ESG and Defence Finance: Cutting the Gordian Knot with ESGR

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The European Commission should use its regulatory power to cut through the tangled knot of Environmental Social and Governance (ESG) standards that undermine the European defence industry's capacity to finance arms production. ESG clearly should not prevent financing arms production to ensure national self-defence. Yet, 'bureaucratic mission creep' has infected ESG principles, making it difficult for weapons producers large and small to obtain funding. The European Commission can address this problem by the adoption of a short, carefully worded EU regulation that would provide a partial legislative redefinition of ESG. This would include resilience, defined to entail funding for the defence production for national defence, the defence of NATO allies, or for states subject to or threatened with an attack that violates Article 51 of the UN Charter within the European continent. Enacting such an ESGR regulation would turn ESG into an ally for defence funding, rather than a barrier to it.

Environmental, Social and Governance (ESG) investment criteria started out as a legitimate way of seeking to strengthen corporate social responsibility. Common ESG standards were established for investors and those standards influenced both investors and the firms they invested in. The ESG movement has expanded exponentially over the past two decades, so that over $30 trillion of assets are now managed under ESG principles, which are substantially drawn from the Paris Agreement on climate and the UN 2030 Sustainable Development Goals.

In theory, defence industries should not be penalised by ESG standards, as these standards pertain to environmental, social and governance issues, not defence. However, almost all ESG policies operated by public and private institutions prohibit funding certain types of weaponry (such as anti-personnel mines) and/or the funding of weaponry to states with poor human rights records, at the very least. Thanks to 'bureaucratic mission creep', these defence exclusions have over time expanded to exclude funding for practically the entire defence sector. Defence is in effect placed in the same ESG 'bad' investor category as real harms such as the funding of pornography, addictive drugs, tobacco or gambling.

These ESG restrictions are a serious threat to European security when there is a large-scale state-on-state war in process on the continent. European governments know that even if a ceasefire is achieved in the current Russo-Ukrainian conflict, Moscow will continue building its war machine, which it may well use subsequently against EU territory.

In this context, EU member states desperately need to rebuild and strengthen their capacity to defend themselves and each other. Despite the clear and present security dangers facing the Union, European public and private banks have refused to change their position on ESG.

European defence firms have continued to find it difficult to obtain funding despite the ongoing security crisis. For example, even as the external security situation has worsened, the European Investment Bank (EIB) has resisted funding lethal weaponry. This remains the case even after Commission President von der Leyen tabled her ReArm Europe proposal, which would involve raising common EU funds for defence amounting to €150 billion. The EIB appears to be concerned that any change to include funding for lethal weaponry would undermine the bank's triple A status.

The banking industry's refusal to recognise Europe's extremely dangerous security situation requires a decisive response from the EU institutions. EU member states have to send a strong political signal to the finance sector to show they are determined to remove barriers to defence funding, underpinned by EU legislation that makes funding easier to obtain for defence companies. What is proposed here is a short, carefully worded EU regulation which would permit capital to flow to the European defence sector.

The principal aim of the EU regulation would be to establish a partial redefinition of ESG. That means it would not provide a complete legislative definition of what constituted ESG. Rather, it would seek to add to the definition of ESG by including resilience within all existing ESG standards and protocols on principles applied by banks operating on Union territory. It would then also provide a definition of resilience. Over the last decade, resilience factors have become embedded in national security discourse. That discourse has included a broad range of resilience factors including emergency management, protection of critical infrastructure and conflict management, as well as defence capacity. Resilience as a concept also dovetails and indeed overlaps with existing ESG standards and principles, particularly in respect of climate change and global development. The definition would draw from this discourse to establish a broad definition of resilience.

The regulation would then go on to explicitly provide that ESGR included funding for the defence sector. Defence sector funding under ESGR would be funding for defence goods and services for national defence, for the defence of NATO allies, or for states subject to or threatened with an attack that violates Article 51 of the UN Charter within the European continent, such as Ukraine.

In an annex to the regulation, goods and services that fall under the new definition would be further specified. This annex could include a non-exclusive list of defence goods and services to provide greater specificity as to the type of goods and services that the Union saw as critical to the security of the Union and its member states. The Commission would be granted delegated powers by the Union legislature to periodically amend the list in the annex as technical and security demands require.

The legislation would act to insert the new resilience standard into all existing ESG standards and principles deployed by public or private financial institutions. This new ESGR standard would affect all existing and future ESG protocols, providing direct legislative guidance to the financial sector. The regulation creating an ESGR standard would also provide a strong political signal from the Union to the financial sector and to defence companies that funding should be available for national defence and for the defence of our allies.

Before legislation touching upon the defence sector can be proposed and adopted, however, they must have a legal basis under the Treaties. It is true that the scope of Union law in the defence sector is restricted by Article 346 of the Treaty on the Functioning of the European Union (TFEU). However, those restrictions only cover the transfer of national security information and the production or trade in arms. The Charter of Fundamental Rights in the European Union (CJEU) has narrowly construed both these aspects of Article 346 TFEU and has required objective justification.

There is a compelling argument that the Commission could table this proposed legislation as a Single Market legislation under Article 114 TFEU. The argument here is that this is a measure involving the free movement of capital. With greater demand for defence products and services across the Union and differing ESG standards, this legislation would be a proportionate response to providing a common basis for the application of such standards in the ESG sector. Additional and alternative legal support can be found elsewhere, including in Article 173 TFEU dealing with the EU's development of industrial policy, which has been deployed as a legal base to establish the European Defence Fund (EDF). It has also been deployed alongside Article 114 in respect of the proposed collective legal base for the European Defence Industry Programme (EDIP).

The advantage of enacting legislation to partially redefine ESG to become ESGR should be clear. The proposed EU regulation would be adapting ESG to enhance the Union's capacity for resilience, including for self-defence purposes, so that it can no longer act as a barrier to defence funding across the European banking sector. In addition, the entire existing ESG machinery across all European financial institutions would then have to take account of the defence sector in its funding and investment operations as part of their ESG investment profiles. The EIB, for instance, would find it difficult to sustain its argument that its triple A credit rating and reputation were threatened if it provided funding for lethal weaponry. Once the EU regulation came into force, re-defining ESG as outlined above would include lethal weaponry for the purposes of national defence. All public or private financial institutions on Union territory would be bound by that definition and need not worry about this type of funding impacting their credit ratings and reputations.

The Union's external security situation is deteriorating, and all EU member states and their allies need to strengthen their defence sectors, and find the funding to do so. Clearly, funding one's own defence and that of one's democratic allies should not be a violation of any sane ESG standard, but the impact of 'end of history' thinking has turned ESG as operated by the European banking sector into a menace to European security. The solution is clear – cut the Gordian Knot.

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