
Challenges for the Defense Industry Against the Background of ESG (Environmental, Social, Governance) Concepts

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Abstract:

Purpose: The purpose of this article was to present the defense industry in the context of ESG.

Design/methodology/approach: For a variety of reasons, the defense sector has so far not cared to build awareness of the importance of the defense industry in supporting the armed forces' efforts to ensure the security of their country's citizens. The fact that this sector has a strategic status requires reinforcement at the level of communication and separation from other sectors of the economy.

Findings: National security, including the defense industry, will increasingly be seen as a necessity in support of ESG.

Practical implications: It would certainly be helpful for the European Commission to develop a coherent and consistent policy on the defense industry, not only denying its harmfulness, but emphasizing its strategic importance, hence requiring special status and special conditions in the context of the ESG taxonomy.

Originality value: For a variety of reasons, the defense sector has so far not cared to build awareness of the importance of the defense industry in supporting the armed forces' efforts to ensure the security of their country's citizens. The fact that the sector has a strategic status requires reinforcement at the level of communication and separation from other sectors of the economy (possibly also through the application of different regulations specific to the sector) as in this research.

Keywords: Defence industry, environmental, social, governance.

JEL: O13, L97, M19.

Paper type: Research article.

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1. Introduction

In the past decade, two conflicting value systems have largely influenced the world of the arms industry, casting a shadow over countries' ability to provide security. Corporate social responsibility, sustainability and caring for the environment have found their way into most sectors of society, including the financial sector. The so-called ESG model as a system that sets criteria for sustainable business has been welcomed and eagerly implemented by almost every progressive organization.

As a result, this has led to a reluctance on the part of financial institutions to work with industries that do not share this optimism. In the European Union, policies are being developed for a new taxonomy and ecolabeling. Although no final decisions have been made in this regard, and the policy itself has not yet been implemented, its impact is already making a noticeable mark on the entire arms industry.

The geopolitical situation in and around Europe has deteriorated behind Russia's aggression against Ukraine. In view of these events, most countries have increased defense budgets and are investing heavily in modernizing their armed forces. For the defense industry, this trend has led to high expectations for the production and delivery of military equipment. In order to deliver, the defense industry needs to invest in expanding capabilities in terms of broadening production entities, increasing their capacity and exports. This development requires greater access to financing.

Key task of any national is ensuring security:

In general, security is related to identifying and assessing threats. From the analysis of threats, capabilities are derived, the provision of which determines the security of the state. Achieving capabilities involves defining the needs of the armed forces and then seeking solutions to meet those needs. This approach requires close cooperation between the military and the defense industry, including political and financial decision-making.

Increasingly, there is a need for the broader industry to respond to issues related to sustainable development and environmentally safe investments. Sustainable development takes place when it is based on stable and sustainable economic growth in environmentally friendly sectors. Furthermore, it is required to reduce unemployment by using existing social resources in the labor market (Wysokinska, 2018, p. 76). Programs in the area of sustainable development are often brought together under the concept of ESG (Environmental, Social, Governance) - all issues related to environmental, social and corporate governance.

The purpose of this article is to present the defense industry in the context of ESG. The defense industry, as one of the most important elements of the country's security system, will increasingly be seen as a necessity to support ESG.

Currently, there is a lack of comparable and reliable research on the impact of ESG on the defense industry. Because the degree of the problem varies from one European country to another and from one company to another, there is a lack of data that would give a complete and reliable picture of the current situation.

2. Functioning and Organization of Security

Providing security to citizens is one of the key tasks of any national. This security is an issue that is well known in the literature and has lived to see many definitions and approaches. One definition that, from the point of view of the content discussed in the article, most describes the essence of the phenomenon is the one proposed by S. Koziej. He presented it as a field of state action, which includes countering all kinds of external and internal threats to national interests and shaping the most favorable conditions for the realization of these interests (Koziej, 1998, p. 10).

Security consists of many elements. One of them is the maintenance of the potential of the armed forces and guaranteeing military credibility, which is essential for deterring enemy threats. This element is exquisitely influenced by the ability to provide the armed forces with modern military equipment that meets current needs.

This is closely related to the entire system of acquiring equipment with the appropriate level of technological sophistication, quality and quantity, and then maintaining, servicing and eventually decommissioning it. With constant technological changes, this challenge becomes even more complex. If the military equipment in use, at any given time, is a reflection of potential threats, then as technology evolves, it can be interpreted also as a potential threaten to country's security.

In order to defend against this, it is necessary to implement those technological solutions that will help or at least neutralize the threats. Building and maintaining the state's ability to adequately perform tasks in the area of providing security depends on the proper organization of technological solutions (Mitkow, 2019).

In general, the provision of security at the national level is a complex process that consists of a number of institutions and tasks that ensure the enforcement of the necessary activities to be undertaken. Some of them are performed preventively, others are carried out as a direct response to the changing environment. As a rule, dedicated structures are singled out for the implementation of tasks in this area, which take care of the strategy and tactics for carrying out security functions.

The day-to-day fulfillment of security tasks is related to identifying threats and needs and then seeking solutions that are able to respond to these needs. Sometimes smooth operation requires close cooperation between law enforcement and the world of science and industry, as well as political and financial decision-making. The very process of defining threats and needs while analyzing possible solutions can be a

process that is inaccessible to both the world of science and industry. But even then, it remains a responsibility of science and industry to properly address these needs taking in consideration that some of access to the information is restricted, confidential or even top secret.

In order to respond to the emerging needs of the national in the field of security, synergy between industry, science and armed forces is required. –This cooperation must respect mutually agreed requirements that guarantee its transparency in financial and formal terms, but on the other hand will guarantee the exchange of knowledge, thoughts and ideas that take into account the real needs, opportunities and production capacity of the industry. These requirements are related to different certification and testing processes, compared to solutions that are familiar to the civilian world.

Equipment that goes into law enforcement often goes through a testing process that lasts for months, many times more expensive than the rigors to which equipment produced for civilian purposes is subjected. A certain peculiarity of production for military purposes is also the volume of production. In the defense industry, very often the solutions ordered are in “retail rather than wholesale quantities”. Unlike in the civilian industry, armaments production does not involve millions of pieces but only single units, possibly hundreds or, in the case of smaller equipment, tens of thousands. Ammunition, for example, should be considered an exception, as it is a product produced in large numbers in terms of number of units, cannot be compared to the number of cell phones or personal use articles.

The defense industry, is an integral part of industry, comprising of industries and enterprises that produce for the defense needs of the national, while usually defense manufacturing is only a part of the overall production⁴. Such a definition makes it possible to qualify in this category of all specialized production enterprises that manufacture battlefield and technical equipment for security and defense needs (Wróbel, 1994, p. 132).

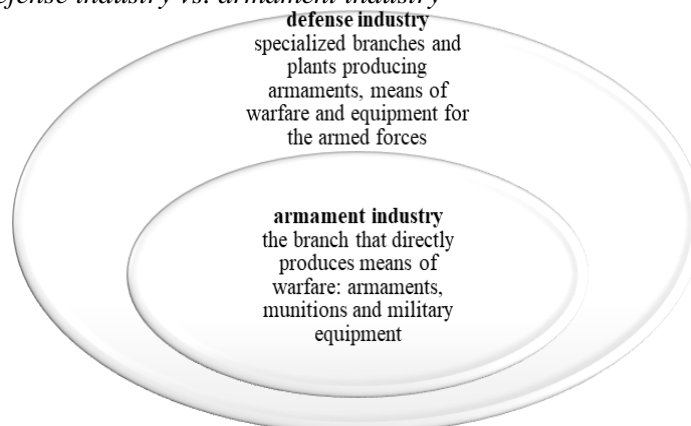
In the literature, the term arms industry (Figure 1) is quite commonly used, although its meaning has evolved in recent decades, and until the end of the Cold War period it was also referred to as the war industry. In this context, the arms industry is a specialized part of the national industry engaged in the production of armaments and military equipment, providing the armed forces with the means to carry out tasks arising from the adopted defense doctrine and national policy (Zamelek 2014, pp. 121-122).

Arms industry defines as all firms involved in the design, development, production, and sale of arms where these are defined as lethal equipment (Hartley 2018, p. 31). The European defense industry is important to the entire European economy. Like other fields of activity, the defense industry must move toward ever-increasing

⁴ *Słownik terminów z zakresu bezpieczeństwa narodowego, AON, Warszawa 2008, p. 110.*

efficiency in order to provide its customers with the best possible value for money while protecting the interests of shareholders. The defense industry is important to the EU because of its technological and economic policy aspects.

Figure 1. Defense industry vs. armament industry



Source: Own study.

The competitiveness of the European defense industry is crucial to the credibility of the Common Security and Defense Policy. It is important that EU member states work together to abandon policies and practices that prevent companies in the European defense industry from cooperating more effectively⁵.

Taking this into account, naturally, the products supplied by the armament industry are therefore inherently many times more expensive, and their production time correspondingly longer. There is also some specificity in the time for which solutions are produced. While in solutions that are known from civilian life it is more and more common that equipment is produced for a short period of time (refrigerators or washing machines often last a few years, cars a dozen or so), solutions produced for security needs are planned for thirty or even fifty years. All this has an impact on the final price of products supplied for military needs. At the same time, although it is no secret knowledge, for natural reasons the price factor has an excellent influence on how secure a country is. Very often a country's military strength is determined not only by its human potential and training, but also by the equipment it has.

In this context, it is noteworthy that recently the armament industry has begun to signal more loudly and clearly a new threat related to access to financial products. This problem today is admittedly occurring on a larger scale in our western neighbors than in Poland. Nevertheless, this issue may also soon affect the Polish

⁵https://www.europarl.europa.eu/ftu/pdf/pl/FTU_2.4.4.pdf Dokumenty informacyjne o Unii Europejskiej – 2021, s. 1 (European Union Information Papers - 2021 p. 1) (accessed: 01.07.2022).

industry as well. This threat is hidden under the three letters ESG, the significance of which is becoming increasingly known around the world.

Environmental measures are only effective if they cover all possible areas - including the appropriate way the armed forces conduct operations. This is why, in the armies of most Western countries, environmental protection is becoming as important a requirement as missile range, vehicle speed or ship autonomy. The choice of a given system may therefore now also be determined by whether it is environmentally friendly and to what extent during its production, operation and, eventually its disposal. Similar considerations are also being taken into account in operations planning and infrastructure development⁶.

3. ESG Concept

The origins of ESG date back to the 1960s and for many countries and citizens it is known with a broad understanding of corporate social responsibility. So-called "ethical," "socially responsible" or "green" investment strategies are therefore nothing new. In the 1960s, stock market investors began to exclude both individual companies and entire industrial sectors from their portfolios due to specific business activities. This included companies involved in the apartheid regime in South Africa at the time as well as those involved in weapons or tobacco production.

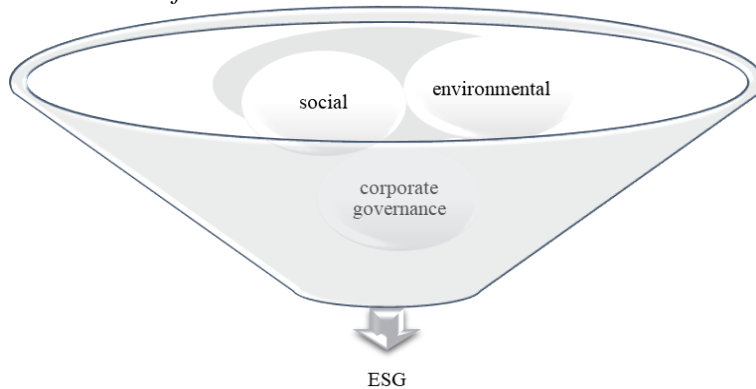
The term "ESG" was first used in a 2004 report entitled "Who Cares Wins, Connecting Financial Markets to a Changing World". Developed jointly by the United Nations and the Swiss Federal Department of Foreign Affairs, the report recommended ways for the financial sector to better integrate environmental, social and governance factors into its practices, including asset management⁷. The acronym ESG comes (Figure 2) from three English words: "environmental", "social" and "governance". They refer to environmental, social and corporate governance issues and an attempt to redirect capital flows toward more sustainable operations and investments.

Environmental is an attempt to look at how a company works for the good of the planet and what impact does this have? The social area measures how an organization treats its employees, customers, suppliers and local communities. It includes factors such as racial diversity, inclusion and hiring practices. The last relates to corporate governance. It attempts to answer questions about how a company should be run.

⁶M. Dura, *Ekologia – nowy sposób modernizacji zachodnich sił zbrojnych. MON tworzy wytyczne ws. ochrony środowiska* <https://defence24.pl/sily-zbrojne/ekologia-nowy-sposob-modernizacji-zachodnich-sil-zbrojnych> (accessed: 01.07.2022).

⁷A. Michael, *ESG Investing: The Only Way Is Ethics – Or Is It?*,

<https://www.forbes.com/uk/advisor/investing/best-esg-funds/> (accessed: 30.06.2022).

Figure 2. *The essence of ESG*

Source: Own study.

It covers a variety of elements like compensation policies, how the company communicates and interacts with shareholders⁸. Public acceptance of such concern for the world has led to an even more thought into how to promote “green behavior”. Against this background, a number of initiatives by European countries promoting the “European Green Deal” began.

The European Green Deal is a development strategy aimed at transforming the European Union into a climate-neutral area. The idea is to counter the climate crisis and environmental degradation. The European Union has set as its main goal the achievement of climate neutrality by 2050. According to the assumptions presented in the European Green Deal Q&A, this is to be achieved, among other things:

- providing clean and safe energy,
- implementing a closed-loop economy,
- buildings with lower energy demand,
- accelerating the transition to sustainable and smart mobility,
- protecting and restoring ecosystems and biodiversity,
- adapting to climate change,
- health care.

The effects of these actions are expected to reduce greenhouse gas emissions. It will become a legal mandate in the European Union, guaranteeing the irreversibility of the transition to climate neutrality while creating a predictable business environment for industry and investors (Buczowska, Tomalkiewicz, Szcześniak, Rdzanek, Jagiełło, Ciszewska-Brierre, Roszczyńska, Wiącek, and Anton 2021). Achievement of these goals is to be guaranteed by the Paris Climate Agreement. A document was

⁸*Ibidem.*

signed by 188 countries responsible for emissions of more than half of the world's greenhouse gases.

The European Union, betting on a “green deal”, is creating regulations aimed at promoting sustainable development and creating a system of incentives to achieve the climate goals of the “Paris Agreement”. The intention is to redirect the existing stream of financial resources in a direction that is in line with the “Green Deal”⁹.

According to a report by consulting firm PWC, “the concept of ESG is becoming increasingly important for many companies and institutions, but also for the economy as a whole. This has to do, among other things, with increasing regulatory pressure in the EU, market pressures, ownership requirements (with an increasing segment of investors opting for “green” investments) and the possibility of obtaining financing, especially in the long term.

Although ESG rules apply to every sector, the impact will vary. Redirecting capital flows toward more sustainable operations and investments has a real impact on the operations of financial institutions. The European Commission expects that banks, among others, are the entities that will play an important role in redirecting financing away from carbon-intensive sectors toward low-carbon sectors or toward the energy transition. This will be done through changes in the investment and lending policies of financial institutions¹⁰.

The goal is to transform the European Union's economy and achieve climate neutrality by 2050. The apparel industry has resonated with the unethical actions of global corporations that have manufactured their products in Asian countries, aware of blatant rights violations. The pressure on companies to comply with ESG standards is increasing. This is primarily due to the growing awareness of society.

The EY Future Consumer Index survey shows that 60 percent of respondents in Poland and 69 percent globally believe that established brands have an obligation to make ESG changes. In turn, 45 percent of consumers in Poland say they will pay more attention to the environmental impact of their consumption. The situation is no different when it comes to employees. According to the Cone Communications Millennial Employee Engagement Study, more than 60 percent of so-called millennials would not be employed by an employer that does not consciously implement a social responsibility strategy. As many as 83 percent said they would be more loyal to an organization that helps solve social and environmental problems¹¹.

⁹*Zielone finanse po polsku. Jak ESG zmieni sektor bankowy i finansowanie firm?* <https://www.pwc.pl/pl/publikacje/zielone-finanse-po-polsku-jak-esg-zmieni-sektor-bankowy-i-finansowanie-firm.html>? p. 2, (accessed: 25.06.2022).

¹⁰*Zielone finanse po polsku...*, op. cit. p. 2.

¹¹*Biznes z ludzką twarzą procentuje*, <https://www.parkiet.com/esg/art19400551-biznes-z-ludzka-twarza-procentuje> (accessed: 30.06.2022).

Against this backdrop, it is worth looking at ESG not only in ethical terms. A World Economic Forum study found that companies that have established sustainable supply chains can see an increase in revenue of up to one-fifth compared to companies that have not implemented similar solutions. In turn, costs associated with supply chain operations can decrease by 16 percent.

Another important issue is the possibility of obtaining financing. Here, the approach of banks plays a very important role - their turn towards financing pro-environmental investments is already well visible. This is clearly shown, for example, by the fact that over the past four years almost half of the world's 60 largest banks have reduced their lending exposure to fossil fuel-related sectors. Non-ESG-compliant investments carry a higher risk (due, among other things, to the possibility of recording a loss of value for unsustainable reasons). Of course, this also works the other way around: companies that respect ESG principles can raise capital more cheaply, which translates into higher returns on investment. Sustainability financing will be an increasingly important part of banks' activities over the coming years¹².

According to J. Wojciechowski (founder of the Investthink Association), "not only individual companies, but entire sectors may be overlooked for investment by a large group of investors, and this in turn may translate into lower stock valuations compared to the broad market and some sectors may be overlooked for investment by a large group of investors". J. Poświata (managing partner of Bain & Company) adds that "according to research, the younger generation is much more willing to engage with companies that behave in a socially responsible manner. implementing a sustainability strategy means easier access to capital and a lower cost of raising capital for many companies, as more and more investors and banks perceive socially responsible companies as less risky"¹³.

Until recently, social responsibility meant nothing more than a concern for companies that with their production "devastated" the environment to take responsibility for their actions and offset the negative impact they have on the environment. The legitimacy of this is no longer questioned by virtually anyone, because the world has long realized that being driven by short-term business goals does not take it in a direction that will guarantee future generations the ability to live in conditions no worse than they are now.

Being socially responsible has become a "fashion" in the positive sense of the word. A fashion that for many was also beginning to pay off. This is because increasingly, before making investment decisions, investors pay attention to whether the companies they want to invest in offset their negative impact on the environment. Similarly, employees looking for jobs, ask themselves whether perspective

¹²*Ibidem.*

¹³*Biznes z ludzką..., op. cit.*

employers share their beliefs or customers before making buying decision. But from our knowledge of history, we know situations when the products were marketed under the guise of “sustainability”, that had little to do with environmental performance. An example is the scandal in the automotive industry described by J. Ewing, which had its media climax in 2015 with Volkswagen.

This is when it came to light that the world's largest car producer falsified vehicle tests results for the interest of profit. Due to its deceiving practices, Volkswagen persuaded many corporate social responsibility enthusiasts who, believing the falsified emissions score tests, bought their vehicles. As a result, there were more than 11 million VW cars on the market (Ewing, 2017, p. 55) Ultimately, this did not exclude Volkswagen out of the automotive industry.

However, companies that manufacture weapons and military equipment have long been blacklisted. If one considers Russia's aggression against Ukraine, the question may arise: if an arms manufacturer supplies missiles to a nation perceived as weaker in the conflict is it also acting unethically? What if one were to look at another sector against the backdrop of an event that has dominated life around the world for the past few years, i.e., the COVID 19 pandemic? Some investors may bypass the pharmaceutical industry because of moral objections to drug testing on animals.

Understanding what consequences such practices have for animals, it's hard to argue with that. But when human lives are threatened and the only way to expedite the introduction of a vaccine that can save human life is to test vaccines on animals then is this practice still considered unethical?

4. ESG Versus the Armament Industry

For number of companies the importance of the ESG become more prominent especially when applying for funds. Increasingly, ESG compliance is a prerequisite for participating in competitions or tenders. Financial institutions, pension funds, insurance companies - all have their policies designed specifically to comply with these new standards. The idea itself seems as good as possible.

According to the PWC report: 80% of the commercial banks surveyed have already introduced elements of sustainable financing in their business strategies and product offerings, and almost all of them are incorporating climate risks and environmental risks in their lending processes. Importantly, the vast majority of banks that took part in the survey have a positive view of the emerging ESG regulatory requirements - they see them as an opportunity for their organizations, as well as for the entire banking sector and economy¹⁴.

¹⁴*Zielone finanse po polsku. Jak ESG zmieni sektor bankowy i finansowanie firm. Maj 2021 (Green finance in Polish. How ESG will change the banking sector and corporate finance. May 2021).*

The defense industry, however, does not share this optimism. Based on the committee's work in the 33rd edition of the SERA course¹⁵, the ESG problem has been identified by several member states. One such example is the French Department of Defense, which has raised the issue in the French Parliament. Several other member states are also sounding the alarm that it is unwise to categorize the entire defense sector as unsustainable.

However, European countries are not equally affected by this situation. The situation varies depending on a number of factors such as company size, ownership structure, and the type of products or services provided. In general, access to financing becomes more difficult for small and medium-sized companies, while large companies most often suffer the consequences indirectly, caused by problems in their supplier chain. Typically, private companies also face problems with access to financing more often than state-owned or co-owned companies. It is also likely that companies with less liquidity may face greater difficulties. For some companies, the problem is mainly related to financing, while other companies may face difficulties related to insurance, real estate/office rentals or exports.

The situation also varies greatly on the part of the financial institutions themselves. Some have stricter rules than others, so companies have different experiences depending on which financial institution they work with. The situation is more complex in EU member states, especially in Western and Scandinavian countries, than in some European countries outside the EU like the UK or Switzerland. The problem regarding access to financing for the defense industry has been identified by several European countries, mainly because the industry is reporting the issue through national defense industry associations. Several associations expressed concern about the issue and reported the potential problem to the European Commission¹⁶.

However, no member national has taken real action to address the problem. This may be due to the fact that there is still no national or European Union-level regulation to sanction ESG. However, financial institutions, in anticipation of formal regulations, are themselves making internal rules and regulating their own operations, so that when ESG is regulated they will not find themselves in a difficult situation and having to accelerate compliance. Thus, states remain helpless to counter its position that has no legal standing. The degree of the problem varies

¹⁵SERA - a course organized since 1989 by the Institute of Advanced Study in National Defense. It is intended for representatives of the European Union member states, as well as Switzerland, Norway, Turkey, the European Defense Agency, the European Commission and representatives of organizations supporting the defense sector. Its purpose is to integrate those representing the defense sector in Europe, to use the intellectual potential of participants to unravel the issues facing the European defense sector, and to promote the capabilities of host countries.

¹⁶No sustainability without a defence and security, BDSV Mars 2022.

between European countries and different companies, there is a lack of data that would give a complete and reliable picture of the current situation.

In part, this may be due to the fact that the problem for the armaments industry with ESG started initially only in some countries, and the effect of spreading it to other countries took place over a longer period, mainly due to broken supply chains and the increasingly restrictive policies of banks in their subsidiaries across Europe. Given the interdependence in defense industry cooperation in Europe, if this situation continues it could lead to the loss of some players' ability to provide their services. The defense industry is already experiencing "labeling" and difficulty in accessing services (i.e., financing or office rental) due to expected new regulations related to ESG.

This status of the defense industry probably comes from the fact that defense forces account for a significant portion of total carbon emissions. The G20 alone - a group that includes some of the world's armed forces - accounts for nearly 80 percent of the world's carbon emissions. While the defense forces of some countries have significantly reduced fossil fuel consumption since 2000 there are still many countries that have a long way to go in this regard.

For example, in the U.S., the armed forces emit about as much CO₂ as the whole of Serbia - of which nearly two-thirds comes from vehicles, ships, aircraft and other equipment used in combat, tactical or rescue operations, as well as law enforcement, emergency response or space flight. The situation is similar in Canada or the United Kingdom¹⁷.

There is no doubt, then, that organizations around the world need to prepare for the coming changes by focusing on sustainability and building the long-term value of companies. Risks and opportunities related to climate, social and corporate governance (ESG) issues have a real and measurable impact on business. Regulatory and market pressures, as well as pressure from capital owners, are designed to gradually lead to a transformation of global economies and companies. The impetus for real change in economies is to flow from the financial sector, on which the European Union, among others, is focusing its efforts.

The aim of these activities is to redirect funding streams towards sustainable business activity and create new conditions for raising capital. Financial institutions will have to consider non-financial opportunities and risks in their investment and financing process¹⁸.

¹⁷*The Greening of Defence. The time to act is now,*
<https://home.kpmg/ca/en/home/insights/2022/02/greening-of-defence.html>

¹⁸*ESG – miecz Damoklesa czy szansa na strategiczną zmianę?*
<http://www.wmadvisory.pl/wp->

According to A. Słomka-Gołębiowska: Companies that do not adhere to the rules derived from ESG and are not able to present their activities in ESG areas will reduce their chances of raising capital in the long term. They will be exposed to low valuation, as well as difficulties in retaining partners in the supply chain.

The focus on environmental, social, corporate governance issues is motivated by the expectations of investors and regulators. That is not to say that investors are no longer interested in issues of the best possible operational and financial performance. New capital will flow more quickly and cheaply to companies that have ESG embedded in their strategies, policies and processes, and thus can strive for solid financial performance over the long term¹⁹.

An interesting thread to this issue is the current situation in Ukraine. Russia's aggression has raised questions for many about the ethics of investing in war-related industries. Just as investing in war bonds became a patriotic duty during World War II, is it possible that the Russian invasion of Ukraine will provide a patriotic justification for investing in the armament industry? Socially responsible ESG investments tend to have little connection to military and defense stocks. Most companies in the aerospace and defense industry are involved in the production of weapons, which are clearly identified as negatively from an ESG perspective.

However, the current situation has re-emphasized the importance of the military for peacekeeping. So, it is increasingly common to find conflicting viewpoints in the media. Some analysts, now argue that investment in the arms industry can be considered part of the ESG investment program, given the importance of defense and deterrence for the future of the nation.

In other words, avoiding war and international conflict is, in many ways, the foundation of any sustainable development effort. But others at the time strongly argue that defense stocks have not been and should not continue to be considered socially responsible²⁰. An interesting example comes from Sweden. SEB Investment Management announced after the outbreak of war in Ukraine, it had lifted the total ban on any company getting more than 5% of its revenues from defense for six of its funds²¹. Just a year after Swedish bank SEB adopted a new sustainability policy that excluded defense stocks from its funds, the group made a 180-degree turnaround. SEB justifies this change in approach by "the serious security situation and rising

content/uploads/2021/05/ESG_Miecz_Damoklesa_raport_PwC_2021.pdf p. 6 (accessed: 21.06.2022).

¹⁹ *Ibidem*, p. 23.

²⁰F. Newport, *Defense Investing in the Context of U.S. Public Opinion*, <https://news.gallup.com/opinion/polling-matters/390644/defense-investing-context-public-opinion.aspx> (accessed: 30.06.2022).

²¹S. Jessop, T. Wilkes, T. Hephers, *Defence firms ramp up pitch to exit sustainability wilderness*, <https://www.reuters.com/markets/europe/defence-firms-ramp-up-pitch-exit-sustainability-wilderness-2022-03-11/> (accessed: 30.06.2022).

geopolitical tensions," culminating in Russia's invasion of Ukraine²². The Swedish bank has not been unique in avoiding arms companies. Investors and financial institutions have been withdrawing from cooperation with the defense sector for some time, fearing the consequences of such cooperation when ESG-related regulations are implemented in European Union countries.

German bankers BayernLB and LBBW have decided to stop doing business with the armored vehicle manufacturer. Banks in Germany, Belgium, the Netherlands, Sweden and Finland are breaking off cooperation with companies that generate only 5-10 percent of their revenues from defense activities²³. The puzzling thing about this situation is that it took a war to realize the importance of the European defense industry.

Some analysts believe that defense companies will end up on the EU's taxonomy list, which is a framework that indicates to investors that a particular type of business is conducted with respect to ESG principles. This could happen if the Russian war in Ukraine does not end soon. Indeed, the Russian attack has accelerated changes in public consciousness. There is a growing commitment to, spending on arms among NATO countries, both among the public and government elites. And this favors armament companies²⁴.

5. Probable Consequences

The defense sector undoubtedly faces a major challenge today. On the one hand, due to the current situation in Ukraine, the importance of the defense industry has been recognized and has become even more important. The result is that some countries have decided to significantly increase their defense budgets and recognize the need to upgrade the equipment of their armed forces in order to ensure peace in Europe.

On the other hand, the defense industry is currently facing serious challenges related to a shortage of resources, both on the raw materials and materials side and adequate manpower and imbalances in supply chains. Moreover, armament companies are beginning to experience increasingly acute problems with access to financing.

To meet the demands of the current situation, the defense industry therefore needs the support of its governments as well as the European Union. Such support must be guaranteed over the long term, as increasing production capacity by defense

²²R.G. Eccles, *Vladimir Putin's Contribution To ESG Investing*, <https://www.forbes.com/sites/bobeccles/2022/03/06/vladimir-putins-contribution-to-esg-investing/> (accessed: 30.06.2022).

²³P. Hollinger, *Ukraine war prompts investor rethink of ESG and the defence sector* <https://www.ft.com/content/c4d4fe6a-2c95-4352-ab88-c4e3cdb60bba> (accessed: 30.06.2022).

²⁴<https://www.esginfo.pl/wojna-testuje-reguly-esg/> (accessed: 03.07.2022).

companies is often a risky and financially demanding business decision that requires a vision of a stable market in the future. The defense industry therefore needs support to overcome the challenges that plague the industry today and must have certainty in accessing financing. Today's uncertainty affects key R&D decisions and the production of key military technologies and equipment.

An important element that should also be emphasized is changing the perception of the defense industry. The image of defence industry should be of strategic importance. After all, it is difficult to talk about sustainable development without security. If such a narrative is consistently maintained across Europe, the public will also see the defense industry as crucial, and financial institutions will not be afraid of a bad reputation if they cooperate with it.

With that said, it should be noted that the defense industry's unattractive reputation is also due to the defense industry's failure to take appropriate action. Many of the industry's players do not go through the trouble to build a desirable image in the general public. However, the fact that this can be taken care of is proven, among others, by Northrop Grumman, which publishes reports presenting its readiness to operate in the new conditions of sustainable development²⁵.

To start facing the problem, the first step is to understand it. This is not an easy task due to the complexity of the current situation. The fact that defense companies are struggling to access the financial resources necessary to fulfill their strategic role is just the tip of the iceberg. The problem, however, goes deeper. The depth of the problem stems from the underestimation of the defense industry's role for peace and security, due to its bad reputation and lack of public interest in peacetime. All this makes financial institutions automatically assume that the defense industry will continue to be viewed negatively.

However, despite differences in the intensity of the problem across Europe, it is clear that security and the industry's ability to function smoothly are at risk. A defense industry deprived of access to financing will not only degrade, but will negatively impact Europe's technological accessibility, unique know-how and valuable labor market.

However, the lack of comprehensive and relevant data on the current situation is considered one of the main reasons for low situational awareness. To overcome this challenge, to better understand the possible ways to reconcile the specifics of the arms industry and respect for the principles of corporate social responsibility, it is necessary to ensure reliable data. Such analyses should be prepared both at the national and European levels.

²⁵See K. Maraist, A. Poreda, *ESG Case Study – Northrop Grumman*, <https://finance.yahoo.com/news/esg-case-study-northrop-grumman-120025374.html> (accessed: 30.06.2022).

It certainly wouldn't hurt either to have reliable communication related to existing EU policies. This is because at the moment there is no legal basis for financial institutions to take restrictive actions against the defense industry. This is because regulations in this regard have not yet entered into force. However, financial institutions, anticipating what might happen in the future, have decided to implement the relevant internal regulations.

Given where we are today in the effort to promote corporate social responsibility, it is to be expected that the work of formally introducing ESG into the legal order of individual member states will certainly be completed. Paradoxically, the uncertainty surrounding this process today is worse than the final introduction of the principles. This uncertainty has led to a situation in which financial institutions have begun to restrict and regulate themselves in terms of cooperation with selected sectors. Armament companies should already be preparing for the reality of how they will conduct their business and how to integrate ESG into their strategies and operating models.

6. Conclusion

The issue of defense industry access to financing is complex and differs from country to country. Analyzing the available information, one can find countries like France, Belgium and the Czech Republic confronted with ESG as a real problem hindering business operations. From the information presented during the course of the 33rd edition of SERA, in some countries there are already real problems with access to funds nominated for the defense industry. On the one hand, the defense sector has not been recognized anywhere as a sector that should be excluded outright from financing. However, it is happening right now in given countries.

In Poland, there are signs heralding that ESG may become a challenge. However it is certainly not yet an issue that cannot be overcome. The current geopolitical situation of a given country influences the dynamics of the ESG standards dissemination. An interesting example in this case is that of Sweden, where, after the banks' very enthusiastic and restrictive adherence to orthodox compliance with ESG obligations changed their approach in the face of the threat posed by Russia's war with Ukraine.

Certainly, the approach to ESG is also related to the sector's reputation. For a variety of reasons, the defense sector has so far not cared to build awareness of the importance of the defense industry in supporting the armed forces' efforts to ensure the security of their country's citizens. The fact that the sector has a strategic status requires reinforcement at the level of communication and separation from other sectors of the economy (possibly also through the application of different regulations specific to the sector).

This issue, however, is not a responsibility solely for the institutions of the European Union, but should also be seen as a national issue, which should be pursued in parallel with actions taken at the European level. A tone of communication needs to be developed in such a way that it doesn't focus only on the harmfulness of the arms industry but emphasizing that it is strategically important for ensuring the security and sustainable development of the European Union.

With a comprehensive approach to this issue in all EU countries, there is an opportunity to change attitudes toward the armament industry by building communication with the public emphasizing the strategically important role of the armament industry in supporting the armed forces, and thus peace and democratic values in Europe. In parallel, the industry should also be encouraged to be more transparent about its ongoing efforts and goals to adapt and improve its production operations and end products in accordance with ESG criteria.

It would certainly also be helpful for the European Commission to develop a coherent and consistent policy on the defense industry, not only denying its harmfulness, but emphasizing its strategic importance, hence requiring special status and special conditions in the context of the ESG taxonomy. It would also be desirable to support the European Defense Agency as an institution that could conduct a study to verify to what extent there is access to ESG financial problems in various countries and what types of companies are affected. This is because today it is difficult to clearly identify which specific financing challenges represent future risks and which already exist.

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Wyzwania dla przemysłu obronnego na tle koncepcji ESG (środowisko, społeczna odpowiedzialność, ład korporacyjny)

Streszczenie: Z różnych przyczyn sektor zbrojeniowy nie dbał dotychczas o to, aby budować świadomość znaczenia przemysłu obronnego we wspieraniu wysiłków sił zbrojnych na rzecz zapewnienia bezpieczeństwa obywatelom swojego kraju. Fakt, że sektor ten ma strategiczny status wymaga wzmocnienia na poziomie komunikacji i oddzielenia od innych sektorów gospodarki. Bezpieczeństwo państwa a w tym przemysł obrony coraz bardziej postrzegany będzie jako konieczność wspierająca ESG. Celem artykułu było przedstawienie przemysłu obronnego w kontekście ESG.

Słowa kluczowe: przemysł obronny, środowisko, społeczna odpowiedzialność, ład korporacyjny.