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SEMINARIO

"Insider trading in an equilibrium model with default: a passage from reduced-form to structural modelling"

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Abstract:

We study in the framework of Back (1992) an equilibrium model for the pricing of a defaultable zero coupon bond issued by a firm. The market consists of a risk-neutral informed agent, noise traders, and a market maker who sets the price using the total order. When the insider does not trade, the default time possesses a default intensity in the market's view as in reduced-form credit risk models. However, we show that, in equilibrium, the modelling becomes structural in the sense that the default time becomes the first time that some continuous observation process falls below a certain barrier. Interestingly, the firm value is still not observable. We also establish the no expected trade theorem that the insider's trades are inconspicuous.