China Insight

Corporate Social Credit System in China
Top 5 Implications for the Risk Management

Dear Sir or Madam,

China's new Corporate Social Credit System ("CSCS") has a significant regulatory and business impact on companies operating in China. Please find below the top 5 implications for the risk management in the new world of CSCS.

Kind regards,
CMS, China

1. Strategic Risk Management

Compliance and risk management will become more important in China given to the positive and negative effects under the mechanism of CSCS. CSCS aims at incentivizing those companies, which are compliant with Chinese laws and to punish those, which are not compliant. The compliance status of the individual company will be evaluated by the Chinese regulator based on ratings. So far this rating mechanism applies to certain, but not yet to all conducts of the company. The rating results provide regulatory and business related positive and negative impacts on the involved company. High CSCS ratings can trigger advantages for the company, such as the accelerated process for approvals from authorities, easier access to get loans from banks and easier access to acquire land-use rights from the Chinese State. Low CSCS ratings can trigger disadvantages on the company, such as the restricted issuance of governmental approvals, increased inspection rates by authorities on the company's operation and the prohibition to participate in procurement projects by the Chinese State. In addition, companies may be added under certain requirements on the positive redlist, negative close-watch list or negative blacklist. Therefore, CSCS will likely lead to a new assessment from companies what their appetite for risks is. Companies will likely look closer at those risks, which could trigger blacklistings under CSCS. This will not only avoid blacklisting risks, but also "protect" existing redlistings, given that redlistings could be removed, once blacklistings arise. That means, that strategic risk management becomes likely more important for making businesses risk-proof in the new world of CSCS. Companies, which have already mitigated those risks, which could lead to blacklisting risks under CSCS, will have a competitive advantage towards those companies, which are still operating in the grey area.

2. Managing Blacklisted Suppliers

Suppliers, which got blacklisted under CSCS, will trigger significant challenges. Key question is whether business with blacklisted suppliers may be kept ongoing or must be terminated, and which legal and rating related risks could arise in conjunction with blacklisted suppliers. Companies need to assess whether business with blacklisted suppliers must be aborted. Important parameter will include the applicable laws and regulations, the agreements of the involved companies and the company rules (including the Code of Conduct). Legal risks, which could arise from customers in conjunction with blacklisted suppliers, must be assessed too. If no caveats exist from the legal perspective to involve blacklisted suppliers in the individual case, reputational criteria will become more important. Irrespective of the legal and reputational challenges in conjunction with blacklisted suppliers, CSCS-blacklisted suppliers could increase significantly the disruption risks in the supply chain. The reasons may be found in the mechanism of CSCS. Suppliers, which got blacklisted at CSCS will face the risk to get the required approvals for their businesses only with restrictions, and that they could be excluded from procurement projects of the Chinese State. Restricted approvals and less business will increase the risk that the involved suppliers and the supply chain will collapse. These scenarios can trigger a significant damage on unprepared companies.

3. Risks and Opportunities in Sales

CSCS will also impact sales in China, which is reflected in the following two scenarios. First: Customers could just reject buying products and ceasing business with the seller, if the seller, or one of its suppliers got blacklisted. This scenario does not need necessarily be driven by legal reasons. Reputational considerations can just trigger the concern to buy from blacklisted companies. This is not a CSCS specific risk, but CSCS has been significantly marketed by global media and reflects a very prominent, maybe the most prominent, blacklisting risk in China. Second: The flipside is that CSCS can help to increase sales opportunities in the Chinese market. Companies, which are selling their products in China through high-rated and redlisted business partners (e.g. distributors), may benefit from the good standing of these business partners, and leverage their business opportunities in China.

4. Corporate Reputation Management

CSCS will also have a significant impact on the company's reputation management. The data of CSCS, including the names of the blacklisted companies, is publicly accessible online just within a few klicks. Information on blacklisted companies could spread like wildfire and damage their corporate reputation. Executives in China need to anticipate these reputational risks, and need to develop solid strategies, in order to anticipate and to be well prepared to manage the reputation crisis. Given to the direct negative impact of blacklistings on the corporate reputation, it is essential to understand the mechanism of the various listings and the removal from blacklistings under CSCS. The removal of blacklisting records during the publicity period will depend on the level of severity of the blacklisting record. For the most serious blacklisting record, which provides a publicity period of 3 years, the removal of the blacklisting record during this 3-year term is not possible, so that strong corporate reputation management will be required in this scenario. Needless to say, it takes time to build up a good corporate reputation, but it can be damaged quickly.

5. Whistleblower Management and Investigations

CSCS could increase the activities of whistleblower, given that the comprehensive database of CSCS will provide whistleblower a new tool in conjunction with their allegations on the business. Another driver could arise from the mechanism of CSCS, given that complaints (if the complaint is regarded as self-reporting information, which has been provided by companies to Chinese authorities as required by laws and regulations) shall be one of the information sources of CSCS. It remains to be seen to which extent the whistleblower activities will increase due to CSCS. If there is a rise of whistleblower allegations, it will lead to more investigation risks - externally by regulators and internally by the affected company. This will also affect the personal risk profile of executives in China. Executives, no matter whether they are running the business in China or abroad, face an increasing level of personal liability risks in conjunction with disclosure, investigation and risk prevention obligations. Businesses need to be aware of the regulatory do's and don'ts in conjunction with the management of whistleblower allegations, external investigations by regulators and internal investigations.

CSCS has changed the risk landscape for companies doing business in China. Executives need to develop risk management strategies, in order to make their business risk-proof and to achieve the regulatory and business benefits under CSCS.

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