Are At-Risk Measures Useful Measures of Risk at the Corporate Level?

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Abstract

Value-at-risk (VaR) is a widely used risk measure among financial institutions. Cash-flow-at-risk (CFaR) is an attempt to transfer the same ideas to the setting of a non-financial firm. In this paper I argue that at-risk measures may fall short of being the best guides for risk management decisions in the non-financial firm since they are not easily interpreted in terms of existing theories about risk management, which emphasize costly financial distress and underinvestment due to financing constraints. Assessing such outcomes requires information on the firm's presumed access to external sources of funding. What is called for is thus a framework that qualifies cash-flow-based measures of risk on the state of the firm's debt capacity. The group of risk measures presented in this paper incorporates this information and thus renders hedgeable magnitudes that can be given interpretations consistent with risk management theory. They can inform risk management strategies by indicating if a hedge is likely to act as an effective substitute to equity capital, and whether these benefits are large enough to outweigh the costs of implementing a hedge.