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Chapter 1 The Seeds Are Sown

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Chapter 2 Two More Tools in the Tool-Kit

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the FHA-required 3% down payment with the understanding that the seller would subsequently make an “equal” donation to the charity after the sale was completed. A seller down-payment program was started in California by Nehemiah Progressive Housing Development Corporation. In 1997, Nehemiah filed a lawsuit on the basis of differential by HUD loan officers. The law suit settlement allowed Nehemiah to continue (1) to provide charitable donations to home buyers, (2) after closing the purchase transaction, to receive donations from the sellers of the properties. HUD’s Office of General Counsel found that the scheme did not conflict with the mortgage rule book by then. The FHA published a rule change to ban the practice in 1999 but backed down in the face of a vigorous campaign from down-payment assistance providers. It will be clear that Congress would never have supported any such rule anyway.

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Chapter 6 The GSEs and the Developing Crisis

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- 3 CRS Report for Congress, Fannie Mae, Freddie Mac and SEC Registration and Disclosures, July 11, 2003, Mark Jickling, p. 7.
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- 5 Ibid.
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- 7 Congressional Financial Services Committee hearing, September 10, 2003, p. 3.
- 8 Congressional Financial Services Committee hearing, September 25, 2003, p. 9.
- 9 Congressional Financial Services Committee hearing, Sept 25, p. 31.
- 10 Op.cit pp. 51–52.
- 11 The next stage would be for the full Committee to prepare and vote on its final recommendations to the House or Senate. That may be after the Committee has conducted further reviews, held more public hearings, or voted on the Subcommittee’s report. Subsequent would be the publication of a Committee report, including items such as the purpose of the bill, its impact on existing laws, budgetary implications, etc. It would then be placed on the legislative calendar of the House or Senate and face another six stages, if it is to have any chance of becoming law, since each stage is a further hurdle.
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- 14 As reported by Fortune, Jan 24, 2005, (CNN Money) p. 7.
- 15 DowJones Newsletter, June 9, 2003.
- 16 OFHEO Annual Report to Congress, June 2003, p. 38.
- 17 Freddie Mac’s press release, June 9, 2003.
- 18 Supplementary and detailed statement released by Freddie Mac, June 25, 2003.

- 19 The GSE report, June 17, 2003 p. 7.
- 20 CRS Report for Congress, Accounting and Management Problems at Freddie Mac, November 2005, p. 1.
- 21 Report of the Special Examination of Freddie Mac, OFHEO, December 2003, p. i.
- 22 These and other examples are given on p. ii of the Executive Summary and OFHEO's conclusion is on p. iii.
- 23 FAS 133: Accounting for Derivative Instruments and Hedging Activities requires that entities recognize each derivative as an asset or liability on their balance sheets as a fair value or cash flow hedge, or as a derivative with no hedge designation. Different accounting applies to each of these alternatives, with different implications for the equity of shareholders and current earnings. Freddie Mac adopted FAS 133 on January 1, 2001. It was also affected by FAS 140: Accounting for Transfers and Extinguishment of Liabilities, which revises the standards (of FAS 125) for securitization and other transfers of financial assets and collateral and requires certain disclosures, but importantly, provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.
- 24 Op.cit p. 8.
- 25 Op cit p. 10 and 12.
- 26 Op.cit pp. 35–36.
- 27 Op.cit p. 36.
- 28 Section 303 c of the Federal Home Loan Mortgage Corporation Act, 12 U.S.C. 1452.
- 29 See especially pp. 63–66.
- 30 In 2003, OFHEO reported that it was still conducting investigations into the activities of counterparties in improper transactions, which involved some of the members of the Reference Notes Securities Auction Dealer Group, which underwrote the largest debt income issues of Freddie Mac and is a source of substantial underwriting income. The counterparties in the linked swaps also rank highly among the dealers which Freddie Mac used for its usual derivative activities, *ibid*, p. 74.
- 31 Audio tape transcript, Ray Powers, Aug 14, 2001. OF 2001659.
- 32 Op.cit p. 81.
- 33 Op.cit pp. 88–89.
- 34 This is one of the principles laid down by the Institute of Internal Auditors, Guidance Overview of the Professional Practices Framework, October 2001. These were the principles to which OFHEO looked in order to assess the internal audit function of Freddie Mac. This was entirely justified, as the Freddie Mac Charter explicitly states that the internal audit function should comply with the standards set out by the standard-setting body, the Institute of Internal Auditors as well as the Senior Vice President-General Auditor.
- 35 Quoted by OFHEO from an interview with Melvin Kann of the internal audit department, p. 116.
- 36 Memorandum prepared by Baker Botts re: Mollie Roy Interview, Feb 13, 2003, OF 2000589, op.cit p. 152.
- 37 Op.cit p. 153.
- 38 The number of class action suits filed grew steadily following the passage of the Private Securities Litigation Act, 1995. About 60% of these were based on financial reporting misstatements. Source Stanford Securities Class Action Clearinghouse website: <http://securities.stanford.edu>
- 39 CalPERS is the California Public Employees Retirement System, and with \$239.2bn assets under management as at April 30, 2011, the largest pension scheme in America and one of the largest in the world.

- 40 Op.cit p. 143.
- 41 Op.cit pp. 159–161.
- 42 The corporate governance issues described here do not cover other disturbing elements described in an article in the *Washington Post*, August 16, 2004, “Board members, executives and families can still benefit”. It covers a range of companies but refers to Fannie Mae, which reported in 2003 that it paid \$375,000 to the Duberstein Group, a lobbying and consulting firm led by Fannie Mae Director and former White House Chief of Staff, K. Duberstein and also hired Swygert’s son, after Swygert joined the Board.
- 43 James R. Doty, Partner in charge, Baker Botts, LLP. The references are to his statement to the hearing.
- 44 Op.cit p. 9.
- 45 Op.cit p. 8.
- 46 Hearing before the Subcommittee on Capital Markets, Insurance and the Government Sponsored Enterprises, Jan 21 2004, p. 18.
- 47 Prepared statement of Baruch Lev, Philip Barnes Professor of Accounting and Finance, Stern School of Business, New York University, p. 17.
- 48 Op.cit p. 15.
- 49 Report to the Board of Directors (of Freddie Mac): Internal Investigation of Certain Accounting Matters, July 2003 by Baker Botts L.L.P. with James Doty in the lead.
- 50 Hearing before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, p. 28.
- 51 Bloomberg, June 6, 2011, Fannie Mae Silence on Taylor Bean opened the way to \$3bn fraud.

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- 1 Hearing before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the Committee on Financial Services, Oct 6, 2004, 108th Congress.
- 2 Wayne Passmore, The GSE Implicit Subsidy and the Value of Government Ambiguity, 2003-64 Federal Reserve Board, Finance and Economics Discussions Series.
- 3 Testimony of Chairman Alan Greenspan, Government-Sponsored Enterprises before the Committee on Banking, Housing and Urban Affairs, US Senate, Feb 24, 2004.
- 4 See Wayne Passmore The GSE Implicit Subsidy and the Value of the Government Ambiguity, 2003-64, Federal Reserve Board, Finance and Economics Discussion Series.
- 5 Congressional Budget Office, Federal Subsidies and the Housing GSEs, May, 2001.
- 6 Congressional Budget Office, Updated Estimates of the Subsidies to the Housing GSEs, Director, Douglas Holtz-Eakin, April 8, 2004.
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- 8 Government Sponsored Enterprises. A Framework for Strengthening GSE Governance and Oversight, David Walker, Comptroller General of the United States, Testimony before the Committee on Banking, Housing and Urban Affairs, US Senate, Feb 10, 2004, p. 9.
- 9 Testimony of Chairman Alan Greenspan, Government Sponsored Enterprises, before the Committee on Banking, Housing and Urban Affairs, Feb 24, 2002, p. 3.

- 10 Ibid, pp. 3–4.
- 11 OFHEO news release, October 9, 2003.
- 12 The OFHEO Report: Allegations of Accounting and Management Failure at Fannie Mae, op.cit p. 9.
- 13 OFHEO Letter to Franklin Raines, Feb 24, 2004, pp. 1–2.
- 14 Business Day, *New York Times*, Fannie Mae's Earnings Drop but its Mortgage Profit Rises, 20 April, 2004.
- 15 *Wall Street Journal*, April 20, 2004.
- 16 *Financial Times*, March 9, 2004.
- 17 Bloomberg, March 16, 2004, James Tyson.
- 18 OFHEO News Release, May 6, 2004.
- 19 Quoted by The GSE Report, May 24, 2004.
- 20 Review of the Office of Federal Housing Oversight and the Federal Housing Finance Board, Joint hearing before the Subcommittee on Oversight and Investigations and the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, July 13, 2004, pp. 34–35.
- 21 Op.cit p. 17.
- 22 Office of Compliance Office of Federal Housing Enterprise Oversight, Sept 17, 2004.
- 23 Address to Audit Group on What We Can Do to Help Achieve \$6.46 EPS, Sampah Rajappa, FM SRC OFHEU, Special Examination of Fannie Mae, May 2006, p. 42.
- 24 Report of Findings to Date Special Examination of Fannie Mae, Sept 17, 2004, p. i.
- 25 This comes from OFHEO's Report on the Special Examination of Fannie Mae, May 2006, pp. 170–171, which also documents the KPMG work papers and the quoted memorandum, pp. 170–171.
- 26 A REMIC entitles the investor to a claim on the principal and interest payments on the mortgage underpinning the security. The interest rate paid is usually related to the rates homeowners are paying on their mortgages.
- 27 OFHEO also discovered that if negative, a deferred expense was calculated as far back as 1995; and that the calculation of a constant effective yield for REMIC securities had not been carried out at all, even though SFAS took effect in 1988.
- 28 Op.cit p. 13.
- 29 SFAS 91 Accounting for non-refundable fees and costs associated with originating or acquiring loans, and the initial direct costs of leases, Dec 1986, Financial Accounting Standards Board.
- 30 Memorandum from Mr Jeff Juliane to Distribution, dated March 12, 1999, OFHEO *ibid*, pp. 40–41.
- 31 Op.cit p. 86.
- 32 *Ibid*, p. 86.
- 33 Op.cit p. 93.
- 34 Op cit. pp. 138 and 144.
- 35 Op.cit p. 145.
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- 37 Op.cit OFHEO interview with Sam Rajappa, p. 155.
- 38 Op.cit p. 165.
- 39 Enhancing confidence in financial reporting, Group of Thirty, p. 14.
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- 43 Standard & Poor's Corporate Governance Score, Standard & Poor's, January 30, 2003, p. 2.
- 44 Op.cit, p. 3.
- 45 Op.cit p. 5.
- 46 Full hearing p. 11.
- 47 FM Watch was a group of mortgage insurers and lenders and trade associations, which was opposed to Fannie and Freddie's operations and kept a careful watch on the behaviour of the GSEs. From the point of view of Fannie Mae, they were a group of insurers, high-cost lenders and trade associations representing subprime lenders who wanted to roll back Fannie Mae policies that cut the costs to the consumers.
- 48 Op.cit p. 19.
- 49 Op.cit p. 64.
- 50 Op.cit pp. 65–66.
- 51 Op.cit pp. 3–4.
- 52 Op.cit p. 7.
- 53 Op.cit p. 87.
- 54 Op.cit p. 23. Armando Falcon's oral testimony to the hearing.
- 55 Op.cit p. 69.
- 56 Op.cit Reply of Mr Raines to Mr Scott, p. 90.
- 57 Op.cit p. 103.
- 58 Op.cit p. 117.
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- 61 Press release form the office of Representative Michael G. Oxley, 12/15/2004.
- 62 Letter from Rep. Richard H. Baker to the Honorable Armando Falcon, Director of OFHEO, 12/16/2004.
- 63 OECD Economic Surveys, 2004, United States, p. 17.

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- 2 Richard Baker, quoted in The Main Wire, 27/01/2005, quoted in The GSE Report, Jan 31, 2005.
- 3 Bloomberg News, 01/27/05.
- 4 Press Release from the office of Representative Barney Frank, 12/16/04.
- 5 Each Congress lasts for two years. The 106th Congress covered the years 1999–2000. Hearing, 109th Congress, April 13, 2005, p. 1.
- 6 Op.cit p. 6.
- 7 Op.cit p. 7.
- 8 Op.cit p. 24.
- 9 Op.cit p. 4.
- 10 Statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System before the Committee on Banking, Housing and Urban Affairs, US Senate, April 6, 2005, p. 5.
- 11 Op.cit p. 7.
- 12 Op.cit p. 23.

- 13 Op.cit pp. 2–3.
- 14 CBO Testimony Douglas Holtz-Eakin, Aligning costs and benefits of the housing GSEs, April 21, 2005, see Table 1, before the Committee on Banking, Housing and Urban Affairs.
- 15 Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO, 2003, p. 55 (note that all the figures relate to year end 2001).
- 16 OFHEO's analysis was based on Fannie Mae's analysis and methodology as used in mid-2000 and then updated by OFHEO for the 2003 report; see pp. 75–77 of the report.
- 17 Statement of Douglas Holtz-Eakin, Aligning the Costs and Benefits of the Housing Government-Sponsored Enterprises, before the Committee on Banking, Housing and Urban Affairs, US Senate, April 21, 2005.
- 18 Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO, OFHEO, Feb 2003, p. 63.
- 19 Congressional hearing, April 13, 2005, op.cit pp. 44–46.
- 20 Concentration and risk in OTC markets for US dollar interest rate options. Staff report for the Federal Reserve, March 2005.
- 21 Risk Transfer and Financial Stability. Federal Reserve Bank of Chicago's 41st Conference on Banking Structure, May 5, 2005.
- 22 Op.cit p. 3.
- 23 Risk Transfer and Financial Stability, Federal Reserve Bank of Chicago's 41st Annual Conference on Bank Structure, May 5, 2005.
- 24 Op.cit p. 3.
- 25 Remarks by Chairman Alan Greenspan to a conference on Housing, Mortgage Finance and the Macro-economy, Federal Reserve Bank of Atlanta, May 19, 2005.
- 26 Op.cit p. 3.
- 27 Op.cit pp. 4–5.
- 28 US Fed News, 07/28/05.
- 29 Dated Sept 2, 2005.
- 30 A report to the Special Review Committee of the Board of Directors of Fannie Mae, Paul, Weiss, Rifkind, Wharton & Garrison LLP, and Huron Consulting Group, February 23, 2006.
- 31 Op.cit p. 2.
- 32 Op.cit p. 416, Rudman report.
- 33 Ibid.
- 34 It was based on the documents it eventually received from Fannie Mae after numerous requests, amounting to some 2.8m pages of hard copy document and 4.1m pages of electronic documents from Fannie Mae and the Special Review Committee, plus over 700,000 work pages and other documents from KPMG, LLP and Ernst & Young. To that total should be added the documents the Counsel to the Special Review Committee received from Fannie Mae, as well as copies of memoranda of 241 interviews it conducted with current and former employees of Fannie Mae and third parties. OFHEO also reviewed the transcripts of 47 interviews of current and former employees conducted by the SEC. OFHEO conducted 26 informal interviews and 55 formal, on-the-record interviews of current and former Fannie Mae employees and board members as well as 7 interviews with current and former KPMG employees assigned to Fannie Mae.
- 35 Hearing before the Senate Committee on Housing, Banking and Urban Affairs, June 16, 2006, p. 71.
- 36 Op.cit p. 2.

- 37 Congressional Committee on Financial Services, Subcommittee on Capital Markets, June 6, 2006, p. 7.
- 38 Testimony of Christopher Cox, Chairman US Securities and Exchange Commission, "Accounting Irregularities at Fannie Mae," Before the Senate Committee on Banking, Housing and Urban Affairs, June 15, 2006.
- 39 Op.cit. p. 8 and p. 6.
- 40 Hearing before the Committee on Banking, Housing and Urban Affairs, June 16, 2006, p. 17.
- 41 Op.cit p. 19.
- 42 Op.cit p. 24.
- 43 Op.cit pp. 43–44.
- 44 For example, Chairman and CEO of the Ashley Group, since 1997, President of the Genesee Corporation from Dec 2000–May 31, 2004, Chairman and CEO of Sibley Mortgage Corporation & Sibley Real Estate Services, from 1991–96, and various positions in the Manning and Napier Group since 1996, as well as being a former President of the Mortgage Brokers Association. Bloomberg Business Week.
- 45 Op.cit pp. 47–48.
- 46 Op.cit p. 30.
- 47 Dow Jones International News, 07/26/06.
- 48 Reuters, 07/11/06.
- 49 Credit Union National Association, News Now Archive, Aug 30, 2006.
- 50 Senate Banking Committee hearing, Federal Reserve Second Monetary Policy Report to Congress for 2006, July 19, 2008, pp. 30–32.
- 51 Remarks of Randal K. Quarles, Under Secretary for Domestic Finance, US Department of the Treasury, press release, 7/19/2006 HP-21.
- 52 Hearing before the Subcommittee on Housing and Transportation and the Subcommittee on Economic Policy, Sept 13, 2006.
- 53 Senate Banking Committee Press Release, 03/07/2007.
- 54 Chairman Barney Frank, Congressional Financial Services Hearing, Legislative Proposals on GSE Reform, March 15, 2007, p. 3.
- 55 George W. Bush, Statement of Administration Policy, H.R. 1427, 2007.

Chapter 11 The Subprime Market Grew and Grew and No One Knew

- 1 Systemic Risk: Fannie Mae, Freddie Mac and the Role of the OFHEO, Feb 2003, p. 45.
- 2 Systemic Risk: Fannie and Freddie and the Role of OFHEO, Feb 2003.
- 3 Conforming loan limits applied throughout the USA apart from specific high-price areas, such as Hawaii, Alaska and the Virgin Islands, set in 1992 with the addition of Guam in 2001.

Median sales prices of new homes USA (from US census bureau for new homes: 1999 between \$153,000 and \$172,000; 2003 between \$181,000 and \$207,000; and 2006 between \$226,700 and \$257,000. Conforming loan limits (including both first and second loans) 1999-\$240,000: 2003-\$322,000 and 2006-\$417,000.
- 4 Statement of John Duggan, Comptroller of the Currency before the Financial Crisis Inquiry Commission, April 8, 2010. Appendix B, p. 1.
- 5 In November 2008, Fannie acknowledged that it had "other loans with some features that are similar to Alt-A and subprime loans that (it had) not classified as Alt-A or subprime because they do not meet (its) classification criteria." P. 182 of Fannie's Q3: 2008 10-Q.

- 6 The HMDA data were deficient in many ways, and HUD sought to augment the data by identifying lenders who predominantly originate subprime loans by using a combination of industry trade publications and HMDA analysis. To confirm those lenders thought to be engaging in subprime lending, HUD conducted interviews with lenders and those who confirmed that at least 50% of their conventional originations were subprime loans were included in the list of subprime lenders. This methodology has been used in virtually all studies of subprime lending using HMDA data.
- 7 *Op.cit* pp. 1–2.
- 8 C. Mayer, K.M. Pence & S.M. Sherland, *The Rise in Mortgage Defaults*, 2008, p. 4.
- 9 These comments and examples are given in “A Journey to the Alt-A zone” by Nomura, 3 June, 2003. It is especially interesting as it looks at Alt-A mortgages from the point of view of investment in MBSs, and provides an insight into market behavior in 2003, quite early in terms of regulatory and analysts’ concerns about subprime lending and foreclosure risks.
- 10 P. 3., “A Journey to Alt-A,” Nomura.
- 11 *Op.cit* p. 12.
- 12 Christopher Mayer & Karen Pence, *Subprime Mortgages: What, Where and to Whom?*, Federal Reserve Board, 2008–29, p. 1.
- 13 *Subprime Markets, the Role of the GSEs, and Risk-Based Pricing*, prepared for HUD by K. Temkin, J. Johnson & D. Levy, March 2002. It is designed as advice to HUD and was based on interviews with subprime lenders amongst others.
- 14 *Credit Risk, Credit Scoring and the Performance of Home Mortgages*, Federal Reserve Bulletin, July 1996, Robert Avery, R. Bostic, P. Calem & G. Canner, p. 644. The same paper notes the likely geographic concentration of delinquencies and foreclosures, which is obvious given the impact of the CRA requirements to lend in certain Census tracts defined by low-to-moderate incomes or very low incomes. At that time the research had not been carried out except for a very limited study in Philadelphia, see page 647. For some reason, this seems to have been regarded as a novel consideration by later researchers, no doubt influenced by the concentration of foreclosures, especially in urban areas as 2008 approached.
- 15 Opening statements of Chairman Sarbanes and Senator Gramm, Senate Committee on Banking, Housing and Urban Affairs, *Examination of the Problem, Impact, and Responses of Predatory Mortgage Lending Practices*, July 27, 2001, pp. 5–7.
- 16 Report of the Staff to Chairman Gramm, Committee on Banking, Housing and Urban Affairs, Aug 23, 2000.
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 - 37 E. Pinto: Memorandum: Sizing Total Federal Government and Federal Agency Contributions to Subprime and Alt-A loans in US First Mortgage Market as at 30th June 2008. Ed Pinto was formerly Chief Credit Officer at Fannie Mae in the 1980s, and subsequently a consultant to the mortgage-finance industry; he is now a Resident Fellow at the American Enterprise Institute.
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 - 38 Fannie Mae 2009 Second Quarter Credit Supplement, p. 5.
 - 39 Fannie Mae 2008 Q 2 10-Q Investor summary p. 30. This is the result of multiplying the 5% difference noted times Fannie's trillion total single-family portfolio at June 30, 2008. This yields \$133bn before addressing overlap.
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a sixth feature was added, FICO 620–659 in the amount of \$164bn, bringing the total to \$752bn.

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- 44 Between Q1 2008 and Q3 2009, the MBA has reported that it covers between 80 and 85% of outstanding first lien mortgages and the total number of loans reported by the NDS varies by no more than 800,000 over this period, indicating that the variance over this period was about 1 million loans. Pinto argues that using a midpoint of 82.5% coverage and 45.4 million first mortgage loans covered by the Q2, 2008 survey yields a total of 55m first lien loans.
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Chapter 12 Why Did Fannie Mae and Freddie Mac Get Away with It for So Long?

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OFHEO's Progress in Implementing A Comprehensive Oversight Programme for Fannie Mae and Freddie Mac, July 29, 1998.
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Chapter 13 The End Cometh

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The GSE MBS purchase program. Treasury will buy newly issued Fannie and Freddie MBSs in the open market as needed to improve the availability and affordability of mortgage credit.

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- 65 S&P Press Release, Jan 30, 2008.
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Chapter 14 What Next?

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