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Credit Scores: Not-So-Magic Numbers

The once-vaunted FICO credit scoring system is now being blamed for failing to flag risky home-loan borrowers. Will an overhaul be enough to appease angry lenders?

by Dean Foust and Aaron Pressman

From humble beginnings in 1956, Fair Isaac Corp.'s credit score— developed by engineer Bill Fair and mathematician Earl Isaac to help banks and department stores calculate their customers' creditworthiness—has come to loom over consumer finance like no other statistical measure ever has. The ubiquitous three-digit FICO score now helps determine everything from the interest rates people pay on their credit cards to their attractiveness as job candidates. Some hospitals have even begun checking FICO scores before admitting patients. "FICO is the wizard behind the curtain of the economy," says Matt Fellowes, a scholar at the Brookings Institution, a Washington think tank.

But with mortgage defaults surging and credit-card issuers bracing for more problems, the wizard seems to have lost some of its magic. A slew of unforeseen problems, some of Fair Isaac's making and others not, have combined to weaken the credit-scoring system on which most U.S. lenders and investors rely. The FICO score, last overhauled in 1989, is based on a complex formula using many variables—and yet it can be manipulated fairly easily by ordinary people. In the past few years a group of "credit doctors" and mortgage brokers began devising tricks, some illegal, to help borrowers juice their FICO scores to qualify for credit cards and mortgages on homes they couldn't afford. At the same time new, exotic mortgages were bursting onto the scene and Fair Isaac was slow to keep up with the changes. By the end of the housing boom in 2006, FICO's accuracy in predicting the likelihood of a borrower's repaying a debt had slipped. "The more heavily lenders and bankers relied on credit scores, the more mistakes were made," says Anthony B. Sanders, a finance professor at Arizona State University and former head of asset-backed research at Deutsche Bank (DB) in New York.

Yet as FICO was becoming less effective, lenders were relying on it more and more. In earlier times, banks would go to great lengths to vet potential borrowers, checking pay stubs and tax returns, calling employers, poring over investment account statements, and on and on, a process called underwriting. The mortgage boom changed all that: Wall Street investment banks were buying up every loan in sight, and lenders had to race to keep pace with the surging demand. The FICO score became as important as a pitcher's earned run average: It was a single, universal statistic that, in theory, could communicate a loan's quality to lenders, investment banks, and investors. Emboldened by its success, Minneapolis-based Fair Isaac marketed the score for other purposes and began offering new products for different industries.

Now the credit markets are in disarray, and big mortgage players like HSBC (HBC), JPMorgan Chase (JPM), and Washington Mutual (WM) —perhaps opportunistically—are laying much of the blame at Fair Isaac's feet, arguing that its score didn't predict delinquencies as expected. (Meredith Whitney, an analyst at CIBC World Markets, called FICO scores "virtually meaningless" in a December note to clients.) Consumer advocates and state regulators are clamoring for Fair Isaac to disclose its formula. And credit-card providers are beginning to question the score, too. "So many people, I think incorrectly, looked at FICO as being the' measure of risk," Discover Financial Services (DFS) Chief Executive David W. Nelms told analysts in December.

Fair Isaac vigorously defends its product. "We don't think FICO scores have caused or contributed to the subprime mortgage problem," says CEO Mark N. Greene, a 12-year IBM (IBM) veteran who took the helm at Fair Isaac last February as its problems were becoming apparent. Lenders that followed traditional underwriting standards, he says, "

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