DEFENCE FINANCING IN EUROPE

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Financing of defence: looking beyond banking

Before Russia's invasion of Ukraine, defence financing played a marginal role in EU banks' lending portfolios. Many banks were even retreating from that segment. The geopolitical shift that followed prompted both policymakers and banks to reassess the sector's financing needs.

Even though its importance has increased since then, defence financing accounts for only ca. 0.3% of loans and advances of EU banks. They now made clear their support to defence investment, which included joint initiatives with the EIB.

According to the EBA's Risk Assessment Questionnaire, 34% of EU banks aim to increase their financing of defence and security companies. They have a focus on defence related R&D and supply chains. Our survey shows that over 70% of banks expect rising loan demand in this sector in the next 12 months, making it the sector expected to rise the most.

Defence has drawn interest from many financial institutions, such as investment funds and non-bank lenders. While banks compete in some areas of defence financing with non-banks e.g. private credit funds, the latter can play complementary roles, such as in venture capital or equity financing. Consequently, the increasing participation of private credit should not be seen as a threat to banks. It is important to ensure that the two are not too intertwined to limit contagion risk.

From a prudential perspective, the framework should remain risk-based. Defence exposures should not be penalised because of the sector, nor should they receive lower capital requirements not justified by their risk profile. Prudential regulation should avoid stigma or privilege: its role is to ensure that risks are identified, measured and capitalised.

The main issue is credit risk capital. For banks using an internal ratings-based approach, capital requirements reflect specific borrower and transaction parameters. This allows defence exposures to reflect borrowers' strength, collateral, contractual structure and expected recoveries.

Capital requirements calculated through the standardised approach should not be an impediment either, neither for banks applying it directly, nor for large banks using internal models which makes standardised requirements a binding reference point through the output floor introduced by CRR3.

In many cases, defence financing is provided to large industrial groups with external ratings, with the standardised approach differentiating credit quality. The framework assesses exposures based on their specific risk characteristics rather than by sector alone. It also provides differentiated treatment for specialised lending and project finance, which can be relevant for well-structured defence-related investments. In addition, the EU framework includes SME and infrastructure supporting factors and recognises the role of trade finance instruments, such as letters of credit and other off-balance-sheet instruments. They enable the execution of large public contracts while remaining consistent with prudential risk sensitivity.

Overall, the current framework provides channels through which defence financing can be treated in a risk-sensitive manner which should allow to properly take into account the sector's features and support viable defence investment.

Moreover, the EU sustainable finance framework is compatible with those investments. They are to be assessed on a case-by-case basis like any other sector. As clarified by the Commission, banks should not treat defence as a de facto excluded or disfavoured sector, but may finance defence activities subject to sustainability, due diligence and disclosure principles that apply across the economy.

> Current rules allow banks to play a key role in a defence financing, which so far remains scattered.

In conclusion, it is essential to look beyond banking. The review of EU securitisation rules can help banks transfer risk, diversify funding sources and free balance-sheet capacity for new lending, while maintaining transparency, due diligence and financial stability. The reviews aim to make securitisation simpler, updating due diligence and transparency requirements and increasing the risk-sensitivity of the prudential framework.

Finally, the most powerful lever may lie outside prudential regulation: better defence procurement. Larger, more coordinated and predictable procurement programmes would improve industrial planning, strengthen supply chains and create investment opportunities better suited to banks and institutional investors. The EU Defence Readiness agenda rightly emphasises joint procurement, closing capability gaps and strengthening the EU defence industrial base. A resilient, risk-sensitive prudential framework and a more integrated defence market are therefore complementary: together, they can support Europe's defence readiness without compromising financial stability.

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Financing Europe's rearmament: a public-private compact for the supply chain

Europe's rearmament is as much a financing challenge as an industrial one. Public budgets set the demand, but the ramp-up of production will be delivered by thousands of SMEs and mid-caps whose balance sheets were not built for it. The French experience shows that a structured public-private approach can unlock financing at scale, provided each actor plays its role.

Public authorities should provide predictability and correct market failures; private finance should carry the bulk of the effort. The role of the State is to give the industrial base predictable order books, to remove unjustified obstacles and to intervene only where the market does not deliver. In France, the "dialogue de place" launched in March 2025 brought together banks, insurers, investment funds, defence primes and public authorities and found no regulatory obstacle to bank lending to defence: no emblematic case of refusal on defence exclusion grounds was identified, and outstanding financing from the six main French banking groups to French defence companies exceeded 46.6 billion euros at end 2025, up 26 % in one year. On the equity side, more than thirty investment vehicles dedicated to defence and sovereignty are operational or being raised, targeting over 7 billion euros.

For supply chain SMEs and mid-caps, the priorities are working capital and equity. French defence SMEs are more indebted and less capitalised than their civilian peers, with longer payment terms. Two levers address this. First, a "cash neutral" objective throughout the subcontracting chain: generalising advances, down payments and responsible payment practices so that executing a defence contract has minimal impact on suppliers' cash positions. Second, closing the equity gap, estimated at 4 to 6 billion euros by 2030 in France to reach full production capacity. This requires leveraged and private debt funds, guarantees, but also credible exit routes: reinforcing listed small and mid-cap funds is essential to make IPOs an attractive prospect for investors. These challenges differ across Member States according to the depth of capital markets and the structure of the industrial base, but equity and cash constraints are common priorities almost everywhere.

> **Public authorities are providing predictability de-risking, and a continuous political momentum.**

Genuine European cooperation can be built while preserving national strategic interests. Any EU-funded instrument should carry European preference criteria, so that common money strengthens the European industrial and technological base. Demand aggregation and joint procurement, supported by SAFE and EDIP, reduce costs, avoid duplication and give suppliers the volumes that justify capacity investment. National strategic interests, such as security of supply and sovereign technologies, are best preserved through this coordination, not against it. All of this must remain consistent with credible national budgetary trajectories, which underpin the financing conditions of the whole effort.

Financing tomorrow's defence also requires dedicated attention to innovative dual-use companies. A structural financing gap persists at the growth stage for companies carrying breakthrough innovation. France is responding with a 3rd phase of the Tibi initiative[1], prioritising deeptech and associating defence primes as partner investors, in order to build investment vehicles of significant size and limit dependence on non-European capital. Mobilising large defence contractors alongside institutional investors has a strong multiplier effect and anchors these strategic technologies in Europe.

EU instruments should be optimised for visibility, leverage and sustainability. The European Defence Fund supports R&D upstream; EDIP must now finance the industrial ramp-up and SAFE must provide long-term loans to Member States for joint procurement with European preference criteria for both instruments. InvestEU and guarantees can de-risk private financing of dual-use technologies. The EIB Group has made security and defence a transversal objective and financed 4.5 billion euros of projects in 2025; the EIF has made several changes to clarify its eligibility rules for defence funds, and a fund of funds dedicated to cybersecurity and defence companies will be launched. Finally, the Commission notice of December 2025 confirmed that the EU sustainable finance framework imposes no limitation on financing defence: this clarification must now be reflected in investors' practices.

The lesson of the French experience is clear: public authorities need to provide predictability of demand, clarification on legal standards and targeted de-risking, so that private finance follows, at scale and durably. Europe's rearmament will be financed on that basis.

1. *The Tibi Initiative marshals institutional investors – particularly insurance companies managing French savings held in life insurance and retirement savings plans – to channel a portion of these funds towards tech companies, through specialised funds (venture capital, growth capital and specialised technology stock funds).*

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Reducing regulatory complexity and strengthening the resilience of the EU prudential framework – a contradiction or a chance?

With the publication of the European Commission's report on the competitiveness of the EU banking system and the expected legislative proposals in early 2027, the discussion among policymakers, authorities and stakeholders about the simplification of the current financial regulatory system has gained new momentum in the EU. The current framework is often characterized by inefficiencies, complexity and fragmentation along national lines making cross-border capital allocation difficult. The lack of completeness in the euro area's banking union represents another hurdle.

While there seems to be consensus about the goal of simplification that needs to be achieved, the real challenge is HOW it should be done to avoid unintended consequences.

The main problem is that the current prudential system is very multifaceted and multilayered. All bits and pieces are intertwined, some of them in a very complicated manner. Thus, the question is, can the whole system be simplified without weakening the resilience of the banking sector? Every layer of the system must be considered, all decisions for simplification and their consequences must be thought through carefully. Changing elements of this multidimensional system should not result in counteraction of their effects.

When it comes to restructuring an existing system, a look at other systems for comparison and inspiration might be the first step. A seemingly simpler prudential system can be found in the U.S. But to what extent could it be applied to European needs and purposes?

A starting point of this discussion could be centered around Megabanks, as both are found in the EU and in the US. Megabanks are a subset of Global Systemically Important Bank (GSIB), meaning large internationally active banks that hold above a trillion in total assets measured respectively in US dollars for US banks and in euros for EU banks[1]. Since the second Trump Administration the policy for US Megabanks is marked by deregulation, conducted by significant changes in stress-testing scenarios and methodology and a reduction in leverage capital standards[2]. In addition, the supervisory capacity of US federal banking authorities has been sharply reduced, in both quantitative and qualitative terms, most likely leading to harmful effects on supervisory effectiveness and subsequently on financial stability in the long term.

Renovating an existing system is sometimes more difficult than building a completely new one.

Thus, following the US example is not the best option for EU banks. Simplification and enhancing competitiveness should never come at the cost of supervision and financial stability. Hollowing out the Basel standards would not enhance efficiency in the regulatory framework. Stable capital requirements alongside the resolution frameworks, leverage ratio requirements and capital buffers established by the Basel setting and implemented into EU legislation have contributed over the years to the resilience of the EU banking sector against significant macroeconomic shocks such as the COVID-crisis, the Ukrainian war and the geopolitical turmoil in the Middle East.

Different from the US, it is a consensus among European policymakers and authorities that simplification should not lead to deregulation. Thus, capital requirements should remain stable while complexity in their setting must be reduced. This might entail a more simplified regulatory regime for small and non-complex banks with tailored reporting and disclosure requirements. The Basel III regulations were designed from the ground up for complex, internationally active institutions (such as Megabanks) and do not focus on smaller credit institutions, which often operate locally and would benefit from a more proportional prudential regime. In addition, overlaps across regulatory layers should be reduced but without diminishing overall safeguards. It is well understood that reporting burdens should be cut as well, which also includes a better exchange of data between authorities. However, the creation of additional administrative burden or institutional structures should be avoided.

Although reducing complexity and streamlining capital requirements regarding simplification remains a challenging task, what has already been achieved is a wide level of understanding among the private and the public sector for the necessity of simplification. With that growing awareness among policymakers, authorities and banks, it is generally agreed that for facing current and future economic and geopolitical challenges, a strong and competitive banking sector with an efficient prudential framework is of substantial importance for growth and sustainability of the EU banking landscape.

1. *See Mejino-López, J. and N. Véron (2026) 'European Union capital requirements on megabanks: the low road or the high road,' Working Paper 18/2026, Bruegel, p. 5*
2. *See Federal Reserve Board - Agencies issue final rule to modify certain regulatory capital standards (https://www.federalreserve.gov/newsevents/pressreleases/bcreg20251125b.htm)*

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Europe's defence challenge is financial as much as military

Europe's defence debate has centred on spending. European NATO defence spending has increased from just over €300bn in 2021 to more than €500bn in 2025, while Germany, Poland and the Nordic countries have all committed to further increases this decade. Yet the real test is not how much governments commit, but how effectively those commitments are converted into industrial capability.

Europe's defence challenge is no longer constrained by political intent; it is constrained by the speed at which capital, industry and procurement can move together.

This is where Capital Markets Union takes on strategic significance. Conceived as an economic integration project, it has become a key enabler of Europe's security. Money appropriated by governments does not strengthen Europe's defence; money converted into factories, technology, supply chains and production capacity does.

Europe wants a world-class defence industry, yet too often fails to treat defence as a strategic asset. This tension lies at the heart of Europe's defence financing challenge.

The first barrier is access to capital. Defence is a strategic public good, no different from energy security or critical infrastructure. Yet many institutional investors maintain exclusion policies that limit capital flows to the sector. One of the key sovereign institutional investors, for example, excludes companies involved in producing components used in weapons systems. Individual investors are, rightly, entitled to define their own investment policies, but Europe should recognise the broader inconsistency. If governments expect industry to expand production, they must also ensure that long-term private capital can finance that expansion and that regulatory and investment frameworks enable such capital to flow into the sector.

Europe's security depends on converting capital into capability.

The second barrier is fragmentation. European security increasingly depends on collective capability, yet procurement remains overwhelmingly national. The UK's exclusion from SAFE and the collapse of the Future Combat Air System (FCAS) programme, following the failure to agree work-sharing and industrial responsibilities, demonstrate how national priorities continue to outweigh European strategic interests. Capital markets will more readily support programmes with sufficient scale and profitability. Yet fragmentation persists across Europe's defence industrial base.

Industrial policy must evolve alongside financing. Europe does not necessarily need more defence factories; it needs more factories capable of becoming defence factories when strategic circumstances require. The debate surrounding Volkswagen's Osnabrück plant illustrates the opportunity. While Rheinmetall ultimately decided not to pursue the site, the debate highlighted how underutilised industrial capacity could, where commercially and strategically appropriate, be repurposed to strengthen Europe's defence industrial base. A manufacturing ecosystem capable of shifting between civilian and defence production would strengthen resilience, improve asset utilisation and shorten J-curves, making the sector more financeable. It would also serve a broader public interest by supporting regional employment and ensuring strategically important industrial capabilities remain utilised, thereby improving both economic and national resilience.

The third barrier is financial innovation. Banks helped build the financing architecture behind Europe's energy transition through green bonds, blended finance and sustainability-linked instruments. Defence deserves the same ambition. Defence bonds, procurement-backed financing, dedicated private credit vehicles and public-private risk-sharing mechanisms can broaden the investor base while supporting Europe's defence sector. Banks will play a critical role as arrangers, underwriters and distributors, connecting institutional investors with financing opportunities and mobilising private capital at scale. Public financial institutions such as Bpifrance have shown how targeted intervention can unlock private capital, attracting €3.8bn of demand for a €1bn defence bond. Europe now needs to replicate that model at continental scale.

Europe's security will depend not only on what governments are prepared to spend, but on whether the entire ecosystem (public authorities, investors, banks and industry) can evolve and align behind a common objective. The real challenge is transforming twenty-seven national defence markets into a single European industrial capability. Until that happens, Europe will continue to spend like a major power while procuring, financing and producing like a collection of smaller ones.

Capital Markets Union was conceived to deepen Europe's single market. Today's geopolitical reality gives it a far greater purpose: helping convert Europe's economic strength into strategic capability. Done well, it can become one of the most important enablers of Europe's security, ensuring that capital, industry and innovation move at the pace the moment demands.

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Stronger European markets for a stronger European defence

The financial sector can hardly afford to remain indifferent to the financing of defence, as the increase in European military spending is a crucial element in reinforcing the continent's credibility.

Demonstrating that the European Union is becoming more strategically autonomous in this field can only strengthen global investors' confidence in Europe's resilience. Moreover, the modernisation of European defence, as a driver of technological innovation - particularly in areas such as cybersecurity - can also help revive productivity growth across the continent.

What lessons have we at AXA drawn from our already well-established financing activities in the defence sector? In our view, regulatory obstacles - particularly those related to ESG - are not the main impediment, once certain inconsistencies, such as exclusions embedded in some national sustainability labels, are corrected. That said, the transparency requirements associated with the most ambitious responsible investment products can be difficult to reconcile with the nature of defence companies' activities which can cover both civilian and military purposes.

Until now, the main constraint has instead been the defence sector's limited demand for market financing. After two decades of declining military expenditure, European defence companies have generally relied on traditional bank financing, leaving limited room for other financial institutions, particularly insurers.

If the renewed defence effort is pursued on a sufficiently large scale, it should lead to a broader range of financing instruments, as all participants in the financial community will need to play their part.In this area, however, what matters most for long-term investors is the visibility of future demand facing defence companies.

That visibility depends primarily on the commitments made by national governments, which are the sector's principal customers. Yet it may come into conflict with the principle of annual budgeting in public finances, especially at a time when national budgets are under unprecedented pressure across many European Union countries.

The EU should use joint defence funding to create a common risk-free reference asset.

This has resulted in substantial sovereign financing needs that may compete with those of private companies. Russia's war in Ukraine—and the prospect of a reduced US security commitment—have created a broad European consensus in favour of a long-overdue rebuilding of military capabilities. That consensus must not be allowed to weaken, and greater clarity is needed on the major strategic defence procurement programmes jointly undertaken by several Member States.

What is still missing to give Europe's new defence ambition a durable financial foundation is the establishment of common financing mechanisms.

Over the past twenty years, the euro area has addressed its existential challenges by pooling financial resources. This was the case in overcoming the sovereign debt crisis of 2010–11 through the strengthening of solidarity mechanisms such as the European Stability Mechanism (ESM).

Likewise, the severe macroeconomic consequences of the pandemic were addressed through a collective European response with the Next Generation programme. For now, however, mutual funding on defence remains very limited. European "federal debt" has been an asset of choice for us, as well as for many institutional investors.

The European Union should not miss the occasion to use joint funding of defence projects to raise the availability of a common risk-free asset of reference. With – fortunately – the disappearance of the funding needs of the ESM, once the full capacity of the Next Generation programme is used, Europe will no longer produce such reference asset. This would complement Savings and Investment Union and go a long way towards putting the European financial system on a more equal footing with the US.

Europe needs to direct more if its plentiful savings towards its own investment priorities, and defence is one of the most urgent ones. European defence and SIU naturally complement each other. .

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Financing Europe's defence industrial base: a public private partnership

The return of high-intensity risks in Europe, the deteriorating geopolitical environment and the need to accelerate Member States' defence ambitions are forcing an unprecedented change of scale: stronger military capabilities, technological innovation, secure supply chains and reindustrialisation. Achieving these objectives will require massive investment in the years ahead.

This goes far beyond the defence sector alone. The European Commission estimates that more than €1,000 billion in additional investment is needed every year to finance Europe's major societal, environmental, energy and technological transformations. States alone cannot cover such needs.

Budgetary room for manoeuvre will be constrained in most Member States. The question is not how much to invest, but how to finance this collective effort, and private-sector players will have a decisive role to play.

Bank financing is the first driver. European banks are already an essential asset for financing the defence technological and industrial base (DTIB), not only by supporting major prime contractors but by financing the entire value chain: specialised SMEs and mid-caps, with unique know-how, often on critical technological segments. Europe's defence effort depends on the ability to foster investment, increase these companies' production capacity, recruit highly qualified staff and drive innovation, while respecting each Member State's industrial know-how.

Access to financing is a matter of competitiveness, but also of strategic independence. Banks have a central role in directing savings towards productive investment and supporting companies' growth projects. As Nicolas Namias, CEO of BPCE, recently recalled, "a bank's fundamental mission is to make its clients' projects possible" and to finance the major transitions redefining global economic balances. Retail banking networks, through their physical presence across the regions (thousands of branches), are major players in sovereignty.

Banks and investors: key players in European sovereignty.

Within Groupe BPCE, the commitment to supporting the DTIB has long been part of a long-term trajectory, considerably accelerated since 2022, with multiple initiatives ranging from bank financing to innovative market operations. BPCE was the first bank to issue an european defence bond (€750 million), and the first French bank to benefit from a significant EIB envelope supporting the DTIB Supply Chain across the regions.

Bank credit alone will not meet all future needs. A second pillar must be fully mobilised: capital markets financing. Many defence companies will need to durably strengthen their capital to finance growth, secure industrial investments or support internationalisation, which requires directing more capital investment towards Europe's defence players.

This requires better visibility of the defence industrial ecosystem. While the largest companies are generally well identified by investors, many SMEs in the Supply chain beyond level 2 remain insufficiently visible, even though they carry out activities critical to the industrial autonomy of Member States which have a DTIB. A finer, more dynamic mapping of value chains would help identify and qualify these players, improve understanding of industrial dependencies and, in fine, facilitate the allocation of capital towards the companies that need it most.

Visibility is essential to securing supply chains and private investment, along with better predictability of order books, industrial outlooks, future activity flows and well-controlled payment terms. The more clearly financing players can read industrials' needs and outlooks, the faster and more effectively they can mobilise financing for the DTIB.

Lastly, a few targeted regulatory adjustments could usefully amplify this effort. The aim is not to question the prudential requirements underpinning the solidity of the European financial sector, but to ensure excessive rules do not hinder the financing of strategic companies. Simplifying certain provisions for financing the real economy, particularly in specialised lending or trade finance, would strengthen the private sector's investment capacity without compromising financial stability.

Europe has the financial and industrial players, and the resources, to support its defence and security ambition. The priority is therefore to give industrial companies, banks, markets and investors the room they need to act, rather than adding unnecessary constraints. Stronger spaces for cooperation must also be built, respecting each Member State's industrial know-how. Finally, a deeper investor base must be organised for the European DTIB, with active support for export momentum.