Financial Implications of Importer Security Filings

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In January 2008, US Customs and Border Protection (CBP) published a Notice of Proposed Rule Making (NPRM)[1] that will increase the information currently required for shipments bound for the US. Since 9/11, CBP has required the ocean carrier to report 24 hours prior to loading cargo in the foreign port. This report is required under what has become known as the "24-hour rule" and includes basic information such as shipper, consignee, port of discharge, and commodity. The NPRM calls for an Importer Security Filing (ISF) that will require even more information: 10 data elements from the importer and 2 from the carrier (hence, it is also referred to as "10+2"). If the ISF becomes a requirement as promulgated, it will dramatically change the import process. Understandably, there is much controversy over the ISF that has been generally well covered in the comments submitted, and we urge you to review them[2]. Curiously, few comments addressed the potentially disastrous financial implications of the ISF, which we are covering here.

As proposed, the ISF will initially only apply to ocean shipments – air, truck and rail shipments will be added over time. CBP believes this will improve our homeland security, but at what cost to the importing community? In addition to the massive data transfer from importers to CBP, there is the issue of penalties for failure to file or late filing of the ISF. Since vessels may inadvertently load cargo without knowing if the ISF has been filed (carriers will not be penalized for importer errors), the cost of most penalties rests squarely on the importer. Inaccurate as well as late filings will be penalized if the NPRM goes forward as it is proposed.

As the physical supply chain (companies, brokers, shippers and logistics providers) scrambles to get ready for the ISF data filing, the financial supply chain (company CFOs, lenders, and sureties) should also be considering the potential financial impact. This is not just the one or two days of incremental inventory carrying cost that CBP noted in the NPRM. The bond requirements to support this ruling could have a serious negative impact on the capability of financial markets to support importer surety bond requirements.

This negative impact starts with the wording of this section of the proposed ruling:

> "**VI. Amendments to Bond Conditions** In order to provide a clear enforcement mechanism…the proposed regulations would add a new condition to those provisions in 19 CFR 113.62 required to be included in a basic importation and entry bond."

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[1] Federal Register/Vol. 73, No. 1/Wednesday, January 2, 2008/Proposed Rules

[2] One of the best and most thorough is the comments of Alan Klestadt on behalf of the National Customs Brokers and Freight Forwarders Association of America. Go to

http://www.ncbfaa.org/files/FileDownloads/ISFComments.pdf

This means that the import bond that covers the ISF will have the added liability of a timely and accurate ISF filing, otherwise a penalty can result in the form of liquidated damages equal to 100% of the value of the shipment. CBP has made it clear that this penalty will be levied against the importer's bond:

> "CBP is proposing to amend 19 CFR 113.62 to include a condition whereby the principal agrees to comply with the proposed Importer Security Filing requirements. If the principal fails to comply with the proposed ISF requirements, the principal and the surety (jointly and severally) would pay liquidated damages equal to the value of the merchandise involved in the default." [3]

Here are four questions importers, sureties, and lenders should be thinking about when trying to figure out the impact on their surety bond requirements:

1. What bond value will CBP require? Currently, a continuous import bond is calculated as 10% of the anticipated duties and taxes that will be incurred over a one year period based on the previous year's imports (or the minimum plus ½% of the total value of shipments where little or no duties are paid)[4]. Higher amounts are required for special product groups, but as more and more items come into the country duty free, the financial cost to importers has not risen significantly. If the import bond will soon cover 100% of liquidated damages under an ISF, how will the amount of the bond be determined – the full shipment value or some percentage thereof?

2. If the ISF is included under the import bond, how long will the bond have to be outstanding? Most sureties assume that they are taking risk on no more than 1-2 years of duties and taxes based on the entry liquidation process (generally 314 days from date of entry)[5]. Since we do not know if CBP is thinking of this as part of an entry filing or a separate risk with its own liquidation timetable, it is hard to determine the impact.

3. If the ISF bond value has to be 100% of the shipment value, will the sureties be able to cover it? Again this depends on the time the ISF portion of the bond is outstanding and its value. Many sureties are part of larger insurance and reinsurance underwriters, but there is a limit to their capability which is already being strained by turmoil in the global financial markets. Capital needed to underwrite this new risk may add to the strain. Further, sureties also have capital adequacy requirements to qualify with CBP that can be effected.

4. Will sureties ask the importer to secure part of this incremental risk? Occasionally importers are asked to secure their surety bonds with cash or letters of credit from their bank if the risk or value of the bond will be greater than the value the surety can reasonably underwrite. Either of these could be a strain on the importer's capital structure. The importer may not have enough

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[3] USCBP-2007-0077: It should be noted that "principal" has not yet been defined in this proposal; however for purposes of this paper, it is assumed to be the Importer of Record/US Principal Party in Interest rather than an agent of the IPR/USPPI.

[4] CBP "Monetary Guidelines for Setting Bond Amounts": Directive #099-3510-004 dated July 23, 1991

[5] Administrative Message 97-0531 for "no change liquidations" dated May 29, 1997

availability under a line of credit or cash on hand that can be placed in a blocked account to cover issuance of the required LC. A letter of credit is just like drawing down a loan or line of credit. The lender considers it a loan and charges for the risk and line utilization accordingly.

This problem could affect businesses large or small due to their total exposure in the "global" credit insurance markets. Because many of the sureties are part of these larger insurance companies, they might have overall client risk limits making it difficult to underwrite incremental corporate risk on any given importer. Insurance companies underwrite trade risk in many different forms including trade credit insurance on receivables and payables. If they are already taking substantial trade credit insurance risk on importers as buyers, additional ISF risk coverage could be both costly and difficult to obtain.

To put this in tangible terms, here is an example of a small business importer. The company imports roughly $1 million of product per month ($12 million per annum). They pay limited duties and taxes so their continuous bond requirement is roughly $60,000 or ½% of total annual shipments of $12 million[6].

By comparison, what will the ISF bond requirement be – 100% of $12 million? Even if the ISF bond is only 10% of the shipment value, the continuous bond would still have to increase by $1.2 million to cover the ISF versus the current $60,000. If the time period of the ISF is less than one year (the statutory period for entry liquidation), perhaps this could be reduced even further. However at this point in time, there is no way of knowing what CBP is thinking.

With this new requirement, the surety has to take a different look at the credit risk it is taking on the importer. Prior to ISF, the surety's credit risk assessment was on $60,000. Now the risk is 20 times the original value at $1.2 million+. The surety may need to get credit approval from its underwriters or reinsurers. If the underwriter (this is the equivalent of a bank credit officer) decides that it can only take 50% of this new ISF risk, they must ask the importer to put up cash or a stand-by letter of credit (LC) to cover the shortfall – in our example $600,000. If the importer does not have the cash, the importer's bank will be the next stop in an effort to meet this requirement.

The bank is going to look at what collateral the company has to cover this stand-by LC. The bank may also ask for cash to collateralize the LC. Chances are the importer does not have the ready cash and may not even have receivables, inventory or fixed assets to pledge for this new bond value. They probably already have most of their assets pledged to run the business.

In addition to this liquidity crunch, the importer has to deal with the incremental costs of the higher surety bond fees, the bank LC fees and perhaps even the loss of use of cash that has to be devoted to this new bond requirement. There is no way to tell what the cost could be in terms of lender and surety fees, but it will be one more cost that the importer now has to pass on to the American consumer.

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[6] CBP Monetary Guidelines for Setting Bond Amounts, #099-3510-004 dated July 23, 1991

One of the unintended consequences of this bond could be more companies cutting back on ocean vessel imports or routing imports through Mexico and Canada until this proposed ruling is applied to land border entries. An 8-12 month delay in enforcing these regulations plus a shift to Canada and Mexico could give the importer as well as these countries and their producers an opportunity to cash in on an untested import requirement and regulatory change. Producing in a NAFTA country may again become attractive.

The reality is that solving one problem – homeland security – can lead to unintended consequences such as increased financial burdens. The timing could not be worse for the economy. Adding this new financial cost to the physical supply chain costs of ISF will no doubt squeeze profit margins even further, thus risking the financial wellbeing of many companies. We can only hope CBP will establish reasonable bonding requirements for the ISF.

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