

# The Financing of Small and Medium Enterprise in China: A Case Study of China's Pawn-broking Industry

L.M. ZHOU

*Zhejiang University, Hangzhou, P.R. China*

**ABSTRACT:** This paper analyzes the four governmental regulations on pawn-broking industry in China, which includes the recessive regulation of market access, the strict regulation on financing of pawn enterprises, the regulation of the cap of lending rates and the unreasonable regulation to the dispose of overdue pawned objects. From the respect of law and economics, this paper analyzes the loss of producer surplus in pawn-broking caused by regulation. This paper finally puts forward some reasonable suggestions on development of China's pawn-broking industry.

**KEYWORD:** Pawn-broking; Pawn Financing; Financial Regulation

## 1 INTRODUCTION

The Pawn-broking industry is an industry providing capital to mortgagee who deposits property as a pledge. As we know, the pawn-broking industry has been gradually developing along with the development of commodity economy and the monetary lending activities. At the early stage of pawn-broking industry, it plays a formal financing role which belongs to one of the mainstream financing modes. Under the lacking of financial products and services, pawn as a financing mode meets the demands of financing of poor people and making a profit of the capital of bureaucrats and plutocrats.

China is one of the earliest countries engaged in the pawn-broking industry. The social basis of the early pawn-broking industry is the demand of the bottom of society, and the main customers of pawnbrokers are the people on the bottom of society. Most of the pawn-loans are used for the basic daily consumption. The modern pawn-broking industry originated in 1987, there have been great changes in the customers and trade characteristics. The average amount of each loan of modern pawn-broking industry in China, by contrast, is much higher than other places in the world, the main customers of pawnbrokers are SMEs and individual businesses, the population in poverty and the low income group aren't usually the customers of pawnbrokers. The purpose of loan is not to pay the living expenses but to meet the demand of investment.

In fact, the new pawn-broking industry, to a

certain extent, has alleviated the financing predicament of SMEs and individual businesses in China. A part of SMEs and individual businesses who can't get capital from the banks have obtained the capital from pawnbrokers by means of mortgage or pledge, and have relieved the demand of short-term emergency financing. However, the financial regulation of government is too severely. To some extent, the strict financial regulation seriously hindered the development of the pawn-broking industry in China.

## 2 GOVERNMENTAL REGULATION ON PAWN MARKET

From the aspect of supplying, we found that the amount of pawnbrokers and the capital were closely related with the governmental regulation in China's pawn-market. The reappearance of China's pawn-broking industry was promoted by the demand of market financing, however, the direction and the scale of the pawn-market was decided by government in the financial repression. Therefore, the regulation in pawn-broking industry adopted by the government is the source of the uniqueness of China's pawn-broking industry.

### 2.1 *The Recessive Regulation of Market Access*

In according to the article 7 of Pawn Management Act, the establishment of a pawnbroker should have seven conditions including legal constitution,

adequate registered capital and qualified shareholder, a business site as required accompanied with suitable safety and other related facilities. In the sight of the Act, although the requirements of establishment is more strict than that of ordinary company, it seems the bar to entry is not high..

However, the establishment of a pawn-company is difficult in fact. In China, a pawn-company is established by the examination system, and under this regime, not any pawn-originator possessed the requirements of establishment can be licensed by the examination and approval authority. Even have these conditions, it is still very difficult to establish a pawn company. In fact, there are many other factors should be considered for authorities besides above seven conditions. On one hand, the reasonable layout and design should be considered when establishing the pawn-company to avoid excessive pawnbrokers in one place. On the other hand, there has a prejudice against pawn for more than a thousand years. It's never nice to establish too many pawn enterprises. In fact, the examination and approval of the ministry of commerce and local trade departments are extremely cautious. As a result, establishing a pawn-company usually requires ample connections resources.

In the on-the-spot survey, the author found that more than a third of pawnbrokers claimed the examination and approval of their establishment of pawn company were not going very smoothly in spite of many pawnbrokers had communicated with the government department concerned.

## 2.2 *The Strict Regulation on Financing of Pawn Enterprises*

Since the reappearance of pawnbroker in 1987, the pawn-broking industry has serviced a large number of enterprises for financing. However, pawnbroker's own financing demand can't be satisfied because of the strict regulation. Under the existing management policy, it is hard for pawnbrokers to obtain funds in capital market. The greatest advantage of pawnbroker is providing a convenient and swift bridge loan to SMEs, but when pawnbrokers want to grow their funds to expand their own business, the method is undiversified in fact, the legal channel is only adding to investments by shareholder. At present, none of pawnbrokers can go public for raising capital. Though XiangYiRongTong Group is engaged in pawn business, it is also engaged in other business, such as Lease, loan guarantee, etc. According to the Pawn Management Act, the pawnbroker can get loan from banks up to the proportion of 1:1 (the proportion of the loan and the net assets). The regulation on the proportion of loan greatly limits the source of funds. To an industry whose business is borrowing money, the difficult financing greatly hinders their development. In fact,

even some pawnbrokers having large-scale, were unable to produce scaled effect because of inadequate capital.

A main reason for all above problems is that pawn enterprise isn't classed as a financial institution in spite of its business is more similar to financial institution. The ministry of commerce is responsible for the total management of Pawn enterprise as a special industry for the moment. To the foreign investment, there is no related rules can be followed so far. As a result, foreign investment can't enter China's pawn-broking through the proper channels under the current policy, which actually also limits the channel VC and PE entering China's pawn-broking industry.

A significant contrast is the pawn market abroad. Most of the pawn enterprises in Europe and America are listed companies. On account of the good financing channels, most pawn companies in Europe and America have large-scale[1]. A good case is Cash America Pawn (CSH). CSH was founded in 1984, and became the listed company in 1990. Now it is the biggest pawn company in America. The total amount of loans was \$ 440 million in 2000[2].

The strict financial regulation on pawn-broking industry by the government causes pawn enterprises unable to obtain fund supplement when encounter risks of the shortage of capital.

## 2.3 *The regulation of the cap of lending rates*

The population of China is larger than that of America, the history of China is also longer than that of America. However, the number of pawn shops in China is much less than that of America. Why? Besides the access control of pawn-broking, another possible explanation may be: China has more strict laws to ban usury. That is to say, there is more severe restrictions on interest rates in China.

As far as more free rates in America's pawn-broking is concerned, the usury (high rates) was regard as an *exploitation of the poor in China*. As a result, the Chinese government has always ruthlessly cracked down on usury. In fact, the only true method to reduce the dependence on usury is not to impose tougher punishment on lenders, but to guide more people joining the group of lenders so as to increase the supply of capital in the market. In this sense, deregulation of pawn-broking industry, lowering the access threshold, easing the restrictions of rates to pawn-broking, may be the best way for beneficial development of pawn-broking.

A good case is the pawn-broking in England. The number of pawnshops almost doubled when the restrictions of rates was removed by government in England. There are 115 pawnshops in 1980, after the limitation of interest rates of pawn was canceled in 1985, the number of pawnshops is mounting to 175 [3].

## 2.4 The unreasonable regulation to the dispose of overdue pawned objects

According to tradition of pawn-broking, if the pawn things are overdue, their ownership will be transferred to the pawnbrokers, and the pawnors (consumers) will lose them. Now the tradition has been revised. According to the article 43 of Pawn-broking Management Measures, the unredeemed items more than RMB 30,000 should be sold by public auction, and the pawnshop can't get it's ownership as tradition. The money of auction after deduction of auction fee and the pawn loan and its interest should be refunded to the customer, the shortfalls should be requested from customer.

The unreasonable regulation has two related effects on SMEs and pawnshops separately. To SMEs, they will prefer pawning large-value goods to raise average pawning levels. To pawnshops, the cost of withdraw loans was very high, a large portion of large loan can only be solved by litigation. Economic depression caused dispute and increasing litigation, inefficient implement and long term of Chinese civil action pushed up the disposal cost of pledge further. In turn, the increasing uncertainty of pawn brought by the regulation also further reduced pawning attraction to the firms as a financing method.

All these regulations of Chinese government have affected the numbers of pawnshops and the supply of capital in pawn-market. As a result, the China's pawn-broking driven by demand of financing has its unique features under financial repression.

## 3 THE LOSS OF PRODUCER SURPLUS IN PAWN-BROKING UNDER GOVERNMENTAL REGULATION

On one hand, the above regulation of Chinese government did comply with the demand of financing of SMEs. On the other hand, it also brought additional system cost of pawn-broking industry.

From the point of supplying, we found that the number of pawnbrokers and the capital were closely related with the governmental regulation in China's pawn-market.

Assume  $S_p$  is the supply of capital in pawn-market,  $D_p$  is the demand of capital in pawn-market,  $Q_p$  is the total amount of pawn financing, the pawnshop own capital is  $K_0$ , the confine interest rate (including comprehensive rates) is  $R$ , the cost of disposal of overdue pawned objects is  $C_d$ . And assume the demand of capital  $D_p$  and other conditions unchanged in a given period of time.

The recessive regulation of market access constrains the number of pawnshops in pawn-market, that means reduces  $S_p$ , and under the

premise of demand of capital  $D_p$  unchanged, the total amount of pawn  $Q_p$  in pawn-market will decline with the  $S_p$ . At this time, if there is no restriction of pawn rates, because  $D_p$  is fixed, the pawn rate will rise to  $r_{p1}$ , the corresponding total amount of pawn is  $Q_{p1}$ . Now, government has a restriction to pawn rate and restricted the cap of pawn rate is  $R$ , the demand of pawn in this rate is  $Q_{p2}$ , the supply of pawn reduced to  $Q_{p3}$ . the strict regulation on financing of pawn enterprises limits the source of capital of pawnshops, and cause directly the decrease of supply of capital in pawn-market, the curve of supply moves to  $S_{p2}$ , the supply decreased to  $Q_{p4}$ . At the same time, government practice rate control, in the control, the actual supply is  $Q_{p5}$ . Considering the falling of investment demand due to economic depression, the demand of financing  $D_p$  will move down to  $D_{p1}$ , the supply of pawn is obviously insufficient.(see figure 1).

Take account of each business transaction of pawn is based on the a mortgage or pledge of assets, apart from employee salary , rent, investment of equipment and daily operating costs , the highest cost in a pawnshop is the cost of disposing of the overdue pawned objects.

Base on the above assumptions, we assume employee salary, rent, investment of equipment and daily operating costs is a fixed number  $C_f$ , then we can simplify the profit of pawnshop is  $\pi_p$ .

$$\pi_p = K_0 R - C_f - C_d \quad (1)$$

The maximization of profit of pawnshop is

$$\max \pi_p = \max(K_0 R - C_f - C_d) \quad (2)$$

The only practical method to increase profit for pawn enterprise is cutting the cost when demand of financing is stable. In (1) (2), if pawn enterprise want to increase profit  $\pi_p$ , it must reduce  $C_f$  and  $C_d$ .

Regarding the capital of pawn loan as a product, the loss of profit of pawn-broking which resulted in governmental regulation can be expressed in a figure just like the expression of producer surplus. See figure 1:

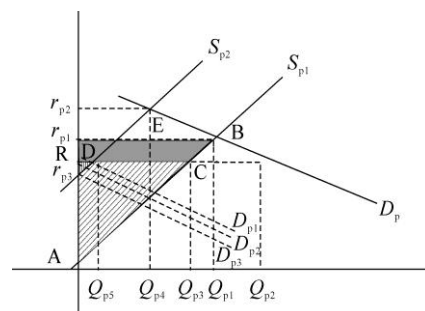


figure 1. The loss of producer surplus in pawn-broking under governmental regulation

In figure 1, assume the demand of pawn financing in a short term is  $D_p$ ,  $D_p$  is stable. When the supply of pawn capital is  $S_{p1}$ , the corresponding pawn rate is  $r_{p1}$  if government relaxes the pawn rate. The producer surplus of the pawnbroker is the triangular areas  $ABr_{p1}$ . Because of the restriction of the rate, the cap rate of pawn-broking is  $R$ , the producer surplus reduce to the triangular areas  $ACR$ , lost the areas  $RCBr_{p1}$ . The regulation of government is not confined to rate, the recessive regulation of market access, the strict regulation on financing of pawn enterprises and the unreasonable regulation to the dispose of overdue pawned objects, all the regulation are going to reduce the supply of pawn. In figure 1, the supply curve  $S_{p1}$  move to  $S_{p2}$ , the producer surplus of the pawn enterprise is only the triangular areas  $r_{p3}DR$ .

#### 4 THE SUGGESTION FOR IMPROVEMENT OF GOVERNMENTAL REGULATION

All the governmental regulation on pawn-broking will lead the development of pawn-broking industry. The economic policy of a country, especially the monetary policy, will exercise a great influence on pawn-broking industry. In order to play a better role in financial area, there are some measures should be done in pawn-broking industry in China.

Firstly, it is necessary for pawn-broking to perfect the mechanism of access and withdrawal.

In fact, there are some recessive regulations of market access in pawn-broking industry. Compares with the Western country's pawn-broking, China's pawn-broking have smaller scale. The main reason is the governmental regulation. Releasing the regulation of access and withdrawal is good for the

marketing of China's pawn-broking.

Secondly, governmental regulation should be coordinated with the free transaction. At present, the regulation of government is too strict. The restriction of scope of business, the strict regulation on financing of pawn enterprises, the regulation of the cap of lending rates and the unreasonable regulation to the dispose of overdue pawned objects, all of these regulations has restrain the development of China's pawn-broking industry. More freedom of transactions will benefit the pawn-broking. For an example, the capital resources of pawn enterprises should be enlarged. One possible suggestion is to expand the proportion of the loans from commercial banks, for example, the existing loan proportion which no more than the registered capital of the pawnshop can be enlarge to five times or more. The restrictions on lending in the same industry can also be relaxed appropriately. The financing of pawn enterprises can be led by pawn association in certain region, it can balance the fund surplus and deficiency between pawnshops. Further proposal is to learn from the experience of developed countries, arrange some pawn enterprises listing or issuing bonds to raise funds.

Finally, strengthen the legislation of pawn and improve the legal system.

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