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ANALYSIS

FUNDING THE ARMS INDUSTRY

Why Financial Institutions Hold Back and How Europe Could Move Forward

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EXECUTIVE SUMMARY

As a result of the current geopolitical climate, defence budgets and defence investments have dramatically increased across Europe. In response to this fundamental shift in demand, arms producing companies are expected to urgently and substantially raise production levels, extend production capacity, attract new personnel and invest in the development of new military technologies. Next to the increased availability of public funds via national defence budgets or initiatives such as the European Defence Fund, arms companies continue to rely on private financial instruments to finance the investments needed to accommodate this increased demand. But such access appears to be, according to arms companies and industry interest representatives particularly, and apparently increasingly, difficult. While these actors (often echoed by government officials) refer to the rise of so-called ESG-criteria as the main reason for this specific approach towards the defence industry, very little attention has been paid to the variety of motives and considerations that are effectively driving financial institutions' policies.

This article aims to deconstruct the current debates on the defence industry's access to financial markets and the main reasons and motives behind these difficulties. In doing so, this article aims to explore the main drivers and considerations behind financial institutions' policies with regard to the defence industry and the steps that arms companies could take to respond adequately to the financial institutions' concerns and considerations. Gaining a better understanding of the main concerns of financial institutions regarding financing arms companies could help to identify the concrete steps which the defence industry and governments could take to reconcile the broad variety of drivers behind financial institutions' policies on arms companies.

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Introduction

Although most European countries, after the historical low in the wake of the 2008–2012 financial-economic crisis, had been gradually increasing their defence budgets, the Russian invasion of Ukraine further catalysed this gradual growth in national defence budgets. Since February 2022, most European countries have drastically increased their defence budgets, mainly with a view to replenishing their depleted stocks and procuring new military equipment.

This steep rise in investments in defence has resulted in arms companies being expected to increase their production capacities rapidly. As a consequence, the defence sector is now confronted with several challenges: to be innovative, to be able to produce key systems (and do so in greater volumes and at a faster rate) and to secure value and supply chains.[1] Accordingly, at the national, European and NATO levels, various public initiatives are being implemented to support the defence industry financially in this endeavour. Despite public budgets increasingly being made available for research and development (R&D) investments and procurement, arms companies continue also to require access to financial instruments (both public and private) so as to finance the investments needed to live up to these renewed expectations. However, arms companies across the EU appear to be being confronted with difficulties in gaining access to public and private financial instruments. Calls for public and private financial institutions to change or relax their policies with regard to the arms industry, in response to the changed geopolitical climate, have become increasingly vocal during the past couple of years.

The EU has responded to these calls by partially adapting the policies of existing EU financial instruments and institutions, such as the InvestEU regulation and the European Investment Bank (EIB), besides these government financial instruments. However, arms companies continue to rely on private financial instruments to finance the investments needed to accommodate this increased demand. But such access appears to be particularly, and apparently increasingly, difficult for arms-producing and -exporting companies. The growing reliance of banks and other financial institutions, in particular in the EU, on the so-called Environmental, Social and Governance (ESG) criteria is proposed by defence industry representatives (and echoed by various government officials) as one of the main reasons for this. In particular, the extension of the EU Ecolabel to include retail financial products and the implementation of the EU Green taxonomy to label sustainable funds has triggered much turmoil in the defence industrial sector. In response to these statements by the defence industry, national and European policymakers have been exerting increased pressure on the financial sector to facilitate arms companies' access to much-needed financial instruments. But whereas the financial institutions appear to be sensitive to these calls and display an openness to reconsider their existing policies, they equally continue to be reluctant to change their policies fundamentally.

This article aims to deconstruct the current debates on the defence industry's access to financial markets and the main reasons and motives behind these difficulties. Two research questions are central to this article: (1) 'What are the main motives and drivers behind financial institutions' policies regarding financing the defence industry?'; and (2) 'How can these insights guide arms companies and national governments in developing concrete actions to respond to these drivers and motives?' We used a combination of methods to provide answers to these research questions:

- an analysis of the relevant existing (academic) literature on the defence industry and its access to financial markets;
- relevant public statements by defence industry representatives, financial institutions, policymakers and civil society;

- EU (European Commission and European Council) policy documents;
- an analysis of policy guidelines on the defence industry of 15 of the largest European banks;[a] and
- a series of in-depth interviews with representatives of the financial sector and of international think tanks (see Annexure 1 for an overview).

In doing so, this article aims to explore the main drivers and considerations behind financial institutions' policies with regard to the defence industry and the steps that arms companies could take to respond adequately to the financial institutions' concerns and considerations. Indeed, gaining a better understanding of the main concerns of financial institutions regarding financing arms companies could help to identify the concrete steps which the defence industry and governments could take to reconcile the broad variety of drivers behind financial institutions' policies on arms companies.

The first part of this article provides an overview and analysis of the renewed calls on the defence industry to provide security by increasing its production capacity in order to accommodate the increased demand for military equipment. This part also describes the public funds made available to support the defence industry's efforts to scale up their production and to subsidise investments in military R&D in new and innovative military technologies. In the second part, the article focuses on the apparent challenges that arms companies are confronted with in gaining access to private financial markets. As with other private companies, for a variety of reasons arms companies continue to require access to private capital markets and private financial instruments. The section analyses the statements made by arms companies and government officials about the main reason for this access to finance being difficult, that is, the increased reliance on so-called ESG criteria in financial institutions' policies.

However, because very little attention in this debate is given to a profound understanding of financial institutions' perspectives and motives, this part of the article concludes with an in-depth analysis of the different reasons behind financial institutions' policies regarding the financing of arms companies.

The third and final section of this article then builds on the insights gained from this analysis and identifies several possible initiatives and steps arms companies and national governments could take in order to be responsive to the concerns of the financial institutions.

A renewed call on the European defence industry as security provider

Whereas defence spending in most EU countries has – slowly but consistently – been increasing since 2014, the Russian invasion of Ukraine has acted as a catalyst to a more rapid increase. According to the Stockholm International Peace Research Institute (SIPRI), military expenditure in Europe in 2023 was 62% more than in 2014 and 16% higher compared to 2022.[2] Interestingly, the growth of the budget available for defence investments (in both R&D and the procurement of new defence equipment) has increased disproportionately as a subset of the total military expenditure

a These 15 banks were selected by taking their size and geographical distribution into account. Consequently, banks from 11 European countries (UK, France, Germany, Spain, Italy, Switzerland, the Netherlands, Belgium, Austria, Denmark and Sweden) listed among the top 50 of largest European banks were selected.

in Europe, having more than doubled between 2014 and 2022, from €28 billion to €58 billion.[3] The special €100 billion defence fund announced by German Chancellor Scholz on 27 February 2022, only five days after Russia invaded Ukraine, supports this observation. This fund would be in addition to an increase in long-term defence spending from the at that time annual 1.5% of German GDP to 2%.[4] Other EU Member States are reflecting the same tendency, with data from the European Defence Agency indicating that the total defence expenditure has increased from €171 billion in 2014 to €279 billion in 2023, with defence spending in 2024 by all EU Member States combined projected to have reached €326 billion.[5]

Many armed forces have implemented or are preparing to implement substantial new procurements of military equipment, for which they are mainly looking for off-the-shelf products because of the need to have quick access to such new equipment. Consequently and after almost three decades of downsizing production capacity, EU arms companies are being expected to turn a low-capacity but continuous production process around very quickly into a high-quantity and dramatically increased production capacity. Arms companies are therefore confronted with diverse challenges in responding effectively to the increased demand for short-term deliveries. First, they are rethinking and restructuring their supply chains in order to speed up deliveries of the required components and raw materials, which is crucial to satisfying the recent demand. Second, arms companies must build new production lines and production sites, which requires additional production machinery. Third, the arms companies need to hire additional staff with the necessary technical skills to operate the new production lines. In all, these companies are confronted with the need for substantial financial investments to satisfy this increased demand.

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Increased national and EU funds for defence investments

Substantial funding mechanisms are being developed at the national, EU and international/NATO levels to provide financial support for the R&D activities of arms companies and research institutes. First and foremost, the substantial increases in national governments' defence investment plans have been crystallising in several concrete contracts, mostly aimed at the procurement of readily available equipment. However, because of the European defence industry's focus on low-quantity but continuous production rates, EU companies are not always able to fulfil all the current needs, given the fact that speed is often of the essence – as stated by German Defence Minister Boris Pistorius.[6] Consequently, European governments are also procuring non-EU-produced equipment, which is often more readily available and can be delivered more quickly. Notable examples include the German procurement of 24 (US-made) Apache attack helicopters and also the decision of the German-led EU Sky Shield initiative to collaboratively procure air defence systems and, in addition, to purchase US-made Patriot and Israeli-made Arrow 3 missile systems. Another example in which the choice to procure non-EU equipment was justified by the speed of delivery is the procurement by Poland of more than 672 K9 howitzers and 180 K2 main battle tanks from South Korean producers.[a]

In addition to the nationally led initiatives and budgets, the EU, and in particular the European Commission, has launched new initiatives to support the development of the European Defence Technological and Industrial Base (EDTIB). As early as 2017, the Commission announced the setting up of a **European Defence Fund**, the aim of which would be to support the EU defence industrial base. As part of the 2021–2027 Multiannual Budget, the fund foresees allocating €8 billion to support – in the form of grants – collaborative programmes between companies and research institutes to conduct R&D activities for new and innovative military capabilities. In addition, the 2022 Russian invasion of Ukraine triggered new EU initiatives to support the European defence industry without delay and to stimulate the collaborative procurement by Member States of EU-made military equipment. With regard to the former goal, the EU ASAP regulation – the **Act in Support of Ammunition Production** – was adopted in the autumn of 2023 with a view to supporting the EU's arms industry so that it could ramp up its production capacities in ammunition and missiles.[7] This regulation sets out to provide a mechanism to map, monitor and anticipate more accurately the existence of bottlenecks in the supply chains, an instrument to support the reinforcement of the EU's industrial production capacities financially and to introduce a temporary regulatory framework that responds effectively to the ammunition supply crisis.[8] Eventually, 31 projects received funding to reinforce and increase ammunition production across Europe, covering a total budget of €500 million.[9]

Regarding the second element stated above – stimulating joint procurement – the **European Defence Industry Reinforcement through Common Procurement Act** (EDIRPA), adopted in October 2023, foresaw a budget of €300 million to respond to the EU's most urgent and critical defence capability gaps and to incentivise EU Member States to procure defence products jointly. In order to be eligible to qualify for this arrangement, steps must be taken by a consortium of at least three Member States, must involve new cooperation or an extension of existing cooperation to new Member States and must respect those procurement procedures that reflect the involvement of the EDTIB.[10] In November 2024 the Commission decided to fund five cross-border projects aimed at the common procurement of military equipment, with each project receiving €60 million.[11]

Continuing need for access to public and private financial instruments

While these initiatives direct several billions of euro in public funding towards supporting the R&D activities of arms companies and increasing the procurement of military equipment from EU arms companies, voices in the defence industry emphasise that public funds can, however, not "be seen as a substitute for the involvement of private actors, which remains unavoidable".[12] This changing reality necessitates arms companies gaining access to private financial markets in order to make possible the investments needed to finance the ramping up of production processes, attract new personnel, erect new facilities, etc. However, many defence companies, large multinationals and SMEs state that they are increasingly struggling to gain access to a broad variety

a The substantial technology transfer included in the deal and the licensed production of more than 800 K2 Panther tanks in Poland starting in 2026 and the resulting effect of strengthening the Polish defence industry was also an important argument. Similarly, the agreement on the K9 howitzers includes the transfer of technical documentation on the guns. In addition, maintenance, renovation and modernisation works will be set up and selected howitzer parts will be produced by the Polish defence industry.

of financial instruments. The pressure on financial institutions – both public and private – has therefore been mounting in the direct wake of the Russian invasion of Ukraine in February 2022. At the EU level, several calls have been made that echo the industry's concerns and that call for measures to ease arms companies' access to private financial markets.

As early as March 2022, the European Council mentioned in its Conclusions 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.[13]

A similar call was also stressed in the EU's Strategic Compass of March 2022.[14] In this context, the European Commission's Expert Group on the European Defence Fund's Financial Toolbox[a] stressed that "further work needs to be undertaken by the Commission, European and national promotional institutions to fully enable defence companies to benefit from the financial instruments". Similarly, the EU Defence ministers, in their capacity as members of the EDA's steering board, issued a joint statement in November 2023 on "strengthening the EDTIB's access to finance and its ability to contribute to peace, stability and sustainability in Europe".[15]

This call was reiterated in its 22 March 2024 meeting Conclusions, in which the Council acknowledged the need

> to improve the European defence industry's access to public and private finance. In this context, the European Council invites the Council and the European Commission to explore all options for mobilizing funding. … Furthermore, the European Investment Bank is invited to adapt its policy for lending to the defence industry and its current definition of dual-use goods, while safeguarding its financing capacity.[16]

The March 2024 European Defence Industrial Strategy, launched by the European Commission and the High Representative of the Union for Foreign Affairs and Security Policy, also reiterated this issue.[17] In it, the need to develop the financial means to underpin this EU defence industrial readiness is stressed. To achieve this, it was stated, the Commission and the High Representative, where appropriate, will work with Member States, industry and the financial sector to improve the EDTIB access to both private and public finance. Most recently, Mario Draghi's September 2024 report on the future of European competitiveness suggests that "limited access to financing" is one of the key challenges to the competitiveness of the EU's defence industry. The report further calls on financial institutions, in the short term, to "improve access to finance for the European defence industry, including by removing restrictions on access to EU-funded financial instruments".[18] The Niinistö report on civilian and defence preparedness, published in October 2024, similarly echoes this call.[19]

Access to public EU financial instruments: gradual policy changes

Despite a growing concern among civil society organisations (CSOs) about the increased militarisation of the EU and the undermining of the EU as

a This expert group included EU country experts from the ministries of finance and defence, the European Defence Agency, OCCAR (Organisation for Joint Armament Co-operation) and the European Investment Bank Group. It was chaired by the DG ECFIN and included the representatives of other services and institutions, such as the European External Action Service.

a peace project,[20] several EU-level financial instruments and initiatives have been adapted or implemented to make the defence industry eligible for European public investment structures. One example is the 2021 InvestEU Regulation that added the defence industry as an eligible area for investment, with a specific focus on: (1) the EU's defence industry supply chain, in particular through financial support to SMEs and mid-caps; (2) companies participating in disruptive innovation projects in the defence sector and closely related dual-use technologies; (3) the defence sector supply chain when participating in collaborative defence R&D projects, including those supported by the European Defence Fund; and (4) the infrastructure for defence research and training.[21] The regulation establishing the InvestEU programme comprises three building blocks:

- the InvestEU Fund, which provides an EU guarantee to support the financing of and investment in internal EU policies;
- the InvestEU Advisory Hub, which supports project development, access to finance and capacity-building assistance; and
- the InvestEU Portal, which gives visibility to projects seeking finance and information on investment opportunities.[a]

Another important EU institution that is increasingly being called upon by defence industry associations and government officials to change its policy with regard to investments in the European defence industry is the European Investment Bank (EIB). In 2022, in response to these pressures, the EIB launched the Strategic European Security Initiative (SESI). This instrument foresees a budget of up to €6 billion for eligible projects focusing on cybersecurity and "disruptive emerging technologies" such as new space, artificial intelligence (AI) or quantum technologies. In 2023, this budget was increased to €8 billion. In addition, the European Commission and the European Investment Fund (EIF), which is part of the EIB group, launched the Defence Equity Facility in January 2024. This facility will provide €175 million in equity to venture capital and private equity funds which invest in European companies that are developing innovative technologies with dual-use potential. Its implementation is the responsibility of InvestEU and it is funded via the EIF, which contributes €75 million, and the European Defence Fund, which contributes €100 million.[22]

In April 2024, the EIB published a Security and Defence Industry Action Plan, which had already been announced at a press conference on 22 February 2024 by EIB president Nadia Calviño in Ghent. Through this plan, the EIB aims to step up investments in security and defence, which is seen as one of its main priorities.[23] This plan comprises the following policy changes:[24] (1) the requirement that dual-use projects derive more than 50% of their expected revenues from civilian use will be waived; (2) a one-stop shop for defence and security will be created, which would speed up investments and access to EIB Group funding for clients in Europe's security and defence sector with a view to deploying the €8 billion in financing available under the SESI; (3) its rules for SME financing in the sector of security and defence will be updated, opening up dedicated credit lines for a great number of smaller companies and innovative startups which require funding for dual-use projects; and (4) partnerships and collaboration with key stakeholders will be strengthened, including by signing and updating memoranda of understanding with the European Defence Agency and other partners.

a Importantly, however, these projects will also need to undergo sustainability testing to receive InvestEU support. In the regulation, the sustainability of financing and investment operations is introduced as an important element in the decision-making process when approving the use of the EU guarantee. Here, 'sustainability' refers to three dimensions: climate, environment and social.

Although SESI and the Defence Equity Facility reflect a change in EIB policy with regard to financing and investing in (potential) defence-related products and technologies, they both focus strongly on dual-use capabilities. This means that investments in conventional military projects continue to be excluded from the scope of the EIB's investment policy: eligible projects (for EIB funding) can have a military application, but they "need to be primarily motivated by their civil applications, meaning that projects are expected to have a predominant civilian use".[25] This reflects the current general EIB investment policy, which defines "ammunition and weapons, including explosives and sporting weapons, as well as equipment or infrastructure dedicated to military/police use" as a bank-wide excluded activity, meaning that such activities cannot benefit from EIB financing. Calls on the EIB to revise this long-standing policy, which reflects the EU's historical identification as a peace project, have, however, not yet resulted in a fundamental change in EIB policy.

Very few financial institutions have a fundamental objection to or impose a comprehensive ban on arms companies' access to the different financial instruments.

Access to private finance – challenges and barriers for arms companies

The issue regarding access to financing has been raised by national defence industry associations in several European countries.[26] Currently, long-standing tensions between the banking and the defence sectors appear to exist, "with the latter reproaching the former for its 'timorousness' in financing its activities".[27]

These calls on the financial sector to change its existing policies towards arms companies are being felt by the sector, as was stressed by several national banking federation representatives: "There is indeed a growing pressure by some politicians and defence advocacy organisations on financial institutions to relax their policies towards the defence industry. At the same time, civil society organisations are pushing banks not to change their policies."[28] It is clear that banks and other financial institutions are not unaware of the changed geopolitical climate and of the challenges to national security. This acknowledgment is resulting in a more nuanced appreciation of the arms industry and an exploration of ways to balance ethical and legal considerations with the critical importance of defence capabilities in maintaining peace and security.[29] UK Finance, the British banking federation, for example, stresses that

> the current geo-political environment ... has thrown a spotlight on the necessity and value of maintaining a resilient and thriving defence and security industrial base in the UK. In turn, this requires UK-based financial products and services, to enable businesses to operate, invest, innovate, and grow.[30]

The analysis of the defence industry policy guidelines implemented by various European banks[a] makes it clear that, except for **so-called "controversial weapons" (see box 1) to which most banks apply a strict exclusion policy, very few financial institutions have a** fundamental objection to or impose a **comprehensive ban on arms companies'**

a The links to the publicly available policy documents of the different banks are included in the table in Annex 2.

access to the different financial instruments. With the apparent exception of British-based bank HSBC,[a] none of the banks analysed and interviewed apply a principled exclusion policy to arms companies.[b]

Although many European banks have only recently published public guidelines on their position regarding the arms industry – with most guidelines having been published since 2020[31] – most of them had already been implementing these policies for some time before then. Interestingly, several of the banks included in our analysis (e.g., Danske Bank, SEB, KBC Group) have updated their policies in the light of recent geopolitical developments. The Belgian-based KBC Group, for example, states that

> while KBC acknowledges that the defence industry presents certain specific risks, it also recognizes the right of sovereign states to defend themselves, in line with Article 51 of the UN Charter, and hence the necessity for the armed forces of sovereign countries to have appropriate equipment available.[32]

Similar clauses and lines of reasoning can be found in various European banks' policy guidelines on the arms industry, such as those of SEB, Danske Bank, Handelsbanken, Bayerische Landesbank, Deutsche Bank or ING Group.

Box 1. Controversial weapons: what's in a name?

Many financial institutions in their investment policy distinguish between so-called controversial weapons and conventional weapons. Manufacturers of the former category are in many cases completely excluded from access to the financial instruments in banks' portfolios. Importantly, this not only covers manufacturers of the complete weapons; companies involved in developing and producing components of such weapons or which are involved in their maintenance, also fall within the scope of these policies.

Despite the lack of a universally shared and legally binding definition of what constitutes a controversial weapon, the available information in European banks' policies indicates a strong similarity in the weapons being defined as 'controversial' and therefore being excluded from financing. These include anti-personnel mines, cluster munitions, biological and chemical weapons, nuclear weapons, white phosphorus and depleted uranium. Banks mostly rely on international treaties and legislation to determine which weapons they consider to be controversial. Some banks also list certain conventional weapons – more particularly, firearms intended for civilian purposes – as controversial.

The main challenge may therefore not be the unclarity of what constitutes a controversial weapon, but rather the fact that in particular many of the largest arms companies are to a certain extent involved in the development, production or maintenance of such weapons and are as a consequence subjected to these exclusion policies. In reality, most of these companies are involved in the development, production or maintenance of nuclear weapons, which are conditionally and temporarily legal according to the provisions in the Non-Proliferation Treaty.

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a HSBC's policy document on the defence industry states that "HSBC does not provide financial services to clients who solely or primarily manufacture or sell other weapons. … Where a client undertakes a mix of business activities, including other weapons business as defined above, HSBC may form a relationship with that client, but will not provide financial services directly to subsidiaries involved with weapons."

b Another exemption is the policy implemented by the Global Alliance for Banking on Values (GABV). This group of European and non-European banks released a statement in February 2024 – the "Milan Declaration" – calling upon all "financial institutions everywhere to follow its lead and divest from the arms industry". Although the GABV represents about 70 institutions in more than 45 countries, it mostly includes relatively small banks that focus specifically on sustainable investments. Collectively, the network retains more than $200 billion of combined assets under management and employs about 80 000 people (https://www.gabv.org/about-us/).

This therefore raises a question about the motives that are driving banks' approach to arms companies. Different reasons help to explain why both large defence companies and small-scale start-ups and SMEs active in the defence sector encounter difficulties in securing bank loans or equity financing. The following sections build on the different interviews conducted and the in-depth analysis conducted of the available policy documents to develop a better and more nuanced understanding of the drivers behind financial institutions' policies.

Defence market as an imperfect market

A first important set of reasons and considerations is of a financial nature and refers to issues and challenges related to the typical **outlook and organisation of the defence industry and its market characteristics**. Factors include these:

- the oligopolistic market structure;
- the substantial dependency on public procurement;
- the substantial up-front investment costs arising from participating in public tenders;
- the high costs (and high risks) associated with R&D costs and manufacturing;
- the long duration of programmes and uncertainties about their timing;
- the possibilities of further commercialisation and exports; and
- the fragmented markets along national borders.[a]

All of these exert pressure on the extent to which arms companies are able to find access to financial markets or are confronted with difficulties in attracting private capital to finance investment and production.[33] The volume of production of the arms industry generally, especially when compared to that of civilian industry, is much lower, with orders being "in retail rather than wholesale quantities".[34] The economic weight of the defence sector, its profit margins and the return on investment (ROI) are therefore lower compared to those of the civilian sector. In fact, the arms industry represents a mere 1.5% of the global investment universe. The combination of these factors with the lack of a secure long-term view (more than 5–10 years) on investment and procurement plans helps to explain why, from a financial-economic perspective, the integration of arms companies in financial institutions' investment strategies is limited.[35]

A related factor in this context is the outlook of the European financial sector. In Europe, compared to the United States, arms companies are funded much more by banks and less so by private investment funds, with the latter type of financial institution being more prone to risks and open to investing in high-risk sectors and companies.[36] Although there appears to be an increasing appetite by private equity companies and venture capital funds to invest in defence technology start-ups and larger defence companies,[37] the dominance of banks in the private financial market in the EU and the elaborate legal framework they are subjected to is another explanation for arms companies' finding it more difficult to gain access to financial instruments.[b]

a The relatively small size of arms companies in Europe is especially relevant to large investment banks as they use specific thresholds with respect to the market capitalisation of a company when deciding whether to invest in shares or company obligations in order not to disproportionally influence share prices.

b Importantly, a certain degree of caution about the involvement of private investment or private equity funds in the defence sector could be necessary. Private equity firms have emerged as major investors in the US defence industry, with such firms more recently being responsible for more than 40% of annual mergers and acquisitions in the US defence industry. However, the bankruptcy rates among companies with private equity backing are significantly higher than those among defence companies

However, whereas these financial-economic factors influence the attractiveness of the defence sector negatively for private investors, **other non-financial motives** appear to be equally important in guiding financial institutions' decision-making processes regarding arms companies. Such extra-financial reasons and motives are increasingly guiding financial institutions' investment policies and strategies.

New European ESG standards as the main reason?

The evolving regulatory framework on sustainable and responsible finance is increasingly being given as an important reason why arms companies believe they face greater difficulties in gaining access to private financial markets compared to non-arms companies. Over the years, an increasing number of financial institutions in the United States and the EU have implemented ethical and so-called ESG principles as part of their investment policies. These principles refer to a set of standards for a company's behaviour used by socially conscious investors to screen potential investments. The relevance of investments in sustainable funds and ethical financing has increased rapidly since the financial crisis of 2008. Whereas such investments were previously very limited, "the demand for ethical investments met the desire of banks and funds to restore their image."[38] Today, many asset managers and hedge funds have integrated ESG factors into their investment decision-making policies with a view to reducing the long-term risks and ultimately enhancing their ROI.[39] ESG funds have grown in value exponentially in the past few years. For instance, Bloomberg forecast in 2022 that ESG assets would be able to surpass "50 trillion dollars by 2025, which is about one-third of the total projected assets under management globally".[40]

Much turmoil was triggered among arms companies and industry associations by two interrelated initiatives announced by the European Commission in 2020, as part of the EU's Green Deal. The first initiative was the **extension of the EU Ecolabel**. Whereas the Ecolabel has been in existence since the 1990s, with its extension also to include financial products, the European Commission aimed to develop an EU-wide label for green retail investment products. The Ecolabel would increase investor protection and channel capital towards green projects to help finance the Green Deal. The Ecolabel is a voluntary scheme that requires compliance with six main criteria, some of which focus on exclusions from the fund portfolio (or maximum thresholds) on aspects of ESG.[41] Two of these criteria are of specific importance in this context: more specifically, if (1) a company makes its turnover from the production of or the trade in controversial weapons or (2) if a company makes more than 5% of its turnover from the production of or the trade in conventional weapons or military products used for combat. In such a case, an arms-producing company would not be able to fulfil the Ecolabel criteria for its own bonds.

A second initiative was the entry into force of the **EU Taxonomy regulation** in July 2020 with which the European Commission is attempting to develop a shared definition of economic activities that can be considered environmentally sustainable.[42] In it, four conditions are described that an economic activity has to meet if it is to qualify as being environmentally sustainable.[a] Through this taxonomy, the Commission intends to direct

with no such backing – which may have a negative impact on security interests (Mahoney, C., Tkach, B. & Rethmeyer, C. (2024), Leveraging national security: private equity and bankruptcy in the US defence industry, *Business and Politics, 26*, 362–381).

a In order for an economic activity to be environmentally sustainable, it should (1) contribute substantially to one or more of the environmental objectives set out in the Regulation; (2) not significantly harm any of those environmental objectives; (3) be carprivate capital towards environmentally sustainable activities by providing clarity and certainty for investors and decision-makers. The regulation also envisages the possibility of extending the taxonomy to include a social taxonomy, one that classifies socially sustainable economic activities.

The Platform on Sustainable Finance, an independent expert group, was asked to give its advice on this option. Whereas a July 2021 draft report explicitly labelled arms production as a socially harmful industrial sector,[43] the Platform's final report of February 2022 watered this down significantly. The 2022 version now only lists international conventions, treaties and other international initiatives which label so-called "controversial weapons" that could guide decision-making on socially harmful activities. No further reference was made to the production of "ordinary" conventional weapons.

This proposal to develop a social taxonomy in particular raised substantial concerns among defence companies and the representatives of their interests, with the European interest organisation for the European Aerospace, Security and Defence (ASD) sector stating that

> we observe with great concern a tendency to follow a misguided perception of defence business as socially harmful. ... This would further damage the reputation of defence companies in the financial market and spread disaffection from public and private credit organizations, insurers, and rating agencies.[44]

The Dutch defence and security industry branch organisation NIDV stated similarly that

> the defence and security sector is experiencing difficulties in accessing private finance. Referring to Environmental, Social and Governance (ESG) criteria, companies in the sector would not be able to access private financing from pension institutions, insurers and financial service providers. Because of the same criteria, the sector is experiencing difficulties in opening accounts with private banks.[45]

Some are concerned that banks and investment funds will anticipate and go further than the requirements forwarded in the existing and ensuing regulations and engage in "over-compliance" with forthcoming regulations when deciding on funding defence-related companies.[46]

In response to these initiatives and the strong concerns that raising the ESG criteria is severely limiting arms companies' access to private capital, industry interest representatives, individual companies and political representatives are calling for an exemption to be made for the arms industry and for financial institutions to reassess and preferably lower their standards in the case of the arms industry. An alternative solution that has gained in importance in the wake of the Russian invasion of Ukraine in 2022 is the suggestion that the EU and national governments should formally designate strengthening Europe's defence-industrial capacity as an essential prerequisite to advancing the ESG goals, because "unless security can be assured on the European continent, ESG ambitions are likely to prove very difficult to achieve".[47]

In a similar way, ASD stresses that the existing EU framework for sustainable finance fails to reflect properly the defence industry's vital contribution to the achievement of long-term sustainability goals. Defence industries guarantee security, a precondition for sustainability and for the protection of democracy, individual freedom and civil society.[48] According to the ASD sector, the EU should therefore issue a high-level document clarifying the intended application of sustainable finance regulation to defence companies.[49] In

ried out in compliance with minimum safeguards laid down in the Regulation; and (4) comply with the technical screening criteria established by the Commission.

addition, existing regulations should allow for exemptions that would apply specifically to the defence industry, as illustrated by the suggestion that asset managers would be allowed to exempt investments in defence companies from the "principal adverse impact statements" that they are obliged to publish in terms of EU legislation.

These calls are finding a willing ear among high-level policymakers at the national and international levels. The European Commission, for example, in the March 2024 European Defence Industrial Strategy (EDIS), formally states that it considers the defence industry to enhance sustainability, given its contribution to resilience, security and peace. At the same time, it stresses that there are no plans to issue a "social taxonomy" and that the EU's environmental taxonomy does not prejudge defence industries' environmental performance and should therefore not affect their access to finance.[50] With this statement the Commission appears to be responding to concerns shared and forwarded by defence industry representatives about how the Ecolabel and the possibility of a social label would further increase the thresholds for arms companies to gain access to financial markets. In a similar way, new NATO Secretary-General Mark Rutte stated in his 12 December 2024 speech:

> tell your banks and pension funds it is simply unacceptable that they refuse to invest in the defence industry. Defence is not in the same category as illicit drugs and pornography. Investing in defence is an investment in our security.[51]

However, it appears that merely stating that the defence industry is sustainable would not be sufficient to exempt arms companies from the elevated due diligence and risk assessments which the financial institutions apply to their requests for financial support. As a representative of a national banking federation stated:

> we have the feeling that there is the idea that the war in Ukraine in itself is a sufficient argument to push banks to change their policies and to consider arms companies as sustainable. However, a trade-off between ESG and security/the notion of the defence industry as security provider is not realistic or needed. Many defence companies have a good story to tell on ESG.[52]

Merely stating that the defence industry is sustainable would not be sufficient to exempt arms companies from the elevated due diligence and risk assessments which the financial institutions apply to their requests for financial support.

This conclusion is also echoed in a 2024 PriceWaterhouse-Coopers report in which the criteria used by 30 major ESG funds and indexes are analysed. It shows that, whereas the easing of some of these exclusion criteria – in particular the hardest-to-abate criterion of the full exclusion of all arms companies – is currently under discussion, there are other criteria that are likely to remain in place and which may limit the extent to which the public regards arms companies as being ESG-embracing.[53] Interestingly, these criteria are not defence-specific but are generally applicable to other industries.

Furthermore, the increased relevance of these ESG principles and their impact on the sustainability of financial institutions' investment policies is only part of the picture. Other drivers, although they can also relate indirectly to ESG criteria, are equally, if not more, important in explaining why arms companies are strongly scrutinised when applying for access to the different financial instruments available on the private financial market.

Other drivers behind financial institutions' policies on arms companies

The analysis of existing defence policy documents and the interviews conducted indicate that financial institutions (are obliged to) conduct comprehensive risk assessments that of necessity go broader than the ESG criteria. Both the content and the extent of this risk-assessment process conducted by financial institutions are influenced by a combination of reputational and legal obligations and drivers.

This conclusion is well illustrated by French bank BNP Paribas, which states that, while acknowledging the right of countries to defend themselves and protect their national security, 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) corruption and diversion.[54] A similar conclusion was formulated in a "flash" mission by the French National Assembly, which found that the financial and banking sector was reluctant to deal with the arms industry. This reluctance had arisen because the risks were seen to be insufficiently controllable, thanks to the banking sector's strengthening of its internal control mechanisms after the adoption of a French law on transparency, fighting corruption and modernising economic life.[55]

A first important non-financial driver behind financial institutions' approach to the defence industry is the **risk of corruption**, **money-laundering** and **bribery**. Whereas corruption can occur everywhere, it is particularly prevalent in certain kinds of transaction (e.g., when awarding public or private contracts or government licences), in certain economic sectors and in certain high-risk countries.[a] Two analysts have expressed the concerns as follows: "The defence sector often provides a fertile ground for … malign activities due to the culture of secrecy and impunity that shields it from rigorous scrutiny."[56] As stated by the then chairman of the OECD Working Group on bribery, Mark Pieth, in 1999: "If you look at the figures, far more [bribes] are actually paid in industrialized countries, for example, in the arms trade."[57] A recent European Commission report similarly views the defence and security sector as one of the sectors that is at high risk of corruption. Patronage, political expediency, profit motives and foreign policy objectives are among the many factors interfering efforts to ensure accountability and transparency.[58] Several factors make this sector particularly vulnerable to corruption and bribery:[59] in particular, these are the lack of transparency on (large) arms-procurement contracts; the fact that governments act as the sole clients; the (sometimes substantial) role of arms sales in international geostrategic policy-making; and the high level of complexity of the administrative processes on arms acquisition.[60] Corruption in the arms business is not simply a matter of opportunity for personal enrichment, though; it is closely connected to the pursuit and practice of political power at both the buyer's and the seller's end, and also to the national security interests of exporting states.[61]

A crucial explanation for financial institutions' focus on corruption risks is the significant growth of the (inter)national regulatory framework that financial services organisations have to operate within and the substantial financial penalties that could be imposed in cases of non-compliance – in particular, in relation to money laundering, terrorism and proliferation financing, and bribery and corruption.[62] Banks and other financial intermediaries are legally expected to play a pivotal role in preventing and sanctioning money-laundering and corruption and in helping to tackle tax and financial fraud among corporations.[63] Banks have therefore invested heavily in anti-bribery and anti-corruption due diligence processes to

a A more general overview of cases of corruption, fraud and the use of bribery in international arms sales can be found in the Compendium of Arms Trade Corruption, which is accessible at https://sites.tufts.edu/corruptarmsdeals/.

discover or determine the likelihood of both current and historical bribery and corruption in relation to the target or other parties involved in financial transactions. Not having such systems in place to counter or mitigate the risks of bribery and corruption associated with making payments to overseas third parties may expose banks to substantial fines.[64]

Second, **concerns about and assessments of the end use of the produced items** are equally important in financial institutions' risk-assessment practices. Next to the risk of corruption in countries of end use, one is able to observe an increase in the relevance of human rights and international humanitarian-law considerations in the due diligence policies and risk assessments implemented by banks. The increased attention paid to these considerations is driven by the adoption of both soft and hard law during the past few years. The most relevant examples of soft law are the 2000 UN Global Compact,[65] the 2011 UN Guiding Principles on Business and Human Rights[66] and the OECD Guidelines for Multinational Enterprises on Responsible Business Conduct.[67] Relevant examples of hard law are the EU 2022 Corporate Sustainability Reporting Directive[68] and the 2024 Corporate Sustainability Due Diligence Directive.[69]

Next to the risk of corruption in countries of end use, one is able to observe an increase in the relevance of human rights and international humanitarian-law considerations in the due diligence policies and risk assessments implemented by banks.

Most financial institutions include criteria in their risk-assessment policies that pertain to the end use of the goods produced. Many exclude transfers to unstable and authoritarian regimes or to countries with very poor human rights standards and they demand a focus on the European context, with production taking place in the EU and the goods being produced specifically for European or NATO customers (e.g., Danske Bank, Intesa Sanpaolo, Bayerische Landesbank). Another European bank, for example, uses a similar eligibility criterion that pertains to the end use of the exported weapons, on the assumption that at least 80% of companies' arms-related turnover emanates from NATO or Ukraine deliveries.[70]

The presence of such considerations in financial institutions' assessments could understandably be challenging for European arms companies. After the Cold War, national governments actively encouraged arms companies to export arms in order to survive and to guarantee a viable defence industry at a time when national defence budgets were shrinking significantly. According to the 2023 SIPRI arms transfers analysis, EU Member States together account for about 25–30% of the global exports of conventional weapons.[71] Many of these exports went to unstable non-democratic countries.[72]

Such exports and the (mis)use of exported weapons in armed conflicts across the world have negatively influenced public perspectives on the arms industry. According to one interviewee, these less-than-positive perspectives on the defence industry are more pronounced in Europe compared to the United States. In the United States, it is something of a national honour and increasingly a duty to invest in defence companies, whereas this industry in Europe, for many historical reasons, has had a more negative connotation attached to it.[73]

The recurring inclusion of contested arms exports in the political and social debate offers another explanation for financial institutions' lack of appetite to invest in arms companies. Crucially, however, a financial institution representative stressed that these reputational concerns also have an important legal dimension, because the European Central Bank obliges banks to conduct a reputational litigation check in their risk-assessment framework. It insists on this because reputational damage could possibly have a negative impact on a bank's financial stability.[74]

Because of these concerns and considerations, arms-producing companies are subjected to **enhanced due diligence risk-assessment procedures**, which brings about the need for closer scrutiny and more detailed information-sharing by arms companies. According to various representatives of financial institutions, this is also the main reason why government-issued export licences are not considered to be sufficient in and of themselves. They claim that such export licences do not fully satisfy the compliance and autonomous due diligence requirements that underpin the provision of finance regulations.[75] In addition, state due diligence does not examine the challenges and issues that banks consider, such as the debt ratio and viability of a company. Another reason is that government policies may change over time, even when the objective circumstances have not changed.[76]

These enhanced due diligence procedures lead to a strong emphasis being placed on dialogue and engagement with the companies involved with a view to receiving or sharing detailed information about the end use and end user of the goods in order for financial institutions to conduct their risk assessments. French bank Crédit Agricole, for example, does not finance a transaction if it is impossible to identify all of the involved counterparties and all of the geographical locations of the transfer unambiguously.[77] Importantly, however, this does not result in a principled exclusion of arms companies, but rather constitutes a call to engagement by arms companies with banks and other financial institutions to communicate openly and constructively about the risks their activities are subject to and the possible measures that could be taken to mitigate such risks.[78]

A third important reason behind the difficulty that arms companies experience in gaining access to private finance plays an important role here: the **lack of transparency** in the arms industry is in direct contrast to the need for financial institutions to apply elevated levels of scrutiny to the sector. For reasons of national security, arms companies are not able or willing to share detailed information with financial institutions and this significantly hampers and negatively influences the outcomes of risk-assessment procedures. This "national security" argument, however, appears to have created a more generalised culture of secrecy and a lack of willingness to share information and to engage in meaningful conversations with financial institutions. Although (national) security concerns could effectively limit the amount and type of information that could be shared, the arms industry appears to have "used its national security status and the umbrella of essential secrecy to deflect pressure for reform".[79] National reports on arms exports illustrate clearly that increased transparency does not necessarily affect national security concerns negatively. Across the EU, these official reports have become increasingly transparent regarding licensed and actual arms exports, which indicates that the previous secrecy levels were not an absolute requirement but could change over time without compromising national security.

The "national security" argument, appears to have created a more generalised culture of secrecy and a lack of willingness to share information and to engage in meaningful conversations with financial institutions.

To conclude, financial institutions are not unresponsive to the role that arms companies, in the light of the current geopolitical climate, can fulfil in contributing to security and stability in the EU. In fact, several European financial institutions have adjusted or are reconsidering adjusting their policies on the defence industry in the light of the

Box 2. An increased civil–military merger. implications for companies

The once-clear distinction between civil and military companies is increasingly becoming blurred. Because of the strong innovation potential in the civilian sector, which has surpassed that of the traditional military sector, the arms industry is actively looking for cooperation with and the integration of civilian companies and research institutes in military R&D programmes. As a consequence, an increasing number of previously purely civilian companies are becoming involved in defence-related activities. The expanding scope of what are considered arms companies offers both opportunities and challenges for companies with regard to their access to financial instruments.

On the one hand, this evolution might tackle the issue with the market imperfections for traditional defence companies, as civilian companies would possibly target a much bigger market and have more direct opportunities to access commercial markets. Governments are therefore not their only clients and a larger ROI could therefore be expected. This evolution might also enable companies to remain below the thresholds sometimes used by banks to apply stricter HRDD practices, as these companies would generate only a minor proportion of their turnover in the defence sector.

On the other hand, an increased involvement of these companies may substantially expand the scope of the stricter due diligence policies of financial institutions, because the mere involvement in military supply chains could be a sufficient argument to trigger more stringent risk-assessment procedures. This could possibly result in those companies gaining less access to private finance due to their increased defence or military connections. Civilian companies are, compared to traditional arms companies, often even more sensitive to societal and public concerns regarding their reputation, but the obligations regarding secrecy related to military projects could influence their ability to engage with the public and financial institutions.

changed geopolitical climate and they are displaying an increasing willingness to contribute to strengthening European security. However, a variety of reasons and drivers continue to guide financial institutions' policies regarding the defence industry. Concerns remain, though, about the potential misuse of EU-produced weaponry in and by non-EU countries. These concerns have been added to by a substantial number of cases of large defence procurement procedures in which European arms companies have been suspected or found guilty of corruption. Another of the chief motives behind these policies is the continuing lack of transparency on the part of arms companies. These concerns and the accompanying risk-assessment procedures mainly originate in international norms and binding (inter)national legislation that exert strong (legal) pressure on financial institutions to implement far-reaching due diligence practices.

Elements for further constructive action

This analysis of the main drivers behind financial institutions' policies regarding arms companies clearly indicates that expecting banks and financial institutions to countenance a blunt exemption to the defence industry by urging them to reconsider their existing standards and policies is not a viable or realistic option. The analysis of the financial institutions' guidelines regarding the defence industry, the literature analysis and the conducted interviews helps to identify several relevant issues that are instrumental to reconcile arms companies' practices with financial institutions' policies. Taking steps to understand, deal with and respond to the main reasons behind financial institutions' practices geared towards the defence industry appears to be more durable, effective and realistic. The analysis conducted in this article suggests that (1) reflecting on initiatives to balance transparency and national security considerations, (2) paying attention to effective and transparent actions to counter corruption, bribery and money-laundering and (3) implementing effective mechanisms to identify and mitigate possible adverse impacts related to serious International Humanitarian Law (IHL) and International Human Rights Law (IHRL) violations in downstream supply chains are central issues in this discussion. Important is that these discussions need to take the specificity of the global defence industrial sector into account, which also necessitates explicit attention to the role governments (can) play.

Transparency and national security: finding a balance

A first important issue is the need to reconsider current rules and practices on secrecy in the arms sector. Initiatives and reflections about how more transparency could be achieved would be welcome as this would be particularly relevant in relation to anti-money-laundering (AML) and anti-fraud or anti-corruption obligations that banks are legally subjected to by national and international legislation. Banks are required to conduct additional due diligence and Know-Your-Customer (KYC) procedures for AML and are therefore risk-averse in this area. To respond to such challenges, engaging with banks in a more transparent and constructive manner would possibly make a substantial difference.[80] A similar argument accounts for the European Investment Bank's (EIB) policies, as the EIB also places substantial emphasis on the EU's legal principles on public procurement – equal treatment, non-discrimination and transparency – which are all challenging for the defence industry.[81] National security concerns could be a legitimate reason to curtail the public availability of concrete information on arms development, production, use and trade. However, transparency and secrecy are not two mutually exclusive concepts but rather the two opposite poles of a continuum.

Increased transparency in existing policies could already be a useful step in the right direction. Many arms companies, especially the bigger ones, have well-developed internal policies on anti-corruption and ethical guidelines. Making such policies public would also be an important step forward in responding to the financial institutions' concerns and their risk-assessment processes.[82] The fact that banks are also obligated to preserve confidentiality when dealing with information provided by their customers could, as was suggested by an interviewee, also be a factor that mitigates concerns about the information that would be shared.[83]

Effective and transparent counter-corruption and bribery actions

In response to different scandals, the defence industry has invested heavily in efforts to reduce, even prevent, corruption and bribery. Compared to the recent past, therefore, it is acknowledged that the defence sector has made significant progress in taking measures to counter corruption. This is, for example, illustrated by the inclusion of a "zero tolerance to corruption" principle in the 2009 Global Principles of Business Ethics for the Aerospace and Defence Industry – a set of principles developed jointly by the Aerospace Industries Association of America (AIA) and the AeroSpace and Defence Industries Association of Europe (ASD).[84] Many companies do very well in developing internal policies to counter corruption, albeit with a strong intra-company perspective. However, very few arms companies publish such policies publicly or communicate transparently on their initiatives. As part of their legal due diligence obligations with regard to AML, anti-corruption and anti-fraud measures or policies, financial institutions require strong engagement and communication with sectors that tend to be vulnerable to corruption and fraud in order to identify how certain concerns are being mitigated and to display a willingness to move forward and remedy such practices.

The external side of anti-corruption measures, related to companies' supply chains, has proved to be a much more challenging issue for them to resolve. One very specific element that has a severely negative impact on anti-corruption efforts in this context is the continuing existence of "offsets". An offset is the practice of "compensating" a country that purchases military equipment by investing in that country or buying other items from that country. These deals are "remarkably unregulated and almost entirely opaque" and they can easily be used to funnel rewards to companies and individuals. The transactions can either be "direct (included in the sales contract) or indirect (separate from the sales contract)".[85] Not only do offsets affect the financial-economic nature of a transaction (as it may negatively influence the value of a transaction and the ROI), but history has shown that such offsets are often highly vulnerable to corruption and bribery.[86]

Relevance of "Responsible Business Conduct" and "Due diligence" policies

Human Rights Due Diligence (HRDD) is traditionally defined as a process through which enterprises can identify, prevent, mitigate and account for the way in which they respond to their actual and potential adverse human rights impacts.[87] It is part of a broader tendency to stress Responsible Business Conduct (RBC). Many industrial sectors have been implementing due diligence policies in the wake of the adoption of the United Nations Guiding Principles (UNGPs). But the idea of autonomous corporate responsibility in assessing possible adverse impacts of a company's activities has been considered irrelevant to the arms-producing industry.[88] This contributes to the prevailing lack of understanding that the UNGPs have implications for arms companies beyond mere compliance with export controls.[89] The explicit exemption of companies that fall under strategic goods export controls arising from the scope of the 2024 EU Corporate Due Diligence Directive (CSDDD) seems to bolster this unique position of arms companies. However, the activities of financial institutions are subjected to both the UNGPs and the CSDDD, through which obligations to implement HRDD policies will increasingly be required of companies applying for financial support, including arms companies.

Importantly, several interviewees from the financial sector stressed that arms companies can take steps proactively towards strengthening the management of those risks associated with their activities. Implementing a due diligence policy can indeed contribute to this. Swedish SEB bank, for example, expects large arms companies[a] to have an HRDD process in place that covers their sales and export activities.[90] The changing geopolitical landscape has prompted financial institutions to reconsider their policies regarding investments in arms companies and European security. However, in many cases it is very challenging for banks to effectively separate companies' European security-focused activities from their extra-EU export operations. This complicates due diligence and risk assessment in their lending decisions, and thus the ability to fully support the European defence industry.

While the inherent risks of the defense sector cannot be completely eliminated, concrete measures can be implemented to help banks better assess and manage these risks.[91] It is important, however, that any new initiative include binding commitments rather than voluntary guidelines:

> For example, in an issue paper published by the European Commission on this topic in late 2023, in the process to inform the development of the European Defence Industrial Strategy, the idea of a Voluntary Code of Conduct for arms companies was forwarded.[92] However, this approach on its own is likely to prove insufficient in encouraging financial institutions to modify their policies, as its non-binding and imprecise nature fails to provide the concrete assurances banks require for their risk assessment processes.[93]

Implementing the RBC effectively appears to increase companies' access to financial markets.[94] Moreover, it could also result in an increased ability to attract and retain talent. In the current war on talent and the urgent need for arms companies to hire well-educated technical personnel, this argument is also extremely valid.

In addition, not only the mere implementation of the RBC and due diligence policies appears to have a positive impact on accessibility to financial institutions; higher levels of transparency about corporate social responsibility (CSR) initiatives also seem to be able to render access to finance easier.[95] Of course, the specificity of the arms industry and its intricate link to national security and defence will bring about specific challenges to the implementation of due diligence policies and practices and to the issue of the transparency of business processes.[96]

Pivotal role of the government …

Importantly, these former elements for arms companies to consider in developing a better and more constructive relationship with the financial sector cannot be considered in isolation. Given the close and specific relationship between the defence industry and national governments, the role of the latter is also indispensable, as was stressed by many of the interviewees. First, several interviewees from the financial sector stressed the need for financial institutions to have a long-term perspective on procurement and investment plans. Banks need to follow financial due diligence procedures to reduce the credit risks they are faced with when deciding to invest.[97] From this perspective, governments – often the sole client of arms companies – need to offer arms companies a higher level of certainty about their investment and procurement plans for the long term. This argument was, for example, forwarded by some Dutch banks and private pension funds in the recent discussions on facilitating defence companies' access to finance.[98]

Second, the approach of financial institutions to financing defence industrial actors also results

a A company is defined by the SEB as a large company if it fulfils at least two of the following three criteria: "more than 250 employees", "turnover above 50m EUR" and "balance sheet value above 43m EUR".

from the legal obligations that national governments have imposed on those institutions to conduct thorough risk assessments to prevent fraud, corruption and money-laundering. The stringent legal obligations on financial institutions have obligated these institutions to implement comprehensive due diligence and KYC policies and to adopt a risk-averse approach to policy-formation. The same conclusion holds for the soft- (and increasingly hard-) law initiatives in respect of corporate HRDD adopted at the international, EU and national levels. Arms companies often argue that these due diligence regulations do not apply to them because they are subject to export controls, an argument often echoed by national governments.[a] Financial institutions, which are also subjected to these HRDD principles, however, do not apply this distinction between the defence industry and other industrial sectors. Instead, the nature of the goods produced by the defence sector and the enhanced risks of IHRL and IHL violations related to these goods dictate that a heightened risk assessment by financial institutions is a logical consequence of these international regulatory initiatives on HRDD.

Governments should take more seriously the international regulations on arms export decisions which they themselves have agreed to.

Third, there is the pivotal role that national governments play in conducting their due diligence obligations with respect to the transfer of conventional weapons. Although the relationship between governments and arms companies may not necessarily be unique, it is a very specific one because of the important role these companies play in national governments' defence, security and foreign policy-making. In this respect, arms companies are sometimes rendered instrumental by their national governments for political and strategic reasons in selling weapons to certain countries and turning a blind eye to corruption and bribery.[99] Governments should therefore take more seriously the international regulations on arms export decisions which they themselves have agreed to (e.g., in the Arms Trade Treaty or the EU Common Position on Arms Exports). In particular, they should be taking serious account of the references to human rights, international humanitarian law, diversion and corruption in these documents.[100]

… and the need for a dedicated trialogue between industry, government and the financial sector

Various policy documents at the European and national levels stress the need for a dialogue between governments and the financial sector with a view to convincing the latter to ease its existing policies regarding the defence sector. The EDIS, for example, states that the Commission, together with the EDA and the Member States, will reach out to banks and investors for a high-level dialogue to "find ways to stimulate private sector engagement to support defence investments".[101] Importantly, as has also become clear in this article, industrial involvement and engagement in such a dialogue – and in the process creating a so-called **trialogue** – is indispensable. In such a trialogue, arms companies would need to be willing to discuss feasible and effective actions that would mitigate the concerns expressed by financial institutions.

a Illustrative of this is the inclusion in the 2024 EU Corporate Sustainability due diligence directive of a clause explicitly excluding products subject to dual-use or conventional arms export controls from the scope of the directive (*Article 3g(ii) Directive 2024/1760 of 13 June 2024 on corporate sustainability due diligence*, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L_202401760).

Importantly, rather than setting up such a trialogue in order to put pressure on the financial sector to ease its current policies, such a trialogue could be particularly valuable in allowing governments and arms companies to gain a better understanding of the main drivers behind financial institutions' policies and to explore possible measures through which to adhere to these policies. In such a trialogue, not only the challenges related to the specificities of the defence market (such as the complexity of and uncertainty about procurement procedures) could be discussed, but the high risks of bribery and fraud in this sector could be recognised, as could the different cases of irresponsible arms exports of the past couple of decades and their negative effects on the sector's image and reputation would also be a crucial part of the discussions. Including the defence industry in these discussions on how to deal with these motives and decrease the risks related to the specific sector in which they are active would give the discussions a strong added value. For example, one of Europe's national banking federations mentioned that

> we had a dedicated trilogue, in which financial institutions, the government and the defence industry participated. This discussion helped to raise awareness among the defence industry about the financial institutions' willingness to support the sector while also needing to comply with a robust regulatory framework and about the fact that ESG was not as impactful as they assumed.[102]

Conclusions

The deteriorating geopolitical environment and the political reinvention of the defence industry as an important actor in building security in Europe have had an impact on the general approach to this industry and its access to financial markets. In response to these concerns, public funds are increasingly being made available to support EU defence companies at both the national and the EU level. In addition, the European Commission has expressed its willingness to broaden the current eligibility criteria of the EU's existing financial instruments and has also encouraged the European Investment Bank to reconsider its investment policy with a view to also allowing investments in producers of conventional weapons. Despite the strong increases in government financial support to the defence industry – via new procurement programmes and various mechanisms to finance military R&D – arms companies continue to need access to private financial markets to finance their daily activities and the investments required to respond effectively to the present increased demand. Arms companies across Europe are, however, voicing difficulties in obtaining access to private financial markets, which has resulted in increased calls by industry representatives and government officials to financial institutions to adjust their policies.

The analysis presented in this article has indicated an increasing openness among private financial institutions to give arms companies access to their financial portfolio. Only very few financial institutions appear to continue to exclude arms companies from their financial activities. It also became apparent that so-called ESG criteria and the EU Green Deal are not, contrary to many public statements, the main reasons for these apparent difficulties. Suggestions for acknowledging the indispensable role of the defence industry in guaranteeing sustainability – which are being heard increasingly – and a call for public statements to label the defence industry as sustainable will do very little without meaningful steps being undertaken by the arms companies themselves. Several drivers are behind the enhanced scrutiny that financial institutions subject the arms industry to. These drivers and accompanying procedures are, importantly, not unique to the arms industry but are actually applicable to all industrial sectors.

At a more fundamental level, financial institutions' considerations and legal obligations stress the need to acknowledge the nexus between internal and external security. In other words, discussions about initiatives to support the strengthening of internal European security also need to take into account the ways in which they influence extra-EU security. For many reasons, financial institutions consider the effective (country of) end use of the products – which in the case of the arms industry is often outside the EU – in their risk-assessment procedures.

The combination of increased domestic and/or European demand for military products, the initiatives to facilitate European procurement of new military equipment and the public financing of arms companies' R&D efforts, creates leverage for both governments and arms companies to apply a more responsible perspective on arms exports to non-EU (and non-NATO) destinations. A more thorough and critical assessment of arms exports and export markets not only affects IHL and IHRL considerations; it also has a clear security interest. First, decreasing the EDTIB's dependence on extra-EU exports could positively affect the security of supply in the EU, as European arms companies could be obliged to honour their export contracts also in times when their own domestic clients – that is, their national armed forces – are in direct need of these goods. Second and more fundamentally, limiting arms transfers to unstable and repressive regimes, especially in the broad EU neighbourhood, could help to tackle the insecurity and instability extant in those areas. Arms not only play an increasingly important role in contributing to the EU's and its citizens' security; they can also, when exported without real and meaningful controls, be used to strengthen insecurity, instability and conflicts in other parts of the world. This increased instability could in the long term threaten the internal security of the EU, as it may trigger migration flows, international trade disruptions and illicit arms trafficking back to the EU. Responsible arms transfers are therefore part and parcel of a balanced security policy and in the interests of EU countries and their citizens.

The increased internal demand for military equipment by EU Member States could help to reduce the strong reliance of the EDTIB on exports to non-EU countries. However, these investments and increased public financial funding will also increase the international competitiveness of European defence companies. Given the overall rise in defence budgets across the world, and the important role of EU defence companies in the global arms trade, increased demands for arms transfers from European companies could be expected. As a consequence, discussions about and decisions taken on the export of conventional weapons will remain important in the future, especially in a context where defence budgets and procurement programmes are increasing in many countries across the world.

The possible ways forward included in this article may, if dealt with effectively by arms companies and national governments, result in easier access to finance for the defence industry. Real adherence to these possible solutions at the same time holds the potential of a more transparent and responsive industry, with arms companies providing more openness about their business, taking effective steps to tackle corruption, fraud and money-laundering, conducting thorough risk assessments of the potential negative impacts of arms exports and responding accordingly. National governments should also play a pivotal role in this, given their specific multi-role position as legislator, controlling actor and single client of the arms industry players.

Annex 1. Overview of the interviews conducted

#		Date
1	Representative national banking federation	19 September 2024
2	Representative European financial institution	15 October 2024
3	Representative national banking federation	24 October 2024
4	Representative European think tank	7 November 2024
5	Expert on defence economics, European university	7 November 2024
6	Expert on transparency in the international defence sector	15 November 2024
7	Expert on business, financial institutions and human rights, international research institute	15 November 2024
8	Representative European financial institution	26 November 2024
9	Representative European financial institution	6 January 2025

Annex 2. Overview of selected banks and their policies on the defence industry

Bank	European ranking	Country	Public policy on defence industry?
HSBC	1	United Kingdom	https://tinyurl.com/w55rt79b
BNP Paribas	2	France	csr_sector_policy_defence_final_2017_en_v_3.pdf
Crédit Agricole	3	France	198936
Barclays	4	United Kingdom	Barclays-Statement-on-the-Defence-Sector.pdf
Banco Santander	5	Spain	Financing for Sensitive Sectors
Deutsche Bank	8	Germany	Deutsche-Bank-ES-Policy-Framework-English.pdf
Intesa Sanpaolo	9	Italy	Guidelines governing transactions with subjects active in the armaments sector.pdf
UBS	12	Switzerland	/
ING Group	13	Netherlands	Defence | ING
Unicredit	15	Italy	Defence Sector Policy
Danske Bank	24	Denmark	danske-bank-position-statement-arms-and-defence.pdf
KBC Group	28	Belgium	CSD_KBCGroupPolicyonArms-relatedActivities.pdf
Handels-banken	30	Sweden	72-97677
Bayerische Landesbank	37	Germany	https://tinyurl.com/2yxcd5n4
Raiffeissen	44	Austria	https://tinyurl.com/y2r4ks8t

Endnotes

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