International Business Management 10 (24): 5752-5756, 2016
ISSN: 1993-5250

Application of Innovative Financial Product for Increase of Efficient Realization of Leasing Operations

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Abstract: Hedging of risks arising in the implementation of leasing activity, it is today one of the main problems faced by lessors. In the process of expansion of the amount of risk will increase the market. One of the effective and innovative financial products to reduce the credit risk of financial and credit institutions of leasing operations is an innovative leasing option. Risks same supplier, in this case the overlap compensation which was paid to the lessor at the conclusion of innovative leasing option, the risks of non-repayment of investment funds on lease options is practically reduced to a minimum compared to the repurchase agreement. For the use of his right to sell the leased object to the supplier, the lessor pays a lump-sum award last but these costs he can pass on to the lessee and included in lease payments. Proposed in this study an example of using the securities market instruments as a way to reduce the risks will allow to companies operating in the leasing market, expand business scope, increase the efficiency and the number of transactions carried out at the expense of funds raised in the stock market.

Key words: Innovative financial products, innovative leasing option, financial market, option contract, strike price, financial risk

INTRODUCTION

Innovative leasing option is one of the innovative financial products used for decrease of leasing operations credit risks of finance and credit organizations. This notion was spelled out for the first time in innovative leasing in a bank (Ajyupov, 2002). The essence of this instrument is the following: when leasing company makes a leasing contract with user of equipment it is necessary at the same time make an innovative leasing option contract-put, i.e., put option. This option purchased by leasing company from counteragent allows the company during the time agreed in option contract to sell the equipment to option seller at a strike price defined in the contract. Option gives its buyer only the right to sell, not obligation, i.e., fulfill or not to fulfill option contract is entirely up to leasing company.

Based on this statement, we will try to define innovative leasing option. We think that leasing option is the right of leasing company during the terms of option contract to sell the equipment to option seller at a strike price defined in the contract. Also the first party pays the second a preliminary defined sum called premium for the ability to execute this right.

MATERIALS AND METHODS

Theory: Let us, consider the mechanism of realization of this instrument in greater detail. Based on the definition, innovative leasing option gives a leasing company the right to sell leased equipment to the counteragent and thus decrease its credit risks, i.e., ensure the return of investment. On the other hand the option seller is under an obligation to fulfill the right under the conditions defined in the agreement.

Credit risk of not returned investment is more or less present during all the term of lease agreement. Based on this term of innovative leasing option contract should be equal to term of lease agreement between leasing company and leasee. The right of leasing company to realize lease option occurs when leasee does not fulfill the obligations according to lease agreement. Obligations can be either financial (non-payment or systematical delay of leasing payment) or administrative. For example, leasee is late with insurance or has not insured property against anientisement or destruction in favor of leasing company, leasee does not carry out scheduled maintenance, etc. In such situations leasing company as a rule is forced to withdraw property. Later, it can sell this property

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according to innovative leasing option contract all fines and surcharges will be claimed in the arbitral court. Thus, leasing company hedges its credit risks in case of leasee's non-compliance with the contract by selling withdrawn property to the counteragent with whom the leasing company negotiated innovative leasing, option contract (Ajupov *et al*., 2014).

In the research mentioned it is also said that strike price stays invariable during the term of agreement (leasing option contract) until the expiration date, i.e., the end of agreement term (Ajupov *et al*., 2015). We believe that if strike price stays invariable during the term of leasing option contract, the credit risks of the leasing company are not fully covered. This is due to the fact that strike price at which leasing company can sell leased property might be lower then invested money, i.e., lower than depreciated property cost. Depreciated investment cost of the property equals the money invested by leasing company into leased equipment less money paid by the leasee as part of leasing payments. Based on this definition the possibility of depreciated invested cost being higher than strike price is very high in the beginning of the agreement term as the amount of leasing payments at this stage is small (Beisov *et al*., 2013).

Taking this in consideration we think it is necessary to make a schedule of depreciated cost of leased property for specified date in the innovative leasing option and strikeprice should be adjusted in accordance with the schedule of leasing subject cost, i.e., it will be variable, not fixed. Thus, the price of buying leased property for option seller has direct connection with the moment when leasing company will decide to execute its right to sell the property as the price will decrease with the lapse of time. Moreover, the later this moment occurs the more profitable it is for option seller and credit risks of the leasing company will be minimal. On the Fig. 1, relation of Strike Price (P) according to the classical Option Contract (OC) and the strike price according to Innovative Leasing Option (ILO) and the market value of the leased subject in time (t).

Relation of strike price according to OC, ILO and market value of the leased subject. As can be seen from the Fig. 1, during the first time period until point t1 the strike price according to OC is lower than market value and even lower than strike price according to ILO which means it is lower than depreciated investment cost. So, we can make a conclusion that in this time period leasing company risks are not fully covered. Also in this time period, the market value is lower than strike price according to ILO but option seller's risks are covered by

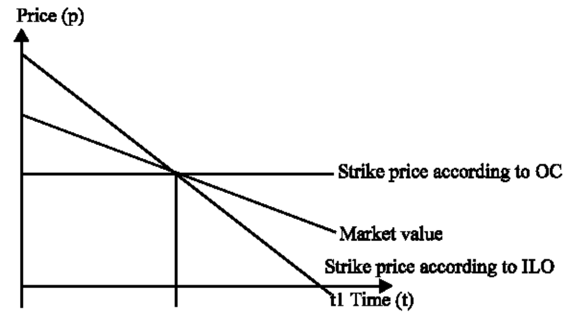

Fig. 1: Relation of strike price according to OC, ILO and market value of the leased subject

premium paid by the leasing company for the right to realize object of lease. Further, after point t1, it is profitable for option seller to buy the lease object at a strike price according to ILO as it is below market value especially taking into account the received premium. Point t1 at the figure marks the moment of time when strike price according to OC, strike price according to ILO and market value are approximately the same. Even if the leasing company decides to sell the lease object the option seller is insured from losses by the amount of premium.

RESULTS AND DISCUSSION

Let's demonstrate how these prices are formed in a numerical example. Standard contract for an automobile costing 900000 rub. leased for 3 years (36 months) with advance payment of 0%. On such terms the leasee will depreciate investment cost by 25000 rub. monthly by making leasing payments. Market value of the automobile bought from the seller in the beginning of its operation is 15-20% lower as the automobile is not the new one once it is bought. Automobile cost will decrease by 10-15% annually. Let's assume strike price according to classical option at 550000 rub. From month 14-16 the prices are approximately equal.

Federal regulation No. 164-FZ "On financial rent (lease)" establishes three-sided relationship in leasing. In innovative leasing option there are also three-sided relationships if option seller and lease subject supplier is the same person (Fig. 2).

However, it is also possible to have four-sided relationships in innovative leasing option if the option seller is not the supplier of the equipment and this role is taken by for example stock the first party is the owner of the property (leaser). It can be a person or an organization which by means of own or borrowed monetary funds purchases property in the course of leasing relationships. Then, the leaser grants it as a lease object for a specified

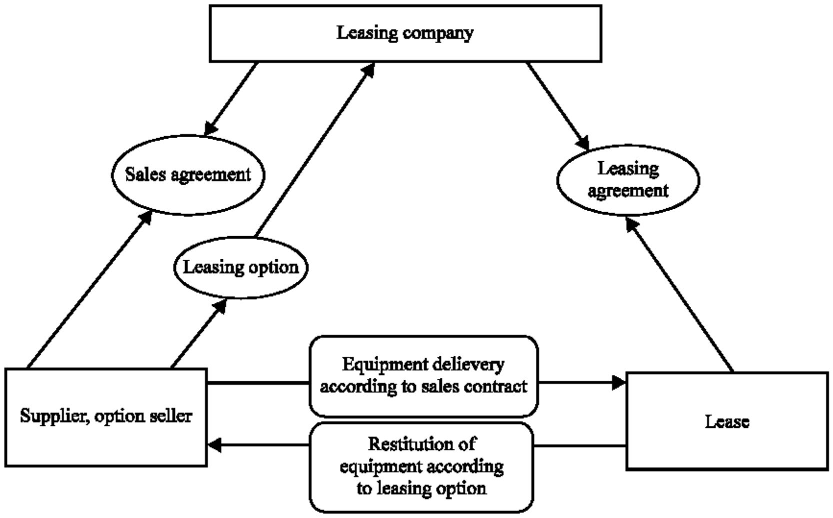

Fig. 2: Three-sided relationships in leasing with use of innovative lease option

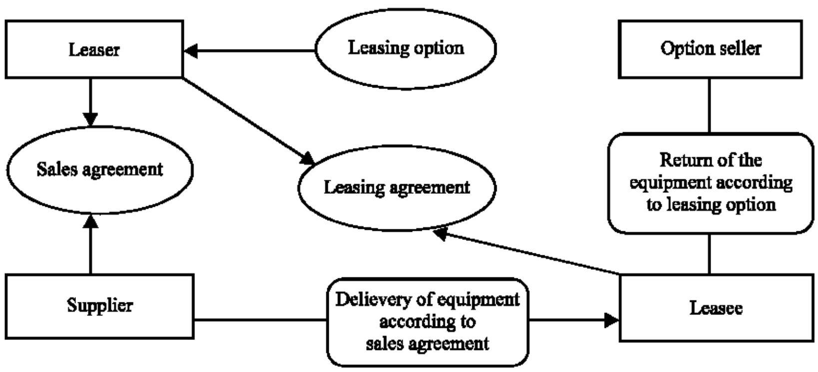

Fig. 3: Model of leasing operation application by financial and crediting organizations with employment of innovative leasing option

sum, time period and on specific conditions to a lease; the lease object is provided for a temporary ownership with transfer or without transfer of the right of ownership for a lease object to the lease. The following organizations can act as property owners: a bank or bank's branch if its studys stipulates for such activity; also specialized affiliate leasing company of a bank which provides the whole package of services associated with maintenance, repairs and servicing of the property. Financial leasing company created specifically for leasing operations which in accordance with the above Law is defined as a commercial organization acting as a leasing company in accordance with its articles of association and having permission (license) for exercising leasing activity according to RF legislation any firm or organizations for which leasing is not prohibited by the its articles though it is not necessarily its main activity. Such organizations have licenses and financial means for carrying out leasing operations (Fig. 3). The second party is property user (lease). This can be an organization of any type or an individual which in accordance with the leasing agreement must accept the lease object for a specified payment, time period and on specific conditions for a temporary ownership. The third party is a seller (supplier) of the property (in accordance with 1988 Convention specifically machines and equipment). This can be an organization: manufacturer of property, trading mediatory organization and also a person which in accordance with sales contract with a leaser sells the latter in a specified term produced (purchased) property which is a lease object the same party can act as a seller of innovative leasing option.The fourth party is an independent option seller. This can be an organization of any type or an individual. The seller of the innovative leasing option can be the following:

supplier (manufacturer) of leased property; as a rule in leasing operations the sellers (suppliers, manufacturers) of the leased equipment are large specialized companies (dealers) who aim their activities at selling specific product. Such companies usually have clients who are ready to buy this equipment with depreciation. This means that it is profitable for a supplier to buy back leased equipment at a depreciated investment cost which is lower than market one.

Stock-broker using the fact that option right of the leasing company remains unclaimed and counting on receiving profit from this option contract in the form of premium. He also can resell this leasing option on the market, for example to the supplier of the equipment in case the risk from option right realization has the tendency to increase. Independent potential buyer of lease object who expects to purchase the equipment at a price lower, than market one. The example of such equipment can be any innovative product such product can be lease object and its price at the moment of purchasing by leasing company is higher because of its innovative quality. Any of the leasing subjects can be both RF resident and non-resident and also subject of entrepreneurial activity with participation of foreign capital, conducting its activity in accordance with Law "On Foreign Investment in RF". As a rule the following relationships exist between the lease parties mentioned above. Future leasee needing specific types or property clearly understands what kind of equipment is needed. It is in leasee's interest to make sure the equipment is fully consistent with technical requirements and production expenses are minimal. That is why it is necessary for leasee to choose manufacturer and come to an agreement with it about all terms of the sales contract. Leasee agrees on subject, price, terms and delivery point of the contract. As the leasee has no financial resources necessary to purchase this property it approaches the future leaser which has sufficient financial resources, to participate in the deal. Leaser receives from future leasee sales agreement project and signs it only if there is a leasing contract.

Leaser becomes the owner of purchased equipment, acquires the corresponding rights and obligations but as a matter of fact its role is limited to financing of necessary equipment purchase and giving it to leasee on a terms agreed on in advance. Besides three parties mentioned above in some cases it is possible to have others, e.g., broker's leasing offices (firm's) which do not provide property but act as middlemen between supplier, leaser-bank and leasee. Number of parties in classic leasing falls back to two in cases when supplier and leaser are the same legal person or (in case of return leasing) when leasee sells its own property to the future leaser with the purpose of purchasing the same property by the means of leasing contract. In the first case we deal with the variant unlike company Bell operation when supplier and leaser not only legally but in fact as well are the same person. In our case affiliate company dealt with leasing issues; this affiliate company was created by the manufacturer as subsidiary or branch organized specifically for promoting its products on the market by means of leasing.

The object of leasing is passive (immovable) property. This includes buildings and facilities for production and other uses. Also active (movable property) such as machines, equipment, transportation, etc. Practically any objects can be involved in leasing relationships, these objects in the process of production do not lose their material form, except property forbidden for free market circulation by the law.

Naturally strike price do not take into consideration this factor and is set by parties based on principles mentioned above. Also additionally to innovative product option leasing contract can be made about product having high market profitability at least for term of the

Table 1: Comparative characteristics of innovative leasing option and classic option contract

Characteristics	Classic option contract	Innovative leasing option
Duration	As a rule from several hours up to a year	For all term of leasing agreement (as a rule 1-7 years)
Strike price	Constant	Changes, decreases proportionally in time
Premium	Is paid by option buyer and is viewed as his expenses	There is a possibility to transfer to leasee's expenses
Probability of fulfillment as the expiration date approaches	Higher	Lower
Assets	Financial or material	Material object of leasing operation
Option buyer	Any subject	Only leasing company

Table 2: Comparative characteristics of innovative leasing option and repurchasing agreement

Characteristics	Repurchasing agreement	Innovative leasing option
Compensation for supplier for repurchasing	No	Is defined by agreement of parties
Cost of repurchasing of leased property	Is defined by the supplier based on market value	Equals depreciated investment cost according to schedule
Obligation for leaser to sell the lease subject	Obligatory	Not obligatory, at the discretion of leaser
Obligation for supplier to repurchase lease subject	Not always obligatory, depends on agreement terms	Always obligatory
Risk of not returning investment fully	Higher	Minimal

option contract, e.g, vehicles, construction equipment, etc. Even if the leaser does not execute the right of leased property selling, the seller of the option will receive its premium in any case. Premium paid by the leaser to the option seller can be included in leasing payments of the leasee, e.g., as insurance payment.

In its character innovative leasing option is very similar to classical option. Option is an agreement according to which the buyer has the right (but not obligation) to make a purchase or sale of assets at a pre-set price. At the same time, there are several differences allowing reckoning leasing option among separate category of derivative financial instruments. Comparative characteristics of innovative leasing option and classical option contract are shown in Table 1.

Table 1 shows that innovative leasing option differs in each criteria from option contract and more profitable for using in leasing operations. In civil segment of contemporary Russian practice of leasing operations there are repurchasing agreements similar to innovative leasing option but with specific differences. These repurchasing agreements are not widely used because for the supplier as a rule, it is not profitable to repurchase leased property on the terms of standard agreement. Differences between repurchasing agreements and innovative leasing option are shown in Table 2.

CONCLUSION

Innovative leasing option is more profitable for leaser and supplier compared to repurchasing agreement. For executing its right to sell lease object to the supplier the leaser pays the latter non-recurring premium but it can transfer this expense to leasee and include it in leasing payments. According to repurchasing agreement as a rule, supplier sets the price after inspecting lease object taking into account market value. As a result this price can be insufficient to cover all leaser's investment expenses and thu,s there is a risk of not returning invested money in full as the leaser has the obligation to sell the lease object to supplier at a set price. Owing to this fact the leaser must find means to return investment other than selling the lease object to supplier according to sales agreement.

In innovative leasing option the price equals depreciated investment cost, thus there is no risk of non-return. Supplier's risks in this case are covered by premium which is paid by the leaser when making innovative leasing option. Leaser having leasing option, has the right not to sell the lease object if it is less profitable for it. For example, if there is a buyer for this property willing to pay more or if the leaser has possibility to use the lease object as it sees fit. According to repurchasing agreement supplier has a possibility not to repurchase lease object at all, for example if its market value is zero but according to option supplier has to do it.

Based on the above, we can make a conclusion that risks of investment non-return in leasing options are practically minimal compare to repurchasing agreements. Risk hedging in leasing activity now is one of the main issues for leasing companies. As the market expands the number of risks increases. This research provides an example of utilization of financial market instruments as means of risks decrease. This will allow the companies working on leasing market to expand the sphere of their activities, increase efficiency and number of deals secured by money earned on the stock market.

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