Why does anyone take S&P seriously?

By Roger Martin | August 9, 2011

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The opinions expressed are his own.

It drives me nuts that anybody treats the Standard & Poor's downgrading of the U.S. government's credit rating with anything but contempt. I am, by the way, not saying that the circus in Washington didn't deserve an immediate smack-down before the real one it will be getting in 15 months. But it stuns me that people don't ask themselves just what S&P is and who its credit raters are before actually paying one iota of attention to them.

So who are those S&P raters anyway – the people who actually determine whether the U.S. is AAA or AA+? The only thing that can be known about them is that if they are rating bonds at S&P, they can't possibly be good at rating bonds. The bond market is a multi-trillion market that is immensely lucrative. Bond trading is a great way to make a buck because there are unlimited bucks to be made – if, and only if, you know something useful about whether the bond in question actually has a lower or higher risk inherent in it than level implied in the market's current pricing.

So if you are any good at all at rating the riskiness of debt instruments, you will not be working for a couple hundred thousand a year at S&P, you will be working for yourself, or for the bond trading desk of an investment bank or a bond hedge fund making tens of millions of dollars per year – or a lot more if you are running the hedge fund. Only if you are incapable of knowing something useful about the true risk profile of bonds will you take a job rating bonds at S&P. Or alternatively you actually know something useful but have no confidence whatsoever that you know do so you won't put any personal financial risk behind your opinions. In either case, the output is clear: because of the position you occupy, you are someone to whom no one should listen.

Some may argue that no, these people are public servants, like teachers or judges, who rate bonds business they think it is a higher calling and even though they could earn tens to thousands more trading bonds than rating them, they stick it out because of their great hearts.

That is a pretty difficult argument to make. S&P is a subsidiary of publicly-traded corporation McGraw-Hill. S&P is driven to help McGraw-Hill march its quarterly earnings ever forward lest bad things happen to both subsidiary and parent. This is hardly the environment in which we are likely to find a huge agglomeration of public servants.

And remember the business model of S&P: it makes its money from charging those it rates lots of money to rate them. Prior to the crash of 2008, it was an awesome business because the use of its product was legislatively driven. That is to say, most institutional investors have regulatory fiduciary requirements that necessitate the use of credit ratings as part of their daily business. They may think that S&P really has no useful insights, but they still need to use its ratings. So this business is pretty much like any business that is given a legislative right to serve – like your local electric or gas utility: it doesn't need to worry much about being any good because the customer doesn't have much choice.

This is all theoretical, you might argue. OK then, let's go empirical. What is S&P's recent track record on understanding and rating debt instruments in the USA? Answer: disastrously bad. Three years ago it could not have possibly been more wrong on its ratings of U.S. mortgage debt instruments. Chimps throwing darts would have been infinitely better than these so-called experts were.

So the question has to be asked again: Why on earth do we pay any attention whatsoever to S&P's downgrade of U.S. government debt? It has a horrible track record and in fact helped enormously to get the U.S. government into the crisis for which it now condemns the handling. Their raters wouldn't be rating bonds if they actually were any good at it. It operates in a protected industry that insulates it from the usual consequences of incompetence. And its business model is one big conflict of interest.