

OPENING THE BLACK BOX OF FICO

by [Steve Brown](#)

There are many misconceptions about the credit score developed by the Fair Isaac Corporation ("FICO"). While many independent banks feel the score is more of a "retail thing," FICO plays a vital role in determining the underlying quality of the guarantor(s) in CRE lending as well. In fact, research shows that FICO is a better predictor of guarantor repayment than either net worth or liquidity. Because of this, it is important to understand how FICO scores are constructed. In general, a FICO score breaks down as follows: 35% of the weight is from payment history, 30% is from amounts owed, 15% is from length of credit history and 10% each come from types of credit in use and new credit lines extended. While these percentages are general guidelines, the importance of any single factor depends on the overall information in the credit report, so different credit histories can change the importance of a given factor in determining the score.

Payment History - Since payment history is such a big component of the score, it is important to understand how it is used. Information is collected on credit cards, retail accounts, installment loans, finance company accounts and mortgage loans. That data is then augmented with information on bankruptcies, foreclosures, lawsuits, wage attachments, liens and judgments. Finally, this portion of the score then incorporates late or missed payments and considers how late they were, how much was owed at the time, how recently they occurred and how many there were. A 60-day late payment made a month ago will affect a score more than a 90-day late payment from 5 years ago. In short, delinquent payments and collections have a major negative impact on the FICO score.

Amounts Owed - For this portion of the calculation, the score takes into account the total balance owed in the last month, amount owed on specific types of accounts, the number of small balance accounts with strong payment histories, total debt outstanding as a percentage of the original loan amounts, how much of the total line available has been used up.

History - This piece of the score takes into account the age of the oldest account, the age of the newest and the average of all accounts.

New Credit - This component takes into account the number of new accounts opened; how long it has been since a new account was opened; the number of requests for credit made in the past 12 months and the length of time credit inquiries were last made by lenders.

FICO Facts and Fallacies - It is TRUE that the score only looks at information in a person's credit report; that late payments lower it; re-establishing a good track record raises the score; keeping outstanding balances low increases the score; and opening new accounts negatively impacts the score. It is FALSE that the score includes age, salary, occupation, title, employer, date of employment, geography, specific interest rates charged, any information not found in the credit report, any information that has not been proven to be predictive of future credit performance. Finally, we close by ranking FICO scores (which can range between 300 and 850). A score over 750 is considered 'excellent', 720 to 750 is 'very good', 660 to 720 is 'acceptable', 620 to 660 is 'uncertain' and anything less than 620 is considered 'risky'. While no single tool will do everything, as one can see, the FICO score can serve as a great early warning system.

BANK NEWS

Acquisition

PNC (\$86B, PA) will acquire Mercantile Bankshares (\$17.3B, MD) for almost \$6B in stock and cash. The 28% premium for Mercantile equates to approx. 2.9x book and extends PNC's reach into the eastern seaboard.

Acquisition

United Security (\$661mm, CA) will purchase Legacy Bank (\$81mm, CA) for \$21.7mm or 2.0x book.

Acquisition

Alerus Financial (\$712mm, ND) will pick up Stanton Trust Co. for an undisclosed sum.

CRE Lending

The chief risk officer for Wachovia said intense competition for CRE loans has resulted in looser credit standards among many banks. While stating he did not expect a significant increase in problem credits, he suggested the next 18 months would see more. He also said some independent banks were using irrational pricing in some of their markets.

Housing Sector

The MBA is reporting the percentage of mortgages that have shifted into foreclosure process in the 2Q climbed to the highest level in a year. While the level remains low by historical standards, many analysts say the trend will continue. In a similar report, online foreclosure marketplace RealtyTrac reported the number of properties that entered foreclosure in August surged 24% over July and 53% over the same period last year. By state, FL jumped 62% over the prior year, while CA climbed 160% and NV increased 255%.

CEO Position

A study by consulting firm Booz Allen Hamilton finds that in 2005, more than 15% of CEOs lost or left their jobs, up 67% from levels of a decade ago. Another interesting finding – companies that keep their CEO around as Chairman have 4% lower shareholder return than those who did not.

Stock Buybacks

S&P is reporting that companies included in the S&P 500 index bought back a total of \$349B of their own stock in 2005, a 77% jump over the prior year.

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