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Information Asymmetry and Risk Transfer Markets

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Abstract

We provide a tractable model of counterparty risk in a risk transfer market, and analyze the consequences of this risk being private information. We show that unknown type information can be revealed in the presence of a large trader identification policy; however, the market allocation is shown to be constrained inefficient. The inefficiency is highlighted by considering the imposition of a transaction tax, which can improve welfare by encouraging more information revelation and increasing risk transfer. The results suggest that increased transparency and/or central counterparty arrangements in over-the-counter derivative markets may promote transparency of counterparty risk.

Keywords: Risk Transfer Markets, Asymmetric Information, Counterparty Risk, Regulation

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