

Quick Takes

NOVEMBER 2025

TIMELY TOPICS FOR INSURANCE EXECUTIVES

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A Portfolio of War and Peace: The ESG Defence Dilemma

Sentiment is shifting on how defence is viewed by sustainable investors and lenders. What role might the sector play in insurers' portfolios?

As sustainability factors become embedded in insurers' investment strategies, and non-financial disclosures become more standardised globally, the defence sector presents both challenge and opportunity within fixed income strategies. Long viewed as a standard exclusion, institutional investors are reassessing their stance on the sector and considering the potential positive impact that may be achieved through selective investment in the space, supported by regulatory guidance.

We explore the context for this shift in sentiment, potential investment opportunities and what the regulatory guidance is for those aiming to include the sector in a sustainably invested portfolio.

THE RETURN OF WAR TO EUROPE

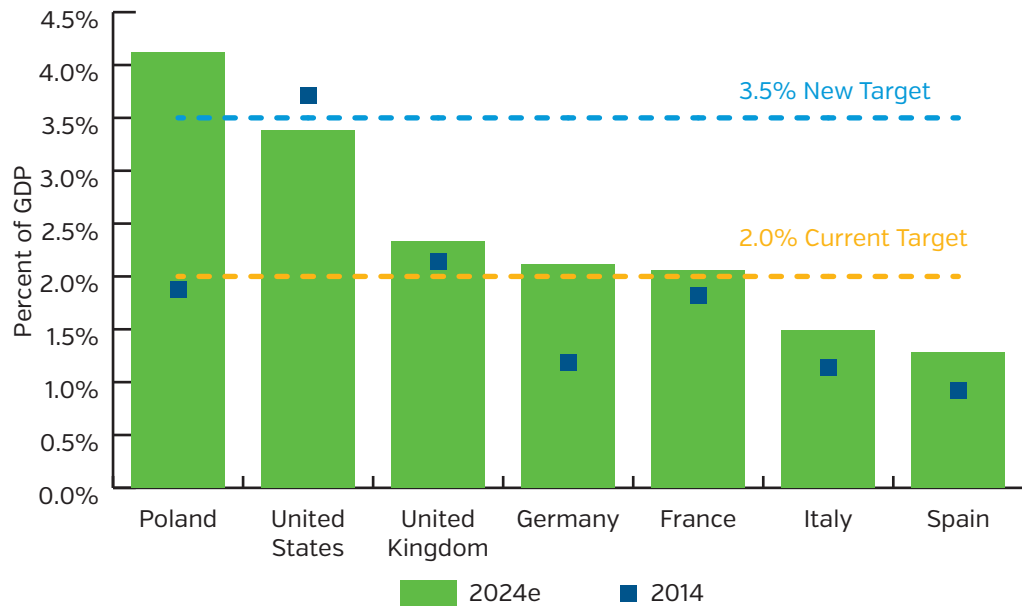
With Russia launching a full-scale invasion of Ukraine in February 2022 (which continues today) along with increased air incursions into Europe, and the Trump Administration's push for Europe to increase its share of NATO defence costs, focus has materially increased on the defence industry in Europe.

This has (and will) lead to a material increase in European defence spending, formalized by the NATO agreement in June 2025. All NATO countries (except Spain) agreed to increase defence spending to 5% of GDP by 2035, 3.5% allocated to core defence (troops, weapons, operations) and 1.5% to defence-related infrastructure and resilience (bridges, cybersecurity, etc.). This is up from the previous 2% target set in 2014. As a result, the US reaffirmed their commitment to NATO specifically related to Article 5 (collective defence).

More broadly, the EU recognises this shift in sentiment with the EU's *White Paper for European Defence – Readiness 2030*¹ stating "Europe faces an acute and growing threat. The only way we can ensure peace is to have the readiness to deter those who would do us harm."¹

The increase in military activity combined with raised NATO contributions will see European defence spending grow from ~\$480 billion per annum currently to ~\$1.25 trillion per annum by 2035, (~70% core defence, ~30% infrastructure).

Exhibit 1. NATO Spending Targets

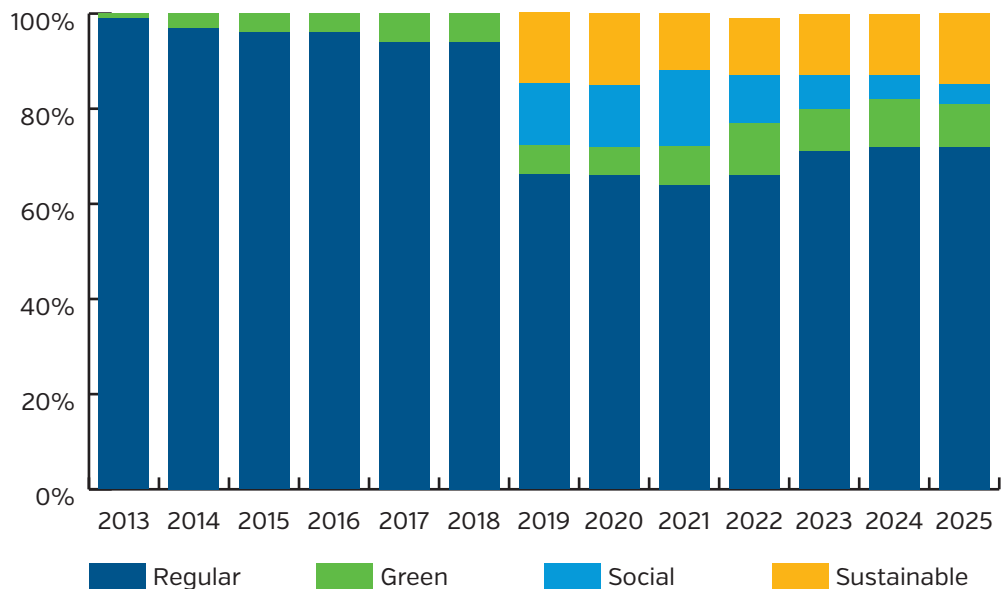


Source: NATO, NEAM

FUNDING INCREASED SPENDING

The next decade's defence spending will likely be funded by both public and private sources. The EU launched a €150 billion SAFE² facility in May 2025 offering long-term, low interest loans to support joint procurement of defence equipment by EU member states. In March 2025, Germany passed a constitutional amendment to its strict "debt brake" rule, in an overall \$1 trillion package with defence spending above 1% of GDP now exempt from the debt brake, enabling significant borrowing for military modernisation. Sovereign issuance is expected to rise across NATO countries, though the impact on ESG issuance plans remains to be seen (see chart below). European governments, recognising the large amounts required, are taking a more nuanced approach with the French Minister of Economy stating in March that "Some consider that financing our defence would not be consistent with an ambitious ESG policy. This view is false."

Exhibit 2. SSA bond supply (EUR/USD/GBP)



Source: CITI, NEAM

Private capital and bank lending are also crucial. The European Defence Bond Label (EDBL) launched by Euronext in May 2025, aims to direct capital towards eligible European defence and security projects with several objectives:

- Establish a common framework to identify and label bonds financing eligible European defence and security activities.
- Improve transparency and investor confidence.
- Support EU's strategic autonomy and resilience.

The EDBL outlines different activities that it believes can be an eligible use of proceeds but also sets out a comprehensive list of activities that are excluded (e.g. cluster munitions, chemical weapons).

Given the labelling framework was launched earlier this year, we have only seen one such bond issued to date - Groupe BPCE (a French G-SIB bank³), issued the first European Defence Bond on 28th August 2025 (€750 million 3.125% 2030 Senior Preferred Paper 3.7x oversubscribed). Proceeds will finance/refinance loans and guarantees for entities contributing to the defence sector. It does not, however, qualify as a "sustainable bond instrument" under ICMA⁴ guidelines.

Separately, HANetf recently launched the first SFDR Article 8⁵ defence ETF in Europe (ticker: ARMY) focusing on European NATO member defence and cyber defence spending, excluding controversial weapons. Over the last 3 years, Article 8 funds have roughly quadrupled their exposure to Aerospace and Defence "A and D" stocks to ~2.5% as of June 2025.

DEFENCE ENTERING THE ESG CONVERSATION...

"Weapons" were once broadly excluded from most ESG strategies. However, rather than simply excluding "problematic" sectors from their portfolios, investors are now taking a more nuanced approach and considering the potential impact from engaging with and financing specific areas of these sectors that may lead to more positive outcomes, while still avoiding other areas of that same sector, in an effort to influence issuer behaviour. The sectors of A and D are prime examples of such areas.

Not only has investors' approach to exclusions evolved, but so too has perception of what constitutes "defence". Increasingly the EU bloc is defending against hybrid threats in diverse sectors such as cyber, biosecurity, infrastructure, energy and media. Also, AI, biotech and robotics are all key inputs as identified by the EU's *White Paper for European Defence – Readiness 2030*.

WHAT IS THE REGULATORY POSITION?

Current sustainable investment frameworks in Europe and the UK do not automatically exclude defence investments. Moreover, regulators have explicitly confirmed that such investments are not considered fundamentally incompatible with sustainable investment frameworks.

There is recognition, however, that not all defence is equal. The EU's *Delegated Regulation 2020/2018* [also used in UK law] specifically defines "Controversial Weapons," allowing investors to apply more targeted exclusions, which enables inclusion of military weapons and issuers who produce essential software for deployment of weapons such as guidance systems, while excluding a subset of the sector seen as socially or ethically problematic. Some investors also exclude nuclear weapons on this basis, while others permit inclusion of manufacturers covered by the 1968 *Treaty on Non-Proliferation of Nuclear Weapons*. In an effort to provide clarity, the EU Commission has proposed amendments to the

Delegated Regulation which would list “Prohibited Weapons” with the aim of ensuring that sustainability related investment restrictions do not unnecessarily hinder defence investment. This approach is reflected in the EDBL and the new European Defence ETF.

CONCLUSION

The defence environment in Europe has altered materially in recent years together with investors’ understanding and view of related environmental and social factors. Insurers will need a well-defined understanding of their appetite for engagement in A and D when it comes to being able to avail of future opportunities.

KEY TAKEAWAYS

- It is increasingly appropriate for insurers to review their existing exclusion policies to ensure they have a clear view of what may or may not be permitted in terms of future investment in the defence space.
- In this new environment, investment opportunities in A and D through labelled instruments and ETF’s are likely to become more common.
- Insurers should ensure that they are well positioned from a strategic and compliance perspective to take advantage of these opportunities as appropriate.
- As ever, insurers should maintain alignment in strategy across investment and underwriting activity to avoid regulatory and reputational risk.

ENDNOTES

¹ European Commission, March 2025

² Security Action for Europe “SAFE”

³ Global Systemically Important Bank “G-SIB”

⁴ International Capital Market Association “ICMA”

⁵ Funds falling in scope of Article 8 of the Sustainable Finance Disclosure Regulation “SFDR” are products that promote, among other characteristics, environmental or social characteristics, or a combination of those characteristics. – The Irish Funds Industry Association.



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