Pact, the European Commission proposes to qualify defence investments as a priority (alongside green investments, resilience, or energy security). Several initiatives could be useful, such as:

- Encouraging European countries to dedicate a significant part of their military expenditure to European industrial investment is one way to do so, either through the introduction of a criterion complementary to the 2% criterion, or through a relaxation of the stability pact on the public deficit. The increase in public investment could then create a leverage effect attracting private financing.
- The European recovery plan following the Green Pact provides that in the future, 37% of public spending in Europe should be dedicated to the energy transition and the fight against climate change, could a comparable framework for defence equipment spending in Europe be established?
- The consolidation of the European defence market has been a long-standing objective of the Commission. It should be pursued and strengthened because the more European companies find outlets within the EU, the less dependent they will be on their exports. As the country risk associated with arms exports is a brake on the banks' involvement with defence companies, such a development could create a virtuous circle favourable to the defence industry.
- Defence policy choices (acquisition or export) also determine the exposure of industrialists to compliance and/or reputational risks and, consequently, their vulnerability. Taking these ESG constraints into account during the arbitration leading

to these choices can also provide certain guarantees and reduce the risks taken by investors and bankers, thus facilitating their relations with the defence industry.

- Moreover, it is not enough to say that defending Europe is an essential condition for resilience and sustainability. It is important to make it a reality by explicitly addressing this activity in all the initiatives of the European Commission's Sustainable Finance Action Plan. For example, the interpretation of what constitutes a controversial weapon varies significantly from one investor to another. The European taxonomy, because it aims to harmonise the definition of concepts, must therefore also specify this one.
- Indeed, the specificities and constraints of this industry need to be integrated into the criteria for assessing the sustainability of economic activities and into the taxonomy. Rather than excluding, it could be useful to build an approach aimed at permanent improvement, to provide for exemptions under certain conditions, or even to create either a criterion or even a "sovereignty" label that would recognise the interest of investments in this area.

Finally, it seems essential to strengthen collective intelligence around a better understanding of the real objectives of sustainable finance, but also of the specificities of the arms industry and the challenges of European sovereignty in this field. For example, it may be useful for industrialists to take the initiative to work on common good practices, but also to improve their dialogue with financial actors on these good practices as well as the conditions and guarantees necessary to limit compliance or reputational risks.

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The Armament Industry European Research Group (Ares Group) is a high-level network of security and defence specialists across Europe. Its aim is to provide a forum to the European armament community, bringing together top defence industrial policy specialists, to encourage fresh strategic thinking in the field, develop innovative policy proposals and conduct studies for public and private actors.