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

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Contemporary organizations seek for new, innovative ways of building up competitive advantage. One of them is financing operations using new forms racing. Such a form is innovative leasing option which leaves the leaser the right to sell the leased equipment to the leasing company, which in turn is obliged to buy it. This way the risk for the company is smaller and the decisions to invest in such a way are taken more easily. The article deepens the topic showing advantages of such solutions to the companies.

Keywords: leasing option, innovation, operations financing, competitive advantage.

Introduction

Innovative leasing option is one of the innovative financial products used for reducing leasing operations credit risks of financial and credit organizations. This notion appeared for the first time in *Innovative Leasing in a Bank*. The essence of this instrument is the following: when a leasing company makes a leasing contract with a user of equipment it is necessary at the same time to make an innovative leasing option contract-put, i.e. put option. This option purchased by a leasing company from a 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. fulfil or not to fulfil option contract is entirely up to the leasing company.

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

1. The nature of innovative leasing options

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

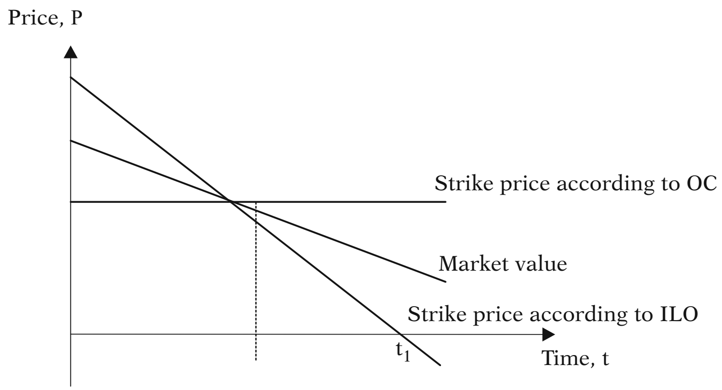
Credit risk of not returned investment is more or less present during all the time of lease agreement. Based on this, the time of innovative leasing option contract should be equal to the time of lease agreement between the leasing company and the leasee. The right of the leasing company to realize the lease option occurs when the leasee does not fulfil the obligations according to the lease agreement. Obligations can be either financial (non-payment or systematical delay of leasing payment) or administrative. E.g. the leasee is late with insurance or has not insured property against anientisement or destruction in favor of the leasing company, the leasee does not carry out scheduled maintenance, etc.

In such situations the leasing company, as a rule, is forced to foreclose the property. Later it can sell this property 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.

In the research mentioned above it is also said that strike price stays invariable during the time of the agreement (leasing option contract) until the expiry date, i.e. the end of the agreement time. 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 the strike price at which the leasing company can sell the leased property might be lower than invested money, i.e. lower than depreciated property cost. Depreciated investment cost of the property equals the money invested by the leasing company into the leased equipment less money paid by the leasee as a part of leasing payments. Based on this definition the possibility of depreciated invested cost being higher than strike price is very high at the beginning of the agreement time as the amount of leasing payments at this stage is small.

Taking this into consideration we think it is necessary to make a schedule of depreciated cost of the leased property for specified date in the innovative leasing option, and the strike price should be adjusted in accordance with the schedule of the leasing subject cost, i.e. it will be variable, not fixed. Thus the price of buying the leased property for option seller has direct connection with the moment when the leasing company decides 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 the option seller and credit risks of the leasing company will be minimal. The Figure 1 below shows 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).

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



Source: Research results.

As can be seen from the Figure, during the first time period until point t1 the strike price according to OC is lower than market value and even lower than the strike price according to ILO, i.e. it is lower than depreciated investment cost. So a conclusion can be made that in this time period the leasing company risks are not fully covered. Also in this time period the market value is lower than the strike price according to ILO, but option seller's risks are covered by the premium paid by the leasing company for the right to realize the object of lease. Further, after point t1, it is profitable for the 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 in the Figure marks the moment of time when the strike price according to OC, the 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.

Let us demonstrate how these prices are formed in a numerical example. Standard contract for an automobile costing 900 000 rub. leased for 3 years (36 months) with advance payment of 0%. Under such terms the leasee will depreciate investment cost by 25 000 rub. monthly by making leasing payments. The market value of the automobile bought from the seller at the beginning of its operation is 15–20% lower as the automobile is not the new one once it is bought. The automobile cost will decrease by 10–15% annually. Let us assume the strike price according to classical option at 550 000 rub. From month 14 to month 16 the prices are approximately equal.

2. Three sided relationship in leasing

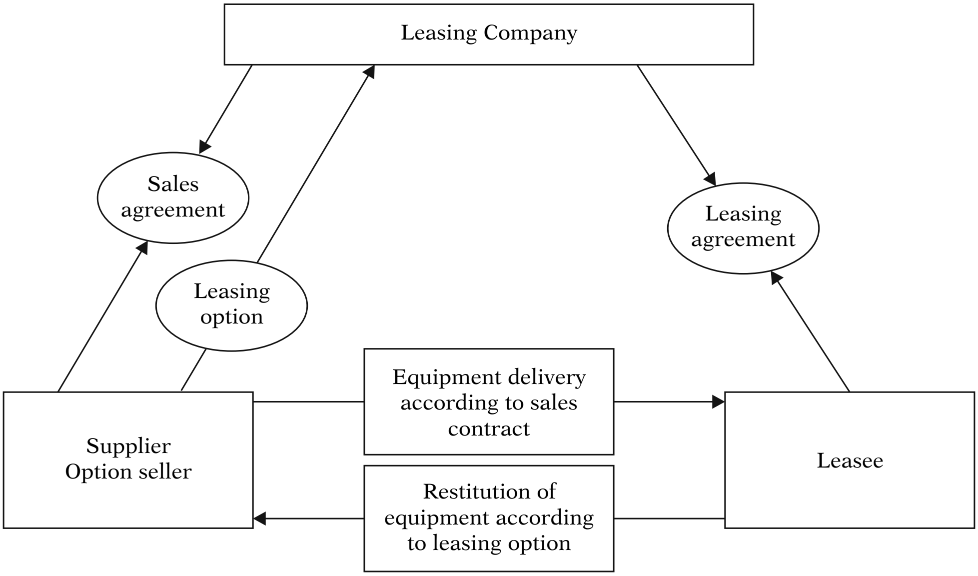
Federal regulation No. 164-FZ "On financial rent (lease)" establishes three-sided relationship in leasing.

In innovative leasing option there are also three-sided relationships if the option seller and lease subject supplier is the same person (see the Figure 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-broker or separate buyer of lease object (see the Figure 3).

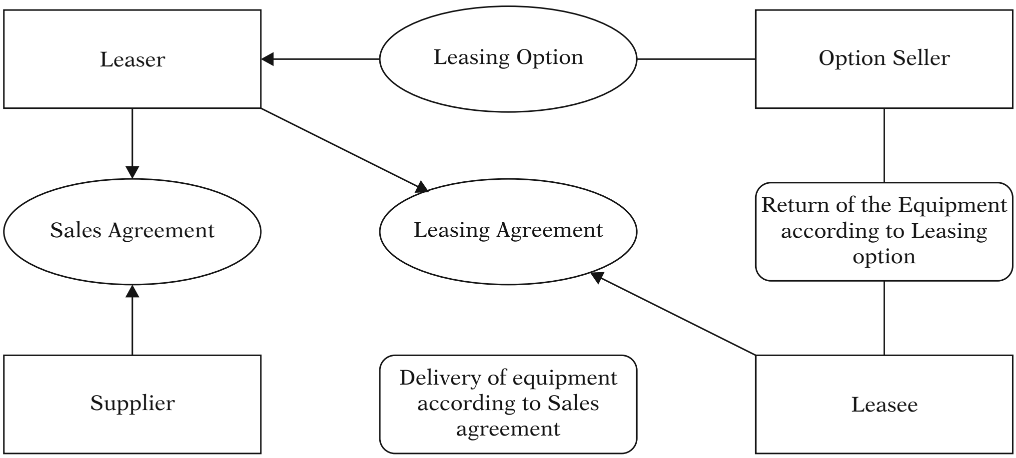
The first party is the owner of the property (leaser). It can be a person or an organization which by means of their own or borrowed funds purchases the property in the course of leasing relationships. Then the leaser grants it as a lease object for a specified sum, time period and on specific conditions to a leasee; the lease object is provided a temporary ownership with transfer or without transfer of the right of ownership for a lease object to the leasee.

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



Source: Research results.

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



Source: Research results.

The following organizations can act as property owners:

- a bank or bank's branch if its Articles stipulate such an 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 founded 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 its Articles though it is not necessarily its main activity. Such organizations have licenses and financial means for carrying out leasing operations.

The second party is property user (leasee). This can be an organization of any type or an individual who 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 the 1988 Convention – specifically machines and equipment). This can be an organization: manufacturer of property, trading mediatory organization, and also a person who in accordance with sales contract with a leaser sells the latter in a specified time 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:

1. 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.
2. Stock-broker using the fact that the 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, e.g. to the supplier of the equipment in case the risk from option right realization has the tendency to increase.
3. Independent potential buyer of the lease object, who expects to purchase the equipment at a price lower than the market one. The example of such

equipment can be any innovative product, such a product can be lease object and its price at the moment of purchasing by the 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 costs are minimal. That is why it is necessary for the leasee to choose manufacturer and agree on all terms of the sales contract. The 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, who has sufficient financial resources, to participate in the deal. The leaser receives from the future lease sales agreement draft and signs it only if there is a leasing contract.

The leaser becomes the owner of the purchased equipment, acquires the corresponding rights and obligations, but as a matter of fact its role is limited to financing 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 (firms) which do not provide property but act as middlemen between supplier, leaser-bank and leasee.

The number of parties in classic leasing falls back to two in cases when both supplier and leaser are the same legal person or (in case of return leasing) when the leasee sells its own property to the future leaser in order to purchase the same property by the means of the leasing contract. In the first case we deal with the variant unlike *the Bell* company operation, when the supplier and the leaser not only legally, but in fact as well are the same person. In our case the affiliate company dealt with leasing issues; this affiliate company was established by the manufacturer as a subsidiary or a 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 as well as 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 the strike price does consider this factor and is set by parties based on principles mentioned above. Also additionally to innovative product the option leasing contract can be made concerning a product with high market profitability at least for the time of the 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. The premium paid by the leaser to the option seller can be included in leasing payments of the leasee, e.g. insurance payment.

3. Innovative and classical options

In its character an innovative leasing option is very similar to a classical option. An 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 the Table 1.

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 time 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 their expenses	There is a possibility to transfer to leasee's expenses
Probability of fulfillment as the expiry date approaches	Higher	Lower
Assets	Financial or material	Material object of leasing operation
Option buyer	Any subject	Only leasing company

Source: Research results.

As can be seen from the Table 1, the innovative leasing option differs in all the criteria from the option contract and is more profitable for using in leasing operations.

In the civil segment of the contemporary Russian practice of leasing operations there are repurchasing agreements similar to innovative the 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 the leased property on the terms of standard agreement.

Differences between repurchasing agreements and innovative leasing option are shown in the Table 2.

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

Characteristics	Repurchasing agreement	Innovative leasing option
Compensation to 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

Source: Research results.

As can be seen the innovative leasing option is more profitable for the leaser and supplier compared to repurchasing agreement. For executing its right to sell the lease object to the supplier the leaser pays the latter non-recurring premium, but it can transfer this expense to the leasee and include it in leasing payments.

Under the repurchasing agreement, as a rule, the supplier sets the price after inspecting the lease object taking into account its market value. As a result this price can be insufficient to cover all leaser's investment costs and thus there is a risk of not returning all the invested money in full, as the leaser has the obligation to sell the lease object to supplier at a set price. Therefore, the leaser must find means to return the investment other than selling the lease object to the supplier according to the sales agreement.

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

Conclusions

Based on the above a conclusion can be drawn that risks of investment non-return in leasing options are practically minimal compared to repurchasing agreements.

The 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 a means of risks decrease. This will allow the companies operating in leasing market to expand the scope of their activities, increase efficiency and number of deals secured by the money earned on the stock market.

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Резюме

Применение инновационных финансовых продуктов для увеличения эффективности лизинговых операций

Современные организации ищут новые формы конкурентных преимуществ в разных, часто незамечаемых до сих пор областях. Одна из них – поиск современных источников привлечения капитала. Одной из таких форм, обсужденных в статье, являются инновационные лизинговые операции, которые характеризуются правом лизингополучателя на продажу машин и оборудования лизиновой фирме, которая обязана их купить. Таким образом решения, касающиеся финансирования, принимаются фирмами, ищущими капитал, легче, так как риск ниже. В статье обсуждается тема таких вариантов лизинга, показываются их механизм и преимущество для предприятий.

Ключевые слова: варианты лизинга, инновации, финансирование деятельности, конкурентное преимущество.

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