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Are Defensive Weapons Social?

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When Russia's Ukraine war woke us up from the illusion that peace will stay forever, Germany's historical shift to boost military spending by targeting the budget to 2% of GDP from currently 1.5% in addition to an one-time surge of allocating [100 billion Euros](#) won applause. Meanwhile, the European defense industry made a case for labeling themselves as sustainable for their contribution to national security and peace. However, this idea was largely rejected by the Final Report on Social Taxonomy published in Feb 2022 though leaving room for interpretation.

As a backdrop, the Social Taxonomy is proposed in the EU as a parallel to the Environmental Taxonomy to define a list of economic activities with screening criteria to achieve social objectives, which is to fill the gap in the current market of lacking consistent definition of social investments and to direct capital into these socially valuable activities. Ultimately, these sustainable activities will be awarded with lower cost of capital by the market as investors are getting more and more conscious of sustainability.

Lucrative business, ESG-beleaguered

Defense industry, in fact, has been on the blacklist of investors, asset managers and ESG labeling organizations for a long time. For example, both the Austrian ecolabel and the FNG label, a Germany-based renowned qualification for sustainable investments, require applicant funds to exclude both controversial and conventional weapons. Nevertheless, weapon producers argue that "No sustainability without a defense and security industry" with their role being to protect democracy and freedoms in a very unstable global environment, contributing to a proper implementation of the UN Sustainable Development Goals, particularly SDG 16 'Peace, Justice and Strong Institutions'.

No wonder that the defense industry is defending themselves on the front of sustainable finance. It is a lucrative business. Europe is home to some of the world's largest weapon producers, with 26 companies on the SIPRI top 100 list (the Stockholm International Peace Research Institute (Sipri) Top 100 Arms-Producing and Military Services Companies). With combined arms sales of \$109 billion in 2020, these 26 European companies accounted for 21 per cent of total Top 100 arms sales. France, Germany, UK, Spain, Italy, and the Netherlands are among world's top 10 exporters of major arms. With an annual turnover of €180 billion, the industry in Europe as a whole, though lucrative, are facing challenges of declining profit margins and lack of financing as banks begin to cut ties and investors shun. As a result of lacking investments in innovation and technology, the sector is at risk of weakening and losing competitiveness.

Harmful activities

However, weapon producers will fail the "do no significant harm criteria" (DNSH) test to be included in Social Taxonomy. On the one hand, weapons of mass destruction, be it nuclear, radiological, chemical, or biological, are destructive by nature and they kill civilians indiscriminately or are specifically prohibited by international treaties. On the other hand, conventional weapons, such as cluster munitions, pose a particular hazard to civilians as they are unreliable, inaccurate, prone to indiscriminate use, and expose civilians to severe and lasting risks from blasts. Apart from this, the proliferation of small arms and light weapons and the use of these weapons in violent and illicit activities are undercutting EU's own security, spurring political instability, fueling the drug trade worldwide, and supporting terrorism, of which EU itself had become a victim, as seen in the 2015 Paris and the 2020 Austria attacks.

Good intentions meet bad actors

Even if the "do no significant harm" criteria were not considered and assuming that weapons for defensive purposes were socially sustainable, it is not possible to ascertain where those weapons end up because of significant diversion and misuse risks due to poor arms control, illicit transfer, and loose regulation. Consequently, arms are often used to destabilize entire countries and regions instead of defending populations or to enhance local or regional security as it is claimed. Astonishingly, there is virtually no effective international regulation of arms exports despite the lucrative business fuels conflict, destruction and devastation, and untold human suffering. As a case in point, arms of prominent weapon producers are reported to land in the hands of rebels in crisis areas around the world as well as in several states that are the target of export bans, although it is unclear how it happened.

Setting the bar high

Turning to the social taxonomy, which economic activities will qualify in the Hall of Fame? Apart conducting economic activities that make substantial contribution to social objectives, fulfilling technical screening criteria, companies are assessed against “do no significant harm” DNSH criteria and minimum safeguards in order to align with social taxonomy. While the [Final Report](#) provides guidance on the selection of activities that could substantially contribute to objectives, the list of socially sustainable economic activities, and technical screening criteria, as well as minimum safeguards are still to be unveiled. Nonetheless, the Final Report on Social Taxonomy has identified three social objectives to be attained, with corresponding stakeholders being workforce, end-users/consumers, and affected communities.

These three social objectives are:

1. Decent work (including for value-chain workers)
2. Adequate living standards and wellbeing for end-users
3. Inclusive and sustainable communities and societies.

Substantial contribution can be made in three ways:

1. Avoiding and addressing negative impact
2. Enhancing the inherent positive impacts of social goods and services and/or basic economic infrastructure
3. Conducting activities that enable substantial risk reductions in other sectors.

Objectives	Sub-objectives (non-exhaustive list)	Stakeholder groups
Decent work	<ul style="list-style-type: none"> • Decent work • Equality and non-discrimination • Human rights in the value chain 	Workers
Adequate living standards and wellbeing for end-users	<ul style="list-style-type: none"> • Products quality and safety • Product design: durability and repairability • Cybersecurity • Personal data and privacy • Responsible marketing 	End-users
	<ul style="list-style-type: none"> • Water, incl. waste-water management • Food, incl. the food value chain • Housing • Healthcare, incl. care work • Education (incl. vocational training) 	End-users
Inclusive and sustainable communities and societies	<ul style="list-style-type: none"> • Basic economic infrastructure: transport, telecommunications (including the internet), financial services and electricity • Land rights, indigenous people's rights, human rights 	Communities and societies

Source: Erste Asset Management, EU Platform on Sustainable Finance

Room for interpretation and pending decision

The Final Report explicitly lists a number of international treaties and conventions which prohibit or restrict the employment of controversial weapons and certain conventional weapons as a source for identifying harmful activities. Upcoming treaties for examples on autonomous weapons will be considered as well. Yet, the treaties listed do not cover all types of weapons, leaving room for interpretation on including remaining or other kind of weapons.

Noteworthy, the advice of the Final Report on Social Taxonomy is non-binding, based on which the European Commission needs to decide whether to go ahead with the Social Taxonomy by July 2022. Although in the past, the EC has chosen to align to the technical advice, market liberalists may question whether we need interventions from regulators to tell people where investments should go especially when definition of “social” is so varied from different point of views. Admittedly, unlike any science-based criteria, there are a thousand definition for “social” for a thousand people. For some, it is right to exclude weapon producers from the social taxonomy, while some others disagree. No matter how the rule is proposed, the defense industry will exist and be financed, as seen from governments’ response to the wake-up call of the Russia-Ukraine war.

Please note: Since 2012 Erste Asset Management has committed to refraining from investments in companies that are involved in controversial weapons. Among them are:

- Biological and chemical weapons
- Submunition, including possible launch and ejection systems
- Anti-personnel mines, mine-planting systems, and other mine systems
- Nuclear weapons
- Depleted uranium weapons

You can get further information here: <https://www.erste-am.at/en/private-investors/sustainability/publications-and-guidelines>

This article is part of the **ESGenius Letter** on the topic “Social – The ‘S’ in ESG”. Further information and insights from our experts on social factors in sustainable investment can be found [here](#).

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