EBF Policy Note

The Role of Banks in Financing the EU Defence Industrial Base

1. Introduction

In response to shifting geopolitical and economic realities, **EU political leaders have recognised the need to strengthen Europe's defence readiness.** From an industrial viewpoint, capability gaps and structural disconnects in the Union's own capacity have underscored the necessity to grow the European Defence Technology and Industrial Base (EDTIB) and support the development of a more responsive, integrated, and resilient supply value-chain. Against this backdrop, **promoting and streamlining access to finance for European defence companies** has emerged as a high-priority topic on the EU policy agenda.

It is worth recalling that the EU and its Member States have been actively shaping a **coordinated policy response**:

- First, through the adoption of multiple initiatives, such as: the European **Commission's European Defence Industrial Strategy (EDIS)**, the **European Defence Fund (EDF)**, the **EU Defence Innovation Scheme (EUDIS)**, **European Defence Industry Reinforcement through common procurement (EDIRPA)** and the **Act in Support of Ammunition Production (ASAP)**, with notable initiatives like the **Defence Equity Facility**.
- Second, with the release of the Commission's **White Paper on "*The Future of European Defence*"**, outlining the goal of enhancing industrial competitiveness and supply chain resilience as part of the Readiness 2030 Agenda, and of **ReArm Europe**, focusing on leveraging all financial tools to help Member States increase defence public spending, including further engagement by the European Investment Bank, and mobilise of private capital.
- Third, on June 17th, the European Commission issued its proposal for a **Defence Readiness Omnibus**. The package is set *to "support Member States' efforts to strengthen the defence industrial base and the EU's overall defence readiness and agility by 2030, by creating the necessary conditions to frontload investments in defence capabilities, providing necessary predictability to industry and reducing red tape"*. By 2030, therefore, the EU aims to ensure that its defence sector can rapidly respond to crises, sustain high-intensity operations, and reduce dependence on external suppliers.

Against this background, the **European Banking Federation (EBF) fully recognises the importance of a pan-European dialogue on upscaling and financing Europe's security and resilience**. The EBF stands ready to continue contributing to the discussion on building a more integrated and resilient European Defence Technological and Industrial Base and fostering access to finance, growth, and investment opportunities for companies of all sizes.

1.1 Objective of the Note

This EBF Policy Note **provides a high-level overview of key EBF considerations**. The document does not aim to shed a comprehensive light on all aspects of defence industries' operations and their financing in the EU. Rather, it conveys essential descriptive elements of the main views, activities and initiatives by banks in the defence industrial space.

The paper features two parts: (i) an overview of **key messages** and (ii) a short **descriptive section** introducing the context of banking operations in the defence space.

European Banking Federation aisbl

Brussels / Avenue des Arts 56, 1000 Brussels, Belgium / +32 2 508 3711 / info@ebf.eu
Frankfurt / Weißfrauenstraße 12-16, 60311 Frankfurt, Germany
EU Transparency Register / ID number: 4722660838-23

www.ebf.eu

2. EBF Key messages

2.1 The EBF fully recognises the importance of the EU's objective of strategic autonomy in the defence sector, and urges policymakers to consider a strong and competitive banking sector as key to its achievement.

The banking sector remains at the **centre** of the EU's **growth strategy** and continues to play its **strategic role** in meeting the challenge of financing a more resilient, secure, competitive and prosperous Union. In the defence space, **this commitment is reflected in recent initiatives, such as the revision of internal exclusion policies and guidelines for funding entrepreneurship in the defence sector**.

It is important to note that, whilst EU legislation does not impose internal self-exclusion policies, these have been voluntarily adopted by some credit institutions based on different criteria, including reputational risk (which affected -and sometimes still does affect- banks in some member States when financing companies active in the defence sector). As mentioned above, many **European banks have been revising such exclusion policies** in reaction to the shifting geopolitical landscape. However, the EBF emphasises that, as different banks may have diverse roles, responsibilities, business strategies and stakeholder expectations, each institution needs to retain the necessary scope to develop and define its specific market positioning in the defence space, as this is still often subject to public, political and stakeholder scrutiny.

2.2 The EU regulatory framework is broadly supportive of defence financing.

The EBF considers that **the EU regulatory framework**, including ESG regulation, **does not pose any specific barriers for banks to provide financing to companies in the defence industry**.

In fact, banks lend to defence firms, as they do to other sectors, considering elements such as business viability and steering their lending and investment activities based on commercial considerations (i.e. bankability, risk, cash flow, etc) and dedicated models for ESG targeting and alignment (e.g., SBTi).

2.3 While there are no regulatory barriers, improvements are possible.

Where appropriate in targeted areas, additional guidance (and similar relevant initiatives) could contribute to facilitating further financing to these enterprises. It is not a matter of removing EU regulatory obstacles, but rather a matter of **fine-tuning** the legal ecosystem to make the process smoother. Preliminary views in this regard will be better described in the following section, with the intention of creating investment-ready markets by consolidating demand, issuing clear procurement signals, and reducing financial risks (this requires coordinated public spending, targeted state aid, public-private partnerships, and adjustments to procurement regulations).

3. Key concepts for understanding the role of banks in financing Europe's defence sector

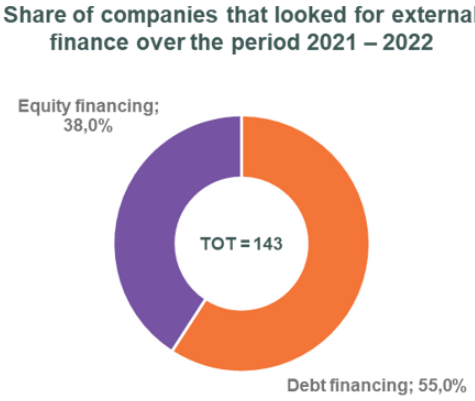
To contextualise the role of banks in the financing of the defence sector, it is helpful to recall -from a more general standpoint- several key concepts describing both the basics of the commercial banking business model, as well as some high-level features of the EU defence technology and industrial base. These concepts help better illustrate how capital is intermediated towards the sector, how risks are assessed, and what legal and regulatory obligations may come into play.

3.1 Distinguishing Bank Loans and Equity Financing

In the context of corporate access to finance, one crucial distinction to be recalled is that between **credit-based** and **equity-based financing.** These two forms of financing cater to distinct needs and involve different risk profiles, regulatory considerations, and financial structures that are relevant to any production sector of the economy.

Bank loans, provided by credit institutions, require repayment and are often secured against tangible assets, making them more appropriate for established companies with a more consolidated financial

record and available tangible collateral. Equity financing, by contrast, involves investors providing capital in exchange for ownership stakes, taking on higher risk for the potential of long-term returns. This form of **risk capital** is particularly suited for **high-growth**, **innovative SMEs**, which often rely on intangible assets and lack sufficient collateral at an early stage.



Source: CSIL / SpaceTec Partners

In fact, access to risk capital is especially relevant for firms developing technologies with **long development and R&D cycles**, which require patient capital. For such companies, external support through equity and quasi-equity instruments can play a critical role, at and beyond the initial seed stage. Integral to growing equity investments in innovative firms, the **Savings and Investments Union (SIU)** aims to develop and integrate EU Capital Markets to ensure that EU businesses can access capital and more diverse financing options.

As recognised by a survey-based study of November 2024 by the European Commission's Directorate-General for Defence Industry and Space (DEFIS)[1] SMEs in the defence sector primarily require financial support for their R&D activities and the commercialisation of new products and services. This underscores their high level of innovativeness compared to other sectors.

Against this background, the study finds that debt financing, primarily in **bank loans, has constituted the leading choice of external financing source by defence SMEs**.

To support growth and innovation in the defence sector, therefore, it becomes all the more necessary to make tangible progress on the facilitation of growth capital and risk equity investments under the SIU agenda.

Furthermore, innovation within the defence industry frequently originates from small, rapidly growing, and heavily leveraged companies. Such companies are particularly disadvantaged by the **ECB Guide on Leveraged Transaction**s, which places blanket restrictions on lending to highly indebted firms—without adequately accounting for their growth potential or innovative capacity. This represents not only a disproportionate interference in the business strategies of banks but also complicates access to financing during a critical phase in a company's development.

3.2 The Key Role of Public Spending

Integral to sustaining demand for defence capabilities and assets, public spending is certainly the focal point for growing and aggregating procurement efficiently and at scale. The defence sector relies on public procurement and spending policies to grow, and Member States' defence budgets continue to be the EDTIB's main source of funding[2]This is particularly true for the financing of larger defence companies, which comes mostly from governmental contracts.

1 European Commission: Directorate-General for Defence Industry and Space, Access to equity financing for European defence SMEs, Publications Office of the European Union, 2024, https://data.europa.eu/doi/10.2889/698738

[2] European Parliamentary Research Service, Financing the European Defence Industry, EPRS Briefing PE 762.383, European Parliament, 2024, https://www.europarl.europa.eu/RegData/etudes/BRIE/2024/762383/EPRS_BRI(2024)762383_EN.pdf

Notably, long procurement cycles and delayed payments from prime contractors create cash flow issues for SMEs in the defence supply chains. Often, the return-to-risk ratio is too low. Smaller defence companies encounter common issues faced by other smaller businesses; they often lack a strong order book and tend to suffer from a rather incomplete industrial infrastructure. Factories have to be built for mass production, which is very expensive and thus risky. Private investors alone may not be willing and/or able to take these kinds of risks, particularly when long-term demand from governments is uncertain and not formalised in the respective contracts.

Therefore, while banks act as enablers and providers of services for the different operators composing the defence industrial supply value-chain, it is important to keep in mind the essential role that efficient, predictable and aggregated public spending plays in creating the attractive conditions for the mobilisation of private capital suggested in the ReArm EU proposal. It will be of particular importance, therefore, to ensure more predictability of procurement lead times.

Equally, greater focus should be placed on accelerating processes and adapting mandates within existing guarantee or insurance schemes—such as those offered by the EIB or other investment banks like the NIB—to enable stronger involvement of private banks and their capital, thereby creating a multiplier effect, rather than relying solely on the limited capacities of direct public or DFI funding.

For instance, to support growing scale, the EIB mandate could be expanded to include more defence investments (e.g. weapons and ammunition), encouraging operations involving financial intermediaries, to better reach SMEs. These could be done through dedicated funding, through guarantee schemes or other instruments, with flexible structuring options and by simplifying the eligibility criteria to access EIB defence and security tools, which are currently complex, cumulative, and primarily geared towards dual-use activities.

3.3 How do banks finance companies operating in the defence sector?

Both from an operational and a financial point of view, access to bank credit for companies in the defence sector does not differ from that of companies active in other sectors. Before providing financing to a company, banks go through a structured review process to ensure compliance with legal, regulatory, and risk management requirements. These key steps typically include:

- **Legal compliance**: Banks must ensure the company complies with national and international laws, including arms export controls, sanctions regimes, anti-money laundering (AML) rules and ESG criteria. Banks check that the company holds valid licences and is not involved in banned or controversial weapons.
- **Due diligence**: Banks conduct detailed background checks on the company, including ownership structures, business operations, clients, and countries of operation. This is to assess whether the products or services could be misused or diverted to sanctioned or high-risk parties.
- **Financial risk assessment**: This includes reviewing the company's financial statements, cash flow stability, and exposure to political or procurement risk, such as heavy reliance on government contracts.
- **Reputational risk assessment:** banks evaluate whether financing the company could pose reputational risks, notwithstanding AML and export controls, that significantly mitigate it. For example, reputational risk concerns could still rise due to involvement in sensitive areas of the defence industry or business in conflict-prone regions.

Examples above represent key decision points throughout the credit generation process. These ensure that banks operate within the law, evaluate and manage potential risks, and make informed decisions about lending to companies. Oftentimes, therefore, if loans to defence companies are rejected, this is due to regular financial risk assessments, rather than regulatory obstacles – especially if considering EU law. In fact, specificities of the defence sector (such as export controls) are traditionally exposed to national security rather than the EU's sphere of competences.

3.4 The International Framework on Controversial Weapons and Dual-Use Defence Companies

The generic term of **controversial weapons**, although not officially defined in the law, refers to weapon systems that are either banned or heavily restricted under international treaties due to their indiscriminate, inhumane effects and disproportionate capacity to inflict civilian casualties. These include biological and chemical weapons, anti-personnel landmines and cluster munitions. In line with international law**, banks apply strict policies** to avoid supporting any activities linked to such weapons, excluding financing or

investment in companies involved in the production or distribution of weapons systems banned under international law.

However, it is important to keep in mind that the international legal framework does not have a single, uniform scope of application. Rather, it requires careful interpretation, as not all states are signatories to the same treaties and therefore are not necessarily subject to the same set of binding rules — leading to what are often referred to as "variable geometries."

Ambiguity around the classification of said banned/ controversial weapons across Member States may therefore bring uncertainty and compliance complexity to financiers. One such example is that Defence companies that are involved in "controversial weapons" are excluded from EU climate benchmarks and ESG-labelled funds under SFDR. At the same time, Article 12 of the Delegated Benchmark Regulation includes "companies involved in any activities related to controversial weapons" as a part of the exclusion list from the development of benchmarks. The scope of these (exclusion) definitions does not appear to be fully harmonised at the EU level. These pieces of regulation contain different definitions (e.g., with the BMR delegated act referring to a broad "any activities").

Furthermore, identifying companies involved in the production of controversial weapons can be complex, particularly given the nature of the defence industry in Europe, where many companies operate in both civilian and military markets. Rather than being dedicated arms producers, most firms active in the European defence sector are part of a wider industrial supply chain, providing components, systems, or technologies that can be used for both purposes. These so-called "dual-use" companies may contribute to defence projects while also manufacturing goods for commercial use. As a result, defence financing decisions often require a case-by-case assessment of the nature and scale of a company's defence-related activities within its broader business model.

Against this background, the EBF recognises that the proposed Omnibus on Defence attempts to address this issue by replacing the term "controversial weapons" with "prohibited weapons," clarifying that the types of weapons to be excluded from sustainable investment benchmarks under the Benchmark Regulation are those "prohibited by the international arms conventions to which the majority of Member States are party." While this seeks to respond to demands from investors and industry stakeholders for greater clarity, it still does not provide a precise and uniform definition, leaving room for divergent interpretations. The EBF therefore suggests working within such a proposal to further establish unambiguous definitions at the EU level.

About the EBF

The European Banking Federation is the voice of the European banking sector, uniting 33 national banking associations in Europe that together represent some 3,500 banks – large and small, wholesale and retail, local and international – employing about 2,7 million people**.**

EBF Contacts

Jacopo Borgognone
Senior Advisor, Savings and Investments Union
j.borgognone@ebf.eu
+32 (0) 474 98 2265