TheCityUK

ADS

Finance and investment for UK defence

A TheCityUK and ADS Group joint position paper

About TheCityUK

TheCityUK is the industry-led body representing UK-based financial and related professional services. We champion and support the success of the ecosystem, and thereby our members, promoting policies in the UK and internationally that drive competitiveness, support job creation and enable long-term economic growth. The industry contributes over 12% of the UK's total economic output and employs almost 2.5 million people – with two thirds of these jobs outside London across the country's regions and nations. It is a major contributor to the government tax revenue and the largest net exporting industry. The industry plays an important role in enabling the transition to net zero and driving economic growth across the wider economy through its provision of capital, investment, professional advice and insurance. It also makes a real difference to people in their daily lives, helping them save for the future, buy a home, invest in a business and manage risk.

About ADS

ADS represents businesses operating in the aerospace, defence, security and space sectors.Our membership ranges from major multinational businesses with substantial UK presences, to hundreds of small and medium-sized companies in every part of the country. Companies in our sectors employ 425,000 people in the UK and generate exports worth over £38bn a year.

ADS is here to represent industry, connect our members to business opportunities that support growth, and convene activity that contributes to the growth of the sectors. Our dedicated team supports around 1500 businesses throughout the UK – over 90% of whom are SMEs.

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Key messages

- The defence, and financial and related professional services industries have the capacity and skills to help government meet the strategic aims of the forthcoming Strategic Defence Review (SDR) and Defence Industrial Strategy (DIS) to support a better, more integrated, more innovative, and more resilient UK defence and security ecosystem and critical national infrastructure. The successful delivery of the SDR and the DIS depends upon leveraging the collective strengths of the defence and finance industries.
- One of the challenges facing the UK defence industrial base is the financing environment for SMEs and scale ups within the wider supply chain, which sit below the major defence contractors (primes). Recent increased interest in investing in defence companies is welcome, but this increased appetite needs to flow through to the supply chain in the form of greater cashflow and investment opportunities. Ensuring SMEs are appropriately supported is especially important because a healthy supply chain with a mix of companies, including SMEs, is good for growth, resilience, and innovation in the UK defence and security sectors and will produce positive spillovers to the wider economy.
- There are a range of challenges facing SMEs across all sectors of the economy, such as recent tax rises, skills and labour shortages, and access to finance. However, the defence and security sectors present specific features and challenges that do not arise in other areas of public-private partnership, and which need to be understood on their own terms:
    1. UK procurement processes, primarily the impact of bureaucracy and slow pace on cash flow, have been highlighted to us as the most significant barrier to growth for SMEs in the sector and therefore their ability to attract private finance and investment. Announcements on procurement reform are welcome, but the contracts in place need to offer reassurance to potential financial services providers at the same time.
    2. Some companies in the sector struggle to access essential financial services, including banking and insurance, which increases their cost base. In addition to financial viability assessments, financial services providers are required to run enhanced anti-money laundering (AML) and Know Your Customer checks (KYC) for businesses in the defence and security sectors. This is due to the specific risk factors identified under regulations including the Money Laundering Regulations 2017 and other associated risks of the industry related to anti-bribery and adherence to global sanctions. This due diligence may take longer and require more evidence, which increases administrative costs for financial services providers and defence sector SMEs (which may also lack the resources and/or the ability to share sensitive information to demonstrate compliance). We would like to see government, regulators, and industry cooperation enable the deduplication of due diligence checks for SMEs who are MoD approved suppliers.
    3. Despite its support for UK defence businesses, the financial and related professional services industry does not always feel it has sufficient political 'air cover' from government. For example, bank branches have been repeatedly targeted and damaged by anti-defence protestors. This places a responsibility on all parties to approach this crucial topic with care.
    4. One of the other issues impacting the defence industry is the ability to secure investment for working capital needs or longer-term capital to support scale up opportunities. ESG is another, albeit limited, factor influencing the investment environment for defence firms in the UK. As the government has identified, solutions can include some regulatory measures in connection with ESG ratings and fund labelling. Above all, increasing private investment in UK defence requires clear signalling from government and in some cases additional support. Government should make clear that defence investment is compatible with ESG objectives. For example, the European Investment Bank has publicly committed to working collaboratively with industry to identify pathways for projects that demonstrate a balancing of defence needs with environmental sustainability.[1] Investors and decision makers in government both want to ensure a return on investment when supporting the defence industry, and confidence from the customer (MoD and HM Government (HMG) more broadly) is essential to this.
- Ultimately, attracting private finance and investment requires commercial benchmarks to be met, since private sector parties make investments on a risk-weighted return basis. However, there is a unique opportunity and need to maximise the contribution of private finance and investment to supporting UK defence and security businesses, and make the public sector budget go as far as possible to deliver value for money to the taxpayer. This requires government to marry its various strategic aims with the realities of financial markets and the motivations of different classes of finance and investment, and to understand how to bring commercial opportunities to the private sector that cater to different risk appetites. These range from innovative dual-use start-ups/SMEs to primes underpinned by long contracts, and/or housing accommodation for military personnel, storage facilities, infrastructure projects, and so on.
- Furthermore, market reforms aimed at democratising access to all asset classes, such as the recent FCA proposal to simplify public offerings of corporate bonds[2] has the potential to source capital from a wider investor base by means of "defence bonds". This could attract investors who are not seeking equity exposure but are otherwise willing and able to contribute to the build-up of the defence industry.
- With global defence spending on the rise, increasing UK defence exports is both a growth opportunity and a means of sustaining a broader and more resilient UK defence industrial base. We welcome announcements that UK Export Finance has an additional £2bn to support UK defence companies that export overseas, as this supports growth in the defence sector in scenarios where UK government may not be the initial customer. New UK-EU defence cooperation, supported by mutual access to European co-financing and procurement budgets, should increase both scale and cross-border supply chain integration.

1 https://www.defenceprocurementinternational.com/features/maritime/financing-hurdles-for-eu-defence-companies-amid-esg-push
2 https://www.fca.org.uk/news/press-releases/fca-sets-out-further-proposals-support-growing-business-and-investment-opportunities

Policy proposals and next steps

To address these concerns, ADS and TheCityUK are calling for the following policy proposals:

Government demand signals and the political narrative

- **Change the culture of government as a customer:** The government, particularly the MoD, should provide clearer, stronger, and longer-term demand signals regarding its intentions for defence spending to guide decision making in the finance and investment community. This will also require a shift in culture within MoD procurement to:
  - **Deliver strategic procurement clarity** – Defining and signalling what the UK will purchase, collaborate on, and develop domestically would help defence firms to plan their manufacturing and skills needs and financial institutions to identify where different types of financing are required. Accompanying this, the MoD should publish long-term equipment pipelines and technology roadmaps to signpost future demand and opportunities. Within these established priorities, bureaucratic processes should be reformed to increase speed and agility within UK procurement. Additionally, we look for the MoD to provide greater clarity on how procurement reform of Single Source Regulations will better support a market where there are sole-suppliers, and allow for more commercialised pricing, which will encourage innovative firms to enter the market.
  - **Align to long-term strategic reviews** – While the SDR and DIS will set the broad direction, their outcomes are still to be confirmed. The UK government should consider additional signals that can reduce risk, instil confidence, and encourage investment. For example, Australia's 2024 National Defence Strategy was accompanied by an Integrated Investment Plan, setting out broad 10-year budget allocation estimates for various domains and technologies.[3]
  - **Enhance investor confidence** – Clearer visibility of market trends, spending priorities, and routes to acquisition will provide investors with the confidence to align their capital with the UK's defence and security sectors. Longer-term contracting, and the timely award of contracts, would remove the feast and famine contract cycles that pose significant challenges to SMEs' cashflow, and ultimately enable faster project cycles to support our armed forces. Government should set clear pricing signals and adopt market-appropriate pricing, to incentivise innovative companies into the defence market. The defence sector would welcome consideration of the MoD shifting away from the cost-plus price model to fixed pricing in scenarios where this is better for the industry and therefore better for programme delivery.
  - **Improve the pathway for innovative SMEs** – Alongside the new MoD SME support initiative, the government should further increase its commitment to allocate defence procurement spending to SMEs to help these companies rise above the barriers to entry of the industry. Acknowledging the existing mechanisms available to help support innovators and SMEs, including the expansion of schemes to be more inclusive of defence, gaps remain in the support offered for firms on the pathway to contracts (e.g. not yet on a contract with either the MoD or a prime). Formal collaboration agreements between primes, mid-tiers and SMEs would recognise the strategic importance of innovators and SMEs and should aim to share some of the risk. To improve cashflow for smaller businesses operating in the defence supply chain, there is also a need to ensure prompt payment practices apply between government, primes, and their supply chain, and the defence sector presents a real opportunity for the government to leverage its purchasing power and make the new Fair Payment Code a requirement for all larger entities in the defence supply chain.
  - **Consider dual-use and export potential when reforming procurement** – Armed forces' preference for 'gold-plating' or over specifying procurement requirements not only increases the cost of individual projects. It also limits the scope for dual-use applications for products and technologies, and it reduces the potential scope for exports. SMEs developing products with dual use applications and export potential are more likely to be commercially viable and therefore attract private finance and investment.
- **Send clear political signals to give reassurance to financial providers** – Clear government commitments and messaging can offer reassurance to institutions hesitant to engage due to reputational concerns or activist pressure. The UK government could take a leading role in underlining via policy statements the important role of the defence industry in ensuring national security, the desirability of investment in defence and security and by using the National Wealth Fund, encouraging Local Government Pension Funds and other public investment vehicles to allocate funds to the sector. The FCA's position that its sustainability rules do not prevent investment in or finance for defence companies should be re-emphasised.[4] The FCA should be encouraged to continue to proactively reassure industry on this point.
- **Continue to promote greater transparency around ESG considerations** – Bringing ESG rating agencies within the regulatory perimeter will force greater transparency. There will of course always be a cohort of investors whose ethical preferences are not to invest in defence and their freedom of choice should be respected. However, regulatory measures and guidance can clarify the boundaries for the benefit of investors and the industry.

3 https://www.defence.gov.au/about/strategic-planning/2024-national-defence-strategy-2024-integrated-investment-program

4 https://www.fca.org.uk/news/statements/our-position-sustainability-regulations-and-uk-defence#:~:text=Our%20sustainability%20rules%20do%20not,or%20finance%20for%20defence%20companies.

Access to finance and financial services

- **Promote and support cross-industry dialogue** – Recognising that financial institutions operate in a highly regulated environment, with significant penalties for non-compliance, the government should establish a dedicated forum to facilitate transparent dialogue between government departments, regulators, the defence sector and the finance community to identify and address the specific challenges defence sector companies have in accessing financial services and investment.
- This forum should **develop mechanisms for greater information exchange to reduce compliance burdens:**
    - The UK government has a strategic supplier list, and the defence industry is already subject to strict compliance standards, including those mandated for securing MoD contracts and additional requirements for export licensing. This could be linked to the new Central Commercial Platform which is the single registration point required of suppliers for UK government contracts. The government, regulators, and industry should work together to use this information to reduce duplicative compliance checks – which would level the playing field for defence SMEs.
    - While not a guarantee of commercial viability, establishing improved channels to enable government and defence SMEs to share more information with financial services providers could also act as a signal to financial institutions and investors that accredited firms are more likely to find a route to acquisition.
    - SMEs that have undergone agreed processes, including but not limited to national security vetting and export control due diligence, could then be considered as pre-approved for some basic anti-money laundering, KYC, anti-bribery purposes, and against government departments' requirements on adherence to international guidelines on corporate sustainability and human rights.[5] This would need to have the support of both industries, UK government and regulators to ensure viability and effectiveness.
    - There is an active discussion across government and industry about definitions for defence companies. As there is no Standard Industrial Classification (SIC) code in official data, it becomes difficult to ascertain where defence related activity is taking place in the economy. Without a defence SIC code it is also difficult to locate potential defence customers and provide them with specialist support. We will continue to support this dialogue to enable better understanding of which firms are active in the defence sector and how the financial and related professional services industry is supporting them. A better understanding of the industry gives opportunities to provide more targeted support and data sharing.
    - The goal should be that all commercially viable businesses legally operating in defence can access the financial and related professional services and investment that they need. Ultimately, commercial viability will largely be driven by SMEs' business models and the issues around government signalling and procurement practices outlined above.

5 See https://www.gov.uk/government/publications/implementing-the-un-guiding-principles-on-business-and-human-rights-may-2020-update

- **Assess the wider regulatory and supervisory framework** – Work should be undertaken to assess whether the implementation and supervision of prudential regulations, such as capital requirements, inadvertently creates obstacles to mobilising financing towards this type of investment.

Public sector co-financing and investment

- **Offer a clear range of co-finance and co-investment support for UK defence** – As a strategic national priority, UK defence needs to be supported by publicly backed financing mechanisms, which can deploy flexible capital to help address market failures to support defence objectives and technology development.
- Government can strengthen existing initiatives such as export support linked to the trade strategy, the role of the British Business Bank, the National Security Strategic Investment Fund (NSSIF), NATO Innovation Fund (NIF) and NATO's Defence Innovation Accelerator (DIANA). This will help leverage the country's technological and strategic advantage, making the defence sector more attractive to investors.
- A new Guarantee Scheme for Defence would allow companies to receive bank lending that may otherwise be limited or unavailable. Much like existing programmes run via the British Business Bank or UK Export Finance, the guarantee would act as collateral and give lenders comfort when lending against less certain cashflow profiles. If this scheme came alongside the public funding institution agreeing to undertake some part of the KYC/due diligence checks then it would be easier to attract a wider range of lenders to support companies in the sector.
- The defence industry typically prefers capital and debt financing. However, start up and scale up firms, especially those engaged in developing capabilities such as autonomous systems, artificial intelligence, cyber, new propulsion systems, among others, are more likely be attractive to investors with a different risk/reward appetite to traditional lenders. The defence, financial and related professional services industries welcome the establishment of the UK Defence Innovation Agency. The agency should develop a strategy to nurture the venture-capital backed defence technology ecosystem, including facilitating deals and supporting routes to market, much like IQT has in the US.[6]

6 https://www.iqt.org/about

International collaboration and exports

- **Continue to develop and diversify international partnerships** – The UK has developed a range of international defence partnerships, including under AUKUS, with the US and Australia, and the Global Combat Air Programme, with Japan and Italy, which provide for cross-border technological collaboration and greater economies of scale. The recently announced 'UK-EU Security and Defence Partnership' establishes a way forward for further cross-border collaboration and export potential, which would be supported by mutual access to European co-financing and procurement budgets. Securing access to broader partnerships has the potential to unlock the investment required for startups and scale ups.

  The UK-based financial and related professional services industry is keen to work with government, and the wider industry across Europe to explore how to best support European allies. For example, while the current UK and EU ESG regulatory regimes do not expressly prohibit financing or investing in defence companies, further clarification could be provided to unlock much needed investment. Discussions around the Defence and Security Resilience Bank (DSRB) and its potential home in the City of London would be a demonstration of the UK's ongoing commitment to broader European defence and the security agenda.

- **Ensure government and industry align to increase UK defence's export potential** – When the MoD commissions new capability, it should take account not only of cost and technical compliance but also its responsibility to nurture and grow the UK defence base's export potential. For example, it should consider to what extent 'gold-plating' can be reduced to increase unit numbers and increase export opportunities to markets which do not require or desire such specifications.

Conclusion

ADS and TheCityUK are jointly committed to improving knowledge sharing and working with the defence, financial and related professional services industries, government, and regulators to develop mechanisms that can help derisk the industry in the minds of the finance and investment community. Our shared goal is that all viable businesses operating in defence can access the financial and related professional services and investment that they need to grow and contribute to enhanced UK defence and security capabilities.

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