

stars insights: 26 April 2019

How the Chinese Government Steers Company Behaviour by Leveraging Digital Technology: Regulatory Ratings and the Social Credit System

Mostly unnoticed, but progressing at a rapid pace, China is currently restructuring its market regulation regime. Under the broader mission of “opening-up” the market to foreign players, the country is gradually moving away from hard market access constraints like joint venture requirements and negative lists for investments. Instead, China’s government is replacing them with more subtle and sophisticated regulatory instruments to closely monitor and steer corporate activities. In fact, the lifting of hard market barriers can, in part, be explained by the government’s growing confidence in its own ability to influence companies’ behaviour in a more fine-tuned, more targeted way. This shift will profoundly impact how international companies operate in the Chinese market, writes Sinolytics, a European specialized consultancy entirely focused on China.

At the core of this are regulatory ratings. Rating mechanisms are fundamentally changing the regulatory context for all companies doing business in China, including international ones. The ultimate goal of the Chinese government is algorithm-based and mostly automated ratings that enhance implementation and enforcement of regulatory compliance. But ratings are not limited to mere compliance issues but are more broadly applied to incentivize corporate behaviour defined as coherent with the Chinese government’s preferences and economic goals. Every company with business interest in China therefore needs to understand and prepare for the implications of the emerging rating system.

To clarify one persistent confusion: regulatory ratings for corporations are conflated with the overarching plans for a so-called Social Credit System. The Social Credit System has garnered international attention especially because of plans to rate individual citizens’ behaviour. In fact, the fundamental principles of individual and corporate ratings are the same and both are part of the same overarching systems. The application of the Social Credit System as an instrument to steer companies is, however, distinct from the individual ratings. Distinguishing the two aspects is a prerequisite for clearly understanding either side.

How does it work?

First, setting the ratings and rating requirements. The Chinese government, with the National Development and Reform Commission and the People’s Bank of China in the lead, defined a spectrum of different ratings. The early ratings are already well known like the tax, customs authentication or environment rating. Others are still in emergence like the product quality, cybersecurity or pricing rating. A multinational corporation (MNC) with significant business in China can expect to be subject to >25 different ratings, many of them already implemented. Next, the government defined the requirements that are used to compute the different ratings for each company. For each rating there is a set of corresponding requirements to determine the rating score. A MNC will be rated along approximately 300 different requirements.

Almost all of these requirements are already clearly formulated and explicitly published in regulatory and legal texts or in industry standards. The perception of many companies

that what is expected from them remains opaque is, to some degree, a misperception: the requirements are clear, explicit and public. The lack of transparency has a different reason: details on the ratings and the requirements are spread over a vast amount of regulatory and legal documents. Consolidating this information into a company-specific picture requires a high level of experience and specialized expertise.

Second, collecting and processing company data. Algorithm-based regulatory requirements are only as powerful as the data used to compute them. Therefore, the Chinese government has undertaken major efforts over the past years to improve its capability to collect, consolidate and process data on the activities of companies. Financial data, statistical data, technological data, employee data and others have been routinely transferred to government authorities in the past. But a clear expansion occurred in recent years: virtually all companies with business activities in China agree that the amount, frequency and level of detail of the required data transfers to government entities has increased significantly. This includes the expanding use of new technological abilities that allow for real-time monitoring of data, for example for electric vehicles or emissions from production sites.

Initial data collection remains decentralized with a broad spectrum of government entities at national and local level receiving different data packages from companies. But the subsequent consolidation of collected data at the national level is progressing fast. The National Credit Information Sharing Platform, operational since 2015, has grown into the centerpiece of the government's ambitious data collection efforts. Equally ambitious are the government's efforts to process the vast amounts of collected data and compute ratings with help of big data technology. More than 100 state-owned as well as commercial rating agencies calculate different ratings based on the company data collected.

Third, implementing sanctions and rewards. Most of sanctions for negative rating results and the rewards for exemplary behaviour have already been defined and published. The basis is, in most cases, a Memorandum of Understanding between a large group of government ministries. 51 of these MoUs have been signed in recent years. The sanctions and rewards defined in the MoUs are then legally substantiated through regulatory decisions, laws or industry standards. Sanctions are far-reaching and severe: unfavorable conditions for financing, exclusion from public procurement, non-issuance of government permits or licenses, to name but a few. Rewards for high ratings are also substantive, from tax breaks and access to subsidies to fewer government inspections and expedited administrative procedures.

What is different?

While the definition of principles and mechanisms is already far advanced, the implementation on-the-ground is currently still unfolding. Many of the sanctioning and rewards mechanisms are not fully applied yet and therefore still largely invisible to companies. This picture is already changing rapidly as implementation is gaining speed. Companies need to expect increasing impact from regulatory ratings as more and more become active.

Regulatory ratings are built on the existing regulatory system. Only parts of the rating requirements are new, many are existing regulatory requirements that are now integrated into the ratings. Nevertheless, regulatory ratings bring profound changes to the regulatory reality companies in China are facing:

- The binary nature of regulatory stipulations with a clear dividing line between legal and illegal behaviour is complemented or replaced by a continuous scale between “good” and “bad” behaviour. This changes the strategic thinking on regulatory compliance: Determining where a company wants to be on the scale requires a complex multi-factor decision-making process.
- Implementation and enforcement are significantly enhanced through digitization of data processing combined with automatic triggers for sanctions and rewards. Ultimately, compliance violations will be detected much faster and more completely than before. Consequences will take effect more immediately.
- Automation of regulation decreases the leeway for informal solutions and exemptions. The ratings leave less room for case-by-case consideration of the context and reasons behind compliance violations. Consequences thus become more predictable, but also more rigorous.
- Envisioned sanctions for unfavorable ratings are severe. Even small infractions, like late or incomplete transfers of data, can lead to draconic punishments. The stated goal behind the regulatory ratings is to limit, and in severe cases block, market participation of low-rated companies. Consequences of compliance violations will hurt operations in China more directly than before.
- Regulatory ratings, in their basic conception, limit discriminatory application of regulation. They apply equally to all companies active in China (Chinese-owned, joint venture or wholly foreign owned). It might prove to introduce a tougher, but also more level playing field for international companies in China. Ratings will not make it easier for MNCs in China, but possibly fairer.

What needs to be done?

For companies with business activities in China, there is still time to prepare. At this point, it has become quite clear what companies can expect from the Social Credit System, meaning they can get ready in an efficient and effective way. At the same time, implementation is ongoing and rolled-out step-by-step, giving companies a time window for making the necessary adjustments.

To do so effectively, companies need to find out exactly which current and future ratings apply to their business activities and which corresponding requirements they need to fulfill in order to achieve positive rating results. Companies need to check their business activities at the operational level through the lens of these requirements, identify concrete vulnerabilities and devise approaches to mitigate the corresponding risks. Some of the necessary adjustments will be of a technical and limited nature, others will require strategic decisions on company-level processes and structures.

Given the fragmented complexity of the rating stipulations and the level of knowledge needed to understand and navigate the intricacies of the system, most companies will require highly specialized and tailor-made advice to prepare for the emergence of regulatory ratings.

*This article has been written exclusively for stars by Mirjam Meissner, Björn Conrad and Markus Herrmann of Sinolytics. **Sinolytics is a European specialized consultancy entirely focused on China** – based in Berlin and Zurich, Sinolytics provides in-depth research, expert analysis and strategic advice at the nexus of business and policy to international firms, investors and the public sector, enabling well-informed China strategy development and decision-making.*

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