



**Defence Industry**  
Leadership Program

# Financing Defence SMEs in complex supply chains

Environmental, Social and Governance  
considerations

Defence Industry Leadership Program 2022 Concept Paper

Henry Atkins, Jason Brusnahan, Philip Mulholland, Jason Skene, Lee Webb

## Executive Summary

Environmental, Social, and Governance (ESG) considerations are playing an ever-increasing role in the financial services sector and the rate of change has accelerated with the global pandemic. In the defence sector, financial institutions are stepping up demands on companies to not only cut their carbon footprints but urging greater transparency over the manufacture and sale of weapons, and the nuclear supply chain. Several financial institutions are also questioning whether it is socially acceptable to invest in the defence sector at all. Our research has shown that this is particularly evident in Europe, where a number of financial institutions have refused to fund companies undertaking defence related work, leading to significant implications for small to medium enterprises (SMEs) in the defence supply chain.

To gain an understanding of potential social implications of ESG on financing SMEs within the Australian defence supply chain, perspectives on this issue were sought from representatives from the Australian financial sector, SMEs, primes and relevant government bodies. It was clear that the Australian Government and Australian financial institutions do not currently have a consistent approach to ESG with regards to defence industry activities, and policy development is in varied stages of maturity. It is imperative that the Australian Government and the Australian finance industry learn lessons from the European situation, and consider Australia's strategic objectives when developing ESG policies that will apply to the Australian Defence Supply chain. Failure to do so will put the development of key Defence capabilities at risk.

This paper's key recommendations are:

- 1) The Australian Government should provide leadership to industry by developing an ESG policy for the defence sector.
- 2) Australian banks establish a consistent approach to dealing with the ESG assessment of defence industry participants
- 3) The Australian Government considers establishing a domestic equivalent of Export Finance Australia (EFA) to close the potential gap in funding required by SMEs to build capability in the domestic supply chain.

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## Acronyms

<b>Acronym</b>	<b>Definition</b>
ADF	Australian Defence Force
ANZSIC	Australian and New Zealand Standard Industrial Classification
ASD	Aerospace and Defence
AUKUS	Australia, the United Kingdom, and the United States
BayernLB	Bayerische Landesbank
CA	Commercial Account
CEO	Chief Executive Officer
DEC	Defence Export Controls
DILP	Defence Industry Leadership Program
DTC	Defence Teaming Centre
EFA	Export Finance Australia
E&S	Environmental and Social
ESG	Environmental, Social, and Governance
ESSM	Evolved Sea Sparrow Missile
EU	European Union
GWEO	Guided Weapons and Explosive Ordnance
HSBC	Hongkong and Shanghai Banking Corporation
LBBW	Landesbank Baden-Württemberg
MoD	Ministry of Defence (UK)
NAB	National Australia Bank
NATO	North Atlantic Treaty Organisation
NIA	National Interest Account
QUAD	Quadrilateral Security Dialogue
SEB	Skandinaviska Enskilda Banken AB
SME	Small and Medium sized Enterprise
UK	United Kingdom
US	United States



## About

This concept paper has been prepared for the 2022 Defence Industry Leadership Program (DILP) by a group of representatives of the South Australian defence industry. The authors represent a range of professional and employment backgrounds, with experience working for Primes, SMEs and Government.

## Acknowledgements

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## Disclaimer

The contents of this report are the opinions and conclusions of the authors and do not necessarily represent the views of the author's organisations, the contributors, the contributors' organisations, the Defence Industry Leadership Program (DILP), or the Defence Teaming Centre (DTC).

## Research Methodology

### Interviews

Representatives from within financial Institutions, SMEs, Primes, and Government bodies were interviewed to better understand challenges with the way in which banks approach ESG assessments for participants of the defence industry. Interview participants nominated to remain anonymous, allowing them to provide candid and honest perspectives.

### Open-source information

The quantitative information contained within the paper was collected from publicly available sources and attribution is available in the reference section.

## Environmental, Social, and Governance (ESG)

The definition of ESG is in an ever-evolving state as the drivers of each facet shift with public sentiment (1). The authors of this paper concluded that there is no universally accepted definition of ESG and can be dependent on the context of which industry it is applied within. The definition of ESG for the purpose of this paper is a framework that refers to an organisations ability to manage risk in each of these factors. These focus on the impact of an organisation on the natural environment, the ability to manage relationships with the community and provide social equality, and the organisations corporate management principles and practices. Examples of assessment metrics are provided in Table 1.

Environmental	Social	Governance
<ul style="list-style-type: none"> <li>• Managing carbon and climate change vulnerabilities</li> <li>• Water, waste and pollution management</li> <li>• Transition to a circular economy</li> <li>• Renewable energy and clean technology</li> <li>• Consideration of the unique rights of First Nations peoples to access, maintain and protect their lands</li> </ul>	<ul style="list-style-type: none"> <li>• Human capital development</li> <li>• Health and safety</li> <li>• Ethical supply chain and sourcing</li> <li>• Human rights</li> <li>• Privacy and data security</li> <li>• Community engagement, including a focus on First Nations peoples</li> </ul>	<ul style="list-style-type: none"> <li>• ESG reporting</li> <li>• Risk-mitigation and management</li> <li>• Board diversity</li> <li>• Executive pay</li> <li>• Tax transparency</li> <li>• Business ethics</li> <li>• Policies that enhance corporate behaviour including protection of human rights</li> </ul>

Table 1 – Exemplar ESG considerations (2)

## ESG and Defence

ESG considerations are playing an ever-increasing role in the financial services sector, and the rate of involvement has accelerated since the start of the global pandemic. (3) Increased ESG scrutiny on a particular industrial sector can have a tangible impact on the ability for an organization to continue operations.

In the defence sector, financial institutions are stepping up demands on companies to reduce carbon footprints and urging greater transparency in supply chains, particularly for the manufacture and sale of weapons. (4) The increase social pressure has resulted in financial institutions and investors questioning whether it is socially acceptable to invest in the defence sector at all.

An analysis of current ESG policies publicly available from financial institutions (Appendix A – ESG Policy Details) and information gained from interviews conducted provided examples of social impacts considered:

### *Social*

- Ethical supply chain and sourcing
- Human rights
- Some financial institutions have no nuclear policy – globally (excludes resources/mining)
- Bank Australia have a ‘no arms’ policy and will not finance anything associated with defence. They claim that 82% of their customers agree with this stance. (5)
- Concerns on final destination of weapons including safeguards
- Concerns that nuclear submarine supply chain components will only be furnished for Australian, and NATO based countries.

## ESG and the European Defence Industry

The implications of ESG on the defence industry have already been demonstrated in Europe, which is at least a five to ten years ahead of Australia on ESG policy according to Stephen Jones, Federal Minister for Financial Services. (6)

Investors and financial institutions have been backing away from the European defence sector for fear of being tainted by controversy over the arms trade. (7) For instance, SEB, one of the biggest banks in Sweden, adopted a new ESG policy in 2021 that excluded the funding of any enterprise in Defence. (8)

In January 2021, the chief executive of Rheinmetall revealed that the company’s long-time German bankers, BayernLB and LBBW, had decided to stop doing business with them (8). Just as concerning, the CEO also highlighted that any ESG changes to the qualification criteria for being accepted to or remaining on stock indices could also harbor risks for the company. (9)

The Aerospace and Defence Industries Association (ASD) has warned that the ESG-driven label could restrict defence SMEs access to capital, significantly affecting the supply chain. (10) ASD have also highlighted that this is contradictory to the desire of many European nations to strengthen their capability in defence. They pointed to banks in Germany, Belgium, the Netherlands, Sweden and Finland that were already cutting ties with companies generating as little as 5-10 per cent of revenues from defence activities.



## Australia's Strategic Environment

The Indo-Pacific is at the centre of greater strategic competition than ever before, making the region more contested and apprehensive. The region is in the midst of the most consequential strategic realignment since the Second World War, and trends including military modernisation, technological disruption and the risk of state-on-state conflict are further complicating Australia's strategic circumstances. (11)

The COVID-19 pandemic has highlighted how globalised supply chains can be disrupted, which over time have become a critical element for many of Australia's national economic sectors and Defence capability planning. In addition, the US is looking to its allies and partners to do more of *the heavy lifting* in developing defence capability, leading the Australian Government to assert that Australia will take greater responsibility for its own security into the future. (12)

## A Sovereign Industry Focus

The strategic context with which Australia is presented in 2022 has underscored the importance of developing the Australian defence industry and continues to increase the focus on maintaining control over our own capability.

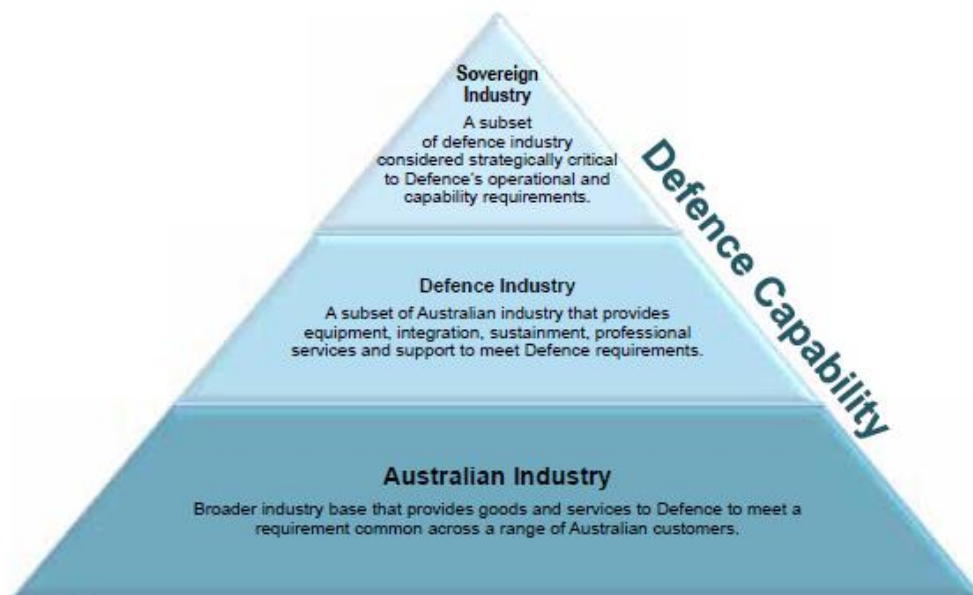
The Hon. Richard Marles MP, Minister for Defence stated - "*We need to be looking at sovereign capability. We need to protect the country, to defend the continent and defend our key interests.*"

The sentiment expressed by the minister are reaffirmed in the 2022-26 Defence Corporate Plan which explains that strengthening our industry partnerships, building and growing a sovereign defence industry is critical, along with addressing supply chain vulnerabilities exacerbated by COVID-19 and conflict in eastern Europe. (12)

The precise definition of sovereignty in the context of defence industry is debated (13), however, for the purposes of this paper we can assume that a sovereign industry is one in which the Australian Government has the ability to exert influence or control over decisions and foreign nations do not.

The relationship between the broader Australian Industry and the subset of industry considered to be sovereign industry is visually represented in Figure 1. The 2018 Defence Industry Capability plan makes the assertion that Sovereign Industry is critical to delivering Defence Capability.

Figure 1: Australia's Sovereign Industry is critical to providing the ADF with capability. (14)



### Key Australian Defence Programs

The Australian government has announced two programs of work that have a key focus on sovereign capability:

1. Australia will acquire at least eight conventionally armed nuclear-powered submarines under the AUKUS security partnership. The stated intention is to build, maintain and sustain these platforms in Australia maximising the use of local industry.
2. On 31 March 2021, the previous Government announced the accelerated establishment of a Guided Weapons and Explosive Ordnance (GWEO) Enterprise to enhance Australia's self-reliance and supply chain resilience.

The new AUKUS partnership's advanced technologies programs and the GWEO Enterprise offer Australia the prospect of realising meaningful new capability to Defence; however, both the nuclear and GWEO industries present in Australia are small by global standards and will be expected to grow rapidly to support these programs. The Australian Defence industry will need to play a key role in supporting Defence to deliver this capability, ensuring supply chain resilience, and surety of supply during times of conflict.

### Australian Defence SMEs

The Australian Defence industry contains over 4000 business and employees approximately 30,000 staff (15). SMEs account for the vast majority of these businesses, however, the Australian Strategic Policy institute has described the industry as having an hourglass profile. The industry is characterised having a large number of small firms at the base, a small volume of mid-sized companies in the centre, and large foreign primary contractors at the top. (16)

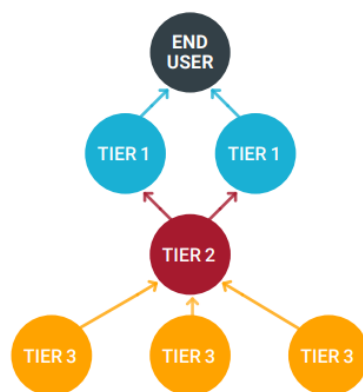


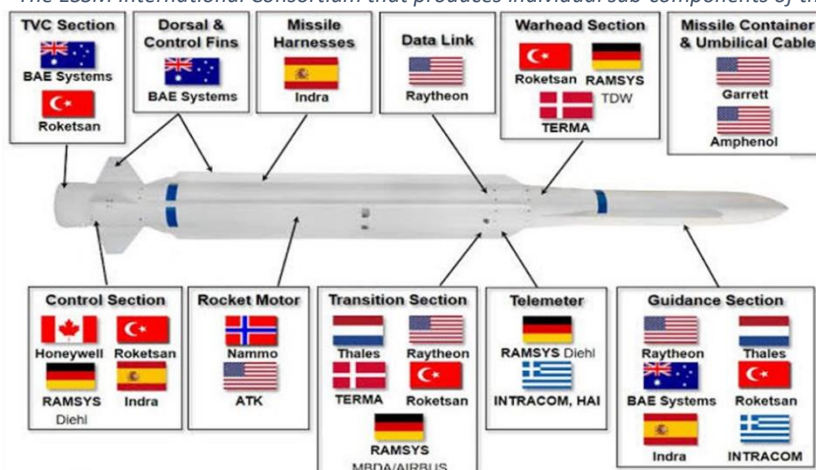
Figure 2 Hourglass supply chain showing concentration at the midstream (17)

This arrangement places a heavy responsibility on organisations at the larger end of the SME definition as Case Study 1 below demonstrates.

### Case Study 1 – GWEO (ESSM)

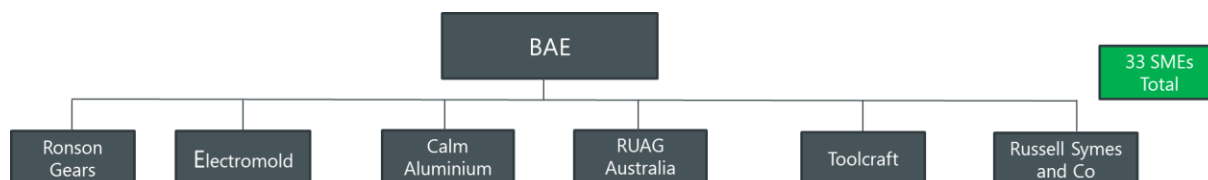
The global Evolved Sea Sparrow Missile (ESSM) program is an international venture between 12 member nations of the NATO SEASPARROW Consortium to deliver an enhanced capability surface to air missile, Figure 3. ESSM is a medium-range, surface-to-air missile developed to protect warships from advanced anti-ship cruise missiles. BAE Systems was the lead Australian participant, and their capabilities were crucial to the development of the original Block 1 ESSM, which entered production in 2000. That is one Australian Prime amongst 12 international partners that feed into the global supply chain for this weapon system, demonstrating the complexity of GWEO supply chains.

Figure 3 The ESSM International Consortium that produces individual sub-components of the missile.



Development of the Block 2 ESSM commenced in 2015, with development focused on a new dual-mode guidance section and enhanced warhead. Under the contract, BAE Systems and Australian industry partners will deliver critical software and hardware sub-assemblies for the ESSM Block 2 program. Around 33 Australian industries will manufacture and deliver missile components to BAE Systems’ manufacturing facilities at Edinburgh Parks, with Figure 4 highlighting six of these SMEs. (18)

Figure 4 SMEs that are supporting BAE in delivering to the overall ESSM supply chain



As we have observed in Europe and the common theme throughout our research in industry interviews, the funding of weapons manufacture is heavily influenced by public sentiment. Several interviews with other SMEs (not listed above) involved in the supply of sub-systems or materials to other weapon systems indicated that this was a small part of their overall business. They typically also manufacture similar sub-systems or materials that are used in other technologically challenging industries, such as automotive, mining, medical, and space. These industries are not as controversial as the production or supply of weapons and essentially allow the SMEs involved in the supply chain to provide the relevant sub-components whilst going ‘under the radar’. As initiatives such as GWEO increase, this may no longer be an option.

Thus, one needs to ask: what would happen if the SMEs involved in BAE’s supply chain were to experience financing issues due to financial institutions ESG policies that do not allow the financing of weapons? The denial of finance to key SMEs would affect BAE’s ability to deliver to the ESSM international consortium, and consequently impact Australia’s ability to access advanced guided weapon systems.

### Case Study 2 - SME Perspective on Entering the International Nuclear Supply Chain

In one interview with a SME representative, it was raised that in 2020 they were looking to purchase a UK company that had developed a prototype technology that was applicable for the nuclear supply chain. Initially, the purchase of this company was going to be financed by a multinational bank, however, once the bank realised that this was to fund the purchase of technology that would feed into the nuclear submarine supply chain, the bank withdrew their initial finance offer.

Obtaining finance from an Australian bank was not an option for the SME as their bank did not have an existing position on providing finance to the nuclear supply chain. Given these difficulties, this prompted the SME to seek alternative means of finance in the UK, which was an option for them as they had an established office presence there already. Utilising UK finance came with a significant overhead as the UK based financial institution needed to vet a lot of people within the SME, including the executive’s family. It was also observed by the SME that the banking system in the UK is much more dated than the progressive system we have in Australia.

The inability of the SME to secure finance from an Australian bank, exemplifies the possible risk to establishing a sovereign nuclear submarine supply chain within Australia to support the local manufacture and maintenance of the future nuclear submarines.

### An emerging ESG challenge

The nature of the nuclear-powered submarine and GWEO programs will expose participants involved in the supply chain to unique ESG challenges. The handling of dangerous materials, treatment and storage of hazardous waste, and compliance with Australia's relevant non-proliferation treaties are new territories for most Australian organisations involved. There is limited institutional knowledge within broader industry and financial institutions directly supporting the supply chain. These organisations either do not have policies to address risks associated with funding defence supply chains (especially the nuclear-powered submarine program), or currently have policies that specifically preclude the funding defence related industries. Unknown public appetite and fear of resulting public backlash could reduce the likelihood of investment by the banking sector and limit the ability of Australian SMEs to source capital to fund business growth. This would jeopardise the ability for Australian industry to build a sovereign defence industrial sector, within these two identified areas of strategic importance.

## Potential Funding Sources for SME's

Our interviews revealed that the banks are just one source of financing for SMEs in the defence supply chain, with other alternative sources captured in Figure 5.



Figure 5 Potential Funding Sources for SMEs

Two sources of financing were highlighted in all interviews with SMEs and the financial sector: Various forms of government grants, and Export Finance Australia (EFA). Noteworthy is the fact that both are initiatives of the government to achieve policy objectives in developing the defence industry.

- EFA States “We support the Australian Government’s objective of fostering a defence exports industry in Australia by administering our Defence Export Facility.” (19)
- Sovereign Industrial Capability Priority Grant has a stated purpose to provide “Funding for Australian businesses to build industrial capabilities that fit with Defence’s Sovereign Industrial Capability Priorities.” (20)

An overwhelming theme identified in interviews with SMEs, was that it was difficult for SMEs to make use of these options to solve the specific financing issues they were facing. The challenges surrounding grant funding are an important problem but are considered out of scope for paper. EFA can be considered as a credit agency and as they are operationally similar to a bank, the ESG considerations surrounding lending will be discussed further below.

Another point that was raised in interviews was the link between the nature of ownership and the ability to obtain funding from owners. One interview highlighted the limited ability of family-owned SMEs to inject capital without putting their personal assets at risk, while other interviewees highlighted that SMEs may be purchased by a Primes for the purpose of boosting AIC, but the Prime may have limited ability to inject capital for risk of exceeding a 49% ownership limit, which would result in the SME being precluded from access to various grants.

The remainder of this paper will focus on financing SMEs through the banking sector.

## The Application of ESG in Banking

### Bank Financing for SMEs in the Defence Industry Supply Chain

Before discussing the process of ESG evaluation, a brief introduction to how the financing needs of SMEs are met by the banking sector should be discussed. Some examples of general business finance products provided by banks that were mentioned in our interviews are:

- Car & equipment finance. (Purchase assets for a business.)
- Line of credit, such as a Business Overdraft. (Overdraw from a transaction account to cover a cash shortfall)
- Bank Guarantee. (Provide a security bond for a property, asset, or project, or give a customer or supplier certainty that a payment can be made.)

We have also heard of lending needs that are more specialised than general businesses banking:

- Acquisition finance for purchase of an existing business.
- Export finance to deliver goods for an overseas purchaser.

During our interviews, we heard extensively about the difficulty of financing the research and development of new capability. Generally, bank financing is not used for research and development or proving of capability where there is no guarantee of cash flow to repay the loan, in these cases equity and/or grant funding is most applicable (refer to the previous section). However, we found there are some options for loans that can be obtained at this stage:

- Loans where a security guarantee is provided by company directors, or
- A line of credit can be obtained from cash flow in other parts of the business.

While the development of new capability is not necessarily funded by bank lending, it was made clear that once a project is initiated and contracts are in place to deliver a capability, the funding to purchase land and buildings for expansion of production, equipment, and materials for scaling production and so on that are critical for implementing capability requires bank financing. In comparison to earlier stages, equity and grants become less viable at this stage due to several factors. An example of the issues that have been raised are:

- Particularly for privately held businesses, equity may need to come from a small shareholder base, such as the owning family, whom do not have significant equity outside of the business itself to invest.
- Some capability development grants are no longer available once a project has been announced and the government contracts are in place.

### Bank Financing, Due Diligence and Risk Assessment

Banks will apply due diligence and perform a risk assessment before providing finance to client. Due diligence is the use of a process to ensure that the bank has the adequate information for its decision making in relation to a client. The risk assessment will use this information to determine if providing credit to a client has an acceptable level of risk. According to our sponsor, the Commonwealth Bank, this broadly falls into two categories:

- Credit Risk. This assesses the credit risk that the client will have the means to repay the loan and will fulfill the terms of the lending contract. (The Current Terms and Conditions for



Business Finance (21) document from the Commonwealth Bank outlines some of these terms)

- ESG Risk. This assesses the alignment with the bank's responsibility to manage exposure to ESG risks and ensure it is not financing activities that are contrary to the banks ESG policy. In the 2022 Annual Report of the Commonwealth Bank (22) ESG risks are classified as Strategic risks for the organisation.

It was evident that the bank needs to be satisfied it is not exposed to a credit risk, or an ESG risk that is considered material when entering a contract with a client. It is important to note that a negative evaluation of both categories of risk can result in credit being denied (this process can be referred to as a negative screen).

Credit risk will not be discussed further, as the scope of this paper is limited to ESG considerations when financing SMEs in the defence industry supply chain.

### The Banks Public ESG Statements on Defence

The four major Australian banks all have comprehensive ESG policies and include ESG summaries in their annual reports to shareholders. An edited summary of the position of several banks is provided in Table 2 below, with the key points selected by the authors of this paper highlighted in bold. Detailed excerpts from public policy statements are listed in the Appendix A – ESG Policy Details Table 5 without editing.

The Commonwealth Bank Environmental & Social (E&S) Framework (23) document indicates that the E&S policy is a separate internal policy, which has board level approval and reporting, and that it represents considerations that have been identified through feedback and engagement with customers, staff, communities, and shareholders. The framework represents a set of minimum standards the bank seeks to abide by, while the procedures for applying the policy may be specialised by business units.

In addition to the four major Australian banks a sample of policies that are hostile or accommodating to the defence industry supply chain are included. One is from a smaller Australian financial institution, Bank Australia, which has taken a strong ESG focus on positive social outcomes. The other is from a global multinational financial institution, HSBC, which is active in over 60 countries. Involvement in multiple jurisdictions could lead to a conflict of interest if they were to fund one particular state over another, particularly in a time of conflict. Export Finance Australia is also included, as they have a very well defined ESG policy with a dedicated policy for the defence industry that supports the government policy of fostering the defence exports industry.



<b>The Big Four</b>	
ANZ (24)	<p><b>The policy confirms that we do - and will continue to - provide financial services to defence sector customers,</b> including the provision of general corporate facilities.</p> <p>Our policy states that we do not wish to be involved with customers that are involved in the sale or manufacturing of controversial weapons.</p>
Commonwealth Bank (23)	<p><b>We recognize the right of countries to defend themselves and protect their national security.</b></p> <p>We will not knowingly support, invest in or provide financial services to clients that buy, sell, manufacture or store: Controversial Weapons; or nuclear weapons outside NATO.</p>
NAB (25)	<p><i>We maintain a High Risk ESG Sectors and Sensitive Areas list. It sets out sectors and activities <b>where we have restricted or no appetite; this includes the nuclear industry, arms-dealing.</b></i></p>
Westpac (26)	<p>Westpac <b>may provide products and services to customers in the defence sector</b> particularly where materiel is for use by the Australian Defence Force and/or New Zealand Defence Force.</p> <p>Westpac will not provide products and services to customers involved in controversial weapons, nuclear weapons (except NATO), export to countries with an arms embargo.</p>
<b>Other Financial Institutions</b>	
Bank Australia (5)	<p><b>We do not lend to businesses that produce or sell armaments.</b></p>
HSBC (27)  (HSBC is a British multinational universal bank, it is the largest bank in Europe.)	<p>HSBC decided in 2000 <b>to withdraw progressively from the financing of the manufacture and sale of weapons.</b></p> <p><b>HSBC does not provide financial services to customers who solely or primarily manufacture or sell other weapons.</b></p> <p>Where a customer undertakes a mix of weapons, weapon-related or other business, HSBC may form a relationship with that customer, but <b>will not provide financial services directly to subsidiaries involved with weapons.</b></p>
Export Finance Australia (28; 19)	<p><b>EFA supports the Australian Government’s objective of fostering a defence exports industry in Australia.</b></p> <p><b>The due diligence approach relies heavily on the approval processes and capabilities of DEC.</b> More information about export controls can be found <a href="#">here</a>.</p> <p><b>Transactions involving the export of offensive weapons (and all components of such devices) are subject to Board approval.</b></p>

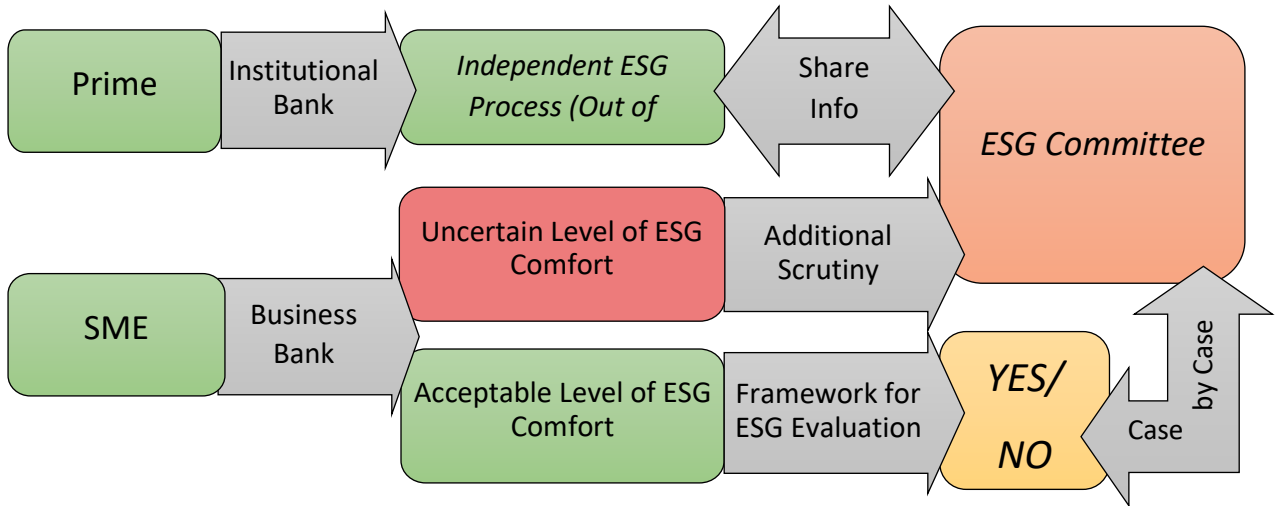
Table 2 - Edited summary of Bank ESG Statements on the Defence Industry.

## The Application of ESG for SMEs in the Defence Industry Supply Chain

A common distinction in the defence industry supply chain is between prime contractors for government and the SMEs that supply goods and services for these ‘Primes’. In this context we are referring to a Prime as a large defence contractor engaging with Defence on major projects (29) .

Primes have a different relationship with the bank. As shown in Figure 6, Primes work with the Institutional Bank section, whereas SMEs work with the Business Bank section. This difference is due to the relative sizes of the organisations, with the larger organisations of the Primes warranting more bespoke financing solutions (29). This paper is limited in scope to only consider SMEs, so while the ESG processes of the Institutional Bank are different, they will not be discussed. The ESG committee shown in Figure 6 will provide some coordination between the processes of the Institutional Bank and Business Bank.

Figure 6 Schematic demonstrating the difference in screening process for a Prime and SME in securing funding from the banking sector, from an ESG perspective.



The general case of ESG evaluation is to apply a framework that results in an approval or denial of credit. However, if the loan officer has some concern about the client or project, then the evaluation may be forwarded to the ESG guidance committee. This results in additional time and uncertainty to the evaluation.

Discussion with members of the financial industry has suggested that a SME in the defence supply chain is more likely to be forwarded to the ESG guidance committee, as it is a considered a sensitive sector; consistent with the ESG polices captured in Table 3.

### A Framework Based ESG Evaluation Overview

A framework based ESG evaluation is a systematic process driven approach. It can be broken down into several stages, as shown in Figure 7. This process represents the process of the Commonwealth Bank, with more details involved for each step provided in Table 3.

Figure 7 ESG Evaluation Process



<b>Classification</b>	Industry classification, such as an ANZIC code, is one way a bank can classify a business. The classification indicates the risk profile of the business and informs the relevant framework to be employed.
<b>Framework</b>	The framework identifies the risks that are considered material for a business with a given classification. It allows information on industry-specific impacts and general description of industry activities to be incorporated into the evaluation. Is only used internally, it is not provided to clients or third parties.
<b>Evaluation</b>	Evaluation is performed by bank staff, working with business clients, using the framework as a decision-making tool. Interviews are conducted, based on questionnaires provided by the framework. Associated risks are identified by looking deeper into the business to understand the value chain, that is what the business is doing and how does what they do impacts ESG risk considerations. The bank will map out business responsibilities against regulations and compliance requirements. A matrix of risk vs involvement will be developed, and the business and the bank will work together to ensure appropriate risk management strategies are in place.
<b>Decision</b>	Approval to extend credit.

Table 4 - ESG Evaluation Stages

The bank staff who perform the risk assessment will not be experts on the technical nature of the business they are assessing, so they must be guided by a framework that provides the tools to perform risk identification and risk analysis. Anything requiring technical expertise need to be delegated to an external subject matter expert. They will be looking for “evidence of processes” and do not have the technical expertise to assess the activities. Ultimately, the Bank relies on good faith that the client performs the processes that they claim to.

The evaluation is performed before extending credit, but the framework may also require that an annual review of clients is conducted.

Outside of the Commonwealth Bank, a break down into industry sectors and development of industry specific guidelines is also the approach of the Equator Principles (30), a global ESG risk management framework used by over 100 financial institutions, including NAB in Australia.

We were made aware of several shortcomings in the application of this process for SMEs in the defence supply chain. The stages of most concern are:

1. Classification. The existing classification methodology relies heavily on the industry sector classification embodied in ANZIC codes and does not have the ability to classify business according to the nature of the defence projects for which they form part of the supply chain.
2. Framework. The existing frameworks are not tailored for defence. For example, they are do not appear to be constructed to identify risks that would be assessed by a major prime contractor, and the processes that a prime may require to be in place to manage them. While there is a general recognition of the rights of countries to defend themselves, is there a process in which the framework can evaluate the sovereign risks of finance not being available? Does the framework recognize the social benefits of the work performed by the Australian Defence Force.

## Issues Raised by Interview Participants

From our interviews the following are paraphrased summaries of key points that were discussed, and these have been reported as four key themes:

1. There appears to be an inconsistent approach to ESG assessment.
  - An SME only became aware of the existence of ESG screening and the implications on their business activities when they were denied finance by an international bank which had a negative screen for the defence industry.
  - A common theme in the interviews was that there is a lot of variances depending on factors such as the size of a businesses, individual assessors and even being in a geographic location where defence is a significant industry or not. Financing of defence SMEs can be dependent on having a champion (who you know) as opposed to a strategic approach.
2. There is an opportunity for banks to learn from the Primes.
  - Several participants raised the point that a significant evaluation process is undertaken by Primes on the SMEs with a particular focus on their sustainability. Only one participant in the financial sector indicated they had engaged with Primes to be educated on their processes for evaluating SMEs in their supply chain.
  - A Primes noted that they will offer support to assist SMEs develop business cases and provide letters of support to lenders to indicate that they will utilise the supplier subject to them obtaining finance, however under no circumstances are they able to underwrite any work of their suppliers.
3. Banks need to have awareness of the geopolitical situation and end users.
  - Several banks expressed that a major concern in funding weapons production was the final destination in where the items may end up. When the user is the ADF they have no concern. Otherwise, they need to be satisfied the weapons will only be sold or resold to appropriate purchasers with the requisite checks and balances.
  - A common theme was that the banks are willing to be involved in international supply chains involving NATO countries. When questioned about Australia's recent support of Ukraine, or emerging partnerships, such as the QUAD which involve non-NATO countries, Japan and India, it was raised that banks are not, and should not be, experts in geopolitics to evaluate such matters.
    - One bank expressed that they are prepared to support SMEs involved in the nuclear submarine supply chain provided any components only end up in NATO countries.
    - One bank expressed a desire for a defined point of engagement with the government to get guidance on the current geopolitical situation in relation to ESG and financing.
    - Another financial institution stated it had engaged with Defence Export Controls (DEC), recognising that was the authority on such matters, and recommended the major banks do the same and take advantage of the DEC outreach programs.
4. Messaging is as important in explaining the social responsibility of the defence sector.
  - One bank had a "no sharps" policy, that places restrictions on financing the production of warheads and other effectors. However, they will fund everything up to the warhead. Funding grey areas such as the rocket motor or launch systems of a weapon, would require escalation to senior leadership within the bank for approval.

- One bank expressed that part of the key to ensuring internal support for its ESG positive stance on defence was to emphasise the importance of supporting the members of the ADF who are taking personal risks to defend the country.
- One bank no longer refers to Defence funding but uses the phrase ‘National Security’, which covers cyber, weapons, border control etc. The term National Security is more palatable to the board and can be considered a form of national infrastructure.

The analysis of the key interview findings from engagement with financial institutions indicated that a more consistent approach to the defence industry is required by the banks. While there were institutions where an individual may have a significant understanding of the defence industry, there were others where the expertise was not observed. When the expertise was present, it did not seem to be integrated into the organisation such that any SME could benefit from it. For all banks, there did not appear to be an institution wide approach to dealing with the key stakeholders in the defence industry (Department of Defence and major primes), that could also engage directly with the SMEs and contribute to their financing approval process.

### Export Finance Australia (EFA)

As mentioned already in this paper EFA was cited in almost all interviews as a potential source of finance that can support SMEs. We also saw that EFA has a well-defined ESG policy with a standalone defence industry policy that is supportive of the Australian sovereign defence industry.

EFA is the Australian Government’s export credit agency. As a corporate Commonwealth entity, with an independent board responsible for its management, it operates mostly on a profit and loss commercial account (CA) but also has a national interest account (NIA) and administers the Defence Export Facility. (31)

From our interviews EFA was highlighted with the following limitations from the perspective of SMEs:

- Remit to fund export opportunities only.
- Complex, time consuming and invasive process required to secure funding.
- Uncompetitive lending rates compared to other lines of finance.

Given EFA’s focus on providing funding to SMEs that have an export market ready product, and the possible reluctance of the Australian sector to provide funding to Defence related SMEs, there is a possible funding gap that may present itself to SMEs that are focused on delivering sovereign capability to the ADF. Thus, consideration for the establishment of a domestically focussed EFA type credit agency may be necessary to alleviate this potential funding gap.

### Australia’s changing social sentiment

It was unanimous amongst the banking representatives interviewed along with a number of SMEs that the awareness of society’s opinions and views was becoming more complex and critical in the funding evaluation process. Public sentiment may be influenced through various spheres including domestic and foreign governments policies and actions, industry, media, social interest groups, strategic partnerships and alliances, public feelings of fear and apprehension and societal values.

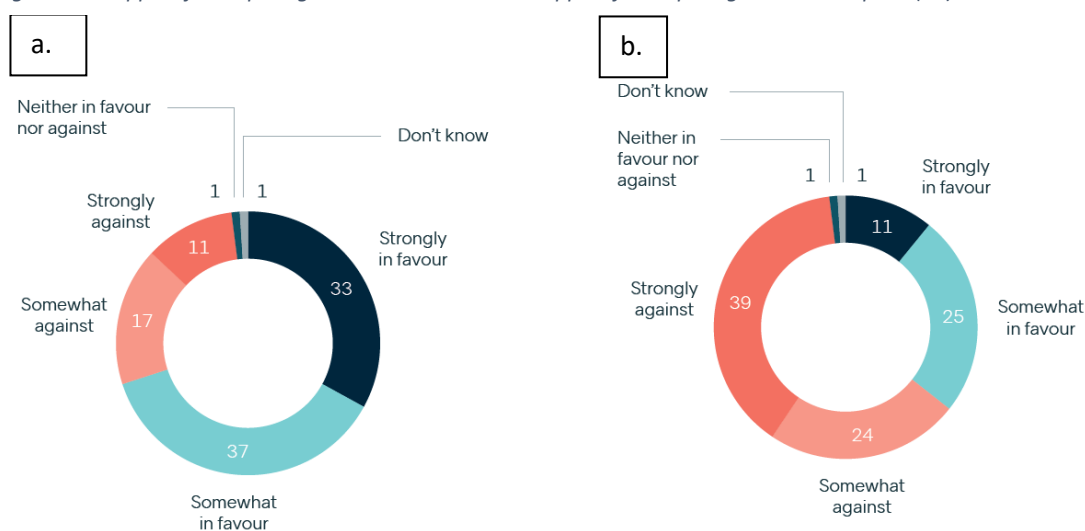
According to the latest Lowly Institute Poll, which involved a national survey of over 2000 Australians between 15 and 28 March 2022, Russia’s invasion of Ukraine in February 2022 has had a clear impact on threat perceptions for many Australians. Russia’s foreign policy tops the list of threats in 2022, with

68% of Australians saying Russia’s foreign policy poses a critical threat to the vital interests of Australia in the next ten years. This marks a striking 36-point increase since 2017 (32%). (32)

At the same time, Australians are also concerned about China and the potential for conflict in the Taiwan Strait. More than six in ten Australians (65%) say China’s foreign policy poses a critical threat to Australia’s vital interests, a 29-point increase from 2017 (36%). Concern about military conflict between the United States and China — the world’s two superpowers — has been on an upward trajectory in Australia. In 2022, 64% of Australians say ‘a military conflict between the United States and China over Taiwan’ poses a critical threat, a 12-point increase from 2021 (52%) and 29 points higher than in 2020 (35%). (32)

With regards to the development of a nuclear submarine industry in Australia, 52% of respondents expect the agreement to make the country safer compared to just 7% who fear that it will make the nation ‘less safe’. A further 70% support the acquisition of nuclear submarines but in contrast there is a significant lack of support for acquiring nuclear weapons at only 36%, Figure 8. The evaluation of non-nuclear weapons was not analysed as part of this survey. (32)

Figure 8 a. Support for acquiring nuclear submarines b. support for acquiring nuclear weapons (32)



## Ukraine Conflict and New ESG Perspective

Australia should view Europe as a cautionary tale. Views are changing in light of the war now raging on the EU’s border, with calls to label the defence industry as socially harmful being ditched. In March this year, SEB indicated that it was reversing a ban on investing in weapons as it adjusts its ESG policy to match Europe’s new geopolitical reality. (8)

The European Union is providing leadership through drafting policy around the social aspects of ESG, where it mentions that the safety and security of a nation’s citizens should qualify for some recognition in the social element of ESG, particularly the protection of their human rights. (33) The UK ministry of defence is also showing leadership in this area through providing clear direction to prospective partner companies that ESG practices will be considered from 2025 before the MoD awards any contracts. (34)

## Conclusion

Freedom and democracy are not a given. They do have enemies and as history has shown, these enemies sometimes do not shrink back from using force. One of the primary functions of any state is therefore to ensure the security of its citizens.

Australian values, interests, security, independence and integrity are neither given nor acquired for free. Australia must be ready and prepared to defend them and contribute actively to preserving peace, preventing conflicts and strengthening international security. This will not be possible if diplomacy cannot be backed up with credible military capabilities as a means of last resort.

The defence industry is a critical fundamental input to capability, consisting of both primes and SMEs. This capability plays a key role in ensuring that the ADF has the advanced military equipment it requires to protect our democracy. Without it, the armed forces cannot fulfil their mission. Only trusted and innovative companies, who have the necessary technological know-how and defence expertise, are able to develop and produce such equipment. Thus, the Australian defence industries make an indispensable contribution to Australia's security, and thereby help to protect Australia's peaceful, democratic, and sustainable economic and social development.

A common theme across all interviews was that SMEs emphasise their involvement in commercial sectors such as the automotive sector, or involvement in popular initiatives, such as the space industry. They stated a belief that their involvement in defence projects is not commonly known outside of those involved in the sector. However, given the large amount of funding involved in both the GWEO Enterprise and the Nuclear Submarine Program, it is expected that the level of scrutiny from society will increase in this area, and SMEs involved in such programs may not be able to continue to operate 'under the radar'.

It currently remains an unknown what impact ESG will have in the future. However, what is certain from our discussion with members of the supply chain is that any increases of difficulty in financing will have a significant impact, and that they currently benefit from a lack of social awareness to the implications of some of their activities. The potential impact of a change in social sentiment should not be underestimated.

Thus, it is imperative that the Government take a leadership role in devising an ESG policy framework that will ensure financial institutions will continue to provide the necessary finance to SMEs, particularly in areas that may be controversial such as weapons or nuclear submarines, to ensure the viability of this fundamental input to defence capability.

## Recommendations

- 1) ESG Policy should be Government led to meet our sovereign requirements.
  - Take leadership by defining a comprehensive ESG policy for the Department of Defence.
  - Continue to influence the narrative about the positive social impacts of the defence industry.
- 2) Banks should establish a consistent approach to dealing with the defence industry.
  - Standardise ESG policies and procedures.
  - Increase understanding of defence industry.
  - Employ subject matter experts.
  - Engage with Primes, SMEs and DEC.
  - Workshop with the broader defence industry to maintain awareness.
- 3) Government act on closing the potential funding gap for building capability in the domestic supply chain.
  - Consider establishing a domestic equivalent of the EFA.



## Follow on Work

The interviews conducted for this paper were designed to focus on the nominated topic, however, industry participants provided numerous examples of finance related issues that were often considered more pressing than challenges related to ESG assessments. The two topics most frequently raised by SMEs in particular were: over insurance on projects, particularly those involving energetics; and challenges obtaining timely funding irrespective of the source.

### Investigation of Insurance for SMEs

A notable and recurrent topic of discussion throughout the interviews was the overburdening of SMEs with onerous insurance requirements. A defence industry SME explained during an interview that no insurance, meant no contract could be awarded, which prevented finance from being obtained, ultimately preventing the project from starting.

Two key aspects relating to this topic were mentioned during interviews:

- The over insurance of defence projects. Each level of the supply chain is required to have insurance and, in some instances, the total amount of insurance across the project supply chain far exceeded the total project value.
- Excessive premiums when working with energetics. SMEs working on GWEO projects or in the space industry are required to pay insurance premiums that are unrealistically large or in some instances some activities are deemed uninsurable.

The topic of insurance was additionally raised during feedback sessions with industry experts. A topic for future work could be an investigation of insurance related barriers to entry for SMEs in the defence market.

### Investigate the Role of Alternative Finance in Developing Capability

The banking industry was the primary focus of this paper, however, the difficulty of obtaining finance to develop capability before major projects are confirmed irrespective of the source was a common theme of almost all interviews with SMEs. Grant financing (such as Sovereign Industrial Capability Priority Grant) has been a common topic of discussion, with focus on the difficulty in utilising them.

An alternative to bank and grants finance is equity financing. This takes many forms, investment of personal funds by founders, venture capital, private equity, public equity via a share market listing. Retained profits are also classified as equity.

SMEs are often tightly held by a founder or family, restricting access to equity without borrowing against personal assets or finding additional investors. Private equity can step in here as a new investor injecting funds for expansion. For example, CPE Capital and Pemba Capital have recently started to invest in the defence industry.

The biggest manager of investment funds in Australia is the Superannuation industry. It provides equity in most forms listed above, in particular funding public equity markets. It is important to consider how ESG and social sentiment are navigated in this significant form of equity.

The role of equity funding models as an alternate to bank and grant financing was out of scope for this report but is recommended as a future topic.

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## Appendix A – ESG Policy Details

This section lists excerpts from public policy documents without editing. The statements highlighted in bold represent key points selected by the authors of this report, and the bold formatting is not reflected in the original material.

<b>The Big Four</b>	
ANZ (24)	<p><a href="#">Our Social and Environmental Risk Policy</a></p> <p>ANZ consider the defence industry a sensitive sector and provide a dedicated public policy statement. (35)</p> <p><a href="#">INFORMATION ABOUT ANZ’S MILITARY EQUIPMENT POLICY</a></p> <p><i>ANZ’s Military Equipment policy guides decision-making relating to transactions and relationships with the manufacturers, distributors and sellers of military equipment.</i></p> <p><b><i>The policy confirms that we do - and will continue to - provide financial services to defence sector customers, including the provision of general corporate facilities. We recognise that military equipment has a role to play in ensuring that governments are able to defend their citizens and territories.</i></b></p> <p><i>However, we acknowledge that some defence sector customers have been the subject of claims about involvement in the manufacture of controversial weapons such as cluster munitions.</i></p> <p><i>Our policy states that we do not wish to be involved with customers that are involved in the sale or manufacturing of controversial weapons as defined in our policy, or the production of components designed for specific use in controversial weapons.</i></p>
Commonwealth Bank (23)	<p>The Commonwealth Bank provides a statement on the defence industry in it’s primary public policy statement.</p> <p><a href="#">Environmental &amp; Social Framework</a></p> <p><b><i>We recognize the right of countries to defend themselves and protect their national security, and we acknowledge the potential irresponsible end-use of defence equipment is a key issue in this sector.</i></b></p> <p><i>We will not knowingly support, invest in or provide financial services to clients that buy, sell, manufacture or store:</i></p> <ul style="list-style-type: none"> <li>• <i>Controversial Weapons banned under agreements to which Australia is a party; or</i></li> <li>• <i>nuclear weapons outside NATO country government-controlled programs that are authorised under the Nuclear-Non Proliferation Treaty.</i></li> </ul>

<p>NAB (25)</p>	<p>The NAB does not seem to have a detailed public statement specific to the defence sector.</p> <p>A high level set of 6 principles guide NAB’s ESG policy (<a href="#">Our ESG Risk Principles</a>).</p> <p>The defence sector is covered under the following blanket statement on high risk and sensitive areas, although it is noted that the details of the policy do not appear to be public.</p> <p><a href="#">ESG Risk Policy Settings</a>  <i>We maintain a High Risk ESG Sectors and Sensitive Areas list to help our bankers and procurement professionals know which sectors and activities may have a higher inherent exposure to ESG-related risks. It also sets out sectors and activities <b>where we have restricted or no appetite; this includes the nuclear industry, arms-dealing and predatory financing.</b> This list is reviewed and updated to incorporate emerging and changing ESG risks.</i></p>
<p>Westpac (26)</p>	<p><a href="#">Specific policies and positions</a></p> <p><i>The following position statements set out our approach to assessing the environmental, social and governance dimensions of our banking and financing activities. <b>These are supported by policies in Westpac's credit manuals:</b></i></p> <p><a href="#">Defence Sector Position Statement.</a></p> <p><i>Westpac <b>may provide products and services to customers in the defence sector</b> particularly where materiel is for use by the Australian Defence Force and/or New Zealand Defence Force.</i></p> <p><i>Westpac will not provide products and services to:</i></p> <ul style="list-style-type: none"> <li>• <i>customers involved in controversial weapons;</i></li> <li>• <i>customers involved in nuclear weapons, except where they only contribute to government-controlled nuclear weapons programs in NATO countries that are authorised to possess nuclear weapons under the Nuclear Non-Proliferation Treaty;</i></li> <li>• <i>facilitate the export or provision of defence equipment or services, directly or indirectly, for end use by any country that is:</i> <ul style="list-style-type: none"> <li>○ <i>in contravention of an arms embargo imposed by the United Nations Security Council, Australia, the US, the UK or any other jurisdiction in which Westpac Group is registered, operates or otherwise has a presence; or</i></li> <li>○ <i>not a member of NATO</i></li> </ul> </li> </ul>
<p><b>Other Financial Institutions</b></p>	

<p>Export Finance Australia (19; 28)</p>	<p>Export Finance Australia excludes military equipment from its standard ESG policy, and instead provides a standalone policy for the defence sector.</p> <p><a href="#">Our environment and social policy</a></p> <p><i>In line with these Global Approaches, we screen and, where relevant, classify all transactions, <b>excluding military equipment</b>, to identify the type and degree of environmental and social risk assessment necessary.</i></p> <p><a href="#">Military equipment transactions: Our due diligence process</a></p> <p><b><i>We support the Australian Government’s objective of fostering a defence exports industry in Australia by administering our Defence Export Facility. These military equipment transactions are considered under a Board-approved policy that covers the export of military equipment and dual-use goods (that is, exports which could be adapted for military use).</i></b></p> <p><i>The Defence Export Controls agency (DEC) is responsible to the Minister for Defence and regulates the exportation of defence and strategic goods and technologies.</i></p> <p><i>These exports include:</i></p> <ul style="list-style-type: none"> <li>• <i>military items designed or adapted for military purposes</i></li> <li>• <i>commercial items and technologies that may be used or adapted for use in a military program (dual-use goods).</i></li> </ul> <p><b><i>Our due diligence approach relies heavily on the approval processes and capabilities of DEC in relation to these exports. More information about export controls can be found <a href="#">here</a>.</i></b></p> <p><i>Our policy requires that our support for exports of military equipment from Australia must have a valid export permit from DEC. Australia’s Export Control Policy is based on five key criteria to assess the exportability of defence and strategic goods:</i></p> <ul style="list-style-type: none"> <li>• <i>international obligations</i></li> <li>• <i>human rights</i></li> <li>• <i>regional security</i></li> <li>• <i>national security</i></li> <li>• <i>foreign policy considerations.</i></li> </ul> <p><b><i>We require that transactions involving the export of offensive weapons (and all components of such devices) are subject to Board approval, regardless of the transaction value.</i></b></p> <p><i>Export of military equipment and dual-use goods are not considered under our Policy for environmental and social review of transactions. This is consistent with the OECD Recommendation of</i></p>
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	<p><i>the Council on Common Approaches for Officially Supported Export Credits and Environmental and Social Due Diligence (the OECD Common Approaches).</i></p> <p><i>The OECD Common Approaches specifically exclude exports of military equipment.</i></p>
<p>Bank Australia (5)</p> <p>(Bank Australia was formed in 2011 from the CSIRO Co-operative Credit Society, 71 other credit unions and co-operatives as a publicly owned bank.)</p>	<p><a href="#">Responsible Banking Policy</a></p> <p><b><i>What we don't fund</i></b> <b><i>Negative screens</i></b></p> <p><u><i>The arms industry</i></u> <i>The arms industry manufactures and sells weapons, including guns and military technology. We recognise arms are a necessary part of defence however, the sale and manufacture of arms can be problematic when sold to countries with repressive regimes, militia organisations and organised crime syndicates. There are also several types of weapons that are designed and manufactured to cause maximum harm to people who are often civilians. These include nuclear weapons, cluster munitions, biological and chemical weapons and landmines.</i></p> <ul style="list-style-type: none"> <li>• <b><i>We do not lend to businesses that produce or sell armaments</i></b></li> </ul>
<p>HSBC (27)</p> <p>(HSBC is a British multinational universal bank, it is the largest bank in Europe.)</p>	<p><a href="#">Defence Equipment Sector Policy</a></p> <p><i>HSBC decided in 2000 to <b>withdraw progressively from the financing of the manufacture and sale of weapons</b>. The definition of a weapon and deciding which businesses may be involved in its manufacture are particularly challenging. Weapons are usually manufactured from components, necessitating a judgement on whether a component is a material part of a weapon or significant to a supplier's business. Some businesses provide products to a number of sectors, including defence, requiring detailed analysis to appreciate the full implications of any engagement by the bank. Other businesses may provide services rather than products.</i></p> <p><b><i>HSBC does not provide financial services to customers who solely or primarily manufacture or sell other weapons.</i></b> We do not provide financial services for transactions for the purchase of other weapons. 'Other weapons' are defined as: weapons which can be clearly identified, such as guns or missiles; platforms for weaponry, such as tanks and combat aircraft; and material parts of a weapon or a platform for weaponry with no generally accepted non-military use, such as the turret of a tank.</p> <p><u><i>Weapon-related equipment or services</i></u> <i>HSBC undertakes additional checks to assess: whether major capital equipment, such as military transport, is designed to use weapons; whether material components, such as aircraft engines, are designed only for military applications; whether equipment or services may support the offensive use of weapons, such as target-</i></p>



	<p><i>tracking systems; and whether personal firearms may be used by parties other than law enforcement agencies. Clearance takes into account the likely end-use of the equipment or service and the proportion of weapon-related business conducted by a customer.</i></p> <p><u><i>Conglomerates</i></u>  <i>Where a customer undertakes a mix of weapons, weapon-related or other business, HSBC may form a relationship with that customer, but <b>will not provide financial services directly to subsidiaries involved with weapons.</b> We will not establish any relationship with a holding company where subsidiaries manufacture or sell anti-personnel mines or cluster bombs or where the conglomerate's business relates primarily to weapons (ie more than one third of turnover).</i></p>
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Table 5 - ESG Policy Statements

Almost all financial institutions have policies to prohibit involvement with “controversial weapons”. The definition of this term varies, but the intent appears to be to capture weapons that are banned under international agreements.

ANZ (24)	<i>(anti-personnel mines and cluster munitions, as defined in the ‘Convention on Cluster Munitions’ and the international ‘Mine Ban Treaty’)</i>
Commonwealth Bank (23)	<p><i>Weapons banned under international agreements ratified by Australia. These include <b>but are not limited to:</b></i></p> <ul style="list-style-type: none"> <li>• <i>nuclear weapons (except as authorised under the Nuclear Non-Proliferation Treaty);</i></li> <li>• <i>biological weapons;</i></li> <li>• <i>chemical weapons;</i></li> <li>• <i>non-detectable fragment producing weapons;</i></li> <li>• <i>blinding laser weapons;</i></li> <li>• <i>anti-personnel land mines;</i></li> <li>• <i>cluster munitions;</i></li> <li>• <i>incendiary weapons; and</i></li> <li>• <i>depleted uranium ammunition.</i></li> </ul>
Westpac (26)	<p><i>Customers involved in controversial weapons are those that manufacture, distribute, sell, maintain, or acquire controversial weapons. This includes components designed for specific use in, and forming a key constituent component required for the functioning of, controversial weapons. Controversial weapons are those weapons banned under international agreements ratified by Australia: cluster munitions (as defined in the Convention on Cluster Munitions: <a href="http://www.clusterconvention.org/">http://www.clusterconvention.org/</a>); anti-personnel land mines (as defined in the international ‘Mine Ban Treaty’: <a href="http://www.un.org/Depts/mine/UNDocs/ban_trty.htm">http://www.un.org/Depts/mine/UNDocs/ban_trty.htm</a>) and chemical and biological weapons (as defined in the Chemical and Biological and Toxic Weapons Conventions).</i></p>

Table 6 - Controversial Weapons Definition