COAC Bond Subcommittee
Bond Reduction Proposal
Surety Review

At the request of CBP, the CSEC convened on November 6, 2008 to discuss the current proposal to reduce the import bond amount for participants in the Importer Self Assessment program. This memorandum summarizes the collective thoughts expressed at that meeting by the various companies which are members of CSEC, as well as several which are members of the COAC Bond Subcommittee.

CSEC is the Customs/Surety Executive Committee that was formed in 2001 to facilitate the business relationship between CBP and participating Surety Associations. Membership of this committee is limited to valid surety associations representing Treasury Circular 570, approved sureties that underwrite Customs bonds. The CSEC charter was signed on July 24, 2001.

COAC Proposal

The COAC was presented with the task of reviewing a recommendation to reduce the import bond amount calculation for importers that participated in the Importer Self Assessment program. The members of CSEC reviewed this recommendation as one affecting only members of the ISA program (170 to 200 importers), and did not evaluate or comment on the subsequently expressed opinion in the COAC Bond Subcommittee that the recommendation might be applied to C-TPAT members as well (e.g., potentially another 8,000 importers of record). Obviously, the broader proposal has greater implications for the ability of surety companies to meet their fiscal responsibilities at the current rates for writing bonds.

The recommendation to reduce bonds was a result of the Assistant Commissioner for International Trade, Dan Baldwin, questioning why companies that are low risk should be treated the same as all other importers and reacting to a series of Trade recommendations over the years for enhanced benefits for compliant and secure importers, which typically included bond formula reduction as one of the several recommendations. In addition, comments attributed to the Assistant Commissioner indicated that CBP had evidence that bonds are expensive to the corporate bottom line.

The Crowe Report

The current bond formula applied by CBP has been reviewed by an independent consultant and found to be fair to all importers and appropriate to protect the federal revenue and legal obligations secured by customs surety bonds. In 2006, CBP hired Crowe Chizek & Co. to analyze the continuous bond formula. The review resulted in the report entitled *U.S. Customs and Border Protection: Bond Sufficiency Study* dated May 25, 2006 (the "Crowe Report").

The referenced report states, *"For CBP, the bond formulas' basis of 10% of the prior year's duties, taxes and fees, or 100% of the anti-dumping duty applies to all importers. As long as they are* applied *consistently and on an equal basis, the bond formulas are fair and non-*

discriminatory, even though the resulting bond amounts may vary." (Section 2.2.3: Comparison of Customs Bond Use to Other Environment, page 7)

The above statement indicates that the current bond formula is fair for all importers. If CBP were to allow some importers to use a lower formula, the system would become discriminatory. The concept of allowing some importers to use a lower formula is considered "adverse selection" and sureties generally tighten underwriting requirements under these circumstances. This would create a problem for some importers as bonds would not be as freely available. If there is adverse selection, premiums will likely increase.

The report concludes, *"Through our review procedures, we found no qualitative correlation between importers' participation in any of the Importer Participation Program initiatives and importer payment performance with respect to CBP's collection of duties, taxes and fees. The purposes of the two programs are distinct and any overlap or shared benefits appear to be coincidental, not cause-and-effect in nature. Therefore, we observed no reason that program participation should affect an importer's bond requirement."* (Section 8: Conclusion, page 36)

The conclusion clearly states that there is no correlation between an importers' good standing in a partnership program and its ability to pay duty and other charges to CBP.

Reduction in Bonds v Premium

A reduction in the bond penalty amount does not necessarily result in a proportionate reduction in the premium. First, 92% of all continuous import bonds are the minimum required amount ($50,000). There is no indication that the minimum bond amount would change. A reduction in the amount of a bond may affect only 8% of the continuous import bonds on file with CBP.

Second, surety companies charge a minimum premium. It is unlikely this would change.

Third, many of the large importers (and conceivably a very large percentage of ISA importers), already receive substantial discounts on their customs bonds as a result of placing that business through the same agent or insurance company which handles the full range of insurance needs of the company. Logic suggests that the further discounting of those rates is highly unlikely to match the percentage in reduction of the bond amount.

Minimal Savings to Importers would Result in Major Increases in Government Exposure

Under this proposal, CBP will be giving up a lot so importers can save a little. A basic insurance quote is "Never risk a lot to save a little." A small reduction to importer premium corresponds to an enormous increase in CBP exposure. For example, a current $2 million bond may cost $10,000[1]. At a 50% reduced bond, the importer may save $5,000, however CBP exposure increases by $1 million. The bottom line is that the government's additional exposure to loss of revenue is disproportionate to the amount of premium saved by the importer.

[1] The assumed premium in this scenario is $5 per $1,000 of exposure ($2,000,000/1,000 = $2,000; $2,000 X $5 = $10,000)

Bond Costs in Relation to Value and Duty

We estimate that annual customs continuous bond premium to be $50 million. Public comments by CBP suggest that about 95% of imports are secured by continuous bonds. Total duties calculated for 2007 were $26.1 billion. The estimated duties secured by continuous bonds were about $24.8 billion[2]. Using the premium estimates above, total annual continuous bond premiums equal two tenths of one percent of estimated duties.

Previous comments made by members of COAC suggested that bond premium is calculated at $5 per $1,000 of bond penalty amount. An analysis attached (Exhibit A[3]) indicates that based on this premium amount, the cost of a continuous import bond is five hundredths of one percent (0.005%) of the annual duty paid. Furthermore, the premium amount is less than one-thousandth of one percent (0.00075%) of the total entered value of merchandise. Clearly, bond premium is a very small amount in relation to the duty paid and value of imported merchandise.

"Under-Bonding" is Primary Reason for Uncollected Revenue

Recently, the "black eyes" inflicted upon CBP by Congress, GAO, and others have been a result of "under-bonding". Unpaid anti-dumping duty is the biggest current source of uncollected duties, due to CBP's failure to require adequate bonding.

An emerging new category of insufficiently bonded exposure arises from recently modernized procedures, such as, periodic monthly statement ("PMS") which allows an importer to pay duty monthly as opposed to ten days after entry. Aside from anti-dumping duties, unpaid estimated duties are the highest loss category for surety companies and the Revenue Division has made recent statements indicating the duties due on a monthly statement have become an increased concern. The formula used by CBP (10% of the duty paid in the prior twelve months), is often smaller than the amount of unpaid duty accrued during the 45-day period prior to the importer making a monthly payment. It is more deficient when measured against the additional unpaid duties which accrue after the 45-day payment period and prior to any action taken by CBP to put an importer on a "cash-basis" (i.e., another month or more).

Other Elements of CBP Exposure

No consideration of a possible reduction of the bond formula should ignore the fact that the current formula generally provides importers with the benefit of a very small bond expense while leaving the government dramatically under-secured for many important obligations. For example, there are additional risks associated with a bond that are not addressed in the current bond calculation formula:

- Periodic Monthly Statement: The basic bond formula should be changed to 20-25% for importers using monthly statement due to accumulation of estimated duties and delays in assessing a non-payment claim. This exposure is in reality more than 36.5 days on importers with larger bonds that more precisely approximate 10% of annual duties.

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[2] $26.1 billion in annual duty X 95% = $24.8 billion
[3] The analysis is based on importers that pay $500,000 and more in annual duties.

Under monthly statement, duty is not due until the 15th business day of the month following entry activity. Allowing for weekends and holidays, this is at least 46 days and up to 54 days from the earliest entry date. We know that CBP doesn't issue a claim until 30 to 60 days after the discovery of a non-payment. So, for up to 90 days, an importer may not be paying duty (if they missed one payment, what indication do we have that they are making the subsequent payments). The current bond calculation allows an importer to have a smaller bond for the actual exposure CBP has if an importer is paying duty via periodic monthly statement.

- Liquidated Damages: CBP uses liquidated damages as its primary compliance enforcement mechanism. The 10% formula ignores liquidated damage issues. Redelivery is an enormous exposure not addressed by the bond formulae. For example, at least one-third of US imports are regulated by the FDA and each FDA-regulated entry is subject to possible liquidated damages set at three times the value of the shipment, CBP is likely to be under secured for any one FDA-regulated entry in a twelve month period (i.e., a single entry valued at $20,000 would exhaust a $50,000 bond and will over 90% of importers post only a minimum $50,000 bond). CBP should not "give back" something they've never required.
- 10+2 / Importer Security Filing: It is not yet known what the ISF bond exposures/loss experience will be or whether bond amounts are to be adjusted to address ISF exposures. If the final rule includes the new liquidated damages provision set forth in the NPRM, bond liability is expanded into an entirely new area and an entirely new class of claim will be competing with revenues for bond proceeds.
- Preference Programs v Duty-Free Merchandise: Bonds are set at 10% of the duty, taxes and fees paid during the prior twelve months, a formula which drives bonds to a minimum amount for all importers importing duty-free goods. Where goods are absolutely duty-free this formula maybe an appropriate protection of the revenue. Where the goods must be qualified for duty-free treatment under preferential programs, the formula ignores the fact that preferential claims have historically been a fertile area for increased duty assessments under standard liquidation, audit and enforcement programs. The formula completely ignores the exposure taken on by CBP under these programs.
- Inflation: The $50,000 minimum import bond was set in April of 1991. The consumer price index at that time was 135.2. The current CBP is 218.8. If the bond amount kept pace with inflation, the current minimum import bond amount should be $80,000. Also, the Crowe report indicates *"Amount the $50,000 bonds (the minimum size permitted), the average bond usage was 153%, indicating that the correct bond size is $80,000…."* (Section 9.2., Appendix A2, page 38).

<u>Current Economy and Financial Issues</u>

In this time when the most prominent, well-respected companies with long-term histories of handling all their financial obligations, are seeking government bail-outs and raising concerns about credit availability while the economy continues to decline in the face of dramatic new challenges, how can the government reduce the security (the import bond) it has to protect the revenue of the United States? This subject underscores the disconnect between compliance/security issues, fiscal soundness of a given principal, and CBP's responsibility to protect the revenue. Companies like Bear Stearns, Merrill Lynch, AIG, Lehman Brothers, Fannie Mae, Freddie Mac and others were highly respected members of the financial community. Their knowledge and operations were sophisticated and were extremely well capitalized. In the end, none of these things kept them from falling into dire financial straits due to unforeseen financial and economic events. There was no indication that Enron was in severe trouble until the day of their insolvency.

Financial analysis is not foolproof. The fundamental purpose of the bond is to mitigate CBP's exposure to credit risk. The idea of CBP conducting its own financial review of principals and accepting a reduced bond amount on the basis of perceived financial strength is contrary to that purpose. This subject is also consistent with the findings of the Crowe report, "*But more important to our conclusion that CBP should not attempt its own financial analysis is the fact that it would be largely redundant to the value provided by the surety bonds.*" (Section 2.2.2.2., page 5 and elsewhere).

Viable Alternative Incentives

Partial or even full reduction of bond requirements is such a minimal financial benefit to importers that it clearly would not provide any meaningful incentive to importers to incur the obligations and financial commitments inherent in the ISA program (or in the C-TPAT or other CBP compliance or security programs). However, there are other, far more substantive benefits[4] that could be extended to ISA partners:

1. Further reduction of audit frequency.
2. Further reduction in intensive exam frequency. The elimination of just one or two intensive exams per year could provide savings in excess of those accruing from a bond reduction.
3. Additional mitigation on liquidated damages and penalties.
4. Prior disclosure benefits where no actual prior disclosure has been made.
5. Dollar-for-dollar credits for future liquidated damages and penalties. A "get of jail free" card, modeled after the successful Carrier and Super-Carrier Agreement programs.
6. Reduce the frequency of bond sufficiency reviews from monthly to semi-annual or annual reviews.

Conclusion

The few supporters of the proposal to reduce bonds advocate that "compliant importers" are inherently better credit risks and that CBP would not suffer additional monetary losses as a result of bond amount concessions. We agree with the Crowe report that there is no basis in logic or fact for this assumption. However, assuming *arguendo* that it is true, it would follow that the bond reductions for "compliant importers" would not result in a corresponding reduction in surety losses on customs bonds overall. Since these importers would presume to pay less for their bonds, a premium rate increase for all other principals would appear to be inevitable. If the losses remain the same or increase due to global economic issues, the surety company would have to institute a premium increase in order to offset the premium reduction afforded to

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[4] Benefits 1-5 proposed by Lee Sandler, benefit 6 by Aaron Gothelf (both members of the COAC Bond Subcommittee)

“compliant importers”. This arrangement would not be viewed favorably by importers whose overhead would rise even a small amount. This causes adverse selection, which we indicated would cause a surety to tighten underwriting requirements, or possibly cause some sureties to pull out of this market.