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RETHINKING RISK MANAGEMENT

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Abstract

This paper presents a theory of corporate risk management that attempts to go beyond the "variance-minimization" model that dominates most academic discussions of the subject. It argues that the primary goal of risk management is not to dampen swings in corporate cash flows or value, but rather to provide protection against the possibility of *costly lower-tail outcomes*–situations that would cause financial distress or make a company unable to carry out its investment strategy. (In the jargon of finance specialists, risk management can be viewed as the purchase of well-out-of-the-money put options designed to limit downside risk.)

By eliminating downside risk and reducing the expected costs of financial trouble, risk management can also help a company to achieve *both* its optimal capital structure and its optimal ownership structure. For, besides increasing corporate debt capacity, the reduction of downside risk also encourages larger equity stakes for managers by shielding their investments from "uncontrollables."

The paper also departs from standard finance theory in suggesting that some companies may have

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relative to the market. If risk managers want to behave like money managers, they should be evaluated like money managers.

Citing Literature

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