



## Legal and Corporate Governance Framework for Islamic Banks in Pakistan

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## Legal and Corporate Governance Framework for Islamic Banks in Pakistan

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### Abstract

As custodians and trustees of public money, Islamic banking institutions (IBIs) must have a good reputation that cannot be achieved without a strong legal and corporate governance (CG) framework. The base for good governance inside financial institutions including IBIs in any jurisdiction is provided by the legal framework of the country, since the respective roles and responsibilities of corporate governance players inside IBIs are derived from the established law. In this study, the general legal and corporate governance framework for the banking sector in Pakistan is discussed. It is found that unfortunately the Islamic banking sector, which has great potential, is functioning without a proper legal cover which is a challenge for good governance as well as transaction implementation of IBIs, especially for the unilateral promises by the counterparties and hence for their soundness in future. Therefore, proper law must be promulgated, wherein all the respective roles and responsibilities of different CG players are declared mandatory, followed by punitive consequences in instances of non-compliance by them. Also, all the transactions should be given legal validation, which should resolve the issue of breaching any of the different contracts by the counterparties, especially their unilateral promises.

**Keywords:** legal, corporate governance framework, Islamic banks, Pakistan

### Introduction

Legal and regulatory framework has been the topic of debate among scholars for several years. This is why after the collapse of some well reputed corporations, such as Enron and WorldCom, the US Congress passed the Sarbanes Oxley Act, 2002 (Junarsin, 2010) to ensure the soundness of the companies. Similarly, in Malaysia, the appropriate legal and corporate governance framework has contributed to the development of Islamic banking industry (Hassan, nd). The risks faced by Islamic banks can be managed with the help of corporate, legal and regulatory framework (Mejia et al, 2014). Critically analyzing the regulatory and

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supervisory framework for Islamic banks, Khan et al (2015) found that conflicting views of Islamic jurists and policy makers have further aggravated the *Shari'ah* based problems of Islamic banking in countries like Pakistan, Malaysia, Bahrain and Saudi Arabia. In view of Chohan (2009), the absence of *Shari'ah* compliant legal framework, weak regulations and problems with corporate governance pose serious questions about the future targets of Islamic banking industry. Such factors lower the pace of penetration of the industry not only at the global level but also at the national level. On the other hand, religious scholars claim that the practices prevalent in Islamic banks are fully in accordance with *Shari'ah* (Ayub, 2007; Usmani, 2008; Usmani, 2015, Iqbal and Mirakhor, 2011; Thiagraja et al., 2014). These scholars attempt to justify the legality of different aspects of such banking being Islamic. However, all the transactions undertaken by Islamic banks have not been declared legal through an Act of Parliament or individually by the courts' precedents. This has not been done so far, while the matter has been left to the directives of the State Bank of Pakistan (SBP) and the rulings of *Shari'ah* scholars of Islamic banks. These bodies, or other like them, have no authority to legislate where the *Shari'ah* is concerned. The position and status of these bodies can only be similar to the position of *muftis*, whose ruling are not binding in nature. People follow them in cases when the ruling concerns their personal matter and the interest of another are not violated. When one seeks funds, then for that purpose, proper legislation is required.

Law has strong relation with financial institutions (FIs) as the very existence of an FI is based on the law. All the respective roles, responsibilities and powers of FIs as well as of their inside players are derived from the established law of the country where these FIs are incorporated. Even the regulators of the FIs cannot exercise their regulatory powers unless provided by law. In fact, being custodians of public money, FIs need to be under strict observation, which cannot be achieved without a proper legal framework.

In Pakistan, Islamic banking is working since 2002 when the Meezan Bank was given license by SBP. Islamic banking is growing with an approximate growth rate of 20% per annum (Minhas, 2013). Islamic banks have captured a substantial part of the overall banking industry<sup>4</sup> of Pakistan. Unfortunately, this important sector, which has great potential for growth, is functioning without a proper legal cover. The lack of a separate enabling Islamic law is a challenge for

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<sup>4</sup> Currently, Islamic banks have total Assets of Rs. 1, 745 Billion and total deposits of Rs. 1, 461 Billion, respectively. The Islamic banks' assets have captured 11.4 percent of the market share of overall banking industry in Pakistan, whereas, the deposits of IBIs hold 13.2 percent of market share of the industry. Similarly, currently five (5) full-fledged and 16 conventional banks having standalone Islamic banking branches, with total of 2,146 branches in 98 cities are working across the country. (See State Bank of Pakistan, Islamic Banking Bulletin, June, 2016, [www.sbp.org.pk/ibd/bulletin/2016/Jun.pdf](http://www.sbp.org.pk/ibd/bulletin/2016/Jun.pdf) (Accessed: 12.10.2016).



good governance of IBIs and hence for their sustainable growth and development in future.

In Pakistan, Islamic banks are established according to the requirements of the Companies Ordinance, 1984 (CO, 1984), the Banking Companies Ordinance, 1962 (BCO, 1962) and the guidelines issued by SBP for the establishment of IBIs. Unfortunately, the former two Acts have been promulgated without taking into account the peculiarities and nature of IBI's transactions, and the BCO, 1962 is an outdated law in itself (Chohan, 2009).

For ensuring *Shari'ah* compliant environment in IBIs, SBP (as regulator) has issued *Shari'ah* Governance Framework (SGF) for them. The SGF assigns the role of *Shari'ah* compliance to different CG players (BODs, management, SB, internal and external auditors/*Shari'ah* auditors) inside IBIs. However, SGF is silent about instances of non-compliance of the players with its provisions. In other words, the provisions of the SGF do not hold the players accountable for their actions which are non-compliant with its provisions.

Therefore, the objectives of this paper are to analyze different provisions of the existing Pakistani legal and CG framework (which is conventional in nature) in order to highlight its impact on different transactions and good governance of IBIs. None of the previous studies, except by Chohan (2009), has discussed the issue in depth, whereas his research work lacks discussion about the impact of the lack of a separate enabling legal framework on the transactions of Islamic banks. Moreover, suggestions for further improvements in the legal and corporate governance framework for IBIs are also given at the end.

## 2. Methodology

The study is qualitative in nature, where content analysis has been made of different provisions of the current Pakistani legal and corporate governance framework. Legal data is obtained from the primary sources of Pakistani statutes namely the CO, 1984 and the BCO, 1962. Other primary data relating to CG and *Shari'ah* governance (SG) including SGF, instructions and guidelines for *Shari'ah* compliance in IBIs has been accessed from the websites of SBP, whereas the Code of CG, 2002 and the revised Code of CG, 2012 have been accessed through the website of the Securities and Exchange Commission of Pakistan (SECP).

### 2.1. Limitations of the Paper

The paper is limited to the qualitative content analysis of the provisions of the CO, 1984, BCO, 1962, the revised Code of CG, 2012, SGF, and the instructions/guidelines for IBIs issued by SBP.



### 3. Literature Review

One of the important characteristics of good governance is the rule of law (Ali, 2015) and companies cannot be an exception to such rule. Hence, good corporate governance lies in adherence to legal rules which are applicable to the companies. Unfortunately, the regulation for Islamic banks in most of the countries is promulgated in the image of conventional banking system, the notable issue of which is the lack of dedicated Islamic banking law for Islamic banks (Zulkhibri and Ghazal, 2012; 2015). In addition to Islamic law, Islamic banks are subject to laws relating to business like contract law and company law of the jurisdictions in which these banks operate. This legal complexity is a challenge for Islamic banks, especially since the development of this sector relies heavily on the existence of a solid legal foundation that supports Islamic banks' functions (Aldohni, 2011). The right legal system promotes economic growth in developing countries (Paredes, nd). Similarly, La Porta, et al (1997) are of the view that in jurisdictions providing strong legal protections to shareholders, firms have a higher access to external finances and better opportunities for growth (Porta et al., 1997). Corporate law plays a significant role in the alignment of interests of shareholders with managers which helps to resolve agency problems (Fanto, 1998). The role of law inside firms is that it prohibits executives from excessive compensations, insiders from placing friends and family members in high ranking positions, managers from self-dealing transactions and theft (Paredes, nd). In view of Shleifer and Vishny (1997), apart from concentrated ownership structure, effective and good corporate governance inside firms can be achieved through a strong legal framework and an active capital market. Gevurtz, nd argued that two questions are important in order to prevent financial crises in future. The questions are: (1) what substantive rules are necessary to prevent another crisis, and, (2) who should impose such rules?

Hilt (2014) studied historical development of American corporate governance and found that whenever American economy faced crises, it sought legal innovations in addition to institutional and market-based solutions to overcome the problems.

In view of Fanto (1998), as a result of increasing emphasis on stock market funding and decreasing emphasis on the monitoring of management by state, the corporate and securities laws of France is bound to play a more critical role in the French corporate governance system than ever before. Right after the collapse of some well reputed corporations, such as Enron and WorldCom, the Congress passed the Sarbanes Oxley Act, 2002 (Junarsin, 2010). For sure, its purpose was to suggest strong legal framework to stop such collapse in future.

Given the risks faced by Islamic banks, they need corporate, legal and regulatory framework to handle these risks (Mejia et al, 2014). Critically



analyzing the regulatory and supervisory framework for Islamic banks, Khan et al, (2015) found that conflicting views of Islamic Jurists and policy-makers have further aggravated the *Shari'ah* problems in countries like Pakistan, Malaysia, Bahrain and Saudi Arabia.

Scholars have discussed the significance of law in the growth and development of Islamic banking and finance, but quite a few such as Chohan (2009) have discussed the effects of the lack of a separate legal framework for IBIs on their good governance. But these scholars did not give much attention to the impact of the lack of legal framework on the transactions between IBIs and their customers, which can be a potential threat to the soundness of IBIs in the long run.

#### 4. Legal and Corporate Governance Framework

The Institute of Chartered Accountants of Pakistan (ICAP) took initiatives in Pakistan in 1998 for the development of good corporate governance in the country. For the purpose, a committee was established, which was composed of members from the Institute of Cost and Management Accountants of Pakistan (ICMAP), the Institute of Chartered Accountants of Pakistan (ICAP), the Securities and Exchange Commission (SEC, nowadays the SECP) and all the three stock exchanges (SEs), namely Karachi Stock Exchange (KSE), Lahore Stock Exchange (LSE) and Islamabad Stock Exchange (ISE). Then, a sub-committee was constituted to give recommendations for making a draft on CG. Resultantly, the code of CG was prepared and issued by SECP in 2002. SECP directed all the three SEs to incorporate the code in their respective listing regulations and accordingly they did so. Since then, the code has been applicable to all listed companies of Pakistan (SECP, 2002).

The 2002 Code, is composed of best practices, the provisions of which were non-mandatory. Later on, a survey was conducted by SECP, ACCA, and Pakistan Institute of Corporate Governance (PICG) in collaboration with International Finance Corporation (IFC) on CG practices in Pakistan. In that survey, contemporary CG practices were analyzed and recommendations were made for improvements in the current CG system of Pakistan. Hence, the revised code of 2012 was issued by SECP.

Primarily, the 2012 code is also applicable to listed companies in Pakistan. However, according to prudential regulation G-1, it shall be applicable to banks and development financial institutions (DFIs) so long as it does not contradict the provisions of BCO, 1962, the Prudential Regulations and the instructions/guidelines issued by SBP (SBP, 2011). It is inferred that the 2012 code is applicable to IBIs so long as it does not contradict the provisions of the above mentioned laws. It means that it is not the 2012 code which is the core



governance code for banks, rather BCO, 1962 and other instructions and guidelines issued by SBP govern banks.

Unfortunately, the provisions of BCO, 1962 mainly cover conventional banks and not Islamic banks, which creates some complications for IBIs. For example, its section 7(1) entitles banks to engage in all businesses<sup>5</sup> mentioned therein, in addition to the business of “banking”. The forms of businesses mentioned in S. 7(1) of BCO do not cover Islamic banking businesses. Similarly, the word “banking”, as defined in section 5(b)<sup>6</sup>, BCO, 1962 also does not conform to the Islamic principle of prohibition of *ribā* (usury). Section 7(2) restricts the business of banks to those mentioned in section 7(1). Furthermore, section 9 prohibits banking companies from performing any trade. This must be a serious concern for Islamic banks in Pakistan. Besides, a clause (aa) has been added to section 23(1) of BCO, 1962 in order to accommodate the Islamic banking branches in the existing conventional banks. But the problem is that proper legal definition of Islamic banks and Islamic banking is not provided. The BCO, 1962 also lacks provisions dealing with the roles and responsibilities of CG players, such as Board of Directors (BODs) and management.

Further still, full-fledged Islamic banks have not been recognized through legal provisions and accommodated only through the instructions<sup>7</sup> by SBP, where IBIs are allowed to offer Islamic modes of finance under section 4 of the circular no. 02 of 2008. According to section E of the instructions, IBIs are allowed to offer these modes or products based on these modes<sup>8</sup>. However, section E (4) provides that other than these, IBIs are free to develop new products if any, subject to prior approval of the *Sharī‘ah* advisor. IBIs may also do other businesses mentioned in section 7 of BCO 1962, provided they are *Sharī‘ah* compliant.

The instructions mainly deal with appointment, removal and working of *Sharī‘ah* advisors, conflict resolution in *Sharī‘ah* rulings, *Sharī‘ah* compliant modes, use of charity fund, offering new products/services and schedule of services charges etc. (SBP, 2008). On the other hand, the instructions also provide

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<sup>5</sup> For detail see section 7(1) of BCO, 1962.

<sup>6</sup> According to Section 5(b) of BCO, “banking” means the accepting for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise”.

<sup>7</sup> The instructions are guidelines are attached as Annexure 1 and Annexure 2 to Islamic banking department (IBD) Circular No. 02 of 2008 respectively.

<sup>8</sup> Such as (1) Participatory modes like *mudhārabah* (contract of participation in which one party provides capital while the other uses skills); (2) trading modes like *ijārah* (lease); (3) Debt based mode like *qardh* (loan); and (4) other modes like *wakālah* (agency). (See *Instructions for Sharī‘ah Compliance in Islamic Banking Institutions*, issued by SBP, p. 3)



guidelines about *Sharī'ah* compliance, internal *Sharī'ah* audit, investment in shares, profit distribution policy etc. (SBP, 2008).

Section F of the instructions includes 'Essentials of Islamic Modes of Financing' as Appendix-A, which are *minimum requirements* for *Shari'ah* compliant products. If any product falls beyond such essentials, the AAOIFI's *Sharī'ah* Standards may be used as guidelines (SBP, 2008).

In collaboration with ICAP, SBP has planned to adopt the AAOIFI *Sharī'ah* Standards with necessary changes, but the standards are not mandatory for IBIs so far. This has left the issue of lack of standardization of contracts<sup>9</sup> as it is.

With respect to developments in the Islamic banking industry over time, a comprehensive "*Sharī'ah* Governance Framework" has been issued. The aim of SGF is to further strengthen the overall *Sharī'ah* compliant environment in IBIs (SBP, 2014). Accordingly, Section A, B, C & D of Annexure-1 (Instructions) and Section I & II of Annexure 2 (Guidelines) of IBD Circular No. 2 of 2008 stand replaced with SGF (SBP, 2014). The SGF is somewhat comprehensive in the aspect of *Sharī'ah* Governance, covering role of BODs and executive management, *Sharī'ah* Board (SB), *Sharī'ah* Compliance Department (SCD), Internal/external *Sharī'ah* Audit, their competency etc. However, it is silent about instances of non-compliance of the players with the provisions of SGF. In other words, the provisions of SGF do not hold the players accountable for their actions which are not in compliance with its provisions. The non-mandatory provisions provide greater space for the players to violate its provisions whenever they want. Such non-compliant behavior of the players will shake the confidence of stakeholders (customers, Investment Account holders, clients and prospective clients) of Islamic banks. Resultantly, they may prefer to withdraw their deposits. Such withdrawals in huge amounts may lead to the collapse of IBIs.

Based on the above discussion, it can be said that overall CG provisions relating to IBIs in Pakistan are in scattered form. These provisions are more related to conventional banking companies' vis-à-vis the Islamic ones except the provisions of SGF and instructions and guidelines for IBIs, the provisions of which are non-mandatory in nature. This scattered form of legal and corporate governance framework raises the question of the possible effects of such a conventional framework and/or the non-mandatory Islamic provisions on the

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<sup>9</sup> It is a big issue in the Islamic banks in Pakistan that each bank has its own set of contracts, which is different from the set formats of other Islamic banks even for the same mode of finance such as *murabaha* (sale by mentioning cost price and profit margin), Diminishing *musharakah* (Participatory mode of finance in which the ownership's units of financier are purchased by the client gradually) and *ijarah* (lease financing).





transactions as well as on the good governance of IBIs. In the following section of the study, the effects of the existing framework are discussed in detail.

## **5. Effects of the Non-Availability of Separate Islamic Banking Laws in Pakistan**

The current Pakistani legal framework has neither defined “Islamic bank” nor “Islamic banking”. Also, none of the Islamic finance transactions have been legally defined or validated through any legal provisions. Most of the transactions are morally enforced only. The current legal framework does not give the process flow of the modern Islamic finance transactions like *Ijarah muntahiyah bittamleek* (lease that ends with ownership) *ijarh waiqtina*’ (lease followed by gift), *salam* and parallel *salam, istisna*’ (contract of manufacturing) and parallel *istisna*’ and diminishing *musharakah*. In the absence of a separate legal framework that is more enabling, there can be no legal authority for Islamic modes of finance. Hence, the claim of the Islamic scholars that Islamic Banking is really “Islamic” remains dubious.

There is no standardization in the contemporary modes of Islamic finance practiced by different Islamic banks. Every bank has its own format as well as documentation requirements for the same transaction, which are different from other Islamic banks. This creates serious problems for transactions across the banks since the requirements of one are not applicable to other. Therefore, the proposed act should also define the standardized formats of contracts.

Due to the absence of any legal authority, Islamic banking has serious transaction implementation issues especially in case of default and breach of promise/commitment by counterparties, unless all the transactions undertaken by Islamic banks have been declared legal through an Act of Parliament or individually by the courts. In this regard, the breach of unilateral promises by the counterparty creates problems because the other party has no right to enforce through court the unilateral promise undertaken by the counterparty. In the current legal system of Pakistan, the unilateral promises of the counterparties in the contemporary form in Islamic finance have not been legally validated to be binding upon the promisors. This is a potential threat to Islamic banking transactions because majority of these transactions involve unilateral promises, either from the customer or from the bank. In the current Pakistani legal system, these unilateral promises have no enforceability. For example, in *murabaha* transaction, if the customer gives unilateral promise that he/she will purchase the car after it is purchased by the IBI and then refuses to purchase it, the respective



IBI has no right to compel him through court for purchasing the car<sup>10</sup>. It can be possible only after the unilateral promise is given legal enforceability through an Act of Parliament. The same risk is involved in all other transactions, such as Diminishing *Musharakah* and *Ijarah muntahiyyah bittamleek*, in which unilateral promise is given by any of the counterparties. Here also arises another issue, that is, the judges do not have proper knowledge of modern Islamic finance transactions. No training is given to judges in this regard. Therefore, they find it difficult to decide the matters of Islamic transactions between Islamic banks and their customers. In the proposed Islamic Banking Act, an Islamic banking court shall be established.

In the absence of a legal framework, IBIs have serious problems at all levels of the board and management committees' meetings since proper representation has not been given to Islamic banking players at these forums. Hence, appointments at all key positions in Islamic banks, the roles and responsibilities of different CG players, their eligibility criteria, educational qualification and experience will remain unsolved. As long as these elements are not properly tackled in statutory law, they are not mandatory. Because of the non-mandatory nature of the current framework covering most of CG provisions related to the players of IBIs, they shall be under less pressure to comply with such provisions. Further, due to the unavailability of any punishments for the players in instances of violations of these provisions, they can easily be circumvented. Especially, the provisions of the current SGF are very much relevant in this regard, because SGF is the main document which is related to good *Sharī'ah* compliant corporate governance inside Islamic banks. SGF covers all important aspects of corporate governance practices including BODs, management, SB, internal/external audit/*Sharī'ah* audit, SCD and conflict resolution process. However, its provisions are non-mandatory and it does not provide any punitive consequences for the actions of the players, which are non-compliant with its provisions. This may pose a question mark on the good governance of IBIs in instances when any player does not comply with the provisions of the said framework. Therefore, all the powers, roles and responsibilities of CG players, in addition to other ancillary requirements, need to be combined in proper statutory law for IBIs.

## 6. Conclusion

In Pakistan, there is no separate statutory law for Islamic banks. By introducing a law IBIs shall be statutorily recognized. The proposed law (Islamic Banking Act) will properly define and authorize the businesses of IBIs. The unilateral promises

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<sup>10</sup> The party cannot be compelled for "specific performance" of contract, because, the *murabaha* contract has not yet been entered into, rather, a unilateral promise is being taken from the customer.



shall be given legal enforceability in case of breaches of promise by the parties. Roles and responsibilities of different CG players shall be properly defined, proper eligibility criteria like minimum qualification and experience shall be statutorily introduced. As the nature of the provisions shall be mandatory, therefore, if any IB or any of its CG players do not comply with the provisions, punitive actions shall be taken against them. In this manner, the players shall be bound to comply with the law. As a result, the goal of good governance in IBIs shall be achieved. For the purpose of motivating the players to comply in letter and spirit with the law, the importance of good governance as a result of such compliance shall be highlighted to them in orientations and training programs.

Further, the current CO, 1984 have some provisions<sup>11</sup> which hold the CG players accountable for non-compliance in their actions. But, the powers and duties of the players with respect to Islamic banks are dealt with in SGF. The provisions of SGF are silent in case of non-compliance of CG players with its provisions. In view of the researcher, it is the fear of punishment which compels CG players to perform their duties in conformity with the set parameters. Therefore, it is opined that IBIs need a separate statutory law so that roles and responsibilities of different CG players are streamlined and properly segregated and necessary actions<sup>12</sup> are taken against those who do not comply with the provisions of the law.

All transactions undertaken by Islamic banks, starting with the opening of bank accounts, the granting of loans, the discounting or otherwise of negotiable instruments, the provision of guarantees, the issuing of the letters of credit, pledges, mortgages, and so on, will become the subject of prompt legislation so that the Islamic forms of these transactions become known to all. It is only then that Islamic banking will begin to acquire a form that is Islamic. In other words, the parliament should specifically approve every form of these transactions. Once legislation has been passed, Islamic banks will be required to publish specimen instruments, contracts, guarantees and other documents that have been implemented in compliance with such legislation. Finally, all specimens shall be available for reading and downloading on the websites of these banks. This will not only make the transactions implemented, as well as the banks Islamic, but it will also generate confidence among the stakeholders of IBIs. Without such steps, Islamic banking has no authority and that can be a potential threat to the soundness of Islamic banks in future.

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<sup>11</sup> Such as section 189; 196(4); 214(1) & (6); 216(1) & (3); Section 157; 158; 255 and 261 of CO, 1984.

<sup>12</sup> The actions shall include removal from office, imposition of fine and imprisonment for some period.



It is sincerely recommended that the state should legislate in the areas that have been indicated. This will make investment in Islamic banking products safer and legally valid. The legislation should also cover all investment and products offered by Islamic banks. Without such legislation, the legality of the transactions is difficult to accept, which remains dubious at best. The question about bank's interest being *riba* or prohibited interest also needs to be decided by the Federal *Shari'at* Court (FSC) of Pakistan. As an alternative, as long as the required legislation is not undertaken as suggested, the unwritten law of Islam as laid down by the Islamic jurists should be allowed to take over all aspects of life in the entire country.

The proposed Act shall provide legal bases for the establishment of Islamic banking courts, which will specifically deal with the matters between IBIs and their customers. The minimum degree requirement for the judges of these courts is suggested to be LLB (Hons') *Shari'ah* and Law and they should have sufficient knowledge about Islamic financial transactions. In this regard, the judges shall be given periodic trainings about Islamic banking and finance. Such training is also recommended for the existing judges as long as separate Islamic banking courts are not established.



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