

Special Briefing

The Wider Impact of the ISIS Rebellion in Iraq

Overview

The rapid advance of the Sunni Muslim militant group ISIS in Iraq has completely changed the balance of power in the country; this threatens not just the integrity of Iraq itself but could also lead to the redrawing of borders across the wider region.

We expect the situation to deteriorate further in the short term, as Shi'a in the south form their own militias, are armed by the Shi'a-led government, and join forces with the regular army. The resultant civil war is highly likely to draw in other countries trying to protect their religious, political, security and commercial interests, as well as jihadi fighters from other countries.

In order to attempt to resolve the issue the unlikely pairing of Washington and Tehran will have to join diplomatic forces and even possibly co-operate militarily. A successful resolution will also require Iraqi Sunni leaders to support any US-Iran initiative; this is highly unlikely at present, but if ISIS adopts a fundamentalist interpretation of Islam (which appears highly likely) this could push moderate Sunnis towards the US-Iran camp in the medium term.

The highly uncertain situation has prompted us to outline six different scenarios; due to the complexity and volatility of the situation, other outcomes are also possible. Our main scenarios are listed below, and look at the possible impacts on the local, regional and global security situation, along with the impact on the oil price.

Commercial Implications

- The risk environment will deteriorate significantly in Iraq itself but also (in descending order of severity) in Syria, Jordan, Turkey, Iran, Lebanon and the GCC states
- The global arms industry can be expected to receive a significant boost to sales, particularly in relation to drones
- Capital flight will detract from investment (and therefore growth) in Iraq, but will benefit the Lebanese and the Gulf states' financial sectors
- Intra-regional trade, investment, jobs and remittances will all be adversely impacted, as will tourism
- Security spending, particularly in the hydrocarbon sector, can be expected to increase not just in the short term, but in the longer term too
- Global energy prices will include an 'Iraq' premium in the near term at the least
- Iran is set to benefit as its international rehabilitation is speeded up

Recommendations

- Look for investment opportunities in the Kurdish north of Iraq, where the peshmerga militia will ensure stability
- Be prepared for a period of protracted and significant violence in Iraq; this violence is also set to spill out over Iraq's borders, requiring additional security expenditure
- Look for investment and trade opportunities in Iran as sanctions are lifted more quickly than originally expected
- Plan for higher global energy costs in the short term as oil prices strengthen
- Be prepared for an increase in attacks by militant Islamists on Western countries and companies over the medium to long term

Outline Scenarios

Scenario A: Iraq descends into long-term civil war in a Syria-style scenario. Oil prices would surge beyond USD150/b. In terms of security all neighbouring countries would be severely impacted, while Western countries would be subjected to increased threats of action by militant Islamists. Western companies throughout the Muslim world would also face increased security threats.

Scenario B: Iraq splits into three parts, based on ethno-religious identities: a relatively stable Kurdish north and Arab-Shi'a south, along with a contested Arab-Sunni central area. The new borders are extended into neighbouring Syria, and possibly into Turkey and Iran. Oil prices would see a small 'Iraq' premium until markets become convinced that supplies were unlikely to be interrupted significantly. In addition, the redrawing of borders in Iraq could encourage groups in other Middle Eastern countries to target similar outcomes, adding to regional security risks. Western countries and companies would also face increased security threats, but of a lower intensity than under Scenario A.

Scenario C: As Scenario B, but with conflict remaining contained within the existing borders of Iraq. The impact on oil prices would be similar to Scenario B. In terms of security, Syria, Turkey and Iran could face insurgencies in areas bordering the old Iraq. The resultant threats to the stability of other regional countries and the increased security risks for Western countries and companies are also similar to Scenario B, albeit of a lower degree.

Scenario D: ISIS over-stretches itself, allowing the central government, aided by international support, to regain control of his country's central region; however, in the interim, the Kurds carve out a separate state. Oil prices would see a small 'Iraq' premium until markets become convinced that supplies were unlikely to be interrupted

significantly. Unrest in the Kurdish areas of Turkey, Syria and Iran would increase, while Kurdish autonomy could encourage groups in other Middle Eastern countries to seek similar outcomes. Western countries and companies would also face increased security threats, but at a lower level than in Scenario C.

Scenario E: ISIS over-stretches itself, allowing the central government, aided by international support, to regain control of Iraq. Oil prices would see a larger 'Iraq' premium than in Scenario D until control was regained. Security threats would be lower than in Scenario D for Turkey, Syria and Iran, and for Western countries and companies. However, it is possible that jihadis could foment unrest in other less stable Middle Eastern countries, such as Yemen.

Scenario F: ISIS gains control over the whole country. Oil prices would surge well beyond USD150/b. In terms of security all neighbouring countries would be severely impacted, while Western countries would be the subject of increased threats of action by militant Islamists. Western companies throughout the Muslim world would also face increased security threats.

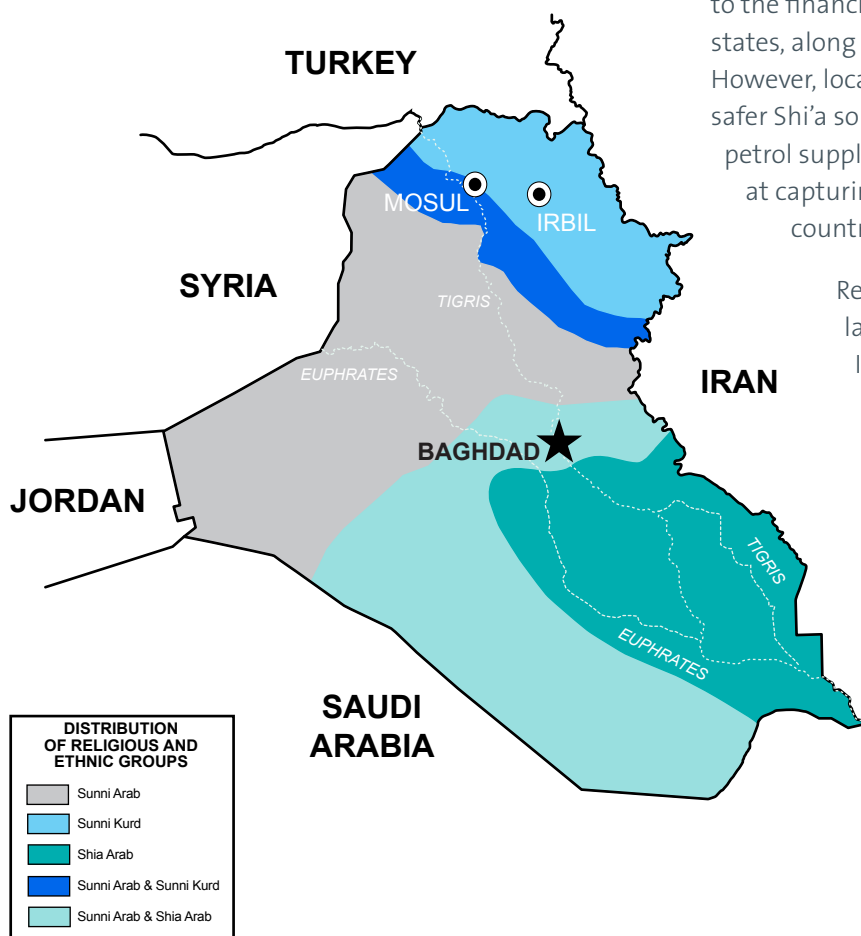
We consider Scenario B to be the most likely outcome at present, with a probability of 50-60%, followed by Scenario C with a probability of 40-50% and Scenario A with a probability of 30-40%. Scenario D and E both have a probability of 10-15% in the short to medium term. However, the degree of success ISIS has in maintaining control of any area in the medium to long term will depend on the policies it adopts. If, as seems most likely, it attempts to implement a strict Sunni Islamic agenda, this is liable to provoke a backlash from the local Sunni population, making any resultant ISIS state unstable. Scenario F is the least likely, with a probability of 1-5%.

Background and Context

The roots of the violence are highly complex and stretch back almost 100 years. The four main factors are:

1. The creation of Iraq in 1921 incorporated three major groups divided along ethno-religious lines: Kurdish Muslims; Sunni Arabs; and Shi'a Arabs (see map).
2. The political system introduced after the overthrow of Saddam Hussein in 2003 reinforced these identities, at the expense of a more inclusive Iraqi identity.
3. The more sectarian nature of the rule of Prime Minister Nouri al-Maliki's democratically-elected government has marginalised many Sunni.
4. The Syrian civil war has added to the Shi'a-Sunni divide.

Majority Ethno-Religious Groupings



These factors have supported the rapid advance of the Sunni militant group Islamic State of Iraq and al-Sham (ISIS, also referred to as Islamic State of Iraq and Levant, ISIL) in Iraq in June 2014. Although initially ISIS primarily relied on foreign fighters, local Sunni have become willing supporters. This has completely changed the balance of power in Iraq and threatens not just the integrity of the country itself but could also redraw borders across the Middle East and North Africa.

The high level of violence and the uncertainty of the outcome will see commercial activity severely constrained in Iraq, with negative impacts rippling outwards across the region. In Iraq, we expect to see investment and therefore growth curtailed, with significant capital flight to the financial sectors in Lebanon and the Arab Gulf states, along with severe disruption to supply chains. However, local supply chains will be less affected in the safer Shi'a south and Kurdish north. However, refined petrol supplies may be curtailed if ISIS is successful at capturing refineries situated in the centre of the country, impacting further on supply chains.

Regionally, trade, investment and migrant labour flows are all set to be curtailed.

In addition, tourist numbers will fall in neighbouring countries such as Jordan and Lebanon. Importantly, companies with strong cross-border links to Iraq will see opportunities fall, putting pressure on cash flows and profits, and increasing the chances of default. Iranian, Jordanian and Gulf state companies will be significantly impacted.



Globally, oil prices have already risen and will include an 'Iraq' premium until markets are assured that Iraqi oil supplies are unlikely to face significant disruption. We believe that while there may be occasional attacks on the upstream hydrocarbon infrastructure, the sector will continue to function at a level that ensures global oil prices do not increase significantly. Ironically, attacks on refineries in Iraq could lead to local shortages of petrol, electricity and heating fuel.

Finally, with the economic environment, the civil war will further boost support for militant Islamic groups, at least in the short and medium term. The more successful ISIS is, the greater will be the boost. This will result in an increased propensity for attacks by militant Islamists, both regionally and globally, as fighters return to their country of origin. Importantly, we expect that Western countries and companies could be targeted, especially countries that support Maliki's government against ISIS.

On the positive side, the conflict represents a significant opportunity for Iran, which is an important actor in Iraq, to resume its place at the international table. We expect the international community to speed up the easing of sanctions and to encourage trade and investment in Iran as the nuclear negotiations continue to make stuttering progress.

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