

Islamic Finance: An Opportunity for Micro, Small and Medium Enterprises (MSME) Financing

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MASA POLICY DEVELOPMENT PROGRAMME

POLICY BRIEF 12

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PREFACE

Institut Masa Depan Malaysia (MASA) is an independent think tank that brings together experts in government and academia to provide quality research, policy recommendations, and analysis on the full range of public policy issues guided by the shared prosperity values.

Since its inception, MASA has been actively involved in shaping national policies and frameworks. MASA Policy Development Programme (MPDP) was introduced as a pioneering initiative aimed at promoting policy research among researchers from public and private universities across the country, in alignment with the Shared Prosperity Vision 2030 and the Sustainable Development Goals, which are integrated with the 12th Malaysia Plan.

Through the MPDP 1.0 initiative, 30 Policy Briefs have been successfully produced, encompassing policy input and recommendations across sectors such as economics, social issues, education, and sustainable development.

MASA expresses its gratitude to Associate Professor Dr. Foo Lee Peng and her team for the production of this policy brief. The commitment of the MPDP grant recipients, along with close cooperation with relevant stakeholders, is highly appreciated and is hoped to continue making a positive impact on national policy development.

Azril Mohd Amin

Chief Executive Officer

Institut Masa Depan Malaysia

ABOUT MASA

Institut Masa Depan Malaysia (MASA) is an independent think tank that brings together experts in government and academia to provide quality research, policy recommendations, and analysis on the full range of public policy issues guided by the shared prosperity values.

MASA was established in January 2019. The formation of the organisation was inspired and mandated by the Seventh Prime Minister, YABhg. Tun Dr Mahathir Mohamad and the Eighth Prime Minister, YB Tan Sri Dato' Haji Muhyiddin Bin Haji Md Yassin. It was founded out of a passion to forward the philosophy of shared prosperity in Malaysia and this region.

MASA also was commissioned by the government of Malaysia to author and develop the Shared Prosperity Vision 2030 plan as the new socioeconomic plan for Malaysia.

Our Vision

To be a thought leader on policy ideas and analysis guided by shared prosperity values.

Our Mission

To create a world where no one is left behind by influencing policymakers to develop data-driven policies that ensure equitable wealth distribution and continuous improvement of people's well-being.

ABOUT MPDP

MASA Policy Development Programme (MPDP) is a pioneering effort in promoting policy research that has become part of MASA's flagship project, in line with the 12th Malaysia Plan which is aligned with the Shared Prosperity Vision and the Sustainable Development Goals.

The research grant, introduced for the first time in 2021, received an encouraging response public and private institutions of higher learning as well as non-governmental organizations.

MPDP researchers have produced studies across various strategic areas, including multidimensional poverty, education for the B40 group, sustainable urban planning for low-income communities, regional inclusivity in Sabah and Sarawak, social enterprise models for Micro, Small and Medium Enterprises (MSMEs), green economy potential and food security.

Other strategic areas of studies include empowerment of the ecotourism sector, climate change, health preparedness and crisis resilience, addressing learning loss, business acceleration, affordable housing and social protection.

All these are reflections of the initiatives and aspirations, inspired by the 8th Prime Minister and Chairman of MASA, Tan Sri Dato' Haji Muhyiddin bin Hj. Md. Yassin.

LIST OF MPDP 1.0 POLICY BRIEFS

NO	TITLE	PROJECT LEADER
1.	Family Digital Citizenship in Pandemic Recovery: Prospects, Challenges, and Policy Considerations	Assoc. Prof. Dr. Nor Diana Mohd Mahudin
2.	Kajian Kelestarian Perusahaan Sosial di Malaysia: Perspektif Pasca Pandemik COVID-19	Dr. Abu Hanifah bin Ayob
3.	Increasing Medical Specialists in Malaysia: Beware of Vicious Cycle	Asst. Prof. Ts. Dr. Chang Jing Jing
4.	Public Reactions and Acceptability on Carbon Tax Implementation in the Malaysian COVID-19 Economic Recovery Plan	Assoc. Prof. Dr. Izlawanie bt Muhammad
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14.	Grey Matter - An Examination of Malaysians Perspectives Towards Ageism and Impacts of Health	Prof. Dr. Choo Wan Yuen

NO	TITLE	PROJECT LEADER
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19.	Pembangunan Sabah ke Arah Mencapai Kelestarian Hidup Masyarakat dan Kunci Kepada Malaysia Sebagai Negara Maju 2025	Dr. Mohd Ikbal bin Mohd Huda

NO	TITLE	PROJECT LEADER
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22.	Input Polisi Bagi Penyelesaian Kemiskinan Situasi Untuk Keperluan Pelan Pemulihan Negara (PPN)	Assoc. Prof. Dr. Wan Ahmad Amir Zal bin Wan Ismail
23.	Ruang Hijau Bandar Sebagai Indeks Untuk Dasar Kesihatan Mental Mampan Semasa Pandemik	Assoc. Prof. Dr. Mohd Ramzi bin Mohd Hussain
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25.	Model T-Digital dalam Memupuk Perpaduan Masyarakat Majmuk di Malaysia	Dr Khairul Azhar bin Meerangani

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BIOGRAPHY

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Foo Lee Peng is a Senior Lecturer associated with the Faculty of Accountancy, Finance and Business at Tunku Abdul Rahman University College (TAR UC). She is the research lead for Centre for business and Policy Research (CBPR). She was actively involved in several research activities at domestic and international level.

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Executive Summary

Micro, Small and Medium Enterprises (MSMEs) in Malaysia comprised a large amount of the country's total business establishments in 2020. Microenterprises made up the most significant percentage of the total MSMEs.

Nonetheless, when the COVID-19 pandemic hit Malaysia, this group was badly affected. Maintaining MSME businesses during the COVID-19 pandemic has been challenging, especially for entrepreneurs seeking funding to ensure business sustainability. Although Malaysia's government announced various stimulus packages to ensure that the impact of COVID-19 was minimised for MSMEs, microenterprises have noted that many of these efforts have not been easily accessible.

As a result, a vast number of enterprises had temporarily shut down. According to the vice president of SME Corporation Malaysia, based on their recent survey, only 8.6% of SME businesses carried on as usual, whereas the remaining 91.4% have suffered losses in revenue between 25% to 100%, during the pandemic period, with most them being MSMEs (Azman, 2021).

The authors would like to suggest SME Corporation Malaysia offer loans to micro-enterprises with a 'Mudarabah' element. Under the profit-sharing method of the Islamic economic system, microenterprises could contribute their efforts while the SME Corporation Malaysia could offer capital/funding.

SME Corporation Malaysia is in an excellent position to understand the challenges of microenterprises, especially as it has become the primary reference for SMEs, including MSMEs seeking help. At the same time, they could manage and monitor the implementation of SME development programmes. With the proposed 'Mudarabah' concept loans under SME Corporation Malaysia, training could also be provided to microenterprises and supervised by SME Corporation Malaysia.

Key Messages and Recommendations

Recommendation 1

- To offers a “Mudarabah” element in their loans while reducing the requirements to obtain a loan.

Recommendation 2

- To provide and disseminate relevant and updated information to SMEs, and as a channel for feedback on SMEs issues.

Recommendation 3

- To monitor the provided loans and continuous support to the SME Corporation.

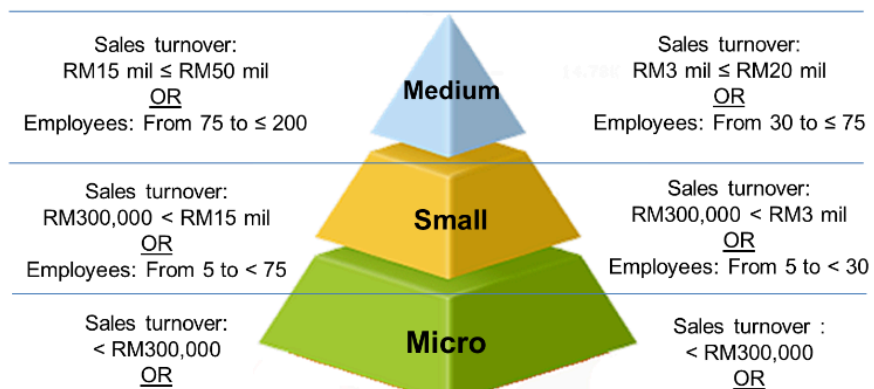
Introduction

Small and Medium Enterprises (SMEs) in Malaysia comprised 97.2% of the total business establishments in 2020 (Department of Statistics, Malaysia, 2021). The contribution of SMEs to Malaysia’s GDP was about 38.2% of the total GDP.

They also provided job opportunities to more than 7.25 million workers in the nation, comprising 48% of the total employment in Malaysia (Department of Statistics, Malaysia, 2021). Among them, 80% came from the services and manufacturing sectors.

The guidelines cover the sales turnover and number of employees within a firm (see Figure 1). A business can be qualified as Micro, Small and Medium Enterprises (MSMEs) if it is in the manufacturing or service sector with a sales turnover not exceeding RM300,000 or full-time employees not exceeding 5 workers.

Figure 1
Definition of SME in Malaysia



Source: SME Corp. Malaysia, 2020

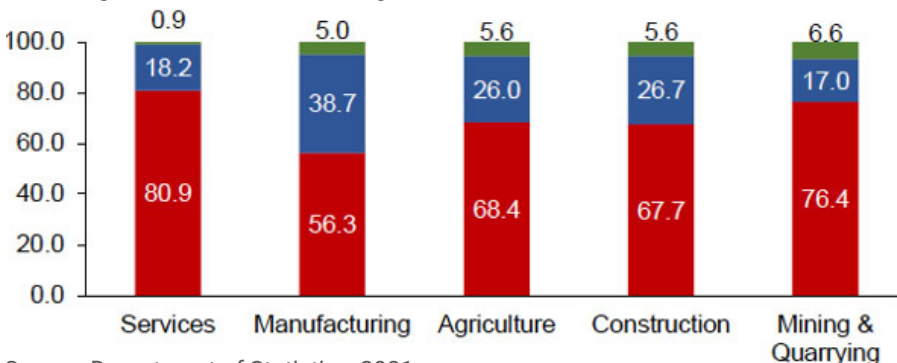
If a business fulfils either one criterion across the different sizes of operation, then the smaller size will be applicable. For instance, if a firm’s sales turnover falls under microenterprise categories but employment falls under small categories, the business will be deemed as an MSME.

Over years, the MSMEs have made an immense contribution to the country’s GDP and employment landscape. However, due to the COVID-19 pandemic, the amount contributed by MSMEs to Malaysia’s GDP in 2020 has dropped to its lowest level in 17 years.

According to the Prime Minister’s statement, a total of 1,246 businesses have closed down during the Movement Control Order (MCO) period from March 2020 to July 2021 (Rahim, Tan and Carvalho, 2021). This situation was mainly due to most of the SMEs in Malaysia being MSMEs (refer to Figure 2).

Figure 2

Percentage of Total SMEs According to Size



Source: Department of Statistics, 2021

MSMEs comprise the most significant percentage of SMEs in Malaysia. When the COVID-19 pandemic hit Malaysia, this group was badly affected. The effects of the COVID-19 pandemic led to a drastic drop in domestic demand, which impacted the Malaysian economy's short-term indicators, such as private consumption and the economy's structure.

Fortunately, effective from 1 October 2021, most industries have been allowed to operate subject to their location under phases 1 to 4 of Malaysia's National Recovery Plan. As of July 2022, all industries have been allowed to operate as usual. Although some standard operating procedures (SOPs) must be followed, most restrictions have been eased.

After the National Recovery Plan was implemented, there was a temporary rebound in economic activity due to "revenge spending". However, the new minimum wage law (introduced in May 2022), combined with higher price ceilings for certain food products and demand-pull inflation from economic reopening, caused consumer confidence to hit multiple lows.

The impact of low purchasing power was also seen on consumers' perception of the general economic situation and employment. Overall spending was shored up by essential spending, which is mostly influenced by prices.

Maintaining MSME businesses during the COVID-19 pandemic has been challenging, especially when entrepreneurs have sought additional funding to ensure business sustainability. As a result, many MSMEs have closed down their businesses.

Although before the pandemic, several agencies, such as; Bank Negara Malaysia and the Credit Guarantee Corporation Malaysia Berhad, had put much effort into MSME financing. However, small firms have noted that many of these efforts have not been easily accessible.

The main difficulties faced by the SMEs were; information asymmetry, creditworthiness, the lack of proper business plans and the need to show good sales turnover. As a general rule, although many options are available, MSMEs have been limited in their choice of funding sources. These include “Im sme”, the first SME Financing platform.

The platform states that applicants can access fast and real-time information on financing/loan options online. However, the source of funds is from banks (ImSme portal, 2021). Therefore, applicants still have issues if they have not maintained financial records, such as bank statements. As such, they have no other option but to rely on internal funds or cash from friends and family.

Policy Responses to COVID-19

During the COVID-19 pandemic, Malaysia's government announced various stimulus packages to ensure that the impact of COVID-19 was minimised for MSMEs. About 15 per cent of MSMEs in Malaysia were temporarily closed due to a lack of funds stemming from the COVID-19 pandemic. To foster MSME resilience, Malaysia's government announced various forms of financial support to weather the impact of the COVID-19 pandemic. A small amount of financing goes a big way in helping these businesses grow.

The policy perspective is gradually shifting from their liquidity position and business survival, which remains a priority in most countries, to reviving the economy. The authors of this study have listed below the existing financial support provided by the government to MSMEs.

(1) Prihatin Special Grant

The Prihatin Special Grant (GPK) assistance was aimed to help MSMEs to overcome the implementation of the Movement Control Order (MCO), which impacted businesses badly, especially businesses that were not allowed to operate during the MCO period. It helped to ensure businesses' cash flow was uninterrupted and prevented their debts from mounting during the pandemic.

Name of initiatives	Amount allocated to each MSME
GPK 1.0 & 2.0	RM3000
GPK Plus	All GPK 1.0 and GPK 2.0 recipients in 12 states under the MCO enforced in January and February 2020 will obtain RM1,000, while MSMEs in states that were not under the MCO will receive RM500.
GPK 3.0	RM1,500 (The first allocation is RM1000 and increase to RM1,500)

(2) Micro Enterprises Facility (MEF)

About 4 million of Malaysia's labour force work in the gig economy, and the numbers have been growing (Department of Statistics of Malaysia, 2021). Such workers include; part-timers, freelancers, independent contractors, and project-based workers.

Working part-time and freelancing has always been common, and involvement in the gig industry has grown in popularity due to the rise of digital platforms and the Internet, particularly since the COVID-19 pandemic hit and many people were laid off.

As such, MEF was introduced to improve access to credit for MSMEs. It included self-employed individuals, gig workers on digital platforms and participants of the iTEKAD programme. Eligible MSMEs could obtain financing of up to RM50,000 for working capital and capital expenditure purposes (Ministry of Finance, 2021).

(3) BSN Micro/i Kredit

BSN Micro/i Kredit Prihatin is a micro-financing/loan scheme offered to MSMEs whose business has been affected by the COVID-19 outbreak. Beginning 1 April 2021, this initiative has been replaced by the BSN Micro/i PEMERKASA

The micro-loans allocate up to RM50,000 for each MSME to finance their working capital and capital expenditure. The financing is offered at a three per cent interest rate, without collateral, to all micro-entrepreneurs in various segments with the condition that they have been in business for at least six months.

(4) Disaster Relief Facility (DRF) 2022

The DRF is an aid initiative designed to ease the burden of flood victims, especially SMEs and MSMEs, allowing them to resume operations after a disaster.

The initiative was introduced following the flash floods that occurred on 16 December 2021, impacting eight Peninsular Malaysia states (Rahman, 2022). Many affected MSMEs had to stop operations, as their factories were badly damaged and machinery had become covered by mud and debris.

The DRF 2022 assists MSMEs in covering the expenses of repairs and/or replacement of flood-damaged assets for business usage (e.g. plants and machinery), as well as working capital.

The DRF 2022 is open to SMEs, including MSMEs, with a maximum loan amount of RM500,000 for SMEs and RM75,000 for microenterprises.

The financing lasts a maximum of 5 years, with a postponement or reduction of instalment payments for up to six months. The financing rate, including any guarantee cost, is up to 3.50 per cent per annum.

(5) BSN Micro/i Semarakniaga

BSN Micro/i Semarakniaga is a micro-financing/loan facility under the Semarakniaga Keluarga Malaysia (Semarakniaga) Programme, which has been offered to MSMEs to provide assistance and support to businesses. The financing has been offered at a four per cent interest rate.

(6) eTrade Programme

Under this programme, Malaysian MSMEs have been offered two schemes of export facilitation initiatives: an onboarding scheme worth RM5,000 and a digital marketing and training (DMT) scheme worth RM20,000 for each company, respectively.

The funds can be used to promote their products overseas and for e-commerce-related training programmes they choose to attend. MSMEs can diversify their export markets and upscale their exports through a presence in various cross-border e-commerce marketplaces (MATRADE, 2021).

Critique of Current Policy

Currently, bank lending is the most common source of external finance for many MSMEs and entrepreneurs, which rely heavily on traditional debt to fulfil their start-up, cash flow and investment needs (Bank Negara Malaysia, 2019).

In addition, various sources of government funding have been introduced under different ministries. Recently, Bank Simpanan Nasional introduced the BSN Micro/i Semarakniaga financing scheme aimed at micro-enterprises, but the funds are restricted for use as working capital or purchasing assets only.

At the same time, the other provided assistances (as mentioned in Section 1.4) are more likely to be one-time off payments and soft loans.

These efforts cannot solve the root cause of MSME's failure. It is necessary to understand what can lead to business failure and how each obstacle can be managed or avoided to safeguard a new or established business.

For instance, poor planning and lack of management skills are reasons MSMEs fail to sustain their businesses. Despite the government's funding, MSMEs can still not manage their businesses well and must close.

As such, an agency that could play the role of a funding coordinator and monitor MSMEs' performance is crucial.

Analysis and Findings

Government and Bank Negara Malaysia initiatives have enabled the tremendous growth of Islamic finance in Malaysia. Malaysia is also a leading international Islamic financial hub, with a 48% market share of global Sukuk issuance in 2019 (The Edge, 2020).

This study's authors suggest that the SME Corporation broaden the range of financing instruments available to MSMEs and entrepreneurs to enable them to continue to play their role in investment, growth, innovation and employment.

Further, this study's authors urge the provision of soft loans using the "Mudarabah" concept being introduced to MSMEs, while at the same time, the SME Corporation can monitor the development of such MSMEs through training and guidelines.

The proposed Mudarabah concept also aligns with Bank Negara Malaysia's mandate to promote Malaysia as a leading Islamic finance hub. Malaysia's microfinance industry practices Islamic microfinance by offering interest-free loans but charging a certain administrative fee on top of the loan (Rahman, 2007).

Under the Shariah principle, "Mudarabah" acts as a business contract between a capital provider (SME corporation) and an entrepreneur (MSME) (Ryandono, Kusuma & Prasetyo, 2021). It has been seen as an alternative mechanism in financing techniques that differentiate it from conventional financing, using the interest mechanism.

Under a Mudarabah contract, a capital provider will offer funding for a business, while an entrepreneur will manage the business (Asadov, 2020). It provides an opportunity for the capital provider to invest their capital without being involved in managing the capital.

At the same time, the entrepreneur will solely manage the business. The SME corporation does not have a right to interfere in the management of the business, which is the sole responsibility of the MSME.

However, the SME Corporation has every right to specify conditions to ensure better management of its money. Based on the pre-agreed profit sharing ratio (PSR) that is mutually agreed upon, the profit will be shared among the capital provider and the entrepreneur (Yustiardi et al., 2020; Kusama, 2018).

Profits generated are shared between the parties according to a pre-agreed ratio of 50%-50% or 60%-40%. However, losses will be completely borne by the capital provider if there is no evidence of the entrepreneur's misconduct, negligence or breach of specified terms (Bank Negara Malaysia, 2015). Whereas the entrepreneur will lose the time and effort invested in the project.

While Mudarabah concept products represent a growing market segment, Mudarabah and Musharakah currently cover less than 10% of the total Islamic banking and financial business worldwide (Rahman, 2018). Mudarabah can be divided into two categories: Unrestricted Mudarabah (Mudarabah Mutlaqah) and Restricted Mudarabah (Mudarabah Muqayyadah).

Unrestricted Mudarabah is a contract where the capital providers permit the entrepreneur to administer the fund without specific restrictions, e.g. business type or location. The restricted Mudarabah is a contract in which the capital providers impose specific restrictions and boundaries such as; location choice, investment period, project type, etc. (Bank Negara Malaysia, 2015).

Benefits of Mudarabah Deal

One of the advantages of the Mudarabah concept is to eliminate predatory effects on the business relationship between a capital provider/lender and an entrepreneur.

Unlike a conventional loan agreement that involves the use of collateral (guarantee of repayment), where if an entrepreneur is facing a problem, the bank will quickly assert itself by collecting the collateral to protect the interests of its investors and executives.

At the same time, a capital provider under the Mudarabah concept undertakes to pay a certain amount of any guarantee in the case of default. Therefore, using the Mudarabah system, capital providers will not attempt to create a one-sided deal with entrepreneurs or the entity desiring to build a business venture or a project.

In other words, there is an incentive for the capital providers to consider the entrepreneur's long-term success and not just the financial institution's short-term profits (Sapuan, 2016).

Policy Recommendations

SMEs, particularly MSMEs, have not found it easy to obtain funding via the above mentioned approaches. However, it is worth noting that the assistance sources mentioned mostly comprise one-time funding for a short period.

This study's researchers suggest that the SME Corporation Malaysia offers loans to MSMEs with a "Mudarabah" element. Under the profit-sharing method of the Islamic economic system, MSMEs could contribute their effort while the SME Corporation Malaysia could offer capital/funding.

Such a suggestion is not new, considering it has been implemented in several countries, such as Indonesia and Saudi Arabia (Albukaai, Al-Kafry and Albuti, 2017; Huda, 2012). Maybank and SME Bank have also offered a similar service to SMEs in Malaysia.

However, the requirements remain rigorous and might not be easily fulfilled by SMEs, particularly microenterprises. Banks are unwilling to provide financing where their capital is at risk.

The authors propose the SME Corporation Malaysia to offers a "Mudarabah" element in their loans while reducing the requirements to obtain a loan. The SME Corporation Malaysia should endeavour to support MSMEs encountering financial difficulties.

As for now, The SME Corporation Malaysia is a central coordinating agency that develops broad policies and strategies for SMEs and oversees the execution of SME development programmes across all relevant government ministries and agencies.

Acting as the Central Coordinating Agency, one of the SME Corporation Malaysia's functions is as a centre for advice and information, to provide and disseminate relevant and updated information to SMEs, and as a channel for feedback on SMEs issues.

If the SME Corporation accepts the proposed new role, it will act as a fund provider while, at the same time, monitoring the development of MSMEs with the existing training and guidelines. This role will allow it to evaluate whether the existing training and development programmes can tackle the issues and problems faced by MSMEs

The authors noted that Axiata, under CIMB bank, offered a COVID-19 Assistance Program to SMEs. The program was categorised as a commercial loan with no repayment for the first six months and with interest rates as low as 0.50% per month with a maximum loan amount of RM20,000 (SME Corporation Malaysia, 2021).

At the same time, some of Malaysia's state governments have also assisted SMEs. For instance, Sarawak introduced a Micro-Credit scheme for Sarawakians residing and operating their businesses in Sarawak in all business sectors except agriculture (Sarawak Government, 2021). However, this assistance comprised of commercial loans and did not offer training to develop MSMEs.

The most common reasons why small businesses fail include; a lack of capital or funding, an inadequate management team, faulty infrastructure or business model, and unsuccessful marketing initiatives.

Although MSMEs have managed to receive funding via various sources, many of them have been unable to survive. As such, if the loans provided were monitored and continuous support and advice were offered by the SME Corporation, the outcomes of MSMEs might be more successful.

In contrast, the SME Corporation Malaysia is the central coordinating agency (CCA) under the Ministry of Entrepreneur Development and Cooperatives (MEDAC), coordinating development programmes for SMEs across all related ministries and agencies. The SME Corporation Malaysia is in an excellent position to understand the challenges of microenterprises, especially as it has become the primary reference for MSMEs seeking help.

With the proposed Mudarabah concept loans under SME Corporation Malaysia, training can be provided to MSMEs and supervised by SME Corporation Malaysia. Instead of giving MSMEs money directly, guidance will be provided to lead them to the success.

After all, the primary purpose is to help microenterprises, as not all businesses can go online. Raw material costs have increased sharply as industrial production has rebounded. Prices for raw materials, such as iron ore and copper, have surged to all-time highs amid the global post-coronavirus recovery. MSMEs have been badly shaken during the COVID-19 pandemic; sadly, some have had no choice but to close down.

Conclusion

Recent headwinds, such as; supply chain disruptions, soaring material costs, and prevailing inflationary pressures, have dampened the country's purchasing power, thereby threatening the market's recovery from the COVID-19 pandemic.

COVID-19 has further exacerbated the poor business performance of the MSMEs and delayed achieving the UN's Sustainable Development Goal (SDG) 8, which is to promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all. MSMEs provide employment opportunities and have the potential to promote decent work and entrepreneurship.

The proposed new role of the SME Corporation would help monitor and provide continuous support and advice to MSMEs. Under the profit-sharing method of the Islamic economic system, MSMEs could contribute their effort while the SME Corporation Malaysia could offer capital/funding.

The SME Corporation Malaysia is in an excellent position to understand the challenges of microenterprises, especially as it has become the primary reference point for SMEs, including MSMEs seeking help.

At the same time, they could manage and monitor the implementation of SME development programmes. With the proposed “Mudarabah” concept loans under SME Corporation Malaysia, training can be provided to microenterprises and supervised by SME Corporation Malaysia.

It is also in line with Bank Negara Malaysia’s mandate to promote Malaysia as a leading Islamic Hub. The role of MSMEs is crucial to promote economic inclusion for low-income groups, ensuring they are not marginalized.

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