Pak. j. life soc. Sci. (2024), 22(2): 22877-22887 E-ISSN: 2221-7630;P-ISSN: 1727-4915

Pakistan Journal of Life and Social Sciences
www.pjlss.edu.pk

https://doi.org/10.57239/PJLSS-2024-22.2.001627

RESEARCH ARTICLE

Agency Theory in Banking: Balancing Incentives and Mitigating Moral Hazard in the Principal-Agent Dilemma

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ARTICLE INFO

Received: Nov 15, 2024

Accepted: Jan 4, 2024

Keywords

Incentives

Moral Hazard Banking

Principal-Agent

Agency Theory

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ABSTRACT

Financial management aims to maximize firm value, while agency theory discusses how to achieve this goal in the context of the separation of ownership and control. Thus, financial management and agency theory focus on creating value by managing potential conflicts of interest. Financial decision making, namely investment, funding and dividend decisions in financial management must consider agency implications. Making capital structure decisions does not always consider the cost of capital but also as a debt monitoring control to minimize agency costs. This research is not only about moral hazard, but also about the broader application of agency theory in the banking context. Explores various aspects, including contract design, regulations, and risk management practices resulting from the principal-agent dilemma and moral hazard in banking. Comprehensively examines agency theory, banking, incentives, moral hazard, and principal-agent relationships. Financial management cannot be separated from the application of agency theory principles to create value for all interests with comprehensive and effective corporate financial management. Agency theory has practical implications in various aspects of financial management, not only as a theoretical concept to help financial managers, investors and policy makers in designing more effective strategies and practices to manage conflicts of interest and increase company value.

INTRODUCTION

Financial management has three functions, namely funding, investment and dividend policy functions. These three functions are inherent in all types of companies (Damodaran, 2014). Especially for public companies, it also considers the functions of corporate governance and risk management. Study (Hussein et al., 2025) predicts the impact of the financial crisis, public sector accounting, governance and audit quality on the financial performance listed on the Tehran Stock Exchange. There is an important role of the board in improving the disclosure of reporting practices for the sustainability of a company study in Nigeria (Kumo et al., 2024). Through geocentric can be as one of the alternatives to improve financial performance (Sukendri, 2024). This geocentric concept can also provide added value in the financial management of MSMEs (Sukendri & Andriyansah, 2024).

Financial management can be referred to as corporate finance or business finance. Financial management is an integral part of the management function concerned with the efficient use of important economic resources, namely funds, also concerned with the procurement and effective use of funds in business or the application of general managerial principles in financial decision making by aligning individual motives and corporate goals. Financial management includes all aspects of administrative activities or functions required by the organisation, the movement of funds to achieve organisational goals with high productivity and meet its obligations. The purpose of managing financial management is how the company can prosper shareholders.

Agency theory is one of the financial theories that plays an important role in financial management (Amrulloh & Amalia, 2020). Agency theory is related to the framework of understanding the dynamics of the relationship between various stakeholders in a company. One of the urgencies of this study is that with the development of modern companies, there can be a significant separation between owners and managers. Therefore, it is necessary to manage potential conflicts of interest by managing the separation of ownership and control. Managers as direct managers may have different access to information than shareholders. Information imbalance can also lead to conflicts of interest and suboptimal decision-making and even possible losses for shareholders. The existence of differences in objectives between managers and shareholders can result in decisions that do not always maximise the company. As for one of the efforts to align the interests between managers and shareholders, it will be able to cause costs known as agency costs. This agency theory is one of the important foundations in the development of good corporate governance practices.

The literature study on the role of agency from various issues in accounting, namely agency is based on three assumptions, namely assumptions related to human characteristics, organisational structure and information that describe the relationship between the principal and the agent (Sutisna et al., 2024). An understanding of agency issues affects various strategic financial decisions, including capital structure, dividend policy, and investment decisions. Financial managers need to consider agency implications in each of their decisions. This theory provides a framework for evaluating managerial performance by considering the potential for opportunistic behavior, assisting in designing a more effective appraisal system.

Developments in the industrialized world have increased the complexity of global business operations so that agency theory has become increasingly relevant in understanding and managing relationships between various stakeholders in various jurisdictions. In this case, innovation is needed in financial instruments and organizational structures that aim to reduce conflicts of interest that can increase efficiency (Dewatripont, n.d.). A review of the need for strategic planning in making credit decisions, a case study of Commercial Banks in Iraq (Mohammed & Bougatef, 2024). The role of agency is related to various fields of science that have several different perspectives in the fields of economics and finance, sociology, political science, law have their own perspectives. In the context of banking, agency theory has significant relevance to the relationship between banks and depositors, where agency problems can arise due to information asymmetry and potential differences in interests between banks and depositors who entrust their money to banks (Diamond, 1984).

Agency theory also explains the importance of good governance in the banking industry to align the interests of bank management (agents) with shareholders and depositors (principals) (Levine, 2004). In addition, in the context of loans, banks act as principals and borrowers as agents. Agency problems can arise due to information asymmetry and potential moral hazard (Stiglitz & Weiss, 1981). Agency theory can also help explain why banks may take excessive risks. Bank managers (agents) may have incentives to take greater risks than shareholders or regulators (principals) would like (John et al., 2000). The application of agency theory in banking shows the complexity of the relationship between various stakeholders (Bebchuk & Spamann, 2010). The theory helps explain various phenomena in banking and provides insights for better policy design and management practices.

Previous research studies on financial management in relation to conflicts of interest, namely related to Corporate Governance and Conflicts of Interest, found that broader stakeholder governance does not always reduce conflicts of interest, and can even create new problems in corporate decision making (Bebchuk, 2020). Meanwhile, studies related to Financial technology (Fintech) explain that although fintech can increase financial inclusion, it can also create new forms of conflicts of interest, especially in terms of data privacy and algorithmic credit scoring (Philippon, 2019).

Previous research on conflicts of interest in asset management revealed that large investment managers such as BlackRock have significant influence over the companies they invest in, which can lead to conflicts of interest between their various clients (Massa et al., 2015). Another study on conflicts of interest in financial auditing explains that despite regulatory efforts, conflicts of interest in the audit industry remain persistent, which may affect the quality of financial statements (DeFond & Zhang, 2014). Another finding on Executive compensation and conflicts of interest found that compensation structures that focus too much on short-term performance can create conflicts of interest between executives and long-term shareholders (Edmans et al., 2021). Conflict of Interest in Pension Fund Management explains that pension fund managers often face a conflict of interest between maximizing short-term investment returns and meeting long-term obligations to pension participants (Andonov et al., 2017).

The existence of inconsistent research related to the impact of debt to Equity Ratio, Dividends, and non-financial factors on agency cost explains that DER has no effect on agency cost, which describes it as not in line with Jensen's theory in 1976 that corporate debt is one of the mechanisms for mechanisms in uniting the interests of managers with their shareholders. Dividends also have no effect on agency cost, which shows that it is inconsistent with the theory that ownership and dividend policy can reduce agency problems. The size of the board of commissioners and the independent board of commissioners have no effect on agency costs proxied by KAP, meaning that directors cannot reduce the differences in objectives between management and shareholders that can maximize firm value (Destriana, 2015). Research related to financial regulation and conflict of interest mitigation explains that post-crisis financial regulation has helped reduce some conflicts of interest, but financial innovation continues to create new challenges for regulators (Thakor, 2019).

Therefore, several studies and their findings suggest the potential to explore various aspects, including contract design, regulation, and risk management practices resulting from the principal-agent dilemma and moral hazard in banking. This paper aims to identify the role of agency theory in financial management and attempt to design practical management policies and strategies to assist financial managers, investors and policy makers in understanding and addressing the challenges arising from modern corporate ownership and management structures.

RESEARCH METHODS

This research uses a qualitative research approach that can be done with a literature review (Yam, 2024). This article uses a literature review method that explores specifically using Agency theory. This research is conducted to examine the theoretical concept of conflict of interest in financial management which is reviewed with literature and literature sourced from existing theories. This discussion is sourced from books, journals, references that are relevant and can be used in reviewing the discussion of this topic. The stages in this research can be described as follows:

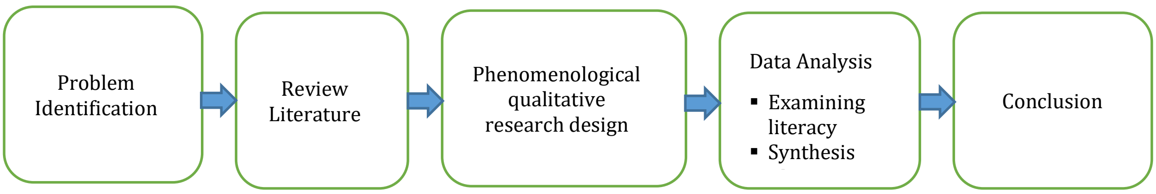

Figure 1: Research stages

The initial stage of this research began with identifying the problem, namely the existence of a participant and agent dilemma, namely the potential conflict of interest that occurs in various industries. Furthermore, by reviewing some relevant literature related to the management of conflicts of interest that lead to phenomenological qualitative research designs that occur in banking. The next stage is to analyse the data by reviewing literacy and synthesising specific theories on agency theory studies so as to provide research conclusions that can have practical implications in various aspects of financial management managing conflicts of interest.

RESULTS

The application of agency theory focusing on banking shows the complex correlation of various interests. This theory can help explain various phenomena in banking and provide insights into the design of better policies and management practices. Previous research studies provide an overview of the role of agency theory in various scientific fields which can be explained in table 1 State of the Art below.

Table 1: State of the art

Researcher Sources	Results
(Jensen & Meckling, 1976).	Economics and Finance Agency theory addresses the relationship between shareholders (principal) and corporate managers (agent). The theory explains the potential conflict of interest and information asymmetry between the two parties which suggests that agency problems can lead to inefficiencies and reduce firm value.
(Turner, 1986)	Sociology Agency theory in sociology focuses on the ability of individuals to act independently and make free choices in the context of social structures suggesting that agents have the capacity to influence and change social structures.
(Ferejohn, 1986).	Political Science Agency theory in political science addresses the relationship between voters (principal) and elected politicians (agent), as well as how political institutions can mitigate agency problems suggesting that agency problems can lead to suboptimal policies and political corruption.
(Eisenhardt, 1989)	Management Agency theory is used to explain a wide range of organisational phenomena, including governance structures, contract design, and firm performance.
(Macey & Miller, 1997)	Law Agency theory addresses the relationship between a client (principal) and a lawyer or other legal representative (agent) suggesting that conflicts of interest may affect the quality of legal representation.
(Dutta et al., 1992)	Marketing Agency theory is used to analyse the relationship between firms and marketing agents showing that appropriate incentive structures can reduce agency problems and improve marketing performance.
(Bandura,Albert, 1999)	Psychology Agency theory deals with the concept of self-efficacy and the ability of individuals to control their own actions showing that individuals' beliefs about their ability to control their actions affect motivation and performance.
(Mahaney & Lederer, 2003)	Information Technology Agency theory has been applied to explain the relationship between software developers and clients showing that agency problems can affect the quality and success of IT projects.

The development of the business world, many researches related to agency theory in financial management strengthen and provide a broader understanding of the importance of innovation in financial instruments and organisational structures to minimise conflicts of interest that can increase efficiency. Some of the findings in table 1 explain the relevance of agency theory to various fields of science that have several different perspectives. Agency theory has significant relevance in the context of banking, in relation to the relationship between banks and depositors, where agency problems can arise due to information asymmetry and potential differences in interests between banks and depositors who entrust their money to banks (Diamond, 1984). Agency theory also explains the importance of good governance in the banking industry to align the interests of bank management (agents) with shareholders and depositors (principals) (Levine, 2004).

Banks act as agents for depositors (principals), and banks can take excessive risks where banks as agents have an incentive to take greater risks than shareholders or principals want to take, and related to banking regulation that regulators can also act as agents for the public interest (principals). Agency theory helps explain the design and implementation of banking regulation to address agency problems in the industry. Based on the lending context, banks act as principals and borrowers as agents. Agency problems can occur due to information asymmetry and potential moral hazard (Stiglitz & Weiss, 1981). Agency theory can also help explain the design of bank executive compensation systems to align the interests of management with shareholders and the long-term stability of the bank (Bebchuk & Spamann, 2010). In addition, agency theory can act as a financial innovation such as securities that can influence agency relationships in banking (Bebchuk & Spamann, 2010).

Agency theory and its evolutionary development

Agency theory provides a framework for understanding and managing conflicts of interest between owners (shareholders) and managers. This understanding is important to optimise financial decision-making and increase firm value. The development and evolution of agency theory is described as follows:

Table 2: Development of agency theory

Early developments in the 1930s (Berle and Means, 1932)	Berle and Means (1932) in the book 'The Modern Corporation and Private Property' first identified the problem of separation of ownership and control in modern corporations highlighting the potential conflict between shareholders and professional managers.
Early Development of Corporate Theory in the 1950s (Simon, 1972)	Herbert Simon introduced the concept of 'bounded rationality' which explains the limitations of managers in decision-making which is the basis for understanding why managers may not always act optimally in the interests of shareholders.
Formulation of Agency Theory in the 1960s-1970s (Jensen & Meckling, 1976)	Wilson (1968) and Ross (1973) began to develop the formal framework of agency theory. Jensen and Meckling (1976) published the seminal paper 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' which became the cornerstone of modern agency theory defining agency relationships and explaining the concept of agency costs.
Expansion and Applications in the 1980s (Eisenhardt, 1989)	Fama (1980) and Fama & Jensen (1983) expanded the theory by focusing on the separation of ownership and control in the context of efficient markets. Eisenhardt (1989) integrating agency theory into the organisational and management literature.
Developments in Corporate Governance in the 1990s (Shleifer Andrei and Vishny, 1997)	Shleifer & Vishny (1997) reviews the corporate governance literature from an agency theory perspective. Agency theory is the basis for corporate governance reform in many countries.
Criticism and Refinement in the 2000s (Ghoshal, 2005)	Ghoshal & Moran (2005) criticised agency theory's overly pessimistic assumptions about human nature. The development of stewardship theory as an alternative, which emphasises the intrinsic motivation of managers.
Integration with other theories in the 2010s until now (Wiseman et al., 2012)	Agency theory is integrated with behavioural and organisational psychology perspectives. Wiseman et al. (2012) proposes a more contextualised approach to agency theory. Recent research focuses on how technology and changes in organisational structure affect agency problems. Further developments relate to applications in

	Fintech and the Digital Economy. Recent developments look at how agency theory applies in the context of digital platforms and new business models. Issues such as data privacy and algorithm liability are beginning to be analysed using an agency theory framework.

The development of agency theory reflects changes in the business environment and our understanding of organisational behaviour. Initially focussed on the relationship between shareholders and managers, the theory has evolved to encompass a wide range of stakeholder relationships in complex business ecosystems. Despite criticisms, agency theory remains one of the most influential frameworks in financial management and corporate governance.

Agency theory, agency problems, and agency costs

Agency Theory, Agency Problem, and Agency Cost are interrelated concepts of economics and management science (Panda & Leepsa, 2017). Agency Theory describes the relationship between two parties, namely the principal (owner/shareholder) and the agent (manager/employee). The principal authorises the agent to run the business and make decisions on behalf of the principal which aims to align the interests between the principal and the agent so that the agent's actions are in line with the interests of the principal. Agency problems are problems that arise when there is a conflict of interest between the principal and the agent such as the agent acting in his own interests, not in the interests of the principal, the agent does not try his best to achieve the principal's goals, the agent hides important information from the principal or uses information for his own interests. In practice, agency theory, agency costs, and agency problems are important topics in corporate governance and are important considerations for principals in managing their relationships with agents. Meanwhile, agency costs are costs that arise due to differences in interests between principals and agents such as monitoring costs incurred by principals to oversee agent actions, costs incurred by agents to show their commitment to principals (bonding costs), costs of losses arising from differences in decisions between principals and agents (residual loss).

The relationship between agency theory, agency problems, and agency costs can be explained that agency theory describes the contractual relationship between the principal and the agent so that agency problems can arise as a result of the differences in interests between the principal and the agent (Panda & Leepsa, 2017). Agents may not always act in accordance with the interests of the principal, but tend to maximise their own interests. Agency costs here are costs arising from efforts to overcome agency problems, while agency costs are efforts to minimise conflicts of interest. The difference in decisions between the principal and the agent still has the possibility of residual loss. Agency theory explains the contract between principals and agents, agency problems are problems that arise due to differences in interests, and agency costs are the costs that must be borne to overcome these agency problems. Therefore, the interrelationship of these three concepts is important for the principal to understand in managing his relationship with the agent effectively.

Specifically, there are several types of agency problems, namely:

Table 3: Types of agency problems

Type	Description	Problem
Type I	The difference in interests that occurs between shareholders (principals) and managers (agents).	Differences in interests and asymmetric information between shareholders and managers, where the behaviour of managers acts in their own interests (Jensen & Meckling, 1976) and (Fama, 1980).
Type II	The difference in interests that occurs between majority shareholders (principals) and minority shareholders (agents).	Majority shareholders can take personal advantage to the detriment of minority shareholders. One of the obstacles is where majority shareholders can use their control to obtain personal benefits such as majority shareholders who make transactions with affiliated companies at unfair prices, which can harm minority shareholders (Shleifer Andrei and Vishny, 1997) and (Villalonga & Amit, 2006).

Tipe III	The difference in interests that occurs between debt holders (creditors) and shareholders (principals).	Shareholders can take actions that are beneficial to themselves, but detrimental to creditors where principals can take excessive risks or take other opportunistic actions that harm creditors. One example is that shareholders make high-risk investments in the hope of getting high returns, but if it fails, it can harm creditors (Jensen & Meckling, 1976) and (Fama & Jensen, 1983).

The three types of concepts in Table 3 are important for principals to understand in managing their relationship with agents in order to identify and minimise agency costs that may arise.

Improved corporate governance

Given the potential for agency problems, companies can design better governance structures. One strategy in managing the improvement of corporate governance for the better is to manage the formation of an effective board of directors, appropriate compensation policies, and strong oversight mechanisms. Some of these strategies are efforts to improve better corporate governance. This strategy is reinforced by research studies which explain that agency theory is relevant as the main foundation related to several issues in the field of accounting in fraud management, corporate governance, and auditing (Sutisna et al., 2024). Improving corporate governance in banking can improve the performance, efficiency, and competitiveness of banks, as well as maintain stability and trust in the banking system.

Capital structure optimisation

Agency theory can also influence capital structure decisions. The use of debt can reduce agency problems by limiting free cash flow and increasing external supervision, but it can also create conflicts between shareholders and creditors. Capital structure decisions with debt financing need to be considered according to the optimal proportion in order to provide maximum benefits for the company. Excessive debt financing will reduce the value of the company with additional costs including agency costs. The optimisation of capital structure is strengthened by research that explains that capital structure acts as moderation that can strengthen the company's financial performance (Savestra et al., 2021) and the need for consideration in choosing the source of capital funds (Sukendri et al., 2023). Banks must be able to maintain capital adequacy, optimise funding sources between core capital funding capital and loan capital, be able to manage their liability structure well by maintaining the availability of liabilities and minimising the cost of funds, be able to manage risky assets, strive to improve operational efficiency to reduce costs and increase profitability at the bank. Optimisation of capital structure in banking is important to maintain the adequacy, balance and efficiency of capital, so that banks can operate in a healthy and sustainable manner.

Effective dividend policy

An understanding of agency problems helps company managers design a dividend policy that balances the need for reinvestment with a reduction in free cash flow that could potentially be misused. So, with these potential agency problems, a dividend policy strategy is needed regarding the proportion of dividend distribution or the need for reinvestment. In line with research explaining that dividend policy and bank health can affect firm value in banking, (Martha et al., 2018) and (Fauziah, 2017) explained. Banks must be able to maintain the capital adequacy ratio by considering the impact of dividend payments by maintaining a balance between retained earnings and distributed earnings, considering the need and expansion and investment. Banks must be able to consider market conditions, industry trends, and business prospects with a flexible dividend policy that can maintain competitiveness and investor confidence. Banks must be able to maintain the continuity and consistency of dividend payments, compliance with regulations and fulfil shareholder expectations that can increase shareholder satisfaction. An effective dividend policy in banking must be able to consider the balance between the interests of shareholders, capital requirements, and the financial stability of the bank in the long term.

Risk management

Agency theory helps in understanding how different attitudes towards risk between managers and shareholders can affect the company's risk management decisions. Companies must be able to identify risks and manage risks from differences in attitudes between managers and shareholders. Bank management as an agent can have an incentive to take risks that are not in line with the interests of the principal which creates a potential conflict of interest. The application of risk management is needed in managing financial performance in the banking industry (Pratiwi & Kurniawan, 2018), also reinforced by research studies on the need for risk management in minimising customer moral hazard in Islamic banking financing (Mauludin, 2020). In addition, the role of religious values has an important role in the sustainability of the company. Religious values can correlate in improving consumer behaviour (Andriyansah et al., 2024). The concept of Tri Hita Karana, which is one of the Hindu cultural concepts, can also play a role in the sustainability of the company (Sukendri & Andriyansah, 2024). There is risk mitigation needed in the management of MSMEs through the concept of Tri Hita Karana (Sukendri, 2023). There is a relevance between CSR and the Tri Hita Karana cultural concept (Sukendri & Putra, 2022).

Information asymmetry between bank management and stakeholders can trigger agency problems, there are differences in information about the risks faced by banks, while stakeholders have limited information so that the importance of risk management to minimise the risks that occur supported by adequate supervisory roles such as audit committees and risk management committees) and the application of good corporate governance principles that can strengthen risk management. The implementation of effective risk management and supported by good corporate governance, banks can reduce agency problems and provide a balance of management interests with stakeholders that can improve the stability and performance of banks in the long term.

Investment evaluation and decision

Agency theory can be a performance evaluation that provides a framework for evaluating managerial performance by considering potential opportunistic behaviour and conflicts of interest. Agency theory can influence how investment decisions are made and evaluated, by considering the potential for managers to choose projects that favour themselves over shareholders. There is an alignment of the interests of managers with shareholders such as performance-based compensation or share ownership by managers by designing contracts and incentive systems to be provided. One of the necessary strategies is also to carry out transparency and disclosure of information to reduce information asymmetry between managers and shareholders. In addition, financial innovation strategies are needed by supporting the development of new financial instruments and organisational structures that can minimise agency costs and increase efficiency.

Agency theory has an important role in financial management. This is reinforced in line with the research of a critical perspective on agency theory which explains that agency as a process where actors rationally perform intensive, effective planning and management to achieve certain goals (Kumalasari & Sudarma, 2013). Agency theory discusses if there is a difference between the interests and goals of individuals and others. If owners acquire high power and have the ability to command their agents then agents should carry out their activities based on the interests of the owners to maximise their own wealth. Agency theory can provide important benefits to the banking world, namely the need to improve corporate governance by strengthening supervisory mechanisms both internally and externally, transparency in financial reporting, alignment of interests by designing incentive contracts, implementing share ownership policies, the need for effective risk management, improving communication, strengthening the role of the audit committee, developing an ethical culture, as well as optimising the board structure.

Comprehensively, agency theory in relation to financial management plays an important role in shaping modern financial management practices by highlighting the challenges arising from the separation of ownership and control in the company, the need to develop strategies and mechanisms to align the interests of various stakeholders, improve operational efficiency so as to maximise firm value.

CONCLUSIONS

Financial management aims to maximise firm value, while agency theory addresses how to achieve this goal in the context of separation of ownership and control. Thus, financial management and agency theory focus on value creation by managing potential conflicts of interest. Financial decision making, namely investment, funding, and dividend decisions in financial management must consider agency implications. Capital structure decision-making does not always consider the cost of capital but also as a debt supervisory control to minimise agency costs. Agency theory is also considered in managing risk management, the importance of incentives in balancing interests, effective corporate financial governance practices, the need for transparency in financial reporting.

Agency theory is also needed as a reference that optimisation is in line with the interests of shareholders and managers, that financial management focuses on optimising resource allocation. Companies must be able to conduct a holistic performance evaluation, which considers agency issues and is able to create long-term value so that a long-term financial strategy is needed by paying attention to ethics and social responsibility in financial management practices. This research is not only about moral hazard, but also about the broader application of agency theory in the context of banking by exploring various aspects, including contract design, regulation, and risk management practices resulting from the principal-agent dilemma and moral hazard in banking. Comprehensively examines agency theory, banking, incentives, moral hazard, and principal-agent relationships. Therefore, financial management cannot be separated from the application of the principles of agency theory to create value for all interests by comprehensive and effective financial management of the company. Agency theory plays an important role in shaping modern financial management practices from the separation of ownership and control in companies that will encourage the development of strategies and mechanisms to align the interests of various stakeholders, improve operational efficiency, and ultimately maximise firm value.

Strategies so that agency theory can provide benefits to the banking world, namely the need to improve corporate governance by strengthening supervisory mechanisms both internally and externally, transparency in financial reporting, alignment of interests by designing incentive contracts, implementing share ownership policies, the need for effective risk management, improving communication, strengthening the role of the audit committee, developing an ethical culture, as well as optimising the board structure. Agency theory has practical implications in various aspects of financial management, especially in banking, not only as a theoretical concept to assist financial managers, investors, and policy makers in designing more effective strategies and practices to manage conflicts of interest and increase firm value.

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