FINANCING THE EDTIB TO ENSURE THE SECURITY AND SUSTAINABILITY OF THE EUROPEAN INDUSTRIAL MODEL

ARES Group

Octobre 19th 2023

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ABOUT THE SEMINAR

This ARES Seminar Report summarises the exchange between the panelists. This seminar intended to provide an opportunity for a constructive and forward-looking debate between national and European decision-makers, financial stakeholders, and defence companies, to share views on the financing challenges faced by the EDTIB, with the aim of improving the sustainability of the European industrial model.

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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PROGRAMME

ARES Seminar

FINANCING THE EDTIB TO ENSURE THE SECURITY AND SUSTAINABILITY OF THE EUROPEAN INDUSTRIAL MODEL

October 19th, 2023, Brussels

9:00 – 9:05: Welcome Address

Jean-Pierre MAULNY, Deputy Director, French Institute for International and Strategic Affairs (IRIS)

9:05 – 9:30: Introductory Speech

Arnaud DANJEAN, Member of the European Parliament

9:30 – 11:00: Understanding the Challenges of Financing the Defence Industry

Baudouin HEUNINCKX, Deputy Director for Industry, Synergies and Enablers (ISE), European Defence Agency

Sylvie MATELLY, Director, Institut Jacques Delors

Jan PIE, Secretary General, ASD Europe

Moderation**: Jean-Pierre MAULNY**, Deputy Director, French Institute for International and Strategic Affairs (IRIS)

11:20 – 12:50: Supporting Investors to Increase the Financial Attractiveness of Defence Companies

Anne FORT, Head of Unit, Defence Industry and Market Policy, European Commission

Kim JØRGENSEN, Director General and EIB Permanent Representative to the EU Institutions in Brussels

David LEBAIN, Associate Director, Weinberg Capital Partners

David LUENGO, Director, Head of Brussels Office, Indra

Moderation**: Gaspard SCHNITZLER**, Research Fellow, IRIS

13:00: Conclusion

Jean-Pierre MAULNY, Deputy Director, IRIS

INTRODUCTION

On October 19th 2023, the European-wide ARES Group gathered experts and high-level speakers in Brussels to address some of the complex questions concerning the financing of the European Defence and Technology Industrial Basis (EDTIB). Indeed, as the war in Ukraine has highlighted the need for the European Defence Industry to ramp up and help the member states to face the challenge of possible future high-intensity war, access to private fundings becomes even more a strategic objective for defence companies. The problem of financing was identified several years ago, before the war on Ukraine, and it was even thought that with the apparition of a conflict so close to Europe, the bankers' mind would be different. Nonetheless, the obstacles remain strong at a time where funding the industry is more than essential to ensure security and sustainability.

During two successive panels aimed to address these problems, the first panel entitled "*Understanding the challenges of financing the defence industry*" and the second "*Supporting Investors to increase the financial attractiveness of defence companies",* the participants were able to first discuss the challenges regarding the financing of the defence Industry and then to talk about ways of supporting investors in order to increase the financial attractiveness of defence companies. After recalling the issues, the defence industry is facing, the panellists discussed the possible leads for solutions to these issues.

UNDERSTANDING THE CHALLENGES OF FINANCING THE DEFENCE INDUSTRY

The discussions showed that the defence industrial sector remains a very challenged sector. During the talks, different issues, which are making the access to financing for the defence industry difficult, were identified and considered. Indeed, the choices of investors to support other industrial sector instead of the defence industry are due to various reasons such as the specific characteristics of this sector, the issue brought by the ESG criteria and finally the risk of contradictory European regulations at a time when the defence industry needs to be mobilised to strengthen Europe's security.

The Complex Specifics of the Sector

As a participant explained, ESG criteria are not the only issues that make access to investments difficult for defence companies. The ability of the defence industrials to attract investors is weak, and this in particular can be explained by the complexity of understanding the defence

sector and its specificity. Arms production and the defence industry have indeed specific characteristics. On the one hand, a large part of arms production activity is linked to innovation and, within this sector, almost 80% of R&D projects end up failing, which reflects the high risks involved in this business. In addition to that, risks are difficult to assess in this sector, which increases investors' reluctance to get involved.

The issue of returns on investments also plays a role. Unlike other sectors of the economy, the return on investment of defence industry companies is considered as much lower, as the development of a weapon takes a long time. Bankers also tend to consider that this sector is not that important in terms of growth and contribution to GDP, not to mention that it is very costly in terms of investment. Additionally, the fact that this industry is geared towards its customers, who are none other than states/governments whose decisions are based on political considerations, also influence the choice of investors. In fact, the defence industry delivers and serves its customers, but is not really aimed at making economical profit. However, this particular aim doesn't fit the mind of investors and bankers, who are primarily looking for profit.

In addition to all these factors, bankers also need to invest time in understanding this sector. Indeed, the absence of guidelines, explaining in concrete terms how to invest in this sector and how to understand its characteristics, is a further deterrent to investors, for whom time is of the essence.

The Issue of the ESG Criteria

In addition to all the previously listed challenges due to specific characteristics of this sector, comes the issue of the ESG criteria. The "Environmental, social and governance criteria", also known as ESG criteria tend to push financial players to exclude the defence industry as this sector is by essence considered as not compatible with sustainability. This is complicating access to finance by private investors and we see banks avoiding investing in the sector, claiming ESG criteria is a reason for no longer having any defence companies in their portfolio. At the time of the green and digital transition, an issue appears regarding the need for companies to become carbon neutral and greener in a short time. Indeed, this process costs a lot of money and leads to competition between the different sectors of the economy to access to new funds. At the same time, there is also the problem of the restrictive monetary policy following the inflation that affects the liquidities and increases the costs to find and obtain money.

However, defence industry representatives mentioned that the European defence industry faces the complexity of finding a way to reconcile sustainability with security in Europe. Investors understand that there is a real need to focus on sustainability, since it is on this aspect that public opinion expresses itself and demands/expects the most. As a result, if given the choice of financing sustainability or security, bankers will opt for sustainability at the expense of financing security. It is therefore crucial to reconcile these two aspects and make people understand that without security, there can be no sustainability. As a representative of the European institutions mentioned, this is even recognized among the Ministries of Defence. And it appears that one year and a half after the beginning of the Ukraine war, the assessment of the balance between sustainability and security by the bankers and the investors have not really change. Otherwise, there is a risk that ESG criteria will increasingly become a pretext for crowding out and refusing to finance companies in the defence industry, as is already the case for some SMEs. However, this is contrary to the original role of ESG criteria, as they were initially created to direct investment towards sustainable investments.

Another problem lies in the ability of banking institutions to anticipate the regulations defining sustainability before they even exist. Indeed, even before a regulation on the definition of sustainability is adopted, they are already in the process of anticipating, which complicates the matter since, in the absence of regulations, there is no clear and accepted definition of what is considered “sustainable” and therefore no level playing field.

The definition of “sustainable” remains an emerging problem with a major impact, as the lack of a clear definition has led players to define “socially sustainable” themselves. Following this, some of these players – mainly bankers but also insurers and energy suppliers – sometimes refuse to engage with companies in the defence industry as they don’t meet their definition of “socially sustainable” and also bring a reputational risk. ESG indexes or certificates exclude companies that produce weapons. Indeed, the interpretation of the ESG criteria by financial institutions can lead to a refusal for them to work with defence industrials and prevent them from opening a bank account or increasing their investment as it does not seem reconcilable with the ESG criteria. A challenge arises from the fact that these players make business-driven decisions, so if the defence industry is considered too risky and represents only a small part of their portfolio, they will not hesitate to abandon this sector.

This problem is all the more important because it is occurring at a time when a war of aggression is underway at the gates of Europe and countries are asking their defence industries to strengthen and increase their capabilities. This is undermining the process, as companies are not necessarily able to keep up with the demand because their access to

financing is made difficult. In the last 2 to 3 years, member states have started to realize the issue of the ESG criteria, as there was previously a lack of familiarity with the subject.

A representative of the EU institutions explained that the latter have started to get involved on these issues. The EDA has identified various limits of the ESG criteria leading to problems. Among the limits identified, the EDA is aware of the issues related to ESG indexes or certificates leading to the exclusion of defence companies. ESG regulations also impose reporting obligations that are particularly complex for the defence sector, since their customers are States/governments, it is difficult to assess what they have done with the products sold. In the case of the theft of a weapon during the conflict in Ukraine, the supplier is unable to intervene. Furthermore, the semantics associated with this sector seem unfair to its treatment. The simple fact of producing or selling a weapon is considered not socially sustainable, not socially acceptable. As long as this discourse and understanding persist, there will be a double vision.

The risk of contradictory European regulations at a time when the defence industry needs to be mobilised to strengthen Europe's security

In addition to these challenges, the presence of contradictions between the policies and initiatives of different services of the European Institutions or different European organisations also plays a role and contributes to reinforcing the dissuasive reasons for financial players to invest in the defence industry. The preparatory work on the extension of the EU Ecolabel to certain financial products illustrates these contradictions, as it has been proposed that companies deriving more than 5% of their income from defence activities should be excluded from the benefits of these labelled funds. Contradictions are thus emerging between the specific and transversal levels as the European Commission wants to boost its defence industry by implementing new tools. As a representative of the European institutions mentioned, the Commission has launched a number of short-term instruments, such as ASAP and EDIRPA, which will support the defence industry. These are evidence of the awareness of the European institutions, but these first instruments, EDIRPA and ASAP, are limited in time, fading away in 2025, and limited in financial support, which makes closing the gap entirely impossible. Changes are being made to resolve these problems. Indeed, the European Commission has decided to adopt a top-down approach in order to reduce the contradictions, and Russia's war of aggression on Ukraine has put the defence sector front and centre. However, the majority trend of investors turning their backs on the defence industry has not changed and even today, bank accounts of defence industry companies are being closed, while war rages at the gates of Europe.

SUPPORTING INVESTORS TO INCREASE THE FINANCIAL ATTRACTIVENESS OF DEFENCE COMPANIES: THE POSSIBLE SOLUTIONS

Having shed the light on the major issues responsible for a difficult financing of defence industrials, the discussions also led to sharing thoughts on possible solutions, as there is a need to involve all European institutions and organizations to reduce the contradictory claims and policies and send a stronger political signal to the private investors.

A request of change in public players' mind and a need for guidance by public authorities

For a number of speakers, public players, i.e., European institutions and in particular the member states, play a very important role in sending a signal to investors for supporting the defence industry and there is a need for the European institutions and the member states to do more. Governments should change their approach and realize that the defence industry is not a sector like any other where commercial goods are purchased. The reliance of investors on the cursor between risks and opportunities is also important to consider when it comes to financing the defence sector, where such a cursor depends on the public authorities' decisions and where the investors are mindful of the regulations established by the public authorities. To play on this cursor, there is a need for a better communication by the institutions.

The use of EU tools as incentives to invest in defence industry

Many initiatives are being taken at European Union level either by the commission the EDA, and by EIB but some progress is still needed.

The European Commission

At the level of the European Commission, firstly there is a targeted public consultation on the sustainable finance disclosure regulation which is open until the December 15th and allows to provide feedback on a broader scale.

Secondly, ASAP provides for a 30 million ramp-up fund, "in order to leverage, de-risk and speed-up investments needed to increase manufacturing capacities, a facility offering debt solutions ("Ramp-up Fund")". If the money is not used, it will be returned to the original ASAP programme. The European Commission also wants to develop financial tools aimed at inviting investors to provide loans.

Finally, to face the issue of the short-term instruments and their limits, the Commission intends to put in place a more structural instrument with the European Defence Industrial Strategy, which will require wider consultation and should make it possible to resolve the already recognised problem of access to finance for defence companies.

The EDA

At the level of the EDA, there was the creation of an ESG networks. The rationale was that member states were not familiar with the ESG criteria issue, thus leading the European Defence Agency to decide to create a network of ESG experts called the "ESG network" with representatives from the member states and also to hold discussions with industry to try and find a solution. This problem needs to be resolved collectively, i.e., not just at European level but also at the level of the member states and industry. Even though the member states do not really share a common point of view on how to resolve this issue, there is a common recognition that more importance needs to be given to resolving this problem. It appears that that EU member states are not against sustainability and support companies, by pushing for green, circular and sustainability.

Finally, it led the EDA to propose a common declaration of the EU Defence ministers to send a political signal, that has, since the organisation of this ARES conference, been adopted during a Meeting at the Steering Board of the European Defence Agency (EDA) on November 14th[1].

The EIB

The European Investment Bank has also strengthened its involvement in financing the defence industry. Indeed, the EIB has always supported large defence companies such as Leonardo, Thales and others on dual-use initiatives. However, the EIB realized the need to target smaller, growing companies and therefore developed a venture debt product to support smaller companies as they contribute to Europe's field of excellence in the defence industrial sector and are proposing the most innovative solutions. Furthermore, it is undeniable, as the EC recommendation on critical technologies shows that the interconnection between civil and military innovation is growing all the time, and that the line between the two is becoming blurred. €1.5 billion were deployed by the EIB in the EC designated critical technologies sector since 2022 through the Strategic European Security Initiative, also known as "SESI". This year, until September there was a €500 million growth on further financing. The big companies rely on these smaller companies for their ramp up and without any funding of them, the supply

[1] EU Defence Ministers Call for Strengthening the Defence Sector's Access to Finance, 15 November 2023, https://eda.europa.eu/news-and-events/news/2023/11/15/eu-defence-ministers-call-for-strengthening-the-defence-sector-s-access-to-finance

chain cannot grow and the ramp up process is compromised. Industry is pushing for more coherence of the member states with the objective to obtain that the EIB can finance real defence activity. The small companies also need funding to continue to spend on R&D and to be able to maintain their excellence and technological edge. This issue could be solved if the board of the EIB, meaning the member states, could allow the EIB to support small and medium companies.

The other request is to allow the EIB to not only to invest in dual-use companies, but also in pure defence players. This would help consolidate the European Defence sector. A representative of the financial sector added that if the EIB or other reference institutions/organisations, could also share a report on the fact that there is no incompatibility between ESG and Defence, then it would help to reconcile sustainability and security and as representative of the defence industry added, this would even explain that this is a prerequisite. A representative of the defence industry also mentioned that the EIB is led by a board of the Finances Ministers, however, the policies set by them can be contrary to the policies defended by the Defence Ministers of the same countries and these can cause a problem for the signal sent. This issue of positions among the governments also has an impact at the state level, as we see that state owned pension funds are still not accessible to defence companies.

In conclusion, the next step for the EIB could be, together with the European Commission and the member states, to communicate on the subject with the same position on the necessity to ease access to finance to the defence sector, as it would be seen as a very strong political signal from the highest political levels and change the current perception for the investors and also for the public, which is demanding more transparency. In addition to that, the Commission could also publish guidelines for investors to explain how to invest in the defence sector due to the lack of knowledge of this sector.

The action of the private sector: the role of the equity funds

There are many leads to explore in terms of actions to be taken to support investors in order to increase the financial attractiveness of companies in the defence sector and one of them comes from the equity funds. They can be used for financing dual-use companies as the close specifications allow civilian innovations to be applied in the military field. Equity funds are also good at explaining what a defence company is to investors and can help setting ESG objectives for defence companies and guide them on how to implement them.

CONCLUSION

Overall, the discussions clearly showed that the European institutions are aware of the problems of access to funding and that they are trying to remedy them. However, the main question remains whether the member states are prepared to do more than they are doing at the moment, and whether it is possible to harmonize the position between EIB and other EU organizations which depend of the EU member states and also sometimes within the European commission. As the speakers emphasised, it is imperative that the highest political levels (the EU Institutions (European Commission) and the member states), but also the EIB, send out a clear signal and communicate. In order to deal with the lack of knowledge of this sector and of ESG criteria, it is essential to provide guidance and support to banks on why and how to invest in the defence sector and to defence industrials on how to ensure ESG compatibility. The elaboration of new instruments at EU level is only a small part of the solution and politicians seem to forget that building new rules and instruments is not enough if new orders of defence equipment don't follow. The discussions also pointed out that there is a need for more dialogue between the different stakeholders to reach out to the opinion and raise awareness about what is at stake. This would also help making a more favourable parliamentary context. Indeed, the European Parliament deputies are currently not aware enough of the specificities of the defence industry and need to understand the stakes. Furthermore, the defence industry needs to be much more present and more vocal to face the lack of comprehension on the necessity of investments for them and explain why they need these investments. It is necessary to communicate that production levels of defence must be maintained at highest level than before the Ukraine war, even if this conflict comes to an end. Indeed, it is important not to return to the previous situation but rather to maintain a certain level of preparations.

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