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Policy | brief

Financing European Defence: Time to Call the European Investment Bank?

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Financing research and development programmes have never been more expensive in Europe. Defence budgets are on the wane, international competition is fierce and high-end technologies are increasingly expensive. Europe's defence-industrial base is under significant strain, and options are needed to fund elements of a sector that is still crucial to Europe's security and industry. This Policy Brief argues that the European Investment Bank could play a much greater role in Europe's defence sector. As a public-private institution the Bank could serve as a life-line to defence R&D, dual-use projects and support for SMEs, especially where regional clusters are involved.

Despite the planned increases in military expenditure in Poland and Sweden following the Ukraine crisis, the legitimate question being asked of governments across Europe is whether the European Defence Technological and Industrial Base (EDTIB) is sustainable in the face of diminishing defence budgets and investment in defence research and development (R&D). However highly one might rank the importance of security and defence, the reality is that governments have to make difficult decisions as to how national budgets should be spent. Nevertheless, the need to maintain the military as a public good has not escaped the attention of heads of government, and they have in some cases embarked on collective ventures to make existing budgets more efficient and effective. A number of suggestions have been made in this regard.

For example, Huxham and Rempling (2013) have called for the use of the Lisbon Treaty's 'Start-Up Fund' as a way of sustaining military capabilities in the European Union (EU). In advance of the December 2013 European Council meeting on defence, the European Defence Agency (EDA) (2013) called for a VAT exemption for Agency-run projects. The European Commission is also pushing forward with ways to make better use of the EU's structural and regional development funds for projects that are dual-use in nature. A number of EU Member States are also looking at ways to cut defence costs, including the privatisation of procurement procedures, private finance initiatives and private-public partnerships.

Continuing in this vein, this Policy Brief argues that the European Investment Bank (EIB) could potentially finance certain defence-industrial initiatives in the EU. When this author first raised this idea in the middle of 2013 it may have sounded outlandish (Fiott, 2013; Fiott, 2014). Yet numerous individuals, groups and even institutional actors have in the meantime echoed this suggestion (EDTA, 2013; SESAR, 2013: p. 3; Coelmont and Biscop, 2014). Indeed, the draft conclusions of the European Council meeting in December 2013 specifically invited the European Commission and the EDA to draw 'on the financial expertise of the [EIB]', even though this line was dropped for the final conclusions (Council of the EU, 2013: p. 7). This Policy Brief builds on this author's initial suggestion by looking at the benefits of involving the EIB in the European defence sector, and, in turn, at the obstacles barring its greater involvement in the sector.

The European Investment Bank

The EIB is owned by, and works in the interests of, the EU Member States. With over €242 billion of available capital, the EIB made project loans totaling €71.7 billion in 2013 – this amount is more than the combined total of French and German defence expenditures in 2012. The EIB principally finances up to 50%

of total costs for public and private projects that exceed €25 million in value: all projects must be economically, financially and technically feasible and environmentally sound. Loans are specifically aimed at addressing economic/social disparities and to promote economic knowledge, skills and innovation in the European economy. The EIB can finance projects on a one-off and fixed-term basis, and it has issued loans to public sector bodies to finance regeneration projects for infrastructure, energy, transport and urban renovation. The EIB, along with the European Commission and participating public/private banks and institutions, is also a shareholder in the European Investment Fund (EIF). The Fund has a range of financial products to offer small and medium-sized enterprises (SMEs).

In-line with EU industrial policy, the EIB can directly issue loans to SMEs or it can make loans through public bodies (called *intermediated loans*). The Bank also offers a range of specially designed financing vehicles. For example, it can offer *guarantees and securitisation* to businesses so that projects can be made more attractive to other investors. Alternatively, it can offer *structured finance* for higher risk projects in the knowledge economy and for SMEs; the *Structured Finance Facility* is valued at a maximum of €3.75 billion. Additionally, the *Risk Sharing Finance Facility (RSFF)*, which is jointly run by the EIB and Commission, provides a maximum of €10 billion in loans, guarantees and investment for complex, long-term and public/private research, development and innovation projects such as applied or industrial research, feasibility studies, experimental development and pilot projects.

Furthermore, there are a number of finance and loan vehicles made available through the European Investment Fund. The EIF specialises in venture capital investment for SMEs and the EIB holds a 62.1% stake in the Fund, along with the Commission (which represents the EU with a 30% stake) and a number of private banks (a total stake of 7.9%). The EIF comprises two financing vehicles. Firstly, the *Joint European Resources for Micro to Medium Enterprises (JEREMIE)* allows national and regional authorities to redeploy part of their structural funds into market-driven financial instruments. Serving as a "holding fund", JEREMIE can offer guarantees, equity guarantees, micro-loans, etc. to SMEs through the EIF. Secondly, the EIF sets up and advises *venture capital* funds in close collaboration with the EIB, European Commission, Member States and regional authorities. The EIF provides risk capital to fund managers for SMEs developing projects that use advanced technologies.

Supporting Defence-Relevant R&D and Regional Smart Specialisation

Many of the aforementioned products and facilities potentially offer financing options for the European defence industry, albeit in very specific ways. For example, while the EU's structural funds and budget comprise an important element in the development of dual-use projects and support to SMEs, these instruments cannot be used for 'purely' military projects. As stated in the Lisbon Treaty, however, there are no (at least theoretically speaking) obstacles to the EIB and the EIF being used for 'pure' defence programmes. As Article 309 of the consolidated version of the treaties states: '[t]he Bank shall, operating on a non-profit-making basis, grant loans and give guarantees which facilitate the financing of [...] projects in *all sectors of the economy*' (emphasis added). Article 309(b) specifically refers to projects that seek to modernise, convert or develop fresh activities that benefit "the establishment or functioning of the internal market", especially where these projects refer to the "common interest" of several Member States. This certainly applies to those elements of Europe's defence sector that are increasingly seen as falling under the internal market.

In this regard, a key role the EIB could play is to sure up the attractiveness of defence-relevant SMEs to other investors. *Intermediated loans* and *guarantees and securitisation* initiatives could lend credibility and resources to SMEs seeking investment to develop innovative dual-use projects. More importantly, *intermediated loans* could be used to encourage civilian SMEs to engage in defence-relevant R&D and demonstrator projects. Such an initiative could tick the boxes of promoting economic knowledge, skills and innovation and it could eventually also enhance the international competitiveness of those SMEs involved in such R&D programmes.

There are additional opportunities afforded by the EIB's and EIF's funding schemes. For example, the Risk Sharing Finance Facility could assist with public/private dual-use research – i.e. both at the stages of invention (the R&T-phase) and applied research (the R&D-phase). With the RSFF's €10 billion loan ceiling, a number of defence-relevant projects could be developed. For example, Taranis – a Remotely Piloted Air System (RPAS) being developed by the British Ministry of Defence and firms such as BAE Systems – has so far cost £185 million (approx. €230 million) (BAE Systems, 2014). The spin-off technologies that derive from such projects may eventually benefit the commercial sector and lead to the type of profits that can be used to repay investment loans.

Additionally, regional clusters specialising in industrial niches (also known as "clusters of excellence") could benefit from EIB/EIF involvement. Such clusters are premised on the idea that large firms, SMEs and research centres are combined in close geographic proximity in order to increase R&D collaboration and specialise in a specific technology area (e.g. aircraft engines). Financial and political investment in these clusters are critical if defence firms are to commercialise their technologies, internationalise their business and to benefit from the structural funds. Smart specialisation is a pre-condition for access to structural funds. While the decision to prioritise regional clusters rests in the hands of local and regional government actors, EIB financing could lead to successful technology demonstrator projects and the development of industrial and scientific partnerships between firms and research centres. Such investment could have positive knock-on effects for regional skills development, high-tech knowledge base and scientific/industrial interdisciplinarity.

The EIB is no panacea

While the EIB potentially offers a range of useful instruments there are a number of obstacles barring their application in the defence industry. Quite obviously, finances from the EIB cannot fill the gaping holes in the defence budgets of Member States. Neither can EIB loans be used to maintain and acquire new military equipment and capabilities. Under the Bank's understanding these would not be categorised as investments and it would be politically sensitive to do so. Furthermore, EIB loans could not be used to supplement the operational budgets of the EDA, unless they are channeled to projects run by the Agency. The intrinsic nature of loans and investments is that they need repaying (with interest); defence, as a public good, does not always result in the kind of returns necessary to service loans.

There are some further, more specific, restrictions to involving the EIB. First, the EIB can only make loans for projects that 'are of such a size or nature that they cannot be entirely financed by the various means available in the individual' member states. In essence, should member states want to draw on EIB loans they would have to demonstrate that they do not have their own funds (on a national and collective basis). Whether states would be prepared to put up the other 50% of the funds needed for EIB participation in projects over €25 million remains to be seen.

Second, any idea to develop a JEREMIE-style initiative for 'pure' defence initiatives would surely fail given that it would rest on employing unused structural funds for loans and guarantees. However, as stated earlier, only dual-use projects would benefit from JEREMIE-style guarantees, equity guarantees, micro-loans, etc.

Third, any EIB loans would come with interest payments and sundry expenses (e.g. legal costs, project-appraisal, etc.). While the EIB offers both fixed interest and variable rate loans, all rates are 'quote-specific' following a project appraisal and agreement on the loan period, the amount borrowed, and the currency of the loan. The application for an EIB loan may, once all costs have been considered, be more expensive than funding an initiative via central government.[1]

Fourth, experience from the United States shows that defence-industry access to capital markets is greatly enhanced when the risk of an initial outlay by a lender is offset by a coherent strategic plan for long-term investments (Levy, 2011: p. 2). Unfortunately, in the EU there is no long-term vision for defence investment and so the risk involved in funding defence-relevant projects is higher.

Fifth, the EIB prefers to deal under open procurement procedures, and takes seriously the EU's principles on public procurement: equal treatment, non-discrimination and transparency. The EIB therefore favours competitive tendering (based on cost and quality) for project proposals, which, despite the provisions of the EU Directive on defence procurement (2009/81/EC), could be a big hurdle in the EU defence-sector where open procurement is not the norm. For example, from August 2011 to March 2013 only 3% of total contracts awarded under the procurement Directive were cross-border in nature (European Commission, 2013: p. 15). Additionally, transparency in defence procurement is challenging given the sensitivity involved in classified defence R&D.

Finally, loans made under the EIB are not free from political considerations. Indeed, the EIB Board of Directors is principally composed of Member State representatives and a Commission representative. The EIB is an independent institution but its shareholders are the Member States. France, Germany, Italy, Spain, Sweden and the United Kingdom (Europe's major defence-industrial players) contribute approximately 76% towards the EIB's capital base of €242 billion (EIB, 2013). These states are likely to be reticent about what EIB support will entail. Therefore, it is little wonder that heads of government dropped any reference to the Bank in the final conclusions of the December 2013 European Council on defence.

Conclusion

Despite the sensitivities and obstacles involved in drawing on the EIB for defence-industrial initiatives, there is still scope for the Bank to play a positive role. It is principally the European Commission, given its connections to the EIB and its 30% take in the EIF, that can make the case for greater involvement of the Bank in European defence. Building on its policies aimed at SMEs and regional smart specialisation, the Commission could – within the boundaries of the obstacles mentioned in this Brief – investigate the ways in which the EIB might play a role in promoting economic knowledge, skills and innovation in the European defence sector.

Without careful consideration of the sensibilities and reservations held by a number of Member States however, the European defence industry should not bank on support from the EIB anytime soon.

Notes

[1] I am indebted to Alexander Mattelaer for bringing the issue of interest rates to my attention

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