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An Overlapping Generations Model of Taxpayer Bailouts of Banks*

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Abstract

The paper constructs an overlapping generations model to evaluate how different bank rescue plans affect banks' risk-taking incentives. For a non-competitive banking industry, we find bailout with tax imposed on the old generation or equity bail-in to be efficient policies in the sense that they implement socially optimal risk-taking. In a competitive banking sector, no-bailout implements the socially-optimal risk-taking. Bailout policies financed by a tax imposed on the young generation always induce excessive risk-taking.

Keywords: Bank failures, taxpayer bailout of banks, equity bail-in, risk-taking by banks, financial fragility.

JEL Classification Number: G21, G28.

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