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# Pawnshop as an instrument of microenterprise credit in Malaysia

Pawnshops as an instrument

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## I. Introduction

The importance of formal financial intermediation in economic growth and development has been emphasized by Gurley and Shaw (1956). They provide the analytical framework for analysing intermediation in subsequent publications (see Gurley and Shaw, 1956; 1960). The accumulation of capital is believed to be essential for economic growth. The financial intermediations allow the capital to be held indirectly through transformed assets to facilitate economic development.

The evidence in the developing countries, as mentioned by Bouman (1988), shows that the rural economy still relies on the informal financial intermediation. Therefore, its importance increases in proportion to the level of underdevelopment which has further enhanced this interest. In Malaysia, the pawnshop as the main informal financial institution has grown in importance over the past few years. The issues that could be raised here are: first, how important is pawnbroking in resource mobilization? Second, how could pawnshops be used to finance the microenterprises?

## II. Pawnshops in Malaysia: some background

### *a. The importance of pawnshops in Malaysia*

There are no official estimates of the importance of pawnshops as a source of credit in the Malaysian financial market. The Central Bank of Malaysia does not collect data on pawnbroking and does not include an estimate of pawnshop credit in its statistics on total domestic credit. However, by exploring the data provided by a few pawnshops, it can be seen that the total pawnshop credit is estimated about RM125 million at the end of 1995 (of which RM67 million is new credit). For comparison purposes, the outstanding credit at the end of 1995 amounted to RM306.6 billion, of which RM174.2 billion was accounted by commercial banks loans and RM62.7 billion by finance companies.

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By these measures, pawnshops appear to deserve the status as a small bank as they are the source for only about 0.03 per cent of new credit in the Malaysian financial market. By other measures, pawnbroking clearly plays a key role in the Malaysian financial market. At the end of 1995, there were 282 pawnshops in Malaysia or about one pawnshop for every five branches of commercial banks. Moreover, in that year, the number of borrowers amounted to about 1,015,200 (with an average of 300 customers per month). The average loan is only RM803, therefore pawnshop lending as a percentage of total credit is much less significant than as a percentage of the population served (in 1995, the total Malaysian population was 19 million).

Beyond these aggregate measures, pawnshops are also very important to thousands of Malaysians, especially the low income group (< RM500) and less educated (secondary level), whose credit risks exclude them from formal financial markets. A survey by Ragayah (1986) shows that the occupation of borrowers can be classified into three groups, i.e. housewives, private and government employees. These customers turn to pawnshops for credit because they are not eligible to borrow from formal financial markets. Other customers use pawnshops for their convenience; such as for household and emergency expenses. The borrowed amount can be disbursed in a few minutes and with very few questions asked.

*b. The regulatory framework*

In Malaysia, pawnshop businesses operate as one-stop financial centres for their customers. These pawnshops are mostly privately owned and operated for profit. However, in the early 1990s, the Islamic-based pawnshop owned by a charitable group (Yayasan Pembangunan Ekonomi Islam Malaysia), and state government, and operated by Bank Rakyat (co-operative bank), Permodalan Kelantan Bhd and Muasasah Gadaian Islam Trengganu were allowed to open branches through out Malaysia, Kelantan and Trengganu, respectively. In addition to the above conventional motives, these Islamic-based pawnshops are established to fulfil social responsibilities.

Both conventional- and Islamic-based pawnshops, are separately regulated by Pawnshop Act (1972) and Pawnshop Act (1972) (with several amendments). Although, the acts vary, a general pattern could be discovered. First, when a customer pawns goods, terms of the loan contract must be specified in a receipt, a copy of which the customer receives. The receipt states the customer's name and address, a description of the collateral, amount lent, maturity date and the amount that must be paid to redeem the assets.

Detailed account of the assets, amount and maturity are provided in Table I. The Islamic-based pawnshops only allow gold to be pawned and the amount lent depends on the value of the gold.

Second, the interest rate and other charges are determined by each pawnbroker. Normally, the interest rate is fixed at 2 per cent per month. This rate is expected to increase if the maturity of the loan is more than one month. In the Islamic-based pawnshop, the loan granted is based on two concepts, i.e.

*al-qardhul hassan* (loan without interest, but the borrower pays service charge) and *wadiyah yad dhammanah* (keeping valuable goods by guarantee). The deposit fee is based on the value of gold, as shown in Table II. This fee is charged differently by each pawnbroker.

In the case of a loan default, the collateral becomes the property of the pawnshop after the loan is overdue by a specific period of time, usually up to six months. The Islamic-based pawnshop regulations require any surplus from the sale of the gold over the amount owed to the pawnbroker, including accumulated deposit fee and any costs related to the sale, to be returned to the customer. Default rates of 5 per cent to 10 per cent are reported in the states for which there are data. Therefore, default rates as a percentage of the number of loans are higher than default rates as a percentage of the amount of loans, indicating higher default rates on smaller loans.

*c. Characteristics of a pawnshop loan*

Because pawnbrokers lend only on the basis of collateral left in the broker's possession, brokers do not gather information to assess credit risk but, rather, focus on properly evaluating the collateral. Once this procedure is determined, a cash loan is advanced immediately on the completion of the pawn receipt. A typical loan processing lasts less than one hour. Hence, it is normal to see a customer wishing to pledge a precious asset and completing the transaction

Types of pawnshop	Pledge Assets	Maximum borrowed amount (RM)	Maturity (Months)
Conventional-based	Jewellery and electronic instruments	50 per cent of the value of pledged assets	6
Islamic-based	Gold	50 per cent of the value of pledged assets	6

**Table I.**  
Types of pledged assets, amount and maturity in pawnshop

Value of pledged asset <sup>a</sup>	Islamic-based pawnshop			
	Bank Rakyat (RM per month)	Permodalan Kelantan Berhad (RM per month)	Muasassah Gadaian Islam Trengganu (RM per month)	Conventional-based pawnshop (% per month)
RM1-RM400	-	0.60	No charge	2
RM1-RM1,000	0.40	-	No charge	2
RM401-RM2,000	-	0.80	No charge	2
RM1,001-RM5,000	0.50	-	No charge	2
RM2,001-RM10,000	-	0.95	No charge	2
RM5,001-RM10,000	0.60	-	No charge	2

**Note:**

<sup>a</sup> In the conventional-based pawnshop. This value refers to the total loans

**Table II.**  
The charge rates in pawnshops

within a few minutes provided that there is no suspicion that the assets may be stolen.

In most transactions, pawnbrokers make loans with maturities up to six months. However, it is commonly understood for customers to renew these loans by paying extra fees or interest on the loan extension. In certain circumstances, customers may redeem within a week or two. In fact, as mentioned by Bouman and Houtman (1988), there are cases where money is borrowed not once but repeatedly and loans are made piecemeal for extremely short periods.

A pawnbroker lends a customer a percentage of the value which the pawnbroker believes the collateral would bring in a compensation. The loan to the collateral ratio varies over time and across pawnshops, but a loan of about 50 per cent of the value of the collateral is common. Furthermore pawnbrokers offer twice the loan limit of the commercial banks while seldom imposing a maximum limit on loan size. This means that the pawnbroker almost always makes a one-time profit from a default. However, pawnbrokers prefer the customer to redeem the collateral. A customer who loses his/her collateral may feel uncomfortable towards the pawnshop. Therefore, pawnbrokers prefer to lend repeatedly to a customer rather than gain a one-time profit from a default.

Normally pawned items include jewellery and electronic assets. These items maintain their value over a reasonable period of time and are easy to store, especially jewellery. However, in the Islamic-based pawnshop, gold is the permitted item.

### **III. The distribution of pawnshops**

As indicated in Table III, pawnshops are highly unevenly distributed across the Malaysian states. Perak, with 40 pawnshops, has the most of any state but Trengganu and Perlis, with five and four respectively, have the most pawnshops per capita. Kuala Lumpur and Pahang with only 16 and 13 pawnshops, have the least per capita.

What is not apparent in Table III is another characteristic of pawnshop location. In states with many pawnshops per capita, the majority of towns with a population over 10,000 have at least one pawnshop. In states with few pawnshops per capita, pawnshops are located almost exclusively in major urban areas. What are the factors that caused this skewed distribution of pawnshops?

Before attempting to answer, it is useful to consider two key characteristics of the pawnbroking industry: high customer transportation costs per loan ringgit and relatively free entry into the industry. To obtain a loan or redeem a collateral, a customer must physically transport the collateral to and from the pawnshop. With an average loan of around RM800, transportation costs per ringgit of credit are significant, and customers normally prefer to do business with the nearest pawnshop. Thus, to achieve the economy of scale, strong demand for pawnshop services across a broad geographic area is usually met by numerous, dispersed pawnshops.

State	1983-1985	1986-1988	1989-1991	1992-1994	Pawnshops as an instrument
Perlis	1	1	2	5	
Kedah	22	22	23	29	
Penang	22	22	23	27	
Perak	37	37	39	49	
Selangor	16	19	20	27	
Negri Sembilan	15	16	16	19	
Malacca	11	13	13	15	
Johore	28	26	25	30	
Pahang	11	13	13	17	
Trengganu	4	3	5	8	
Kelantan	4	7	10	13	
Kuala Lumpur	10	10	13	18	
Labuan	–	1	1	2	
Sabah	6	7	24	25	
Sarawak	8	9	25	28	
Jumlah	195	204	252	309	<b>1347</b>

**Source:** Ministry of Consumer and Domestic Affairs and Bank Rakyat Malaysia Bhd

**Table III.**  
The distribution of pawnshops in Malaysia

Barriers to entry into pawnbroking are small. Pawnshop start-up costs are within reach of most middle-income entrepreneurs. Consequently, new pawnshops quickly enter areas that promise high profits and demands. As the new pawnshops enter, the customer base per pawnshop shrinks because customers switch to the most convenient pawnshop. With the shrinking customer base, profits will decline because each pawnshop must cover its fixed costs from a smaller cash flow.

This development suggests an explanation for the skewed national distribution of pawnshops. Because the existing law permits small pawnshops to operate profitably by charging interest rate, and high customer transportation costs mean they will be patronized, it is expected that there will be more pawnshops per capita in states with higher interest rates. It is also expected that there will be less pawnshops per capita in states that do not charge interest rate. Furthermore, with the establishment of Islamic-based pawnshops, an alternative pawnshop which offers a much cheaper service charge is expected to contribute to the distribution of pawnshops. These arguments are evidenced by the number of pawnshops in Table III.

The uneven distribution of pawnshops across the states may also be explained by differences in population densities and the need for pawnshop credit. The population density may have an ambiguous effect on pawnshops per capita. If people are extremely dispersed, pawnshops might draw too few customers to survive. On the other hand, if the population is densely concentrated in a small area, one large pawnshop could serve the whole community. Finally, some states especially in the east coast of Malaysia may also have a stronger per capita demand for pawnshop services because a larger percentage of the population is excluded from the mainstream credit markets.

The above findings have several implications for regulatory decision. First, the current system of charging interest rate in the credit market has been criticized as harmful to low-income consumers because financial institutions under this system tend to allocate credit to only the most creditworthy borrowers, who generally belong to middle- or high-income groups (low risk borrowers).

Second, the above implication is not the case with pawnshops, because all customers provide collateral, eliminating the need to distinguish high-risk and low-risk borrowers. Third, a higher interest rate would shift the credit from the mainstream credit market to pawnshop. However, the low interest rate in pawnshop, especially in the urban areas, could be a trade-off with higher number of customers which can cover their overhead. Fourth, the customers might prefer the Islamic-based pawnshop which is less expensive and a convenient credit to all.

#### **IV. Pawnshop and microenterprise credit**

##### *a. Formal credit to small-scale enterprises*

In order to assist small borrowers in obtaining credit facilities from the Commercial Banks at reasonable cost, the Credit Guarantee Corporation (CGC) was established on 5 July 1972. The credit facilities was extended to eligible small-scale enterprises (SSEs) covering the agricultural, commercial and industrial sectors for financing their capital and operational requirements. In 1995, the commercial banks were required to extend new loans amounting to at least RM1,000 million to SSEs.

The total outstanding SSEs loans guaranteed by CGC were RM1,758.7 million or 0.9 per cent of the total outstanding loans in 1995, compared with only RM11.8 million or 0.2 per cent in 1973. And CGC will guarantee 70 per cent of the portion of credit facilities extended by the lending financial institutions that is not covered by the available collateral under the banks' normal lending practices. The interest rate charged on loans granted under this scheme is pegged to float at 1.5 percentage points above the base lending rate (BLR). For example, as the BLRs of the two lead banks for 1989 was 6.75 per cent per annum, the maximum interest rate on CGC scheme was 8.25 per cent per annum, which is still too high.

##### *b. Capital in microenterprise credit*

The increasing amount of credit given by the financial institutions, as discussed in section IV(a), shows the aggregate effect of increasing capital requirement. The number of SSEs is expected to increase into the foreseeable future as a result of industrialization. The structural changes accompanying this development are the demand for capital which is translated into the growing demand for credit. Although the exact number of microenterprises in Malaysia cannot be estimated precisely, nevertheless the general trends are quite clear.

Therefore, aggregate capital and credit needs will continue to increase. However, production, income, capital and credit use will become increasingly

concentrated among the larger borrowers. The owners and operators of the microenterprises will stay in business largely through their growing reliance on income from internal and informal sources. These trends raise some important questions. First, can the financial institutions that supply credit continue to meet the challenge of providing for the financial needs of this sector? Second, how can the pawnshops provide credit with the rapidly rising capital requirements?

With regard to the first question, of course, the financial institutions are able to provide the credits to the microenterprise. However, some borrowers are willing to get credit from the pawnshop. Among the reasons are: first, transportation and waiting costs. To obtain a loan, a customer must travel to and from the branches of financial institutions which are normally located in the city. In addition, the loans processing time is about one month. With an average loan of around RM5,000 (for SSEs), transportation and waiting costs per ringgit of credit are significant, and customers normally prefer to do business with nearest the closest pawnshop because of its quick procedures and low transaction costs.

Second are interest rate regulations. Although, the interest rate in the formal financial institutions has been liberalized, the trend shows that this interest rate is expected to increase in the boom period. However, the interest rate charged by the conventional-based pawnshop is quite high compared with the interest rate charged by the financial institutions. The higher interest rate in conventional-based pawnshop is partly compensated by the marginal costs of transportation and processing. However, relatively speaking, the customers prefer the Islamic-based pawnshops which are much cheaper.

Third is that the other main factor is likely to be an increase in the number of people who do not use the formal financial institutions because of poverty. Although the poverty rate has declined from 15.4 per cent in 1976 to 7.5 per cent in 1989 (Table IV), the number of low-income groups is still significant. As discussed earlier, low-income individuals are much less likely to use formal financial institutions.

Fourth are the effects of financial liberalization. Bank deregulation may be another factor contributing to an increase in the population operating independently of the banking system. Following the financial liberalization in 1980s, banks increasingly introduced charges on several services. Since people without bank accounts would find it extremely difficult, and most likely impossible to obtain bank or finance company loans, the trends may indicate an increase in the percentage of the population forced to turn to pawnshops to meet short-term credit needs.

Fifth is duration of the loan. Normally pawnshop credit is used for very short periods, to tide over until the next pay-day when the pawned item will be redeemed.

Sixth is confidentiality of the loan. In acquiring pawnshop credit the customers need not reveal the reason for acquiring the loan. It is deemed that the customer is in the best position to determine how the loan will be utilized.

**Table IV.**  
Malaysia: urban  
poverty by state,  
1976, 1984 and 1989

	1976			1984			1989		
	Total households (1,000s)	Total poor households of poverty (1,000s)	Incidence % among poor (1,000s)	Total households (1,000s)	Total poor households of poverty (1,000s)	Incidence % among poor (1,000s)	Total households (1,000s)	Total poor households of poverty (1,000s)	Incidence % among poor (1,000s)
Johore	73.8	9.0	12.2	130.3	7.6	5.8	137.5	8.2	6.0
Kedah	26.0	6.3	24.2	31.5	4.2	13.2	36.1	5.4	14.9
Kelantan	25.5	9.0	35.3	53.0	11.5	21.7	63.0	12.4	19.7
Melaka	19.8	2.5	12.6	18.3	1.3	7.3	20.2	1.0	5.2
Negri Sembilan	20.2	2.0	9.9	48.6	3.0	6.1	45.4	1.6	3.6
Pahang	21.4	2.8	13.1	54.7	5.0	9.2	56.3	3.7	6.6
Perak	105.1	16.5	15.7	136.9	14.4	10.5	134.8	11.9	8.8
Perlis	-	-	-	3.1	0.2	7.1	3.2	0.1	2.8
Pulau Pinang	73.5	12.2	16.6	87.6	7.1	8.1	91.7	4.8	5.3
Selangor	59.1	5.5	9.3	133.3	5.2	3.9	161.0	7.6	4.7
Trengganu	26.4	10.0	37.9	52.3	10.0	19.1	57.5	11.0	19.2
W.P. (Kuala Lumpur)	92.6	6.3	6.8	242.1	11.8	4.9	255.5	9.8	3.8
Peninsular Malaysia	543.4	82.1	15.1	991.7	81.3	8.2	1,062.2	77.5	7.3
Sabah	30.7	5.9	19.2	52.4	7.5	14.3	57.7	8.5	14.7
Sarawak	39.3	6.4	16.3	51.2	4.2	8.2	62.8	3.1	4.9
Malaysia	613.4	94.4	15.4	1,095.3	93.0	8.5	1,182.7	89.1	7.5

**Source:** Fourth Malaysia Plan, 1981-1985 and Household Income surveys, 1984 and 1989

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Seventh are the banking hours. It is often said that banks keep awkward hours: opening late in the morning while closing early in the afternoon, weekends and public holidays. It is during these periods that pawnbroking business is at its most brisk. When pawnshops stay open at the hours preferred by the customers, they offer greater access and discretion, speedy processing and few formalities.

Therefore, the development of microenterprise could be enhanced by providing capital through pawnshops. The amount of capital, the terms and conditions under which it is obtained, and the way it is used, determine to a large degree, the level of income, especially to eradicate poverty. Usually when the word pawnshop and poverty are mentioned, the image portrayed is that of a poor farmer in the rural area trying to raise credit via the pawnshop. There have been numerous studies and literature in this area, for example Adams *et al.* (1984).

However, we could also look at urban poverty and pawnshops as a means of acquiring credit. With rapid urbanization we are experiencing an increase in the rate of urban poverty, as indicated in Table IV. Similar to their rural counterparts, these groups of the population too will need access to credit for all intent and purposes. As discussed earlier, for reasons best known for these marginalized groups of society, pawnshops offer a better alternative to acquiring loans.

If we accept that rapid industrialization is synonymous with urbanization, which in turn causes a corresponding increase in urban poverty, then we have to accept the importance of pawnshops as a leader of the preferred last resort in financing. Perhaps this is one of the factors that led to a steady increase in the number of pawnshops as indicated in Table III, with Johore being the exception.

Capital for providing the operating expenses of microenterprise needs careful management. Thus short-term funds could be raised in a number of ways, such as retained profits, self-finance or borrowing. However, the limited amount of retained profits and self-finance forces the microenterprises, alternatively, to borrow from the pawnshops. Mechanization and new production methods have all been combined to increase production. These methods have brought about several significant changes in the management of microenterprises' funds.

## **V. Conclusion**

The present trends in the credit market show that the amount of loans is expected to increase over the 1990s. In addition, the number of small-scale enterprises is expected to increase into the foreseeable future as a result of industrialization. These developments are expected to increase the amount of credit in pawnshops to finance the microenterprises. Several factors have been identified to explain the ability of pawnshops to provide credit to the microenterprises. First are cheaper transportation and waiting costs. Second is interest rate regulations. Third is the accessibility to the formal financial market. Fourth are the effects of financial liberalization. Fifth and sixth are

duration and confidentiality of the loan, and seventh, the banking hours. Therefore, the pawnshop is expected to develop permanent financial linkages for the microenterprises while most formal financial markets are supposed to improve their services in order to compete between these two markets.

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