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## MANAGEMENT OF CREDIT RISKS IN AGRICULTURE

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**Abstract:**

*From all the risks which can affect a bank, many authors consider that one of the most important is the credit risk. This risk of default of loans granted, when not properly managed, can affect the activity of commercial banks. Credit risk presents related features to the customer activity and it is for sure that the credit risk related to the agriculture it's much higher than in other sectors. Given the events generating risk exposures to clients working in agriculture, there are some tools available to a bank to decrease this risks which we propose by this paper.*

**Keywords:** *credit risk, policies on credit risk management, risk exposures in agriculture*

Risk can have a considerable impact on the bank or financial institution analyzed, the impact itself, as losses incurred direct and induced impacts, and also caused by the effects on customers, staff, business partners and not least, on banking authority.

Similarly, the perceived risk will mean the present value of all losses and additional expenses that a financial institution may suffer. This definition emphasizes that the exposure to risk of the financial institutions may be actual or potential.

From all the risks which can affect a bank, many authors consider that one of the most important is the credit risk. This risk of default of loans granted, when not properly managed, can affect the activity of commercial banks. Credit risk "expresses the possibility that borrowers or issuers of securities do not honor their obligations at maturity. Credit risk may be caused by many causes, such as: the general economic context, unfavorable domestic circumstances of the client, over-funding or grant funding inadequate to the customer needs, etc. Events generating credit risk are varied and can occur at any time in the life of a loan.

Also credit risk and should be analyzed in terms of activity sector, taking into consideration the particularities of the client's business.

Thus, a recent analysis of the National Bank of Romania shows that credit risk is different in terms of sector activity and also presents different levels in different periods. Thus the credit risk in different sectors of activity has remained relatively

constant in the first quarter of 2008 compared to quarter 4 2007, with some exceptions, such as:

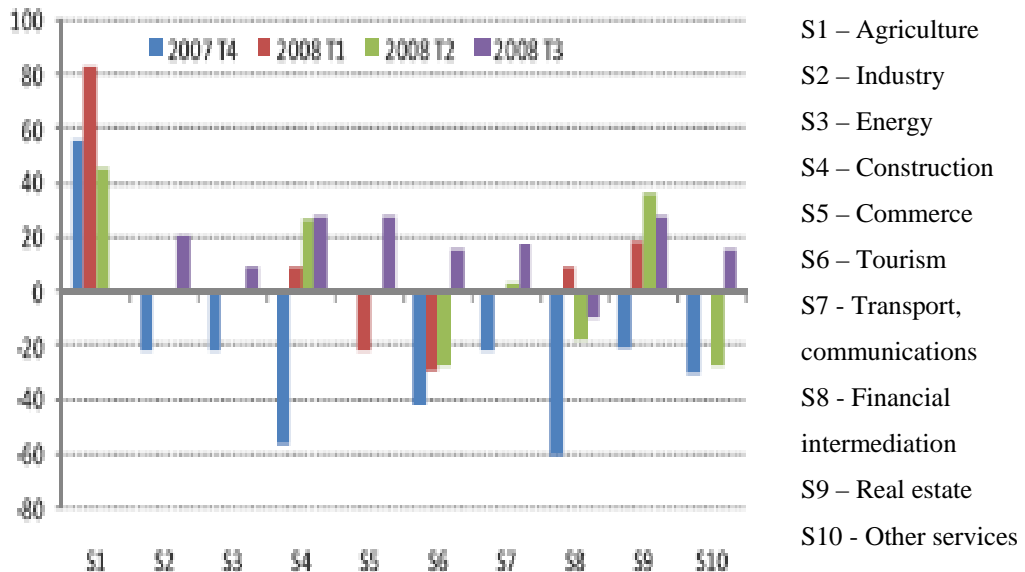
- agriculture is perceived as significantly more risky
- real estate, financial intermediation and construction are in some wise more risky
- trade and tourism are in some wise less risky.

For comparison, in quarter 4 of 2007, credit institutions believed that all sectors of activity, except agriculture, were less risky.

The same situation in the second and the third quarter of 2008 shows that agriculture remains the most risky sector, but also in other sectors it is notice an increase of the credit risk (chart 1). The permanent increase in the credit risk in agriculture can also be associated to the increase of the amounts that were granted for this sector

Chart 1:

Evolution of the credit risk on the branches of activity (note: Balance short - positive values indicate an increase in credit risk)



Credit risk presents related features to the customer activity and it is for sure that the credit risk related to the agriculture it's much higher than in other sectors. Among the reasons for generating credit risk in agriculture would be:

- the risk of default may be determined, to a greater extent than in other sectors, by the risk of "natural disasters" (in Romania in 2005 and 2007 agriculture had a negative influence on GDP growth);
- level of training of managers and staff performance of the companies active in this field;

- most of those working in agriculture can not exceed the limits of subsistence activities;
- lack of relevant historical work (many of the loan beneficiaries are newly established companies);
- lack of a proper contribution to an investment or inability to support current business after finishing an investment;
- lack of a consistent heritage of the agricultural companies;
- collaterals, as a means of hedging credit risk, have a high degree of risk in terms of safety for the recovery of loans after selling them; such guarantees given by the entrepreneurs in agriculture are often difficult salable (land, the houses located in rural areas, farms) or with a high degree of specialization, which affects their liquidity (agricultural machinery).

Therefore, the risks associated with agriculture credits are varied and some of them can not be reduced or prevented.

Foundation of a healthy management of credit risk lies in the ability of management policies on credit risk to identify existing and potential risks inherent in any lending activities, and to limit or to reduce them. Thus, classical policies on credit risk management can be divided into three categories:

- Policies designed to limit or reduce the credit risk - the central bank imposes a maximum limit of exposure to a single debtor;
- Policy on classification of assets - each asset is assigned a degree of risk depending on the probability of default;
- Provisions policy for possible losses from loans.

Management of credit risk can be achieved only if there is a permanent monitoring of the development of clients business and of the collateral of the loans

Given the events generating risk exposures to clients working in agriculture, tools available to a bank to decrease these risks are:

- Setting a maximum exposure to this risky sector in order to determine limited losses if these risks occur;
- Increasing the number and value of the institutional guarantees for such loans, which are, less risky than mortgages on houses in rural areas, farms, land and collaterals on agricultural machinery;
- lending to companies directly involved in agricultural production has to be done only after the establishment of insurance policies of the future crops and this insurance policies have to be permanent renewed
- permanent monitoring of the evolution of the business of the agricultural companies in order to be able to take early measures in case of natural events (droughts, floods and other natural disasters), by restructuring loans and / or by delaying the payment and interest rates for a period during which the company can recover.

In my opinion, to increase funding in agriculture, the central bank should find ways to increase the confidence of commercial banks for lending to this sector. This

could be achieved for example by increasing confidence in securities issued by the guarantee funds. Better management of credit risk in this sector is vital for attraction of European funds for financing agriculture.

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