

# Focus

## CONTROVERSIAL WEAPONS EXCLUSIONS

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#### 1 INTRODUCTION

There are a variety of reasons why financial institutions<sup>1</sup> might wish to pay attention to the issue of controversial weapons: compliance with legislation, reaction to pressure from civil society and the media, satisfying client demands or simply following ethical convictions.

While there are a number of conventions governing which weapons may or may not be used in warfare, they do not explicitly address the topic of financing, investments and/or insurance underwriting. Despite widespread policy development in recent years, financial institutions can still be caught off guard by business relationships with or investments in companies associated with controversial weapons. Consequently, many financial institutions are seeking guidance to better understanding their potential exposure, and how they should approach the topic.

#### 2 SITUATION IN SWITZERLAND

##### 2.1 LEGAL FRAMEWORK

The Swiss Federal Act on War Material (WMA) was amended in February 2013 to include provisions on financing in the context of war materials prohibited in Switzerland, i.e. nuclear, biological and chemical weapons, anti-personnel mines and cluster munitions.

It prohibits the **direct** financing of the development, manufacture or acquisition of prohibited war materials (Article 8b WMA). Direct financing refers to the direct granting of credits, loans, or endowments

## DEFINITION OF CONTROVERSIAL WEAPONS

It is generally accepted that democratic states have the right to use armed force to safeguard national security and secure peace. There are, however, a number of weapons that cause disproportionate harm and remain a threat long after a conflict has been resolved. Although there is no official definition of what constitutes a “controversial weapon”, and different countries, regions, and institutions hold varying views, it typically possesses one or more of the following characteristics:

- Indiscrimination: the weapon is indiscriminate in nature, i.e. it does not distinguish between military and civilian targets;
- Proportionality: the weapon is considered to be excessively harmful, i.e. it causes an inordinate amount of pain and suffering relative to the anticipated military advantage; and/or
- Illegality: the production and use of the weapon is prohibited by international legal instruments.

The controversial weapons most frequently identified by activists and concerned investors are those that have been subject to widespread bans or restrictions by international agreements, i.e. cluster munitions, anti-personnel mines, and nuclear, biological and chemical weapons. Although not subject to a ban or restriction by international treaty, depleted uranium is also often considered among them. Blinding laser weapons, incendiary weapons (those designed to cause burns), and weapons using non-detectable fragments, are not discussed as often, but are still considered controversial by many owing to the substantial amount of long-term injuries they can cause to both military and civilian targets.<sup>2</sup>

or comparable financial advantages, in order to pay or advance costs and expenditures that are associated with the development, manufacture or acquisition of prohibited war materials.

The **indirect** financing of prohibited war materials is banned only if intended to circumvent the ban on direct financing (Article 8c WMA). It refers to participation in companies that develop, manufacture or acquire prohibited war materials, or the acquisition of debt securities or other investment products issued by such companies.

The ban does not apply to financing any other activities of such companies (i.e. activities not linked to prohibited war materials).

## 2.2 APPLICATION IN PRACTICE

In Switzerland<sup>3</sup>, financial institutions tend voluntarily to go beyond the letter of the law in the context of their controversial weapons policies, particularly with regard to anti-personnel mines and cluster munitions, because of the international ostracism of these weapons. Here, Swiss financial institutions typically not only exclude the direct financing or underwriting of controversial weapons production, but extend these bans to the entire company producing such weapons (i.e. controversial weapons producers), as well as to indirect investments as they pertain to their proprietary trading book, actively managed funds, and discretionary mandates, i.e. to transactions under their direct control. Passively managed funds and client assets are not normally included in the ban, as financial institutions do not wish to impose their own ethical considerations on other parties. Rather, they prefer to focus on engag-

ing with clients on the topic and offering appropriate products. Index funds also tend to be beyond the scope of exclusion policies, owing to performance risk issues and the prohibitive costs involved in researching suitable alternatives.

In the case of nuclear weapons, however, financial institutions typically limit their bans to controversial weapons production, following the letter of the law by operating with ring-fencing clauses to permit continued financing for the civilian activities of the companies involved. They also do not prohibit indirect investments, as otherwise the available investment universe would shrink significantly. However, with a new international treaty on a ban on nuclear weapons approved in July 2017 (albeit not yet ratified), financial institutions may have to carefully reassess what the new treaty means to them.

## 3 INTERNATIONAL APPROACH

### 3.1 LEGAL FRAMEWORK

#### 3.1.1 International conventions

A number of international conventions prohibit the development, production, acquisition, stockpiling, transfer and use in armed conflict of weapons and methods of warfare causing unnecessary injury or suffering.<sup>4</sup>

However, none of them explicitly addresses the financing of the development, manufacture, or acquisition of such weapons. While a growing number of countries,<sup>5</sup> particularly in the context of the Convention on Cluster Munitions, have made statements to the effect that they interpret the ban on assistance to include the implicit prohibition of (certain types of) investments, a few states' parties<sup>6</sup> have expressed the contrary view, that the Convention does not prohibit the financing of cluster munition production.

#### 3.1.2 National legislation

Building on the international conventions, a few countries<sup>7</sup> have put in place specific laws, albeit of differing scope:

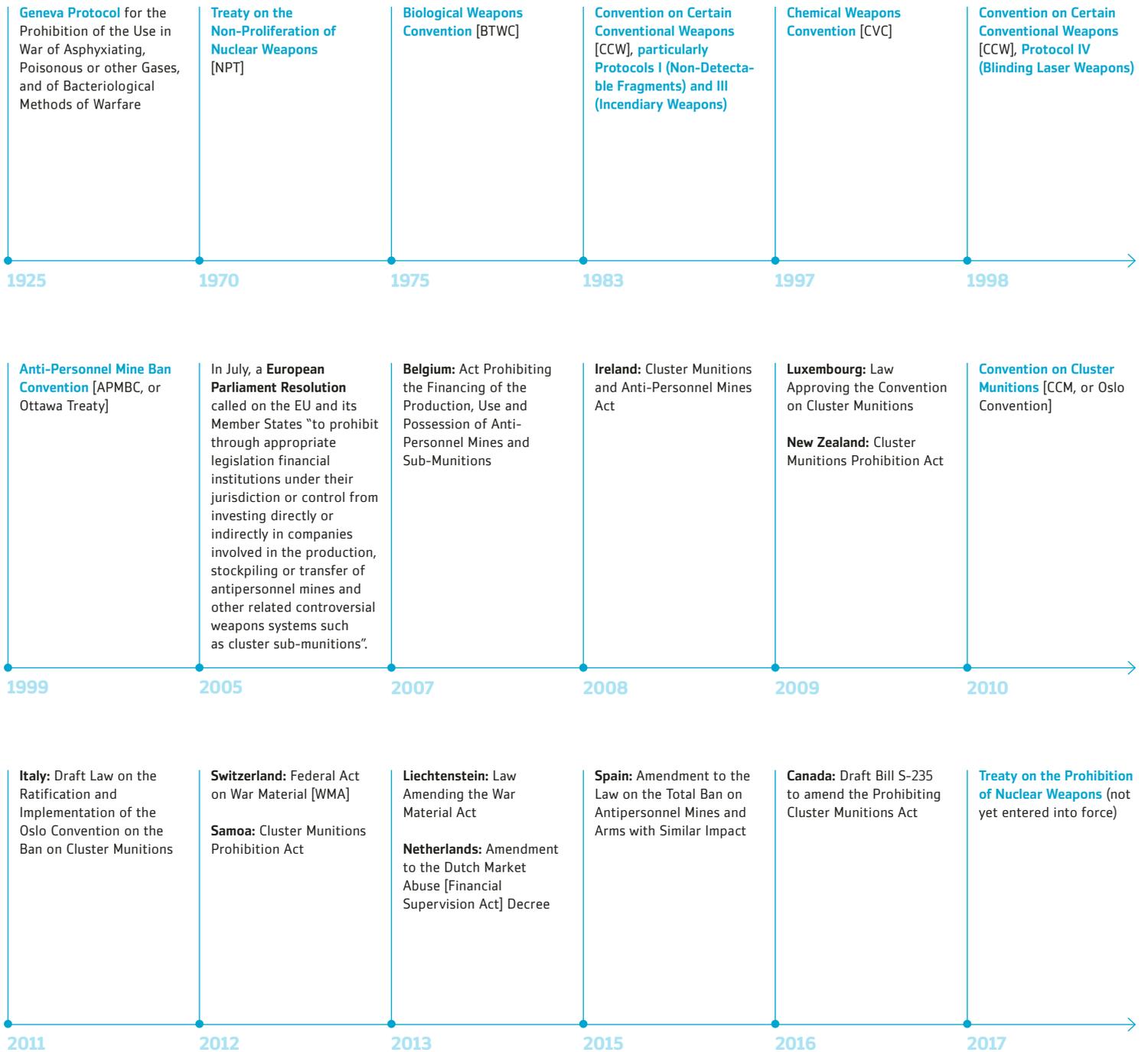
- They predominantly focus on cluster munitions and anti-personnel mines, with only very few extending to other controversial weapons;
- Some prohibit the financing of companies involved in controversial weapons, whereas others prohibit the financing of the production of prohibited war materials only;
- The types of prohibited investments differ (e.g. all forms of financial support; acquisition for the institution's own account of financial instruments issued by a controversial weapons producer; investments of public money only);
- Some explicitly allow investment in index funds, as well as the financing of clearly defined projects carried out by an enterprise, providing such funding is not used for prohibited activities.

It should be noted that laws may also apply extra-territorially. For example, the relevant law in New Zealand explicitly also applies to all acts undertaken or omitted outside New Zealand by a New Zealand citizen, a person who is ordinarily resident in New Zealand, or a corporation incorporated in New Zealand.

#### 3.1.3 Timeline

Figure 1 provides a chronological overview of how international and national legislation on controversial weapons has developed over the years, in particular where financing is concerned.

**FIGURE 1:**  
Timeline of international and national controversial weapons legislation  
(international treaties are highlighted in blue)



### 3.2 APPLICATION IN PRACTICE

Policy approaches to controversial weapons vary across the globe, not least depending upon the legal environment and geographical preferences. Financial institutions across Europe seem to apply a more extensive approach, whereas US-based companies do not appear to apply any restrictions to the defense industry – or at least they do not publicize them. Some financial institutions have different rules for their European business compared with those applicable to assets managed in the United States.

Where policies exist and have been reviewed,<sup>8</sup> they largely focus on anti-personnel mines and cluster munitions, with a few also extending to other controversial weapons such as nuclear, biological, chemical and/or depleted uranium weapons. In common with financial institutions in Switzerland, and with the same rationale, restrictions typically extend to the granting of loans and project finance, investing the institution's own assets, actively managed funds and insurance underwriting. Those funds over which the financial institution does not have the management control to implement its policy, such as investments on behalf of clients, passive funds (including indices), and externally managed assets, are generally excluded from the scope of the policy. Some policies extend only to the production process or to controversial weapons-related projects, whereas others cover the company as a whole. Special rules may apply to conglomerates and holding companies.

## 4 REPUTATIONAL AND COMPLIANCE RISK

The (direct or indirect) financing (including underwriting) of companies that manufacture controversial weapons can generate reputational and compliance challenges. As financial institutions play a critical role in financing economic activity, including in the arms sector, they have been the target of coordinated NGO campaigns in recent years to push companies to stop financing the manufacture of controversial weapons. NGOs are also increasingly calling for stronger regulation for banks in this area.<sup>9</sup> NGOs consider financing to be an active choice, thereby interpreting it as tacit approval of the producers' activities.

The issues most commonly associated with potential reputational risk in the context of controversial weapons are:

- **Definition of what constitutes association with controversial weapons:** there remains a lack of official, credible and verifiable data about companies involved in controversial weapons. In fact, there are multiple lists from various NGOs, investors and research organizations, with a certain degree of discrepancy as a consequence of the different criteria used to develop the list, the scope of companies covered and the robustness of the underlying research.<sup>10</sup> It is thus difficult for financial institutions to be confident that they are meeting the letter and spirit of legislation. This is compounded by the gaps between international conventions and the expectations of civil society.
- **Ring-fencing/exempting project financing or underwriting for civilian purposes:** contractual agreements that prohibit companies from using borrowed or invested funds to manufacture controversial weapons, that restrict a company's use of the financing to civilian projects or that limit insurance underwriting to activities not related to controversial weapons, may legally safeguard the financial institution. However, there is still a reputational risk associated with such transactions. For example, weapons producers commonly finance their production facilities from their gen-

eral corporate capital. There is no way to prevent a company from legally reallocating capital within a group, thus freeing other funds for weapons production.

- **Limiting policies to the financial institution's own involvement:** one of the particular criticisms made by NGOs is that financial institutions often do not apply their responsible investment policies to investments on behalf of clients, whatever the reasons may be. They argue that clients do not always realize which companies are included in investment funds, or the activities in which these companies are involved in, and are thus unable to make an informed decision. Given that the majority of assets under management belong to third parties, continued active campaigning by NGOs is to be expected, with the corresponding impact on financial institutions' reputations.
- **Passive investments:** in addition to direct holdings, investors may face hidden risk exposure to companies with involvement in controversial weapons through passive investment products, including exchange-traded funds (ETFs) and index funds.

## 5 POSSIBLE COURSES OF ACTION

There are various ways in which financial institutions can address controversial weapons in their financing, underwriting and investment processes. These options are shaped by the legal environment, geographical preferences, the criteria agreed between clients and their financial institution for discretionary investment mandates, as well as organizational priorities and risk tolerance levels. Consequently, policies may vary.

Actions that financial institutions might consider to address the issue of controversial weapons in their business transactions are outlined below.

- a) **Evaluate the applicable legislation and regulation** in the different jurisdictions in which you are active.
- b) **Understand your exposure to reputational risk:** seek to understand and weigh the (potentially conflicting) expectations of your key stakeholder groups. Decisions about how to approach controversial weapons typically center on finding the right balance between avoiding ties to weapons producers and maintaining as large an eligible financing and investment universe as possible.
- c) **Determine the scope of your policy:**
  - i. **Type of weapons:** the most frequently excluded weapon categories are landmines, cluster munitions and biological and chemical weapons. The next most commonly excluded categories are nuclear weapons (which may or may not be considered controversial based on region, i.e. US-based investors often do not consider them to be controversial) and depleted uranium. Financial institutions taking a very restrictive approach will likely exclude all types of potentially controversial weapons, including blinding laser weapons, non-detectable fragments weapons and incendiary weapons.
  - ii. **Type of involvement:** it is important to bear in mind the difficulties in defining what constitutes association with controversial weapons. While some financial institutions may seek to avoid only companies most directly involved in producing (key components of) controversial weapons them-

selves, or even only the production itself, others may take a more restrictive approach to also exclude component manufacturers and makers of delivery systems and vehicles, for example, or companies with indirect ownership ties to producers. Financial institutions typically draw upon external specialists to determine their exclusion lists in line with applicable legal frameworks and their policy requirements. These providers then also ensure that the lists are updated regularly in line with changing practices.

- iii. **Type of business activity:** depending on the legal environment and their risk tolerance, financial institutions may choose to apply different approaches to direct and indirect financing, underwriting, actively and passively managed assets, as well as to investments on their own account versus those of third-party assets. In the case of direct financing (e.g. general purpose loans), be mindful that companies and groups can easily reallocate capital internally. Therefore, to ensure that no money flows to activities related to controversial weapons, financial institutions would have to exclude the company in its entirety.
  - iv. **Geographical scope:** consider applying the policy at the group level and consistently across all businesses, building on the strongest law of the jurisdictions in which you operate. Be mindful that laws may apply extra-territorially.
- d) **Develop the policy:** develop a risk management policy to address business transactions associated with controversial weapons and define the corresponding governance processes. A clear, unambiguous position on controversial weapons helps financial institutions mitigate reputational as well as potential legal risk.
- e) **Implement the policy:** consider informing weapons producers of your decision to end business relations because of their involvement with certain controversial weapons. Some financial institutions may choose to engage with the companies concerned, or to exclude those with close ties and engage with those whose involvement is more peripheral. Transparent reporting can show that you are aware of the issues and are trying to manage them effectively.
- f) **Monitor legal and regulatory developments:** laws are not rigid and new conventions may be agreed upon, as the recent negotiation of the Treaty on the Prohibition of Nuclear Weapons confirms. Regular monitoring will ensure that appropriate, timely action can be taken.

- <sup>1</sup> The term “financial institutions” as used in the context of this fact sheet is understood to include asset managers and institutional asset owners (e.g. pension funds, insurers, foundations and family offices).
- <sup>2</sup> For more comprehensive definitions of the weapons discussed, please see Appendix.
- <sup>3</sup> For the purposes of this fact sheet, the approaches of seven financial institutions were reviewed, building on desk-based research and interviews.
- <sup>4</sup> See figure 1 for a chronological overview of legislation related to controversial weapons and Appendix for further details.
- <sup>5</sup> Australia, Bosnia and Herzegovina, Cameroon, Canada, Colombia, Costa Rica, Croatia, Czech Republic, Democratic Republic of the Congo, Republic of the Congo, France, Ghana, Guatemala, the Holy See, Hungary, Lao PDR, Lebanon, Madagascar, Malawi, Malta, Mexico, Niger, Norway, Rwanda, Senegal, Slovenia, United Kingdom, Zambia.
- <sup>6</sup> This includes e.g. Germany, Sweden and Japan.
- <sup>7</sup> Belgium, Canada (draft), Ireland, Italy (draft), Liechtenstein, Luxembourg, Netherlands, New Zealand, Samoa and Spain (for Switzerland see Section 2).
- <sup>8</sup> For the purposes of this fact sheet, the approaches of fifteen financial institutions across six jurisdictions in Europe and North America were reviewed.
- <sup>9</sup> For example, in Switzerland, in April 2017 the “Group for a Switzerland without an Army” (GSoA) NGO launched a popular initiative aimed at prohibiting the financing of munitions producers by the Swiss National Bank, foundations and public and occupational pension funds. Corresponding rules would have to be introduced for banks and insurers.
- <sup>10</sup> See as examples the lists published by the Swiss Association for Responsible Investment (SVVK-ASIR; <http://www.svkk-asir.ch/en/services/>), the pension fund of the City of Zurich (<https://www.pkzh.ch/pkzh/de/index/nachhaltigkeitspolitik/auschlussliste1.html>) and the Norwegian Government Pension Fund (<https://www.nbim.no/en/responsibility/exclusion-of-companies/>).

## APPENDIX – CONTROVERSIAL WEAPONS CONVENTIONS AND DEFINITIONS

**Anti-personnel mines (APMs)** – their use, stockpiling, production, acquisition, transfer, and assistance for or encouragement of any such activity – are prohibited by the Anti-Personnel Mine Ban Convention (“Ottawa Convention”). These are explosive devices that are placed under, on, or near the ground or any other surface and which are conceived or modified so as to explode as a result of the presence, approach, or contact of a person. They are considered controversial owing to their indiscriminate nature, as they are triggered by their victims, whether combatants or civilians, and because the danger of undetonated APMs remains many years following the end of a conflict. The resulting social and monetary costs are significant. APMs not only cause death and injury, but also prevent civilians accessing food, water, and medical care both during and after a conflict.

**Biological and chemical Weapons** are banned by several international conventions: the Geneva Protocol of 1925, the Biological Weapons Convention, and the Chemical Weapons Convention. Combined, these instruments ban the development, stockpiling, acquisition, retention, production, transfer, and use of such weapons. Both chemical and biological weapons are relatively simple and cheap to produce, but their effects are tremendous. Even the smallest quantities have the potential to kill thousands of people. Concern about the use of chemical weapons has increased in recent years owing to their reported use in Syria.

**Biological weapons** are biological agents or toxins, of types and in quantities that are not justified for prophylactic, protective, or other peaceful purposes, and/or weapons, equipment or means of delivery designed to use such agents or toxins for hostile purposes or in armed conflict. The weaponization and use of biological agents and their use in warfare are controversial owing to the potentially widespread and indiscriminate impact they have on a population.

**Chemical weapons** are toxic chemicals and their precursors that can cause death, temporary incapacitation, or permanent harm through their chemical action, where they are produced and stockpiled in amounts that exceed requirements for non-prohibited purposes (e.g. peaceful or law enforcement purposes), as well as munitions or other delivery devices specifically designed to deliver chemical weapons. They have been universally recognized as controversial owing to their indiscriminate nature and unpredictability, coupled with their sometimes gruesome, and excessively injurious effects.

**Blinding laser weapons, incendiary weapons and weapons using non-detectable fragments** are addressed in the Convention on Certain Conventional Weapons and its Protocols. These are weapon types causing unnecessary or unjustifiable suffering to combatants, or that affect civilians indiscriminately. These weapons’ limited destructive capabilities mean that they are not discussed as often, but are still considered controversial by many because of the substantial long-term injuries they can cause to both military and civilian targets. Blinding laser weapons can leave targets totally blind; incendiary weapons can cause extreme burns, causing additional pain and suffering when compared with conventional weapons types; and weapons that contain non-detectable fragments complicate surgical operations because they do not show up using various medical imaging techniques.

**Cluster munitions** are addressed in the Convention on Cluster Munitions (“Oslo Convention”), which prohibits state parties from using, stockpiling, producing, acquiring, or transferring cluster munitions, or assisting in any of these activities. These are weapons containing multiple explosive sub-munitions. They are considered controversial owing to the indiscriminate nature of the weapon system, i.e. the sub-munitions are not specifically targeted but, instead, when released, they impact on a wide area without differentiating between military and civilian targets. As sub-munitions often fail to function as intended, huge quantities can land undetonated on the ground, remaining a fatal threat and obstructing economic and social development long after a conflict ends. The 2006 bombing of areas in southern Lebanon lent particular impetus to the campaign to ban cluster munitions.

**Depleted uranium** is a by-product of the nuclear fuel cycle, and is used in ammunition owing to its high density and its ability to penetrate. The use of depleted uranium on the battlefield is controversial because of concerns about potential long-term health effects. When a depleted uranium missile combusts, depleted uranium particles spread over a wide area and potentially affect civilians and military personnel through inhalation and exposure to skin. Additionally, it is a toxic metal that can contaminate water and food sources.

**Nuclear weapons** are considered controversial owing to their enormous destructive capabilities. They are indiscriminate, considered a weapon of mass destruction and excessively harmful owing to the potential for radioactive fallout and the long-term health impacts on populations. The Treaty on the Prohibition of Nuclear Weapons, negotiated in 2017 but not yet in force, grew out of a renewed recognition of the catastrophic humanitarian consequences of nuclear weapons use, the rising risk of accidental or intentional nuclear use, and a growing sense of frustration that key nuclear disarmament commitments were not being fulfilled. It will prohibit states parties from (threatening to) use, develop, produce, manufacture, acquire, possess, stockpile, transfer, station or install nuclear weapons. The treaty also forbids every form of assistance in the production or maintenance of nuclear weapons. While not expressly mentioned, many countries appear to consider the financing of nuclear weapons a form of prohibited assistance.

### 1. International conventions

Biological Weapons Convention:  
<https://www.un.org/disarmament/wmd/bio/>

Chemical Weapons Convention:  
<https://www.opcw.org/chemical-weapons-convention>

Convention on Anti-Personnel Mines:  
<https://www.apminebanconvention.org/overview-and-convention-text/>

Convention on Certain Conventional Weapons and its Protocols:  
[https://www.unog.ch/80256EE600585943/\(httpPages\)/4F0DEF093B4860B-4C125718000481B30?OpenDocument](https://www.unog.ch/80256EE600585943/(httpPages)/4F0DEF093B4860B-4C125718000481B30?OpenDocument)

Convention on Cluster Munitions:  
<http://www.clusterconvention.org/>

Treaty on the Prohibition of Nuclear Weapons:  
<https://www.un.org/disarmament/ptnw/>

### 2. Organizations

Arms Control Association:  
<https://www.armscontrol.org/>

CMC Cluster Munition Coalition:  
<http://www.stopclustermunitions.org>

ICAN International Campaign to Abolish Nuclear Weapons:  
<http://www.icanw.org/>

ICBL International Campaign to Ban Landmines:  
<http://www.icbl.org>

Facing Finance:  
<http://www.facing-finance.org/en/>

PAX:  
<https://www.paxforpeace.nl/>

### 3. Selected reports

CRO Forum Blueprint on Anti Personnel Mines and Cluster Munitions, July 2012:  
[https://www.thecroforum.org/wp-content/uploads/2012/09/CRO\\_Forum\\_Blueprint\\_on\\_Anti\\_Personnel\\_Mines\\_and\\_Cluster\\_Munitions\\_July\\_2012-1.pdf](https://www.thecroforum.org/wp-content/uploads/2012/09/CRO_Forum_Blueprint_on_Anti_Personnel_Mines_and_Cluster_Munitions_July_2012-1.pdf)

Landmine and Cluster Munition Monitor:  
<http://www.the-monitor.org/index.php/LM/Our-Research-Products/Cluster-Munition-Monitor>

PAX/ICAN: Don't Bank on the Bomb:  
<http://www.dontbankonthebomb.com/>

Worldwide Investments in Cluster Munitions:  
<http://www.stopexplosiveinvestments.org/report>

**Publisher:**  
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**Author:**  
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