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Towards a defence spending model

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A STUDY BY

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The urgent need to re-assess the financial infrastructures for defence and security in the UK and Europe

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Executive Summary

- Europe can no longer be assured of US support to its economic security or its defence and security of its borders.
- The European Union and the UK have committed to significant increases in defence spending.
- However, increases in defence spending will not help reduce dependency on US security frameworks or defence equipment because the supply side in Europe will not be able to adapt with sufficient speed. Some 64% of European defence procurement is from the United States and this is too much for the process to be quick.
- However, the process of supply-side adjustment in Europe can be addressed by a mix of blended finance (combined public and private finance), including the multilateral bank structure in the European Union's Defence and Security White Paper – the Defence Security and Resilience Bank.
- This should be supported by a private credit fund supported by government guarantees to fund those businesses at the base of supply chains, including in Ukraine, to scale production quickly.
- There are no compliance or sustainability grounds for banks to be reluctant to invest in defence and security but reluctance because many of these businesses are small and financially unstable. The private credit fund, as a non-bank, would be able to use contracts or invoices to provide working capital to these types of firms and provide equity where innovation and growth potential can be realised.
- This guarantee type structure does not increase levels of government indebtedness and therefore has a lower likelihood of spooking already fragile bond markets.
- The banks themselves do not have a reluctance to provide working capital into defence and security if there are appropriate supply chain guarantees in place.

This document is intended as a briefing on the key issues and is taken from participation in some of the key meetings taking place in Europe and NATO about defence and security spending, as well as participation in the British Foreign Policy Group's Trade and Economic Security Commission's work on effective defence spending structures over the past year. It also includes participation in the planning of the Defence, Security and Resilience Bank and the Centre for Economic Security's thought leadership work on the Security and Resilience Fund.

Headline policy announcements

- **Europe can no longer rely on the United States for its defence and security**. Ceasefire negotiations between Russia and Ukraine being brokered by the United States do not currently include confirmed further financial or security support to Ukraine. Before he was inaugurated, President Trump stated that he would impose tariffs on the EU if it did not increase its defence expenditure to 5% of GDP; the first few weeks of the Trump administration have given every indication that the new administration will use trade means to achieve non-trade objectives.
- **Re-arm Europe:** The EU has committed €800bn to collective defence and security in the coming years[1] following on from an increase of 11.4% in defence spending during the course of 2024. This proposal has been supported by 26 out of the 27 member states and has been followed through with a Defence White Paper.

Further support to Ukraine has been promised and a further €150bn committed for joint defence procurement across the region.[2]

“Germany is back”: The CDU/CSU, SPD and Greens have agreed to end the defence exemption from the constitutional debt brake, allowing it to increase its spending on defence so that total government borrowing is above 0.35% of GDP. A further €500bn has been committed to infrastructure and €100m to net zero commitments.[3]

UK defence expenditure will rise to 2.5% of GDP by 2027[4]: a further commitment has been made to increase defence expenditure to 3% of GDP “in the next parliament”. This is accompanied by a shift in remit of the National Wealth Fund to allow it to fund defence, a £2.6bn loan fund for Ukraine’s defence and a £2bn fund for UK defence exporters funded through UK Export Finance.[5]

Europe’s own nuclear deterrent? Constitutionally Germany cannot have its own nuclear weapons, but conversations are actively beginning in European capitals (notably Berlin, Paris and London) about the future of the NATO nuclear shield. At present the uncertainty around sustained US support in itself undermines the credibility of that deterrent, even if it is unlikely to be dismantled quickly.[6]

Funding Fundamentals

The EU has spent $52bn on military support to Ukraine[7], the UK $9.8bn and the US nearly $70bn. But with the US now looking to do a deal with Russia on ending the conflict without the UK, EU or Ukraine and reluctant to spend any money on European defence, the “E” element of Defence, Information, Military and Economic (DIME) becomes very important.

Because we have sent so many resources to Ukraine we face severe shortages of equipment ourselves and this requires an increase in spending which is currently unaffordable – we need to think anew about our own credibility and capacity.

Europe is bound by our NATO treaty obligations to support collective defence and in the absence of guaranteed US support, this provides a military and financial imperative to do something.

Considerations in creating a financial infrastructure that doesn’t spook markets

Bond markets are reacting to increases in defence spending: there are likely to be long term positive impacts on the European economies of increased defence and security spending. Estimates of the growth impact suggest that €1 increased defence spending creates a €1 increase in economic growth[8]. Nevertheless, nervousness around the increases in spending in an already tight government debt market caused bond yields to rise by 40 base points on the announcement of German intentions[9]. A rise in yields is effectively a market judgement on the economic risk associated with this additional borrowing.

The capacity for governments to borrow from financial markets is limited by high levels of indebtedness post-pandemic. This situation was significantly worsened by the energy price increases immediately after Russia’s invasion of Ukraine placing the credibility of any threat under extreme strain because Europe has no capacity to scale finance at present.

Any financial model in individual nation states needs to increase spending without increasing public sector net financial liabilities (PSNFL): This broadly is the difference between the assets and liabilities in the government’s balance sheet; defence spending can be treated as a growth asset if it is not paid for through taxation and if there are provisions for defence innovation and defence and security infrastructure. This is a priority for the UK government in particular.

The European’s Resolution on the Security of European Defence[10] lays out a framework for reducing the EU’s dependence on “third countries” but SIPRI research suggests that some 64% of EU procurement is serviced by the United States[11] and real challenges to the supply side in the region’s Small and Medium Enterprise Sector (SMEs) highlight the difficulties of immediate scaling will be at best challenging in the short term. This means that increasing spending in and for itself will not necessarily improve the situation by reducing that dependence immediately.[12]

Creating a preparedness financial infrastructure so that supply chains can adjust: the institutional and systemic solution

At present, there are at least two challenges that limit the extent to which critical supply chains can adjust rapidly to emerging threats:

- Under-resourcing of core capability at a governmental level. This is a function of budgets and procurement processes.
- The risk that critical supply chains will not be able to increase production and supply because of vulnerabilities in their lower tiers where smaller businesses are more exposed to lack of working capital to service contracts. This restricts their capacity to scale up production quickly.

This is happening because:

- On the demand side, governments are fiscally constrained at present and cannot scale domestic budgets sufficiently quickly to enable preparedness in critical supply chains.
- On the supply side, banks are restricted by compliance and shareholder preferences in terms of their capacity to provide working capital into deep tier critical supply chains (especially defence and security) because their risk profiles are financially and reputationally too high.

The solution

The solution is to create a financial architecture based on

- “Blended finance”: (public and private sector joint funding).
- Incentivised private sector finance: bank and investment finance at preferential rates to overcome the high risk profile of this type of funding.

Any financial architecture needs to have appropriate risk sharing and rewards that reflects the balance between the “public” good – i.e. National security interests – and the “private good” – the effective commercial operation of critical supply chains.

First, the EU’s recommendation to create a multilateral funding structure through the creation of a multilateral financial institution is well made for two reasons:

- Such a bank is funded by initial capitalisation from its founding members. This gives it a triple A credit rating and allows governments to borrow for defence procurement on favourable terms.
- The DSRB is funded by national shareholdings – this does not add to national debt as such because it is counted as an asset/investment on national balance sheets. It conforms to the Public Sector Net Borrowing (PSNB) frameworks that the IMF and OECD have been promoting. This is now used in the UK.
- Private sector use of DSRB guarantees does not increase the pool of debt for the government because these are to the private banks who then provide working capital finance to the businesses.
- Where governments are using the borrowing from the bank for investment in infrastructures such as new defence systems these also class as PSNB.

In other words, a multilateral bank can make a significant difference to the way in which defence is funded as well as to the amounts allocated to defence spending without increasing the risks associated with greater national debt. At a time when Europe and the UK have high levels of debt, the multilateral bank solution is an effective, and well-established, way to square this particular circle.

Second, the DSR bank needs to be supported by a Private Credit Fund, or Security and Resilience Fund[13] (SRF) which works with existing sovereign infrastructures and guarantees to build capacity and capability in the supply-side infrastructure base. This fund will operate commercially with a blend of credit and equity to speed the process of supply in critical supply chains and critical resilience and would be funded by capital allocations from commercial banks who would want to fund defence and security without compromising on sustainability priorities. Such a fund will function multilaterally but will equally have a “sovereign” purpose to build capability at a national level as well. The international feature of it is important because:

- Critical supply chains are intrinsically international in nature.
- Many of those supply chains are highly dependent on components sourced in countries broadly defined as “adversaries”.

Finally Commercial Banks (CBs), provide the financial infrastructure to deliver short-, medium- and long-term finance through their payments, trade and working capital, and supply chain finance functions. They are critical to the development of a financial architecture that provides a resilient system to ensure that money reaches the right part of the supply chain at the right time, especially in the area of defence and security as the Centre for Economic Security points out[14]. This reduces the risks and vulnerabilities within the physical supply chain itself. These commercial banks would work with the MLB and the CRF utilising their resources to provide trade finance to parts of the defence and security supply chain system that they find hard to work with at present on compliance and regulatory capital grounds.

It is worth noting:

- Systems already exist for credit insurance and guarantees within the private and public sectors of most NATO members through Export Credit Agencies and EXIM banks.
- The technical mechanisms for delivering supply chain finance make heavy use of payment guarantees and obligations. Non-payment of an invoice or non-delivery of a contract represents the major financial risk to these organisations. These risks are mitigated by assumed ownership of whatever is being shipped within a supply chain and public and private trade credit insurance.

For some time there has been a resistance for banks to engage directly with defence and security, not least because this is seen to run contrary to ESG considerations. However, as UK Finance pointed out in a recent letter[15], these concerns may at times be over-played, while the Financial Conduct Authority in the UK is more direct – there are no ESG compliance considerations that prohibit defence investments or lending in the UK.[16] The British Foreign Policy Group’s Economic and Trade Security Commission explicitly supports the development of a shared understanding between trade finance banks and critical national infrastructure supply chains based on the findings of a year-long investigation.[17]

Crowding in funding to the SRF in the UK

Incentives would be provided through the Capital Gains Tax system (CGT) and through the regulatory capital system to crowd in investment:

- The SRF would act like a Venture Capital Trust for High Net Worth Individuals – they receive reduced rate or pay zero capital gains tax on gains which can be offset against the CGT changes that will exist as a result of the UK budget in October 2024.
- The SRF would enable investments and lending to be made with lower regulatory risk capital requirements making returns higher reducing costs.
- Risks in any blended finance between the Multilateral Bank and the SRF would be structured to reflect the balance between public gain and private gain and would be under-written by credit insurance provided by the MLB for riskier projects. Private credit insurance would need to compete with the lower premiums provided by the MLB.

What all this means

There is a large amount of technical detail in this briefing document which potentially belies the simplicity of the message: that Europe in general and the UK in particular needs to reduce its reliability on the US's security umbrella and, as a result, must increase its defence spending without spooking bond markets. This is an opportunity to put significant investment into infrastructure which over time will promote economic growth as the supply side develop the capability and the capacity to service European-based supply chains.

We need this new infrastructure for the simple reason that the financial and economic institutions of the international rules based order (as defined by Bretton Woods) are no longer fit for purpose in the current geostrategic climate globally. The European Bank for Reconstruction and Development, for example, is a similar multilateral bank framework to the Defence, Security and Resilience Bank proposed here. However, as a founding member, Russia is a shareholder and it is not able to fund defence projects. Similarly, the European Investment Bank is also challenged in terms of its capacity to fund defence and security.

Finding new mechanisms and institutions to fund our own defence and security is the challenge of our era for policy makers and financiers alike. There are of course huge opportunities for the commercial defence sector to grow, and for private investors to invest in these emerging structures buy buying "security bonds" or simply setting aside working capital provisions to fund defence supported by government guarantees.

At present corporates and smaller businesses are struggling with the uncertainties that the current economic environment represents. The US administration has declared the International Rules Based Order "obsolete"[18] and with it the economic and defence security structures that have underpinned international institutions since the end of the Second World War. This is not a risk to business – risks are insurable; it is a huge uncertainty since no-one knows exactly where this is going to end. Uncertainty cannot be insured.

Yet at least one way out of this uncertainty must be to think about the defence and security funding infrastructures since these lead directly to establishing a "preparedness" footing for the European economy. The proposal here offers a structure and mechanism for doing that by crowding in investment to increase the effectiveness of supply chain finance without increasing public sector debt. For financial institutions, it keeps the "sustainable" funding mechanisms such as the EBRD in place but provides a ring-fenced dual use and defence and security framework based on a blend of public guarantees and private capital provision. These structures already exist.

Technical appendix

Crowding in funding to the SRF without increasing PSNFL

Incentives would be provided to invest in the SRF through the Capital Gains Tax system (and through the regulatory capital system to crowd in investment:

- The SRF would act like a VCT for UNWIs – they receive reduced rate or zero CGT on gains which can be offset against the CGT changes that will exist as a result of the UK budget in October 2024
- The SRF would enable investments and lending to be made with lower regulatory risk capital requirements making returns higher reducing costs.
- Risks in any blended finance between the MLB and the CRF would be structured to reflect the balance between public gain and private gain and would be under-written by credit insurance provided by the MLB for riskier projects. Private credit insurance would need to compete with the lower premiums provided by the MLB
- Money is made by the CRF through commercial lending and investment but also through the separate provision of credit insurance and the potential of creating trade finance asset distribution for defence and security supply chains.

The SRF represents the engine that connects the CB/financial infrastructure to the DSRB. The SRF's returns in lending and growth finance are again well-established mechanisms in interest-rate based lending, mezzanine finance and venture capital/private equity funding and of course, direct provision of trade or supply chain finance. This means that the revenue model for the SRF is:

- An administration fee connecting the banks with guarantees and providing data/certification that the deal being done is critical national infrastructure-related.
- An agreed proportion of the deal being done
- Automated regulatory data and certification for smaller deal sizes.

The process of working with the CBs is as follows in order to maximise the amount of funding out there and there are a number of issues which are key to understanding the financial vulnerability in supply chain finance which the SRF will address through guarantees:

- Compliance and capital risk guarantees for key sectors (worth up to 80% of commercial risk) from UK Export Finance, the British Business Bank, the National Wealth Fund and UK Research and Innovation and/or the NATO Innovation Fund. These guarantees already exist, for example through JEF or Bond Support Schemes and the proposal is to extend the risk guarantees specifically to include defence and security where compliance risk concerns are higher.
- Bank capital sum allocated to provide debt provision to businesses who are confirmed to be actors in critical national infrastructure or supply chains and can be supported under the Sovereign Resilience Fund's terms and conditions, which will include formal accreditation of the business or contract within a sovereign capability or resilience structure.
- Where provision of working capital is for innovation or growth, co-investments alongside private investors can be used to crowd in UK-based venture capital and private equity.
- The commitment from banks and growth finance players is to agree to capital sums allocated specifically for the purposes of funding government defined priority sectors in defence and security and critical national infrastructures.
- The commitment from government is to extend existing guarantees to commercially viable projects to include compliance risk.

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- https://www.euronews.com/my-europe/2025/03/14/more-better-european-white-paper-maps-path-for-eu-rearmament#:~:text=European%20Commission%20President%20Ursula%20von,procurement%20for%20defence%20and%20security. ↑
- https://www.dw.com/en/germany-parties-agree-on-historic-debt-deal/a-71922888 ↑
- https://www.gov.uk/government/news/prime-minister-sets-out-biggest-sustained-increase-in-defence-spending-since-the-cold-war-protecting-british-people-in-new-era-for-national-security#:~:text=The%20Prime%20Minister%20has%20today,of%20GDP%20from%20April%202027.&text=Defence%20spending%20to%20increase%20to,3%25%20in%20the%20next%20parliament. ↑
- https://www.thetimes.com/uk/politics/article/rachel-reeves-defence-spend-labour-9f56b6l7f#:~:text=Reeves%20said%20she%20would%20change,projects%2C%20including%20green%20energy%20schemes. ↑
- https://www.dw.com/en/germany-debates-issue-of-nuclear-weapons/a-71924424 ↑
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https://ces-global.net/the-security-and-resilience-fund/ ↑

https://ces-global.net/wp-content/uploads/2025/03/SEC-Military-Supply-Chains-And-Supply-Chain-Finance.pdf ↑

https://www.ukfinance.org.uk/news-and-insight/press-release/uk-finance-letter-role-financial-services-in-supporting-uk-defence ↑

https://www.fca.org.uk/news/statements/our-position-sustainability-regulations-and-uk-defence It is worth noting that the EU's Sustainability Financial Reporting Directive treats "exposure to controversial weapons" as a so-called "principle adverse impact" indicator. ↑

https://bfpg.co.uk/2025/03/why-a-multilateral-defence-and-security-bank/ ↑

https://www.state.gov/opening-remarks-by-secretary-of-state-designate-marco-rubio-before-the-senate-foreign-relations-committee/ ↑