The Effect of Seniority and Security Covenants on Bond Price Reactions to Credit News

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Abstract
We examine the daily abnormal returns of corporate bonds with different seniority and security covenants following Moody's Watchlist and rating change events. We find that bond returns react significantly positive (negative) following upgrade (downgrade) Watchlist events but not necessarily following rating change events. Because Watchlist news precede rating changes, we infer that the Watchlist contains more unexpected information and, hence, the short-run bond price effects are stronger. Especially, we find that subordinated bond prices react more than secured bonds to Watchlist news. However, this finding does not hold when we compare investment and non-investment grade bonds, suggesting that seniority/security can explain the cross sectional bond returns. Our regression results confirm this finding even after controlling for issue- and issuer-specific characteristics such as time to maturity, coupon rate, bond rating, and firm size.

Keywords: Corporate bonds, Seniority/Security, TRACE, Watchlist

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I. Introduction

We examine the short-run performance of corporate bonds with different priorities when news is announced regarding credit rating changes. Using 10-day window cumulative abnormal returns (CARs) surrounding the dates of Moody’s Watchlist and credit rating changes, we find abnormal bond returns around Watchlist news but not necessarily for the rating change events.

As Duffie and Singleton (2003) pointed out, “the possibility that major rating agencies will change the credit rating of a bond issue is an important source of credit risk”; and the credit rating changes and related news can have immediate impacts on bond prices. Defining market risk as the risk of unexpected price changes, our paper is an attempt to analyze the short-term variations of market risk measured by abnormal returns of bonds when there exist ‘possible’ or ‘actual’ changes in credit rating.

Our study adds to the existing literature by (a) using corporate debt transactions data from the Trade Reporting and Compliance Engine (TRACE) together with bond rating agency announcements measured by Watchlist announcements as well as the actual rating changes and (b) exploring the effect of seniority/security structure on bond price reactions. Using TRACE data allows us to identify the announcement effect on abnormal bond price reactions while maintaining short event windows due to the high number of data points around the credit news event. Previous literatures on price reactions to credit rating changes have mainly focused on long-term effect and reported significant results in cases of downgrade news. The use of long horizon window is motivated partly by the need to address market efficiency issues. For instance, in their seminal paper, Pinches and Singleton (1978) used data from 180 rating changes from Moody’s and S&P and found negative reactions occur after downgrades. Goh and Ederington