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## Defending Europe in the Age of ESG: Legal Tensions Between EU Defence Spending and Sustainable Finance Regulation

Driven by the urgent need for stronger collective security, the EU has entered a new era of defence cooperation and investment. The Russian Federation's invasion of Ukraine in February 2022 was as a catalyst for a decisive shift in the EU defence policy. In response, the Versailles Declaration of 11 March 2022 marked a strategic turning point with Member States committing to substantially increase defence spending and enhance cooperation in defence investment.

The European Defence Agency's 2023 Defence Data report highlights the scale of this shift. Defence expenditure across the EU reached an unprecedented €279 billion, representing a 10% year-on-year increase and extending a nine-year trend of continuous growth. In March 2025, the European Commission introduced its ambitious ReArm Europe Plan/Readiness 2030 strategy aiming to mobilize over €800 billion in defence spending. Historically, sustained public investment has sparked private-sector interest, especially when it signals long-term policy commitment and demand. This dynamic is now taking hold in the defence sector, with growing private interest in dual-use technologies, supply chain participation, and co-financing opportunities linked to both national and EU-level procurement.

But just as Europe ramps up its defence ambitions, established EU sustainable finance frameworks may clash with these ambitions. Under current EU policy, *sustainable finance* refers to financing that supports economic growth while minimizing environmental impact, contributing to the climate and environmental goals of the European Green Deal, and integrating social and governance considerations<sup>[1]</sup>. While defence investment is now politically prioritised and increasingly backed by public funds, its alignment with existing environmental, social, and governance (ESG) frameworks remains limited. This raises key legal and policy questions about how "sustainable investment" should be interpreted in today's shifting geopolitical context.

Funds disclosing under Article 8 of the Sustainable Finance Disclosure Regulation (SFDR) are not prohibited from investing into the defence sector, provided they comply with their investment strategy and minimum asset allocation to meet the promoted environmental or social characteristics. Also, SFDR remains neutral on the type of investment strategies such funds may use. In practice, exclusion strategies remain the most widely used ESG strategy in Europe. Many Article 8 funds apply exclusion lists, which is often driven by institutional investors' or stakeholders' preferences restricting or prohibiting investments in defence. Such exclusions are typically embedded in investment mandates, ESG policies and fiduciary guidelines of institutional investors and reflect ethical, reputational or stakeholder-driven considerations, rather than legal prohibitions. In many cases, these exclusions also go beyond the constraints imposed by international humanitarian law or EU sanctions regimes leading to excluding defence companies solely on the basis of sector classification. This divergence between public policy, which encourages defence investment through initiatives such as the European Defence Fund (EDF), the Act in Support of Ammunition Production (ASAP), and the forthcoming European Defence Industrial Programme and private investors' ESG considerations has created a certain impasse. The European Commission has acknowledged this, noting that "access to financing within the defence sector has experienced a tightening trend over the years, largely influenced by the implementation of exclusion policies associated with the advancement of environmental and social sustainability in the financial domain"<sup>[2]</sup>.

In contrast, Article 9 funds are subject to stricter requirements. These funds must invest exclusively in "sustainable investments" as defined under article 2(17) of SFDR. This means all investments must contribute to an environmental or social objective, and crucially, must also pass the "do-not-significantly-harm" test. This test ensures investment do not adversely impact other sustainability objectives, based on the assessment of principle adverse impacts. Defence investments generally struggle to pass the "do-not-significantly-harm" test and are often associated with adverse impacts on the environment or society (e.g., environmental degradation through weapons testing or social issues linked to human rights concerns).

Shifting geopolitical developments are driving a rethink of traditional ESG views on defence. ESG values are supposed to adapt and evolve in response to emerging global challenges. The long-standing practice of excluding defence stocks, mainly due to their links with weaponry and conflict is reconsidered given their vital role in protecting a free and secure society<sup>[3]</sup>. This evolving perception is reinforced by signals from the European Commission, which emphasized the need for sustainable finance initiatives to align with broader EU efforts to facilitate investments in the defence sector<sup>[4]</sup>.

The proposed EU social taxonomy takes a nuanced approach to what constitutes socially harmful activities by limiting this to controversial weapons prohibited by international conventions (e.g., chemical and biological weapons, nuclear weapons, cluster munitions, etc.). It does not include the broader defence sector, including activities such as aircraft, ships, engines, electronics, or cybersecurity. Similarly, the White Paper for European Defence – Readiness 2030 confirms that the SFDR does not prohibit the financing of the defence sector. However, clearer guidance on how SFDR should apply to defence would benefit both the financial and defence sector. The European Commission is expected to provide further clarity in its upcoming SFDR review, planned for Q4 2025, specifically on how defence fits within sustainability framework's investment objectives.

The growing intersection between defence policy and sustainable finance marks a critical turning point for the EU's legal and regulatory landscape. As global instability increases, the EU's ability to stay secure depends more and more on attracting private investment into its defence sector. Bridging the gap between government goals and private investment rules and ESG expectations will require clearer regulations, such as updates to the SFDR and the planned social taxonomy, as well as a broader rethink of what counts as a "socially sustainable" investment when national and collective security are at stake.

In the end, defending Europe in the age of ESG should not be about choosing between sustainability and security. Instead, it calls for a clear and balanced legal and regulatory framework that allows these goals to reinforce each other.

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[1] European Commission, What is sustainable finance?

[2] European Commission: Directorate-General for Defence Industry and Space, *Access to equity financing for European defence SMEs*, Publications Office of the European Union, 2024, p.31

[3] Morningstar Industry Landscape, Defense, Geopolitical tension are driving a new supercycle for global defense markets, January 2025, p. 75

[4] Communication of 15 February 2022 on European defence COM(2022) 60

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## EXPERTISE

### INVESTMENT FUNDS

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