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NEWS

China's corporate social credit system

The corporate social credit system was announced by the Government of the People's Republic of China (PRC) in 2013. Its aim is to fully implement the system by the end of 2019 for all businesses operating in China.

Since that date, the bases to implement and enforce this system have been widely regulated by the central government and local authorities, in line with the system for evaluation of citizens which is already in force.

Will the implementation of this corporate social credit system have a positive impact on foreign investment in China? Or will it restrict access to the Chinese market by foreign firms?

It is important to analyse and provide preliminary answers to a series of questions that arise for foreign companies with the implementation of the credit system and with its consequences for their business activity.

1. What is the corporate social credit system?

The corporate social credit system is a national evaluation system that is being developed by the Chinese government for individuals (citizens) and for companies that operate in China.

This credit system only covers companies that operate in Mainland China and not in the autonomous administrative regions of Hong Kong and Macau.

2. How does the credit system work for companies operating in China?

The evaluation of companies under the credit system is based on three stages:

a) Definition by the Chinese government of the requirements to classify companies:
The Chinese government authorities will define the requirements that companies have to meet to obtain a good score or a bad score.

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b) Supervision/monitoring of the performance of companies:
By using new technologies, the government authorities are able to collect, compare and analyse information on the activities of companies, and to monitor their performance.

c) Obtaining an algorithm based on evaluations and direct consequences for companies:
The data collected are processed and classified according to the requirements defined by the government. This either results in a good score for the company (which will lead to a reward) or to bad score (which will be punished).

3. How are the requirements for performance evaluation defined?

The corporate credit system evaluates the performance of companies through:

(i) specific regulatory classifications by areas/issues (for example, taxes, customs duties, environmental protection and quality of products, etc.); and

(ii) by a set of records of compliance of companies, in terms of anti-trust laws, data protection, pricing of products, and licences, etc.

> "The data collected are processed and classified according to the requirements defined by the government. This either results in a good score for the company or to bad score."

The system is intended to cover all areas of the business of a company that operates in China.

For example: a multinational company operating in China is subject to approximately 30 different regulatory scores and compliance records. The majority of these are already being implemented by local government.

Each score is calculated by a set of evaluation requirements, and for a multinational, there can be as many as around 300 requirements.

4. What types of punishments and rewards are defined by the system?

Although the credit system is not yet fully operational, the truth is that a set of punishments for companies with negative classifications are already in force.

If a company is included on the blacklist, various cumulative punishments will be applied to it.

These punishments result from Memoranda of Understanding (MoUs) that were signed with local government authorities. Currently, a total of more than 50 MoUs have been formally signed.

Up to this date, the MoUs have established more punishments for companies with a negative performance than they have defined rewards for good results.

The penalties are not limited to fines or court orders. They may include higher inspection fees and specific audits, or restrictions on government approvals, for example, land use rights and investment authorisations of investment. Companies may also be excluded from preferential policies such as grants, subsidies and tax rebates. The government may also apply restrictions on purchases of products or real estate, or, in extreme cases, it may personally affect the representatives of the company or the persons holding high-level management positions.

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5. Is the credit system already fully operational for companies operating in China?

In 2013, the Chinese government announced the bases of this corporate social credit system and it should have been fully implemented before the end of 2019.

However, to date, the credit system has not been fully implemented for all companies operating in China.

Since 2013, we have been witnessing a flood of regulations for the corporate credit system. The government authorities in China have already published approximately 350 regulations, laws and policies, on the central level, and approximately 1000 documents at the local level.

Currently, many of the system's mechanisms are already operational and this means most of the companies active in China are subject to classification.

It is apparent that the credit system makes it possible to collect a substantial amount of data, performance rates and results of companies' commercial operations.

However, the full operability of the system is far from being achieved during 2019.

The implementation of the punishment mechanisms is incomplete and the system for sharing business data is still weak and its processing is far from reaching its full potential.

The time needed to remedy these weaknesses will certainly take us beyond the end of 2019. The government has recently announced a new deadline to implement the system: by the end of 2020.

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It is important to remember that, with this system, the government intends to create a mechanism that is constantly evolving, and to improve its performance as its capacity to evaluate companies increases.

The system will be able to use monitoring mechanisms and real-time processing to collect and interpret a large amount of data. This will make it easier to immediately detect conformities/performances that increase or decrease a company's "score".

The credit system seems to be in the final stage of implementation, as the trial version of the National Internet Monitoring System is ready to be launched.

This national system consists of a "mega-database" capable of hosting a comprehensive set of monitoring data and credit information on companies.

Therefore, it seems to be important for foreign companies operating in China to learn about the system. This is because the assessment of their performance will have a decisive impact on their operations in China. In particular, companies with positive scores will have access to lower tax rates, better conditions for access to credit, and more opportunities for public procurement.

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Lower scores can mean serious punishments and penalties in the areas referred to above. At worst, they may even prevent companies from doing business in China if they are included on blacklists.

6. How can foreign companies prepare for the implementation of this system and avoid the risks associated with a negative score?

As mentioned above, in the past 6 years, the Chinese central government has been diligent in publishing and approving a wide range of regulations, laws and policies, at the national level, to define the corporate social credit system mechanism.

This vast number of documents at the national level has been supplemented by regulations at the local level. The latter describe the specific local characteristics of the system's classifications.

The regulatory documents, which are in a constant state of flux, comprise a set of information on the company to be analysed to obtain a complete picture of its performance.

By carrying out an in-depth analysis of these documents, companies can anticipate the exact classifications and the specific requirements applicable to their commercial operations in China.

Most of these documents clearly define the requirements applicable to each specific business activity in China. However, the enormous number of documents that have been approved mean it is not always easy to calculate the applicable scores.

7. What advantages does the new system bring to foreign companies already doing business in China (and to companies wishing to invest there)?

From a first analysis, we can anticipate a series of risks associated with the new social credit system that foreign companies already established in China will face. These risks result from random assessments and subjective inclusion on blacklists.

However, a system that promotes rigour could ultimately turn out to be an advantage for international companies. This is because many of them have internal structures that are more advanced and stricter in terms of compliance than their Chinese competitors.

Furthermore, this new social credit system is not intended to discriminate against foreign companies compared with Chinese companies.

This regulatory system is uniformly applicable to all companies doing business in China. Therefore, the automatic processing of data and the application of classifications could prevent an arbitrary approach and gaps in regulation in some areas.

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Fundamentally, this system will allow fairer access to the Chinese market, but that access will also be more demanding and subject to greater control.

And this requirement could bring great challenges for small and medium-sized businesses.

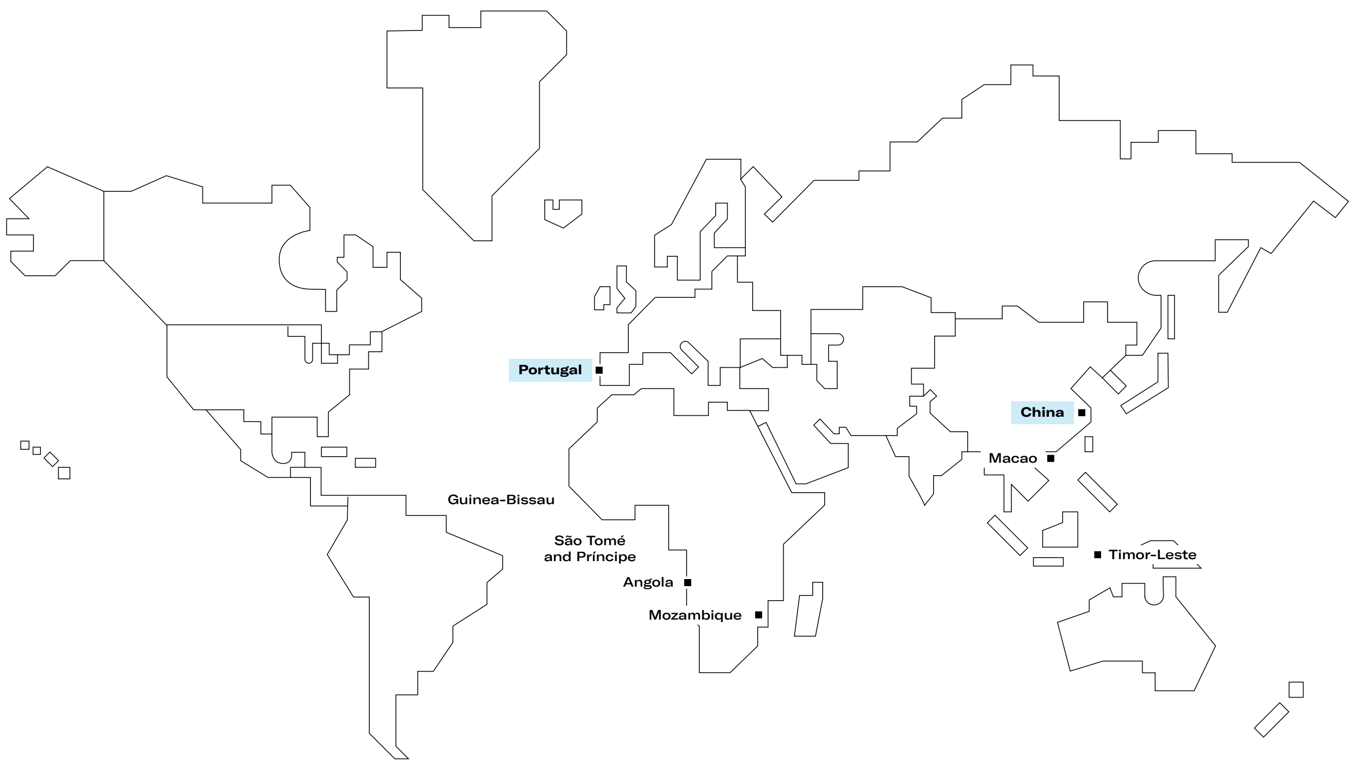
In fact, because of their size, they will find it more difficult to have enough resources to comply with all the requirements of the system.

Another challenge we expect for businesses is the ongoing and necessary updating of the regulations and the standards of classification, which are constantly changing.

Another concern that companies should not overlook is the performance of their business partners in China, which can affect their score and credits. This will require greater care in selecting and monitoring their partnerships in China.

Finally, the challenges for companies are not confined to their performance in their commercial activities. They also encompass the individual scores of their representatives and senior managers.

Companies will face the added burden of keeping a check on the behaviour of their own employees. However, they may be assisted in this by the similar scoring system applicable to local citizens.



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