

Defence of Europe as a Responsible Investment

By Stephen Davis

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The last time the Western investment world saw a robust debate over the parameters of buying shares in the arms industry was roughly in the era of the Vietnam War. In the wake of that fraught conflict, thought-leading socially-responsible investor bodies such as the US Interfaith Center on Corporate Responsibility (ICCR) and counterparts in Europe installed clear guidelines against investing in “controversial” weapons. For many institutions, prompted in part by sentiment among clients, this strategy steadily metastasised into a more general allergy against taking stakes in publicly-traded companies implicated in arms manufacturing. As the Cold War ended and the so-called peace dividend took hold, there was little or no brake on the spread of investor resistance to the weapons trade, especially in Europe. Indeed, the public’s stake in protection against war is conspicuously absent from guidance on Environmental, Social, and Governance (ESG) parameters that have emerged in the capital market over the past two decades. Case in point: None of the 17 UN Sustainable Development Goals, agreed in January 2016, addresses the right to secure borders or deterrence to war.

Now, however, Russia’s invasion of Ukraine, and the rising, acute threat that aggression poses to Europe and its citizens, is combining with the US Trump administration’s apparent retreat from full-throated support for NATO to dangerously erode the region’s safety net. This reordered landscape is prompting calls across Europe to invest in indigenous strategic deterrence companies, despite their being a pariah to some of the biggest regional sources of capital.

The time has come for institutional investors to open a pointed dialogue over whether and how Europe’s armaments companies deserve to be reclassified from untouchables to legitimate components of the “S” in ESG. The products they produce are deployed at least in part to ensure the most basic social good: keeping people safe and free. Widening such companies’ access to capital could boost their dynamism and help achieve the objective of strengthening Europe’s self-reliance at a crucial moment in history. Leaving them to flounder or lose ground to competitors could, by contrast, expose Europe’s nations and citizens to chronic dependence on potentially unreliable partners and to heightened security risks, an assertion underscored by Mario Draghi in his landmark 2024 report on European competitiveness.¹

¹ https://commission.europa.eu/topics/eu-competitiveness/draghi-report_en.

Restrictions today

The reality in advance of such a dialogue is that many leading asset managers currently feature specific asset allocation guidelines against investing in defence industries that breach ethical guidelines. Norway's sovereign wealth fund, NBIM², one of the largest on earth, is among them. Other examples are the big Dutch fund PGGM³, HSBC bank⁴, London-based LGIM⁵, Montreal-based BMO⁶, and Rothschild & Co.⁷ Asset managers typically rely on third-party ESG data sources such as MSCI to screen out companies identified as risks. Indeed, features of today's capital market include not only the rise of ESG to dominance in strategy setting, but also the emergence of a vast new industry of ESG data providers. These agents may be under the radar, but they transform ESG from an aspirational exercise to real measurement and management.

Investor guidelines on defence are often based on international treaties against "controversial" weapons, such as cluster munitions and biological and chemical weapons. Other guidelines are based on broader criteria, such as excluding investment in any companies associated with the production of nuclear weapons.

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www.regjeringen.no/contentassets/9d68c55c272c41e99f0bf45d24397d8c/2022.09.05_gpfg_guidelines_observati_on_exclusion.pdf

³ www.pggm.nl/media/vtajuucd/beliefs-and-foundations-for-responsible-investment-pggm-2021.pdf

⁴ HSBC's Defence Equipment Sector Policy prohibits the provision of financial services to manufacturers or vendors of anti-personnel mines or cluster bombs. HSBC Global Asset Management has adopted a policy that excludes investments in companies involved with banned weapons.

⁵ <https://group.legalandgeneral.com/media/gzndr3ms/controversial-weapons-policy.pdf>

⁶ BMO Global Asset Management adopted a Global Exclusion Policy on Cluster Munitions and Anti-personnel Mines. BMO restricts lending to companies involved in the sale of certain weapons, with high-risk matters escalated to BMO's Reputation Risk Management Committee.

⁷ Rothschild & Co Asset Management has established a formal exclusion policy regarding investment into companies linked to the production of controversial weapons. This exclusion policy is part of a comprehensive Responsible Investment framework for Asset Management activities and are:

- Compliant with the regulations in force;
- Aligned with our approach to ESG criteria integration among our investment strategies;
- Part of a response to the risks induced by ESG risks for our investors.

This exclusion policy applies to our various Asset Management investment activities. It also covers managed accounts and dedicated funds, but it does not apply to index-linked structured products. Defining the controversial weapons sector:

This exclusion policy applies to companies involved in the manufacture of prohibited controversial weapons and associated systems or components, in particular:

- Cluster munitions (Oslo Convention of 2008);
- Landmines (Ottawa Treaty of 1999);
- Biological and chemical weapons (1972 & 1993 conventions);

In 2024, Rothschild & Co Asset Management extended the scope of exclusion for direct management to all so-called controversial weapons and associated systems or components. These include:

- Depleted uranium;
- Blinding laser weapons;
- Incendiary weapons (white phosphorus);
- Non-detectable fragment weapons.

Compliance with these principles is based on information from our extra-financial data provider MSCI ESG Research. The list of issuers concerned is updated quarterly.

Funds that embrace such guidelines are often influenced by opinion among beneficiaries—as determined through surveys, focus groups, and “expressions of wish” instruments. It is vital in this conversation to appreciate that this alignment of investment strategy with beneficiary opinion is relatively new—and very much a product of the EU’s own work in recent years through the Shareholder Rights Directive to advance investor accountability.

As beneficiaries in Europe have gained information and sway, NGOs have stepped up their influence over capital strategy. For instance, the NGO PAX issued a report in 2023 naming 109 financial institutions—most in the EU—who, in response to pressure rather than for the purposes of furthering long-term value, now either exclude or restrict investments in companies associated with nuclear weapons⁸. These institutions include heavyweights such as APG, NBIM, ABN-AMRO, Aegon, Bank of Ireland, BNP Paribas, BBVA, Commerzbank, Credit Agricole, Deutsche Bank, ING, PGGM, Nordea, SEB, and Unicredit. Together these investment curbs constitute one indicator that public opinion in Europe, at least as measured before Russia’s invasion of Ukraine, has been heavily oriented *against* weapons industries. Further, that public opinion is increasingly affecting asset allocation strategy among investment institutions.

So long as citizen-saver views are predominantly negative on armaments, the EU’s push for investor accountability through the Shareholder Rights Directive may represent a further unintended factor braking a flow of capital into the region’s deterrence industry sector.

Overcoming barriers

The good news, however, is that there is a rich history of strategies that enable investment funds to allocate capital to controversial industries, even in the context of formidable grass-roots discomfort with such allocations. The concept is of a set of investment principles that address the target topic. Best known examples are the Sullivan Principles in respect of apartheid South Africa and the McBride Principles in respect of pre-Good Friday Accord Northern Ireland. But many others address such topics as conflict diamonds, climate change, mining, and firearms.

They each depend on a set of assumptions:

1. The target subject is controversial and is to be avoided unless defined standards are met. Principles of this nature may be defined as using an opt-in approach.
2. Sufficient quality information may be obtained to enable implementation of the principles—that is, to identify companies and operations that are at issue.
3. The investor deploys effective stewardship tools to engage with target company boards and executives to advocate positive alignment with the principles.

⁸ https://paxforpeace.nl/wp-content/uploads/sites/2/2023/07/PAX_Rapport_DBotB_Moving_Away.pdf

Take firearms as an example. In 2018 a group of large US-based funds, including State Street and CalPERS, developed and signed a breakthrough code of best practice that would enable investment in certain publicly-traded firearms producers as an alternative to blanket disinvestment in them.⁹ “The Principles are not a political statement”, authors asserted, but rather “focused on taking steps to reduce reputational and financial risks to asset owners by encouraging companies involved in the civilian firearms industry to address gun safety issues.” Moreover, the statement noted that “each signatory investor has the ability to customize how they engage their own portfolio companies to best meet their individual investment and stewardship strategies.”

The Firearms Safety Principles are five in number:

- **Principle 1**
Manufacturers should support, advance and integrate the development of technology designed to make civilian firearms safer, more secure, and easier to trace.
- **Principle 2**
Manufacturers should adopt and follow responsible business practices that establish and enforce responsible dealer standards and promote training and education programs for owners designed around firearms safety.
- **Principle 3**
Civilian firearms distributors, dealers, and retailers should establish, promote, and follow best practices to ensure that no firearm is sold without a completed background check in order to prevent sales to persons prohibited from buying firearms or those too dangerous to possess firearms.
- **Principle 4**
Civilian firearms distributors, dealers, and retailers should educate and train their employees to better recognize and effectively monitor irregularities at the point of sale, to record all firearm sales, to audit firearms inventory on a regular basis, and to proactively assist law enforcement.
- **Principle 5**
Participants in the civilian firearms industry should work collaboratively, communicate, and engage with the signatories of these Principles to design, adopt, and disclose measures and metrics demonstrating both best practices and their commitment to promoting these Principles.

Note that the firearms principles proceed from a negative assumption: that there is downside reputational and financial risk to investors when they invest in firearms manufacturers. This is very much in line with other features of the ESG framework, whether in the private sector,

⁹ <http://firearmsprinciples.com>.

national public sector, or in international bodies, as it has emerged over the past two decades. The focus has largely been on installing guardrails to reduce the risk that investors and companies stray from responsibility, as defined by general public opinion. It has been less focused on steering investment into positive solutions—especially when it comes to defence.

Drawing from these experiences, there are clear options to prompt further investment in the defence of Europe. For one, it seems feasible for investors to develop a collective set of opt-in guidelines—based on those that currently exist at certain institutions—that address negative concerns but recommend stewardship engagement as an alternative to exit or avoidance of investment. General provisions might include:

- Manufacturers must abide by all relevant treaties and laws;
- Sales are covered in all cases by authorised-use standards;
- Measures are in place to curb bribery and corruption in the sector;
- Steps ensure weapons are easy to trace if used in an unauthorized manner;
- Sales are covered by rigorous remedial steps to address unauthorized use of weapons sold.

The bigger prize, though, would be for capital market actors to frame positive guidance that emphasises the financial and ethical advantages of investment in the strategic deterrence industry based on security as a social good. Moreover, at a moment when advanced technologies are emerging rapidly from arms manufacturers, such companies may be understood as a powerful and profitable catalyst for innovation throughout the economy. The EU has had productive experience prompting private sector principles, and could tap that track record in bringing financial bodies together to author a framework of recommendations.¹⁰

Under such an opt-out scenario, institutional investors' default would be positively to favor steering funds into the strategic deterrence industry—perhaps especially to companies nimble, inventive, and most in need of growth capital—both as a social good and a good financial investment *unless* target prospect companies are in breach of law or guidelines. In such cases, stewardship engagement would be a first-order investor response, and exit a last resort. The challenge would be to incorporate measurable indicators into principles so that investors, corporate executives, regulators, and ESG data and index providers can track implementation.

Making such principles effective would hinge as well on the EU continuing on a dual path of (1) encouraging greater transparency through practical, even if streamlined, corporate disclosure rules; and (2) stimulating constructive stewardship on the part of institutional investors.

Principles, however, need to be matched with another priority. The EU has been right to encourage financial institutions to be more responsive to citizens, even if it has had the

¹⁰ For instance, see the Best Practice Principles for Shareholder Voting Research, stimulated in 2013 by the European Securities Market Authority (ESMA). The author served as the first chair of the BPP's independent Oversight Committee. <https://bppgrp.info/wp-content/uploads/2024/11/BPP-Oversight-Committee-2024-Annual-Report.pdf>.

consequence in recent years of making defence less rather than more investable. But this more accountable capitalism makes it that much more critical that policymakers engineer explicit conversations throughout the EU to address the wide gap between what is necessary for the defence of Europe, on the one hand, and where public opinion may lie on arms, on the other. The case needs to be made broadly, persuasively, and persistently that defence is ethical, belonging justifiably to the 'S' category in ESG, and, indeed, a prerequisite, to progress on other vital social issues. A shift in public attitudes in this direction would have a knock-on effect among financial institutions, unlocking opportunities for positive capital investment in keeping Europe safe.