FEDERAL RESERVE BANK OF PHILADELPHIA

SRC INSIGHTS

A newsletter published by the Supervision, Regulation & Credit Department for the institutions that it supervises.

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SVP Observations on…
Realignment in SRC

by Michael E. Collins

The theme in many of my recent articles in this publication was change. As you are aware, there is significant change occurring in the financial services industry, and all of you are in the midst of coping with that change to ensure that you retain your competitive advantage. In SRC, we are also affected by change. Therefore, on October 1, we reorganized the structure in SRC to better align our operating environment to meet the long-term business imperatives of the department over the next several years.

The new structure will address several critical needs. These include:

- Streamlining the amount and level of managerial oversight
- Ensuring a clear, consistent message and approach to supervision
- Improving accountability
- Providing development opportunities
- Establishing a more appropriate alignment of our structure with business processes
- Positioning SRC for the future in response to rapid industry changes.

Reflecting the increased complexity in the Applications process and expedited processing time frames, the Applications unit will now report directly to me. Those of you who file applications with this Reserve Bank will be speaking with a new Assistant Vice President, Bill Gaunt, who joined SRC on November 9. Bill is an attorney who has significant experience in preparing and filing applications on behalf of the institutions where he worked. Now, Bill will be looking at applications from the other side of the fence, so to speak.

As we evolve in our risk focused supervision process, it is increasingly apparent that compliance management is an important element of an institution's overall risk management efforts. Our goal is to effectively imple-

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Should Your Bank Sell Insurance?

by Douglas A. Skinner, Team Manager

In this era of financial modernization, many traditionally commercial-oriented financial institutions are attempting to evolve into diversified financial service companies. As a result, many bank executives are looking to the insurance business as a way to diversify their revenue stream and boost fee income. While banks cannot be an insurance company, meaning they cannot underwrite insurance, more and more banks are engaging in the solicitation and sale of several types of insurance, including property and casualty, life, accident, and health, along with fixed and variable annuities.

Background

In July 1995, the Supreme Court upheld the Office of the Comptroller of the Currency's (OCC) decision to allow national banks the power to sell annuities. In March 1996, the Supreme Court, acting under Section 92 of the National Banking Act, reaffirmed the authority of the OCC to grant Barnett Bank approval to sell insurance products (ref. Barnett Bank of Marion County, N.A. v. Bill Nelson, Florida Insurance Commissioner, 116 S. Ct. 1103, 1108 (1996)). These landmark cases have prompted many states to reassess the separation of banking and insurance in their laws. As of June 30, 1998, thirty-seven states had granted explicit insurance powers for banks and twelve states allow bank sales of insurance as a result of legislation specifically aimed at maintaining parity between state and federally chartered banks.

> Insurance products are regulated and supervised at the state level, not at the federal level.

General Rules

Insurance products are regulated and supervised at the state level, not at the federal level. Despite the significance of the Supreme Court rulings, several state insurance laws are not preempted by the Barnett decision. These state laws include the testing, licensing, and continuing-education requirements for insurance agents, as well as market conduct and unfair trade practices.

Generally, banks that sell insurance products must do so from a place with a population not exceeding 5,000. (A few states, including Pennsylvania, do not subject their state-chartered institutions to the 5,000 rule[1]). Solicitation and sale activities may occur outside the place of 5,000, provided that the agents are managed and paid through the Bank insurance agency located in the place of 5,000. These agents are required to use that Bank agency location as their place of business for licensing purposes.

Pennsylvania. In December 1996, **Pennsylvania** adopted guidelines giving state-chartered banks the same insurance sales authority as national banks. In July 1997, Pennsylvania Act 40 was signed into law, effectively allowing Pennsylvania state-chartered banks the power to sell annuities directly or indirectly through a subsidiary.

A Pennsylvania-chartered bank that engages in the sale of insurance products must also comply with several statutory and regulatory requirements. These include all consumer protection laws in Pennsylvania; the Insurance Department Act; the Unfair Insurance

[1] Under Pennsylvania law, the rule of 5,000 applies to an insurance subsidiary of a Bank Holding Company or a subsidiary of a national bank; subsidiaries of Pennsylvania-chartered banks, however, can locate the insurance operation in towns of any size.

Practices Act; the federal anti-tying provisions contained in 12 U.S.C. 1972; and the Interagency Statement on Retail Sales of Nondeposit Investment Products.

Pennsylvania law also contains several consumer protection provisions, most notably full disclosure (anti-tying), the separation of physical space, and establishing clear signage. In other words, solicitation for the purchase or sale of insurance may only be conducted by persons not involved in the extension of credit, and must be in a place physically separate from and conspicuously signed so as to be readily distinguishable from banking activities.

New Jersey and Delaware. **New Jersey** allows the sale of insurance by regulation and "wildcard" or parity law, which is meant to give state banks equal footing with national banks. Sales can be in the bank, an affiliate, or a subsidiary. **Delaware** also allows the sale of insurance by explicit statute, in the bank or subsidiary.

Elements of a Sound Program

While some federal and state banking and insurance regulators have issued different rules and guidelines for establishing a sound insurance program, the main themes are generally consistent. These elements encourage banks to carefully review:

- the selection of insurance products which they intend to offer
- the qualifications and training of bank personnel who will sell the insurance products
- how the availability of insurance products is communicated to consumers
- employee compensation
- the accuracy of all advertising regarding insurance products
- the terms of all agreements with third party providers of insurance products.

Banks should also establish a procedure for handling consumer complaints, institute safeguards to protect confidential information, and display signs explaining that insurance is not covered by deposit insurance. Banks should also ensure that salespeople do not sell consumers policies they don't need. This practice, known as churning, inflates commissions without providing consumers any benefits. Finally, it is recommended that institutions limit teller involvement with insurance sales, a practice that is aimed at reducing customer confusion.

Bankers' Views are Mixed

In a study released earlier this year by Grant Thornton LLP, more than a third of community banks offered insurance products, and 74% planned to do so within 5 years. Most community banks are opting to buy agencies rather than entering into a joint venture or creating an agency from scratch. The common thinking is that start-ups tend to be expensive and slow to reach profitability, while agencies come with an established customer base.

> Not everyone is convinced that insurance is the answer to increased revenue streams.

Not everyone is convinced that insurance is the answer to increased revenue streams. Some banks have already begun selling their insurance businesses, citing disappointing profit levels. Observers point out that while banks do have the distribution channels to sell insurance already in place with the branch system, whether they can master the sales culture that goes with successful insurance operations and turn a profit remains to be seen. What most observers do agree on is that economies of scale are needed, and that larger banks have an advantage in this volume-driven business.

Views from the Insurance Industry

Insurance underwriters and agents continue to lobby Congress and state legislatures for restrictions on bank insurance powers. However, given the suc-

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Dispelling Misconceptions About Consumer Subprime Lending

by Randolph D. Brown, Examiner

Over the last few years, lending to subprime consumers has received increasing acceptance in the banking industry. Today, individuals who may not have received credit in the past are now obtaining it. Surprisingly, subprime lending is still misunderstood. Some tout subprime loans as a panacea for declining profit margins. Others demonize subprime lending as a vehicle for predatory lending. Neither of these beliefs provides an unbiased account of subprime lending. In order to dispel these misconceptions about consumer subprime lending, this article further explores the positive and negative aspects of the subprime lending phenomenon and details those risk management practices necessary to ensure appropriate loan portfolio oversight.

> The entry of more established lenders has brought increased visibility and competition to the subprime market.

Subprime Lending Defined

The term "subprime" as it relates to lending is broadly defined as extending loans to borrowers with tarnished or imperfect credit histories. This type of consumer lending encompasses auto, home equity, mortgage, and credit card loans. Characteristics of a subprime borrower may include a history of paying debts late, bankruptcy filings, or an insufficient credit record.

Bank Involvement in Subprime Lending Increases

The extent of bank involvement in the subprime market is difficult to quantify because financial reports do not delineate those loans. Historically, banking organizations did not venture into this segment of the credit quality spectrum; finance companies generally extended credit to the less-than-prime market segment. Today's increased acceptance of subprime lending by financial institutions reflects the bankers' perceived need to offset competition-induced shrinking margins on loans to high quality borrowers.

More Choices for Subprime Borrowers. Accompanying the movement of bankers to the subprime market segment is the belief they are preying on consumers who lack the financial acumen or wherewithal to acquire cheaper credit. Many subprime borrowers appear to be either low-income borrowers or those with substantial income who pay higher interest rates because they have suffered a recent financial calamity. Although critics acknowledge that lenders must charge higher interest rates for riskier borrowers, they believe certain lenders are charging exorbitant rates to ensure big profits—not just to account for risk. While it may be true that borrowers in the subprime category are susceptible to abusive lending and harsh collection practices, the entry of more established lenders has brought increased visibility and competition to the subprime market. In return, the subprime borrower gains access to credit that might not have been available before the recent expansion, receives the option of shopping for a lower rate, and improves their credit history by successfully meeting the loan terms.

Credit Scoring Models. Technological advances have provided lenders with automated under-

writing tools such as credit scoring, which streamline the loan approval process and allow financial institutions to handle increased loan volume. Credit scoring can reduce loan approval time, improve objectivity in the loan approval process, allow for unbiased loan pricing, and predict defaults. Based primarily on credit bureau data detailing borrower payment history and characteristics of the borrower, credit scoring models utilize statistical methods to develop a credit score or predictor of a borrower's ability to repay. In most credit scoring models, the higher the score, the lower the chance of a credit problem.

Since subprime borrowers generally score below thresholds established for traditional bank credit, underwriting subprime loans strictly through credit scoring is difficult. Successful subprime lenders are able to differentiate between "good" and "bad" subprime credit. The decision to approve subprime loan applications is usually based on individual circumstances, not just a credit score. This evaluation typically begins with a thorough examination of the borrower's credit report to evaluate the credit background. Particular attention is given to the number and nature of any major derogatory items on the credit report, as well as how the borrower has handled past credit. The underwriting procedures address additional criteria such as the borrower's stability and ability to repay the loan, minimum residency requirements, and both payment-to-income and overall debt-to-income ratios.

> Management must evaluate whether or not the risks outweigh the benefits.

Risks in Subprime Lending

While higher rates and fees are positive by-products of lending to riskier borrowers, lenders are susceptible to compromising underwriting standards and lowering pricing in order to acquire and protect market share. In Financial Institution Letter 44-97, *Risks Associated with Subprime Lending*, dated May 2, 1997, the FDIC noted that "(e)ffective subprime lenders are able to identify the additional default risk inherent in these loans and price the product accordingly." Significant operational risks must also be appropriately managed to achieve satisfactory profits in subprime lending. Inherent operational risks associated with subprime lending include more frequent and earlier delinquencies and defaults, potential strains on underwriting and collection resources, and difficulties in estimating recovery values on repossessed collateral.

Risk Management of Subprime Lending

Well-developed risk management practices are essential to minimize losses resulting from the risks inherent in subprime lending. To ensure appropriate loan portfolio oversight, bank management involved in subprime lending is encouraged, at a minimum, to:

- Detail the nature and extent of the bank's permissible subprime lending involvement in lending policies, including limits on the maximum volume of subprime credits.

- Maintain sufficient management expertise commensurate with the size and complexity of the institution's active participation in this specialized activity.

- Establish proper operational controls to evaluate and monitor exceptions to established loan policies. Any exceptions to established policies should have an appropriate level of management approval. In addition, the number of loans in the portfolio that represent exceptions should be closely monitored and regularly reported to the board.

- Evaluate staffing, information technology, and facilities needs in light of likely demands presented by an increasing volume of delinquent and default credits and the potential for additional consumer compliance risk associated with subprime credits.

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Developments in the Trust Examination Process

by Richard J. Webekind, Supervising Examiner

As with every other aspect of the bank examination process, there have been significant developments in trust examinations in recent years. This article addresses three topics that have received considerable attention from Federal Reserve System trust examiners in 1998—the modified trust rating system, fiduciary services and Year 2000 readiness, and the risk-focused examination methodology as it pertains to trust.

Trust Rating System

On October 13, 1998, FFIEC published proposed changes to the Uniform Interagency Trust Rating System in the Federal Register. The primary reason for these changes was to equate a trust rating of "3" with its safety and soundness counterpart. Heretofore, a composite "3" rating in a trust examination did not necessarily depict an institution with problems; however, this message was not always properly presented to or understood by bank management and the Board of Directors. Hopefully, the definition of a composite "3" rated institution will now convey similar meaning in both the trust and commercial bank examinations.

In conjunction with this modification and recognizing the move toward risk-focused supervision, FFIEC concluded it was also appropriate to modify the individual rating categories. The result is a trust rating system that is now referred to by the acronym MOECA, the components of which include: **M**anagement; **O**perations, internal control, and audit; **E**arnings; **C**ompliance; and **A**sset management. This proposed rating system includes one new category, compliance, and eliminates the categories of account administration and conflicts of interest. However, these two areas will continue to be evaluated under one of the designated MOECA components.

The Federal Reserve anticipates implementing the modified rating system for examinations commencing in January 1999. We still need to amend implementing and frequency guidelines. We also anticipate that work on a new System Trust Manual will begin in the near future, as an adjunct to the development of the revised rating system.

Fiduciary Responsibilities and the Year 2000

On September 2, 1998, the FFIEC issued its interagency statement concerning fiduciary services and Year 2000 readiness. This guidance should not have been a wake-up call for fiduciaries. Rather, it was designed to be used as a yardstick with which to measure ongoing and future Y2K compliance efforts.

The interagency statement calls for each trust institution to determine the effect of Y2K on its clients, the issuers of securities in which the trust institution invests, and third party service

M O E C A

Management
Operations, internal control, and audit
Earnings
Compliance
Asset management

providers and counterparties. In addition, the interagency statement encourages each trust institution to consult legal counsel as to the need to disclose to account beneficiaries the institution's own Y2K readiness and that of its third party vendors and counterparties.

As trust institutions have probably already determined, the amount of labor needed to address the issues presented in the interagency statement is significant. However, the potential exposure to a trust institution that is not prepared for the Year 2000 is even higher. Consider the following examples.

- A system failure at a major client could result in the inability of a client to function, which in turn could result in the loss of significant fee income to the trust institution.

- A broker counterparty with which the trust institution regularly places trades is unable to execute and/or settle those trades, causing the trust institution to miss the intended market price.

- The portfolio of securities in which the ABC Pension Trust is invested suffers a substantial loss, and the plan sponsor expects to be made whole.

The effect of the first example on the trust institution's performance is readily apparent, and the effects of the other two examples may be described in terms of the risks associated with their respective activities. The inability to execute or settle trades is an operational risk, and the decline in the investment portfolio is a market risk. Both of these risks could further develop into legal and reputational risks.

The interagency statement is not suggesting that trust institutions are responsible for fixing the Y2K problems of those with which they do business. However, it certainly encourages the institutions to become aware of the potential liabilities and exposures facing them so that alternative courses of action may be taken.

Wall Street recently announced the results of Y2K testing with clearing brokers and other executing broker/dealers. Although the clearing brokers passed the test, several of the other broker/dealers experienced transaction failures. Clearly, if a trust institution is placing trades through a problem broker/dealer, common sense dictates that the trades be directed elsewhere.

> A fiduciary may be held liable for market losses incurred as a result of investments made in securities of issuers who are not Y2K compliant.

The Department of Labor has suggested that a fiduciary may be held liable for market losses incurred as a result of investments made in securities of issuers who are not Y2K compliant. While the remedy in this case may prove to be as painful as the problem, prudence would seem to require the trust institution to avail itself of all information in order to make an informed judgement about a particular security. The Securities and Exchange Commission (SEC) is requiring Year 2000 disclosures for all registrants in both quarterly and annual filings with the SEC.

Risk-Focused Supervision

The above discussion of the Year 2000 problem highlights the current regulatory predisposition to present everything in terms of risk. In 1995, the Federal Reserve System identified six categories of risk facing commercial banks—credit, market, liquidity, operational, legal, and reputational risk. Not surprisingly, fiduciary businesses are confronted with risks similar to those found in commercial banking.

For example, **credit risk** as it applies to a trust institution is the risk that a borrower or counterparty will fail to perform on an obligation such as a bond,

note, or mortgage. **Market risk** is the risk of adverse movements in market rates or prices, which will affect the value of assets in fiduciary accounts. **Liquidity risk** is the risk that the trust institution will be unable to liquidate assets or obtain adequate funding to meet the obligations of its customers as they come due. **Operational risk** is presented by inadequate management information, data processing, or internal control systems; problems with or breaches in those systems; and fraud or unforeseen catastrophes such as natural disasters or fire. **Legal risk** stems from the improper performance of fiduciary duties, and may result in unenforceable contracts, lawsuits, settlements, or adverse judgements against the institution. Finally, **reputational risk** is defined as the risk that negative publicity, whether true or not, will cause a decline in the customer base or require the trust institution to defend itself through direct customer contact, through the media, or through court proceedings.

As the trust examination process now attempts to classify all findings in terms of risk to the institution, the scope of the examination is the result of significant preplanning and risk assessment. This risk assessment is accomplished by reviewing the results of the previous examination and by discussing with trust institution management any changes that may have occurred since that examination. Based on the results of the preplanning risk assessment, the examiner will allocate resources to those areas of the trust institution that present the most risk.

An important element of both the preplanning process and the actual examination is a review of the institution's own risk identification and management processes. Trust institutions are expected to have a defined process in place for assessing risk within the organization, including controls and procedures that are designed to mitigate risk.

If you have any questions on any issues related to fiduciary responsibilities or examinations, do not hesitate to contact your primary bank examiner. For those institutions that are supervised by the Federal Reserve Bank of Philadelphia, please contact Richard Webekind at (215) 574-3444 or Rufus L. Miley at (215) 574-4129. ■

Y2K

Y2K

- Remember, the SEC and FASB have determined that Year 2000-related expenditures must be expensed as incurred and cannot be accrued or capitalized.
- Be on the lookout for an upcoming FFIEC release of question and answer guidance on contingency planning. Visit their website at www.FFIEC.gov.
- Stay tuned to next month's edition of *SRC Insights* for detailed guidance on business resumption contingency planning.

SVP Observations On…

Realignment in SRC

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ment the risk focused compliance initiative into the overall supervisory process through new products and expanded integration. Further, we will promote expanded use of technology in the compliance function to enhance our analysis, decision making, and business processes to ensure we provide compliance oversight in an effective and less burdensome manner.

To support these initiatives, John Deibel will continue to oversee the International, Specialty, and Consumer Compliance Examination Units. John will also have responsibility for Information Technology. In conjunction with assuming these additional responsibilities, John has been promoted to Vice President.

Reed Raymond, an Assistant Vice President in the Department, will be heading the Consumer Compliance and CRA unit. Reed has extensive experience in international and commercial examinations, which will be of value in the consumer compliance arena. Connie Wallgren will be the new manager in the Consumer Compliance area and will report to Reed.

John Mendell will continue to be the team leader over the Specialty area and will report to John Deibel.

Elizabeth Videira-Dzeng has been promoted to International Examinations Officer and will be the primary contact person in the International area.

We have realigned some responsibilities in the Domestic Safety and Soundness area reporting to Lou Sanfelice to ensure we continue to add value to the supervisory process. Bernie Wennemer will oversee supervision of Third District institutions. Doug Skinner and Eric Sonnheim will be the team leaders reporting to Bernie. Mike Zamulinsky, with Jim DePowell reporting to him, will assume responsibility for the integration of bank supervision technology products into the risk focused examination process. These products are becoming embedded into the core of supervision and need high level attention to spur effective and burden sensitive approaches. Mike and his staff will also oversee continuous supervision of selected Third District institutions and provide special supervisory attention to growth in certain non-bank activities like insurance products. Dianne Lee Houck will report directly to Lou Sanfelice and will have responsibility for Supervisory Resources, Desk and Report Reviews, Interagency coordination, and coordination with CPA firms and outside accountants. Eileen Adezio will continue to be responsible for Enforcement, and will assume responsibility for institutional Banking Surveillance. Frank Doto, Banking Studies Manager, will now report to Eileen.

The Credit and Risk Management function will remain with Gerry Callanan, and he will also become the officer in charge of the administrative support, quality control, budget, outreach, and training units. You can continue to contact Bernie Beck and Dennis Chapman on issues related to the Discount Window and Regulatory Accounting. Cynthia Course, as Sr. Manager reporting to Gerry, will remain in charge of the outreach function—including our Bankers' Forums and the publication of SRC Insights—and will also oversee the administrative support, quality control, budget, and training units.

To assist you in contacting the correct person when you have questions or comments on our supervisory processes, we have reprinted the "Whom to Call" table on the last page of this edition of SRC Insights. As always, we welcome your suggestions on ways that we can reduce the regulatory burden on you, the institutions that we supervise. ■

Should Your Bank Sell Insurance?

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cess banks have had to date entering the field, many have changed their strategies from broadly opposing liberalization of bank insurance powers to trying to influence the direction of these legislative initiatives.

While lobbying continues, both underwriters and agents are pursuing strategic opportunities to capitalize on potential bank insurance relationships. Because of banks' established delivery channels, some underwriters do view banks as a good vehicle for delivering insurance products to consumers and small businesses. Still other insurance agents are investigating approaches for building other relationships with banks, such as partnerships and joint ventures.

Final Thoughts

It is difficult to discuss pending legislation without mentioning the proposed Financial Services Act of 1998, commonly known as H.R. 10. This bill, which passed the House of Representatives in May and ended the last session of Congress in the Senate, would basically allow bank holding companies (BHCs) to affiliate with securities firms and insurance companies, thereby allowing BHCs to engage in, among other things, insurance underwriting. Passage of this bill, to be determined when Congress resumes session, would have a dramatic impact on the future of both the banking and insurance industries.

If you are considered entering the business of insurance, contact your primary regulator as well as your state banking and insurance departments for a copy of their respective laws and/or guidelines. Finally, be sure to evaluate how the business of insurance fits with your bank's strategic plans for the future. ■

Dispelling Misconceptions About Consumer Subprime Lending

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- Ensure that any output generated from a credit scoring model is appropriately tested, validated, and amended for accuracy as needed. Bank management may want to refer to the article entitled "Ten Steps to Better Credit-Scoring" in the Robert Morris Associates' *Journal of Lending & Credit Risk Management* October 1998 issue for additional guidance in this area.

Final Thoughts

Without the necessary investment in a new, specialized credit risk management infrastructure, the banking industry will not enjoy the same profits through lending to subprime consumers as achieved by other lenders. In fact, only if the inherent risks associated with subprime lending are well managed can this activity be profitable.

Before a banking organization decides to enter the subprime market, management must evaluate whether or not the risks outweigh the benefits, and ensure that sound credit risk management techniques and sufficient resources are already in place. For additional information on consumer subprime lending, you can call Randolph D. Brown at (215) 574-4125. ■

Whom To Call?

Officers & Managers

Domestic Safety and Soundness
Louis N. Sanfelice, VP 574-6470
Dianne Lee Houck 574-4138
Bernard M. Wennemer, AVP 574-6485
Douglas A. Skinner 574-4310
Eric A. Sonnheim 574-4116
Michael P. Zamulinsky, AVP 574-4136
James D. DePowell 574-4153

Enforcement & Off-Site Integration
Eileen P. Adezio, AVP 574-6045
Mary G. Sacchetti 574-3848
Frank J. Doto 574-4304

Consumer Compliance & CRA
A. Reed Raymond, AVP 574-6483
Constance H. Wallgren 574-6217

Specialty Examinations
John J. Deibel, VP 574-4141
John V. Mendell 574-4139

International Examinations
John J. Deibel, VP 574-4141
Elisabeth C. Videira-Dzeng, International Examinations Officer 574-3438

Applications
William L. Gaunt, AVP 574-6167

Capital Markets & Payment Cards
Joanna H. Frodin, VP 574-6419
Perry D. Mehta 574-6130
Scott A. Weihrauch 574-4389

Discount Window and Reserve Analysis
Gerard A. Callanan, VP 574-6133
Bernard E. Beck 574-6467
Dennis S. Chapman 574-3848

NEXT ISSUE

Asset Liability Management in Community Banks

The Discount Window and the Year 2000

Yet More on the Year 2000

Editor.....Cynthia L. Course

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