The new Strategic Compass

José Alberto Maia Pereira

| Secretary-General EuroDefense-Portugal

Paula Feliciano Viegas

Member EuroDefense-Portugal |

Reflections on defense investment

1. Reflections on defense investment

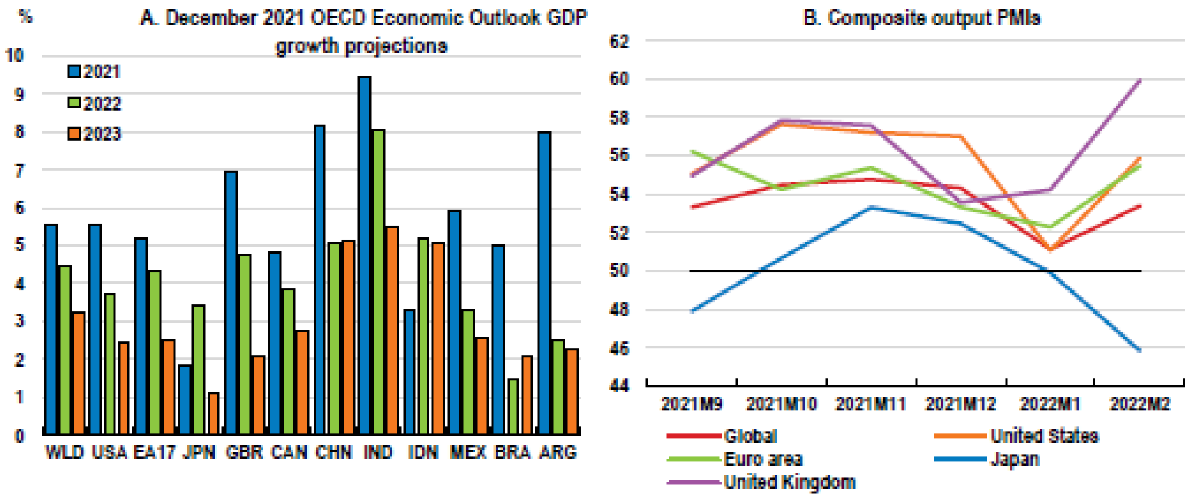
After the sovereign debt crisis, started in 2010, which limited economic growth in most European economies, the entry of the Covid-19 pandemic in 2020 linked to a strong and abrupt retraction on economic growth in these countries. It was in this context that the Recovery and Resilience Plan (RRP) was born. RRP is focused on mitigate the economic and social impact of this crisis, operational until 2026, with an 18 billion euros budget to Portugal. But, in this scenario of economic and social fragility, Russia launched a full-scale military invasion against Ukraine on 24 February 2022, generating a conflict that continues until today.

The Ukrainian conflict brought a new geostrategic context to the european and global environment. Focusing on the European defense and security, some issues have become urgent, influencing political, economic and military decision-makers, namely regarding the need for public investment that:

- Promote the recovery of purchasing power and the quality of life of european citizens and families;
- Reinforce European business recovery, namely the SME ecosystem;
- Ensure the rehabilitation and strengthening of health infrastructures overused during the Covid-19 pandemic;
- Support citizens, households and businesses regarding the sudden rise in energy costs, due to Ukrainian conflict effects on inflation;
- Ensure the modernisation/transition of defense equipment, based on the definitions of the strategic concept of national defense and the military defense planning cycles;
- Support the migration and integration of refugees from Ukraine, which total number, although not yet clearly defined, was, according to the Office of the United Nations High Commissioner for Refugees (UNHCR), on 2 May 2022, about 6 million persons since the beginning of the conflict.[1]

These are the pillars of the new strategic dimension in which we live. According to the recent OECD economic outlook report (OECD, 2022) it was expected, before the Ukrainian conflict, that the post-pandemic economic recovery would take place in 2022 and 2023. However, the outbreak of this war has introduced significant changes to this prospective, which can be seen in the following figures.

Figure 1. Global recovery before the Ukrainian conflict



Source: Economic and Social Impacts and Policy Implications of the War in Ukraine (OECD, 2022)

2. A new context for defense investment

The extreme positions in Ukrainian geopolitics had the direct consequence of an arms race, on which the European Union is not yet well positioned as a top supplier, in a full and integrated way. Indeed, Europe

[1] in https://data2.unhcr.org/en/situations/ukraine (accessed 3 May 2022)

remains dependent on US military equipment, which can be seen as a constraint to the internal development of an effective framework for a defense economy.

The political positioning of supporting the Ukrainian government also provided the context to define a new Strategic Compass, a document that was approved by European Union Council of Ministers on 21 March (EU Council, 2022). Thus, in order to increase European effectiveness to react to crises and threats, but also to strengthen prevention and protection systems, the structure of the document is based on seven key points:

- Rapid deployment capability (force up to 5,000 soldiers);
- Capacity for military planning and conduct;
- Flexibility in decision making (constructive abstention);
- Better coordination between missions;
- Strengthening cooperation/coordination;
- Development of mutual assistance/solidarity;
- Advanced planning.

Security management in the European Union is now thought and defined in five planes: land, sea, air, space and cyberspace. In addition to the concept of "classic war", these plans reinforce the concept of "hybrid war" as dominant in the current panorama, in a modus operandi that resembles omnichannel strategy applied in business - all channels are used simultaneously on targets, in order to achieve the objectives more effectively and with greater scope.

This new way of thinking has a strong impact on the development of new resources and equipment, namely the inclusion of state-of-the-art technology, artificial intelligence and digital transformation. There is also a process of strengthening research and development, undertaken by public or private entities or in partnership.

In terms of investment, the Strategic Compass highlights focus on the collaborative capacities of the European defense industry, as a lever for cooperation between Member States, in terms of operational readiness and technological innovation, through the standardisation of the same defense resources available, thus avoiding disparity and redundancy of equipment from country to country. This collaborative and strategic option is based on a joint effort of research and technological development, transversal to all Member States, which allows homogeneity in military responses but, above all, greater performance efficiency of defense and security sector.

Additionally comes the opportunity that the same option brings to significantly reduce the global contribution of this sector to the world's CO_2 emissions - currently at 2% but forecasted to increase to 25% by 2050[2] - one of the issues that calls for the urgent monitoring of the targets and challenges associated with the world climate agenda adopted by countries, major financiers and private investors.

[2] Source: Boston Consulting Group 2022.

As example, the conflict in Ukraine has led to reactivation of coal-fired power stations in Europe to cope with the increased energy costs already mentioned, resulting in a clear negative environmental impact on the targets for greenhouse gas (GHG) emissions reduction.

Defense has always been assumed as an unavoidable issue in the security of any territory, region or country, and defense investment is one of primary responsibilities of any State, assuming that it should be fully supported by it. This has been the case over the years, with the financial structure of each nation taking responsibility for funding the investment effort in its armed forces, in terms of equipment, renewal, maintenance, expansion, research and innovation. Despite the proliferation of partnerships at all these levels, they are mainly technical, logistical and academic, never financial.

The 2007/2008 crisis brought a new reference to this reality. With the collapse of some of main North American investment banks and the consequent recession in the financial sector, States were suddenly faced with the need to comply with the debt service they usually deferred. In this context, those with less capacity to leverage revenues resorted to issuing public debt.

The speculative appetite surrounding these issues led to the sovereign debt crisis and, in the case of the southern countries of the European Union, to the European Stability Mechanism, known as *Troika*. This new reality led, in these countries, to an increasing scarcity of public capital to finance "non-directly productive" investments, which could include Defense and Security. Surrounded by high interest rates on public debt and strict budgetary control, the states gradually reduced the percentage of GDP invested in Defense, bringing it to a residual level where practically only current and maintenance expenses were ensured.

The European Union has tried to overcome these macroeconomic constraints with the launch of the European Defense Fund (EDF), a mechanism for financing projects in the Defense sector, which goal is promoting the competitiveness, efficiency and innovation capacity of European companies operating in this sector, formally designated as the European Defense Technological and Industrial Base (EDTIB). The EDF has been the main mechanism for supporting Member States and European companies in this sector. However, the access conditions of the programme, the complexity of the application process and the lack of *know-how* available outside defense ministries have led to low take-up of the funds. In addition, the financing of Defense investment by private capital remains a taboo as it is not accepted by broad military, political and financial sectors.

3. Current constraints on defense funding

As previously mentioned, given the economic priorities in the European Union and in Portugal for public investment, the lack of capital to ensure all investment needs is a reality, at least in the poorest countries. This is the first major constraint to investment in Defense, a normally controversial decision that is opposed by several social, economic and financial sectors. However, the intensification of Ukrainian conflict and its potential spill over to neighbouring countries (like the bombing of Transnistria) has brought a new scenario to European geopolitics and, naturally, the need to rethink and re-dimension the above priorities.

In the shortage of public funds, the recourse to private *funding* may be an interesting alternative for European Member States to ensure the proportion of GDP to which they committed to invest in Defense within NATO. In the Portuguese case, the recent budget proposal presented by the government is quite modest in view of the expectations generated following the Ukrainian conflict and the publication of the *Strategic Compass*.

In fact, the investment in Defense foreseen in State Budget 2022 does not go beyond 0.8% of GDP, which is far from the 2% already practiced by several NATO members (USA, Croatia, England, Estonia, Latvia, Poland, Lithuania, Romania and France) and the European median of 1.64% in 2020[3].

Another major constraint is the structure of the EDF itself. Announced by the European Commission in 2016, the EDF was preceded by the Preparatory Action for Defense Research (APIDD, 2017-2019) and the European Defense Industrial Development Programme (PEDID, 2019-2020). Endowed with a €7.9 billion grant, running from 2021 for seven years, the EDF aims to co-finance collaborative defense research and capability development projects (preferably *game-changers* for Member States' armed forces) by scaling up national investments.

With the managing entities being the ministries of defense of Member States, with little sensitivity to relationship with the business ecosystem, the EDF is penalised by the lack of dissemination and, above all, by the absence of personalised support for applications and applicants. These will be the main reasons why only 36% of the 500 million euros made available between 2014 and 2020 have been effectively applied. The main EU mechanism for financing and investment in defense ends up being restricted to a limited set of *players*, the only ones with the necessary *know-how* to promote these applications and finance the respective projects or initiatives.

Thus, given the need and urgency to strengthen defense investment - particularly in research, innovation and development - private funds remain the most viable solution. However, the issue is, in itself, delicate. If, on the one hand, it is a sovereign issue that requires permanent and high levels of planning, scrutiny, monitoring and control, on the other hand, the investment in Defense by private funds is a financial operation and, for this reason, it is subject to regulation.

The regulation of these financial operations, in the form of bank credit or alternative financing (investment funds, venture capital, *leasing*, *renting* or others) falls into two forms:

(i) the contribution to achieving the United Nations (UN) 2030 Agenda for Sustainable Development and its goals[4] , which defines the evolution towards a set of financial standards and regulations called "sustainable finance" and from these to the "non-financial" ESG (Environmental, Social, Governance) criteria, and

[3] Source: Strategic Compass - Chapter 3, p. 30

[4] The 2030 Agenda and its 17 Sustainable Development Goals (SDGs), signed by 193 countries, represents the most important global reference framework in terms of social, environmental and economic sustainability. It underlies the norms and or standards generated for framing performance or projection in environmental, social and economic-financial matters on an international scale, in the most varied sectors by different entities, organisations and States.

(ii) the financial and banking reputational risk, with rules applied by Basel Committee on Banking Supervision.

With regard to ESG criteria, the main focus at European Union level is on the Taxonomy, published in April 2021, understood as a complex system for identifying and classifying investment opportunities aimed at contributing to environmental objectives inscribed in the *European* Ecological Pact - *European Green Deal*. This system is designed to enable agents in the financial sector to redirect capital flows towards investments in activities considered sustainable, making available objective classification criteria and thus reducing the possibility of *greenwashing*. By determining the activities or products of the economy that may be considered environmentally sustainable and, thus, less prone to risk, the prudential safeguard of the assets applied is inferred.

One of the four principles of the Taxonomy, which determines that economic activities are considered sustainable, is that of "no significant harm" (DNSH)[5] to any of the six[6] environmental objectives defined and inscribed in the European Taxonomy Regulation. The DNSH principle is determinant at the level of environmental protection and thus conditions the full compliance with ESG criteria. In the case of Defense, this compliance will include, among others, the use of more environmentally friendly facilities, processes and equipment (known as Green Defense) and the adoption of military practices aimed at the security of states and populations, as in the case of peacekeeping contingents promoted by United Nations in conflict areas and provided by armed forces from various countries (such as UNAMID-Darfur, MINUSCA-Central African Republic, MONUSCO-Congo and MINUSMA-Mali, among others).

With regard to banking reputation risk, this can be understood as the possibility of a negative perception of the bank's public image, founded or not, by customers, suppliers, employees, investors, financial analysts, the media or by public opinion in general. In short, by its stakeholders. Several news items have been released on the role of banking in Defense financing, sometimes bluntly and damaging the reputation of the banking entity, as occurred in December 2009 with the revelation that Credit Suisse had financed the Iranian nuclear programme.

The possibility of the occurrence of this risk is framed by the European Banking Authority (EBA) in the ESG - Pillar 3 risks, which constitutes a strong limitation to the financing of defense economy. This situation stems mainly, but not only[7] , from the interpretation of these criteria at the taxonomy level, which places the defense industry on the same level as, for example, gambling, alcoholic beverages and fossil fuels. The linking of defense economics, through what the taxonomy considers "military contracts" and "controversial weapons", to ESG criteria is established by the possibility of operational and reputational risk.

Under the Basel Accords, these risks are mitigated through predefined *stress* tests and capital requirements (provisioning), which oblige banks to tie up part of their own funds in proportion to these

[5] Do No Significant Harm (DNSH), in its original expression and acronym.
[6] The six environmental objectives of the European Taxonomy for Sustainable Finance: (i) Climate change mitigation; (ii) Climate change adaptation; (iii) Sustainable use and protection of water and marine resources; (iv) Transition to the circular economy; (v) Prevention and control of pollution, and (vi) Protection and restoration of biodiversity and ecosystems.
[7] RobecoSAM one of the largest international investment companies, e.g., starts the categories of its Exclusion Policy with the reference "Weapons-related Exclusions" at https://www.robeco.com/docm/docu-exclusion-policy.pdf.

allocated "risk credits". The situation is strongly controlled, both by the European Union (regulation EU 575/2013 and subsequent diplomas) and by the EBA, which in January 2022 published a set of control indicators (KPI) that it called *Implementing Technical Standards (ITS)*.

In short, given the scarcity of public capital to finance the defense economy in the current geopolitical environment, there is a set of regulatory constraints that will limit the attractiveness and operability of financial agents (banks, para banking companies, venture capital, investment funds, pension funds and other financial companies) in financing this sector and this type of operation.

4. Proposals for streamlining defense funding

With the publication, on March 21st of this year, of Letter nº 7371/22 from European Union Council, the most recent "Strategic Compass", the new strategic plan for security and defense in the European Union entered into force. In addition to the strategic and operational issues linked to this topic, the document dedicates 9 of its 47 pages to the subject "Investment".

In essence, the Strategic Compass advocates a substantial increase in defense spending in Member States (from the current 2% of GDP to at least 4%), the strengthening of European Defense Technological and Industrial Base (EDTIB) and the development of collaborative capabilities in European defense industry. The aim is to boost defense technological innovation in five key areas (land, sea, air, space and cyberspace), filling strategic gaps and reducing technological and industrial dependencies on third countries. The strengthening of the BTDIE will rely mainly on the SME ecosystem and on cross-border participation in defense projects, by increasing/leveraging collaborative investment. But how to ensure this investment?

Firstly, the Strategic Compass takes on the European Defense Fund (EDF) as the main source of funding for defense economy. Secondly, the document extends the sources of funding to other EU support programmes, such as Horizon Europe, Digital Europe Programme, Connecting Europe Facility, EU Space Programme, European Innovation Council and InvestEU. This is an innovative option, as never before have other EU lines been available to support defense investment.

But the innovative *funding of* these investments is not limited to EU funds. At the banking sector level, the Strategic Compass highlights the role of European Investment Bank (EIB) in financing defense economy and promoting and facilitating access to private financing for this sector. But this guidance conflicts with the list of five types of activities excluded from EIB own financing, since April 2013, with "munitions and weapons, military/police equipment or infrastructure" at the top. However, as mentioned in section 4, above, this category of defense sector activities breaks down into: (i) "controversial weapons" - cluster munitions, anti-personnel mines and chemical, biological and nuclear weapons, and (ii) "military procurement" - production of weapons, components and equipment intended for military use, as well as *hardware* and *software* related to this activity.

Although the EIB regulations depend on decisions taken by Ecofin (the European Union Council of Finance Ministers), other European institutions have already begun negotiations, seeking to keep this limitation exclusively for the sub-sector of "controversial weapons". The result of these negotiations will certainly be valid for the remaining banks operating in the European Union. This opens a window of opportunity for projects and companies linked to defense economy to be financed directly by banks. It will even be possible to go further and extend this financing model in programme contracts with the Member States themselves, thus enabling investment in defense to be increased to the desired percentage of GDP.

But financing the defense economy cannot and should not be limited to EU funds or traditional bank financing. Several interesting financial products, which demonstrate robustness and reliability, are increasingly presenting themselves as alternatives. In the range of products known as "off balance sheet", *leasing* and *renting* (financial or operational) may be options in certain investment situations.

On the other hand, venture capital (traditional or virtual) is also an interesting alternative, if the goal is to finance a high potential technological *start-up*, associated to a certain defense economy project or to the integration of circular economy models in the sector. Innovation and new business models will be brought by the need for greater resource efficiency, development of new materials, use of secondary raw materials and more sustainable public procurement will tend to preserve the environment, ensure security of supply, create new jobs, reduce costs for SMEs and make the most of public spending.

There is a growing number of efforts to remove obstacles to partnerships between high-tech *start-ups* and the defense and security industry. It should be recalled that some of the most widely used technological *utilities* today were developed by/in the military industry - e.g., GPS, digital camera. Likewise, the need for the sector to walk on the premise of its own sustainability and on the responsibility of the impact it causes to other sectors and, namely, to the environment - a common link with the populations it aims to protect - is emphasized. This is a great opportunity to build and innovate the efficiency needed to optimise resources and effectiveness, based on needs to evidence in important goals to unlock funding.

Finally, the use of investment funds and/or pension funds allows access to private funds in larger amounts and with longer maturities. This is the case for large structural projects or the financing of military programming cycles, when state budgets or the criteria of budgetary rigour do not allow more funds to be made available for the sector. In this case, it would be a typical "public-private" solution, although from a financial and not an operational point of view. Nothing prevents each country from having a partner or group of partners that, in certain projects, support and complement public investment. Investors are primarily interested in the *yield of* capital invested. The State should, above all, make the investment and thus reinforce its national sovereignty.

6. Conclusions

The current European situation is marked by six priorities in countries public investment, and investment in defense and security is certainly not the most important or even the most pressing. On the other hand, the almost permanent availability of NATO military equipment to support Ukraine makes it possible to provide the armed forces of nearby countries (neighbouring or indirectly likely to be affected, such as Sweden) with technologically advanced and militarily powerful equipment, which makes it possible to meet the expected share of GDP. This naturally leaves out the more distant countries (Mediterranean and others), from which this 'supply' is of little or no benefit.

The publication of the Strategic Compass contributes, in part, to remedy this situation, defining an evolutionary framework that aims the balance of power between all EU Member States, based on innovation and Research & Development, joint, through collaborative projects submitted to available EU programmes, based on SME ecosystem.

The European Union is not restricting itself to EDF and is extending the scope of financing to all European programmes that support technological and digital innovation projects. Moreover, it is assertively and explicitly challenging the EIB to make itself available for the analysis and financing of these projects. Finally, it extends this mission to private capital, whether it comes from banks or funds.

This new philosophy of defense financing has several obstacles or challenges, some of which may, on the other hand, from a visionary and strategic point of view, become opportunities for evolution. Two stand out.

The first stems from a set of standards, global benchmarks and regulatory procedures, particularly European ones, associated with sustainable finance, which aim to direct capital flows to support the energy transition to cleaner energy sources (as a way of combating the acceleration of climate change and reversing the escalation of global warming via, in particular, GHG emissions) and the digital/technological transition, where major disruptive innovations (artificial intelligence, augmented reality, *blockchain*, *internet of* things, robotics and automation, etc.), along with prudential risk management, application of ESG criteria to funding targets, and demanding relationship between the financial sector and its *stakeholders*.

In this framework, the pressure on the financial industry forces to remain investment parameters protected, still, by generic assumptions that tend to summarize (or reduce) the defense industry to an arms market oriented to the prevailing image of war conflict, violent and anchored on so-called "controversial weapons". The evolution of defense sector in terms of sustainable development will also be the evolution of investment financing models and criteria by the financial industry.

The second refers to the decision-making structure associated to investments in this sector, which is highly departmentalized and bureaucratic, closed in itself and unaware of innovations that *start-ups* and *spinoffs* have been producing in the "civil" business ecosystem (examples mentioned above). This often leads to support being directed to the more reputed companies in the sector, thus creating a barrier to entry that is difficult to overcome. It is a matter of philosophy and mentalities that need to be changed.

There is a common understanding that strengthening of European defense economy is not intended, in short or medium term, to replace US military equipment used by most European countries. It is important, however, to generate a strategy of complementarity that will enable European companies in broad sense defense sector (including factories, electronics, transmissions, robotics, IT, transport and other areas), especially SMEs, to gradually enter this market, by the hand of major operators and through partnerships and joint projects. In the short term, this strategy will increase generated Added Value in European area. In the medium term, it will allow European defense industry to be placed at similar level of competitiveness with American, British and Chinese companies.

One of the premises of SDG #16, of UN 2030 Agenda, called "peace goal", recognises that "there can be no sustainable development without peace and no peace without sustainable development". The goals associated with this Goal 16 on peaceful, just and inclusive societies have remained controversial, partly due to geopolitical compromises, but also due to the absence of dialogue with peace, security and defense experts during the process of developing the goals (SDGs) and their targets. Recovering and placing the defense economy under a sustainable spectrum will make it possible to open avenues for repositioning, understanding and harmonisation with civil society, the private sector in general and banking in particular.

For all this, a broad financing structure and a communication agenda with the most relevant stakeholders in the sector are fundamental. It is therefore important to replace old concepts, redefine and/or separate activities (subsectors) of defense and security and build or update knowledge about this industry and the value it brings, as well as to reformulate mentalities, allowing the private sector, in a complementary and controlled way, to support States in their concerns and in daily agenda for the defense and security of citizens, families and companies. More than a desire, this path is today a necessity for a greater benefit and a common future.

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EuroDefense-Portugal
Palácio Bensaúde – Estrada da Luz, 151 1600-153 Lisboa (Portugal)
https://eurodefense.pt/ | eurodefense@defesa.pt