Issue paper #5

Mainstreaming defence industrial readiness culture throughout all policy areas at EU and national levels

The Commission services, together with the European External Action Service in coordination with the European Defence Agency, has launched, based on a first overall consultation paper ('Issue paper #1'), a comprehensive stakeholder engagement process to inform the new European Defence Industrial Strategy. This fifth paper outlines key issues and questions for further discussion on Mainstreaming defence industrial readiness culture.

The purpose of this fifth Issue paper is to support the informal discussions with the stakeholders. It does not constitute an official position of the Commission and does not pre-empt the content of the future Strategy.

Improving the European Union's defence readiness implies the European Defence Technological and Industrial Base ("EDTIB") being able to rely on a favourable regulatory, economic, and social environment, including in relation to access to finance and skills. To ensure favourable conditions, EU policies should contribute to support the overall attractiveness and competitiveness of the sector and its agile adaptation to the new security situation.

Mainstreaming a defence readiness culture into EU policies - and society in general - would help meeting the challenges currently faced by the EU defence industry, as well as foster new opportunities for the sector. This may also, *inter alia*, require closer cooperation between military and civilian authorities in the Member States.

1. Promoting a stronger culture of security and resilience in the EU and its Member States

Despite the recent geopolitical trends, the wide support by European citizens for a stronger EU defence cooperation[1] and increased defence spending in the context of Russia's war of aggression against Ukraine, there still appears to be a certain scepticism towards defence, including its industry, in parts of the society (as opposed to the US for instance, where such a wariness vis-à-vis defence matters does not appear to exist to a comparable extent). Wider social acceptance for the key role and contribution of the defence sector in ensuring the security of EU citizens and society could contribute to foster EU's "defence readiness" and as such, the EU's security and resilience. This is all the more necessary as confrontations, conflicts and hybrid actions are increasingly diversified and multi-faceted, adding new security risks also in the economic and societal domains.

Question:

⇨ *How could the EU and the Member States further promote a culture of security, resilience and defence readiness in Europe?*

[1] For instance: https://defence-industry-space.ec.europa.eu/eurobarometer-shows-public-support-defence-policy-and-industry-2023-07-14_en

2. Facilitating Access to Finance for the EU defence industry, including SMEs and start-ups

After the end of the Cold War, the defence sector was impacted by declining national defence budgets. However, the recent decline of the geopolitical situation generated new investment needs, resulting in increased public spending, which are critical to ensure the adaptation of the EDTIB. Although the development and production of defence-related technologies and capabilities rely mostly on public procurement contracts or grants, **defence companies also need to resort to private financing, notably in the form of equity or debt**.

Ensuring sufficient access to finance for the EU defence sector - in particular for SMEs and mid-caps, which form the backbone of supply chains and are key innovation actors[2] - is vital to the competitiveness, resilience and security of the Union. It is key to allowing companies to mobilise the necessary resources to grow in the EU, innovate and remain competitive at a global level. Access to EU sources of capital, in particular for equity, is also essential to limit the dependence of innovative and/or critical defence suppliers on foreign capital, which may raise security concerns in such a strategic sector.

Access to finance, however, remains a key challenge for the EU defence industry. The reluctance from financial actors to engage with the defence industry has its roots in the perception that such investments can entail certain risks or lack attractiveness, including reasons related to Environmental Social Governance ("ESG") reasons.

Sustainable finance-related factors

There are a variety of non-governmental frameworks for ESG used to drive and report on investment decisions: certain of these frameworks explicitly exclude or present some defence-related investments as risky. The EU sustainable finance framework[3] has been set up to encourage sustainable investments through increased transparency and accountability of companies and investors on their treatment of ESG issues. It is therefore expected to have a significant influence on investment decisions within financial markets. As recalled in the Communication of 15 February 2022[4], the Commission aims to ensure that initiatives on sustainable finance remain consistent with the EU's efforts to facilitate sufficient access to finance and investment for the EDTIB. This is done, inter alia by ensuring that **investing in the defence industry is not, by default, incompatible with the EU's ESG-related standards**.

The EU established a classification of "**environmentally sustainable**" economic activities in the EU Taxonomy[5]. This work concentrated on establishing technical screening criteria for activities with the potential to significantly affect emissions. To date, **no specific defence industrial activities have been included in the EU Taxonomy.** Therefore, like a number of other sectors or activities, the defence sector cannot demonstrate Taxonomy alignment, except for some horizontal activities (building, transport…). Although the activities not included in the EU Taxonomy are not necessarily considered as

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2 The Study will be published by the Commission soon.

3 https://finance.ec.europa.eu/sustainable-finance/overview-sustainable-finance_en

4 Communication on the contribution to European defence https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52022DC0060

5 https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities_en

"environmentally unsustainable", the mere absence of inclusion (which is also the case for several other important economic activities) may be perceived by certain investors as discouraging investments in those activities. The Joint Communication on a new Climate and Security Nexus[6] acknowledges the importance of the defence industry as an important partner for the climate adaptation and mitigation efforts of Member States' armed forces. Ensuring an appropriate visibility and recognition of efforts made by the defence sector towards environmental sustainability could facilitate access to finance.

The EU has not set out a definition of "**socially sustainable**" activities. Therefore, companies and financial market participants report on social sustainability factors according to other existing frameworks[7]. However, these frameworks as well as related "socially sustainable" financial products offer limited possibilities to report on the positive indicators characterising defence-related activities such as "security" or "resilience". In that context, investors lack incentives to invest in the defence sector when striving to pursue a socially sustainable investment policy.

The EU recalled in the recently adopted ASAP Regulation[8] that "**the Union defence industry [is] a crucial contributor to the resilience and the security of the Union, and therefore to peace and social sustainability**". On 14 November 2023, EU Defence Ministers endorsed in the EDA Steering Board a Joint Statement on "Strengthening the EDTIB's access to finance and its ability to contribute to peace, stability, and sustainability in Europe"[9]. A better recognition of the notions of "security" and "resilience" as positive social criteria within EU, national ESG-related policies and other ESG frameworks could therefore improve the attractiveness of the defence sector.

The EU sustainable finance framework also requires companies[10] and investors to report on **how sustainability risks are addressed** and defines minimum social standards considered as incompatible with social sustainability. Under the Sustainable Finance

6 https://www.eeas.europa.eu/sites/default/files/documents/2023/JOIN_2023_19_1_EN_ACT_part1_v7.pdf

7 Such as the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB) or the United Nations Sustainable Development Goals (SDGs).

8 Regulation (EU) 2023/1525 of the European Parliament and of the Council of 20 July 2023 on supporting ammunition production (ASAP) OJ L 185, 24.7.2023, p. 7–25, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32023R1525 Recital 35: "In order to be competitive, innovative and resilient, as well as to be able to ramp up its production capacities, the EDTIB needs to access both public and private financing. As provided in the communication of the Commission of 15 February 2022 entitled 'Commission contribution to European defence', Union initiatives on sustainable finance remain consistent with the Union's efforts to facilitate the European defence industry's sufficient access to finance and investment. In that context, the Union's sustainable finance framework does not prevent investment in defence-related activities. The Union defence industry is a crucial contributor to the resilience and the security of the Union, and therefore to peace and social sustainability. Within Union initiatives on sustainable finance policies, controversial weapons subject to international conventions prohibiting their development, production, stockpiling, use, transfer and delivery, and signed by Member States, are deemed incompatible with the requirements of social sustainability.[…]."

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

10 Under the Corporate Sustainability Reporting Directive, large companies and all listed companies are required to disclose information on what they see as the risks and opportunities arising from social and environmental issues, and on the impact of their activities on people and the environment. Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting OJ L 322, 16.12.2022, p. 15–80, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32022L2464

Disclosure Regulation (SFDR)[11], financial undertakings must report on their "Exposure to controversial weapons"[12], which are deemed incompatible with sustainability[13]. Apart from these activities prohibited by international conventions, **all defence-related activities in general are not as such considered by the EU as incompatible with social sustainability**. Nevertheless, it appears that some investors continue, as they have done for some years, excluding defence-related activities on the grounds of social sustainability considerations (even if all other aspects of social sustainability, such as treatment of workers for instance, may be respected).

In that context, providing **further guidance to the financial sector (including insurers)** on how to assess "sustainability risks" in the defence sector could contribute to support investments. **Fostering a greater mutual understanding** between the defence sector, government authorities and the financial sector, would help to address these challenges. The Governmental Expert Network on ESG, managed by the EDA, is one example of platforms where such mutual understanding and trust could be further developed.

National rules, such as national ESG schemes, also influence private investments through national ESG schemes. For example, today several nationally elaborated ecolabels for financial products exclude investments in retail financial products (e.g. funds, obligations) investing in companies active in the defence sector.

Financial factors and market structure

Other reasons for the **reluctance to invest** in defence industrial activities, despite the high-growth potential of the defence market, can be the **dependency on public contracts** or on large prime contractors which can be perceived as limiting market opportunities. This is combined with the **complexity of defence procurement** and the long timespan of military programmes. In addition, the defence sector is highly regulated (for production, to export, use, access to information, etc…). The perceived complexity of such regulatory framework, linked with the sensitivity and confidentiality of information in the defence sector may also add obstacles to the willingness to invest or provide financing. There seems to be a **lack of understanding of the sector-specific regulations** among the financial actors which affect them in their willingness to engage towards the defence industry. Providing further guidance on the specificities and functioning of the defence market could stimulate investments in the sector.

From the standpoint of equity investors, accurately evaluating the technologies being developed and identifying the potential growth trajectories, can appear challenging. In addition, equity investors are also concerned by the constraints posed on their exit strategy, notably due to limited funding opportunities in the EU for growth stage investments. Developing an ecosystem of investors able to invest in growth stages, facilitating listing on stock exchange or partnering with EU industries, could also encourage early-stage investors.

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[11] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (Text with EEA relevance) OJ L 317, 9.12.2019, p. 1–16. https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32019R2088

[12] "anti-personnel mines, cluster munitions, chemical weapons, and biological weapons, as defined in the Commission Delegated regulation (EU) 2022/1288 of 6 April 2022

[13] See Question 'How does the sustainable finance framework apply to access to private funding for the defence industry? in the EU Taxonomy Q&A. https://ec.europa.eu/sustainable-finance-taxonomy/faq

Questions:

⇨	*How could the EU and the Member States help incentivising and de-risking investments in the defence industry?*
⇨	*How to better integrate and recognise, security and resilience as positive criteria into sustainable finance policies, and investment policies?*
⇨	*How to provide guidance to the financial sector on how to assess sustainability risks in the defence sector? What would be the respective role of the EU, Member States, the defence industry or other actors?*
⇨	*How could the defence industry's transparency on ESG-related performance, in particular social and governance, be enhanced to facilitate access to finance? Could a dedicated industry-wide, voluntary Code of conduct be useful?*
⇨	*How can the defence industry's contribution to environmental sustainability be increased and made more transparent to facilitate access to finance (e.g. possible future consideration of specific activities of the defence industrial sector within EU instruments such as the EU Taxonomy)?*

3. Better access to EU funds

Funding implemented through Member States

While Article 41(2) of the Treaty on European Union (TEU) excludes the use of the EU budget arising from operations having military or defence implications, support to the defence industrial sector is **not excluded from the scope of Union funding. The sector can benefit from funding from the EU budget** provided that they pursue genuine objectives of EU policies (e.g. industrial policy or cohesion, namely Articles 173 or 174 of the Treaty on the Functioning of the European Union (TFEU)) and respect Article 40 TEU on non-affectation of Common Foreign and Security Policy (CFSP)/Common Security and Defence Policy (CSDP) measures. For instance, the European Structural and Investment Funds (ESIF) may be used by Member States in the defence sector if they contribute to the objectives of the fund.[14] As also stated by the European Defence Action Plan[15], **the defence industry can contribute to the goals and the objectives set in the ESIF**, such as promoting the development of regional economies, representing a high investment multiplier on skills, jobs, technological and economic development. More recently, EU defence industrial actions have been also funded under instruments adopted under Article 173 TFEU on the EU industrial policy (EDIDP[16], EDF[17], ASAP and EDIRPA[18]).

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14 ERDF co financed in Poland project of trainer aircraft for Polish Air Forces Project 'Creation of prototype of training aircraft Orlik TC-III with integratedavionic system'. The project consisted of the creation of a prototype, as a result of R&D, of a substantially improved trainer aircraft. Other examples of Cohesion policy funds financing are e.g. the support for Military Technical Academy to develop teaching and R&D base, and for some other companies to participate in defence industry fairs.

15 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A52016DC0950

16 Regulation (EU) 2018/1092 of the European Parliament and of the Council of 18 July 2018 establishing the European Defence Industrial Development Programme aiming at supporting the competitiveness and innovation capacity of the Union's defence industry OJ L 200, 7.8.2018, p. 30–43, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32018R1092

17 Regulation (EU) 2021/697 of the European Parliament and of the Council of 29 April 2021 establishing the European Defence Fund and repealing Regulation (EU) 2018/1092 OJ L 170, 12.5.2021, p. 149–177, https://eur-lex.europa.eu/eli/reg/2021/697/oj

18 Regulation (EU) 2023/2418 of the European Parliament and of the Council of 18 October 2023 on establishing an instrument for the reinforcement of the European defence industry through common procurement (EDIRPA), OJ L, 2023/2418, 26.10.2023. https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32023R2418

Nevertheless, and even though the defence industry is *de jure* eligible for most of the EU funding programmes, there seems to be **a lack of awareness** of the possibility for Member States to support the defence industrial sector through these EU instruments, leading to a significant **under-utilisation of funding opportunities**[19].

There seems to be a perception among the Member States, and the managing authorities that there are legal obstacles to support the EU defence industry through these funds. The same approach seemingly governs the implementation of the Resilience and Recovery Facility. These obstacles should be addressed, including by better explaining and promoting these funding opportunities, in order to ensure that they can fully benefit to the defence sector.

Access to EU Financial instruments

By de-risking investments, Union support channelled through budgetary guarantees **can address some of the prevailing market failures**, both by providing direct support or **acting as a catalyst for private investments**. The EU deploys financial instruments under InvestEU mainly through the European Investment Bank (EIB) Group (the Group includes the EIB itself and the European Investment Fund (EIF)), and to a more limited extent through other multinational or national promotional banks and institutions. "Defence" is an eligible, and strategic sector, under InvestEU. The Commission proposed to top-up InvestEU to create an instrument ("Defence Equity Facility") providing, through the EIF, equity to venture capital or private equity funds investing in defence-related technologies with dual-use potential. ASAP also provides for the possibility of creating a Ramp-up Fund in the form of a blending facility offering debt solutions, in order to leverage, de-risk and speed-up investments needed to increase manufacturing capacities.

However, exclusion policies on core defence activities applied by public banks, such as the EIB Group[20] as well as certain National Promotional Banks (NPBs) and Financial Institutions, **hinder the ability of the defence sector to fully benefit from EU financial instruments**. Indeed, because they provide financing through other commercial banks (intermediated finance) or simply because they constitute **a reference on the market**, public banks also strongly influence the investment strategy and exclusion policies of the private financial market.

In this context, **ensuring that public banks, including the EIB Group, can more assertively invest in defence-related activities (and not only in dual use like today) would significantly improve access to finance for the defence sector across the EU**, in particular for SMEs. The EIB Group's role, as the EU's bank, is to provide finance and expertise for investment projects that contribute to EU policy objectives. Having an EU-wide mandate, the EIB Group plays a key role in addressing market failures across the EU, filling a gap traditionally neither met by the commercial banks, nor by NPBs, which often only invest on their own territory. As defence industrial policy has entered the realm of EU policies, the EIB "should enhance its support to the European defence industry and joint procurement beyond its ongoing support for dual use, where such investments would

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[19] In this context, the EDA established an EU funding gateway and developed and continuously maintains an online tool called IdentiFunding. allowing any defence stakeholder to identify existing funding opportunities at European level potentially available for their defence-related projects. https://eda.europa.eu/what-we-do/eu-policies/eu-funding-gateway

[20] Similar to most other Multilateral Development Banks and International Financial institutions

clearly serve to implement the Strategic Compass priorities",[21] as recalled by the co-legislators in the ASAP Regulation[22]. Change of exclusion policies, and development of defence-specific financial products, would give a strong positive signal to the market. EU Member States have a key role in defining these policies.

Questions:

- ⇨ *How can we promote a more effective access of EU defence industry to relevant EU funds and instruments (e.g. ESIF, etc.)? Notably, how can it be ensured that the EDTIB needs are more systematically taken into account in the programming of these funds and instruments?*
- ⇨ *What type of financial products would be most appropriate to improve access to finance for the defence sector (equity, debt, debt guarantees; direct or indirect financing etc…)?*

4. Skills in the defence industry

Skills is **a critical issue for the competitiveness of the EU defence industry**, and its ability to deliver defence capabilities to the European Armed Forces, especially to meet Member States' increased capability requirements after the Russian aggression in Ukraine. At the same time, **the EDTIB faces a substantial skills shortage**, both for R&D and production. Skills is an issue for all ecosystems in the EU, and several initiatives have been launched the last few years, e.g. the Pact for Skills, the Blueprint projects and the European Year of Skills for 2023-2024. A recent Eurobarometer survey showed that this is, by a large majority, the **most serious problem companies of all sizes are facing today**[23]. There are reasons to believe that the situation is worse in the defence industry than in many other sectors, which **strongly affects the capability of the industry to ramp up**.

Different factors further exacerbate the situation. For instance, demographic factors, a lack of diversity and inclusion as well as the challenge of retaining workforce are affecting the skills availability[24]. In this regard, it should be noted that other sectors, such as automotive or ICT, are investing in the same skillset as the aerospace and defence industries. Therefore, measures need to be taken, including by industry, to retain the workforce while pursuing cross-fertilisation and collaboration with other sectors accordingly.

In addition, a perceived lack of attractiveness of the whole industrial sector, and the defence industry in particular, contribute to worsening this shortage. Moreover, the defence labour market is almost exclusively aligned on national bases, as nationality often is required for employment within the defence industry, at least for certain positions.

The skills shortage cannot be solved by the companies themselves on an individual basis. There is a risk that this shortage could lead to a loss of industrial and technological

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[21] Any enhancement of the role of the EIB in security and defence has to be done within the framework of Article 309(1) TFEU, which defines the task of the EIB as follows: "The task of the European Investment Bank shall be to contribute, by having recourse to the capital market and utilising its own resources, to the balanced and steady development of the internal market in the interest of the Union."

[22] ASAP Regulation Recital 35

[23] https://europa.eu/eurobarometer/surveys/detail/2961

[24] A recent study by the European Commission showed that 53.4% of surveyed professionals had been victims of discrimination at least once (https://defence-industry-space.ec.europa.eu/equality-diversity-and-inclusion-aeronautics-defence-and-space-industries_en)

capacity and/or wage price inflation and associated increased costs in the sector, a lack of competitiveness in the medium-/long-term and, ultimately, to a weakening of the EDTIB, with the subsequent inability to meet the required ramp-up and the development of state-of-the art capabilities. It will require a collective effort by industry, Member States and the European Union to improve the skills situation, respecting titles IX and XII of the TEU. The role of the Member States is of particular importance, since they have the main responsibility for employment and education, as well as for the implementation of a large part of EU funding (see above). The European Commission can support the activities of Member States and industry.

A 2019 report by RAND for the European Commission showed that the EDTIB has a shortage in technical skills (e.g. STEM, cyber, and new technologies such as AI), as well as management/marketing (mainly for SMEs) and domain specific skills.[25] When it comes to technological skills, there are many synergies with other ecosystems, but very few defence specific educational providers. Indeed, for the domain-specific skills, there is a limited number of education providers, and these skills must often be achieved through on-the-job-training, which may take several years. In this regard, a comprehensive understanding of technology trends impacting defence is key for educational providers to plan such specific trainings.

A **greater offer of defence-specific education and training curricula**, in all domains and types of skills, including shorter courses, would improve the skills situation in the defence sector, e.g. by shortening the time needed for on-the-job training and increase its attractiveness among young people. Such courses could be developed through a collaboration between governments, industry, and educational providers (e.g. universities, vocational training centres) and through international cooperation. Governments can act as facilitator for the realisation of these partnerships which would have a positive impact on employment rates and the overall economy.

Questions:

- ⇨ *What actions could be taken by different stakeholders, including the industry itself, to increase the diversity and the attractiveness of the EDTIB?*
- ⇨ *Could the educational and training systems of the Member States better contribute to the availability of the requisite skilled workforce?*
- ⇨ *How can the workforce mobility in EDTIB between Member States be improved? Should we also consider measures to promote that Ukrainian workforce be trained in EU defence companies and vice versa?*
- ⇨ *What actions could be taken to rationalise production and shorten the on-the-job-training time, e.g. through investments, including in AI, for defence-related education and training?*
- ⇨ *How to ensure stronger partnerships between defence industry and educational providers? Which role could and should be played by Member States? Could a dedicated defence community within the European Institute of Innovation and Technology (EIT) and Knowledge and Innovation Communities (KICS) be an option?*

[25] Vision on defence related skills for Europe today and tomorrow, RAND, 2019

5. Regulatory environment

The EDTIB, as any other EU industry, is subject to EU and national regulations that usually have a general scope. Even though certain defence-related exemptions may be actionable, these regulations may have **unforeseen consequences for the defence industry** and therefore to the resilience and security of the Union, that were not necessarily considered from the outset. The regulatory environment may thus create additional and sometimes unintended hurdles for the EU defence industry, while also offering ways to improve and modernise in line with core priorities (digitisation, green transition, critical infrastructure resilience, etc).

As a rule, any exemption from regulations should be kept to a minimum, and only applied when strictly necessary. This is especially true for those regulations aiming at improving the protection of human health and environment or achieving a sustainable and safe development. Exemptions or simplifications for the defence sector could be warranted but only on a strictly exceptional basis, justified by its specific needs to deliver on the security objective, without having an adverse effect on other objectives. Also, there might be situations where although exemptions can be triggered, the economic viability of the activity at issue would be undermined by the 'niche' dimension of defence-related demand (for instance, the ban on lead for civilian ammunition could affect the viability of military production chains), calling for other policy responses.

It is thus essential to **identify the origin of any potential regulatory obstacles (or practical obstacles stemming from regulations) faced by the defence industry**, being at national or EU level, and how they could be addressed within but also beyond the application of regulatory solutions. This is why the Commission services are calling for evidence on the precise nature of obstacles faced by the defence industry.

Questions:

- ⇨ *Are there any specific aspects of the EU regulatory environment which hamper the EDTIB's ability to contribute to the EU defence readiness? Please describe those regulatory hurdles in detail, with specific examples, and indicate why the consequences are specific to the defence industry (and not general in nature).*
- ⇨ *To what extent are those obstacles attributable to the EU regulatory environment itself and to what extent they are attributable to the implementation at national level? Please explain why those regulatory problems could not be solved through existing derogations.*
- ⇨ *How could those possible regulatory hurdles be overcome to facilitate the EDTIB's ability to contribute to the EU defence readiness, while, at the same time, not jeopardising other EU common objectives? What solutions could there be apart from regulatory exemptions?*