

Strategic Defence Review 2024-25

TheCityUK submission

Introduction and context

A new era of intensifying geostrategic competition is unfolding against the backdrop of rapid technological innovation, an increasing number of hybrid threats, and constrained public finances in liberal democracies. The government's commitment to increasing the defence budget to 2.5% of GDP has cross-party support, providing greater certainty to the defence industrial base and therefore helping investment decisions in this area of the economy. However, the range of sovereign capabilities needed to meet the evolving needs of national security, and the breadth of the defence and industrial base required to provide them, also necessitates a new approach to attracting domestic and international private capital to support growth and innovation in these sectors.

The 2022 NATO Strategic Concept notes that “technological primacy increasingly influences success on the battlefield”,¹ while Pillar II of the AUKUS partnership is explicitly designed “to bolster industry and innovation sector collaboration” to provide advanced capabilities.² In 2022/23, the Ministry of Defence spent £25.0 billion with industry in the UK, of which direct expenditure with SMEs was just under £1.4 billion.³ With around 40% of MoD procurement expenditure with the top ten suppliers⁴, these large prime contractors (or ‘primes’) act as gatekeepers to direct defence sales for the start-ups and SMEs in the wider supply chain, which are increasingly important in driving innovation and the development of emerging technologies.

In these terms, a modern defence and national security industrial strategy must promote and intensify the linkages between government defence strategy and procurement in the UK and amongst its allies; the major defence primes; technology and dual-use start-ups and SMEs; R&D funding; and domestic and international private capital. Increased private investment and financing for SMEs and the supply chain should translate into increased competition in the ecosystem, which reduces programme costs for primes and ultimately for government and the taxpayer. Similarly, increased private investment in primes, reduces the cost of capital for companies and increases output.

As a core UK strategic capability, the financial and related professional services industry has an important role to play in supporting this defence-tech-finance ecosystem. The following issues are key to attracting greater private sector investment into this ecosystem and supporting infrastructure:

- Building domestic and international investor confidence via a long-term strategic public-private narrative.

¹ NATO, ‘NATO 2022 STRATEGIC CONCEPT’, (29 June 2022);

https://www.nato.int/nato_static_fl2014/assets/pdf/2022/6/pdf/290622-strategic-concept.pdf

² MoD, ‘AUKUS defence ministers joint statement: April 2024’, (8 April 2024);

<https://www.gov.uk/government/publications/aukus-defence-ministers-joint-statement-april-2024/aukus-defence-ministers-joint-statement-april-2024>

³ MoD, ‘MOD regional expenditure with industry 2022/23’, (8 February 2024);

<https://www.gov.uk/government/statistics/mod-regional-expenditure-statistics-with-industry-202223/mod-regional-expenditure-with-industry-202223>

⁴ MoD, ‘MOD trade, industry and contracts: 2023’, (15 February 2024) ;

<https://www.gov.uk/government/statistics/mod-trade-industry-and-contracts-2023/mod-trade-industry-and-contracts-2023>

- Supporting and leveraging private investment opportunities in emerging dual-use technologies and defence-related physical and digital infrastructure.
- Opening and deepening international markets for UK defence-related companies.

Unlocking investment may be the key role that the financial and related professional services industry can play in supporting UK defence. But the wider role of public-private partnership to enable the provision of people, expertise and skills should also be considered. For example, while innovation is being driven by new technologies, innovation can also come from existing technology delivered via new business models, such as digital. Best practice in areas such as logistics, infrastructure, some engineering, as well as digital, may sit outside government, so the challenge is to leverage private sector investment and broader capabilities to the benefit of defence.

Building investor confidence via a long-term strategic public-private narrative

The defence and security industry can be associated with complexity and risks from an investor perspective, due to the regulatory and political landscape, as well as ethical considerations. However, an important lesson from Russia's invasion of Ukraine is that national security and defence is once again becoming a 'whole of nation' endeavour. Therefore, UK defence needs an explicit organising narrative that aids government and public understanding and awareness that the UK's national security and wellbeing requires the mobilisation of public, private, and public-private resources.⁵ This is especially important given the ongoing debate within the finance sector – and society generally – regarding legitimate areas for ethical investment in the national interest.

Equally importantly, the nature of technological and scientific innovation has changed fundamentally since the major conflicts of the 20th Century. In the post-World War II era, government often spurred innovation directly through its own R&D, or through targeted funding of R&D by others. But we now live in a more complex, interconnected world where innovation, particularly in emerging technologies, increasingly relies on the private sector. For example, in the US, federally funded R&D peaked at 1.86% of GDP in 1964, when it accounted for over 50% of total US R&D, and generally has declined since. Contrastingly, in 2021, business R&D funding rose to 2.50% of GDP, accounting for 77% of national R&D.⁶ Similarly, in the UK, the business sector funded £38.7 billion (59%) and performed £46.9 billion (71%) of R&D in 2021.⁷

While the UK government continues to play an outsized role in funding traditional defence R&D (accounting for 69.3% of funding between 2020 and 2023)⁸, the desire to embrace emerging technologies, which rely on complex ecosystems and serve multiple use cases, implies a need to draw on a broader industrial base and an increased role for the private sector.

A new strategic public-private narrative should seek to address both practical challenges and the wider issue of ensuring societal buy-in to mobilising private capital, expertise and skills for national security. An organising public-private partnership narrative requires:

⁵ RAND Europe, 'Understanding the Value of Defence: Towards a Defence Value Proposition for the UK', (2021); https://assets.publishing.service.gov.uk/media/60ed93598fa8f50c7f08adfd/Defence_Value_Proposition_report.pdf

⁶ National Center for Science and Engineering Statistics (22 January 2024); <https://nces.nsf.gov/pubs/nsf24317>

⁷ HoC Research Briefing, 'Research and development spending, (11 September 2023); [https://commonslibrary.parliament.uk/research-briefings/sn04223/#:~:text=In%202021%2C%20the%20business%20sector,billion%20\(5%25\)%20of%20R%26D.](https://commonslibrary.parliament.uk/research-briefings/sn04223/#:~:text=In%202021%2C%20the%20business%20sector,billion%20(5%25)%20of%20R%26D.)

⁸ MoD, 'Defence sector continues contributing significantly to UK economy', (30 April 2024); <https://www.gov.uk/government/news/defence-sector-continues-contributing-significantly-to-uk-economy#:~:text=The%20UK%20government%20remains%20the,future%20of%20the%20defence%20sector.>

1. Clear and continuous communication from government to stakeholders about what capabilities UK defence is seeking to acquire and how it will do so. Attracting private investment requires commercial benchmarks to be met, since private sector parties make investments on a risk-weighted return basis.
2. Government understanding of how to cater to different investors' risk appetite for investment opportunities with different risk profiles and time horizons. These range from cutting-edge dual-use start-ups and SMEs to primes and/or infrastructure projects underpinned by long-term contracts and strong government R&D funding. A broad view of investor returns should encompass 'through life' and service-based revenues for defence equipment rather than simply the cost/price of initial acquisition.
3. Stable, long-term government funding commitments, which includes charting the trajectory predictably towards 2.5%, and the path of equipment and infrastructure spending within this envelope.
4. While predictability is important, new crises and conflicts require government to react flexibly and quickly to address urgent requirements. Therefore, the defence industrial base must have sufficient capacity to respond. There also needs to be a willingness to use policy tools and instruments flexibly, including contracting terms, to pull through private capital to meet these commitments and reduce bureaucracy. Multi-year settlements for key programmes, with the requisite public finance safeguards in place, would encourage investment, accelerate innovation and delivery of equipment capability into service.
5. A focus on domestic and international scale that ultimately underpins sustainable businesses and a durable, robust ecosystem capable of developing innovative solutions to capability challenges.
6. Government and defence primes working collaboratively to develop frameworks designed to bring the innovation of SMEs to bear, which requires drawing on hundreds of suppliers from within and, increasingly, outside the traditional defence sector.
7. A transparent dialogue between government, the defence industry and private finance around the environmental, sustainability, governance (ESG), and ethical challenges to mobilising private capital.

Supporting and leveraging the investment opportunities of dual-use technologies and defence infrastructure

There are range of dual-use technologies – advanced materials, AI, cyber, drones, hypersonics, quantum computing, robotics, space technologies, etc – that are increasingly important to national security and driving forward growth across the wider economy. Companies engaged in dual-use technologies are more attractive to domestic and international private equity and venture capital, because of the wider spread of prospects that they offer.⁹ Dependency on a small number of large government defence contracts can expose companies to significant concentration risks. However, companies that find non-military, dual-use applications for their technologies can build scale in commercial markets, while buying the time needed to secure long-term defence contracts.

Equally, defence acquisition often seeks bespoke solutions to very specific problems versus “off the shelf” commercial offerings. With limited access to classified information, tech or dual-use firms can struggle to understand the precise nature of these problems. The effort to tailor an existing solution to the “last mile” may also not be compatible with the commercial scale business models employed by tech companies, and which are attractive to private capital. Therefore, wherever possible, defence

⁹ TechEU, 'Investing in dual-use startups: A case for European tech sovereignty', (12 March 2023); <https://tech.eu/2023/03/12/investing-in-dual-use-startups-a-case-for-european-tech-sovereignty/>

acquisition should be flexible enough to open up dual-use opportunities and ensure that SME dual-use products have the potential for wider commercial appeal.

In contrast to the US, the UK does not yet have an established venture capital community standing behind the financing of its SME defence technology companies. The British Business Bank has a subscale fund called NSSIF.¹⁰ NATO operates the Defence Innovation Accelerator for the North Atlantic (DIANA).¹¹ But neither of these mechanisms provide line of sight to nor are they embedded within the procurement process. The US has deep pools of venture and defence tech bodies, such as IQT¹², which fund and help defence technology companies through the procurement process. A UK defence industrial strategy needs to be supported by a publicly backed mechanism, which deploys flexible capital to solve market failure in infrastructure finance, to support defence tech development.

Meanwhile, UK defence requires infrastructure and facilities, manufacturing capability, logistics and everyday operational requirements, and workforce support. These are all areas that can attract longer-term private investment. There should be a clear investment pipeline for infrastructure, facilities, and sovereign manufacturing capabilities, with government having a major role in its creation; and private finance could be incentivised through government-backed loans and co-investment.

Defence SMEs' access to financial services

SMEs tend to either be new to the defence and security sector or, as the lines between technology and defence businesses have become increasingly blurred, they enter the defence industry supply chain as the end-use for their product evolves. New entrants to the defence sector can face a range of challenges in accessing financial services:

- Banks' risk assessments depend on evidence of anti-bribery, corruption, and ethical policies, which some new businesses may lack. New entrants may lack robust corporate governance procedures, hindering access to financial services.
- Emerging dual-use technology companies often rely on international cooperation with industry-leading countries, which can be high-risk countries for anti-money laundering compliance, and therefore complicate meeting Know Your Customer requirements.
- Financial institutions must navigate global sanctions and international trade embargoes, adding complexity to providing services to defence businesses, and defence-related businesses involved with classified information may face challenges in sharing necessary details with banks.

In 2023, UK Finance and ADS published guidance to SMEs on accessing financial services in the UK, and this could be more widely publicised.¹³

¹⁰ <https://www.british-business-bank.co.uk/for-financial-advisors/equity-finance/national-security-strategic-investment-fund/about-us>

¹¹ <https://www.gov.uk/guidance/nato-diana-uk-accelerator-welcome-to-the-uk-accelerator#:~:text=Innovators%20who%20apply%20and%20are,enhancing%20the%20Allied%20innovation%20Ecosystem>.

¹² <https://www.iqt.org/about>

¹³ ADS Group and UK Finance, 'Access to financial services in the UK: A guide for defence and security', (December 2023); <https://www.adsgroup.org.uk/knowledge/access-to-financial-services-in-the-uk-a-guide-for-defence-and-security/>

International exports and collaboration for UK defence-related companies

In 2022 the UK won defence orders worth £11.2 billion.¹⁴ International sales opportunities diversify revenue streams and mitigate risks associated with dependence on domestic markets. In financial and related professional services, as well as defence, the UK is often seen by other jurisdictions as a 'reference nation' in terms of knowledge, skills and experience. Whether or not the UK regulatory framework for strategic export controls is reviewed, the UK should leverage this 'soft power' to work with partners and allies to identify and reduce frictions on trade in defence products and associated technology transfer across markets.

The recently announced exemption to the US International Traffic in Arms Regulations (ITAR) for the UK and Australia removes a significant regulatory barrier to the cooperation and collaboration required to meet the goals of the AUKUS partnership.¹⁵ Given that the US makes up 39% of total global military expenditure and the US' growing focus on rebuilding its sovereign defence and dual-use technological base, continuing to deepen defence industry cooperation in such a way is clearly a substantial prize.

Meanwhile, the EU's new defence industrial strategy, which is backed by new funding initiatives, is designed to encourage joint procurement and increased investment in R&D but establishes a clear preference in favour of EU-based defence firms over non-EU suppliers.¹⁶ This is an issue the government may wish to raise as it explores how to reset the UK-EU relationship via an "ambitious and broad-ranging UK-EU Security Pact".¹⁷

Aside from the political importance of shaping relations in strategically important regions, defence exports are important to government, as well as industry, by:

- Amortising development costs over a greater number of unit sales, reducing costs.
- Increasing employment in highly skilled (STEM) jobs, typically in lower income regions of the UK.
- Facilitating technology and skills transfer to adjacent sectors e.g. aerospace, civil engineering, etc.
- Increasing tax revenue, both from higher profits and greater employment.

Meanwhile, governments in several jurisdictions are developing policies to increase restrictions on inbound and outbound investment in sensitive technologies.¹⁸ These regimes need to be managed

¹⁴ MoD, 'MOD trade, industry and contracts: 2023', (15 February 2024);

<https://www.gov.uk/government/statistics/mod-trade-industry-and-contracts-2023/mod-trade-industry-and-contracts-2023#estimates-of-identified-defence-export-orders>

¹⁵ MoD, 'Historic Breakthrough in defence trade between AUKUS partners', (15 August 2024);

<https://www.gov.uk/government/news/historic-breakthrough-in-defence-trade-between-aucus-partners>

¹⁶ See Report by Mario Draghi, (9 September 2024), 'The future of European competitiveness – A competitiveness strategy for Europe'; and Carnegie Endowment, 'Understanding the EU's New Defense Industrial Strategy', (8 March 2024); <https://carnegieendowment.org/posts/2024/03/understanding-the-eus-new-defense-industrial-strategy?lang=en>

¹⁷ FCDO, 'It's time to reset Britain's relations with Europe: article by David Lammy', (7 July 2024);

<https://www.gov.uk/government/speeches/its-time-to-reset-britains-relations-with-europe-article-by-david-lammy>

¹⁸ See TheCityUK, (5 August 2024), 'TheCityUK response to US outbound investment security consultation';

<https://www.thecityuk.com/our-work/thecityuk-response-to-us-outbound-investment-security-consultation/>;

and TheCityUK, (26 April 2024), 'TheCityUK responds to the EU's White Paper on Outbound Investments';

<https://www.thecityuk.com/our-work/thecityuk-responds-to-the-eus-white-paper-on-outbound-investments/>

carefully, especially for companies developing dual use technologies, or they risk curtailing companies' ability to grow internationally and acting as a disincentive to service the defence market.

Ethical and ESG factors in investors' decision-making

For the past decade it has been considered usual for defence-related activities to be subject to whole or partial exclusion from portfolios for institutional investors. Firm exclusions for controversial weapons are commonplace, while sustainable-labelled funds often impose more restrictive exclusions on direct or indirect investments in defence-related activities. Controversial weapons are those defined as such under a range of national and international law, such as cluster munitions, anti-personnel landmines, etc. For sustainable-labelled funds there may be additional exclusions or exclusion thresholds, such as the percentage of a companies' revenues derived from sales of conventional weapons and/or other military equipment.

Meanwhile, the regulatory environment for ESG investing can also play a role in investors' decision-making. For example, the EU has established a classification of "environmentally sustainable" economic activities in the EU Taxonomy. To date, no specific defence industrial activities have been included in the EU Taxonomy. As a result, the defence sector cannot demonstrate Taxonomy alignment, except for some horizontal activities such as building or transport. The absence of inclusion in such a taxonomy framework may be perceived by certain investors as discouraging investments in those activities and limits clear recognition of the social value of defence among the sustainability community.¹⁹

The prospect of higher growth and returns in the defence sector (in August 2024, the FTSE All-Share Aerospace and Defence index is up 64% over twelve months)²⁰, coupled with heightened societal concerns over national and regional security and the "legitimate" use of military equipment, are sparking a more nuanced and informed debate about the use of exclusions and whether other approaches could be appropriate.

However, important areas remain contested. For example, some ESG standards make it harder to invest in parts of the nuclear weapons supply chain. There is, once more, a shared cross-party consensus around Britain's nuclear deterrent. This is an example of where government policy, which enjoys broad public support²¹, is not reflected in standards being set on investment decisions and this will require government to show clear leadership and to work closely with investors in doing so.

Government should act to ensure that there are no inadvertent disincentives to invest in defence firms more generally. As the example of Ukraine has shown, defending an ally from aggression is impossible without the tools to do so. A transparent dialogue between government, the defence industry and private finance around ESG and ethical challenges to mobilising private capital is essential. This includes how defence and security sectors can contribute to achieving the government's legal commitment of Net Zero emissions by 2050 without eroding defence capabilities. Sustainable fuels might be an example.

¹⁹ See European Commission Issue Paper; https://defence-industry-space.ec.europa.eu/document/download/bebd3d2f-bd0a-46f5-ae2-6ae586dba3ad_en?filename=EDIS%20Issue%20Paper%205.pdf&prefLang=bg

²⁰ See FT, 'FTSE All-Share Aerospace and Defense'; <https://markets.ft.com/data/indices/tearsheet/summary?s=FTASX502010:FSI>

²¹ See YouGov tracker, 'What should happen to Trident at the end of its useful life?'; <https://yougov.co.uk/topics/politics/trackers/what-should-happen-to-trident-at-the-end-of-its-useful-life>

Initiatives such as the UK Defence ESG Charter can provide the financial industry with greater understanding and awareness of the ESG risks and considerations in the sector and therefore support increased investment.²² An important area of focus should be on private capital sources for dual-use technology companies, including the 'boundary' cases, without losing sight of the broad scope for private investment in traditional defence firms and relatively uncontroversial areas such as infrastructure.

Conclusion

We welcome this opportunity to engage with the SDR and our industry would welcome further dialogue on how our industry can continue to contribute to this national mission.

Harnessing private funding for nationally or socially desirable objectives will always carry with it the need for a nuanced analysis of how to marry the objectives with the realities of financial markets and the motivations of different classes of investor. Strategic defence is no exception, although it presents specific features that do not arise in other areas of public-private partnership, and which need to be understood on their own terms. The government's commitment to increasing the defence budget has cross-party support, but there is a need for a new approach to attract private capital to support growth and innovation in the defence industrial base.

Government should work with the financial and related professional services sector to:

- Build domestic and international investor confidence through a long-term strategic public-private narrative for UK defence.
- Promote competition within the defence ecosystem by increasing private investment in SMEs and the supply chain, by supporting and leveraging private investment opportunities in emerging dual-use technologies and defence-related infrastructure.
- Harness UK 'soft power' to deepen international investment and increase export markets for UK defence-related companies.
- Establish a transparent dialogue with the defence industry and private sector finance around ESG and ethical challenges to mobilising private capital, particularly around investment in the nuclear deterrent supply chain.

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²² ADS, 'UK Defence ESG Charter', (25 January 2024); <https://www.adsgroup.org.uk/our-focus/uk-defence-esg-charter/>

Annex

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 12% of the UK's total economic output and employs over 2.4 million people – with two thirds of these jobs outside London across the country's regions and nations. It is the largest net exporting industry, and, in 2022/23, the estimated Total Tax Contribution of financial and related professional services was around twice defence spending.

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.