Microfinance through pawnshops – commercial sustainability and impact evaluation

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This article examines the pawnshop as a vehicle of microfinance. In East Asia, the mainstream financial sector has grown quickly over the past few decades in tandem with rapid economic growth. In this environment pawnshops continue to play a significant role, especially in serving the lower-income segment of the population, whose access to mainstream financial institutions is very limited. Despite the absence of governmental assistance and donor support and the existence, in some countries, of restrictive regulations, the pawnshop has survived for decades and has in fact expanded consistently. This article considers the ways in which the pawnshop, as a microfinance institution, manages to overcome the problems of commercialization that similar institutions face around the world. In addition, using pawnshop data from Singapore, which is the only country in Asia where aggregated statistics on pawnshops are available, and examining qualitative data from interviews with pawnshop owners, an impact assessment of this institution is conducted.

MICROFINANCE PLAYS AN IMPORTANT ROLE in many of the fast-growing countries in East Asia. It has been argued that the East Asian economic miracle was to a large extent the result of the dynamism and efficient functioning of the informal financial institutions in the region, where well-developed money markets are generally lacking (Waldron, 1995). Operating side-by-side with the mainstream financial sector but largely ignored, the informal sector is significant in providing credit finance, particularly to the low-income groups and in areas where mainstream institutions are hampered by bureaucracy.

The pawnshop in East Asia is remarkable for its commercial resilience

The pawnshop, one of the microfinance institutions in the East Asian region, has existed for decades, and is commercially operated. To draw a link with other microfinance organizations, two aspects of pawnshops require further analysis. The first is its commercial resilience, despite the absence of external support. Examining the factors behind this would present lessons for other microfinance institutions around the world, which is relevant given the problems associated with commercial viability facing such institutions (Campion, 2002). The second is an impact evaluation that is common in studies on microfinance institutions (for example, Dolye and Black, 2001). Due to the data-intensive requirements for this, pawnshops in Singapore will be used as a representative case study because this is the only country in Asia that has detailed pawnshop statistics at the industry level. In addition, qualitative data obtained through interviews with pawnshop owners are also utilized to provide a more complete picture.

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How pawnshops operate

A sequence of events involving a pawnshop loan goes as follows. The customer brings an item to a pawnbroker to be pledged as collateral for a loan. Acceptable collateral includes jewellery and anything gold – such as gold bracelets, necklaces, watches and diamonds – since these items have a sufficiently large secondary market. The pawnbroker then evaluates the item and informs the customer of the size of the loan he is prepared to make, taking into account the market value of the item since the customer may default. There is sometimes room for bargaining but it is limited. If the customer accepts, the pawnbroker exchanges the stated cash amount for the item. The customer is also issued with a pawn ticket, which provides details on the item pledged as collateral, the loan amount, the interest and an expiry date. If the customer fails to return before the expiry date, either to extend the loan or make full repayment, he is deemed to have defaulted on the loan and the pledged item is forfeited.

Because pawnbrokers lend only on the basis of collateral left in their possession, they do not gather information to assess credit risk but instead concentrate purely on properly evaluating the collateral. With the presence of trained valuers, this process typically takes just a matter of minutes. Once the value of the collateral is ascertained, a cash loan may be made immediately on the completion of the pawn receipt. The only cause for delay is if the pledged item is suspected of being stolen.

Trained valuers assess the collateral and issue a loan in just a few minutes

Survival as a commercial institution

It has been noted that 'microfinance has been particularly successful in densely populated urban areas and in countries with large informal sectors' (Campion, 2002). Obviously, in the presence of a poorly developed mainstream financial sector, the informal sector – including pawnshops – would rise to meet the demand for credit. It is interesting to note that even if a highly developed financial sector exists, such as in the case of Singapore and Hong Kong, pawnshops can still be found. This is because well-developed financial institutions do not preclude the existence of barriers to obtaining credit. The mainstream financial sector tends to focus its attention on the higher-income group, since the lion's share of the demand comes from this group. They are also favoured because the higher-income borrower is less likely to default. In fact, in many countries there are often explicit barriers to obtaining bank credit for the lower-income group. Minimum-income barriers and creditworthiness requirements are often imposed either by the banks themselves or by the government trying to prevent bad-debt problems that could destabilize the banking system. These barriers exist regardless of the degree to which the formal financial sector is developed, and provide the niche for the pawnshops to survive and grow.

The pawnshop has proved its resilience in Asia as a commercial institution, not only surviving but establishing its niche and growing in size. This commercial viability is significant, for as Woller (2002) points out:

> The provision of financial services [by microfinance institutions] was but a means to this end. Not only that, but microfinance offered a promise to alleviate poverty while paying for itself and maybe even turning a profit – 'doing well by doing good'. That too was a revolutionary concept. This promise, perhaps more than anything, has accounted for the mass appeal of microfinance and its rise to global prominence.

What can microfinance learn from the commercial survival of pawnshops?

This section specifically examines the various factors behind the commercial survival of the pawnshops, which are of particular relevance given the various problems associated with commercialization that microfinance enterprises face (Campion, 2002). In particular, attention will be given to the ability to mobilize savings, risk management, marketing and customer responsiveness, and human resource development (Campion, 2002).

Ability to mobilize saving or capital. For deposit-taking microfinance institutions, attracting sufficient depositors or handling a huge, sudden outflow of deposits are obviously big issues that need to be resolved in order to ensure the smooth functioning of these businesses. Because pawnshops do not accept deposits, they do not need to face these problems. However, there is still the problem of raising enough capital, both at startup or afterwards to keep the business running smoothly. There are two characteristics that pawnbrokers in East Asia have that enable them to address this capital requirement.

The first is that pawnshops tend to be family businesses that rely on the pooled capital of family members. Given the mutual trust inherent among members of the same family, it is much easier to pool saving and resources. In addition, these family businesses tend to have a great deal of continuity because they are passed down from one generation to the next. A number of pawnshops in Singapore, Malaysia, and Indonesia started in the nineteenth century with Chinese immigrants, who provided the initial injection of capital and brought along expertise in running pawnshops.

The second characteristic of pawnshops that solves the problem of having to raise sufficient capital is that the minimum capital necessary for the smooth functioning of a pawnshop is relatively low. In particular, the manpower requirements for operating a pawnshop are low, with the most basic structure involving only one or two valuers, a clerk and an accountant. Very often, these staff members are drawn from within the same extended family or from the family's circle of close friends due to the element of trust. This is the reason why fundraising for these ventures can be limited to within the family and outside sources are not solicited. Because the capital requirement for entry into the pawnbroking business is not high, having a huge pool of savings is not a prerequisite to entry or survival. The entry barriers to the pawnbroking industry are therefore relatively insignificant from a capital standpoint.

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Risk management. In providing bank loans, whether secured or unsecured, mainstream financial institutions such as banks have to screen customers comprehensively for credit risk. In the case of unsecured loans, the justification for this practice is obvious because the financial institution has no collateral if the borrower defaults. In the case of secured loans, screening is still of importance since significant costs often arise in the process of transferring collateral in case of default. Disposing collateral in depressed economic conditions, when default rates tend to be the highest, often involves steep discounts in the price of the assets. This is not to mention the legal costs and commissions that often accompany these default transferrals.

To determine credit risk, mainstream financial institutions generally employ a fairly standardized screening procedure called scoring. Among the variables usually used in determining the credit score are the applicant's income, years on job, occupation, education, credit card ownership, assets, total outstanding debt, and credit repayment history. Applicants with poor credit records, low and unstable incomes, and low education –

which implies low earning power – would tend to be denied access to bank credit.

The existence of a vibrant secondary market is a prerequisite for accepting a pawn item

Since collateral is involved in a pawnshop transaction, the pawnshop loan is a secured one. The pawnshops do not carry out credit screening, unlike their counterparts from the mainstream financial sector. Without having to rely on deposits, risk management for pawnbrokers is focused on attempting to minimize losses from default loans. However, the impact of default is still kept low since the existence of a vibrant secondary market is a prerequisite for accepting a pawn item in the first place. Many of these are gold and jewellery items that are a good store of value. In addition, the transaction costs of disposing collateral from defaulting customers are much lower compared to those associated with secured loans at banks and mainstream financial institutions. Collateral for secured loans at mainstream institutions is usually housing properties, cars and other assets that require significant legal fees and commissions for transferral. In addition, pawnshops reduce the impact of default loans further by establishing close business links with goldsmiths, so that gold items from default loans can be sent to them to be melted and subsequently resold. In fact, many of the pawnshop owners also run goldsmith businesses, which help them to recycle defaulted items even more easily.

The changing range of objects acceptable as collateral at pawnshops also reveals the risk management by pawnbrokers. Pawnbrokers are careful only to accept items that are have a sufficiently large secondary market. In earlier decades in Singapore, for instance, a much wider range of items could be pledged as collateral, including sewing machines, clothes, blankets, spectacles, bicycles, irons, cameras and workman's tools. As Singapore's economy grew and standards of living rose, the secondary market for many of these items started to vanish and pawnshops reacted to this risk quickly by refusing to accept these as collateral. Today, only gold and other jewellery items, for which a large secondary market still exists, are acceptable to pawnshops. The commercial viability of pawnshops owes much to their adaptability to the changing market conditions for the various types of collateral. It also reveals the care taken by pawnbrokers to manage their risk. Much of this experience is shared relatively freely within the pawnbroking community in each country, and is also passed from one generation to the next in this largely family-oriented business.

Marketing and customer responsiveness. The pawnshops are well aware of their niche as a residual credit provider, thus focusing their attention on customers who have limited access to mainstream financial institutions. This group of people, which is typically from the lower-income segment, is enlarged by the presence of various governmental regulations. In many countries, there are regulations that entirely remove the low-income segment of the population from obtaining credit from the banking system. The existence of these restrictions is justified by the need to limit bad debt, which would destabilize the banking system and jeopardize the overall economy. The most common of these regulations are minimum income requirements. In addition, there are other restrictions on nationality and age; most personal loans are made to those who are within the working age range, since the ability to repay is tied to recurring income.

In many countries, there are regulations that entirely remove low-income people from obtaining credit from the banks

Pawnshops play a residual role as a credit provider, catering to those customers whose credit needs are not met by the mainstream financial institutions. The barriers to borrowing that these low-income borrowers face can also cause problems for microfinance institutions, as have been documented before (for example, Glackin, 2002). Among other things, they have poor credit history, lack understanding of the complexities involved in a loan, lack knowledge of legal matters, and do not have any assets that banks would accept as collateral. In marketing to this group of people, the pawnshop attempts to address these issues. By relying on secured lending with collateral and doing away with credit screening, a proper credit history is not necessary to obtain a pawnshop loan. Through accepting collateral that is of relatively low value and that is commonly owned by these low-income individuals, it solves the problem of a lack of collateral. A single, standard interest rate usually holds for the entire duration of the loan, which comes without the complexities of various terms and conditions that are associated with a bank loan. The pawnshop therefore provides the simplicity and transparency that poorer customers want.

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Pawnshops also attempt to leverage on their advantage of having a flexible repayment period. Unlike banks and other mainstream lending institutions that tend to have a fixed repayment timescale, pawnshop customers may choose to repay their loans at whatever time suits their finances, as long as it is within the length of their loan contract. In some countries, such as Singapore and Malaysia, they can postpone settlement indefinitely without default, as long as they make the minimal interest payments periodically. Most of the customers appear to be interested in short-term loans of within a few months, or even days, in order to tide over temporary budget difficulties. This very short-term credit would have been difficult to obtain at banks, even if one happens to have access, because the interest from such a short loan would not justify the transaction costs – credit screening and other administrative costs – involved in setting up a bank loan.

Pawnshops also attempt to attract customers with their speed and efficiency. A customer can come to a pawnbroker and leave with cash in hand within minutes, without having to fill in the numerous application forms and endure the waiting period required for the approval of bank loans. As mentioned earlier, the pawnshop is also attractive due to its simplicity, with its single and standard interest rate, which does not vary like the interest rate charged by banks.

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Human resource development. Due to the nature of pawnshops as family businesses, management and ownership are confined to within the family. Because of this, pawnshops tend to have a great deal of stability in management. Outside of the managerial ranks, the key position in a pawnbroking business is the valuer, who is the person to decide on the amount to be loaned with the collateral offered by the customer. This is a very important position, since offering too high an amount puts the pawnshop at risk should the customer default, while too low an amount would turn customers away. Very often, the managing director and the chief valuer are the same person. Most of the valuers are the next-of-kin or close friends of the pawnshop owner since trust is extremely important for this position. The training process to be a valuer is a long and arduous one, with on-the-job training a necessary part of the whole process. There is no formal training for valuation, and new entrants begin as apprentices under a senior valuer. New valuers are very often sourced from within the same extended family and often stay with the same pawnshop for their entire careers. Given their importance to pawnshops, they are a critical contributing factor to the stability of the businesses.

Impact evaluation

Impact evaluation is often of relevance to microfinance institutions to analyse the breadth and depth of their credit provision capabilities. Since data is clearly required for this exercise, and pawnshops are clearly not motivated to reveal these, we have to look at the statistical agencies for help. To our knowledge, the only country in Asia where pawnshop statistics is provided at the national level is Singapore. Singapore is therefore used as a representative case study in this section on impact evaluation.

Evaluating impact and outreach is an important part of assessing any microfinance institution, and the pawnshop is no exception. This article applies both qualitative and quantitative criteria.

Amount disbursed. The most common measure of loan size is the amount disbursed per loan. From the perspective of borrowers, the amount disbursed represents the largest single purchase possible from loan proceeds. It also represents the addition to overall household liquidity as a result of the loan. For microfinance institutions in general, smaller disbursements are associated with poorer borrowers because they are riskier and hence can only qualify for smaller loans. For pawnshops specifically, smaller disbursements imply greater depth of outreach since poorer borrowers can only pledge collateral of lower value than richer borrowers at pawnshops.

Average loan size was US$306

Using pawnshop statistics from the national statistical agency, the amount disbursed per loan is given by the ratio of the amount of loans disbursed to the number of loans. For 2004, this amount was S$471.58 (US$306). This is only 14.2 per cent of the average monthly earnings in the same year, which is S$3,329 (US$2,165). This shows that pawnshop loans are generally made to lower-income individuals.

Term to maturity of loans. Schreiner (2001) argues for the importance of considering the term to maturity of loans disbursed. Generally speaking, loans of longer maturities are associated with better creditworthiness or higher collateral value, implying that shorter loans reveal deeper outreach to the poor and lower-income groups. The pawnshop statistics from the national statistical agency does not provide details on loan maturity, and there is also no data available on the number of outstanding loans at any point in time. However, there is data on the average loan amount and the average amount repaid, including interest for each year. Noting that since all loans are based on the fixed interest rate of 1.5 per cent per month, a good estimate is therefore

Shorter term loans suggest deeper outreach to the poor

$$\text{Term to maturity (in months)} = \frac{\text{total amount repaid}}{\text{total loan amount} \times \text{repayment ratio}} \quad \frac{1}{1.5\%}$$

Introducing the repayment ratio into the denominator removes the impact of default loans that are not repaid, hence permitting us to concentrate only on the term to maturity of all repaid loans. The repayment ratio is given by the ratio of the number of loans repaid to the number of loans disbursed. Substituting this relationship into the formula above, we get:

$$\underset{\text{(in months)}}{\text{Term to maturity}} = \frac{\text{average amount repaid}}{\text{average loan amount}} \times \frac{1}{1.5\%}$$

However, one problem is that the amount repaid in a given period, say in 2004, could be repayments for those loans made in 2003 or earlier. Hence this formula understates the true value of a growing portfolio. The bias is, however, smaller the smaller is the ratio of the actual term to maturity to the period of measurement. To reduce this bias to the minimum, the maximum period length is thus chosen, which is the 30 years from 1975 to 2004. Based on this, the term to maturity is measured as 4.37 months. This is much shorter than a typical bank loan, which is usually at least one year in duration. The low term to maturity is a strong reflection that pawnshop customers tend to rely on short loans.

Loans are more often taken out at the end of the month

Low-income clients served? Schreiner (2001) points out that the term to maturity of loans also matters in evaluating the degree of outreach to lower-income group. For lending institutions in general, longer loans tend to be made to those with greater creditworthiness, who tend to be those better off financially. Hence the ability of longer loans to meet the needs of the poor is limited. Conversely, shorter loans tend to have greater depth of outreach. In the case of pawnshops, the length of maturity is not fixed but variable, and in particular may be as short as a day if so desired. These loans therefore are able to meet the needs of the lower-income group. As was noted earlier, the average term to maturity for pawnshop is short at around four months. This reflects the depth of outreach to the poor since this group tends to have short, recurring budget difficulties due to their lack of savings as a buffer.

Collateral is needed for pawnbrokers to make a loan, but there is no lower limit on its value. The use of collateral serves two purposes. First, it helps to overcome the borrower's problem of a lack of creditworthiness, which would prevent him or her from getting a loan otherwise, except perhaps through the black market where the interest rate is astronomical. While the collateral limits the loan size, it also enables a loan to be made at a reasonable interest rate. Second, it helps the pawnshop to stay out of trouble in the case of default, since the pawnbroker can sell it in the secondary market. Besides, the use of collateral allows pawnshops to be free of the credit screening that banks cannot avoid, thus saving significantly on transaction costs. The high fixed costs for a bank loan mean that the interest earned has to be high enough – which implies that the loan size has to be sufficiently large or the maturity sufficiently long – in order to cover these fixed costs. Banks therefore do not make loans in small amounts or with short maturity for this reason, which makes them unable to meet the needs of the lower-income group, even if creditworthiness had not been a problem.

By saving on fixed costs, the pawnshop can make small loans and with short maturities, and still remain profitable

Interviews with pawnbrokers support this picture of pawnshop customers. While they report customers from all segments of society, the overwhelming majority are low-income individuals who operate independently of mainstream financial institutions. Given the stringent criteria that have to be met for borrowers of loans from banks and other mainstream institutions, it is not surprising that many of the poorer borrowers would have to rely on the pawnshop to meet their credit needs.

Outreach to women, senior citizens, minorities and foreigners. Since women tend to use gold and jewellery as a store of value, and these are commonly used as collateral in pawnshop loans, female customers form an important part of the customer base of pawnshops. In addition, unlike banks and other mainstream institutions that generally require borrowers to be from 21-60 years of age to obtain personal loans, the pawnshop does not practise any sort of age discrimination. Since gold and jewellery are also not particular to the Chinese, which is the dominant ethnic group in Singapore, the minorities also find it easy to gain access to pawnbroking credit. Furthermore, the mainstream financial institutions have many restrictions on borrowing by foreigners due to governmental regulations, but this again is not an issue in the case of pawnshops.

Pawnshops are used by women, senior citizens and minorities as much as by others

Costs, efficiency and sustainability There is no quantitative data available on the various costs that pawnshops incur, but it is clear that these costs are not high. Besides having to pay rent, each pawnshop only has a very small number of employees. There is of course a head valuer with two or three assistants, and a clerk to keep track of accounts. Job skills, particularly on how to value collateral, are passed from one generation to the next within the same extended family through on-the-job training, and hence there is no need for costly external training courses. Because of this, costs are often very stable and predictable.

Conclusion

In countries where formal banking institutions are absent or poorly developed, pawnshops and other forms of informal finance naturally emerge to meet the demand for credit. In countries with strong mainstream financial institutions, barriers to accessing bank credit still remain and are particularly significant for low-income groups. Consequently, the pawnshop continues to play a significant role in countries with varying degrees of financial sector development. In this article, two aspects of pawnshops were studied due to their importance for microfinance institutions in general: commercial viability and impact. It is significant that this microfinance institution, despite not receiving donor support, has survived for decades in Asia, and in fact around the world. The various reasons behind this commercial viability were examined, including its ability to mobilize saving, manage risk, respond to customers and develop human resources. In addition, an impact evaluation of the pawnshop as a microfinance institution was made using data from Singapore, with the finding that pawnshops have significant outreach to lower-income individuals.

Tthe pawnshop continues to play a significant role in countries with varying degrees of financial sector development

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