

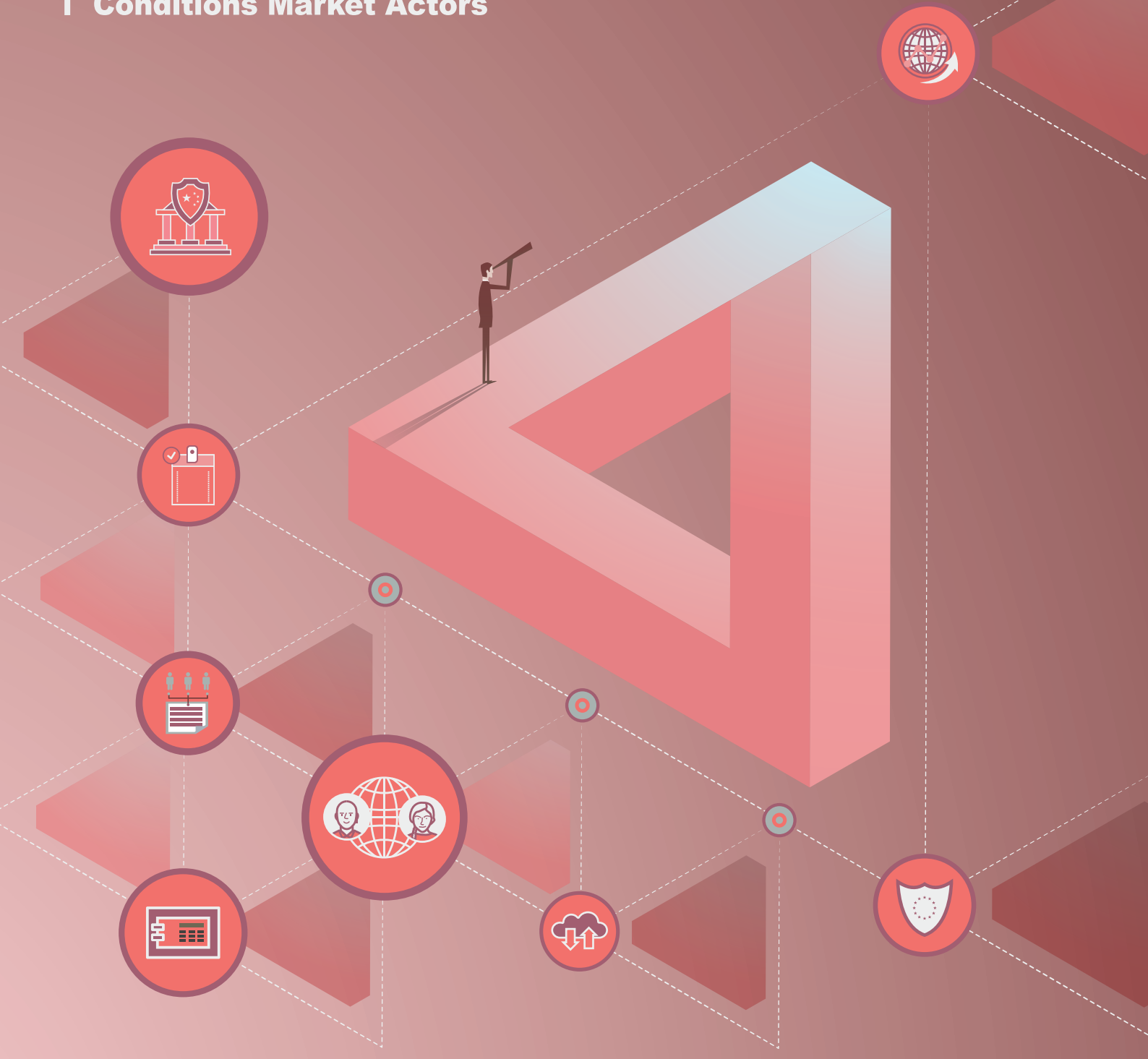


European Chamber
中国欧盟商会



The Digital Hand

How China's Corporate Social Credit System Conditions Market Actors



European Union Chamber of Commerce in China

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The information contained in this report is based on the analysis of government documents that were available up until July 2019. In total, nearly 1,500 published government documents were analysed. However, for reasons of convenience and readability, not all of these documents are mentioned or referenced as source material in this report. The European Union Chamber of Commerce in China and Sinolytics do not assume any legal liability or responsibility for the accuracy and completeness of the information provided in this report.

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President's Foreword

Live by the Score, Die by the Score

Much has been said about China's Social Credit System (SCS) and its implications for individuals. Far less discussion has taken place on how it will affect business, even though the potential disruptions are substantial and wide-reaching. While the lack of awareness about the scale of this system and its effects on daily operations is understandable to an extent, the overwhelming absence of preparation by the European business community is deeply concerning.

As an organisation here to serve European business and sound alarm bells when radical change is on the horizon, the European Chamber felt an urgent need to publish this report on China's impending, all-encompassing, technological regulatory system, in an attempt to knock the blinkers off. It is no exaggeration to say that the Corporate SCS will be the most comprehensive system created by any government to impose a self-regulating marketplace, nor is it inconceivable that the Corporate SCS could mean life or death for individual companies.

Aimed at full implementation by the end of 2020, the Corporate SCS uses real-time monitoring and processing systems to collect and interpret Big Data, which facilitates immediate detection of compliance and raises or decreases a company's 'score'. Higher scores can mean lower tax rates, better credit conditions, easier market access and more public procurement opportunities for companies. Lower scores lead to the opposite, and can even result in blacklisting.

So, what does this mean for European businesses in China?

In some respects, this is good news. Equal enforcement of regulations should become a reality as numbers are crunched by impartial algorithms, before the system then pumps out a rating for each individual firm. It could also mean an end to blanket enforcement in areas like environmental protection. After having invested in world-class emissions control systems, European companies that have until now been routinely shut down alongside non-compliant competitors on heavily polluted days should be able to continue production while polluters will see their scores plummet.

In other areas, the Corporate SCS will bring major new challenges. Small and medium-sized enterprises (SMEs) will struggle to find the resources that compliance demands. Keeping pace with ever-changing regulations and ratings standards will be extremely draining. This issue poses a threat to downstream producers as well, with the flow of supplies being disrupted as their SME suppliers fight to keep their heads above water.

The level of compliance of business partners will also affect a company's score, which will necessitate tighter monitoring of each link in the supply chain. Monitoring concerns do not end there either, as individual ratings of a company's legal representative and high-ranking management will also impact company results. This will require European companies to consider monitoring the individual behaviour of employees, a major taboo for many.

European companies need to start preparing as soon as possible. Having gone through the process myself, it was shocking to comprehend just how much needs to be done to prepare for the imminent implementation of the Corporate SCS. Strengthening communication with the government is a good first step: you will need to stay up to date on relevant regulations. However, improving internal communication is also hugely important, as the actions of one department can quickly impact the score of the whole business.

For better or worse, China's Corporate SCS is here to stay and businesses in China need to prepare for the consequences, and they need to start now.

In conclusion, I would like to extend my sincere gratitude to Sinolytics' Björn Conrad and Mirjam Meissner who devoted many hundreds of hours to dissecting the Corporate SCS and penning this vital report. We hope that together, we can help to raise awareness and ensure that our member companies will live by the score, not die by the score.

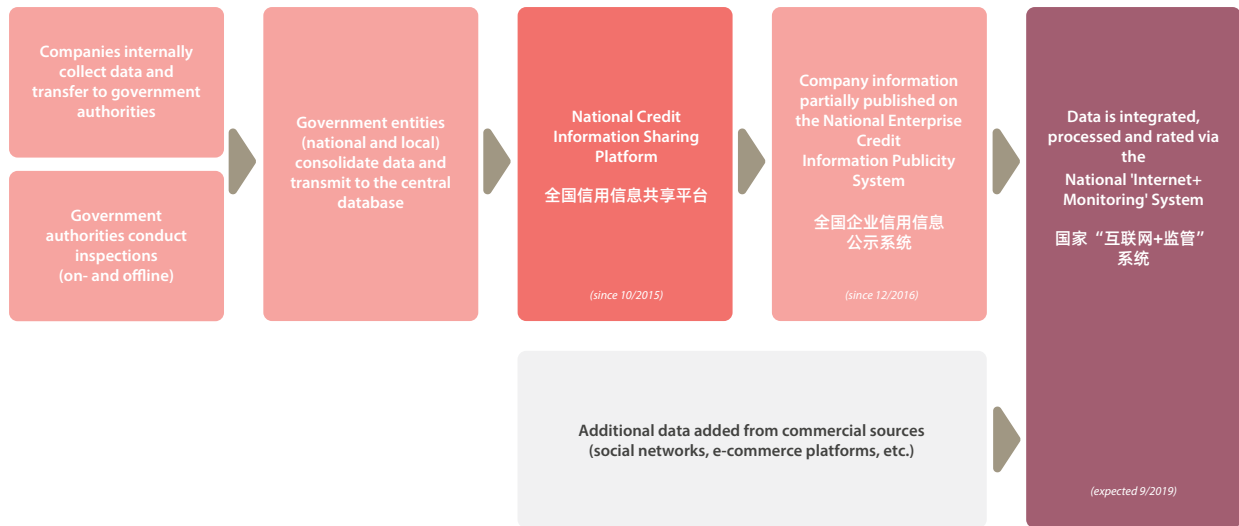


Jörg Wuttke
President
European Union Chamber of Commerce in China



Executive Summary

The final implementation phase of China's Corporate Social Credit System (Corporate SCS, or System) has started: the test-version of the National 'Internet+ Monitoring' System (国家“互联网+监管”系统), a meta-database to integrate the complete set of monitoring and credit information data on companies, is about to be launched. The implementation of the Corporate Social Credit System is moving into the decisive stage. This should act as a wake-up call for European business in China: it's high time to take a close look at the System's far-reaching implications.



The data infrastructure of the Social Credit System

What is the goal of the Corporate SCS?

The Corporate SCS (社会信用体系) is the Chinese Government's comprehensive plan to use technology to monitor and guide market participants' behaviour. Today's technological possibilities to gather, integrate and process vast quantities of data provides the Chinese state with new governance tools, and the Corporate SCS is the most sophisticated attempt to combine and apply these instruments, to date.

The System is part of a major shift in China's market access regime. China continues to open its market to international players, moving away from hard market access constraints like joint venture requirements and investment catalogues, but at the same time, the Corporate SCS is emerging in the background to enhance the government's ability to control companies' behaviour. The lifting of hard market barriers can therefore be explained, at least in part, by the government's growing confidence in its ability to influence companies, both foreign and Chinese, in a more nuanced way.

How does it work?

The logic of ratings under the Corporate SCS follows three steps:

A) Government definition of rating requirements

Government authorities define the requirements that companies need to comply with in order to receive a good rating or avoid a non-compliance record.

B) Monitoring of companies' behaviour

With the use of new technologies, government authorities collect information on companies' activities and monitor their behaviour.

C) Algorithm-based ratings of companies and direct consequences

The collected data is processed and rated against the defined requirements. A good rating leads to rewards and a negative performance is sanctioned.

Ratings and requirements: The Corporate SCS assesses the behaviour of companies through topic-specific regulatory ratings (e.g. tax, customs, environmental protection and product quality) and a parallel set of compliance records (e.g. on anti-monopoly cases, data transfers, pricing and licences). The system covers virtually all aspects of a company's business in China. A multinational company (MNC) in China is subject to approximately 30 different regulatory ratings and compliance records, most of which have already been implemented. Each rating is computed based on a set of rating requirements. In total, an MNC can expect to be rated against approximately 300 such requirements.

Sanctions and rewards: For every negative rating a set of sanctions is already in place. In case of a blacklisting, a comprehensive list of joint sanctions applies. These sanctions are based on Memoranda of Understanding (MoUs) between government authorities. More than 50 MoUs have already been signed. Some of them also define rewards for good rating results but, for the time being, reward mechanisms are less developed than sanctions.

Sanctions are not limited to penalty fees or court orders. They also include higher inspection rates and targeted audits, restricted issuance of government approvals (e.g. land-use rights and investment permits), exclusion from preferential policies (e.g. subsidies and tax rebates), restrictions from public procurement, as well as public blaming and shaming. Sanctions can even personally affect the legal representative and key personnel of a company.

How far has the system progressed?

The SCS is no longer just a vision. Since 2013, China's government authorities have published approximately 350 regulations, laws and policies at the central level and more than 1,000 documents at the local level defining the Corporate SCS. Today, in mid-2019, many of the System's mechanisms are operational. Several ratings are already applied to all companies active in China, and the System already collects large amounts of data, rates performance and impacts companies' business operations.

At the same time, the System is still far from being fully implemented. Execution of the sanctioning mechanisms is still incomplete, data-sharing between different parts of the System remains a weakness and the use of Big Data technologies for data processing is far from its full potential. Closing these gaps will go beyond the initial 2020 deadline. In the long-term, the SCS is designed to be an evolving mechanism that will be continuously improved as it builds capacity for years to come.

Is it too late to prepare?

Fortunately, no. The System's incomplete implementation provides a window of opportunity for companies to prepare for the regulatory ratings. Companies can use the remaining time to gain a full understanding of the System's precise requirements. They can assess their current performance, identify risks and detect negative entries before sanctions are implemented. They can also adjust their internal processes and structures to deal with the Corporate SCS's requirements and to ensure a good rating in the future.

However, this window of opportunity is rapidly closing. China's government is amid a major push towards data integration and sharing, systematically utilising the System's blacklisting mechanisms, with a test-run of these new mechanisms potentially starting as early as September 2019. From then on, companies need to expect that heavy non-compliance will immediately lead to a listing as a distrusted entity, followed by costly sanctions.



What exactly to prepare for?

Compliance challenges: Most rating requirements are concerned with strict compliance with market regulations. While the ratings also introduce new requirements, most directly refer to existing regulation. International companies with strong internal compliance systems will generally be well placed to maximise rating results. However, companies need a full understanding of the ratings. Once detected, gaps in the fulfilment of rating requirements are generally not difficult to fix through targeted adjustments of internal processes, but companies need to know exactly what must be done to secure a high rating in order to act accordingly.

Compliance challenges of the Corporate SCS do not primarily derive from difficulties of meeting the requirements. Instead, they arise from the strictness of the System, the heightened regulatory scrutiny, and the comprehensiveness of the ratings and their crosscutting interdependence. Quicker detection of non-compliance, more rigorous enforcement and more severe sanctions mean that companies must build a comprehensive understanding of the intricate rating processes in order to safeguard against negative consequences. The rating system has limited tolerance for even minor infringements.

Strategic challenges beyond regulatory compliance: A small but important set of requirements goes beyond mere regulatory compliance and creates strategic challenges for companies. For example, the requirements relating to the behaviour of business partners (e.g. suppliers and service providers) burden companies with the responsibility of monitoring their partners' trustworthiness. Similarly, the new trade-related requirements currently in preparation are likely to include aspects beyond regulatory compliance. These structural challenges will not be tackled by process adjustments, rather they will require executive level decision-making and in some cases major organisational alterations.

Challenges to corporate data integrity: The system of regulatory ratings requires the collection of massive amounts of company data, mostly through mandatory data transfers to government authorities. In recent years, the quantity, depth and quality of data required by government agencies has increased significantly. Most of the transferred data points are neither sensitive nor problematic in isolation. In combination, however, they create an increasingly complete disclosure of a company's profile. Considering the government's improving ability to consolidate data streams, companies will need to decide at which point the disclosure of its business operations becomes an issue.

Large data transfers are likely to include some sensitive data points, such as technological details and personnel information. Companies need to engage with the respective government authorities with the goal of modifying data transfer requirements and excluding such information. Knowing the precise data points in question is a prerequisite for a productive exchange. This necessitates a comprehensive assessment of data flows from the company to the authorities.

Will the system create a more level playing field?

In principle, yes. The requirements and consequences of the Corporate SCS apply to all companies registered in China, regardless of ownership structure. This might in fact translate into an advantage for international companies vis-à-vis their Chinese competitors, as many international companies feature more advanced internal compliance structures.

The vision of the Corporate SCS as an automated regulatory system does not lend itself to discriminatory practices against foreign companies. Automated data processing and computation of ratings can largely eliminate arbitrariness and regulatory grey areas. This could lead to a scenario in which the Corporate SCS creates a more level playing

field in China – though with a downside: the game played on that field will be more difficult and controlled than before.

However, this may be an overly optimistic interpretation, as the system does have the potential for discriminatory use towards international companies. First, there is no guarantee that the ratings cannot be applied in a biased way, targeting specific companies with greater scrutiny. Second, some of the rating requirements apply equally to all market participants but are more difficult for international companies to fulfil. This appears to be the case for the State Administration for Market Regulation's (SAMR's) blacklisting mechanism for 'heavily distrusted entities' (严重违法失信主体), which makes the SCS useable in trade conflicts. Third, Chinese companies might have an advantage in navigating the intricacies of the system, potentially enhanced by better information flows from government authorities.

What's next?

With the SAMR's amended draft of the *Measure for Lists of Heavily Distrusted Market Entities*, released on 10th July 2019, and the State Council's release of the *Guiding Opinion on Accelerating the Building of the Social Credit System and Building a Credit-based Monitoring System* on 16th July 2019, the implementation of the system is moving into the decisive stage. Companies need to expect an intensification of implementation activities. The Corporate SCS is crucial for market access reforms, and with the Foreign Investment Law coming into effect on 1st January 2020, China's government needs to ensure that the corporate ratings are ready in time.

Significantly, a consortium led by Taiji Computer Corporation in cooperation with Huawei, Alibaba, Tencent and video surveillance provider VisionVera is setting up a new meta-database. The test-version is likely to be released in September 2019, with a final version completed by the end of the year. The so-called National 'Internet+ Monitoring' System (国家“互联网+监管”系统) aims to fully integrate the complete set of monitoring and credit information data on companies. This includes all government-monitored data and rating results, data from selected commercial rating agencies and e-commerce platforms, as well as video surveillance systems. If successfully implemented, this will remove one of the crucial barriers preventing the Corporate SCS from becoming fully operational—the lack of data integration—thereby increasing the urgency for European businesses to react.



Introduction: The vision and purpose behind the Corporate Social Credit System

The Corporate Social Credit System (SCS, or the System) is the Chinese Government's comprehensive vision of using advanced technologies to monitor and steer market participants. It strives to effectively use large amounts of data on the behaviour of companies and individuals, collected by both government authorities and private companies. The idea behind the Corporate SCS is far from new, but today's technological possibilities of gathering, integrating and processing vast quantities of data mean the idea can finally be turned into reality. Big Data provides the Chinese state with new opportunities, forms and instruments of governance. The Corporate SCS and its regulatory ratings represent the most sophisticated and far-reaching attempt to make full use of this potential. It will fundamentally change how business is done in China for every company and stakeholder in the Chinese market.

Timeline: the Social Credit System is no longer just a vision

In 2014, the State Council published its plan on building the SCS.¹ The plan outlined the key goals, logic and mechanisms of the System and provided a first indication of the timeline: the System is to be implemented by 2020. This is somewhat misleading as it implies a fixed date when the entire System 'goes live'. Instead, the SCS has been, and will be, continuously expanding and evolving. In fact, implementation of parts of the Corporate SCS had started before 2014. Today, in mid-2019, many of its mechanisms are operational and implemented, with several ratings already fully applied to all companies active in China. The System is no longer just a vision: its implementation is well on track, and it already collects large amounts of data, assesses performance and significantly impacts companies and individuals.

At the same time, it is far from being fully rolled out. Implementation of the sanctioning mechanisms is still incomplete, data-sharing between different parts of the system remains a weakness and the use of Big Data technologies for data processing has not yet reached its full potential. Gradually closing these gaps and making the System increasingly precise and efficient will take time, beyond the initial 2020 deadline. In the long-term, the SCS is designed to be a highly flexible mechanism that will need to be continuously improved and adjusted in step with changing economic and political goals. It will steadily increase its capacity and impact for years to come.

The period from 2014 to 2018 was used for designing the mechanisms, setting up the data infrastructure and implementing pilots. The period from 2019 to 2020 is being used to work on remaining gaps and to make final decisions, while at the same time pushing implementation to a new level of speed and scope. In recent months, a remarkable wave of official documents and public statements urging the acceleration of implementation of the Corporate SCS clearly heralded this phase. With the State Administration for Market Regulation's (SAMR's) amended draft of the *Measure for Lists of Heavily Distrusted Market Entities*, published on 10th July 2019, and the State Council's release of the *Guiding Opinion on Accelerating the Building of the Social Credit System and Building a Credit-based Monitoring System* on 16th July 2019, the push towards the 2020 deadline is clearly moving into the decisive stage.²

Company ratings and individual ratings are connected but distinct

The SCS comprises different building blocks that monitor different kinds of 'entities'. Much has been said in debates overseas about the part of the System that rates and affects individuals, but there has been much less attention thus far on the rating of companies, which is the use of the System as an advanced instrument to enforce market regulation. The ratings of individuals and the ratings of companies are indeed part of the same overall framework

¹ *Plan for Establishing a Social Credit System (2014–2020)*, State Council, 27th June 2014, viewed 14th July 2019, <http://www.gov.cn/zhengce/content/2014-06/27/content_8913.htm>

² *Measure for Lists of Heavily Distrusted Market Entities (Revised Draft for Comment)*, State Administration for Market Regulation, 10th July 2019, viewed 11th July 2019, <http://www.samr.gov.cn/hd/zjdc/201907/20190710_303312.html>; *Guiding Opinion on Accelerating the Building of the Social Credit System and Building a Credit-based Monitoring System*, State Council, 16th July 2019, viewed 17th July 2019, <http://www.gov.cn/zhengce/content/2019-07/16/content_5410120.htm>

and follow the same logic. However, they feature substantial differences in their basic mechanisms, rating requirements, implementation status and with regard to the key players involved in the implementation. Clearly distinguishing the two realms of the SCS is necessary in order to understand either side.

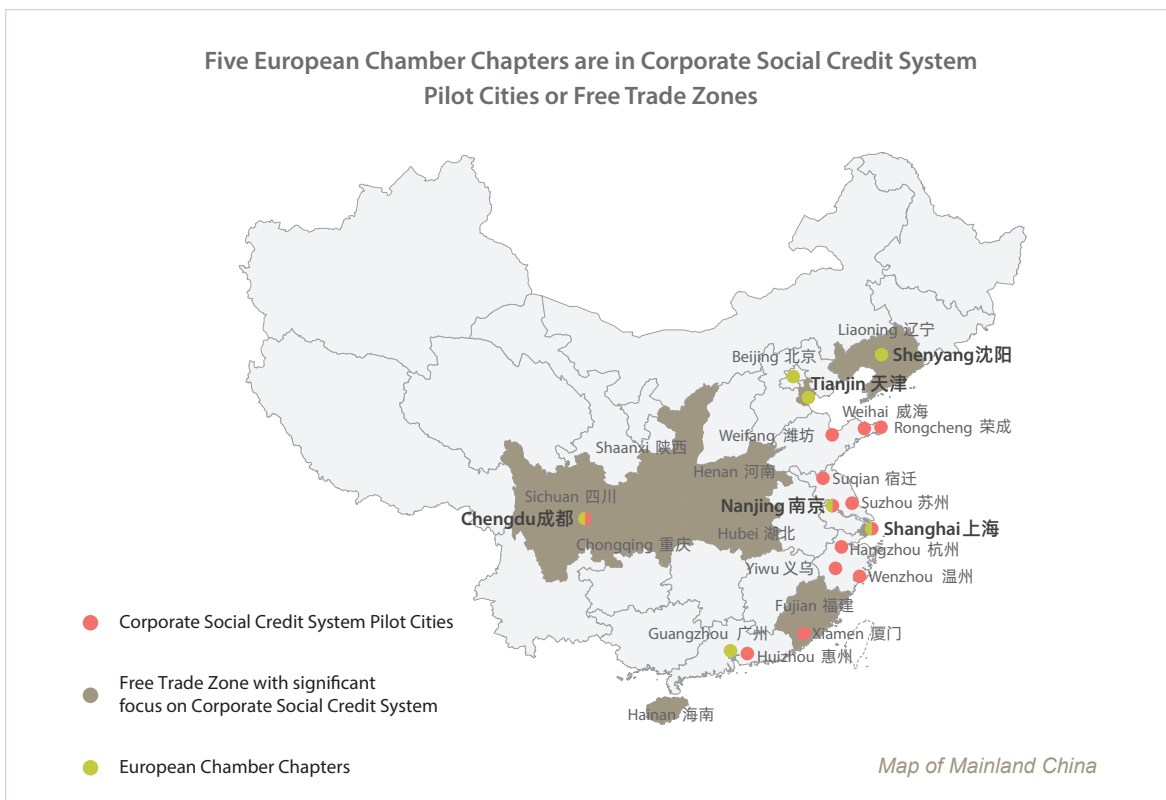
The SCS rating system for individuals is still in a pilot stage when compared to the rating system for companies, which is already much more systematically applied. All companies in China, whether Chinese or foreign, state- or privately-owned, are already being rated under the Corporate SCS, with several having already felt the impact of negative rating results.

The cornerstone of China's new market access regime

The Corporate SCS is part of a fundamental shift in China's market access regime. It is the government's tool to ensure that only companies that prove to be trustworthy can access and participate in the Chinese market. The Chinese Government aims to implement a 'survival of the fittest' mechanism, but with a new definition of 'the fittest'. Under China's new market access regime, the fittest will be those deemed 'trustworthy', with 'trustworthiness' also being defined by the Chinese state, and monitored and enforced through the Corporate SCS.

China is further opening its market to international players, gradually moving away from hard market access constraints like joint venture requirements, investment catalogues and negative lists. At the same time, the Corporate SCS is emerging in the background to enhance the government's ability to steer companies' behaviour. It might seem somewhat paradoxical, but from the perspective of China's leadership, the success and operability of the regulatory ratings is a prerequisite for economic opening up. The lifting of hard market barriers can, in part, be explained by the government's growing confidence in its ability to influence companies in a more nuanced and targeted way. China's new free trade zones (FTZs) are a case in point: the opening of opportunities for international companies is closely accompanied by particularly strict and all-encompassing implementation of regulatory rating requirements under the SCS.

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Market participants in breach of the requirements set by the Chinese Government receive negative rating results then get downgraded or, in severe cases, blacklisted. The more negative ratings a company has, the more restrictions to its business activities it will experience. Restrictions are not merely limited to penalty fees or court orders in cases of legal infringements. They include restrictions on all possible market interactions, including administrative procedures and issuance of necessary approvals (e.g. land-use rights and investment permits), preferential policies, and many more (see Part II for details on sanctioning mechanisms). Sanctions can also affect the legal representative of a company personally and, in some cases, key personnel deemed responsible for negative rating results. In the worst case, a company can be prevented from investing and participating in the Chinese market until its credit is recovered and the entity is removed from the list (also see Part I for details).

The challenge of keeping up with a ‘work in progress’

As this study illustrates, the basic logic of the Corporate SCS is remarkably simple and clear. In practice, however, this simple logic translates into a highly complicated system entailing a multitude of interlinked data streams, processing procedures, rating mechanisms, corresponding requirements, sanctions and rewards. A large multinational corporation (MNC) with a significant presence in China needs to prepare for dealing with approximately 30 different ratings and compliance records based on upward of 300 concrete rating requirements. A small or medium-sized enterprise (SME) would be affected by less ratings, depending largely on the size and scope of their business. However, a core set of key ratings applies to all companies regardless of size or ownership-type.

It is a complicated and time-consuming endeavour to detect, distil and keep track of the concrete details of the Corporate SCS, requiring expertise as well as experience. This is especially the case for the specific and operationally crucial information that is necessary to know in order to fulfil the requirements and ensure a good rating performance. For example, the Sinolytics database of official documents, including laws, regulations, policies and standards, containing concrete, relevant information on regulatory ratings comprises several hundred documents published at the national level alone, and nearly 1,500 when including all relevant documents at provincial and local levels.

As the System remains a ‘work in progress’, with adjustments being made almost daily, keeping a continuous eye on these developments remains a necessary task. Further adding to the intricacy, some parts of the Corporate SCS still lack a government decision on the ultimate design. For example, only during the latest round of releases of official guidance documents did clearer indications emerge confirming the preparation of a comprehensive meta-score.³ How exactly the many topic-specific ratings of the System will be integrated into the comprehensive meta-score and what exact role this meta-score will have within the overall Corporate SCS mechanism does, however, remain opaque at this point. Ultimately, the data infrastructure behind the System—the necessary basis to effectively implement these mechanisms—is still incomplete. Significant gaps in data uploading and data sharing still exist, meaning that not all requirements are reliably tracked, and sanctions and rewards are in many cases not fully or promptly implemented.

These remaining implementation gaps make the anticipation of future impacts a demanding business. However, they also provide an important window of opportunity for companies to prepare for the regulatory ratings under the Corporate SCS. It means that even in the event of negative ratings, the full weight of sanctioning is in many cases not yet felt. Companies can use this opportunity to gain a full understanding of the precise requirements the System demands of them. They can use the remaining time to assess their current performance, identify risks and necessary improvements, and even detect negative entries before sanctions are implemented; they can adjust their internal processes and structures to deal with the Corporate SCS’s requirements and to ensure a good rating performance in the future; and they can anticipate the most difficult rating requirements that might contradict core company interests or values and therefore pose larger strategic challenges.

³ *Guiding Opinion on Accelerating the Building of the Social Credit System and Building a Credit-based Monitoring System*, State Council, 16th July 2019, viewed 17th July 2019, <http://www.gov.cn/zhengce/content/2019-07/16/content_5410120.htm>

However, this window of opportunity is closing. China's government is amid a major shift towards data integration and sharing, as well as towards systematically utilising the System's monitoring and blacklisting mechanisms. The government's timeline is ambitious, with a comprehensive test-run of the new mechanisms likely to start in September 2019. From then on, companies need to expect that most of the currently still-unused data on their performance will be integrated into the Corporate SCS. Cases of heavy non-compliance with the System's requirements will immediately lead to a listing as a distrusted entity, followed by sanctions.⁴

This study aims to provide a basis for companies to prepare for the Corporate SCS, preferably before it fully unfolds. It offers insights on the status quo of the structures, mechanisms and requirements of the System that apply to companies, while outlining what companies should expect and prepare for in the coming months and thereafter. Companies active in the Chinese market need to be the first to deeply understand the System. But ultimately, a system with such a comprehensive scope has the potential to reshape business activities, including international trade, well beyond China. Therefore, the Corporate SCS is a topic that demands the attention of all companies and policymakers at national and international levels around the globe.

⁴ Li Keqiang Presided over the State Council Executive Meeting about the Acceleration of Establishing a Social Credit System to Build a New Market Monitoring System, State Council, 12th June 2019, viewed 17th July 2019, <http://www.gov.cn/premier/2019-06/12/content_5399666.htm?mc_cid=709b9374eb&mc_eid=0b2fe65d29>



Part I: The mechanisms of the Corporate Social Credit System

The part of the Corporate SCS that assesses the performance and behaviour of companies is a system of multiple topic-specific ratings (e.g. tax, customs and environmental protection) and compliance records (e.g. on anti-monopoly cases, data transfers, pricing and licences). In its entirety, the system of ratings and records affects virtually all fields and aspects of a company's business operations in China. Responsibility for implementation of these ratings is distributed between more than 30 government authorities, coordinated by the National Development and Reform Commission (NDRC) and the People's Bank of China (PBOC).⁵

The fundamental logic of ratings under the Corporate SCS follows three steps:

A. Government definition of rating requirements

The responsible government authorities define the requirements that companies need to comply with in order to receive a good rating or avoid a non-compliance record.

B. Monitoring of companies' behaviour

With the increasing use of new technologies, government authorities systematically collect information on companies and, on this basis, monitor their behaviour.

C. Algorithm-based ratings of companies and direct consequences

The data collected on companies' behaviour is processed and rated. A good rating performance leads to rewards and a negative performance is sanctioned.

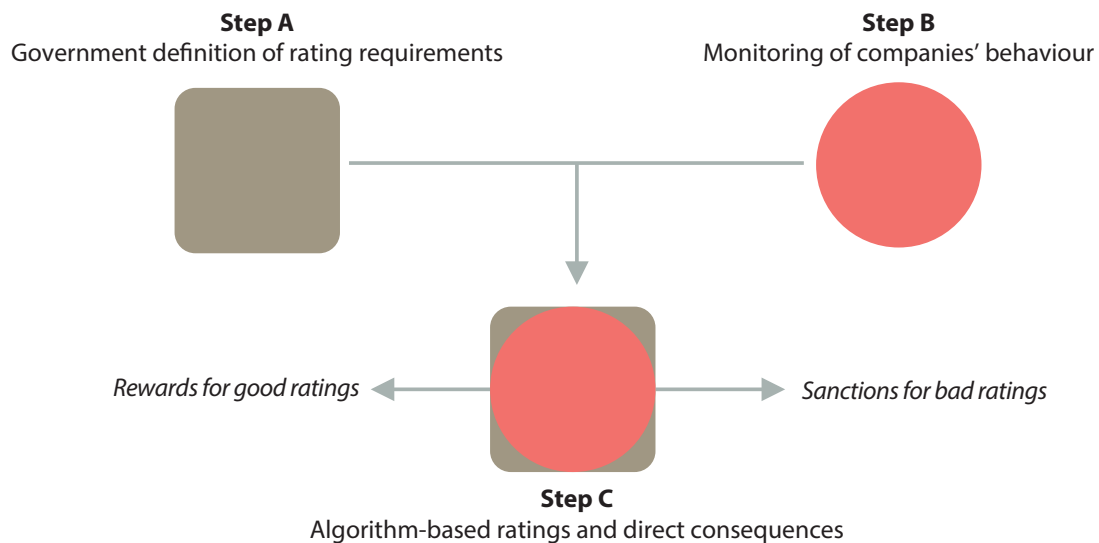


Figure 1: The three steps of the Corporate Social Credit System's ratings

Every single rating on companies follows these three steps separately. At the same time, the central database of the System ensures the sharing of information and rating results between government authorities.

⁵ Plan for Establishing a Social Credit System (2014–2020), State Council, 27th June 2014, viewed 14th July 2019, <http://www.gov.cn/zhengce/content/2014-06/27/content_8913.htm>

Step A: How the Chinese Government defines rating requirements

Between 2013 and early 2019, Chinese central government authorities published approximately 350 regulations, laws and policies at the national level to define the details of the Corporate SCS, including the formulation of rating requirements. This large number of national-level documents is supplemented by local-level regulations which outline the local specifics of the System's ratings. In total, nearly 1,500 government documents have been published by central- and local-level government authorities that stipulate the details of the Corporate SCS.

This still-growing number of regulatory documents is the pool of information to look at to get a full picture of how the Chinese Government defines 'good' behaviour of companies. Dispersed across these documents, companies can—with time and thorough assessment—find the exact ratings (usually around 30 for an MNC) and specific requirements (approximately 300 for an MNC) that apply to their concrete business activities in China. For the most part, these requirements are not vague, but clearly defined and explicitly formulated. Lack of transparency comes primarily from the dispersion of the information across a multitude of government documents.

GLOSSARY	
Regulatory ratings	Overarching term for topic-specific scale ratings and compliance records that are computed for companies under the Corporate Social Credit System.
Rating requirements	Specific requirements used to compute the scale ratings and compliance records. Requirements are defined in laws or other legal and regulatory documents.
Scale ratings	Topic-specific ratings on companies' behaviour measured on a continuous point or letter scale (e.g. 0-1000 points or AAA-D letter ratings).
Compliance records	Record of compliance of companies based on a legal clause stating that non-compliance with the respective regulation or law is recorded in the Social Credit System's database and can lead to a blacklisting.
Blacklisting	Can result from a negative scale rating or non-compliance record, classifying a company as a 'heavily distrusted entity'. Blacklisting will result in joint sanctions.
Joint sanctions	Principle that stipulates that all relevant government authorities levy sanctions based on not only the rating they are directly responsible for, but also in response to negative ratings in all rated fields.

Diving deeper into the structure of the regulatory ratings reveals a two-fold definition of ratings and rating requirements, applied in parallel to cover all fields of a company's operations:

1) Scale ratings

Since 2014, Chinese government authorities have introduced a growing set of comprehensive scale ratings, meaning that companies' behaviour is rated on a continuous point or letter scale (e.g. 0–1,000 points or AAA–D ratings). This includes, for example, topic-specific ratings on the customs, tax and environmental protection duties of companies. Each of these scale ratings comes with a distinct list of detailed requirements that are usually distributed over up to five regulatory documents per rating. If a company fulfils the requirements defined in these regulations, it receives a good rating result. If not, it receives a sub-optimal rating result, and in severe cases a rating as a distrusted enterprise. In all cases of SCS-related scale ratings on companies, the detailed requirements that define 'good' behaviour are precisely formulated in the respective regulations, providing companies with the possibility to understand, through the necessary assessment, what they can actively do to improve their rating result or avoid being rated as a distrusted enterprise.⁶

The expanding use of scale ratings is one of the most fundamental and distinguishing features of the Corporate

⁶ For example: *Measures on Tax Credit (Trial)*, State Administration of Taxation, 4th July 2014, viewed 12th July 2019, <<http://www.chinatax.gov.cn/n810341/n810755/c1150610/content.html>>; *Measures on Customs Enterprise Credit*, CreditChina, 13th March 2018, viewed 12th July 2019, <https://www.creditchina.gov.cn/zhengcefagui/zhengcefagui/zhongyangzhengcefagui1/201803/t20180313_110533.html>



SCS. The traditionally binary nature of regulatory stipulations with a clear dividing line between legal and illegal behaviour is complemented or replaced by continuous scales between 'good' and 'bad' behaviour. This necessitates a change in strategic thinking on regulatory compliance: determining where a company wants to be on the scale requires thorough deliberation.

2) Compliance records

A large part of government regulations and laws published since 2013 have included an explicit link to the Corporate SCS. They usually include a clause, easily overlooked, that references the SCS, stating that non-compliance with the respective regulations is recorded in the System's database.⁷ Through this simple method, the evolving body of market regulation in China has been systematically linked with the emerging Corporate SCS. As of mid-2019, not all of these compliance records have yet been fully embedded in a blacklisting mechanism, featuring clear rules on when an infringement leads to a blacklisting (e.g. if three cases of non-compliance occurred within a certain period of time). In many cases, the trigger mechanism from infringement to blacklisting is still unclear.

However, the SAMR is currently making a major push towards full integration of compliance records into the sanctioning mechanism of the Corporate SCS through the so-called 'heavily distrusted entities list' (严重违法失信名单).⁸ For companies, this means they need to expect that non-compliance with most laws and regulations that have this explicit link to the Corporate SCS will soon be penalised through blacklisting (see Part III for details on these ongoing developments).

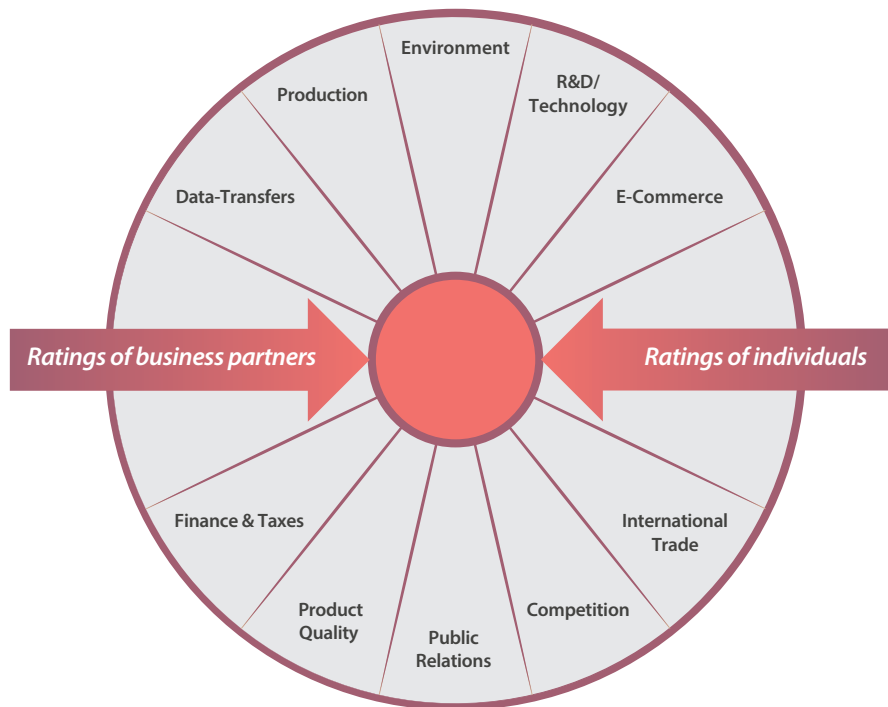


Figure 2: Ratings and compliance records cover all fields of a company's operations

⁷ For example: *Advertisement Law*, National People's Congress, 24th April 2015, viewed 12th July 2019, <<http://www.npc.gov.cn/npc/c12435/201811/c10c8b8f625c4a6ea2739e3f20191e32.shtml>>; *Anti-Unfair Competition Law*, National People's Congress, 23rd April 2019, viewed 20th August 2019, <<http://www.npc.gov.cn/npc/c30834/201905/9a37c6ff150c4be6a549d526fd586122.shtml>>

⁸ *Measure for Lists of Heavily Distrusted Market Entities (Revised Draft for Comment)*, State Administration for Market Regulation, 10th July 2019, viewed 11th July 2019, <http://www.saic.gov.cn/hd/zjdc/201907/t20190710_303312.html>

Continuous adjustments of requirements

The currently applicable set of ratings and non-compliance records is still subject to change. Some ratings are already advanced and implemented at the national level. Further changes to these ratings will likely affect only the details of the rating's requirements. In other cases, new scale ratings are still in the local pilot phase, providing insights into what kind of additional requirements might apply soon. For these ratings, companies registered in pilot cities or provinces are already rated, but a national level implementation is still pending. Some of the current non-compliance records are also likely to be transferred into more complicated scale ratings. For example, this might be the case for the emerging cybersecurity rating. Finally, the number of compliance records that will be integrated into the System's monitoring mechanisms will certainly continue to increase and cover even more aspects of a company's operations.

'Good' behaviour mostly means regulatory compliance – with some crucial exceptions

Analysing the detailed requirements for both scale ratings and compliance records shows that most are concerned with strict compliance with market rules and regulations, or sometimes over-fulfilment of benchmarks set in regulations. For the most part, the Corporate SCS in its current form is an instrument for effectively implementing and enforcing existing and upcoming market regulation.

Only a small group of requirements goes clearly beyond regulatory compliance. Still, these few requirements will be exacting and impose significant strategic challenges on companies. This refers, for example, to requirements relating to the behaviour of business partners (e.g. suppliers and service providers), which burdens companies with the responsibility of continuously monitoring their partners' trustworthiness across the entirety of their business network. This is a complicated and extensive task. Similarly, the new trade-related requirements that are currently in preparation are likely to include aspects beyond regulatory compliance (see Part III on the new blacklisting mechanism for details).

Step B: How the Chinese Government monitors companies' behaviour

The second step of the Corporate SCS, the monitoring of companies' behaviour, is where much of the unique application of the System can be found: the Chinese Government is striving to use the full spectrum of advanced technology to accomplish this task. The latest *Guiding Opinion on Accelerating the Building of the Social Credit System and a Building a Credit-based Monitoring System*, published in July 2019, once again highlights the need to "make full use of next-generation information technologies such as big data and artificial intelligence to achieve comparable credit monitoring data."⁹

However, for the time being, the majority of monitoring is still done by using static information and data collected by government authorities from companies directly (self-reporting) and through inspections. Government authorities mostly use three channels to collect data on the behaviour of companies:

1) Analysis of data transferred by the companies themselves

Companies transfer required data directly to the central database of the SCS and to different government authorities through several reporting processes. Based on in-depth analysis of the data transfers to government authorities by the MNCs that Sinolytics is intensively working with, it became clear that the amount, depth and detail of information requested has increased significantly in recent years. Based on the resulting assessment, much of this increase is related to the further implementation of the Corporate SCS. Companies need to expect that the full array of data they transfer is being used by government authorities to rate their performance or to

⁹ *Guiding Opinion on Accelerating the Building of the Social Credit System and Building a Credit-based Monitoring System*, State Council, 16th July 2019, viewed 17th July 2019, <http://www.gov.cn/zhengce/content/2019-07/16/content_5410120.htm>



create records on their behaviour in the System's databases. This also includes data received during seemingly unrelated bureaucratic procedures like licence applications or product certification.

2) Data gathered during government inspections

Another main source of information is government inspections. Under the catchphrase 'continuous monitoring' (事中事后监管) the Chinese Government is focussing efforts on changing and improving its monitoring capabilities. This is part of China's overarching market access reform agenda: instead of monitoring market access at the 'point of entry' (事前监管), government authorities are now working towards a comprehensive and systematic monitoring of companies' day-to-day behaviour, continuously testing their trustworthiness as they actively participate in the market.¹⁰

Much of these inspection efforts are still uncoordinated among the authorities. This lack of cohesion is supposed to be improved by managing inspections under the principle of the so-called 'two random selections, one public release' (双随机, 一公开).¹¹ Both the inspection target and the responsible inspecting official will be randomly selected and matched, to limit the possibilities of preferential treatment. As a basis for the inspectors' selection, government authorities are currently creating so-called 'monitoring item catalogues' (监管事项目录) in which they divide tasks and precisely define which authority and department is responsible for which monitoring task. This is not only to avoid unnecessary duplication of work, but also to systematically assess the performance of government entities and their officials. Companies should expect a more streamlined approach to inspections and less room for bargaining over inspection results, as the system is being designed to prevent the cultivation of relationships with inspecting government officials.

3) Web-based, digital inspections on company performance

To decrease the reliance on on-site inspections, be more efficient, and increase the frequency and quality of monitoring and inspection results, government authorities are testing new ways of receiving reliable information on companies' behaviour:

a) **Real-time monitoring (RTM):** This will involve remote and RTM of product performance, emissions and logistics, among others. In the long-term, real-time data transfers are likely to expand and to be increasingly integrated into rating mechanisms. For the time being, only a few examples of high-tech, government-driven monitoring of companies' behaviour exist, but instruments are in active testing phases and an increased use of RTM is highly likely. One example is Jiangsu Province, which not only requires companies to implement real-time emission monitoring in their factories, but also uses the transferred data to test a real-time rating of the environmental performance of companies, with rating results being continuously and automatically updated based on the RTM data flow.¹²

b) **Third-party data inputs:** Looking at the next steps of the Corporate SCS's implementation, data collected by private companies such as Alibaba and Tencent are likely to play a much more prominent role. Such third-party data inputs will soon complement government authorities' company monitoring efforts.¹³ For example, Alibaba's existing company rating service will most probably provide data on the e-commerce performance of companies to the relevant government rating mechanisms.

c) **Video surveillance:** Current implementation efforts indicate an intensified integration of video surveillance

10 13th Five-Year Plan for Market Regulations, State Council, 23rd January 2017, viewed 15th July 2019, <http://www.gov.cn/zhengce/content/2017-01/23/content_5162572.htm>

11 *Opinion on Fully Implementing the Joint-Department "Two Random Selections, One Public Release" Supervision in the Field of Market Supervision*, State Council, 15th February 2019, viewed 12th July 2019, <http://www.gov.cn/zhengce/content/2019-02/15/content_5365945.htm>

12 *Interim Measure on the Evaluation of Environmental Protection Credit in Jiangsu*, Jiangsu Provincial Government, 24th December 2018, viewed 17th July 2019, <<http://www.jscredit.gov.cn/hb/7744.jhtml>>

13 *Guiding Opinion on Accelerating the Building of the Social Credit System and Building a Credit-based Monitoring System*, State Council, 16th July 2019, viewed 17th July 2019, <http://www.gov.cn/zhengce/content/2019-07/16/content_5410120.htm>

data into the System's new monitoring platform. This will increasingly digitise government inspection tools and provide the authorities with remote information on all kinds of visible company activities at any time (see Part III on Internet+ monitoring database for details).

Step C: How companies are being rated and impacted by rating results

Government authorities evaluate and rate the behaviour of companies by comparing the collected information (Step B) with the government-defined requirements for 'good' behaviour (Step A). Detected cases of non-compliance are fed into the national database of the SCS and either see the particular company's scale rating results impacted or directly escalate towards a blacklisting. Scale ratings are calculated based on a weighing of the related requirements. The weighing of requirements to calculate rating results is for many ratings explicitly and transparently defined and published. For some ratings the weighing remains opaque.

Rating results and non-compliance records are then published via topic-specific rating platforms, and at the same time also shared with the local databases of the Corporate SCS. The names of companies that receive a blacklisting or a rating as a distrusted enterprise are flagged within the National Enterprise Credit Information Publicity System. The respective lists, with all distrusted market subjects, are published via the website CreditChina.gov.cn. Currently, the common rating update cycle follows a yearly pattern. However, a blacklisting or rating as a distrusted enterprise can happen at any time. Lists on blacklisted or distrusted companies are usually updated and published on a monthly or quarterly basis. With technical advancements, more frequent and even real-time ratings that react to any misbehaviour can be expected, as already demonstrated in Jiangsu Province.¹⁴

Sanctions and rewards

A negative rating or non-compliance record can lead to a blacklisting. The conditions under which this takes place still vary substantially across topic-specific ratings. For some ratings, receiving a negative rating or being listed as a heavily distrusted entity is equivalent to being blacklisted (i.e. customs), while for other ratings the blacklisting is dependent on the severity of specific reasons that lead to the negative rating (i.e. tax). Once blacklisted, a whole set of joint sanctions can be applied to the blacklisted entity.

For every rating, a distinct set of joint sanctions is in place that apply to blacklisted entities. The joint sanctions are based on Memoranda of Understanding (MoUs) between large groups of government authorities.¹⁵ Some of these MoUs also define rewards for good rating results but, for the time being, reward mechanisms are less developed than sanctions for negative ratings.¹⁶ Usually between 20 to 30 government ministries and bureaus sign the MoUs. In these documents, the parties agree to recognise the other government authorities' judgements on an entity as a basis to sanction or reward the respective company in their field of responsibility. Therefore, under the Corporate SCS, a rating as a distrusted taxpaying company not only leads to financial penalties, higher tax rates or other tax-specific sanctions; it can also impact a company's licence approvals, land usage rights and the travel options of its legal representatives, among other aspects. As a last resort, even life-long market expulsion is enforceable in cases of severe violations of laws and regulations. However, this is restricted to business operations that are of special public interest, for example public safety, environmental protection and safe production.

The principle of joint sanctions—meaning that all relevant government authorities levy sanctions based not only on the rating they are directly responsible for, but also in response to negative ratings in all rated fields—is one of

¹⁴ *Interim Measure on the Evaluation of Environmental Protection Credit in Jiangsu*, Jiangsu Provincial Government, 24th December 2018, viewed 17th July 2019, <<http://www.jscredit.gov.cn/hb/7744.jhtml>>

¹⁵ For example: *MoU on Joint Punishments for Distrusted Enterprises in the Field of Customs Authentication*, ChinaCredit, 10th January 2018, viewed 16th July 2019, <https://www.creditchina.gov.cn/biaozhونغuifan/hangyexingbiaozhونغuifan/201801/t20180110_106070.html>

¹⁶ For example: *MoU on Joint Reward Measures for Tax Credit A-level Taxpayers*, State Taxation Administration, 8th July 2016, viewed 10th July 2019, <<http://www.chinatax.gov.cn/n810341/n810755/c2207862/content.html>>



the most important characteristics of the Corporate SCS. It also represents one of the factors distinguishing the System from rating mechanisms elsewhere in the world. The sanctions and rewards government authorities agree upon in the MoUs are rooted in and justified by existing laws and regulations, providing a solid legal basis for their implementation under Chinese law.

As previously mentioned, the sanctioning mechanisms are not fully implemented yet. The main reason is incomplete data processing infrastructure – in particular, data transfers and the exchange of rating results between government authorities is still fragmented, and data that is supposed to be published is not always published. Consequently, blacklisted companies are not yet systematically confronted with the full scale of intended sanctions by all government authorities. The current intensified effort by the government to accelerate the implementation process is likely to significantly improve data exchange and thereby enhance the functionality of the sanctioning mechanisms by the end of 2019.¹⁷

The data infrastructure, government institutions and companies behind the Corporate Social Credit System

The vision of the government is to realise one central database that tracks, records, publishes and shares all rating results and detailed records on companies. It is also supposed to include a risk and early-warning mechanism on potential misbehaviour or unreliability of companies. Since 2015, to structure this database and to precisely assign information to one legal entity, all companies registered in China have received a Unified Social Credit Code (统一社会信用代码).¹⁸ This number is the sorting mechanism for all databases related to the system. It is also used by all participating private companies for collecting data from the system for commercial purposes and for feeding their own collected data into the system.

All government authorities are required to frequently upload information to this national database and to take note of detailed information on companies, in particular the lists of those subject to joint sanctions or rewards. In a fully functioning Corporate SCS, a company could be blacklisted by the tax bureau in Hubei Province and immediately all government authorities would be informed about the case. The company would then also receive sanctions in all other provinces and by all 21 government authorities that signed the MoU on joint sanctions for blacklisted taxpayers. Furthermore, the ratings of the company computed by private companies like Alibaba or HiggsCredit would be immediately adjusted downwards as they integrate the government rating results into their assessments.

However, as long as the central database does not effectively transport the information of a local blacklisting to all other national- and local-level government authorities and rating agencies, the sanctioning mechanisms of the Corporate SCS ratings remain fragmented. For the tax rating, negative rating results are indeed shown on all platforms throughout the whole country which are linked to the System's central database. However, this is not the case for many other ratings such as the environmental protection or customs authentication ratings. In those cases, rating information is either only available via local or topic-specific databases of the responsible authorities, which is not shared with the central database, or made publicly available. This scattering of information substantially limits the effects of the sanctions and rewards that are intended to follow the rating results.

This situation might change fundamentally between September and December 2019. The Chinese Government is currently establishing a new meta-database which will integrate government and private company data on companies. This new National 'Internet+ Monitoring' System (国家“互联网+监管”系统) of the Corporate SCS is jointly developed and implemented by a consortium of technologically advanced companies, namely Taiji Computer,

¹⁷ Li Keqiang Presided over the State Council Executive Meeting about the Acceleration of Establishing a Social Credit System to Build a New Market Monitoring System, State Council, 12th June 2019, viewed 17th July 2019, <http://www.gov.cn/premier/2019-06/12/content_5399666.htm?mc_cid=709b9374eb&mc_eid=0b2fe65d29>

¹⁸ Comprehensive Plan for Establishing a Unified Social Credit System Code for Legal Entities and Organisations, State Council, 17th June 2015, viewed 11th July 2019, <http://www.gov.cn/zhengce/content/2015-06/17/content_9858.htm>

Huawei, Alibaba, Tencent and VisionVera.¹⁹ Part III of this report provides detailed insights into how this platform fits into the current data infrastructure of the Corporate SCS and how it is intended to provide a push towards greater implementation.

As of mid-2019, the data infrastructure of the Corporate SCS has the following design and functionalities:

- **National Credit Information Sharing Platform (全国信用信息共享平台)**

The National Credit Information Sharing Platform is the central database, the data backbone of the SCS. It has been operational since October 2015, and is run by the NDRC and the State Information Center (国家信息中心). The platform is supposed to integrate all local- and central-level government data sources from all departments. This includes information on companies and other legal entities, as well as on individuals. The data transferred to the platform is systematised in three categories: a) information that is fully made publicly available on openly accessible platforms; b) information that is partly published (e.g. good rating results only); and c) information that is not published and remains accessible to government authorities only. The data on this platform will be used to compute a comprehensive meta-score (公共信用综合评价) for each entity. Zhejiang Province is currently testing the calculation of the comprehensive scores and is piloting a credit engineering tool called 531X.²⁰

- **CreditChina (信用中国)**

www.creditchina.gov.cn

CreditChina is the web portal of the National Credit Information Sharing Platform. The website publishes key credit information on companies as well as on individuals, including a list of blacklisted entities. It is run by the National Public Credit Information Center under the guidance of the NDRC and the PBOC, and with technical support from Beijing Baidu Network Technology Company. The website went online in June 2015.

- **National Enterprise Credit Information Publicity System (国家企业信用信息公示系统)**

<http://www.gsxt.gov.cn>

The National Enterprise Credit Information Publicity System is the go-to platform for detailed information on companies' Corporate SCS records. It was set up in December 2016. Run by the SAMR, its data is not yet as complete as envisioned by the government, but for the time being it still provides the most comprehensive overview of SCS information on companies. All provinces, municipalities and autonomous regions have their own provincial-level credit information publicity systems with a varying spectrum of information. On the platform, it is possible to search by company name or Unified Social Credit Code, and the platform flags companies if they have an entry as a 'business with irregularities' or are blacklisted.

- **Privately-run credit information platforms (Qichacha, Tianyancha and many others)**

A significant number of private companies run platforms that make use of the company records published via the National Enterprise Credit Information Publicity System. As with the government-run publicity system, it is possible to use these privately-run platforms—which often have a more accessible user interface—to search for a company by name and Unified Social Credit Code. In addition to company credit records, these platforms also integrate data from various other government sources on, for example, patents, trademarks and legal cases. For full access to all data, the platforms charge a small fee, which is part of the overall idea of the system: to create a new market for companies to use and process credit information on companies that is provided by the government.

¹⁹ Zhujib, *Huawei, Alibaba, Tencent and Taiji Have Won the RMB 25.78 Million Bid for the "Internet+ Monitoring" System*, Zhujib, 21st March 2019, viewed 11th July 2019, <<https://www.zhujib.com/huaweialitengxuntaiji5278wanyuanzhongbiaoguoqijazhe.html>>

²⁰ *Press Conference on Accelerating the Building of the Social Credit System and Building a Credit-based Monitoring System*, State Council Information Office, 18th February 2019, viewed 19th July 2019, <<http://www.scio.gov.cn/32344/32345/39620/41042/tw41044/Document/1659716/1659716.htm>>

• Databases and ratings of third-party rating agencies

Different to Qichacha, Tianyancha and others, third-party rating agencies like HiggsCredit or Alibaba Cheng.Xin use the data provided by the government but do not just make it more accessible; they also build on the data provided by the government by integrating their own data sources to calculate comprehensive meta-ratings. Both privately-run credit information platforms and third-party rating agencies have data exchange agreements with the government, and their rating results will be increasingly integrated into the overall assessment on companies. However, for the time being, it is unclear to what extent they will feed their own rating results back into the government system.

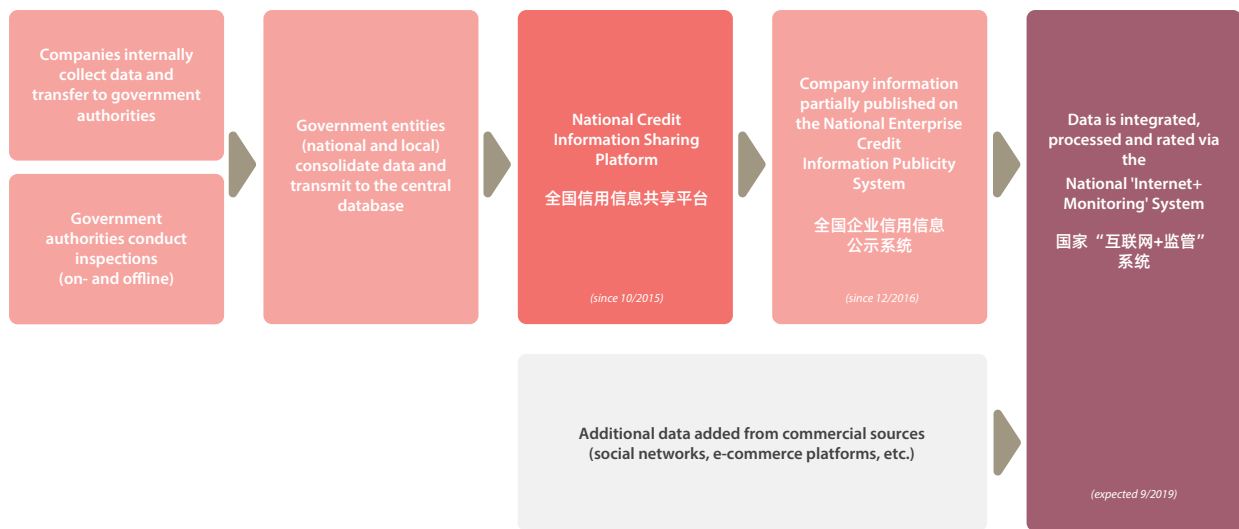


Figure 3: The data infrastructure of the Corporate Social Credit System

Credit restoration and remedies

The NDRC is leading the development of a standardised credit restoration mechanism, through which companies will have the possibility to restore their negative credit entry and stop it from being published online. A first online-service platform was launched in mid-July 2019 on CreditChina, and provides guidance on the bureaucratic process as well as a searchable interface for companies to check their credit restoration status.

Companies must be proactive in applying for credit restoration, as merely fulfilling legal obligations is not enough. To reset its negative record, a company needs to submit a 'credit restoration commitment' letter (信用修复承诺书), in which the company promises to abide by the law and accepts supervision by the government. Depending on the type of negative rating, additional material may be required. This includes proof of participating in credit training, registration documents that require official seals and a credit report (信用报告) (refer to Figure 4 on credit restoration).²¹

Not all blacklisting entries can be restored, however. For example, blacklisting entries that relate to public safety or are due to serious crimes such as fraud cannot, and business operations can be halted.²² Entries that can be restored must usually wait for a minimum publicity period to pass before the company can apply for credit

²¹ Restoration Process Guide, Credit China, viewed 11th July 2019, <<https://www.creditchina.gov.cn/xyxf/lczy/>>

²² Press Conference on Accelerating the Building of the Social Credit System and Building a Credit-based Monitoring System, State Council Information Office, 18th February 2019, viewed 19th July 2019, <<http://www.scio.gov.cn/32344/32345/39620/41042/tw41044/Document/1659716/1659716.htm>>

restoration. The publicity period will most likely vary between three months to five years, depending on the type of entry.²³

If a company is being punished under the joint punishment mechanism of the Corporate SCS, standard remedies under administrative law can apply, as the joint punishments are administrative penalties. This means that companies will be able to follow procedures of objection, repeal, administrative reconsideration or administrative litigation. Objection is possible when a company believes it has been wrongly included on the list, which will require some form of application, within 30 days, to the decision-making administrative body. Repeal requires the circumstances of the law on which the negative rating is based to have changed, and necessitates an application. Administrative reconsideration is an informal legal remedy where an administrative agency reviews both the legality and the reasonableness of the decision, while administrative litigation reviews the legality in court.²⁴

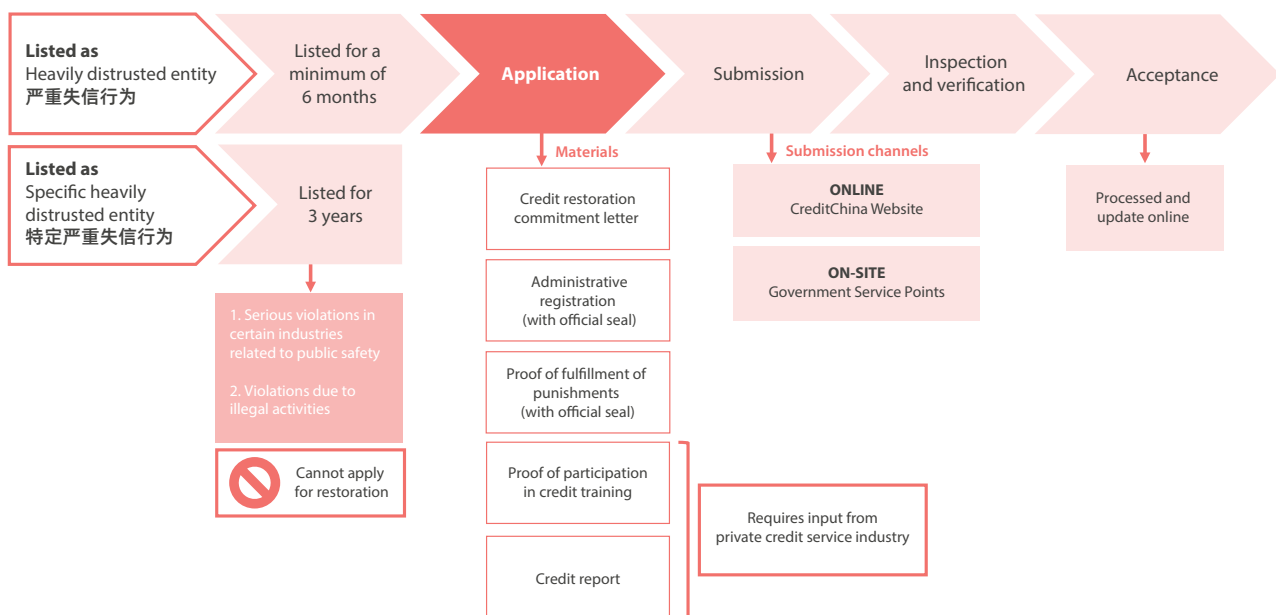


Figure 4: Process of credit restoration

23 Restoration Process Guide, Credit China, viewed 11th July 2019, <<https://www.creditchina.gov.cn/xyxf/lczy/>>

24 Measure for Lists of Heavily Distrusted Market Entities (Revised Draft for Comment), State Administration for Market Regulation, 10th July 2019, viewed 11th July 2019, <http://www.saic.gov.cn/hd/zjdc/201907/20190710_303312.html>



Part II: How the System concretely affects companies in their daily operations

The regulatory ratings under the Corporate SCS pose a new set of challenges that companies need to approach proactively in order to avoid negative impacts on their opportunities to comprehensively participate in the Chinese market. The crucial challenges do not primarily derive from new regulatory requirements introduced by the System. While the ratings introduce several new requirements, most of these refer directly to existing regulation. Instead, operational challenges arise mainly from the strictness, comprehensiveness, intricacy and crosscutting interdependence of the System's ratings. Quicker detection of non-compliance, more rigorous enforcement of regulatory stipulations and more severe and immediate sanctions against compliance offenders mean that companies must build a comprehensive understanding of the rating processes in order to safeguard against negative consequences.

A broad spectrum of regulatory ratings and requirements already applies to companies

A multinational company with significant operations in China will usually be affected by 25 to 30 ratings and compliance records, applying to all its legal entities throughout China. For many of these ratings, companies have already been continually rated since 2015. Companies are often not fully aware of these ratings and their detailed requirements, or their current rating results and potential sanctions. Based on Sinolytics work with MNCs, companies that have received negative rating results have in many cases already experienced negative consequences, for example via denial of administrative permits, but were not necessarily aware of the link between the sanction and the negative rating result. In some of these cases, companies ultimately found out the reasons behind the sanctions through discussions with the relevant government authority.

A proactive approach requires the respective company to be fully aware of the ratings, be able to detect its precise rating deficit and, in addition, know exactly which government authority is responsible for the respective rating. With a proactive approach, companies are often able to make the necessary adjustment to improve their negative rating. In a significant number of cases, an inquiry and subsequent dialogue with the right government authority in fact revealed database errors, for example due to government-side errors in data transfer. In these cases, a correction of the rating results was usually uncomplicated and swift.

A few cases examined by Sinolytics involved a direct approach instigated by the respective government authority, where companies were informed about the risk of an impending downgrading of a rating. One field in which this has occurred in the past is the area of business partner ratings. Companies were alerted to the rating deficiency of business partners and informed that their own rating—for instance the customs authentication rating—would suffer if they failed to monitor the business partner's activities closely.²⁵ In most of these cases, the respective company was not aware that failure to keep track of business partners' ratings could negatively impact its own rating performance.

Expect full coverage

Every company in China, regardless of size or ownership structure, needs to expect that all its operations in the Chinese market are in one way or another, either via scale ratings or compliance records, tracked and recorded by the mechanisms of the Corporate SCS. The existing ratings cover areas ranging from tax, customs authentication and environmental protection via product quality and work safety, to e-commerce and cybersecurity. No aspect of a company's business operations remains completely untouched (refer to Figure 2).²⁶

The implementation status of the Corporate SCS, and with it the intensity of data transfers, tracking and recording,

²⁵ *Measures on Customs Enterprise Credit*, CreditChina, 13th March 2018, viewed 12th July 2019, <https://www.creditchina.gov.cn/zhengcefagui/zhengcefagui/zhongyangzhengcefagui/201803/t20180313_110533.html>

²⁶ *Plan for Establishing a Social Credit System (2014–2020)*, State Council, 27th June 2014, viewed 14th July 2019, <http://www.gov.cn/zhengce/content/2014-06/27/content_8913.htm>

still varies between different industries and locations. But from the perspective of European companies, most of the key industries they are particularly active in are front-runner industries with regard to the System, meaning the coverage of the ratings is already far advanced. This includes the automotive and chemical industries, as well as the entire logistics industry.

Thorough preparation is key

Early and thorough preparation is the key for companies to tackle the challenges of the Corporate SCS. This will allow for sufficient time to detect gaps and make necessary adjustments to solve compliance problems, and gives companies' executive levels the opportunity to carefully deliberate the strategic and potentially normative challenges. With enough preparation, companies will avoid being surprised by the accelerating implementation of the ratings, or suddenly being faced with a rating downgrade, or even a classification as a distrusted enterprise, followed by all the potentially severe consequences.

The good news: thorough preparation is possible, as the current requirements and rating mechanisms are, in large part, clearly defined and can be assessed through detailed analysis. The downside: identifying the exact requirements for a specific company and detecting the necessary areas for action is a time-consuming and complicated task given the many intricacies of the System and the vast number of regulatory documents that need to be reviewed. This analysis needs to be highly company-specific and tailor-made. The exact ratings and corresponding requirements are different for each company depending on a number of parameters defining the company's distinct presence in China: industry sector, product portfolio, production facilities, service provision, licences held, R&D activities, financial services, and many more aspects.

The detailed requirements of the regulatory ratings: the tax rating as an exemplary case

The tax rating is one of the earliest and most advanced ratings of the Corporate SCS. As such, it is particularly suitable as an exemplary case to illustrate the operational details of regulatory ratings and clarify some of the fundamental characteristics of the rating requirements. The relevant rating stipulation was published in 2014, and since 2015, companies have been rated every year. As is often the case, the regulation outlining the rating requirements does not clearly refer to the SCS in its title. However, on second look, it explicitly strives to "expedite the build-up of the Social Credit System" (refer to Figure 5).²⁷

The tax rating rates companies on a scale from A to D, with every letter category referring to a fixed range of points that can be achieved. Whenever a company receives an A rating, this positive information is made publicly available via the National Enterprise Credit Information Sharing Platform.

The rating regulation from 2014 is still valid but retained its status as a 'trial version', allowing it to be updated and adjusted over time. Indeed, since 2014, several amendments outlined additional details on the rating and its requirements. Two MoUs, which have been agreed upon and signed by 21 government authorities, define the joint sanctions in case of a company being listed as a heavily-tax-regulation-violating entity (equivalent to a D-level tax rating) and the rewards in case of a positive (A-level) rating.²⁸

27 *Measures on Tax Credit (Trial)*, State Administration of Taxation, 4th July 2014, viewed 12th July 2019, <<http://www.chinatax.gov.cn/n810341/n810755/c1150610/content.html>>

28 *MoU on Joint Punishments of Parties Violating Tax Payment Requirements (2016)*, National Development and Reform Commission et al., 30th December 2016, viewed 10th July 2019, <<http://www.chinatax.gov.cn/n810341/n810755/c3483946/content.html>>; *MoU on Joint Reward Measures for Tax Credit A-level Taxpayers*, National Development and Reform Commission et al., 8th July 2016, viewed 10th July 2019, <<http://www.chinatax.gov.cn/n810341/n810755/c2207862/content.html>>



Figure 5: Screenshot of the Chinese regulation on tax rating requirements

The tax rating stipulations provide a detailed list of explicit requirements used to compute the point score that is then transferred into the letter rating. The formula for weighting the different requirements is fully transparent in this case: the regulatory documents provide information on the amount of points to be deducted if a specific requirement is not fulfilled. Each company starts out at 100 points and deductions are made for non-fulfillments to arrive at the final score.²⁹

Key characteristics of the tax rating requirements and underlying data

A: Most of the requirements are tax-specific and rate compliance with China's tax regulations

In parallel to all other Corporate SCS ratings, most of the tax rating requirements can be fulfilled by companies if they have solid compliance with tax regulations. Any irregularity in tax payments, reporting requirements, invoices or account books would, however, lead to a point deduction under the tax rating.

One important general characteristic of the regulatory ratings under the Corporate SCS is their sensitivity to violations. Even small infringements on reporting requirements—especially filing reports late or providing incomplete

²⁹ Tax Credit Rating Evaluation Method (Trial Version), State Administration of Taxation, 25th August 2014, viewed 10th July 2019, <<http://www.chinatax.gov.cn/n810341/n810765/n812141/n812242/c1078412/content.html>>

data—will lead to point deductions. Relatively minor non-compliance issues can therefore have consequences. Checking internal reporting procedures, timelines and responsibilities needs to be a first step for every company in order to avoid simple mistakes.

B: Data integrated into the tax rating assessment includes information regularly transferred by companies to the tax authorities, as well as results from government inspections and audits

The major source and basis for the tax rating is the information transferred by companies to the government on a regular basis through self-reporting. However, as in all other Corporate SCS ratings, this data is complemented and verified by government inspections. If a company does not allow a government inspection, this leads to a significant downgrading. If a company has a sub-optimal rating, this significantly increases the rate of inspections. On the other hand, companies with consistently high ratings will undergo far fewer inspections, saving effort and resources.

C: Former rating results impact today's rating

Regulatory ratings have a long memory and it can take a long time to recover from a low rating. For example, being rated as a D-level tax company excludes the enterprise from receiving an A-level rating in the next rating period. Usually, it will take a company several years to achieve an A-level tax rating after a negative rating result.

D: External reference data can also include media reports

As is the case with other scale ratings, the tax rating references media reports as a source of information to assess the behaviour of companies. While any media-based information needs to be verified by tax authorities, it can impact a company's rating result if deemed admissible. Media reports as an information source for rating computation appears particularly problematic to many companies, as its interpretation can be arbitrary, and it is an input that companies cannot directly or fully control through their own behaviour.

The major 'external' source of information, beyond data obtained by the tax authorities through self-reporting and inspections, remains the complete set of consolidated data available via the National Credit Information Sharing Platform. This represents another general characteristic of the regulatory ratings: for their assessment, the respective government authority is envisioned to draw not only on the narrow, topic-specific data set they collect themselves, but on the full spectrum of data gathered on a company's behaviour from all government authorities at all levels.

E: Individual rating results impact company rating results and vice-versa

The tax rating is an example of the linkage between the corporate rating mechanism and the individual rating mechanism of the SCS, as it integrates individual rating results into the assessment of the company's rating. If the company is registered or operated by a person who is individually rated as an 'abnormal' or Grade-D taxpayer, this leads directly to a D-level rating of the company. By the same token, a company's D-level tax rating will also have a significant impact on a responsible individual's personal tax rating. If the company tax rating is D, the individual tax rating of directly responsible personnel will also be downgraded to D.

F: Other rating results (may) impact the tax rating and vice-versa

One of the most important characteristics of the rating requirements is the interdependent impact of rating results in other fields. This becomes clear in the tax rating stipulations: rating requirements explicitly include ratings by other government authorities as a criterion for computing the tax rating. As this is the case for many of the already existing ratings, this linkage creates a ripple effect through which a negative rating in one area also puts downward pressure on the company's other ratings.



Currently, this linking mechanism is not fully operational, and the effects are not yet clearly traceable in practice. The main reason for this is presumably the still-limited sharing of rating information via the central database of the SCS as described above. However, the regulatory basis for the mechanism is well established, meaning it can be activated at any time once the necessary data sharing feature is properly installed. The same mechanism also applies in the other direction. Not only can the tax rating be impacted by other ratings but can itself be used as an input for other ratings. A very clear connection is the one between the tax rating and the customs authentication rating: the relevant MoU states that “if listed as a heavily tax violating entity, the company can no longer be treated as an authorised economic operator [AEO] certified enterprise” (“对公布的重大税收违法案件当事人，不予适用海关认证企业管理”).³⁰

The impact of being rated as a distrusted enterprise: the customs authentication rating as an example

One of the most significant characteristics of the ratings under the Corporate SCS is the principle of joint sanctions: all relevant government authorities levy sanctions based not only on the rating they are directly responsible for, but also in response to negative ratings in all rated fields (for further details on joint sanctions see Part I).

The customs authentication rating is one of the earliest and most advanced ratings with a highly complicated and challenging set of rating requirements and a catalogue of corresponding consequences. Therefore, looking at the joint sanctions to be levied against a company classified as a ‘distrusted customs authentication enterprise’ provides an instructive first view of the scale of sanctions an enterprise can be confronted with.³¹

Key characteristics of the customs authentication rating’s joint sanctions

A: Exemplary sanctions levied by the government authority in charge of the rating

A1: Higher inspection rates

Higher inspection rates are a common sanction within the field of a rating to punish distrusted companies. A rating as a distrusted customs authentication enterprise leads to significantly higher import-export inspection rates. Based on data from the General Administration of Customs, the average inspection rate (进出口平均查验率) for a distrusted customs enterprise was 98.12 per cent in the first half of 2019. By contrast, an AEO-authenticated company (which is equivalent to the best possible rating result under the customs authentication rating) saw an average inspection rate of 0.5 per cent.

A2: Targeted audits

Additional topic-specific audits are another sanction implemented directly by the government authority that imposed the negative rating. In the case of customs authentication, this particularly relates to audits of documents for import and export cargo, as well as to increased export tax rebate audits.

B: Exemplary sanctions taken by other government authorities via the joint sanctions mechanism

B1: Reference point during all kinds of administrative approvals and bureaucratic procedures

If classified as a distrusted customs company, a broad spectrum of administrative approvals and bureaucratic procedures are negatively affected. The negative rating will be taken as a reference point by a multitude of

³⁰ MoU on Joint Punishments of Parties Violating Tax Payment Requirements (2016), State Taxation Administration, 30th December 2016, viewed 10th July 2019, <<http://www.chinatax.gov.cn/n810341/n810755/c3483946/content.html>>

³¹ MoU on Joint Punishments for Distrusted Enterprises in the Field of Customs Authentication, CreditChina, 10th January 2018, viewed 16th July 2019, <https://www.creditchina.gov.cn/biaozhونغuifan/hangyexingbiaozhونغuifan/201801/t20180110_106070.html>

government agencies when assessing whether or not to grant a range of approvals, such as business licences, and other types of certificates and permits, like environmental protection permits.

B2: Reference point for financial and credit affairs

The whole spectrum of financial and credit affairs of a company will also be affected by it being rated as a distrusted customs enterprise. For example, such a company would no longer be classified as a Class A enterprise by the State Administration of Foreign Exchange (SAFE), resulting in stricter controls on foreign exchange activities. [Implementing institutions: NDRC, SAFE, PBOC, China Securities Regulatory Commission (CSRC), Ministry of Industry and Information Technology (MIIT), Ministry of Finance (MOF), Ministry of Commerce (MOFCOM) and other relevant ministries]

B3: Exclusion from public procurement

One of the most common and far-reaching sanctions is the exclusion from government procurement and public tenders. This applies to the customs authentication rating, but also holds true for many of the other regulatory ratings. Companies with a negative rating are restricted or, in severe cases, banned from participating in public projects or from selling their products to the public sector. [Implementing institutions: MOF, NDRC and other relevant departments]

B4: Public blaming and shaming

A key mechanism of the Corporate SCS is the public blaming and shaming of distrusted companies. This includes the disclosure of untrustworthiness to the public via the CreditChina website and the National Enterprise Credit Information Publicity System.

The information shared via these public channels of the System is intended to be used as a reference point for business and investment decisions by corporate partners and customers. The core idea behind this public blaming and shaming is to make sure that distrusted entities cannot successfully continue their business in the Chinese market. The shaming mechanism is not fully implemented yet, but the level of publicity and public scrutiny to be generated in cases of infringements is likely to be ramped up significantly in the coming months. [Implementing institutions: Ministry of Commerce (MOFCOM), NDRC]

B5: Impact on the legal representative and directly responsible personnel

In the customs authentication rating, as in virtually all other ratings of the Corporate SCS, a negative rating has a significant impact on the company's legal representative as an individual. With respect to the customs rating, the legal representative will be hit with travel restrictions if the company fails to pay customs duties or fines and penalties after a corresponding court-order. The legal representative will also be restricted from purchasing insurance products with high cash-value premiums and from purchasing real estate or land if her or his company receives a rating as a distrusted customs company. Usually, she or he is also not allowed to take on another post as legal representative as long as the company is blacklisted. [Implementing institutions: Supreme Court, Ministry of Transport (MOT), MOFCOM, Ministry of Public Security (MPS), Ministry of Culture and Tourism (MCT), Civil Aviation Administration of China (CAAC), China State Railway Group and other relevant departments]

B6: Impact on other ratings or classifications

A downgrading of the customs authentication rating is without exception used as a punishment in the joint sanction MoUs of all other regulatory ratings. As a consequence, any rating as a distrusted company in a field other than customs would also lead to a downgrading of the customs rating. The respective company would lose or would not



be able to receive AEO certification.

For the time being, this comprehensive linkage to other ratings only works in one direction: a downgrading of the AEO status as a result of a negative rating in some other field. Conversely, a negative customs authentication rating is thus far only directly linked to the foreign exchange classification of the company, which would be negatively impacted by a negative customs rating. [Implementing institution: SAFE]

This is likely to change. Several ratings, like the tax rating, already refer to “other rating results” as a criterion and might soon integrate them more systematically into their rating assessment. This could even lead to a systematic ‘vicious cycle’ of interlinked rating downgrades.



Figure 6: Examples of sanctions for a rating as distrusted customs enterprise ³²

Data transfer, data publication and data security

All companies registered in China transfer a significant amount of detailed data to Chinese government authorities. In many cases, companies are unclear about how this data is used as a basis for the government’s computation

³² MoU on Joint Punishments for Distrusted Enterprises in the Field of Customs Authentication, NDRC and 32 Further Ministries, 6th April 2017, Viewed 10th July 2019, <<http://www.customs.gov.cn/customs/302249/302419/xgfg/648296/index.html>>

of regulatory ratings. Taken individually, most of the transferred data points are not highly sensitive information. However, the integration and systematically cross-cutting use of data on the government's side can become a challenge. It provides the government with a full picture of the detailed performance and capability of a company. Ensuring the security of this data is one of the key promises of the government. Companies need to hold the government authorities to this promise and make sure that no detrimental use of this comprehensive data occurs.

Many companies are not fully aware of the significant amount of data that is being made public and is openly accessible to outsiders, including potential business partners, competitors, media and any other institution or individual interested in the company's performance. Companies need to routinely check their entries and data on the respective public platforms in order to detect and remedy cases of negative entries or incorrect information. A proactive approach towards this published data will become increasingly urgent.



Part III: What to expect in the coming months and beyond

Macro-level: full implementation of China's market access regime

China is in the process of introducing a new market access and supervision regime, and the Corporate SCS will play a decisive role in this new regulatory environment. While China is gradually opening new parts of its market, the System is meant to be the gatekeeper to make sure that only those that fully comply with all requirements of the regulatory ratings can access and participate in the Chinese market. A centrepiece of this new market access regime is the Market Access Negative List, applicable to Chinese and foreign-owned companies alike, which unambiguously states that “market access for distrusted market entities who are blacklisted will not be granted or will be limited”.³³

China is counterbalancing steps toward market liberalisation with increased and continuous monitoring. Since the beginning of the Xi Jinping leadership in 2013, this has been at the core of China's economic reform agenda, and is also a key element of what China's FTZs are experimenting with. With every step taken towards more effective monitoring via the SCS and Internet+ supervision, China will continue to open market segments and reduce hard market access barriers like joint venture requirements.

The fact that a functional Corporate SCS plays such an important role in this overarching scheme of things has placed enormous pressure on the implementation process. In recent months, this was illustrated by a number of government statements and documents urging accelerated implementation of the System.³⁴ Market access reforms have a clear timeline, with the Foreign Investment Law coming into effect on 1st January 2020, so China's government needs to ensure that the corporate ratings under the SCS are ready in time. As previously described, the implementation status of the System is not there yet: significant gaps persist that will need to be closed quickly. Therefore, companies should expect a major surge in implementation over the coming months.

An important additional building-block: a new meta-monitoring database is being built

The final implementation phase of the Corporate SCS has just started. Since early 2019, the building of a new meta-database has been underway, which will boost the Chinese Government's capability to enforce rating-result-based monitoring and the steering of companies. The setup is following an extremely tight schedule: the test version is likely to be released in September 2019, a final version by the end of the year, and full and comprehensive coverage of all relevant data and regions is envisaged by the end of 2020, followed by a period of three to five years for incremental improvements.

The new system, called the National 'Internet+ Monitoring' System (国家“互联网+监管”系统), aims to fully integrate the complete set of monitoring and credit information data on companies. This includes all sources of government monitoring data and government rating results, as well as rating results and other data from third parties like (selected) commercial rating agencies and e-commerce platform providers. Ultimately, it also integrates existing complaint and reporting channels like the one for environmental protection offenses (12369 网络举报中心) and the one from the Cyberspace Administration of China for fake news and rumours (国家网信办举报中心), as well as video surveillance systems.³⁵

³³ *Market Access Negative List (2018)*, National Development and Reform Commission, 12th December 2018, viewed 11th July 2019, <http://www.ndrc.gov.cn/zcfb/zcfbtz/201812/t20181228_924067.html>

³⁴ *Li Keqiang Presided Over the State Council Executive Meeting About the Acceleration of Establishing a Social Credit System to Build a New Market Monitoring System*, State Council, 12th June 2019, viewed 17th July 2019, <http://www.gov.cn/premier/2019-06/12/content_5399666.htm?mc_cid=709b9374eb&mc_eid=0b2fe65d29>; *Guiding Opinion on Accelerating the Building of the Social Credit System and Building a Credit-based Monitoring System*, State Council, 16th July 2019, viewed 17th July 2019, <http://www.gov.cn/zhengce/content/2019-07/16/content_5410120.htm>

³⁵ *Guiding Opinion on Accelerating the Building of the Social Credit System and Building a Credit-based Monitoring System*, State Council, 16th July 2019, viewed 17th July 2019, <http://www.gov.cn/zhengce/content/2019-07/16/content_5410120.htm>

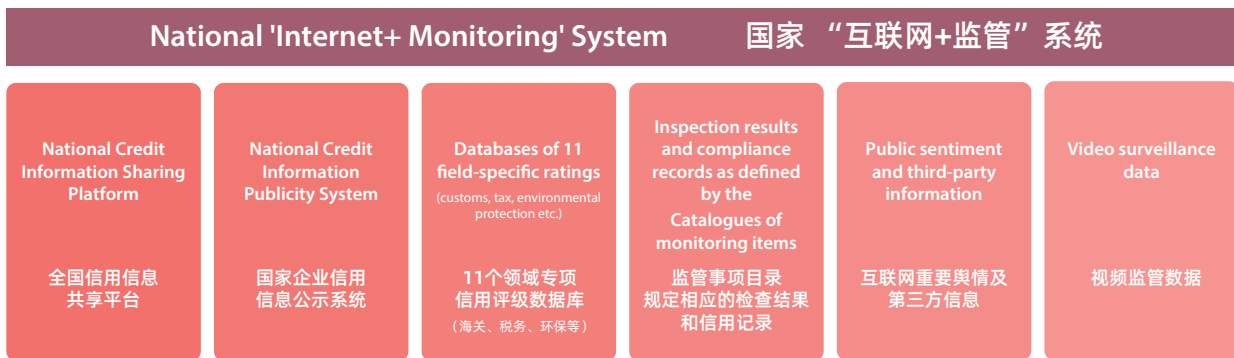


Figure 7: Data sources of the National 'Internet+ Monitoring' System on company performance

A consortium led by Taiji Computer Corporation, in cooperation with Huawei, Alibaba, Tencent and video surveillance provider VisionVera, is setting up the system. Taiji Computer takes the major responsibility for integrating the different data sources into one platform and Huawei provides the server and cloud infrastructure. Alibaba (via AliCloud and Alibaba Sesame Credit Company Credit Rating) and Tencent have a major role in analysing the ratings and records of companies as part of the platform. Finally, VisionVera brings in its video surveillance data.³⁶

	Huawei	Alibaba	Tencent	Taiji Computer	VisionVera
Basic infrastructure					
Big Data centre					
Big Data analysis					
Databases					
Data integration					
Data application					
Risk and early-warning system (on basis of Corporate SCS ratings and records)					
Field-specific					
Overall performance					
Policy- and decision-making support					
Interface					
Video surveillance platform					

Figure 8: The companies behind the 'Internet+ Monitoring' System and their involvement

³⁶ Zhujib, Huawei, Alibaba, Tencent and Taiji Have Won the RMB 25.78 Million Bid for the 'Internet+ Monitoring' System, Zhujib, 21st March 2019, viewed 11th July 2019, <<https://www.zhujib.com/huaweialitengxuntaiji5278wanyuanzhongbiaoquojiazhe.html>>



A new blacklisting mechanism for 'heavily distrusted entities'

The SAMR is currently preparing the integration of existing compliance records into a distinct market monitoring blacklisting mechanism, the so-called 'heavily distrusted entities list' (严重违法失信名单). The draft of the underlying regulation was open for comments until 10th August 2019, and a final version will likely be published shortly before the 'Internet+ Monitoring' System goes online in September 2019.³⁷

Relevant non-compliance cases included in the blacklisting mechanism cover the whole spectrum of market activities of a company by integrating, for example, production and product-specific non-compliance records, anti-monopoly cases and misconduct in e-commerce transactions. The new mechanism provides companies with more transparency and a clearer insight into the most damaging cases of non-compliance. Companies, however, need to be aware that the urgency of avoiding these non-compliance cases will increase substantially as soon as the measure is implemented.

This blacklisting mechanism for 'heavily distrusted entities' will also turn the Corporate SCS into a tool for trade conflicts. Based on the draft version of the measure, companies can be listed as heavily distrusted market entities due to the following reasons (among many other, non-trade-related reasons):

- a. Using boilerplate (standardised) clauses or carrying out fraud, coercion, malicious collaboration or compulsory trading and other methods (利用格式条款或者实施欺诈、胁迫、恶意串通、强制交易等手段).
- b. Endangering national or public interest (危害国家利益、社会公共利益).
- c. Infringing the legitimate rights and interests of customers (侵害消费者合法权益) (this is what FedEx, for example, was accused of in June 2019).

By including these criteria, the measure fully integrates the aspects mentioned by the MOFCOM in May 2019 when announcing an 'unreliable entities list' (不可靠实体清单) in a trade conflict context.³⁸ The abovementioned criteria do not formally discriminate against foreign companies, however they remain vague and could be difficult to avoid, particularly for foreign companies. If the measure is implemented as suggested by the draft, the blacklisting mechanisms of the Corporate SCS will provide the Chinese Government with a strong tool to use the System as a lever in trade conflicts and a tool for targeted action against individual companies. Companies therefore need to prepare for intensified scrutiny and inspections regarding these criteria.

The Social Credit System remains a learning and evolving system

Even after the current push for enhanced data exchange and monitoring, many detailed aspects of the SCS will continue to be subject to changes in the years to come. Relevant government plans already envisage a period of three to five years after 2020 for incremental adjustments, expansion and improvement of the System's mechanisms. New ratings that are currently still being tested in local pilots will likely be introduced on a national level and complement existing ratings. Detailed requirements will be frequently updated, complemented and adjusted to new needs or experiences. With new technological possibilities, more detailed, remote and real-time data will be integrated, and rating evaluation might at some point follow real-time patterns as well. Sanctions will be expanded and adjusted to ensure their effectiveness. Especially in relation to credit restoration, China's commercial credit service industry will grow.

³⁷ Measure for Lists of Heavily Distrusted Market Entities (Revised Draft for Comment), State Administration for Market Regulation, 10th July 2019, viewed 11th July 2019, <http://www.samr.gov.cn/hd/zjdc/201907/t20190710_303312.html>

³⁸ A Spokesman for the Ministry of Commerce Answered Questions about China's Establishment of a "List of Unreliable Entities", Ministry of Commerce, 31st May 2019, viewed 17th July, <<http://www.mofcom.gov.cn/xwfbh/20190531.shtml>>

Outlook: China's Corporate Social Credit System will have an impact beyond the Chinese market

International ambitions have underpinned the SCS from its onset. The *Plan for the Construction of a Social Credit System (2014–2020)* explicitly mentions “enhancing national soft power and international influence” and “promoting the establishment of an objective, fair, reasonable and balanced international credit rating system” as objectives of the System.³⁹ The expansion of the System outside of China's borders should therefore come as no surprise.

The Corporate SCS already rates the behaviour of Chinese companies operating in foreign markets. Through the rating for foreign economic cooperation, Chinese companies can be blacklisted for misconduct abroad.⁴⁰ This rating is mainly targeted at Chinese companies that participate in Belt and Road Initiative (BRI) projects, to safeguard national interests and reputation. However, first indications suggest that China is working on exporting the system more broadly. A monitoring of European companies' behaviour in other markets, including their cooperation and business relationships with Chinese companies even if they are not present in China, is possible in the future. Chinese think tanks continue to evaluate the effectiveness of the Corporate SCS, as well as its exportability, specifically in connection with the BRI. A more comprehensive, non-financial credit rating, like the Corporate SCS, is envisaged to counter the current dominance of Western credit-rating companies. As a NDRC-linked think tank suggests, this would include political, economic, financial, social and environmental credit.⁴¹

Several initiatives on international credit cooperation are already in place and framed as an integral part of BRI cooperation. This includes the establishment of international cooperation knowledge-sharing networks and central databases for credit sharing, both nationwide and at the city level. Summits have already been held on credit cooperation between cities in China and cities in Mongolia, Thailand and France, to name but a few.⁴² China has close bilateral credit cooperation with several countries in Asia and the Middle East, such as Saudi Arabia, which is setting up a Corporate SCS as part of its close BRI cooperation with China.⁴³ The internationalisation of credit cooperation also reaches into central Europe. In June 2019, a delegation from the NDRC's International Cooperation Center and the National Public Credit Information Center visited the Czech Republic to meet government representatives and discuss the construction of an SCS as part of the country's BRI cooperation.⁴⁴

39 *Plan for Establishing a Social Credit System (2014–2020)*, State Council, 27th June 2014, viewed 14th July 2019, <http://www.gov.cn/zhengce/content/2014-06/27/content_8913.htm>

40 *Interim Measure on Negative Credit Record in the Field of Foreign Investment Cooperation and Foreign Trade*, Ministry of Commerce, 5th July 2013, viewed 10th July 2019, <<http://www.mofcom.gov.cn/article/h/redht/201309/20130900316370.shtml>>

41 *Giving Full Play to the Advantages of International Cooperation and Promoting the Establishment of a Credit System-Interview with Huang Yong, Director of the International Cooperation Center of the National Development and Reform Commission, Credit China*, 3rd June 2018, viewed 11th July 2019, <https://www.creditchina.gov.cn/xinyongkanwu/xiliebaodao/xiliebaodao1/wenzhangliebiao1/wendanglebiao/201806/t20180613_118093.html?randid=0.7084926427526753&sign=ABZ0cnNfd2NtX3ByZXZpZXdfYWJZNXNzAAAH4gAAAAUAAAANAAAAEAAAABgAAAAO>

42 *The 'One Belt, One Road' International Cooperation City Credit Union has been Established*, *Xinhua*, 20th October 2018, viewed 11th July 2019, <http://www.xinhuanet.com/2018-10/20/c_1123588676.htm>

43 *The 'Belt and Road Initiative' and Saudi Arabia's '2030 Vision' Cooperation is Pragmatic and Efficient – the Delegation of the International Cooperation Center and the National Public Credit Information Center Visited Saudi Arabia and Achieved Positive Results*, International Cooperation Network, 10th July 2019, viewed 11th July 2019, <http://www.icc-ndrc.org.cn/news_detail.jsp?id=60056252>

44 *The 'Belt and Road Initiative' Opens up a Space for China-Czech cooperation – Delegations from the International Cooperation Network, the National Public Credit Information Center went to the Czech Republic to Promote Pragmatic Exchanges and Cooperation*, International Cooperation Network, 10th July 2019, viewed 11th July 2019, <http://www.icc-ndrc.org.cn/iccndrc/news_detail.jsp?id=60056251>



Conclusion and Recommendations

European companies

Internal adjustments: First of all, companies need to ensure that their internal processes and structures are set-up in a way to effectively and efficiently manage the challenges of the Corporate Social Credit System, safeguarding against negative ratings and corresponding sanctions. Three steps are necessary to achieve this:

1. Understand exactly what the system requires from your company: Every company needs to know precisely which ratings apply to its business operations in China, at the national, provincial and local levels. After identifying the applicable ratings, companies need to go one level deeper and pinpoint the full catalogue of specific requirements that are used to compute the ratings and that need to be fulfilled. Since the information is available but dispersed across a large amount of government documents and therefore difficult to assemble, companies must conduct the necessary analysis in order to gain the transparency they need to proactively prepare.
2. Assess where your company stands regarding the requirements: The identification of applicable requirements provides a company with a checklist to assess its business operations against. A systematic gap analysis, checking if rating requirements are safely and sustainably fulfilled, needs to be conducted in order to pinpoint exact rating compliance gaps as well as future risks for negative rating results. This provides a roadmap of business areas that need adjustments to ensure good regulatory ratings now and in the future. A gap analysis will also reveal the larger, company-wide, strategic challenges arising from the requirements of the Corporate SCS.
3. Design and implement effective adjustments: Based on the gap analysis, companies need to weigh their options for adjustments necessary to close the gaps. Some gaps can be dealt with through simple process enhancements, some require more structural, organisational changes. Preferably, the choice of action should be based on a cost-benefit analysis, comparing different adjustment options and their respective effects. The increasing importance of scale ratings also means that compliance is not an either/or decision anymore. Companies need to decide to what degree they want to comply or over-comply to reach a certain rating, measuring the corresponding benefits of a good rating against the costs to achieve it. In some cases, companies will also have to weigh the decision whether to comply with government requirements against company principles and values.

Continuous monitoring: Carrying out the above three steps will bring a company up to date and position it well to effectively manage the effects of the Corporate SCS. However, as the System continues to adjust, expand and improve, companies need to stay on top of further developments. An effective monitoring system that provides companies with the ability to react quickly needs to cover two dimensions. First, the close observation of government-side changes to ratings and rating requirements. Second, the internal monitoring of business operations with regard to the sustained fulfilment of, sometimes changing, requirements. This will necessitate regularly checking a company's rating scores across all ratings and the monitoring of entries about the company in the different databases.

Exchange with government authorities: Companies should seek direct exchanges with Chinese government authorities to raise questions and problems relating to the Corporate SCS. In order for this exchange to be productive and ultimately helpful, precise preparation is, once again, key. Companies need to know exactly what questions to ask and what issues to raise. Inquiries and statements need to be detailed, concrete and technically precise, with exact reference to the relevant government documents and concrete regulatory stipulations. In addition to identifying the right questions to ask, companies need to know who to ask. Identifying the correct government

authority, at national or local level, that carries the responsibility for a specific issue, is a prerequisite for productive government engagement.

The exchange with government authorities should cover two dimensions:

1. **Clarification:** Even though many stipulations of the Corporate SCS are explicit and clearly stated, the need for clarification of details remains. Companies should engage in an exchange with respective government agencies to clarify imprecise stipulations of concrete importance to their business operations. Two prominent examples in need of clarification are the exact definition of 'responsible personnel' (regarding the linkage between individual and corporate ratings) and the scope of 'business partners' (regarding the responsibility to monitor business partners' behaviour). In addition to questions regarding the clarification of specific stipulations, companies should also engage government authorities on improving the overall flow and accessibility of information related to the Corporate SCS (see also 'Chinese government' below). One example: some ratings explain the weighing of different requirements for the computation of the rating in detail (e.g. the environmental protection rating). It would be productive to expand this level of transparency to all ratings.
2. **Modification:** After conducting the three steps of internal preparations outlined on the previous page, companies will identify the precise requirements that are of major concern and difficult for companies to comply with. One highly relevant example is the inclusion of sensitive (e.g. technical or individual) data into the data transfer requirements. After pinpointing the exact problematic details, companies can engage government authorities with requests to modify these aspects of the Corporate SCS stipulations.

To be clear, advocacy efforts by companies, no matter their size, will not alter the principles and mechanisms of the System. Modification of technical details, however, that can potentially change rating requirements to address specific concerns of international companies, might be possible and should be actively explored.

Within exchanges with government authorities, chambers of commerce and business associations can play a highly productive role. Bundling concerns and coordinating inquiries and requests from many companies, also across industrial sectors, will increase their weight and effectiveness. Leveraging chambers' established communication channels will also facilitate the process.

Chinese government

There is a significant overlap of interests between Chinese government authorities and companies when it comes to the ratings under the Corporate SCS. Both sides benefit from companies performing well and earning good scores and neither wants to experience mistakes and inconsistencies within the System, leading to incorrect company information and, at times, unjustified rating results. From this perspective, it is in the Chinese Government's interest to support the preparatory measures taken by international companies.

Information flow and accessibility: The respective government authorities could facilitate the preparatory efforts of companies by improving the flow of information on ratings and rating requirements to all companies. Consolidation of operationally important information through clear communication channels would be especially valuable for SMEs as they will find it particularly challenging to mobilise the necessary internal resources to acquire and continually track all necessary information.

Clarity and channels of communication: There is a strong need for a productive exchange with government authorities with the aim of clarifying some of the information that is still partially unclear in the existing regulatory texts. Chinese government authorities have an interest in facilitating this process of clarification, not only by reacting



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to the direct inquiries from companies and business associations, but also by proactively improving the precision of Corporate SCS stipulations. An additional step to facilitate the flow of information and enable companies to raise questions and concerns would be the establishment of clear communication channels and defined points of contact for different rating areas.

Targeted modifications: International companies can identify details in the rating requirements that are particularly difficult to fulfil. Some will be due to technical difficulties, but others will be driven by the tension between some SCS requirements and MNCs' corporate principles and norms. A productive dialogue between international companies and government authorities on these details, aiming to find feasible compromise solutions, should be in the best interests of the Chinese authorities.

Transition periods: Adequate transition periods should precede the operational start of sanctioning mechanisms, preferably combined with issuance of clear notifications to alert companies about impending changes. This measure would provide companies with the necessary time to adjust processes and organisational structures accordingly. Ideally, if a company is found to be non-compliant with a rating during this period, notification from the government can help companies to react before full implementation.

European Union and member state governments

As in all questions relating to the Chinese business environment, the EU and its member states play a central role in facilitating the exchange between European companies and the Chinese Government. Any company-to-government dialogue on clarifying and modifying the emerging Corporate SCS needs to be reflected and reinforced through parallel government-to-government dialogues. This also requires close communication between EU institutions and EU companies affected by the Corporate SCS.

Prepare for implications beyond China: In addition to the EU's and member states' roles regarding the establishment of the Corporate SCS, EU decision-makers also need to be aware of the potential international implications of the System. China is pioneering a fundamentally different approach to the regulation of market participants, based on a definition of 'trustworthiness', that reaches far beyond the parameters traditionally applied to business ratings. As already described, the Chinese Government's explicit ambitions are not limited to the domestic market, but also aim to change the international system of business credit ratings. EU institutions and member states therefore need to establish a formal process to enhance understanding of the international implications of the Corporate SCS, and build a solid foundation for clear and strong positioning on this issue.

Strategic and coordinated response: As witnessed with the recent example of the Czech Republic, China will increasingly promote the Corporate SCS as part of BRI cooperation with EU Member States. This creates the urgent need for a strategic and coordinated response by the EU and its member states. The EU should closely monitor China's efforts to promote Corporate SCS implementation in member states and establish frequent, close exchanges with member-state governments on this issue. Member state governments should base any interaction with China on Corporate SCS-related matters on solid knowledge of the system's implications, and coordinate with other member states on this matter to exchange experiences and make well-informed decisions on any Corporate SCS-related initiatives.

Abbreviations

AEO	Authorised Economic Operator
BRI	Belt and Road Initiative
CAAC	Civil Aviation Administration of China
CSRC	China Securities Regulatory Commission
EU	European Union
FTZ	Free Trade Zone
MNC	Multinational Corporation
MOF	Ministry of Finance
MOFCOM	Ministry of Commerce
MOLAR	Ministry of Land and Resources
MOT	Ministry of Transport
MoU	Memorandum of Understanding
MPS	Ministry of Public Security
NDRC	National Development and Reform Commission
PBOC	People's Bank of China
RTM	Real-time Monitoring
SAFE	State Administration of Foreign Exchange
SAIC	State Administration for Industry and Commerce
SAMR	State Administration for Market Regulation
SCS	Social Credit System
SME	Small and Medium-sized Enterprise
VAT	Value-added Tax



European Chamber
中国欧盟商会

About the European Union Chamber of Commerce in China

The European Union Chamber of Commerce in China (European Chamber) was founded in 2000 by 51 member companies that shared a goal of establishing a common voice for the various business sectors of the EU and European businesses operating in China. It is a member-driven, non-profit, fee-based organisation with a core structure of 31 working groups and fora representing European business in China.

The European Chamber now has more than 1,600 member companies in seven chapters operating in nine cities: Beijing, Nanjing, Shanghai, Shenyang, South China (Guangzhou and Shenzhen), Southwest China (Chengdu and Chongqing) and Tianjin. Each chapter is managed at the local level by local boards reporting directly to the Executive Committee.

The European Chamber is recognised by the European Commission and the Chinese authorities as the official voice of European business in China. It is also recognised as a foreign chamber of commerce by the Ministry of Civil Affairs. The European Chamber is part of the growing network of European Business Organisations (EBOs), which connects European business associations and chambers of commerce from 37 non-EU countries around the world.

Principles:

- We are an independent, non-profit organisation governed by our members.
- We work for the benefit of European business as a whole.
- We operate as a single, networked organisation across Mainland China.
- We maintain close, constructive relations with the Chinese and European authorities, while retaining our independence.
- We seek the broadest possible representation of European business in China within our membership: small, medium and large enterprises from all business sectors and EU Member States throughout China.
- We operate in accordance with Chinese laws and regulations.
- We treat all of our members, business partners and employees with fairness and integrity.

About Sinolytics

Sinolytics is a European specialised consultancy entirely focused on China. The company is based in Berlin and Zurich with teams operating from Beijing and Shanghai. It provides in-depth research, expert analysis and strategic advice at the nexus of business and policy. Sinolytics consults international firms, investors and the public sector, enabling well-informed China strategy development and decision-making. Sinolytics provides deep expertise on China's economic, industrial and technology policies and regulation, including new forms of big data enabled business regulation and regulatory ratings. It also puts a focus on the opportunities and challenges of China's rapid digital transformation, advising on digital and technology strategies, venture capital investment, partner scouting and competitor analysis.

Helping companies to prepare for the changing regulatory environment in China is one of Sinolytics' most specialised services. China's government, using increased monitoring and processing capacity enabled by new technologies, is significantly improving the implementation and enforcement of market regulation. Sinolytics experts have analysed this shift in China's regulatory system for many years, building deep expertise and experience. Sinolytics supports its clients to identify compliance and strategic gaps early on and to effectively manage the new reality of enhanced regulatory scrutiny.

Sinolytics had the privilege to work with a number of the largest corporations in Germany, Europe and the United States. In revenue, Sinolytics' clients span a wide range from half a billion to over 200 billion EUR. The majority of companies Sinolytics is working with is listed in the DAX30, others rank among the largest US. companies or are champions of the 'Mittelstand'. Operating at the nexus of business and policy, Sinolytics advises companies from all business and industry sectors, and in all related functional areas. The company has a particularly strong track record in automotive and automotive suppliers, mechanical engineering, consumer electronics, chemicals and pharmaceuticals.

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