



Enforcing America's Trade Laws in the Face of Customs Fraud and Duty Evasion

U.S. Senate Finance Committee

Subcommittee on International Trade, Customs, and Global Competitiveness

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The National Council of Textile Organizations (NCTO) is pleased to offer this testimony regarding the Finance Committee's hearing on "Enforcing America's Trade Laws in the Face of Customs Fraud and Duty Evasion." The issue is timely for a number of reasons. The country continues to struggle economically and customs fraud has become a significant factor in the loss of U.S. textile and other manufacturing jobs in the United States. Customs fraud is also having a significant impact on the level of revenue directed to the U.S. Treasury. We estimate that more than one billion dollars annually is lost, as result of the illegal activity of textile and apparel imports by foreign exporters¹. At a time of increasing deficits and growing unemployment, the U.S. Congress must ensure that Customs and Border Protection address the massive amount of fraudulent activity occurring at our ports and borders.

Customs enforcement is a key priority for NCTO and the U.S. textile industry as trade agreements (and our preference programs) are the textile industry's lifeblood. The majority of products and components that our members produce are exported to the CAFTA/NAFTA/ANDEAN region for assembly and then imported back into the United States duty free. Each of these agreements requires that goods, from the yarn stage to the final garment stage (also called the "yarn forward" rule), be sourced from the region which has helped build a large textile and apparel sector in the Western Hemisphere that covers ten countries, employs nearly two million workers and produces two-way trade in excess of \$25 billion dollars annually.

Because duties on textiles and apparel are relatively high, this trade is vulnerable to abuse. And with minimal chance of getting caught the incentive to cheat is high and the payoff is extremely lucrative. Unscrupulous importers can cut 15 percent or more off the cost of a garment by funneling illegal yarns, fabrics or garments through our FTA and preference regions and claiming those goods to be of U.S. (or regional) origin. Textiles and apparel imports account for 46 percent of all Customs duties collected, nearly \$12 billion a year, so the stakes are enormous and the free trade areas have become a magnet for fraudulent activity.

The mechanisms that illegal exporters use to commit textile fraud are exactly the same as the ones that are used to evade countervailing duty and dumping orders. Goods are illegally transshipped, undervalued or mis-labeled. Phony importing companies are created that pay minimal bonds and disappear once fraud is alleged. Penalties are seen as a 'slap on the wrist' as they are often minimal and very rarely fully collected.

Much of the background on textile fraud is troubling; however, the industry was encouraged by the strong commitment that Customs and Border Protection Commissioner Alan Bersin made to NCTO's membership in April 2011. Bersin admitted that Customs has not paid adequate attention to the costs of textile fraud in the past and assured the industry that Customs would again make textile fraud a top priority. The Commissioner highlighted new efforts the agency has initiated which targets textile fraud out of Mexico, including joint operations with Mexican Customs. NCTO is also encouraged by the appointment of Mr. Al Gina as the new Assistant Commissioner of International Trade at Customs.

Despite the renewed focus, Customs itself is hindered by a bureaucratic mentality and a culture that puts revenue collection and fraud prevention near the bottom of its priority list. Congress must play a key role in refocusing Customs to ensure revenue is collected (and given to the U.S. Treasury) and illegal fraud does not cost us additional manufacturing jobs. Customs commercial enforcement efforts have been underfunded and poorly resourced and we need Congress to send a strong message to Customs that commercial enforcement is a

¹ CVD and dumping experts testified that \$900 million in CVD and dumping duties remain uncollected and that transshipment schemes are now rife for goods under CVD and dumping orders. In textiles, 40 percent of overseas FTA factories are found to be non-compliant when inspected by U.S. Customs and Chinese undervaluation of apparel products shipped directly to the United States and paying full duty has been shown to be widespread. In the textile arena alone, up to one billion dollars in revenue is lost because of customs fraud.

priority. This can be accomplished through a thorough Customs reauthorization bill that will provide Customs the resources and direction it needs to cut down on widespread fraud. As numerous GAO studies have pointed out, Customs efforts in the fraud area more than pays for itself in terms of increased revenue to the U.S. Treasury.

Increase in Textile Fraud Parallels Reduction in Customs Resources

Since the passage of the Central American-Dominican Republic Free Trade Agreement (CAFTA) in 2005, our industry has grown increasingly concerned with Custom's ability to effectively enforce our trade agreements. Following the passage of CAFTA-DR, agreed to fulfill a legislative mandate to hire (73) new textile and apparel import specialists that had dated back to the passage of the Uruguay Round. These hires were intended to boost Customs resources in preparation for the implementation of CAFTA; however, a majority of the staff hired was posted in ports that have minimal textile and apparel trade. In addition, the Textile Enforcement Office was also downgraded in terms of resources and priority and moved into a 'policy focused' department. This prompted a wave of senior staff with decades of experience to leave the office; many of these positions have never been filled. Currently, the office lacks a Director and is 40 percent understaffed. In almost every reporting area, Customs interdiction efforts have show a significant fall-off during the same period of time.

The downturn of this division has occurred while the industry has experienced a sharp increase of textile fraud coming through the CAFTA/NAFTA region. The government's own textile production verification teams are finding a 40 percent average non-compliance rate at FTA factories they visit. U.S. textile "exports" of certain products to NAFTA/CAFTA countries sometimes run at twice the level of actual U.S. production. Mexican trade statistics show that as much a one-third of denim jeans from Mexico are made from Chinese fabric – yet almost all denim jeans from Mexico come in duty free with a certification saying the fabric is from the region. Last year, Customs completed Operation Mirage which confirmed that Chinese exporters were also using multiple schemes to evade duties for a significant amount of apparel shipped to the United States.

Yarns America Example

Perhaps the most stunning example is the case involving Yarns America. Two years ago, Yarns America was highlighted in a subcommittee hearing in the House as a blatant example of illegal activity. Their website claimed they had yarn spinning plants throughout the Southeast but in reality they occupied a one room office in Brooklyn, New York.

In 2009, Harding Stowe, the CEO of R.L. STOWE MILLS, a 103 year old yarn spinner in North Carolina, testified before Congress on the problem with Yarns America. When he spoke, Mr. Stowe had just finished closing his last yarn plant in the United States and laying off the last of his 300 workers. He had watched his yarn export business be captured by companies that falsely claimed to be supplying U.S. made yarn for apparel made in the CAFTA region. He had identified the companies, identified the Pakistani yarn, sent information repeatedly to Customs and then was forced to stand back and watch his three-generation family business go under.

Unfortunately, due to the inadequacy of Customs trade laws, reduced resources and lack of interest on the part of the Justice Department, Yarns America is still bringing in Pakistani yarn and claiming that it was made in the United States. Earlier this year, an NCTO member company offered to set up a sting operation to bring Yarns America to justice; the Justice Department however turned that company down.

\$1 Billion Revenue Impact on the Treasury

In addition to job losses, there is also a significant loss of revenue to the federal government due to textile and apparel fraud. The U.S. Treasury loses twice, first because duties are not being paid and second penalties for customs violations are going uncollected by Customs. A 2008 GAO report² found that Customs failed to collect half a billion dollars in AD/CVD duties and more recent estimates place that number close to one billion dollars. However, recent reports of extreme undervaluation of textile and apparel products coming from China could dwarf those figures. Through Customs own investigations, most notably “Operation Mirage” in 2010, it has become increasingly clear that a large number of importers are deliberately undervaluing textile and apparel imports from China. We understand that there is a single case involving an importer of women’s apparel in New York where duty evasion could amount to \$50 million or more. Reports of undervalued Chinese goods entering into the Port of Los Angeles through phony front companies that are paid pennies a garment have become all too routine.

Another serious concern that underpins all the illegal trade activity is the possible threat to national security. If it is difficult or impossible to identify the true importer of the goods, how confident can we be in the security of the system and supply chain as a whole. Customs fraud has become a type of shell game where phony companies, phony agents and phony claims all work in an orchestrated manner to cheat the system. The inability of CBP to crack down on these fraud networks reveals a serious hole in our national security network. If a phony resident agent can import undervalued Chinese apparel at little or no risk, that same phony agent could as easily import weapons or other dangerous materials that compromise the health and safety of our citizens.

Lack of Customs Response Prompts Legislation

These developments have prompted textile supporters in Congress to take the unusual step of drafting corrective legislation, which would refocus textile enforcement resources at Customs and help to bring a halt to the widening problem of textile fraud. This legislation, the Textile Enforcement and Security Act (TESA), was introduced in the House and Senate last year and will be introduced again later this year.

With its impact on U.S. jobs, losses to the U.S. Treasury, and national security concerns, the area of commercial enforcement clearly needs new attention and new focus. CBP personnel are dedicated and hardworking and the top ranks of Customs are tasked with multiple and sometime conflicting priorities. As Customs responsibilities have grown to encompass new security issues and an increasing number of trade agreements, the agency’s budget and resources have remained static. In certain areas, such as commercial operations, resources have declined sharply relative to the rapid increase in imports coming onto U.S. shores. Customs has been forced to use a shrinking resource pie to deal with ever increasing problems. This phenomenon is nowhere better reflected than in the textile trade enforcement area.

Changing Face of Textile Trade

Over the past twenty years, the U.S. textile and apparel industry has come to increasingly rely on exports to our trade preference areas. This new pattern of trade – the sending of yarn and fabric components to the

² U.S. GAO Report 08-391, “Antidumping and Countervailing Duties; Congress and Agencies Should Take Additional Steps to Reduce Substantial Shortfalls in Duty Collection” March 2008.

CAFTA/NAFTA/Andean region for return as finished garments to the United States – has created the need for more sophisticated enforcement regimes. These regimes must now seek to ensure that not only the final product, the garment, is made in a trade preference country, but that yarn and fabric components are also produced in the beneficiary countries.

These new requirements – which are so important to the livelihoods of millions of workers both inside the United States and in the trade preference regions themselves – have posed new and unique challenges for Customs. In the past five years, the textile industry – as well as Customs – has discovered that many of the enforcement mechanisms that were originally devised have failed to meet the high standards to which they aspired.

As a result, today, our members report seeing much more illegal activity than they did five or ten years ago. There is a general feeling that fraudulent importers and producers have identified the loopholes in the system and how to utilize them for their benefit. At the same time, it also seems clear that Customs ability to pursue commercial textile fraud has been hampered by declining budgets, other priorities and inadequate tools. As a result, our industry has conducted its own internal investigations into why fraud seems to be increasing and we are now at a point where we believe that there are concrete steps that can be taken by the Congress to help Customs better target its enforcement efforts in the commercial trade arena.

Solutions

Several areas that we focus on in the legislation are the direct result of projects and strategic operations that Customs itself has put into place over the last several years as it has attempted to get a better grip on textile customs enforcement issues. Other issues are the result of broader concerns that the textile industry shares with other industry groups. Still other measures are the result of concerns regarding paperwork burdens and other measures that may unfairly encumber trade. All in all, we have tried to address existing concerns in a manner that would provide Customs with useful and supportive initiatives to better combat commercial fraud and increase trade facilitation. We look forward to reviewing our proposals with the Committee and Customs.

Specifically, as a result of our investigation, we came to the following key findings:

1. Customs verification systems regarding free trade and preference claims are burdensome for importers and yet often provide Customs with little actionable information.
2. Customs can do a better job of matching import specialists assignments to high textile trade ports.
3. Importers that do not reside in the United States and are therefore outside this country's legal authority have become an increasing source of fraudulent activity.
4. Customs needs additional resources and focus to combat undervaluation of goods, particularly from China.
5. Customs does not have sufficient resources to effectively partner with foreign customs services, particularly free trade areas.
6. The Justice Department discourages commercial fraud cases, and this discourages high publicity prosecutions that could send a strong message to bad actors.

Review of Key Findings

1. Customs verification systems regarding free trade and preference claims are burdensome for importers and yet often provide Customs with little actionable information.

One of the major reasons for the increase of fraudulent activity in the free trade and preference areas is that the basic system for detecting fraud has broken down over the weight of the illegal activity being perpetrated. The basic textile customs enforcement system was devised during the NAFTA negotiations and it has proven increasingly unable to cope with the current level of fraud occurring. During NAFTA, the prevalent concern regarding textile customs enforcement was the evasion of quotas in place on Asian producers; fraud in the NAFTA region was relatively small. Today, quotas are no longer in place and the scope of fraudulent activity has shifted to the trade preference areas. As trade preference and free trade areas have expanded, so has the realization that the rewards for bringing in goods illegally labeled as made in an FTA country are enormous.

The original NAFTA model that was predicated on relatively low levels of fraud could sustain a resource intensive response that the NAFTA customs enforcement model required. That model no longer works well in today's global environment. For example, under the current NAFTA model, Customs requires that importers of record verify that they meet the rules of origin for textile and apparel products on a shipment by shipment basis. They do this by claiming a duty preference and they are required to have paper documentation to back their claim up. However, most fraud – and almost all fraud reporting – comes at a stage in the import process that is several steps removed from importation. Typically, fraud occurs when Asian yarn or fabrics are substituted for U.S. yarns or fabrics. This takes place either when the goods are knit or woven or when they are sewn together. Thus when fraud takes place, the importer of record often has no idea that the fraud has occurred – all he or she has required of the apparel manufacturer is that they agree to provide CAFTA or NAFTA qualifying goods.

Unfortunately, a system to track whether the apparel or the fabric manufacturer was actually in compliance with the conditions and requirements of the FTA was not seen as necessary when the current enforcement model was developed in the 1990's. And because there are no systems currently in place to track the supply chain compliance, Customs investigations of fraud are enormously time consuming and resource intensive. For instance, when a U.S. yarn producer discovers that they have lost orders to a phony company, they typically contact Customs with the information. They can usually supply the name of the fabric producer and the name of phony yarn company – typically a knitter in Central America – that has been sold the phony goods (usually at a very cheap price). Customs, however, needs to know the name of the importer of record in order to proceed with a fraud penalty. Under the FTA rules, Customs can only penalize the importer of record – no one else in the supply chain can be penalized or held accountable. However, in 99 percent of all fraud cases, the U.S. textile mill has no idea who is listed as the importer of record at the port of entry.

In order to find the importer of record, Customs must begin a laborious and often futile effort which requires that it contact the knitting mill where the phony yarns were sent. Because the knitting mill is typically outside the country, Customs sends a production verification team to the knitting mill and examines its records. The fabric manufacturers' records show where the yarns came from and where the knit fabric (which may contain the illegal yarns) are sent. Customs must then visit the apparel manufacturer who is also most likely to be outside the country. It must send another production verification to that manufacturer to determine which garments were made of the fabrics sent from the knitting mill. Only after Customs finally determines which garments contain the illegal fabrics then Customs can begin to assign rate advances to the importer of record who, knowingly or not, improperly claimed a trade agreement preference rate.

The system has also become further compromised by the use of "blanket affidavits." These affidavits allow the importer of record to get an affidavit from a yarn or knitting mill that certifies that all products sent to the

importer are FTA qualifying. Importers typically insist on these affidavits because sending paperwork along the production chain on a shipment by shipment basis is cumbersome. However, when Customs investigates a fraud claim through the importer of record, an importer of record typically responds with blanket affidavits from U.S. mills certifying that the products sent to the apparel manufacturer are FTA qualifying.

Customs is hamstrung because it can only penalize importers on a shipment by shipment basis but blanket affidavits are typically used to cover dozens or even hundreds of shipments. There is simply no way that Customs can verify whether the yarns or fabrics that are covered by a blanket affidavit are actually those used in a particular shipment. To make matters worse, blanket affidavits are now being used as “cover” to shelter illegal activity. Today, a knitter in Central America may buy a small amount of U.S. made yarn and repeatedly use the same blanket affidavit to “cover” his or her purchases of Pakistani or Chinese yarns and fabrics.

In the last five years, it has become clear to NCTO and its members that major changes are needed to the free trade area enforcement model if fraud is to be brought under control. Our experience has shown that the current model does not achieve the objectives of facilitating trade while also achieving an effective enforcement mechanism.

One possible change is an electronic tracking system that would allow Customs to get aggregate data by yarn and fabric mills to show how much product is actually being produced for each importer of record. This system would allow Customs to match actual U.S. textile exports to claims of duty preferences for imported goods. The system would be relatively easy to construct and would involve entering in the entry document a two digit code that would identify a particular yarn or fabric plant where the components originated. While this type of system would require importers to more closely track components as they move through the production chain, it would eliminate the need for paper records and would also reduce the number of verifications that Customs now must conduct.

The later point is an important one: to find fraud today, Customs must often cast a wide net, reeling in information from importers from dozens or hundreds of shipments to catch a single fraudulent entry. This is disruptive, expensive and time consuming for importers. And many times large and compliant producers are targeted repeatedly for investigations. With an electronic based tracking system, this type of intrusive investigation would be sharply curtailed.

Another possible change is the creation of an account based system that could verify that certain verification procedures were used at the yarn, fabric and apparel manufacturing stage to ensure that only legal goods were getting duty free entry. Today, Customs has no means to compel producers at any stage in the process to keep good records, to segregate compliant versus non-compliant goods and to conduct proper inventory control. As a result, more often than not, the only record keeping is a blanket affidavit. A comprehensive account-based system that would reward good behavior and good systems and allow Customs to better target bad players that could help reduce the likelihood of fraud. The current Automated Commercial Environment System (ACES) program being implemented, which is both electronic and account based, could serve as a useful tool in this effort if the data could be used for export and import commercial verification and if tracking of textile component parts for claims of duty free preferences in free trade areas were added.

2. Customs can do a better job of matching import specialists assignments to high textile trade ports.

In June 2009, the Small Business Committee’s Subcommittee on Rural Development, Entrepreneurship and Trade held a hearing on textile import enforcement which highlighted many of the concerns NCTO is raising today. As a result of last year’s hearing on textile customs enforcement by the Small Business Committee, NCTO discovered that Customs allocation of import specialists trained in textile and apparel verifications no

longer matched the high risk profile of textile trade today. Import specialists are the front line troops in the effort to combat commercial textile fraud and data clearly show that most commercial fraud is being found in free trade areas.

However, import specialist assignments do not reflect that shift in fraud. Today, import specialists that were trained specifically to do textile and apparel verifications are often assigned to ports that receive very little preference area textile trade. And the largest ports that do textile and apparel trade verifications now turn out to have relatively few trained specialists assigned. For instance, data show that Customs has assigned only 6 percent of all trained import specialists to the ports that handle 44 percent of all textile and apparel trade preference claims.

| Import Specialists Trained to Do Textile and Apparel Preference Verifications Vs. Actual Port Textile and Apparel Claims | | | | |
|---|--|------------------------------|--|--|
| Port | Textile and Apparel Preference Trade (TAPT) | Percent of Total TAPT | Textile and Apparel Trained Specialists | Percent of Total Trained Textile and Apparel Import Specialists |
| Miami – Port Everglades | \$4.0 billion | 23% | 8 | 2% |
| Laredo, TX | \$1.8 billion | 10% | 7 | 2% |
| Gulf Port/El Paso | \$1.9 billion | 11% | 5 | 2% |
| TOP TAPT PORTS | \$7.7 billion | 44% | 20 | 6% |

Source: US Customs Service. Data is for the top 25 ports processing textile and apparel preference claims. There are 329 import specialists trained to do textile and apparel verification claims.

Looking at specific ports, we discovered that there were only eight textile and apparel specialists dedicated to the top two –Miami and Fort Everglades- textile and apparel ports (by value) to handle import verifications. These two ports alone import more than \$4 billion worth of textile and apparel trade preference claims annually. And yet, the Champlain, NY port which handles only \$501 million in preference claims has 11 textile and apparel import specialists. These types of disparities are troublesome and we believe the Customs needs to move more quickly to redirect its resources towards high risk areas of textile enforcement. (It is important to note that these specialists, while trained in textile and apparels, also handle other import verifications.)

The problem with staffing reaches higher up in the organization as well. Since the Textiles Office was transferred into the Office of Trade, staffing has fallen dramatically and many senior staff with decades of experience have left the office either through retirement, transferring back to Operations or have transitioned into the private sector. As a result, the office is severely under staffed and the impact is having a direct impact

on its enforcement activities. Commercial fraud figures show that Customs is interdicting less illegal textile and apparel goods than before and penalties have fallen by 50 percent since the office was moved, despite the increase of fraudulent activity. Customs needs additional resources so that it can return the textile enforcement office to optimal staff levels.

3. Importers that do not reside in the United States and are therefore outside this country's legal authority have become an increasing source of fraudulent activity.

Non-residents are required to designate a resident agent in the state for which the port of entry is located. However, the resident agent is not held accountable should the imports be undervalued, or if the nonresident importer is unable to be located to collect duties or penalties. We are concerned that issues regarding this program which are already being raised in conjunction with food safety, toys, and products under dumping and countervailing duty orders are now spreading to the textile and apparel area. It appears that fraudulent actors are increasingly aware of how to game the system. This is done by setting up a resident agent as the "fall guy" for the non-resident importer who remains safely offshore and out of Custom's reach. However there is no real "fall" in terms of the money lost to the U.S. Treasury because the resident agent is not held accountable for penalties. Thus, even when fraud is discovered, there is no way for Customs to successfully punish the offender. This is a complex issue which we know that Customs is grappling with and we urge the Committee to work with Customs to find answers to address this issue.

4. Customs needs additional resources and focus to combat undervaluation of goods, particularly from China.

With the removal of quotas and safeguards, as well as the downturn in the economy, we have received numerous reports of undervaluation schemes. These schemes are an effort to pay minimal duties on high tariff value products. While the majority of these occurrences have been focused on avoiding countervailing duty and anti-dumping orders, such as with honey, Customs has been investigating a significant problem with undervalued textile and apparel products coming from China. At present, Customs lacks the dedicated resources to go after this illegal trade in a comprehensive manner. The amount of duty evasion appears to be significant – a single case may total over \$50 million in lost duties – and this means that losses to the U.S. Treasury are steep and could total hundreds of millions of dollars. While it is next to impossible to physically examine every shipment that enters U.S. ports, systems could be set up to target goods that come in at abnormally low prices. Garments that are imported for less than the cost of the raw materials could be flagged for increased scrutiny. The textile industry would be happy to assist in such a project.

5. Customs does not have sufficient resources to effectively partner with foreign customs services, particularly free trade areas.

Customs could do a better job of investigating fraud claims if they were given the resources to partner with their fellow customs services. Improved coordination and sharing of data would shorten the length and scope of investigations, increase Customs ability to track shipments and locate importers of record and would send an important message to fraudulent producers that multiple sets of eyes are watching. While Customs has attempted to do training with FTA partners regarding custom textile enforcement, budget constraints have hampered their ability to do this in a comprehensive and effective manner.

A recent fraud issue regarding denim trousers from Mexico provides a good example. The Mexican textile industry has become increasingly concerned about large imports of Chinese denim going into Mexican maquiladoras. The maquiladoras are established solely for export of final products to the United States but U.S.

import statistics show that almost all goods coming from the maquiladoras are declared to be made of U.S. or Mexican denim fabric. This illegal trade has grown to be enormous with millions of pairs of denim trousers claiming NAFTA origin but which are actually made of Chinese denim fabric.

On top of this problem, conflicting information from U.S. export data and Mexican import data shows that importers are bringing in Chinese denim “in bond” from the port of Los Angeles/Long Beach and then declaring it as U.S. fabric when it is exported across the border. Because there is no shipment to shipment match or sharing of information between U.S. Customs and Mexican Customs on “in bond” goods, it is difficult for either branch to determine when and where fraud is occurring. Developing communication lines between our Customs official and our trading partners will help both sides to identify fraudulent activity and the fraudulent players.

6. The Justice Department discourages commercial fraud cases, and this discourages high publicity prosecutions that could send a strong message to bad actors

Currently, Customs the CBP sends cases to Immigration and Customs Enforcement (ICE) which are then referred to Department of Justice (DOJ). However, very few cases are ever prosecuted. ICE appears to lack the technical capability to thoroughly investigate these textile and apparel matters and the DOJ’s clear lack of interest in prosecuting such cases further discourages investigation of high level cases.

Conclusion

It is vital to our industry, our workers, and the U.S. government that U.S. Customs and Border protection strengthen its commercial enforcement operations particularly with regard to textiles and apparel in order to increase revenue collection and more effectively manage our trade obligations in the Western Hemisphere and beyond.

Effective trade enforcement and facilitation is key to our economic security and to the livelihood of the U.S. textile sector and our workers. As you develop the Customs Reauthorization bill, we encourage you to look at the role of U.S. Customs and Border Protection in enforcing our trade obligations and its current activity in addressing the growing level of fraud occurring at our border.

I would welcome the opportunity to meet with you and your staff to identify areas in which we can be helpful.

Thank you.