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"Don't Bank on the Bombs"
New European Standards Affecting the Defense Industry

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Key Takeaways

- The European Union is developing taxonomies that classify activity sectors according to environmental and social criteria to target private investments. The inclusion of the defense sector in these taxonomies raises concerns.
- Guided by these indicators, financial players anticipate the markets' expectations and tend to develop sectoral exclusion policies that are harmful to the industry.
- These threats to funding weigh on the efforts undertaken by the sector and compromise the objectives of technological and industrial independence set by the European Strategic Compass.
- The debate on the inclusion of defense industries in the taxonomies is an opportunity to reassess their social impact with regard to their contribution to European security and to rethink the sustainability of their financing methods.

Introduction

While Russia's invasion of Ukraine on February 24, 2022, has underlined the need to upgrade the European armed forces, the urgency of the fight against climate change—as illustrated by reports from the Intergovernmental Panel on Climate Change (IPCC)—requires the political mobilization of the European Union (EU) to carry out the transition to climate neutrality.[1]

The EU has therefore established guidelines for ambitious action in these two areas. Via its Strategic Compass, adopted in March 2022, it intends to contribute to world stability with the support of a permanent and viable defense tool.[2] Via its 2018 green finance plan,[3] the European Commission aims to redirect financial flows toward sustainable activities and thus facilitate the 480 billion euros (€) of additional annual investments which will be necessary if it is to achieve its environmental objectives by 2030.

Are the objectives involved in building a sustainable society compatible with the strengthening of European defense?

The tension between these two objectives—strengthening European defense on the one hand and promoting sustainable finance on the other—was made manifest in lively discussions regarding the integration of the defense sector into European taxonomy projects and the expansion of the Ecolabel.[4] These proposals led to concerns among companies of the European Defence Technological and Industrial Base (EDTIB), wary of the perceived threat to their funding.

These steps come against a background of tension between the banking and defense sectors, with the latter reproaching the former for its "timorousness" in financing its activities. This reluctance on the part of financial actors due to the perceived risk to their image is partly fueled by the naming and shaming campaigns carried out by non-governmental organizations (NGOs), intended to taint the reputation of those engaged in activities deemed harmful by such organizations. *Don't Bank on the Bomb*—a report published yearly since 2012 by the NGO PAX that targets the production and financing of nuclear weapons—is emblematic of the smear campaigns that banks have come to fear. This risk to their image is not based on documents, events, or performance indicators, however, but on the perceived reputation of the defense sector.

1. IPCC, *Climate Change 2022: Mitigation of Climate Change*, Cambridge: Cambridge University Press, 2022.
2. *A Strategic Compass for Security and Defense*, Brussels, European Union, 2022.
3. "Sustainable Finance: Commission's Action Plan for a Greener and Cleaner Economy", *European Commission*, March 8, 2018.
4. Established in 1992 to identify products with a low environmental impact, the EU Ecolabel now covers more than 23 product categories across the member states. Regulation (EC) no. 66/2010 of the European Parliament and of the Council of November 25, 2009 on the EU Ecolabel (OJ L 27, 30.1.2010).

At the same time, the banking sector's strengthening of internal control mechanisms following the tightening of compliance rules[5] complicates the search for financing. In 2021, following a 2020 memorandum from the French Land Defence and Security Industry Association (GICAT),[6] the National Assembly's "flash" mission[7] on the financing of the defense industry concluded that the banking sector was reluctant to deal with the arms industry because the risks were seen to be insufficiently controllable.

Various studies have highlighted this situation, underlining the need to limit the impact of the taxonomies and the expansion of the EU Ecolabel on EDTIB funding. The declarations of the former French Minister of the Armed Forces, Florence Parly, on this subject in the summer of 2021[8] were followed by a National Assembly resolution in January 2022[9] and a drive by companies in the sector to raise awareness of the issue within the European Commission. Taxonomies and the Ecolabel aside however, a question mark still remains over the evolution of acceptability criteria for the defense industry. Are the objectives involved in building a sustainable society compatible with the strengthening of European defense?

The EU's normative framework for the development of sustainable finance could weaken funding of the EDTIB (I). Excluding the EDTIB *a priori* on the grounds that it is not sustainable would be to disregard the efforts of the defense sector to address this criticism and contravene the objectives of the Strategic Compass. It is therefore necessary to support the sector in meeting these objectives, rather than excluding it on principle (II).

Regulatory Inflation Weakens the Defense Sector

These reflections on the consequences for the EDTIB of directing financial flows toward sustainable products are part of a more general movement of financial accountability that has been gaining momentum since the mid-2000s. On the one hand, corporate social responsibility (CSR) objectives prompt companies to take their social and environmental impacts into account, and to operate in a more ethical and transparent manner to contribute to the sustainable development goals. Accordingly, the ISO 26000 standard of November 2010 defines seven areas of application for CSR, including governance, the environment, and human rights. On the other hand, socially responsible investment (SRI) obeys the same

5. Following the French law on transparency, fighting corruption and modernizing economic life, known as the SAPIN II Law of December 9, 2016.
6. F. Ballet-Blu and J.-L. Thieriot (rapporteurs), *Mission « flash » sur le financement de la base industrielle et technologique de défense*, National Defense and Armed Forces Committee, French National Assembly, 2021.
7. *Comment les nouvelles contraintes du système bancaire français mettent en péril notre industrie de défense et de sécurité*, Groupement des industries de défense et de sécurité terrestres et aéroterrestres, 2020.
8. Statement by the Minister of the Armed Forces, Florence Parly, at the economic forum in Aix-en-Provence in summer 2021.
9. J.-L. Thiériot (rapporteur), *Rapport sur la proposition de résolution européenne visant à protéger la base industrielle et technologique de défense et de sécurité européenne des effets de la taxonomie européenne de la finance durable*, report No. 4792, European Affairs Committee, French National Assembly, 2021.

logic in the world of investment. It finds its national application in France in the 2016 Law on Energy Transition for Green Growth.[10]

The dual incentive represented by CSR and SRI leads to the extra-financial analysis of economic sectors through the lens of environmental, social, and governance (ESG) criteria. Fruit of an initiative by Kofi Annan, the then Secretary General of the United Nations, the ESG criteria are not standardized, meaning that practices vary widely. Nowadays, several ratings agencies exist, in particular in the United States of America (USA), such as the MSCI ESG and the Dow Jones Sustainability Index. The French defense company Thales has an A rating in the MSCI ESG, with the best rating being AAA. The European Commission taxonomies propose to standardize ESG criteria across the EU, with investors taking them ever more seriously, as evidenced by the creation in spring 2021 of the CAC 40 ESG Index, featuring the forty companies listed on the Paris Stock Exchange to display the best practices.[11]

The European Normative Framework

The use of normative tools to strengthen the sustainability of European companies is enshrined in both the United Nations 2030 Agenda and the 2015 Paris Agreement. It is in this context that, in 2018, the European Commission launched its action plan on financing sustainable growth. Aiming to achieve climate neutrality by 2050, the plan seeks to reform the financial system by directing private capital toward sustainable investments, taking a tri-fold approach which sees the creation of an environmental taxonomy, the extension of the Ecolabel to retail financial products, and a proposal for the establishment of what is being called social taxonomy.

The "green" taxonomy

Brought into being by Regulation (EU) 2020/852 on June 18, 2020, the sustainable finance taxonomy is a classification system for economic activities whose impact is beneficial to the environment. Companies are required to indicate what proportion of their turnover, investments, and expenses corresponds to sustainable activities. It also affects EU member states who establish public policies, standards, or labels pertaining to green financial products or green bonds. Conceived as a tool for bringing about a "common grammar", the taxonomy is to be used by financial actors (banks, investment funds, etc.), supervisory institutions (central banks, regulatory authorities, rating agencies, etc.) and insurance companies to determine whether an investment is environmentally sustainable. In 2021, the German Federal Financial Supervisory Authority (BaFin) announced that it would be using the taxonomy to define the

10. Law on Energy Transition and Green Growth, establishing the SRI label at the national level, and reinforced by the action plan for business growth and transformation (PACTE law) of March 22, 2019.

11. AFP, "Cac 40 ESG : le nouvel indice boursier qui rassemble 40 entreprises socialement responsables", *Les Echos Start*, March 23, 2021.

requirements that portfolio management companies would have to comply with when creating retail investment funds in order to label them "sustainable".[12]

To this end, the Commission set up a technical expert group (TEG) to develop activity screening criteria covering 67 sectors. To be considered "green", an economic activity must contribute substantially to at least one of the EU's six environmental objectives, and cause no significant harm to the others:

- Climate change mitigation;
- Climate change adaptation;
- Sustainable use and protection of water and marine resources;
- Transition to a circular economy;
- Pollution prevention and control;
- Protection and restoration of biodiversity and ecosystems.

Three categories of activity are established, according to whether they are favorable, harmful, or neutral from a sustainable development perspective. In March 2020, the TEG's recommendations were published in its first delegated act on climate, adopted in 2021. The gas and nuclear energy sectors were initially excluded from the taxonomy. They were later included as transitional activities in a Complementary Act in 2022, subject to specific terms. In a similar vein, economic activities relating to the defense sector were not included in the first delegated act. This *a priori* exclusion may appear to suggest a fundamental incompatibility with the goal of sustainability.

Extending the Ecolabel to retail financial products

In March 2021, the Commission's Joint Research Centre published a technical report establishing evaluation criteria for retail financial products (life insurance, savings accounts) in order to include them within the Ecolabel. This report proposed that any company deriving more than 5 percent of its revenues from the production and trade of conventional weapons and military products used for combat should be excluded from Ecolabeled funds. Although France has asked the Commission to withdraw this criterion,[13] the approach it signals is worrying in terms of the potential side effects for the defense industry, especially for dual companies (producing for both civil and military markets) who could decide to split from their defense branch as a result.

12. "Konsultation 13/2021: Entwurf einer BaFin-Richtlinie für nachhaltige Investmentvermögen, Bundesanstalt für Finanzdienst-leistungaufsicht", *BaFin*, August 2, 2021.
13. Response of the Ministry of the Armed Forces to written question No. 23783 from Ms. Hélène Conway-Mouret, *Journal officiel du Sénat*, February 20, 2022, p. 346.

The social taxonomy

In line with their work on the "green" taxonomy, European Commission experts wished to extend the reach of their investigation by developing a tool to measure the social benefits of economic activities beyond the merely environmental. The objective of this "social" taxonomy would be to raise the profile of companies that contribute to improving quality of life for European citizens, in terms of gender equality and salary conditions for example, but also with regard to human rights as defined in international conventions. The identified products would be classified as participating "substantially", "neutrally", or "harmfully" to "social sustainability".

A new group of experts tasked with working on the social taxonomy proposed the introduction of negative indicators for "significantly harmful" activities, to ward off potential criticism of the taxonomy for being incomplete by failing to consider the full range of sectors. Accordingly, in July 2021, this group of experts stressed the need to "ensure that harmful sectors or activities such as weapons, gambling, and tobacco cannot qualify as socially sustainable despite e.g. good worker-related performance".[14] Critics of this exclusion were quick to react: "To say that defense activities should not be funded by financial organizations and banks is to place them in the same basket as pornography—it is unacceptable!" railed the French Minister of the Armed Forces, Florence Parly, in July 2021.[15] Following this outcry, the progress report recommended limiting the exclusion to weapons that are prohibited by international conventions (cluster bombs, anti-personnel mines, biological weapons), and are not therefore produced by the EDTIB.

Side effects for the defense industry

In the first round of analysis, the defense industry was therefore not identified by the European Commission experts as a likely candidate for inclusion in the environmental and social taxonomies. Although the two projects are not moving forward at the same speed—the green taxonomy follows a calendar of delegated acts which runs to 2023, while discussions are still underway regarding a timetable for its social counterpart—it is nevertheless valid to query their impacts on the EDTIB and the message they send to financial actors. Indeed, financial actors logically tend to gravitate toward the large number of activities already included in these classifications (to maximize their ESG rating in the associated indexes), while moving away from those which are currently unevaluated (all the more marked in the case of companies operating in sectors deemed "harmful" by social or governmental standard-setters).

By targeting the most virtuous, these measures risk complicating the financing of assets that were not taken into consideration

14. *Draft Report by Subgroup 4: Social Taxonomy, Platform on Sustainable Finance*, European Commission, 2021.
15. Statement by the Minister of the Armed Forces, Florence Parly, at the economic forum in Aix-en-Provence in summer 2021.

The defense industry is therefore concerned that banks and investment funds will anticipate or even go beyond the requirements of upcoming regulations, establishing precautionary measures and engaging in over-compliance when it comes to funding EDTIB companies. The French National Assembly's flash mission reported cases of banks refusing to open accounts for start-ups and SMEs on the grounds of their association with the defense sector, even where this involved non-lethal products such as bulletproof vests.[16]

The application of sectoral policies against the defense industry that govern the entirety of a financial group's activities (i.e., lending, investments, insurance) is a cause for concern—particularly where this affects companies given a satisfactory ESG rating by the aforementioned indexes. These sectoral policies take into account the regulatory context arising from the various international treaties, the existence of embargoes and sanctions with extraterritorial application, and the "country risk" generally established by private service providers and used by banks when deciding whether or not to invest in a company or a sector. These sectoral policies increase red tape and thus slow the lending process, to the detriment of SMEs and mid-sized companies in particular. They can also be amended to reflect ongoing developments and to continue protecting against reputational risk. Even where a defense company has ostensibly obtained funding, it may then see this blocked in the event of any public controversy causing shareholders to question the company's management. As the system which reacts to these controversies is automated, funds can be blocked in a matter of hours.[17]

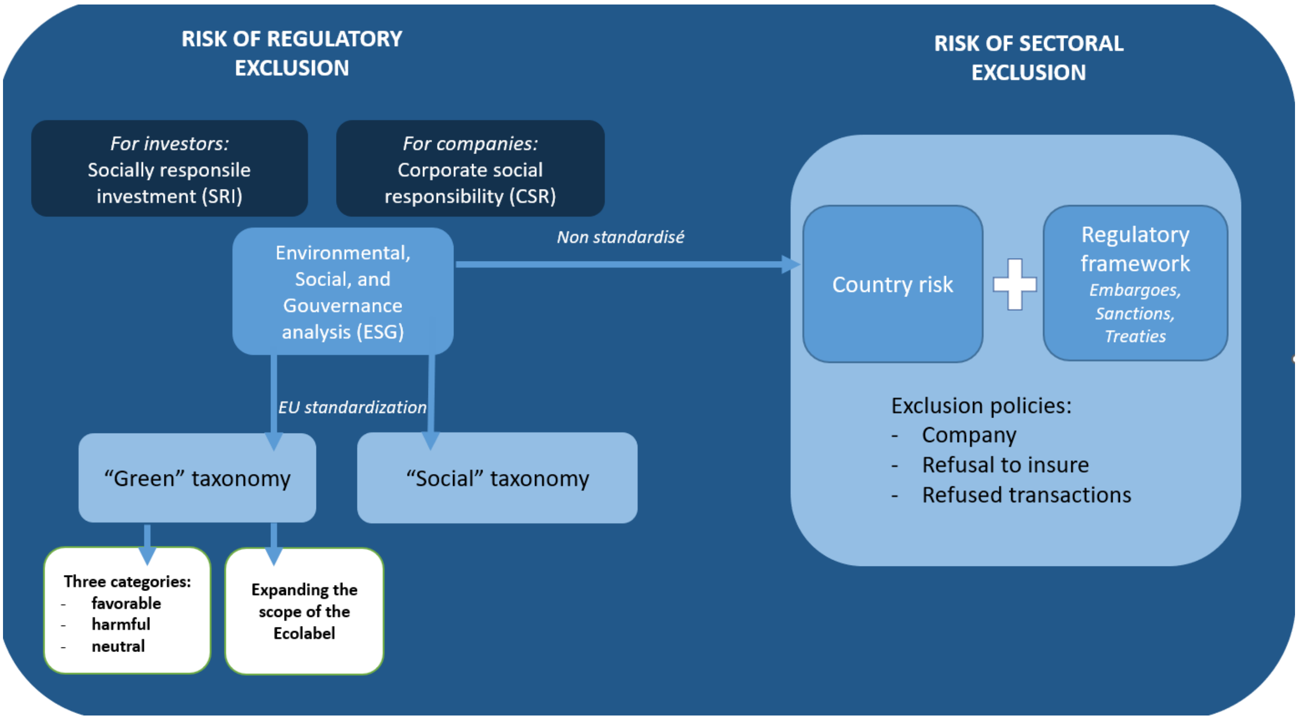
To fully understand the relative risk for banks of excluding this sector, it is worth noting that the EU-wide annual turnover of the EDTIB is a relatively modest €180 billion, with the sector generating approximately 460,000 jobs,[18] whereas agriculture, for example, generates over €420 billion and 8 million jobs across Europe. Economically speaking, the EDTIB is therefore not all that significant, which could explain why the banks might shy away from this sector, given the opportunity cost associated with a publicized controversy.

16. J.-L. Thieriot (rapporteur), *Rapport sur la proposition de résolution européenne visant à protéger la BITDE*, report No. 4792, European Affairs Committee, French National Assembly, 2021.

17. Novethic Conference, held by GICAT, 2022.

18. *Résolution européenne nº 750 du 15 janvier 2022 visant à protéger la base industrielle et technologique de défense et de sécurité européenne des effets de la taxonomie européenne de la finance durable*, Paris, French National Assembly, 2022.

Factors affecting the DTIB's exclusion risk



The Defense Sector and ESG Values

The European Commission's efforts to contribute to the sustainable development goals raise two fundamental questions. First, is EDTIB activity inherently harmful on a social and environmental level? Second, is it not contradictory for the EU to strengthen the EDTIB via public financing mechanisms such as the European Defence Fund (EDF) and the European Defence Industry Reinforcement through Common Procurement Act (EDIRPA),[19] while limiting the private financing of this sector through its normative activity?

Can Defense Be Green?

Evaluation of the defense sector's environmental impact in France and Europe is complicated by the absence of official data with which to quantify its carbon footprint. The French Ministry of the Armed Forces does not publicly carry out any such assessment, nor indeed did the 2015 Paris Agreement contain any requirement for stakeholders to do so.[20]

19. The EDIRPA represents €500 million for the period 2022-2024.
20. *Paris Agreement* (United Nations, 2015).

Nevertheless, the armed forces have devised their own tools to enable them to achieve energy transition while continuing to meet operational imperatives. In France, the *Stratégie énergétique de défense* (Defense Energy Strategy), published in 2022, recommends "generalizing the inclusion of ecodesign and energy efficiency requirements to all armament operations and making it a selection criterion within the ministry"[21]. The objective is to establish sustainability as a differentiating criterion in calls for tender from the French Directorate General of Armaments (DGA). The proactive approach to ecodesign envisaged by the French Ministerial Instruction No. 1618 applies to the entire life cycle of armaments and equipment. To this end, ecodesign indicators for the programs were created as decision support tools in 2008 and updated in 2021, to make it possible to check whether weapons systems provide added environmental value. One example currently under negotiation is the hybridation of Griffon vehicles, with results concerning its environmental value expected mid-2022.[22] This project is carried out within the framework of the Groupement Momentané d'Entreprises (GME), bringing together Thales, Arquus and Nexter. The DGA also uses an ecodesign grid (GRECO), whose purpose is twofold: it evaluates management methods, covering the working methodology of industries as well as the products themselves, and establishes a recyclability target. The weapons industry has therefore made significant efforts and continues to take measures to improve its current performance. First generation nuclear-powered ballistic-missile submarines (Redoutable class) have been responsibly decommissioned for example, a process which involves their dismantling and partial recycling.[23]

> It would be more judicious to support the defense sector's energy transition than considering the industry as harmful on principle

It would therefore seem more judicious from an environmental point of view to incentivize the defense sector's energy transition, rather than considering the industry as harmful on principle and thus discouraging its financing. To this end, the financing facilities from which biofuel and electric mobility stand to benefit, owing to their status as green activities within the taxonomy, could also indirectly be useful for defense.

For a Sovereign European Defense

Military spending has increased in Europe since the first crisis in Ukraine in 2014, a trend which will likely be accentuated as a result of the Russian invasion in 2022. In Germany, Chancellor Olaf Scholz announced the creation of a fund worth €100 billion to upgrade

21. *Stratégie énergétique de défense* (French Ministry of Armed Forces, 2020).
21. L. Lagneau, "Le véhicule blindé Griffon progresse sur la voie de l'hybridation", *Zone militaire*, June 17, 2022, available at: www.opex360.com.
22. AFP, "La dépollution des sous-marins nucléaires démarre à Cherbourg", *GEO*, September 11, 2018, available at: www.geo.fr.

the Bundeswehr, part of which will be allocated to the purchasing of American military equipment (including F-35 Lightning II fighter jets, P-8 Poseidon maritime patrol aircraft, and CH-47 Chinook helicopters), not subject to European regulatory standards. Paradoxically, the drying up of domestic funding sources for the European defense industry could push member states increasingly toward foreign suppliers, a move running counter to the aims of the Strategic Compass, which lists investment in defense as one of four main priorities in order to "reduce technological and industrial dependencies".

Increased dependence on non-European suppliers could also prove counterproductive with regard to ESG criteria, as these suppliers would not be subject to EU sustainability regulations. The difficulties involved in financing the EU defense industry could thus lead to increased imports to cover domestic production shortfalls in the sector, creating a reliance on products that are subject to fewer ecological and ethical checks and whose delivery generates more harmful greenhouse gas emissions than if they were produced directly on European soil.

Alternative Financing Methods

The banking difficulties experienced by the EDTIB mainly relate to the working capital and daily credits for fundraising transactions required to finance the innovation involved in energy transition and to support exports. A variety of solutions have been proposed. In addition to state-guaranteed loans, the French National Assembly's flash mission proposed the creation of a "sovereign industry" label within the SRI framework.[24] This would acknowledge the defense sector's exclusion from existing labels, but nevertheless fails to resolve the issue of the unique position of the defense industry in the finance sector. It also raises questions as to the scope of such sovereignty, which would in this instance be limited to the national domain in France.

The creation of a savings product dedicated to defense and security, along the lines of the Livret A (a partially tax-free savings account available in France), could appeal to citizens wishing to support the defense effort, while benefiting from a preferential and attractive interest rate set by the state. This idea was advocated by former minister for the French party La République en marche (now called Renaissance) Fabien Gouttefarde, as part of a package of special measures to generate additional revenue and bring about the budgetary surplus required for the modernization and development of the armed forces.[25]

At the European level, the EDF allocates €7.9 billion to the funding of joint projects within the EDTIB for the period 2021-2027. It complements The Permanent Structured Cooperation (PESCO) agreed upon during the Lisbon summit and launched in 2017 with

23. Created in 2016 by the French Ministry of Economy and finance, the SRI label is granted to certified investment funds whose assets contribute to sustainable development.
24. F. Gouttefarde, "Une hausse du budget des armées pour maintenir la parité militaire avec l'Allemagne", *La Tribune*, July 13, 2022, available at: www.latribune.fr.

the aim of strengthening synergies across European defense efforts.[26] However, the EDF represents only 5 percent of the total value of the EDTIB, which is estimated at €180 billion. Therefore, these initiatives cannot be seen as a substitute for the involvement of private actors, which remains unavoidable.

To facilitate dialogue between the various stakeholders, the drafting of a defense and sustainability roadmap at both the national and European level would make it possible to work toward a common position within the EDTIB and engage with the financial and banking sector in order to better understand the constraints it faces.

Conclusion: An Opportunity for Defense?

"Without stability and security, there can be no prosperity, inclusivity or sustainable development", said president and CEO of Thales, Patrice Caine, in fall 2021.[27] Tasked with protecting the political community, defense is not subject solely to considerations of profitability but rather must serve the collective or public interest, through the operational effectiveness of the armed forces. A European army which lacks control over the supply of its equipment due to the absence of a sovereign DTIB therefore lacks autonomy and is unable to adequately participate in the mutual and collective defense of Europe.

The defense industry's social and environmental impacts must not be overlooked, yet it is important to recognize the specific constraints faced by the sector, along with the fact that no ecological transition would be conceivable without the security it provides. These considerations are of fundamental importance, as they form the basis of the sector's social acceptance and make it possible to enact public policy that expresses the will of the people, in line with sustainability objectives. As such, although normative proliferation admittedly represents a risk—in particular by encouraging sectoral exclusion mechanisms and making it difficult to access financing—it can also provide a platform for reiterating the need and legitimacy of a sovereign defense tool, while supporting the sector in meeting sustainability goals.

25. PESCO made it possible to define common military requirements (not only in terms of equipment), while the EDF makes it possible to build the capacity necessary to meet them.
26. V. Guillermard, "Défense : Thalès, porté par la hausse attendue des budgets en Europe", *Le Figaro*, March 3, 2022, available at: www.lefigaro.fr.

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