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WORKSHOP SUMMARY

Investing in Europe's Competitiveness:

Mobilising Capital for European Defence

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Investing in Europe's Competitiveness Initiative

In its role as a global, nonpartisan, nonprofit think tank, the Milken Institute has launched an initiative called Investing in Europe's Competitiveness. The aim is to develop actionable steps to catalyse the investment needed in the European Union (EU) and United Kingdom (UK) to meet productivity challenges and generate growth, aligned with themes diagnosed in reports by Mario Draghi, Enrico Letta, and Christian Noyer, as well as UK Prime Minister Keir Starmer's missions.

The initiative is centred on three pillars:

- Attracting new investment into infrastructure and decarbonisation
- Closing the innovation tech gap
- Investing in Europe's defence and security priorities

Executive Summary

On 11 November 2025, the Milken Institute, in partnership with the Royal United Services Institute, convened a roundtable of senior military leaders, defence industry executives, financial-sector representatives, and government officials to explore barriers to effective investment in defence and pathways to mobilise additional capital to meet Europe's defence readiness needs.

Participants examined how the contemporary security environment has shifted decisively from the post–Cold War era, once characterised by benign threats and limited defence investment. The Russian invasion of Ukraine, rising geopolitical tensions, and shifts in global defence priorities have recalibrated defence readiness ambitions across European nation-states. This shift has created a generational opportunity for defence investors and industry, as governments seek to rapidly scale production capacity, modernise forces, and develop new capabilities.

Realising this opportunity, however, requires addressing persistent challenges that hinder inward investment. Participants discussed many issues, including the 'valley of death' for mid-market companies attempting to scale, possible defence-specific constraints in environmental, social, and governance (ESG) frameworks, and inconsistent demand signals from government.

Institutional reforms, including the creation of UK Defence Innovation[1] and the National Armaments Director,[2] alongside the long-awaited Defence Industrial Strategy 2025,[3] reflect important steps in the UK. However, participants cautioned that structural reforms alone will not guarantee results. The UK Ministry of Defence (MoD) has undergone numerous reorganisations over recent decades, which often created new bodies and processes without fundamentally altering outcomes. NATO efforts to strengthen collective defence, coordination, and interoperability among allied forces were seen as essential complements to national-level reform.

The test will be whether new reforms can achieve the speed and agility in procurement needed to provide clear demand signals to ensure defence readiness, and whether fragmented national approaches in Europe can coalesce into the coordinated industrial base that the new security context demands.

Defence Capabilities in a Changing World

A More Hostile Security Environment

A retired senior military official opened the roundtable by framing the current volatility of the new security environment. He noted that the UK is now operating in a 'grey zone', a persistent volatile security environment that demands immediate defensive capabilities against multiple threat actors without being in a state of declared, conventional warfare. This grey zone requires nations to protect their critical national infrastructure, address immediate capability gaps, and operate their defence manufacturing base on an 'always on' mode so that they can rapidly scale production. The

official cautioned against the historic tendency to 'fight the last war', stressing that although the character of war remains largely unchanged, the pace of change is now exponential.

The official emphasised the risk of creating a brittle force by being seduced into thinking we can win purely through 'exquisite capabilities'. Instead, he argued that power in modern warfare depends on three key components: the physical (technology), the conceptual (strategies we use), and the moral (willingness of people to fight)—the latter often being a decisive factor. He pointed to the collapse of the Afghan security forces in August 2021, which, despite having training and adequate equipment, fell within days, in part due to a lack of sufficient will. In contrast, Ukrainian forces successfully defended against a much more advanced invasion in February 2022, despite inferior equipment, highlighting the primacy of will over technology. The official's analysis stressed that warfare is becoming more autonomous and escalatory, with operations increasingly occurring in the electromagnetic domain.

The official presented a 'four plus four' framework for future investment and capability priorities. The military must become more *lethal*, more *defended* (both physically and in cyberspace), more *sustained* (to ensure deterrence credibility), and must *see more and further*. To achieve these goals, the military must also become more *connected* (interoperable with allies), more *adaptable* (through continuous software updates), *less exquisite* (more cost-effective and disposable, alongside some high-end, specialised capabilities), and more *autonomous*.

SMEs Require Policy Support

The official then drew a distinction between two categories of small- and medium-sized enterprises (SMEs), each requiring different policy responses:

Supply chain SMEs: These companies produce critical components which may not be technologically advanced but represent vital potential choke points in the defence supply chain. The official emphasised that the MoD must actively identify and protect these companies to prevent capability gaps, noting examples such as the manufacture of energetics, specialised forgings, and precision components. The MoD's 2024 acquisition of a semiconductor foundry in County Durham was mentioned as illustrating the government's increased willingness to secure critical manufacturing capacity through direct ownership when market mechanisms fail.[4] The facility represents the UK's only source of gallium arsenide semiconductors, which are used in military aviation and other sovereign defence technologies.

Supply chain SMEs often face significant barriers to scaling up. Many have severely limited access to banking services and often rely solely on reinvested profits for expansion, making it difficult to meet rising demands from defence prime contractors. This lack of scale-up funding hampers their ability to respond effectively to increased demand, highlighting the need for tailored financial support to sustain and grow their operations.

Innovative SMEs: These companies specialise in developing cutting-edge solutions to complex defence challenges, often working on novel concepts that have transformative potential. Unlike traditional defence SMEs, they require a distinct set of support structures to thrive. This includes

being linked to the right technical challenges, integrated with relevant programme teams, and safeguarded by stable funding sources, ensuring they have the resources needed to turn their ideas into tangible, deployable solutions. One of the biggest obstacles in supporting such SMEs is identifying truly innovative and capable companies, as they often present themselves amidst a landscape of many unproven, yet compelling, claims.

Both types of SMEs face difficulties in securing scale-up funding from public and private sources. The official emphasised that three prerequisites must be met simultaneously to secure government backing: a strong operational command that demands the capability need, a dedicated product team to administer the funding effectively, and the industrial capacity to deliver the solution at the scale required. The official advocated for a 'one team' approach that integrates industry experts into strategy and intelligence discussions to keep pace with technological advances. He underscored that long-term investment ultimately depends on demonstrating to HM Treasury that defence investment plans are both balanced and manageable.

Technology Must Serve Operational Realities

This analysis provided context for subsequent discussions about innovation and technology investment. A defence industry executive expanded on this theme, warning against excessive 'seduction by technology', particularly artificial intelligence (AI) and autonomous systems, without adequate consideration of operational realities.

The executive cautioned that current AI systems operate in highly constrained domains (primarily textual) and struggle in complex, dynamic environments. Self-driving vehicles, for instance, fail in urban environments of moderate complexity; warfare represents an order of magnitude greater challenge, with constantly shifting rules, contexts, and physical environments.

Navigating Challenges Across Europe's Defence Sector

Mid-Market Companies Face Critical Financing Gap

Defence investment has ramped up significantly in Europe, but capital flows are uneven across the defence ecosystem. According to industry representatives, prime contractors remain well capitalised with robust access to institutional investment. For example, BlackRock has maintained its position as the single largest shareholder in BAE Systems for more than 20 years, providing patient, long-term capital willing to invest in defence for sustained returns. BlackRock's investment demonstrates that when contracts are clear and demand signals are strong, institutional capital will participate.

At the other end of the spectrum, venture capital (VC) is increasingly flowing into early-stage defence technology start-ups. Defence is now Europe's fastest-growing VC sector, projected to expand by greater than 130 percent year-on-year, outpacing every other vertical.[5] A critical gap, however, appears to exist in the mid-market. Companies attempting to scale beyond start-up phase and SMEs attempting to ramp up production often struggle to access the financing required to do so.

A corporate executive highlighted the structural challenge, noting that while institutional investment flows smoothly into large defence programmes, SMEs attempting to scale face severe capital constraints. According to participants, traditional supply chain SMEs, which produce essential components, receive limited investment through prime contractors, while SMEs aiming to innovate and disrupt the market often lack established relationships and struggle to navigate complex procurement processes. Without proven revenue from government contracts, these companies often find it difficult to attract the private-sector capital required for growth.

Banks Have Retreated from Defence-Sector Lending

A former bank executive with defence-sector experience described the financial sector's reluctance to support this mid-market, describing defence lending as 'not in the DNA of most financial institutions'. He observed that banks have increasingly structured themselves away from the defence sector over the past decade and that reversing that trend would require both policy changes and cultural shifts within financial institutions themselves.

A bank representative, focused on SME lending, expressed puzzlement about the lack of defence SME demand for financing. A search using defence Standard Industrial Classification codes identified 6,000 SMEs in the UK with more than £1 million turnover, yet these companies were not seeking bank financing at scale.

As potential explanations, SMEs may obtain financing through other mechanisms (prime contractor support, VC, private equity/credit) or may perceive banks as unwilling to lend to defence and therefore do not seek credit from them. Alternatively, growth opportunities may not be sufficiently clear for SMEs to seek expansion capital.

The UK Infrastructure Bank and British Business Bank emerged as potential vehicles for providing AAA-rated guarantees that could make defence SME lending more attractive to commercial banks by reducing risk-weighted asset calculations. KfW in Germany and the European Investment Bank provide similar functions in other jurisdictions. These mechanisms, however, require explicit policy decisions to extend their mandates to defence-related activities.

Pension Funds Face Structural and Reputational Barriers

A pension fund manager described the challenges that institutional investors often face when engaging with defence. He noted that most defined benefit pension schemes in the UK are closed to new members, with risk profiles that preclude VC exposure. These funds, however, have substantial appetite for credit exposure, suggesting opportunities for bridging gaps left by other potential investors, if structured appropriately. Reputational risks also remain significant for pension funds. One participant noted that the only emails received from citizens during his tenure as a local government pension chair concerned investments in arms companies, and none were supportive.

Pension funds are attempting to understand how security and defence align with other long-term risks that they are mandated to manage. Finding approaches that satisfy regulatory requirements whilst supporting national security represents an ongoing challenge.

Participants acknowledged that pension fund participation is likely essential to closing the scale-up financing gap. European pension funds manage €4 trillion in assets but allocate minimal percentages to growth capital compared to international peers.

During this discussion, participants also noted that the wider EU push towards a Savings and Investment Union would have very positive knock-on effects for defence company scaling. It was suggested that amplified advocacy for the security imperatives of these wider reforms might help to accelerate their progress.

Investment Guidelines and Mandates Require Updating to Reflect Strategic Reality

Participants considered ESG requirements as a barrier to defence investment. Several participants noted that ESG language in investment guidelines and mandates often dates from decades prior, listing defence alongside pornography and gambling as excluded sectors. However, this language often stems from older socially responsible investment mandates rather than from formal ESG disclosure frameworks. ESG investing today involves broader and more nuanced categories. For example, although a fund may not invest in companies that produce controversial weapons (e.g., landmines, cluster bombs), it might invest in companies that produce technology used in defence systems or cybersecurity.

Further, the terminology around ‘controversial weapons’ has created confusion. Although the intent is to exclude weapons such as chemical, biological, and nuclear weapons, participants perceived that implementation often extends to other weapons, such as landmines and cluster bombs, that Eastern European allies, for instance, regard as essential to their defence against Russian threats. However, the situation is evolving. The Financial Conduct Authority has now removed language specifically targeting controversial weapons, and the EU’s Sustainable Finance Disclosure Regulation (SFDR) provides a more defined framework that explicitly lists

anti-personnel mines, cluster munitions, chemical weapons, and biological weapons in the appendix to Article 18(1).

However, one participant claimed that the SFDR risked perpetuating confusion,[6] with proposals under the SFDR implying the development of mandatory exclusions for 'any activities' relating to controversial weapons into Article 8 ESG standards, language which is currently sufficiently broad to continue to hinder defence investment.

Some funds are softening their reputational risk policies to allow for some level of defence-sector investment, although they generally try to avoid the most contentious or 'hard' defence technologies. One participant noted that funds have started to introduce vague language in their definitions of controversial weapons—such as distinguishing between 'offensive' and 'defensive' weapons—which has caused a great deal of uncertainty. This ill-defined approach leaves many investors unsure about what qualifies for exclusion.

A private-market representative commented that closed-ended fund structures, which lock investors into language that is agreed upon years earlier, create long timelines for updating policies, even when the strategic consensus around defence needs has shifted. Therefore, these outdated frameworks can delay necessary adjustments in response to changing geopolitical realities.

Several participants asserted that ESG concerns, whilst requiring attention, should not be viewed as insurmountable obstacles. Policy changes across Europe increasingly accommodate defence investment as essential to national security. The greater challenge therefore lies in updating institutional frameworks, fund mandates, and banking policies to reflect this shifted consensus.

Publishing Defence Planning Assumptions Would Signal Government Commitment

An investment manager with a senior military background asserted that government can and must provide clearer demand signals by publicizing defence planning assumptions. These assumptions, which detail threat assessments, capability requirements, expected force structures, and planned procurement timelines, were routinely published until 2010 but then became classified.

Publishing defence planning assumptions would improve industry and investor understanding of what capabilities will be required, in what quantities, and over what timelines. This transparency signals enduring commitments, thereby enabling longer-term investment decisions, particularly for companies that must build production capacity years before receiving orders. Without such signals, investors struggle to assess which companies to support and which technologies to back.

The UK government, by contrast, often uses language that undermines confidence in procurement commitments. While Norway specifies purchasing 'at least' a certain quantity of F-35 aircraft, the UK specifies 'up to' a number—signalling a potential reduction rather than a sustained commitment. One participant stressed that this linguistic distinction, although seemingly minor, can profoundly affect investor willingness to commit capital.

Skills and Infrastructure Constrain Production Capacity

A participant with infrastructure development experience provided a crucial perspective often absent from defence investment discussions. Large defence programmes require physical infrastructure and skilled workforces that cannot be conjured rapidly.

Barrow-in-Furness in the UK illustrates this constraint: Continuous submarine production requires approximately 10,000 additional workers who require housing. Yet, within the past decade, only one hotel has been constructed and only because government provided financial support. The town lacks the residential and commercial infrastructure to absorb a major workforce expansion. This challenge is also evident in countries such as Germany, where a rapid expansion in both recruitment and retention targets will put a related emphasis on providing needed housing, bases, and equipment.[7]

Skilled labour represents a critical constraint. The MoD repeatedly faces questions from Parliament about why major programmes are rated red for delivery risk. Analysis consistently identifies insufficient numbers of suitably qualified and experienced personnel, within both government and industry, as a primary cause. Addressing skills shortages requires long-term planning, including identifying needed expertise, targeting young people at early ages, and creating career paths across the defence enterprise.

Prime Contractors Require Government Commitments to Support Supply Chains

Prime contractors have historically assumed responsibility for supporting supply chain SMEs through lifetime buys, capability investments, and contracts. This support, however, depends on their confidence in receiving government funding. A prime contractor executive explained that when overall budgets are constrained and programmes are cut, prime contractors are much more reluctant to invest at necessary levels.

A key point emerged about the role of government-to-government agreements in providing confidence for prime contractor investment. Without that top-level political and diplomatic commitment, purely commercial arrangements are often seen as posing too much risk.

Recent British successes in Norway and Türkiye were highlighted as examples of this approach working effectively. These deals took years or decades to develop and were built on long-standing relationships and government commitments. They create jobs, develop skills, and meet capability requirements whilst strengthening alliance relationships. Participants cautioned, however, against assuming such successes can be rapidly replicated because they require sustained relationship-building over extended periods of time.

Europe Requires Greater Interoperability and Procurement Coordination

An investor participant advocated for a focus on standards and component-level interoperability rather than platform-level harmonisation. He drew historical parallels to US standardisation efforts in the 1920s, when the Division for Simplified Practice of the Bureau of Standards convened industry to agree on standard sizes—reducing bed sizes from forty-eight to four options and thereby creating enormous efficiency gains.

Applied to defence, this approach would map supply chains down to Tier 3 components, identifying commonalities across platforms and systems and then standardising those components even when platforms differ. This mapping would likely enable economies of scale in component production whilst maintaining some national variation in end systems.

Procurement coordination, however, remains perhaps the most challenging aspect of European defence cooperation. National procurement cycles operate on different timelines, preventing coordinated purchasing decisions. Countries issue requirements at different times, use different evaluation criteria, and base decisions on national political considerations as much as operational requirements. Efforts to coordinate procurement, whether through the European Defence Agency, NATO frameworks, or bilateral agreements, have achieved modest success but appear to fall short of the integration necessary to maximise efficiency and interoperability. Participants identified this misalignment as a structural barrier that limits industrial planning and prevents economies of scale, even when political will for cooperation exists.

Europe Maintains National Defence Industries Rather Than an Integrated Base

Several participants emphasised that the European defence industrial base remains fragmented along national lines. Recent consolidations, such as KMW and Nexter in Germany, or Leonardo and Iveco Defence Vehicles in Italy, have occurred within countries rather than across borders. Europe has a European defence industry located in Europe rather than an integrated European defence industry. This fragmentation creates inefficiencies and limits economies of scale. Different countries maintain separate production lines for similar capabilities, duplicate research and development efforts, and create interoperability challenges when forces must operate together.

Positive trends, however, are emerging. The France–Germany–UK axis, increasingly including Norway, Italy, and Poland, represents practical defence industry cooperation. The Trinity House and Lancaster House frameworks provide structures for UK–French collaboration, and government-to-government agreements are enabling cross-border investment by defence prime contractors, potentially aligning capital structures and creating mutual dependencies that support sustained cooperation and decreased procurement nationalism. For instance, defence prime

contractor Leonardo has invested substantially in Hensoldt (a Tier 1 supplier focused on sensor technologies), reflecting this trend toward deeper cross-border integration of defence technology and manufacturing.[8]

The EU's recent recognition of defence as essential to competitiveness, reflected in the Draghi report, also offers opportunities for progress. If increases in defence spending can be framed as investments in growth and competitiveness (such as job creation, skills, and technology spillovers) rather than in pure security, then defence expenditure may gain political support from previously sceptical constituencies.

An HM Treasury representative echoed this sentiment but cautioned that even achieving 3.5 percent of gross domestic product (GDP) for defence provides limited benefit if GDP growth itself remains stagnant. He stressed that growth must be the focus—that is, increasing the total economic pie from which defence allocation is drawn—and that regional economic development, skills generation, and export earnings are increasingly being factored into capability investment decisions alongside military readiness.

A significant challenge remains in translating stated ambitions into an integrated European defence industrial base, which will require not only political but also long-term commitment to cross-border collaboration and a shared vision for collective security.

Endnotes

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