**Day 27 Homework**

Be prepared to discuss the following excerpt in class:

Their [the big Wall Street firms – Bear Stearns, Lehman Brothers, Goldman Sachs, Citigroup, and others] handling of FICO scores was one example. FICO scores – so called because they were invented, in the 1950s, by a company called the Fair Isaac Corporation – purported to measure the creditworthiness of individual borrowers. The highest possible FICO score was 850; the lowest was 300; the U.S. median was 723. FICO scores were simplistic. They didn’t account for a borrower’s income, for instance. They could also be rigged. A would-be borrower could raise his FICO score by taking out a credit card loan and immediately paying it back. But never mind: The problem with FICO scores was overshadowed by the way they were misused by the rating agencies. Moody’s and S&P asked the loan packagers not for a list of the FICO scores of all the borrowers but for the *average* FICO score of the pool. To meet the rating agencies’ standards – to maximize the percentage of triple-A-rated bonds created from any given pool of loans – the average FICO score of the borrowers in the pool needed to be around 615. There was more than one way to arrive at that average number. And therein lay a huge opportunity. A pool of loans composed of borrowers all of whom had a FICO score of 615 was far less likely to suffer huge losses than a pool of loans composed of borrowers half of whom had FICO scores of 550 and half of whom had FICO scores of 680. A person with a FICO score of 550 was virtually certain to default and should never have been lent money in the first place. But the hole in the rating agencies’ models enabled the loan to be made, as long as a borrower with a FICO score of 680 could be found to offset the deadbeat, and keep the average at 615.

Excerpted from The Big Short: Inside the Doomsday Machine by Michael Lewis, © 2010, p. 99 – 100