The looming risks of China’s corporate social credit system

Blog post by Senior Associate Jens Presthus, 1 June 2020

China’s corporate social credit system (SCS) is set to be rolled out on a large scale this year. It rates, sanctions and rewards companies operating in China based on a long list of metrics and imposes strict rules that Beijing says aim to root out “untrustworthy” companies. With the social credit system, it could be argued that Beijing is also more strictly enforcing already existing informal rules on the extent to which companies can engage in debates about political issues. It does so by taking a “legalistic” approach that implies foreign companies agreed to comply with China’s rules by virtue of entering its market. Despite promises to treat domestic and foreign firms equally, there are fears among the latter that they could get into the crossfire of rising Chinese-western tensions.

Beijing describes the system in official documents as a tool to improve corporate governance and the environment. For instance, it will measure how firms comply with CO_2 emissions limits and workplace safety regulations, and to what extent they pay their taxes and debts on time. In Jiangsu province, one of China’s main commercial centres, the local government monitors emissions in real time and uses the data to continuously evaluate environmental performance of companies. Companies – or their employees or contractors – that fail to comply or report on time, could face exclusion from public tenders, see business expansion and market entry requests rejected, or find it more difficult to access credit. Unreliable entities are also almost guaranteed to face more inspections by the General Administration of Customs.

But there may be an even more challenging aspect of the credit system. From reading between the lines, foreign companies fear that the SCS could also be used to restrict their leadership and employees from voicing opinions on political and social issues. If so, it may be that only corporates who gain the trust of the central and local government are likely to thrive in the Chinese market. The central government is key because it can be expected to intervene on major decisions. But local dynamics should not be ignored. The provinces are essential, because they not only report to Beijing, but are also tasked with enforcing the system at the local level. Potential differences in implementation provide a significant source of uncertainty.

Some companies have already been warned for failing to comply with China’s Taiwan policy. Beijing has told several international airlines, including Air Canada, Delta and American Airlines, they may face lower ratings, frozen bank accounts and restrictions on movement for local employees if they do not list Taiwan, Macau and Hong Kong as part of China on their websites. And while minor fines and forced apologies have been preferred ways of sanctioning corporates in the past, by pushing out executives over non-compliant behaviour related to the Hong Kong protest movement, the Chinese leadership has hinted it may willing to pursue a stricter approach. Hong Kong and Taiwan will remain issues where it likely will not show any leniency, even for otherwise trustworthy companies that are seen as valuable to the Chinese economy. Recent troubles for large multinationals like Cathay Pacific and HSBC are reminders of this. But otherwise, it can often be difficult to assess where the red line is. The lack of clearly defined formal rules will create even more uncertainty and raise compliance issues for foreign firms.

Consequently, the most significant risks for corporates may not come from rules linked to a long list of technical activities, but rather from the uncertainty about Beijing’s approach to sanctioning companies and their employees for taking an undesired stance on political and social issues. And while it is much harder to create and implement an effective compliance framework for views on the One China principle and civil rights issues, they may in the end be the ones that will decide if a company is reliable or not. Equally important, they pose difficult political and ethical questions for western corporates that will have to weigh the benefits of market access against the costs of potentially ignoring their home governments, which might have their own red lines. The politicisation of business ultimately risks the close economic links between the West and China.