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Almost 10 years after the global financial crisis, the regulatory authorities continue amending the existing regulations and publishing new regulations to make the financial industry more stable and to better protect the consumers. In the recent years, many new regulations such as BCBS 239, GDPR, IFRS 9, etc. were published to address the weaknesses of the banking sector identified during and especially after the crisis. New regulations lead to new challenges for the financial institutions as they are expected to make significant efforts to make sure each regulation is respected and the requirements met by deadline.

The European Central Bank (ECB) has launched the Supervisory Review and Evaluation Process (SREP) in order to monitor the implementation status of each of the relevant regulation regularly. In 2016 SREP was executed for the second time in 19 European countries for more than 120 Significant Institutions (SI). Besides the geographical scope, the ECB defines each year’s focus regulations/topics for the SREP, which are then analyzed and assessed by the Joint Supervisory Teams during the ECB on-site inspections.

This Point of View provides an overview of the outcomes of the SREP 2016 and analyzes the focus topics of the upcoming SREP 2017 by answering the following 4 questions for each of the focus topic:

- What is the focus topic?
- Why is it a focus topic of SREP 2017?
- What is going to be reviewed by the ECB?
- What can banks do to prepare for the ECB inspection?

Finally, the Point of View describes the Capgemini Consulting macro project approach – how banks can prepare for this year’s on-site inspection.
Outcomes of the SREP 2016 and focus topics 2017

In December 2016 European Central Bank (ECB) published the outcome of its second Supervisory Review and Evaluation Process in 2016. The outcome revealed broadly stable capital demand for 2017 for the directly supervised banks, which remains comparable to 2016 (at an average of around 10% Common Equity Tier 1 (CET 1)).

In addition to capital requirements, the ECB imposed higher liquidity coverage ratios (LCR) than the regulatory minimum and in some cases, even specific minimum amounts of liquid assets. The latest was the case, when banks relied too much on wholesale short-term funding or inadequately managed risks associated with collateral management. Finally the ECB also imposed qualitative measures to address weak governance.

Based on an analysis conducted by the ECB with the national competent authorities (NCA), with input from the Joint Supervisory Teams (JST) as well as international bodies, key sources of banking sector risks and their drivers such as the very low/ negative interest rate environment, high-level of non-performing loans (NPLs), the reactions of banks and markets to new regulation, cases of misconduct by banks, cybercrime and IT disruptions, non-banking competition etc. were identified. The analysis outlined the need for the ECB to streamline its supervisory priorities to address the key risks identified – business model and profitability risk and credit risk, which has finally led to the following 3 priority areas for 2017:

• Business models and profitability drivers - thematic review of banks’ business models and profitability drivers especially the assessment of:
  – the possible impact of the UK’s referendum and
  – the potential risk emerging from “FinTechs”

• Credit risk, with a focus on NPLs and concentrations
  – Guidance & supervisory dialogue on NPLs (many banks still exhibit a high stock of NPLs)
  – Investigation of excessive concentrations of credit risk in certain asset classes (e.g. shipping loans) by taking principles from the “targeted review of internal models” as well as the “capital requirements regulation” into consideration

• Risk management
  – Compliance with the BCBS 239 (main focus on data quality)
  – Targeted review of internal models – assess and confirm the adequacy and appropriateness of approved Pillar 1 internal models
  – Review of banks’ outsourced activities – how are the risks of the (increasing number of) outsourced activities managed
  – Review of ICAAP and ILAAP processes
What are business models and profitability drivers about?

The overall business model of a bank is a key driver for sustainability and is directly linked to the risk management function. Currently relevant changes like the increasing competition through FinTechs as well as the British referendum (“Brexit”) are key topics of the next SREP.

Why business models and profitability drivers are focus topics of SREP 2017?

The long period of low interest rates as well as asset impairments have had a substantial impact on the profitability of banks and their overall approach towards building their own specific lending strategy.

The SREP targets an assessment of the maturity of banks to pivot their business model correctly to adapt to the given market situation and align their overall business approach with the risk appetite/strategy.

The currently new topics such as the risks arising from FinTechs occur due to the fact that FinTechs, that are agile by definition, have taken over several financial service offerings and have already proven, that they are capable of competing with banks in their very specific field of expertise.

Rising market volatility, as well as not complying legal boundaries of the United Kingdom (UK) are main factors for the relevance of the “Brexit” in the SREP.

What is going to be reviewed by the ECB?

The assessment will consist of several steps of different granularity – at group level as well as across different entities and business units the Joint Supervisory Teams (JST) are expected to analyze business models and profitability drivers in order to identify company-wide but also unit specific issues.

While it is essential to stay profitable, it is critical to identify possible risks emerging from leveraging methods in order to increase revenue. Lowering the credit granting standards, increasing reliance on short term funding as well as increasing risk exposures might benefit the profitability just by increasing business volume. However the downside of those measures can force a bank into bankruptcy and also conflict with current or future regulations. Considering the possible impact of the changes that Basel IV would bring along, it is rather crucial to optimize the business model by optimizing risk weighted assets (RWA) than increasing the overall risk exposure.

The ECB targets to identify volatility resistant business models, in which certain scenarios do not lead to significantly high losses. This leads to the conclusion, that business models of banks are supposed to be comprehensively linked to the risk management function. Findings from the risk management functions, such as imbalance in the credit risk exposure can lead to changes for strategic planning. As a result, banks will need to prove that they are focusing on validation and back-testing of their risk models in order to identify potential for optimization.

What can banks do to prepare for the ECB inspection?

Depending on the relevance of the institute, the authorities will focus on evaluating the adaptability of their specific business models and the level of maturity of bank specific risk management functions as well as readiness of banks to quantify possible impacts of macroeconomic important changes such as the Brexit. Due to the fact, that increasing market volatility is a really probable consequence of the Brexit, it is important to identify the possible impacts early on and reassess the business model according to the bank specific findings. This can be done by running a comprehensive stress-test that will provide information on possible risks of the Brexit scenario.

For universal banks, it is also significant to have a dedicated strategy to identify, analyze and prevent the risks emerging from FinTechs.

The readiness of a bank depends on its specific investments into innovation and automation of bank specific offerings. Restructuring of internal processes is another important measure to enable quick implementation of FinTech solutions or to adapt given offerings.
What is the focus topic?

Credit risk was already one of the main focus topics in 2016 and it still remains as such. The effective and comprehensive management of credit risks is one of the key challenges of the banking sector. One of the main objectives of the SREP 2017 is to validate the credit risk management function of a bank mainly focusing on NPLs and their handling within an institute as well as on credit risk concentrations. Furthermore, the authorities will evaluate the implementation status of the IFRS 9 requirements, especially since the IFRS 9 impairment definitions are of significant relevance for the classification of loans as non-performing ones.

Why credit risk management is a focus topic of SREP 2017?

While the focus on credit risk is especially explained by the low interest rates as well as by the decreasing profitability in the credit business, the focus on NPLs and credit risk concentrations has several reasons.

ECB focuses on NPLs mainly due to the fact, that the methodology of handling NPL is not harmonized throughout the banking sector; hence, there is no comparability across the banks possible. Also, having a large NPLs exposure forces banks to reduce loan originations as well as prepare equity for possible depreciations. For that reason, correct and standardized classification of NPLs is essential for profitability.

The second focus topic is concentrations. Risks from concentrations arise whenever the distribution of loans is unbalanced and a significant part of total granting is allocated to a certain client, company, sector or region. Especially banks with a regional strategy are bound to face concentration risks. Certain banks strategically decide to have concentrations of risks within certain asset classes due to their own specifications and know-how, which is the reason why concentrations are not necessarily the result of insufficient credit management. However, concentrations and their related loss given default (LGD) can harm a bank’s profitability and continuity and makes concentrations a focus topic for the SREP.

What is going to be reviewed by the ECB?

A focus of the SREP will be to evaluate the current handling of loans, starting from the credit standards that are applied in order to originate loans, to the further processing of credit risk related data on to the methodological, technical and organizational readiness of the credit risk management function.

The “Guidance to banks on non-performing loans”1 will be the benchmark for the authorities during the evaluation of the NPL strategy and the implementation/handling of the NPL strategy throughout every involved business-unit. The assessment will be more restrictive for banks with a large exposure of NPL and a NPL strategy and operating model that does not fully comply with the guidance provided by the ECB. The link between NPL and IFRS 9 is convenient in that matter, and it appears to be logical, that the results of both reviews will be correlated. Concentration risks will be addressed by assessing and evaluating the maturity of stress testing methodology, the granularity of used data as well as the underlying risk models to quantify the risks.

What can banks do to prepare for the ECB inspection?

The first step for banks to take is to analyze their current credit portfolio and their credit risk exposure to a degree of comprehensiveness, which fits to size and business model of a bank. The following step is assuring governance considering the risk management function. This includes data governance, finance and risk architecture as well as methodological issues like credit risk model management.

A dependency matrix of the credit risk management to related regulations and standards like BCBS 239, IFRS 9 etc. is essential to see ongoing progress and possible impacts on current gaps. Therefore a sound documentation of each relevant project status will help to prepare for SREP. One of the main objectives is the compliance with the “Guidance to banks on non-performing loans” while it is important to identify dependencies and interlinks between the NPL project and other related projects like IFRS 9.

NPL handling within a bank will be further assessed regarding governance issues. A fitting strategy and operating model, that enables to identify, value and handle NPL is key to pass especially qualitative but also quantitative checks by the authorities. An early implementation of changes enables comprehensive testing and enhancements, which is a reason, why the implementation status of the projects such as IFRS 9 or BCBS 239 is going to be assessed. So it is essential for banks to act with an accelerated approach, if certain measures have not been taken already.

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5.1. Overview

**Figure 2: ECB SREP 2017**

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<tr>
<th>ICAAP / ILAAP</th>
<th>TRIM</th>
<th>BCBS 239</th>
<th>Outsourcing</th>
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<tbody>
<tr>
<td><strong>What is the focus topic?</strong></td>
<td>Verification of bank’s implementation of adequate processes to assess and maintain capital and liquidity adequacy</td>
<td>Assessment of banks’ internal model’s reliability and comparability to determine Pillar 1 own fund requirements</td>
<td>Review of banks’ compliance with Basel Committee’s principles for effective data aggregation and reporting</td>
</tr>
<tr>
<td><strong>Why is it a focus topic?</strong></td>
<td>Need for improvement observed in 7 priority areas from 2016 experience</td>
<td>• Increased complexity since first introduction (Basell II)</td>
<td>• Increased regulatory expectations regarding data availability, quality and governance</td>
</tr>
<tr>
<td><strong>What will be reviewed?</strong></td>
<td>Respect of principles set by the supervisor for each of these 7 areas</td>
<td>Exploration of practices diversity in topics in which there is a need for harmonization</td>
<td>Banks ability to fulfill 2 consequent exercises: Fire Drill &amp; Data Lineage</td>
</tr>
<tr>
<td><strong>What can banks do to prepare?</strong></td>
<td>Provide specific ICAAP/ILAAP documentation and conclusions</td>
<td>Perform certain calculations and materiality assessments for different types of risks</td>
<td>• Provide consistently validated real time data on short notice</td>
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<td>• Implement interconnected tools with drill down feature</td>
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5.2. Review of ICAAP & ILAAP

**What are the ICAAP (Internal Capital Adequacy Assessment Process) and ILAAP (Internal Liquidity Adequacy Assessment Process)?**

The ICAAP and ILAAP are sets of strategies and processes used by banks to ensure:

- Adequate levels of liquidity buffers and adequate funding
  
  They are subject to a regular internal review to stay comprehensive and proportionate to the institutions’ activities such as nature, scale and complexity (ICAAP) as well as to stay adapted to every business line, currency, branch and legal entity (ILAAP).

**Why ICAAP and ILAAP are focus topics of SREP 2017?**

Generally, a good ICAAP increases the supervisor’s level confidence and the institution’s capacity to manage its risks to remain viable, while a sound ILAAP provides the supervisor an increased level of trust in the institution’s capacity to meet its obligations by reducing uncertainty regarding its actual and to upcoming risks.

As ICAAP and ILAAP are internal processes to be implemented in a “proportionate manner” by each institution in the scope of SREP inspection, different banks can have different interpretations of a “proportionate manner” which can lead to insufficiencies. Indeed, in 2016 the ECB observed a need for improvement across banks’ assessments.
ICAAP & ILAAP principles

1. The management body is responsible for the sound governance of the ICAAP & ILAAP

2. ICAAP & ILAAP are integral part of the management framework of an institution

3. All material risks are identified and taken into account in the ICAAP & ILAAP

4. ICAAP & ILAAP assumptions and risk quantification methodologies are proportionate, consistent and thoroughly validated

5. ICAAP and ILAAP is aimed at maintaining the viability of the institution on an ongoing basis by...
   - ...covering short and medium-term assessments from different perspectives
   - ...ensuring an adequate supply of liquidity and stable funding on the short and medium term

6. Regular stress testing is aimed at...
   - ...ensuring viability under adverse developments
   - ...ensuring sufficient available liquidity to withstand periods of severe stress

7. Internal capital is of high quality and clearly defined
   - Internal liquidity buffer is of high quality, well diversified and its components are clearly defined

Note: 

| ICAAP relevant | ILAAP relevant |

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Figure 3: ICAAP & ILAAP principles

What is going to be reviewed by the ECB?

To tackle this need for improvement, the ECB defined a set of 7 principles to be followed by institutions (see figure 3).

What can banks do to prepare for the ECB inspection?

To face those increased expectations and to ensure convergence in supervisory practices, institutions could prepare to provide the supervisor the following information/documentation:

- A reader’s manual: overview of submitted documents with their status and references providing a link with SREP guidelines and highlighting material changes since last submission
- ICAAP and ILAAP frameworks, business models and strategy and governance: set of documents including a stress testing program, including documentation of results of already performed stress test results
- ICAAP specific documentation: set of documents including ICAAP framework, risk measurement and assessment, capital planning and allocation as well as the documentation of progress made since last review process
- ILAAP specific documentation: set of documents including ILAAP framework, liquidity and funding strategy, liquidity risk management, cost-benefit allocation and contingency plan as well as the documentation of progress since last review process
- ICAAP and ILAAP main conclusions and quality assurance: set of documents including summary of bank’s conclusions, explanation of results’ reliability and internal approvals
5.3. Targeted Review of Internal Models (TRIM)

**What is the TRIM?**

Banks often use internal models in order to determine the minimum amount of capital they must hold by law (Pillar 1 own funds requirements). The targeted review of internal models (TRIM) is the assessment of the reliability of these models as well as their comparability and compliance with regulatory requirements.

**Why is TRIM a focus topic of SREP 2017?**

In recent years the use of internal models has been source of doubts because they have become more and more complex since they were firstly introduced under Basel II. Banks and supervisors struggled increasingly in their understanding and in the assessment of correct and consistent risk mapping. Furthermore, resulting from banks’ relative freedom granted by the current regulation, inconsistencies and high variability in capital requirements calculated by internal models of different banks have been identified.

So to enhance the credibility of approved Pillar 1 internal models permitted for use by important institutions, TRIM aims to reduce unwarranted variability in risk-weighted assets driven by inappropriate modeling.

**What is going to be reviewed by the ECB?**

From 2017, the ECB will carry out hundreds of on-site investigations to explore the complexity and the diversity of internal models practices in order to converge to a uniform method. During those missions, ECB will verify institutions’ ability to perform certain calculations and materiality assessments for different types of risks.

**What can banks do to prepare for the ECB inspection?**

The goal of the calculations and the materiality assessment investigations will be to identify potential deviations from the best practices. Therefore, banks could prepare themselves to perform the following activities for each type of risk:

- **Market risk:**
  - Regarding the methodology for IRC (Incremental Default and Migration Risk Charge) models: banks should be able to perform calculations of IRC and default risk in IRC based on a predefined calculation method\(^2\) and one flat correlation with different correlation assumptions: 0%, 10%, 20%, 30%, 40%, 50%, 60%, 70%, 80%, 90%.

- **Counterparty credit risk (CCR):**
  - Regarding the margin period of risk and cash flows: banks should be prepared to perform impact calculations of variants at least for representative sub-portfolios
  - Regarding the modeling of initial margin\(^3\), banks should be prepared to:
    - Assess the materiality of Internal Models
    - Provide the following measures at a clearly defined valuation date:
      - Number of transactions subject to a margin agreement with an initial margin, number of all margined transactions, and number of all CCR transactions;
      - Number of agreements subject to initial margin, number of all margined agreements, and number of all CCR netting agreements;
      - EAD of netting sets subject to initial margin, EAD of all margined netting sets, and EAD of all CCR netting sets;
      - Risk-weighted assets of netting sets subject to the initial margin, RWA of all margined netting sets, and RWA of all CCR netting sets

- Assess the expected increase in the number of transaction resulting from the new initial margin requirement

5.4. Thematic review of BCBS 239

**What is the BCBS 239?**

The Basel Committee for Banking Supervision (BCBS) Regulation 239 is the consultative paper regarding the principles for effective risk data aggregation and risk reporting. Its 11 principles target the improvement of banks’ IT architectures, risk data aggregation capabilities and reporting systems as a basis for robust risk management.

The first phase of ECB’s BCBS 239 review was composed of ECB on-site reviews followed by individualized deep dives per bank and banks’ compliance

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2 A one-factor Merton Model (e.g. Asymptotic Single Risk Factor model) - simplified credit portfolio risk model which allows to derive analytical expressions for VaR (Value at Risk) and ES (Expected Shortfall), by relying on a limiting portfolio loss distribution.

3 The initial margin is already used in central clearing and currently carries over to bilateral over the counter agreements. The modeling issue with respect to the counterparty credit risk is that the initial margin depends on the risk profile of the future netting set in terms of levels and volatility of simulated market risk factors and on transactions still alive: it is a variable agreement parameter.
self-assessments. The second phase review which started October 2016 and already made banks struggle is composed of 2 consecutive exercises: the Fire Drill and the Data Lineage.

**Why is BCBS 239 a focus topic of SREP 2017?**

The focus on BCBS 239 is a consequence of the increased regulatory expectations regarding data availability, quality and governance. Moreover, the thematic review is already showing difficulties for banks in terms of interpretation matters. Therefore, we can expect that similar exercises to already performed exercises in 2016 the will be carried out by ECB in 2017.

**What is going to be reviewed by the ECB?**

**Example 1: the Fire Drill exercise**

For this exercise, the ECB demands institutions to:

- Collect and submit a selected set of information/indicators within a short period of time (e.g. liquidity data)
- Conduct an independent data submission validation via banks’ internal audit functions

**Example 2: the Data Lineage exercise**

This exercise is deep dive on data lineage of one credit risk and one liquidity risk indicator. During half a day, the ECB demands institutions to:

- Demonstrate the ability to drill down the indicators
- Provide very recent to real time liquidity data on a short notice
- Be able to provide consistent reference data from entity to entity within a group
- Ensure the involvement of the internal audit functions in the BCBS 239 implementation programs

**What can banks do to prepare for the ECB inspection?**

**Example 1: the Fire Drill exercise**

Knowing encountered pain points in 2016, banks should be prepared to:

- Provide very recent to real time liquidity data on a short notice
- Be able to provide consistent reference data from entity to entity within a group
- Ensure the involvement of the internal audit functions in the BCBS 239 implementation programs

**Example 2: the Data Lineage exercise**

Knowing encountered pain points in 2016, banks should be prepared to:

- Implement interconnected tools covering areas such as dictionary and quality management, data lineage and certification support
- Or at least have a reporting system in place that can provide drill down features that describe end-to-end process flows (from extraction to reporting of risk data)

5.5. Thematic review of banks’ outsourced activities

**What are the outsourced activities of banks?**

Many banks outsource more and more activities such as risk management or complex data storage. Although banks developed sufficient controls to lower IT and security risks, they should now focus on managing emerging risks coming from their relationships with vendors. Therefore, ECB will launch a thematic review of banks’ outsourced activities and analyze the related risk management.

**What is going to be reviewed by the ECB?**

The ECB will verify to what extent outsourced activities are subject to correct risk exposure mitigation by using the CEBS guidelines on outsourcing. These guidelines highlight the importance of banks’ senior management accountability, of outsourcing use for non-core strategy activities only, and of having an independent, transparent and contractually defined relationship with suppliers (see figure 4).

**What can banks do to prepare for the ECB inspection?**

Different strategies have been identified to mitigate risks of outsourced activities. Banks could implement one of the following:

**Set different approaches for different vendor risk categories:**

Banks face a variety of potential risks from different sources and levels:

- Different vendors or service providers providing the same operation or service
- Different types of operation or services provided by the same supplier
- Different levels of risk management robustness and criticism for vendor...
Different level of risk associated with each arrangement

To face this complexity, banks are expected to divide vendor risks into categories such as strategic, reputation, compliance, operational or business continuity. That would help them to appropriately adapt the level of control of every category to its level of risk.

Implement a 3 line defense:

- Take a shared risk management approach with the supplier: even though the bank should be accountable for risks, controls should also be performed by the supplier
- Define and implement an enterprise-wide strategy, policies and standards: risk management activities should be coordinated with an integrated view of suppliers compliance, risks and controls to avoid silo analyses
- Document the results of regularly performed internal audits of line 1 and 2 efficiency: vendor risk management practices are correctly designed and operate following the bank’s regulatory requirements and policies

Figure 4: CEBS Guidelines on outsourcing principles
To achieve full readiness to meet the challenges described above, Capgemini Consulting designed a 4 month project approach, split in 3 main dimensions of the SREP 2017.

**Figure 5: Capgemini Consulting project approach and planning**

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<th>Business models (BM) and profitability drivers</th>
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<tr>
<td><strong>Analysis SREP review 2016</strong></td>
<td><strong>Documentation of the current NPL exposure as well as the NPL classification methodology</strong></td>
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<tr>
<td>• Identification of banks main activities/areas of focus</td>
<td>• Documentation of the key achievements made on the action plan derived based on recommendations made after the latest SREP inspection</td>
</tr>
<tr>
<td>• Understanding of materiality of business areas</td>
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<tr>
<td><strong>Identification of the main domains impacted by FinTechs</strong></td>
<td><strong>Identification of the materiality of each outsourced activity</strong></td>
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<tr>
<td><strong>Identification of the main processes and activities located in the UK</strong></td>
<td><strong>Understanding of the materiality of each internal model used for capital calculation activity including the governance of vendor activities based on CEBS guidelines</strong></td>
</tr>
<tr>
<td><strong>Assessment of the business model (e.g. diversified/retail lender, universal bank, etc.)</strong></td>
<td><strong>Gathering bank internal ICAAP &amp; ILAAP documentation (mapped to EBA structure) to facilitate the decision making on ICAAP/ILAAP reliability</strong></td>
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<td><strong>Action plan to close the GAP</strong></td>
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<td><strong>Action plan to close the GAP</strong></td>
<td><strong>Identification of parts of total granting allocated by a certain client, company, sector or region</strong></td>
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As Capgemini Consulting we accompany financial institutions in the conception and realization of their transformational strategies. We offer our clients our IT as well as regulatory know-how, competencies, and deep comprehension of both regulators and markets to help them carry out effective transformation steps towards efficiency and compliance.

Our professionally-qualified team of specialist consultants has a unique perspective on finance and regulatory, informed by our business transformation legacy and our market-leading technology and BPO expertise. Our solutions for regulatory topics, such as BCBS 239, IFRS 9 and GDPR enable you to rethink and redesign current structures, streamline processes, optimize systems architectures, strengthen internal controls, enhance staff capability, simplify and strengthen data structures and improve the presentation and rigor of reporting.
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