

Defence Committee

Oral evidence: UK contribution to European Security, HC 520

Tuesday 1 July 2025

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Watch the meeting

Members present: Mr Tanmanjeet Singh Dhesi (Chair); Mr Calvin Bailey; Alex Baker; Mike Martin; Jesse Norman; Ian Roome; Michelle Scrogham; Fred Thomas; Derek Twigg.

Treasury Committee Member present: Chris Coghlan.

Foreign Affairs Committee Member present: Alex Ballinger.

Questions 235-278

Witnesses

[I](#): Fenella McGerty, Senior Fellow for Defence Economics, International Institute for Strategic Studies, Rob Murray, CEO, Defence, Security and Resilience Bank (DSRB) Development Group and Nicholas Nelson, General Partner, Archangel VC Fund.

Written evidence from witnesses:

– [Add names of witnesses and hyperlink to submissions]

Examination of witnesses

Witnesses: Fenella McGerty, Rob Murray and Nicholas Nelson.

Q235 Chair: I call to order today's evidence session of the House of Commons Defence Committee on the UK's contribution to European security. It is an immense pleasure to have with us three accomplished individuals on our panel. Fenella McGerty is a senior fellow for defence economics at the International Institute for Strategic Studies. We also have with us Nicholas Nelson, who is a general partner at the Archangel VC Fund. It is also a pleasure to see again Rob Murray, who is a CEO of the Defence, Security and Resilience Bank Development Group. A very warm welcome to all of you. It is also a great pleasure for me to welcome Alex Ballinger from the Foreign Affairs Committee and Chris Coghlan from the Treasury Committee, who are guesting today—lovely to have both of you here for the evidence session.

First, are there any Members who have a declaration of interests?

Alex Baker: I have been campaigning for the DSR Bank.

Mr Bailey: I have been advocating for alternative funding mechanisms, one of which is the DSR Bank, with which Rob is associated.

Q236 Chair: Duly noted. Let us move on to the questioning. Today's session is not our usual two hours but only 90 minutes, until 12 noon. Let us get the questions started with access to finance for defence with Alex Baker, please.

Q237 Alex Baker: Thank you for being with us this morning. I want to start by focusing on ESG, and then we will come on to some of the other funding issues. I have actually been doing a lot of work on these issues myself over the last six months. When it comes to the ESG there is a real mix of opinions. The defence industry are really clear that this is an issue. The FS industry are really clear that it is not an issue. FCA, obviously, off the back of the letter that I co-ordinated, confirmed that it is not a regulatory issue, and others are saying that it is not an issue at all. James Alexander of the UK Sustainable Investment and Finance Association, just this week, has said that me and the other MPs involved in this work were focused on the wrong solution. But then we see the International Capital Market Association saying that it cannot see defence projects as being compatible with investments in green, social and sustainability-linked bonds. Where do you sit on this issue—is it still an issue?

Fenella McGerty: Thank you for having me here today. I have previously focused on public financing, but private financing affords opportunities where public financing is struggling due to the economic difficulties that countries are facing. We have often discussed this ESG issue in our interviews with stakeholders, with finance and with the defence industry.

It was certainly a prevalent issue when we were speaking to people a year ago, and it was acting as a significant barrier—the messaging was not



there—but it was not the only barrier. It was one of many barriers that inhibited the industry's access to finance, not least because financing institutions are potentially less familiar with defence, the regulations, the compliance and the issues around it. When a choice is given between two investments, quite often they will choose to invest in what they know.

Largely, the issue is still stemming from the lack of long-term demand signals and long-term planning, which can feed through. It is part of the problem, and we are seeing some reforms to the exclusionary policies, but it is quite small in terms of what companies are starting to do on a limited portion of article 8 funds.

There is also a need to reassure investors on why this is happening and why defence aligns with wider ESG priorities. The messaging across Europe at public level is getting stronger, certainly from NATO and the EC, and the measures and reforms that have been implemented by the EIB to improve access to finance and to engage with the defence sector are coming through. There is still a barrier, because ultimately, if it is still presenting a higher risk to investors and if that messaging has not got through yet, the choice will always fall down to that.

Nicholas Nelson: There are a few different aspects of access to finance. When we talk about this, are we talking about commercial banking access, such as for portfolio companies? I can speak directly with some anecdotal, if you will, as a number of our portfolio companies in the UK as well as mainland Europe have had their accounts suspended, or even pulled entirely, because of the nature of their business. Now, there is not a single entity responsible for this, as it is a misunderstanding of what they are doing, as well as varying regulatory and banking laws—you name it.

It is the old Henry Kissinger-ism, "Who do I call when I want to call Europe?" It is 30 different fragmented markets, including the UK, and our fund is co-based out of Estonia. We have no issues in Estonia, and banks across the Baltics are extremely transparent. We have yet to see a single issue.

At the same time, the companies we have in Germany and the United Kingdom have had much different experiences. I was commissioned along with a retired US admiral, who formerly led European operations for the US navy, to do a study back in 2022 for the Centre for European Policy Analysis on transatlantic thinking, called "Elevating Our Edge". We highlighted these ESG concerns back then, and we had a number of functionalities or measures to track them. We have seen a lot of those improve, but it is very much defined by the tyranny of geography. The Baltics, Poland and even Germany have now significantly improved, although there is still room to improve further in those countries, along with the Nordics. In the UK and southern Europe, to a greater extent, we still see a lot of bulwarks to access to traditional funding instruments.

Shifting gears slightly to basic private capital for these companies, we are an early-stage investor in this space, which means that we take small equity stakes in these companies. We are pan-European, but we focus on

the Baltics, the Nordics and the UK—the JEF-plus countries, for those familiar. Looking for co-investors would not be a problem in the US, as there are 34 different funds either wholly or predominantly investing in defence, and that is what the private markets have dictated because there is no Government presence in a lot of these areas.

In Europe, only a handful of us can actually do defence-first or defence-only capabilities. There is a lot of what I would refer to as defence-use or dual-use washing, which has limited access for those pure-play or defence-majority companies. We are consistently looking for support in that area, but a lot of them will cite ESG concerns, reputational concerns or restrictions within their existing agreements—we call them LPAs—mandated by their Government organisations, such as KfW in Germany, the British Business Bank here in the United Kingdom and even the European Investment Fund.

Q238 Alex Baker: My perception is that it is the tip of the iceberg, but there is a culture issue there that we must find a way to address in the medium to long term. ESG is the tip of the iceberg, but there are a load of other issues. Rob, what are the other issues the industry has? What are the things that Government could do to unlock defence finance?

Rob Murray: We need perhaps to take a step back for a moment and understand what it is we are actually trying to do. Words matter, and often, we conflate defence spending with defence investment. Those two things are different. Fundamentally, this is about making sure that we are able to deter—probably from a European angle, and I include the United Kingdom in that continent—Russia. We must therefore have not only hard power, single-use armaments in our inventories as part of that deterrence; we must be able to unlock capital market deterrence, and use financial tools to be relevant for the era we find ourselves in.

What does that mean in reality? It means that, first, there must be an acknowledgement—a recognition not just across Government, but across the House—that we are no longer in peacetime. The strategic defence review makes that pretty clear. The recently released national security strategy document also makes that clear. That is relevant because, when it comes to defence investment, all our policies, ways of working, and incentive structures have been written, designed and geared for an era we are no longer in. There has to be a recognition that, straightaway, the way in which we architect our defence investment has to change.

We should be looking at, in broad terms, a wide capital stack for defence investment. That means having, as Nick has rightly highlighted, venture capital going in for those new companies that have the potential to do amazing things. Beyond that, we have traditional private equity looking perhaps to finance either the growth of cashflow positive businesses or maybe find a few companies that are kind of in the same market, stitch them together and get a greater scale of economy. Beyond that, we have commercial banks.

Coming back to the point on ESG, there is no legal reason why any bank in this country cannot lend to a defence company. There is no legislative reason stopping that. This is therefore a policy problem inside each and every financial institution for those that choose—and it is a choice—not to conduct defence investment. That has to change. If we are going to have any meaningful capital market deterrence—London is an international financial hub, and this therefore applies not just to commercial banks, but all the insurance industry that lives here and all the other financial services—the Government have to make it explicitly clear that this is now a national priority. Why? Because the “S” in ESG stands for “social”. If you do not have security at the base of society, you have anarchy, and you therefore have to invest in national security and defence investment. The final point on this, when we think about unlocking it, is that you have to be able to measure this. If it is a defence investment, there has to be a return on that investment. Sometimes it will be financial, but more often than not, it will be qualitative, tied to our national security goals and objectives.

Q239 Alex Ballinger: Rob, you said that many banks and insurance companies will not invest in defence companies. What proportion is it, what type of banks are they, and how big of a problem is it that these companies are not getting support from British institutions?

Rob Murray: Alex Baker knows this better than most, having campaigned on this specific issue. This goes back to what Nick just said: for the United Kingdom in the context of Europe, British-domiciled banks are much worse at lending to defence companies than their European counterparts. I would have to follow up with the exact specificity in a written response, but I have worked in this industry for 25 years, and it is clear that British banks have a problem with the reputational risk that they perceive to exist with investing in defence.

Chair: Thank you. It would be great to get that written note from you. You are right, because some of the evidence we received—whether from ADS or Make UK—also alluded to that fact. It is good that you are speaking about Europe, because that is a great segue into what we want to delve into next, which is what is happening on the European continent.

Q240 Mr Bailey: In this section we want to explore industrial capacity in Europe within the context of increasing demand, but limited or unmatched supply. A quite hackneyed anecdote is that the price of a 155 mm shell was £1,700 at the beginning of the Ukraine conflict, and is now £6,800 because the supply simply does not match the demand. With that as a framework for discussion, what are the new funding models and what can we do to prevent such obvious price inflation?

Fenella McGerty: The reforms across the continent at the EU level and by individual countries are quite remarkable, even in the last six months. It is interesting that we were speaking about national banks’ willingness to lend to defence. The EIB has set up a fund with Deutsche Bank and banks in France to discharge funding down into the sub-defence supply chain, so it is engaging with banks on a country level to get that funding in-country.



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The logic behind it is that those banks will understand the regulatory framework and the priorities within that country and where the funding might need to go.

Those kinds of initiatives are really interesting to see, as is France's comprehensive approach to bolstering its defence industrial base. France is obviously in a more constrained fiscal position than a lot of countries in Europe—for all the ambitions from Macron to get to that 3% to 3.5% of GDP on defence, there is that constraint. France has really harnessed whatever potential there is in the private sector to help bolster defence.

There is the establishment of the private fund, where citizens are able to buy bonds, effectively, in defence to raise about €0.5 billion. France is also engaging directly with financial institutions and defence SMEs and start-ups; it is bringing them together in wide forums, providing support and making sure that kind of engagement is there. There has also been some legislative reform in France to speed up the procurement process—the financing process for these industries. Arguably, that comprehensive approach and those kinds of measures could also be enacted here. It is about whether the appetite is there and whether the messaging is strong enough for industry to invest.

Nicholas Nelson: When you look at the ammo shortage that is predominant across all of Europe—much like Rob, I would include the UK on this one—the challenge you run into is that still, whatever one thinks of Russia and how it has been constrained, it still produces more ammo every year than the United States, Canada and the rest of NATO combined. Obviously, that is a huge challenging point to begin with.

Certain countries, like France, have put in more strategic measures. The ones I would instead point to as being successful are those in the Baltics and Poland, where, in two cases, they have already broken ground on 155 factories. They have gone out there with heavily subsidised Government loans because it is a very tactical issue, but really when you step back, it is effectively a strategic problem. You can do all the high-level structural reforms you want, but perfect is the enemy of good, if you will. A lot of it is just about the fact that if there are demand signals, they are effectively heavily subsidised working capital loans.

We know that there is demand—we have enough MOUs and LOIs to kill a horse, to use a colloquialism. Since we have those, let us just break ground and figure out how we are going to pay for it as we go. That is one of the biggest things that I see across Europe—particularly in western Europe, to include the UK. There are a lot of very well-meaning people who want to have these grand sea changes. That is welcome and necessary. At the same time, having been in defence for the last two decades, I use the old example of my grandfather, who was also in the aerospace industry. He used to talk about acquisition reform. We are still here talking about it. He has been dead—God rest his soul—about 22 years now, and we are still talking about it with no meaningful changes.

Q241 **Mr Bailey:** The Russian point is interesting, in that Russia will not see the



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cost inflation. There is a real danger that we are just pump priming taxpayer money into a defence industry incapable of doing what we expect it to. That is a moral and ethical issue. I would like to explore how we go about addressing that by using heavily subsidised loans. What are the mechanisms to do that?

Nicholas Nelson: First, understand where there are clear demand signals. We can go into defence being a better customer, but I think that is neither here nor there for today. If there is demand, which there clearly is from both within the United Kingdom and His Majesty's forces, as well as the continent, for different NATO standards—from 155s to 7.62 ammunition—we can build that up and let the private markets handle it.

The challenge, as we have already delineated today, is where you get the money more effectively—in that case, the working capital loans. Right now, the high street is still not always willing to make those loans. Obviously, there are concerns around market distortion, but it becomes the purview of HMG to decide if they are going to underwrite those existing LOIs to help do that if the banks are not willing to. Having had some conversation with certain banks, and one in particular, I know that they would be open to doing that if they had a clear demand signal from Government. It is not an either/or of Government versus banking; you have to bring both to the table because it is a private sector solution to a public sector problem.

Q242 **Mr Bailey:** That is really important. Where I want to go from that—and I suspect you would like to come back on it—is to explore collaboration within the European sector. If I was going to buy 100 of something, why would I penny packet in 10s and not get the discount? That may be what we have just done with the F-35s and some other systems. There are two parts to the equation: demand and supply. We have discussed supply, but what about demand?

Fenella McGerty: Certainly at EU level, there are moves to try and encourage co-operation and aggregate demand. We are seeing it at NATO as well. Part of the capacity expansion pledge is trying to co-ordinate and aggregate to stop countries competing with each other. Again, going back to the public spending element, funding increases towards a higher allocation for defence happened in a very short time. We have seen remarkable growth in European defence spending over the last three years, but ultimately, it has come at a pace that is not effective for defence industrial investment. With the new pledge to get to 3.5%, it will be interesting to see in those annual submissions how transparent and effective countries will be at making those increases. If we have another “hockey stick”—as Mark Rutte calls it—where all the growth is pushed further to the right, up to \$1.3 trillion in defence funding could be lost, depending on how extreme it is, because you have not allocated funding in a measured way and communicated to industry when funding is coming in and when the annual allocation is happening.

Q243 **Alex Ballinger:** I am from the Foreign Affairs Committee, and we have been doing an inquiry into the EU reset. A lot of that is predicated on what



is going on in Ukraine. It was great to see the security and defence partnership being such a flagship part of the reset at the recent summit. That had a lot of important stuff around collaboration and co-ordination with our EU partners, but a lot less detail on finance and how we are going to work together. How is the UK doing on collaborating with the EU institutions, and what more should we be doing to improve access across the whole European continent?

Rob Murray: I spent 10 years in Brussels, so I know that city and the institutions pretty well. Having spoken about the project of the DSR bank to many of the major EU member states at ministerial and senior official level over the last few months, it is clear to me that they are looking for the United Kingdom to show some leadership on defence and defence investment. The UK is perhaps one of the few countries on this continent that has the right attributes to lead in the specific area of defence investment. I would characterise most of the EU member states that I have spoken with, including all the major G7 ones, as essentially second movers. That is the nature of how Brussels tends to work.

Going back to Fenella's point, when we look at co-ordination with Europe and so on, there are a useful couple of words in the NATO statement, as opposed to a communiqué, that came out of the leaders last week. It is a very short statement—only about 450 words. They asked for nations to present annual plans on how they are going to get defence investment to hit the 5% target.

The point here is that, if this is going to be meaningful for Europe—again, I mean the continent of Europe, including the United Kingdom—then we absolutely cannot have bureaucracies thinking this is a high-line political problem of getting to 5% and throwing in all sorts of accounting assets so that, on the books, we suddenly look like we have hit that target. That will happen across all of Europe. I have lived and worked there, and I have seen this happen. I guarantee you that that will happen, and it will happen here as well.

The point is that it will need political leadership to make sure that defence investment actually takes place. Otherwise, going back to my point at the beginning—what is this all about? This is all about making sure we have the right resources that generate the right sort of power, be it hard power or soft power, to deter Russia. If we think that this is some sort of accounting game, we have totally missed the point. The United Kingdom therefore has a real opportunity to lead in this space in Europe.

Q244 **Alex Ballinger:** Thank you, Rob. I was in Brussels a couple of months ago and I met the Belgian equivalent of the Chief of the Defence Staff. He was talking about using his increase in defence spending to build bridges. There is a role for that, but there is a concern that more of that money would be spent on it than we would like.

I have a similar question for others, but maybe you could also reflect on the SAFE mechanism, which is not part of the security and defence partnership but is an ambition of the UK. How effective are these types of

joint mechanisms in generating finance for defence industries? Should the UK be looking to collaborate in other areas? Maybe Fenella could come to that next.

Fenella McGerty: Of course. I would echo what has been said. When I recently held interviews in Brussels, the sense seemed to be that the European Commission can make these reforms, open the doors, reduce fiscal barriers and bolster private financing, but it is ultimately up to the countries themselves to make those changes and regulatory reforms and make use of the increased options that are now open to them.

Stakeholders there agreed that the UK is in a strong position to lead the effort on different kinds of funding instruments, because this can be all of Europe—it is not restricted to purely bolstering the EU's defence industrial base, and there are no restrictions on the countries that can be involved. You have the advantage of using the different capabilities that countries have and can bring to an agreement.

The recent moves between the UK and EU are positive. The security and defence partnership means that the UK can now participate in common procurements. It cannot receive loans, but the greater opportunity to collaborate should help the UK's engagement with Europe. We have looked at past measures in Europe, and initiatives such as PESCO and third-party access in the EDF. It does not look like there are going to be an awful lot of reforms to enable greater third-party access. Obviously, you can work with third parties but the issues over the loss of the IP and the structuring would really prohibit third parties wanting to engage. Until those issues are overcome, those barriers are still there. On a bilateral basis, because that partnership agreement is now there it could be the way forward, certainly with Germany.

Rob Murray: On the SAFE point, it is worth noting what we are talking about. Of the €150 billion, 65% is going to go to the EU; 35% of it is split among those other countries that have a defence pact with the EU—Canada, the UK, and potentially others. It is running to 2030, and it is Commission money that can be lent directly to Governments, with no debt rollover. The SAFE programme is a great start point, but it is a drop in the ocean. I think it sucked up a lot of political engagement, but we are missing the point of the scale of defence investment needed. SAFE is a great start point—I want to make that very clear—but it is by no means going to resolve the sort of financial challenges that Europe and the United Kingdom face.

Nicholas Nelson: I perhaps have a slightly different perspective. I am not involved in policy; I am very much involved in finance, day to day. From our practical experience of looking at investing in these companies, we have a lot of data that we have put together over the years, going back to the 2022 report that I mentioned, "Elevating our Edge". At the end of the day, these larger cross-border programmes disproportionately, to the extreme, benefit your incumbents. Those incumbents have two forms. The first is your primes. That word gets thrown around a lot, but it should mean companies that can service contracts across all five warfighting

domains: land, air, space, sea and cyber. The other is the national champions. They do not exist so much in the United Kingdom, but in the European Union there are a number of companies that share characteristics of primes, but are either wholly or predominantly owned, or a large minority share in them is owned, by their respective Government or Governments.

Why is that important? I focus on capability development for novel and new technologies—what Rob, when he was at NATO, probably would have called EDTs, or emerging and disruptive technologies. They can run the gamut, from things that resemble deep tech, which have a low level of technology readiness and may be game-changers, but are five to 10 years down the road. It can also be things that mirror more traditional business-to-business software, such as things that are already performing in Ukraine, and that are in our portfolio.

Why do I bring that up? In our view, none of the companies within my prior fund or our current fund have ever benefited from any of these large cross-border programmes. Look at the actual flow down when you have a larger contract. We will use EDF as an example because it was kind enough to publish at least its Excel files, which we were able to back into. It says that it has SMEs on almost 40% of its projects. However, less than 18% of the euro value is going down to those projects, so it is not benefiting those companies, even though they are, on average, doing more than 50% of the work. The equation does not close. That means that they have compressed margins, so they are not making as much money as they would going direct to Government, and at the same time they have to deal with a much higher regulatory burden—ISO standards, cyber-security standards, and so on—being imposed on them. We generally steer our companies away from any of those cross-border grants or programmes.

One of our companies, which just raised the largest defence tech series A funding round in the UK's history, and which has done a fantastic job, prides itself on saying that it has never taken money from the European Union, or an innovation pound from the MoD. That is not to say the company did not try, but it was literally up to private capital to underpin what that company was doing. That is not an indictment of what is going on; it is just to show you that in our niche of the market, venture capital in faster-growing companies, those companies are not serviced by those programmes, nor do they benefit from them.

If you are really looking for transformative capabilities, they will come from those companies. They will not come from the big primes. That is nothing against the primes; they are very much focused on their order books, as they should be. They are delivering current unmet needs, and the things that we have to meet, but to grow as an economy, get the return on investment that Rob referenced earlier, and get the transformative tech out there, you are going to need venture-backed companies, and at scale.

Q245 **Chair:** I know we are looking at how we are going to finance defence



spending increases within Europe, but I want to compare and contrast with what is going on in Asian markets such as South Korea. Ms McGerty, the International Institute for Strategic Studies has done a fair amount of work on that. Can you compare and contrast with how they are funding things there? What can we learn? There is a feeling that the lack of clarity and of long-term commitments, and security of demand means that we within Europe are faring poorly in contrast to Asian markets. Is that how you see things?

Fenella McGerty: If you look over a long time period at the allocations that countries in Asia made to defence, and the fact that countries had co-ordinated plans for spending, capability and security at the same time or worked together towards common threats and common goals, the threat perception in Asia is perhaps clearer in some ways. It tends to focus strategies a bit more, because countries have certain geographies and certain threats that they are trying to respond to, so certain capabilities have to be funded in a certain timeframe. That co-ordination has been effective.

In South Korea, the bolstering of R&D funding over the last 20 years has been remarkable. That is why you now have compelling competitors to European firms on the European continent. That wider engagement has meant that they have been able to offer faster delivery and loan agreements if countries need them. There is a more comprehensive approach to exports as well. Becoming the world's fourth largest defence exporter in the next few years is written into the industrial goals. Having that as a prime target focuses funding, capabilities and ambitions.

Q246 **Chris Coghlan:** I am from the Treasury Committee. Nicholas, on your earlier point, the Treasury Committee has been looking a lot at how to use defence spending to boost economic growth. All the research I am seeing shows that, if you really want to do that, it has to be in the start-up and SME space. You need public R&D for basic research, which then flows into the VC sector. I was interested in your point about incumbents. One of the Treasury Committee's biggest fears is that all this defence spending ends up with incumbents and ultimately does not generate economic growth. What is the best way for Governments to think about overcoming that?

Nicholas Nelson: That is a really great point. First, I will steal one of Rob's phrases, because it is one of my favourites: words matter. In the United Kingdom and across Europe, we have a tendency to use the term "SMEs". Small and medium-sized enterprises are very different from what we invest in: venture-backed start-ups. They have fundamentally different business models and, to a large extent, a different go-to-market—how they sell into industry and go about being part of the value chain or supply chain within defence. When we are doing that, we try to talk about both. One is not intrinsically better than the other, but they have fundamentally different ways of making money and growing.

We already know for a fact that the venture-backed start-up phase produces good return on investment. How do we know that? As you can tell, I am part American. I have spent half my life in the US and half in



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Europe, so I have had a good chance to be under the hood a lot throughout my career within the US. If folks will remember, both NASA and DARPA were founded in 1958. There is no need to explain what those are, but we now have a 67-year track record on what return on investment came out of that across the board. If you look at the NASA example, which is artificially weighed down by planetary science, they estimate that for every US taxpayer dollar that went in, about \$7.30 was returned in economic value. DARPA's estimates are north of 14x. That shows that if you invest in the right R&D priorities, you will have better outcomes.

Let's look at the UK specifically. When I first came up with the thesis about "defence first" capabilities prior to the second Russian invasion of Ukraine, I wanted to understand who is going to work at these start-ups. In the US, for good or for ill, you have been able to co-opt a lot of the traditional silicon valley talent as well as primes. We surveyed 127 different graduates and recent graduates up to three years out, from engineering to politics to computer science, and asked what they were interested in. It came back that money was not their biggest priority; it was up there—don't get me wrong—but their priority was optionality. What does that mean? It means that if I am working for your company and I come out of uni and do not like it, then I walk down the street and go to, say, Rob's company without having to move towns, relocate, break a lease or that kind of thing. I can still maintain that position and try a bunch of different entities.

That is important because if you look at the footprint of the traditional primes, in the United Kingdom they are largely outside your major metropolitan areas—there are some extant in Bristol and you have some smaller presences in London, but it is just a fact of the matter. It is not a bad or good thing; it is just how they have developed over time. If you want to get at this differentiated talent, you have to have ones based around the more metropolitan areas. That is what have seen—now proven in the last few years—for our start-ups.

What they really need earlier on, though, is to be able to directly access Government funding. Traditionally the pathway is, "Hey, I'm at Main Building, go talk to Babcock, QinetiQ or BAE—all great companies." Why do I do that as an acquisitions officer? It helps de-risk them for me, because to get on certain frameworks, as you probably are all familiar, you have to have x number of years in operation—depending on the nature of it and what kind of framework it is—and you have to have y bank accounts.

We have had one of our companies get denied because they were running out of money—of course they are running out of money; they are going to raise another round coming up. That is the venture capital model. That was not taken into consideration. I am obviously biased; I would say they had the best technology by far, but despite that, they ended up not getting on to that framework and eventually had to sub to a larger

company, and still ended up delivering 80% of the work, yet about 60% of the value of that contract.

On the one hand, it is about understanding the difference in the business models between SMEs and start-ups—obviously, there is the talent model there too; there are two that I delineated—but on the other hand, more specifically, it is about getting defence or national security, depending on the part of the Government, to take bigger risks on these companies up front, even if they have not been in operation as long as you would like or it looks like they are running out of money because they have raised venture and accepting a larger degree of risk. I know that is easy to say, in my view, but that is what we look at.

Q247 Derek Twigg: The SDR said we should be looking at new funding models and that that should be explored to see whether we could get more capital into defence. What is your view on that?

Nicholas Nelson: Yes. I absolutely agree.

Q248 Derek Twigg: What should they be? Have you got any idea?

Nicholas Nelson: Sorry, I am being a bit glib. There are a couple of a different things you would want to look at. First and foremost, you want to look at how you have incentivised the venture capital industry in this country. There have been two things traditionally that have done that. First, there is the EIS and SEIS scheme. For those who are not familiar, it effectively allows me, as a high-net-worth individual, to put money into a fund manager or directly into a company, and have it be a tax write-off at the end of the year. Some people take issue with that, but it has worked quite well, and that is why London significantly outperforms any other city in Europe on venture capital per capita—with the exception, some could argue, of Estonia, but that is neither here nor there for a large country at the very least.

The other piece of this is where venture capitalists—when you have bigger funds—get your money. At the early stage, there is not that much of a problem with angel investment—individuals investing—or in some of the smaller funds. The problem is where you get to larger sizes of fund. The biggest backer should be different entities—either pension funds or the British Business Bank—but the timelines they take to make decisions, particularly in the case of BBB, do not always match the timelines for what we need to do.

For instance, if we wanted to raise from BBB, we would normally have to wait anywhere between 12 and 18 months to go through the whole pathway, whereas we have private investors who put money in within three weeks, so we have to make a decision. In cases where we really have a burning platform—with regards to the threat from Russia, and one would also argue China, as well as other regional actors like Iran—we do not have time to wait for that to come out. Similarly, Government-backed money and Government-backed pension funds need to be able to stake venture funds earlier in their life cycle. The same would go for private equity funds as well, which are still lacking from an exit perspective here.



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I know this is a theme from my last answer, but it is about the Government being able to take more risk and provide things like matching fund—so providing a matching capital if a venture capital fund comes in and a company already has a Government contract or a Government grant. I have not invented that; it is not new. It has been done by the US Air Force for the last decade; it is consistently done by the IDF in Israel; and it is done through a number of the Baltic countries. All it is really showing is that if the Government are willing to give this a grant and provide non-dilutive additional capital in there, then when a company—or a fund in our case—comes in during either 120 days or six months, depending on the time window you use, it provides a longer runway and makes those companies more resilient. That is not happening to any great extent here and would be a huge benefit.

I have spoken mainly about the private capital side—I am sure Rob can get more into the public markets. But for what we do in private equity writ large in venture specifically, it is moving faster, and it is being more risk-tolerant within those investments.

Rob Murray: Let me build on some of those points. How do we think about improving the funding within the MoD? In terms of some of the challenges, first of all, the defence budget, not only in this country, but pretty much in every NATO country, works on a 12-month cycle. Ministries of Defence view money as a budget that is allocated by, in this case, the Treasury. There is normally a knife fight that goes on beforehand as to how much you get. We have to be more creative in how we think about money, as opposed to just receiving a budget.

The way I look at it, there are two sides to this coin. The first is the demand side. How can we improve things there? We have already mentioned the British Business Bank. We also have the national wealth fund and various sorts of import and export banks—publicly owned banks in this country. There is no reason why they cannot provide working capital financing to supplement defence budgets, and have that money rebalanced in year 3, year 4, year 5—whenever. It is all owned by the same entity—the state—so there is no reason why that cannot be used more effectively.

Equally, contracting is critical. The manner in which the United Kingdom issues contracts is incredibly inefficient, and therefore, that creates greater cost. One example where there would be a huge opportunity to improve defence investments and how we think about new tools is to take inspiration from Ukraine and Brave1, an entity in Ukraine that connects private sector entities to Ukrainian forces. About a month or six weeks ago, they put in place what is essentially an Amazon marketplace for troops, all the way down to platoon level—the very lowest tactical level. Therefore, for many items, the 22-year-old corporal or the 25-year-old captain can simply order what they want. They have decentralised procurement.

You cannot do that for everything. You cannot do that for planes, ships and submarines, obviously, but there is an awful lot you can do that for.



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Market forces will immediately kick in, because if a handful of 22-year-old corporals give something a five-star review saying, "This works really well", guess what? Everyone will buy it, right? You start to take away a lot of the inefficiencies. That is a massive cultural shift for this country. But the reason that South Korea, going back to the question about Asia earlier, can do what it does is because it has an existential threat on its border. The reason Ukraine is doing what it does is because of the existential threat. Therefore, we have to have a different mindset here.

Q249 Fred Thomas: I am going to come to all three of you and ask about other Government Departments. We have mentioned the Treasury a few times, but I think it is important that other Departments help with the issue of access to the right funding for the right companies, for the right kind of growth in the UK. I will frame this by mentioning two success stories in the European market. Anduril and Tekever had their first contracts in the UK, not with the MoD, but with the Home Office, doing some work over the channel. That was actually very advanced work—probably much more advanced work than the MoD would be capable of fielding today. Coming to Fenella first, particularly in reference to financing, which I know is your specialism, could you talk about how other Government Departments can help the MoD out?

Fenella McGerty: I think it falls into what we are seeing across Europe, which is a blurring between defence and security, how they fit together, and what capabilities are developed that are then beneficial to the defence sector. It is becoming a whole of government and whole of society approach. The Nordics take a total defence approach and bring in other departments to bolster defence and get towards common goals. It is not just about purchasing capabilities; it is about where defence sits among wider Government priorities, effectively.

I think where they can co-ordinate is where you are looking at investment opportunities. You consider those that enhance security and supply chain resilience, reduce vulnerabilities and wastage, and ensure that savings are found elsewhere so that funds are allocated effectively. It is about that kind of co-ordinated approach that can come through. It has been very interesting to see the level of funding that is occurring in these unicorns that have emerged, and we are starting to see those emerge in the UK now as well, which is really exciting. It is about engaging with those and looking at dual use in other parts of Government.

Q250 Fred Thomas: It seems wild to me how quickly other Departments can move companies on to contract, whereas the MoD cannot, unless it is for Kindred to go out the door to Ukraine. We cannot use it ourselves for our own forces.

I want to ask about DSIT, and perhaps I can come to you, Nicholas. There are dual-use capabilities. We all know there are benefits to being a dual-use company if your output is, let's say, software instead of you being a defence-related company. We have covered the ESG-related reasons for that. This Committee has recently had meetings with the NATO air command, who also command space for NATO. We talked about low Earth

orbit networks. I think that will be a key capability for the MoD going forward, and we have had various bits of evidence to that end. Could you talk about the relationship between the MoD and DSIT, and some DSIT-owned capabilities? How can financing benefit from that relationship?

Nicholas Nelson: Certainly. To start from the macro side, they can benefit because, at the end of the day, having multiple Government Departments involved can, yes, add a layer of complexity, but it also allows for greater economies of scale when you are making purchases, be it software or otherwise, and being able to get it into the hands of various end users. I think you had a good point at the very start with regard to how, for instance, Anduril, Tekever etc. actually got into the UK market first as they were expanding into Europe. We have proven that we can work that out.

With that said, when you are looking at dual use, it really depends on the nature of that capability and how you are going to scale it out. Certain things are going to appeal only to one side or the other. At the end of the day, what you should have is what Fenella has referenced—a total defence mindset, a whole of government mindset, where you are seeing the priorities shared and having regular interchange of opportunities.

In our past engagement on innovation programmes that sit within DSIT, for instance, there have been very good conversations, but I think there is still a reticence to get into anything that is too defence-oriented. A good example of this is that with their fellowship programme, they have a very typical size and type of fund they look at; one which we, for instance, would not be eligible for. I think getting that regular interchange with folks like us, but also the venture capital industry and, indeed, the tech side would be really beneficial for both entities.

Q251 **Fred Thomas:** It is obvious that with companies like Palantir—originally a defence company—providing huge services to the NHS, the lines are going to get more blurred as we go forward. Rob, would you like to come in on any of this?

Rob Murray: Just briefly—I think context is important. With the challenges of illegal immigration, and that being in the newspapers every day and in the in-trays of the Ministers of various Governments over the last few years, one should not be surprised that the Home Office was able to move quickly on contracting. The takeaway there is straightforward: we have to have political leadership here. There has to be a recognition of the geopolitical state we are in and therefore it has to be driven through.

Q252 **Fred Thomas:** Do you think this Government will deliver that?

Rob Murray: I think it could.

Chair: On that high note, let's move on to Mike Martin.

Q253 **Mike Martin:** I would like to ask a few questions about VC funding specifically. I will start with you, Nicholas. How would you summarise the challenges to VC companies getting into the defence and security sector? Can you give me some colour? I am thinking of things you have been

personally involved in that have been deeply frustrating.

Nicholas Nelson: Yes and yes.

Mike Martin: See this as a therapy session.

Nicholas Nelson: I appreciate that; that is what I am here for. To be quite honest, it has run the gamut of things. I mentioned earlier about being denied bank accounts or having accounts frozen at short notice. I know multiple companies both in the UK and abroad, within and outside our portfolio, that try to maintain two to three different bank accounts at any given time under the understanding they will potentially have one or two shut down. That is obviously a huge issue, because it drives up extra cost and adds extra complexity, and in one case almost cost one of them a contract because they could not make a payment to a supplier in time. That is some anecdotal data on that one.

For venture capital writ large—because that is more of an SME as well as start-up issue—we sometimes struggle to find co-investors on that. When we are writing a cheque, it can be anywhere on the low side between €300,000 up to €1.5 million. That is good for early stage, but within the United Kingdom, if something is “defence first”, there are very few, if any, co-investors. Thankfully, there are some great US and continental-based firms that we can and regularly do partner with, but within the local ecosystem, they are few and far between.

Even those that receive Government backing are not always willing to write a cheque into a defence tech company, which is a huge challenge, especially if we agree about my earlier statistics on the return on investment generated by Government funding of these entities, or by taxpayer funding, if we really get down to it. We say that if this is a key capability need, then, certainly, the Government money that is going directly into funds or via Treasury into other funds should at least have carve-outs for defence capabilities. Right now, within BBB, for instance, there is no defence carve-out or category. If we look at even the investments that have been made through things like the ECF programme, they are made into generalist funds that do not focus on defence.

Obviously, we are a niche area—we do defence first. We are really the only one in the United Kingdom doing this and one of a handful in all of Europe, so I have a very niche view on this. But if you are trying to do what I am doing—at the end of the day, that is two very basic things. First, can I result in net new capabilities being delivered by our companies into their respective Ministries or Departments of Defence? Secondly, can I also have them, via the power law, give high enough returns that I am able to pay back my limited partners—those who are investing in the funds? That is what I care about.

So when we say “defence” or “defence first”, we mean companies that are either wholly or predominantly selling into defence. But that is the biggest challenge as there are limited numbers of LPs. The Government timescales for Government-backed funds are not really on track with when we need

to raise a fund. More specifically for our start-ups, only one of them has officially taken any money from a Government-backed fund or entity to do that.

That is a huge challenge if you are saying we need to develop UK-based capabilities and UK defence tech champions. We referenced Tekever, which is out of Portugal; Anduril, which is Anglo-American but out of the US; or even Quantum Systems or ARX Robotics, which are both German and are now expanding their presence here. We have yet to really see a true UK one come up. You have Kraken Technologies out of Portsmouth and Labrys Technologies out of London, but they are still basically having to build their own way through.

Q254 Mike Martin: Nicholas mentioned a few there—there is Anduril, Shield AI and Helsing, and a few other examples where it has worked. Do we have a sense of what the magic formula is there and why it has worked?

Fenella McGerty: We have conducted some interviews with VC firms, and part of the challenge is mapping the new ecosystem and mapping which funds are available, because you do not just have private VC firms. You can have sovereign Government funds—say, BPI and NSSIF—and then you have venture capital firms established by defence primes as well. It is about understanding the new ecosystem—it is getting quite crowded, and potentially more confusing—to determine which investments are viable.

A consequence of that might be that we are seeing funding piling into already established unicorns in Europe, which have seen significant increases in their valuations in the last year alone. The same is happening in the US as well. On the point about it not just being the UK, there have been recent funding rounds for PhysicsX, for instance, led by Temasek, which is Singapore-based. It is about the other funding opportunities that are in the market as well—it is not just the European ones you are looking at, but the whole world is effectively looking at investing in VC in Europe.

Rob Murray: Briefly, this goes back to Calvin's question about how we view all this money coming into the sector, whether into venture capital or other areas at different levels. This has implications across the whole ecosystem. The point is that if we are not able to expand production capacity, in small companies all the way through to large ones, ultimately all this money that comes through results in more expensive defence because it results in inflation; we had the artillery shell example earlier.

Having money coming in is good on the demand side, but you need, for example, guarantee systems in place to help banks get credit, in addition to the equity financing that Nick described. Small companies also need access to credit, invoice financing, working capital and supply chain finance, so you have to ensure that guarantees are in place to allow commercial banks to lend, and that is a problem at the moment. That system does not exist at the necessary scale. The EIB work that Fenella alluded to earlier with Deutsche Bank is a start, but there is an awfully long way to go on this.

Q255 Mike Martin: That's really interesting. So we don't really have the financial architecture in place to convert increased defence expenditure into capability without causing massive inflation.

Rob Murray: That is what I have seen. Artillery shells are one example, and I will give you another brief one. Leopard 2 tanks were sold to the Dutch in October last year at \$23 million per tank. Exactly the same variants were sold to the Austrians in February this year—five months later—at \$30 million per tank. Defence inflation is real and it is here.

Q256 Ian Roome: Nicholas, on VC firms and the defence industry sector, we were told about the regulations and ethical and commercial challenges that can restrict capital flows, limit options and increase investment risk. Given the geopolitical situation and the increased Government support for defence, what would your one ask as a venture capitalist be to the UK Government to help the industry thrive?

Nicholas Nelson: I have a lot of asks. To be very direct, I think it is about taking greater risk. I have already given a couple of examples today. I know this is a scary thought, but it is about being able to pick winners and losers. The problem right now is that if you go back to 1990, which I know is a long time ago, for every taxpayer dollar, euro or pound—well, I guess not euros at the time—there was parity for research and development spend between the commercial sector and the Government. By 2010, it was almost 3x commercial to Government R&D, and today it is over 12x. What does that mean? Government and defence have to be involved much earlier to have the impact that they once had. They are no longer the 800 lb gorilla in the room.

For your money to have a greater return on investment, both in terms of returns in dollars and cents or pounds and pence, but also in capability development, you have to be a better customer earlier. That involves making bigger bets.

Spreading grants out to 100 different companies just keeps 100 companies on life support and does not result in net new capabilities. Rather than the Government awarding multiple grants or multiple small contracts multiple times a year—three or four times, in some cases—I would much rather that they do it once, have a down select from there and have a winnowing process whereby those that get the best feedback from the warfighter get bigger chunks of funding.

Systems like that—that winnowing or funnel process—do exist in other MoDs and DoDs across Europe and the US, but they do not exist here. That means that you are spreading it too thin to have any real impact. It is about taking risks and making bigger bets sooner, especially with sovereign solutions.

We can talk about how we want pan-European collaboration. We have talked about the French ecosystem before. I have spent a lot of time in the French ecosystem over time. It is great if you are a French investor or a French company selling to the French Government, but not so great if you are a company from outside trying to go in. At the end of the day, it is

about making bets on European solutions, but more so on sovereign UK capabilities that can produce a return on investment from the capability side and create the great new jobs that graduates, experienced STEM people and transitioning service leavers who can add a tonne of value in that space want.

The big thing that I always say is that, when I look across the US, there are 34 funds like ours that do defence or dual-use wholly or predominantly. The top quartile of them have one thing in common: one of their founders or their sole founder came from one of two backgrounds. They are primarily former SOF—special operations forces—or former intelligence.

What does that tell you? It tells you that having such an understanding of the ecosystem gives benefit in predicting what trends are going to come next. That is all we do in venture capital, no matter whether the industry is fintech or defence. We are trying to bet on the best teams with our own risk capital, and we are trying to determine who will hopefully be the winners and losers. The Government need to do the same thing, which is become more risk tolerant. That was a short answer, followed by a very long description.

Q257 Ian Roome: Obviously, when you are doing a risk audit of your portfolio, and you are looking at what to invest in, what barrier is the procurement process, particularly within the UK? We have seen that they are doing the defence industrial strategy. How much of a barrier is the procurement process within the MoD, given the length of time and the ROI that you are expecting? Have there been cases in which you have had to pull out of funding various SMEs because of that?

Nicholas Nelson: Yes, it is a huge barrier. I would say that within our existing portfolio of companies—or those that we have already invested in—we have had issues where contracts have been delayed, we have been recompeted or funding was not available. That lack of predictability, especially when they are operating on an 18-month runway—or how many months they have in the bank until they directly run out, assuming no new revenue—can actually affect them living or dying as a company.

Yes, the process deeply affects us, and not just because of the length—we can deal with the length. Everyone wants it to be shorter, and we want acquisition reform ad nauseam. However, with that said, as long as you are telling us, the dates are roughly right and the money is going to be there, we can make it work until then.

The process should improve, and it needs to, but as long as it is predictable we can at least plan against it. It is the lack of predictability that gets us. When things get kicked to the right, it is not just about saying, “Oh hey, you’ll still get the money in six months.” It is, “Hey, it is six months, but they may be out of money in four months. Either we or other investors have to step in.” That can be a negative for the company in its valuation and ability to operate.

On companies that we have looked at and maybe not invested in as a result, we have seen in some cases over-zealous officials promising these companies money or contracts. It then sits on their desk and they say, "It just needs a signature," but months then pass and there is not the responsiveness. To some extent, that can be down to individuals, and at other times it is whether internal processes are followed, but it all comes down to predictability. Again, it is about doing what you say, effectively.

Q258 Michelle Scroggaham: Governments are having to balance security and a return on their investment. What do you think the UK Government could be doing to make the defence industry more attractive to private capital investment?

Nicholas Nelson: It is a great question, and I think there are two different things. First, I will start with a bit of a critique. In the US, or in some countries like Estonia, defence is talked about a lot. While there is a dual use, it is fine to put defence first, and we can do that. I think what the UK Government have not always done well is sell to the British people why defence is important. It is not just about saying, "Hey we need to be secure,"—yes—or, "Hey, it should be part of ESG." Heck, I wrote a paper on that back in 2021, here, and I actually got proper hate mail for it.

We are now starting to have the discussion that this is part of ESG and for our defence, but we also have to explain what the taxpayer gets out of it. At the end of the day, the taxpayer should see that this is going to create new jobs, resulting in new tax revenue. We will spend more on defence now, but in three years we will be able to shore up social services or better fund and reform the NHS processes and shorten waiting lists. All that comes from your tax revenue. As with the examples of DARPA and NASA that we discussed before, or even the Israel Defence Forces, defence has been proven to do that for a number of other countries.

This is a repeatable model that results in economic benefit, and that economic benefit also creates deterrence. Not only do you have new capabilities that hopefully cause your adversaries to think twice, in terms of blood and treasure, but at the same time being a wealthier country makes your society more resilient and able to afford the obligations that you have already made.

I would say that there needs to be a more concerted marketing campaign, for a lack of a better term, to get people to understand that this is actually why we should spend more on defence. It is not that spending money on defence means that the NHS does not get its money or that this part of pensions gets cut. It is a short-term trade-off for a really long-term benefit in societal resilience.

The other piece is being unapologetic about doing defence and actually talking about our defence industry. We talked about France earlier. For all the challenges I joke about in the French market, both Bpifrance, which is their analogy to the British Business Bank, and the Macron and, going back, Sarkozy Governments were never shy about being France PLC, and going out and doing French exports in military equipment with not only the

US, but in other ways the middle east. We need this to go from something that has been somewhat marginalised by ESG and reputational concerns to something that is celebrated because it is a great British export.

Fenella McGerty: We are certainly seeing the messaging at the top-level increase in its urgency, such as Mark Rutte saying we need to increase funding for defence and, as a consequence, social spending will have to go down, and there is recognition that funding models in Europe are not sustainable as they currently are. Even the IMF is pointing out that there has to be fiscal reform and restructuring because various crises are going to come on in the next 15 to 20 years, and they are going to account for ever increasing proportions of GDP. It is not just defence; it is your demographic crisis and your climate mitigation costs.

Without reform and without fully funding it, you are ultimately going to end up with a far more fiscally constrained environment, even than we have now. There are various countries that have been quite good at making these reforms. Again, the Nordics are in a very strong position. Other countries are going through this quite painful process now, and not least the UK, where the reforms to, for instance, welfare, have met with resistance.

We need effective management and everything that comes with that, but ultimately the IMF says it is needed. Countries cannot continue to spend at this level. Debt interest rates and debt financing are too high, so something has to change. The messaging seems to be coming through, certainly from NATO. Whenever an announcement is made about defence, it is about how it is promoted as well.

In terms of the help to start-ups and SMEs and so on, it is not only about the financial assistance and the reforms to how you procure military capability, but the practical steps that defence can take to really help the development phase for these companies—actually getting the capabilities into the hands of the users and getting that testing phase. It is not just about the finance or the reforms; there are actual concrete measures that can be taken. And that is the position that the MoD has.

Chair: I note that we have only 20 minutes and there is quite a bit of ground yet to cover. In the interest of brevity, I want both Chris Coghlan and Fred Thomas to come in on this point briefly.

Q259 Chris Coghlan: This will be my final question. Nicholas, I am very interested in what you are saying. We heard from Professor Paolo Surico of the London Business School at the Treasury Committee last week. He said that, in theory, if the UK issued £20 billion a year in R&D bonds and invested that all in defence R&D on the DARPA model that you are talking about—and crowded in £40 billion of private sector investment—that would take R&D up to South Korean levels.

On a four-to-10-year view, we would be a fast-growing advanced economy. You could whack up defence spending to 3% now and, to Fenella's point, that would not actually impact social spending, and the debt to GDP ratio should actually fall because the growth would be higher



than the interest rate. What would your feedback be on that proposal?

Nicholas Nelson: First, why does DARPA work, at the end of the day? DARPA is £4.6 billion a year in the open budgets. That is because it has been operating for 67 years and has this proven track record. The devil, as usual, will be in the details. That money would be terrific and transformative if done in the right way, going towards those sources of innovation and new companies. If it were done in a staggered way with clear, big and audacious bets, then yes. My concern would be that, if you inject that much, it will start going into very high technology-readiness level companies—high TRL companies—and the existing infrastructure, which does not necessarily net out with the creation of new capabilities and jobs.

Q260 **Fred Thomas:** I have a very short question for Fenella; if possible, I would like a very short answer. You spoke about desire from Governments to make quite sweeping and quite deep reforms to change some of this, which we have talked about for the last hour and a quarter. Do you think the current British Government will have the political will and resilience to make those changes?

Fenella McGerty: I think there is the opportunity to do so, and I think moves to work more with Europe are a strong signal that the political will is there to bolster UK defence and improve the prosperity agenda. The fact that it was mentioned, and the fact that the defence budget was increased even before pressure from wider NATO allies, so the UK was ahead of that—

Fred Thomas: That is good. Thank you very much.

Q261 **Jesse Norman:** I want to make one point on Treasury auctions. We have had a couple of recent near-failures in Treasury auctions, so we need to be a little bit careful about the idea of issuing bonds as though it were the solution for anything, given the fragility of the gilts market at the moment.

My question is for Mr Murray. It is about rearmament banks. Obviously, you have a proposal at the moment. The first question is really just to explain something for me. I can see how a rearmament bank that is lending a banking function to support, for example, businesses that Mr Nelson is running at the mezzanine level or something in that kind of area, might be a bank, because it will be charging a putatively semi-commercial rate to enable an activity that might not otherwise happen, in order to get a return from that. If it is financing arms, how is it a bank? Presumably, those arms either sit in a warehouse somewhere if they are not being used, or they are used, in which case, where is the return for the bank? That is the thing I am trying to get my head round. I am sure it is an obvious question, but I would be grateful if you could explain it.

Rob Murray: The model for the Defence, Security and Resilience Bank is based upon the well-trodden path of all multilateral banks that have existed since Bretton Woods. Nation states are the shareholders. This is not about profit maximisation. This is about utilising that model that has existed—it is about 40 multilaterals that exist globally, but none of them

have a mandate for defence and security. That is what the idea of the DSR Bank is looking to do.

We have mentioned the European Investment Bank a couple of times today. The reason the EIB and, quite frankly, all the other multilaterals cannot do this is, first, because it is not in their mandate. You could change that. It is an international treaty, so it would be tricky with some countries, but none the less, it could be done. Technically, however, it would be very difficult to do that, because they have billions of euros of existing bonds already out doing all sorts of infrastructure work. Layering on top new bond issuance directly geared for armaments means that measuring the quantitative risk takes it to a level where confidence is not high enough for them to do so without potentially jeopardising their AAA credit rating. There are also legal reasons, as the issue of bonds previously through the EIB was based upon—

Q262 Jesse Norman: I do not mean to cut you off, but we do not have much time. These other banks—Inter-American Development Bank, World Bank—are often lending to programmes or schemes that will have an explicit economic return or an implicit social return. That is not the case with a defence bank, unless you are lending in the space we have just talked about. If it is not lending in that sense, it is really about shovelling money into an area more quickly than a national Government or an international organisation can do. Is that right? That is really what you are trying to do. You are trying to mobilise capital into defence rapidly.

Rob Murray: I would not characterise it that way. The bank is trying to do three things, briefly. First, it is trying to provide the opportunity for nation states to borrow from it, should they so wish. Secondly, it is trying to allow companies that have contracts to borrow from it, should they so wish. It also offers multi-year financing, getting away from the 12-month problem of defence budgets. Also, the critical point here is that a multilateral bank would provide guarantees to commercial banks—high street banks—to allow them to provide the credit to flood into the sector, where necessary. There is a much more sophisticated approach here than simply trying to put money into the system at a quick pace, because that does not solve the problem.

Q263 Jesse Norman: If commercial banks were able to overcome the concerns that Mr Nelson has mentioned, such as having banking relationships, worrying about ESG, changing their banking rules, and thinking through all the details, then they would be able to borrow from your institution. Obviously, you would require them to do that, because otherwise, it would not make any sense to borrow, since they could not on-lend the money or use the money themselves otherwise.

Rob Murray: Commercial banks would not borrow; they would have a guarantee. It is a guarantee system.

Q264 Jesse Norman: But the same problems would still exist whether they had a guarantee from you, from the UK Government or any other institution, right? Still, the problem is not with the guarantee; the problem is with the

commercial bank trying to get the money over its own ESG rules, moral qualms, shareholder pressure and all those other things.

Rob Murray: The point of having a multilateral bank whose shareholders are nation states implicitly provides the backstop that nations are behind it. The problem with commercial banks is that they are worried about reputational risk, hence why you see some national banks, such as BGK in Poland and KfW in Germany, collaborating to try to do this at a national level, but the scale of investment needed for defence, because it is so expensive, means that they do not have the balance-sheet power to do that by themselves.

Q265 **Jesse Norman:** So losing their identity, in some sense, in a bigger institution protects their brands and gives them more ability to function?

Rob Murray: It allows the commercial banks to lend with the confidence that nation states are behind this.

Q266 **Jesse Norman:** And this would be off-balance-sheet financing from the point of view of the UK Government?

Rob Murray: It could be, yes.

Q267 **Jesse Norman:** If it was 5% or 10% of a bank, it would be, presumably, because they would not have the same level of control.

Rob Murray: The United Kingdom is a shareholder in many multilateral banks, and therefore the accounting rules that are associated with that would be applicable to this as well.

Q268 **Jesse Norman:** So if it was generating assets, they would take some value from that? Or not? Or they might not consolidate them at all?

Rob Murray: Exactly. For example, the United Kingdom is a shareholder in the World Bank. That sits as an asset on United Kingdom's national accounts.

Q269 **Jesse Norman:** I have a final question. You have talked about SAFE as being too small in and of itself to satisfy the need, because the need is much greater? Can you talk a little bit about how this is different from other banking proposals in the market or from the Bruegel proposal?

Rob Murray: I have been working on this for about six years, so an awful lot of work has gone into this, and it is not just me. The teams that have created some of the last multilateral banks have worked on this and there has been legal expertise as well.

Q270 **Jesse Norman:** So there may be more recent players, but you have actually been thinking about this much longer.

Rob Murray: Yes, and it is great. What it demonstrates to me is that people who also like this idea are validating it. That is a net positive.

Q271 **Jesse Norman:** Sorry, but you did not talk about what differences from other banking proposals are and what the difference from the Bruegel proposal is?

Rob Murray: Sorry, but you will have to be more specific.

Q272 **Jesse Norman:** There is a Bruegel proposal out there. How is what you are proposing different from that?

Rob Murray: The Bruegel authors asked me for my input. A few months ago, as they were writing that paper, I spoke to Guntram at length. The main part of the Bruegel paper concerns joint procurement in Europe. The European Defence Mechanism, which is described in the paper, is essentially the DSR Bank at a European level only.

The point is, that will not solve the problem. The reason is, as we have already discussed, that we do not have the capacity in Europe at the moment to make a bank solely for Europe only at this point. It would exclude Canada, Australia and South Korea. We would not actually solve the problem of helping to generate more capacity.

Q273 **Jesse Norman:** You might also be playing the European Commission in, which presumably would gum everything up anyway.

Rob Murray: That would be a discussion with Bruegel, I suppose.

Q274 **Chair:** Mr Murray has been extolling the virtues of the Defence, Security and Resilience Bank; as the CEO, he would obviously be doing that. Ms McGerty, in your view, what is the benefit of the DSRB? More to the point, what do you see as the challenges with this proposal?

Fenella McGerty: Ultimately, what is clear from this entire discussion is that more options are needed. The UK is very fiscally constrained, so we need as many options as possible. It is about effective co-ordination and oversight. I suspect that the greatest challenges will be in starting it up and ensuring that spending is discharged effectively and in a way that aligns with Government priorities and everything like that.

At the institute, we did look at this kind of instrument a few years ago. I would argue that, back then, the appetite and desire from stakeholders for this kind of thing was not as pressing as it is now. The time for these kinds of initiatives is now: I think there is sufficient political will, and the level of threat has intensified to the point where we need these options. So I think that if we were to conduct that exercise again, the responses would be different; there has been that shift. These new, creative funding models for defence are needed.

Q275 **Chair:** But have you or anybody else in the IISS come across any negatives or challenges? I note your point that there is now a greater appetite and Government drive with respect to the DSRB, but what would you say are the negative aspects?

Fenella McGerty: The main thing that we have looked at is funds that have been set up. It is a different kind of model where you have, say, the Polish armed forces fund that has been established. That relies on the bonds being sold; it relies on demand and take-up. I am less familiar with the ins and outs and the logistics of how it would work, but potentially that could present an issue, in terms of getting the issuance and demand.

Q276 **Chair:** You can see why we are doing this. Obviously, the job of the Defence Committee is to scrutinise and to look at the positives as well as the negatives, so Mr Nelson, what are your views with respect to the DSR Bank? We know about the benefits. What do you see as the primary challenges or negatives?

Nicholas Nelson: If you really look at the DSR Bank, the EDF new proposal or any of the others—there are about four that I have now come across—for similar issues, it obviously shows that there is a desire for that. With that said, I am still, as I mentioned earlier—as always, perfect is the enemy of good. Right now in the timelines—I believe the last major bank set up would have been the new development bank out of Asia, so the BRICs bank, effectively. That still took, from inception, about eight years. Then they had their first meeting. I think they didn't end up putting out funds for—I want to say four and a half years; I can double-check that. The challenges right now—if you look at Russia and where the timelines are in terms of it coming into Europe potentially, we do not have four and a half years. If you look at the potential war in the Pacific, what we call the Davidson window estimates that China will invade Taiwan or blockade it by the end of 2027. That has been validated by US and UK stakeholders. If you believe in both those things, we do not have time to start creating something from scratch. I do not think you need to necessarily not do things there long term, but the focus now should be on near-term things that can actually solve short-term problems.

I will share an example from my time in Afghanistan.

Chair: Briefly, please.

Nicholas Nelson: One thing about our development timelines with all the big strategic programmes everyone wanted to run was that it was a case of, "Okay, well, we're going to try to get you something out there," and we would already be back in the States by the time that people actually got the solution to theatre. It was OBE—overcome by events. There was an entity that stood up. They were called the Rapid Equipping Force, and their whole thing was just to get us tactical equipment; it may have been dog-eared or basically fixed with spit and duct tape, but they were getting that solution in there. Within my neck of defence—venture capital, broader private equity in defence, and even just the purchasing market—there are already enough things to play whack-a-mole with. I think that we could start addressing just the tactical and operational problems and still they would not be done for the next three years. In my view, there are much higher priorities to address before we start creating net new entities.

Q277 **Mr Bailey:** Fenella, you raised a question there. Is this or is Rob's bank—maybe Rob can answer this—a regulated bank or a fund, and which should it be?

Fenella McGerty: I will let Rob answer that.

Rob Murray: Again, like all multilateral banks, they are not regulated. Their charter is approved by the respective legislators and it becomes an international treaty and is their credit rating. There is no regulatory, in

terms of a commercial bank, oversight. That is standard from Bretton Woods through to today.

Just to briefly go back to the point, the last two multilaterals created were the Asian Infrastructure Investment Bank and the EBRD, in 2015 and 1991 respectively. They were done in months; they were created in a matter of months. What took time was getting the AAA rating. These are nuanced points that need to be understood.¹

Nicholas Nelson: I can speak, again, to the new bank that was set up. Their final step, I believe—their first investment was made in 2016, but they were basically announced back in 2012, so that was four years. To Rob's point, yes, the AAA credit rating is critical. But by the same token, we should not underestimate how long these entities take to set up from inception and where they get to. As I said, I don't think it is a bad idea by any means. I think it can be helpful for the market. At the same time, there are a lot of other priorities that are going to be competing and anything is a trade-off.

Q278 **Mr Bailey:** I am mindful that time is very short. What is your view, then, on the answer to that question? Which do we need—fund, or regulated bank?

Fenella McGerty: Both—all options.

Chair: Thank you very much. I express my sincere gratitude to all three of your good selves for what has been a fascinating discussion about financing defence. Those within defence will have learned a great deal if they have been watching the session today, but no doubt Members will take on board these points and what we have learned to make further contributions in the Chamber and elsewhere. Thank you for your contribution to our inquiry into the UK's contribution to European security.

¹ The witness later provided further information in written evidence [UKCES031](#)