Pawnshops: The Consumer's Lender of Last Resort

By John P. Caskey and Brian J. Zikmund

Legislators and financial regulators have long been concerned with consumers' access to credit markets. With the extensive deregulation of the financial system in recent years, this concern has focused on the access of the economically disadvantaged to credit markets. Most discussion of this issue has centered on financial institutions' fulfillment of the requirements of the Community Reinvestment Act and on the need for legislation guaranteeing basic banking services to all consumers. Surprisingly, however, little or no attention has been paid to credit alternatives for those excluded from mainstream financial institutions.

This article examines the role of the pawnbroking industry in providing credit to consumers excluded from mainstream credit markets. The study has two principal motivations. First, while pawnshops are an important source of credit for many low-income consumers, no serious study of pawnbroking in the United States has been made since the 1930s. Second, and more important, the study of pawnbroking may give policymakers a better idea of the cost of being excluded from mainstream credit markets and so may assist in judging the potential effectiveness of consumer financial legislation.

The first section of this article discusses the role of pawnbroking in consumer credit markets. The second section describes the business of pawnbroking, including the regulation of the industry and the characteristics of pawnshop loans. The third section examines the geographic distribution of pawnshops and the growth of the industry. The fourth section discusses some policy issues related to pawnbroking and consumer credit.

I. An Overview of Pawnbroking

Pawnshops are one of many financial institutions supplying consumer credit, yet they do not

John Caskey is an assistant professor of economics at Swarthmore College and a visiting scholar at the Federal Reserve Bank of Kansas City. Brian Zikmund is a student at Swarthmore College. The authors would like to acknowledge the support of the Swarthmore College Research Fund and the Joel Dean Foundation. The views expressed in this article are those of the authors and do not necessarily reflect the views of the Federal Reserve Bank of Kansas City.

compete directly with other financial institutions for customers. Rather, they lend to those excluded from mainstream financial markets. This section discusses consumer lending of mainstream financial institutions, the role played by pawnshops in consumer finance, the magnitude of credit extended by pawnbrokers, and growth trends in the industry.

Mainstream consumer credit institutions

The major suppliers of consumer credit are mainstream financial institutions—commercial banks, finance companies, credit unions, and savings and loan associations. These institutions provide credit on either a secured or an unsecured basis. Secured credit is common for large-value loans, such as home mortgages and automobile loans. Unsecured lending is more common for small-value loans, such as those for items purchased with credit cards.

In providing consumer loans, whether secured or unsecured, mainstream financial institutions screen customers for credit risk. In the case of an unsecured loan, the rationale for this procedure is obvious since the financial institution has no collateral if the borrower defaults. In the case of a secured loan, the screening is important because the collateral may be worth less than the loan and because significant costs often arise when transferring collateral in case of default.

To determine credit risk, mainstream financial institutions generally employ a fairly standardized screening method, called "scoring." Among the variables commonly used in determining a credit score are the applicant's years on job, education, occupation, checking and savings account status, credit card ownership, total outstanding debt excluding mortgage debt, and credit repayment history. Applicants likely to be denied access to credit are those with poor credit records, excessive debt burdens relative to their incomes, low and unstable incomes, or an inability to maintain positive bank account balances.

Pawnshops and their customers

Pawnshops play a specialized role in consumer finance. They cater to those consumers whose credit needs are not accommodated by mainstream financial institutions. Broadly speaking, pawnshop customers have two characteristics. First, these customers have high credit risk and so cannot borrow on an unsecured basis. Indeed, pawnshop lending rules require the borrower to leave personal property with the pawnbroker as collateral. Second, pawnshop customers typically require very small-denomination loans that traditional lenders are unable or unwilling to provide on a secured basis.

While there are no estimates of the percentage of the population whose risk characteristics exclude them from mainstream consumer credit sources, available evidence suggests the number is large. Moreover, the poor and poorly educated are disproportionately represented. Not only are many low-income consumers excluded because of their income, but they are also much more likely than the middle class to have unstable incomes and employment patterns (Andreason 1975). In addition, many consumers, especially those with low incomes and little education, do not maintain bank accounts, almost ensuring they would not pass the typical screening requirements of a bank or finance company. For example, the Federal Reserve Board's 1983 Survey of Consumer Finances found that 12 percent of all families did not have a checking or savings account (Canner and Maland 1987).[1] Of these families, 57 percent fell into the lowest quintile for family income, and 59 percent were headed by individuals without a high school education.

Interviews with pawnshop owners support this picture of pawnshops and their customers.[2] While pawnbrokers report customers from all segments of society, the overwhelming majority are low-income individuals who operate independently of mainstream financial institutions. Brokers believe most of their customers would not pass bank or finance company credit-risk screening procedures. Brokers also suspect some of their customers would feel ill-at-ease in a bank because they rarely or never interact with banks.

Cash America Investments, a publicly traded company operating about 100 pawnshops in Texas, Oklahoma, and Louisiana, is typical of pawnbrokers in its description of its customers. For example, in its 1988 Annual Report, Cash America states,

> It has been estimated that 20 to 30 percent of America's adult population chooses to deal with cash-only transactions which require neither bank accounts nor credit cards . . . *These* are Cash America's customers. (p.5)

While pawnbrokers believe most of their customers turn to pawnshops for credit because other financial institutions are closed to them, they also point out that some of their customers, with access to bank or finance company credit, use pawnshops for their discretion and convenience. This is especially true at the small minority of pawnshops that target their business to middle-income and high-income customers by setting comparatively high minimum loans, accepting only jewelry as collateral, and offering the discretion of private booths for taking out a loan.

The significance of pawnbroking in consumer credit markets

Measured by the percentage of total consumer credit supplied, pawnshops may appear to play only a minor role in consumer credit markets. However, measured by the number of pawnshops or the percentage of the population served, pawnshops appear to play a much more important role in consumer finance.

Unfortunately, there are no official estimates of the amount of credit supplied by pawnshops. Thus, for example, national statistics on total domestic credit collected by the Federal Reserve System do not include an estimate of outstanding pawnshop loans. The only data available on pawnshop lending come from state regulatory agencies. While some states collect very detailed information on pawnbroking, other states collect little or no information.

According to estimates made by the authors, pawnshops are probably the source for about one-tenth of 1 percent of consumer credit in the United States. Extrapolating from the data provided by a few state regulatory agencies, total pawnshop credit outstanding at the end of 1988 would appear to be about $689 million, with pawnshops making about $1,723 million of loans over the year.[3] For comparison, outstanding consumer credit at the end of 1988 totaled $744 billion, of which $371 billion was accounted for by commercial bank loans, $174 billion by finance companies, and $87 billion by credit unions.

By other measures, however, pawnshops are important in consumer credit markets. For example, in 1988 approximately 6,900 pawnshops operated in the United States—about one pawnshop for every two commercial banks.[4] In addition, pawnbroking is very significant when measured by the percentage of the population using this credit market. In 1988, the data suggest pawnshops made about 35 million loans. Because the average pawnshop loan is only around $50, even allowing for multiple loans to a core group of customers, pawnshops probably serve several million Americans each year, and perhaps as much as 10 percent of the adult population.

Trends in pawnbroking

In examining the pawnbroking industry over time, three observations stand out. First, the number of pawnshops and pawnshops per capita is now larger than it was at the beginning of the century. Second, over time the industry has shifted from a concentration in older major urban areas, primarily in the Northeast, to Southern and Central Mountain states. Third, in the 1980s, the pawnbroking industry grew in almost all states for which there are data; and in some states the growth was extremely strong.

Perhaps one of the reasons pawnbroking has been overlooked in credit market studies is because there is a popular perception these credit institutions have largely died out since the 1930s. In fact, this appears to be the case in many other advanced industrialized societies. In Great Britain, for example, approximately 3,000 pawnshops operated in 1900. In 1987, only about 175 remained (Lohr 1987).

In the United States, in contrast, pawnbroking has not died out. On the contrary, it has grown. Samuel Levine reported there were 1,976 licensed pawnbrokers in the country in 1911—about one for every 47,500 citizens (Levine 1913). Now, there are nearly 6,900 pawnshops in the United States—about one for every 35,700 inhabitants.

The industry has not only grown since the turn of the century, but it has also shifted from older major urban areas to urban and rural areas in the Southern and Central Mountain states. Levine noted that in 1911 pawnshops were heavily concentrated in the major urban areas: citing 201 pawnshops in greater New York City, 102 in Philadelphia, 77 in Chicago, 72 in Boston, and 47 in San Francisco. A contemporary count for Levine's cities yields 15 pawnshops in New York City, 23 in Philadelphia, 13 in Boston, and 20 in San Francisco. At the same time, 893 pawnshops operated in Florida in 1988, 515 operated in Georgia, 285 in North Carolina, 369 in Oklahoma, and 1,270 in Texas. Today's per capita distribution of pawnshops is highly uneven across the United States (Figure 1). Sunbelt and Central Mountain states tend to have the most pawnshops per capita, while the New England and Great Lake states have the least.

Recent data suggest the pawnbroking industry grew in the 1980s—in some states very rapidly. Time series data on state pawnshop licenses are available for only a few states, but the available data show the number of outstanding pawnshop licenses grew in six out of seven states (Table 1). In Oklahoma and Texas, part of the rapid growth in pawnbroking may be explained by the economic disruptions caused by the fall in oil prices. However, the data show strong growth in Texas pawnshops from 1980 to 1982, which predates the downturn in the state's economy. Of the seven states reporting data, only New Jersey shows a contraction in the industry.

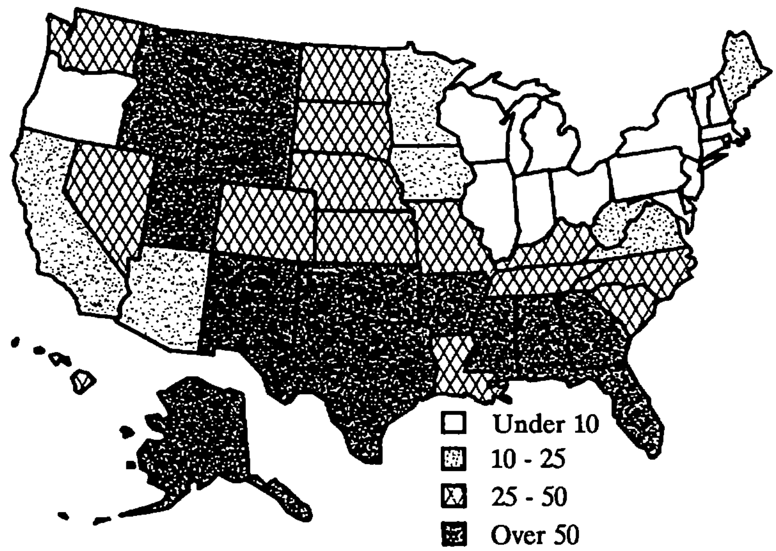
II. The Business of Pawnbroking

Financial historians trace the birth of institutionalized pawnbroking in the western world to the later Middle Ages. Starting in fifteenth-century Italy, charitable groups or governments in Continental Europe and Latin America opened nonprofit pawnshops as a public service for the poor, a tradition persisting to this day. In England and the United States, on the other hand, pawnshops were almost exclusively privately owned and operated for profit.[5]

The regulatory environment

Beginning in England in 1745 and later spreading to the United States, governments generally saw a need to license and regulate private pawnshops. Without regulation, governments worried pawnshops might aid in the transfer of stolen goods. Governments also wanted to prevent unscrupulous brokers from taking advantage of unsophisticated or desperate customers in need of credit. In England, the national government established the regulations;

Figure 1
Pawnshops per Million Inhabitants



in the United States, state and local governments oversaw pawnbroking.

In the United States, pawnshop regulations currently vary from state to state, but generally follow a similar pattern. When a customer pawns an item, terms of the loan contract must be specified on a pawn ticket. The customer retains a copy of the ticket which states the customer's name and address, type of identification provided by the borrower, a description of the pledged item with applicable serial numbers, amount lent, maturity date, interest rate, and amount that must be paid to redeem the good. This last requirement ensures the customer understands the consequences of the interest charge. Pawnshops must also file daily or weekly police reports listing all items pawned and identifying the individuals pawning the goods.[6] In addition, some states regulate the type of items that can be pawned.[7]

Most states regulate pawnshop interest rates and other charges, such as storage or insurance fees. Including these charges, effective interest rate ceilings vary across states from 1.5 percent a month to 25 percent a month.[8] Compounding is not allowed. A few states impose no limits, and the legal limits are widely ignored in some other states. In most states, the broker has the right to charge one month's interest if a pledge is redeemed in less than one month.

If a customer defaults, the collateral becomes the property of the pawnshop after the loan is overdue by a specific amount of time, commonly one to three months. Most states require the broker to notify the owner of the

Table 1
Pawnshop Licenses per Million Inhabitants

	1980	1982	1984	1986	1987	1988
Indiana						
Number of shops	26	25	25	28	28	32
Shops per million capita	4.7	4.6	4.6	5.1	5.1	5.7
Maine						
Number of shops	8	10	8	9	12	13
Shops per million capita	7.1	8.8	6.9	7.7	10.1	10.8
New Jersey						
Number of shops	27	22	16	15	15	16
Shops per million capita	3.7	3.0	2.1	2.0	2.0	2.1
Oklahoma						
Number of shops	n.a.	279	312	340	351	369
Shops per million capita	n.a.	86.6	93.9	102.8	107.3	113.1
Oregon						
Number of shops	11	13	14	13	13	13
Shops per million capita	4.2	4.9	5.2	4.8	4.8	4.7
Pennsylvania						
Number of shops	27	28	29	30	32	37
Shops per million capita	2.3	2.4	2.4	2.5	2.7	3.1
Texas						
Number of shops	787	953	980	1,103	1,195	1,270
Shops per million capita	55.3	62.0	60.9	66.1	71.2	75.7

Source: State regulatory agencies.

pledge by mail that he will lose the right to his property unless he redeems it within the stipulated grace period. In case of default, some states require the collateral be sold at public auction. Thirteen states and the District of Columbia require any surplus from the sale of the collateral over the amount owed the pawnbroker, including accumulated interest and any costs related to the sale, revert to the customer.

Regulatory barriers to entry into pawnbroking are minimal. States or local governments require a license, and some require the broker to be bonded and insured. Even with these requirements, however, a pawnshop can be opened with a modest amount of capital. While a publicly traded company owns a chain of pawnshops in the South Central United States, the vast majority of pawnshops are small shops that are independently owned and operated. The typical pawnshop owner finances his loans with his own capital and with bank credit.

Characteristics of pawnshop lending

As noted earlier, pawnshops occupy a special niche in consumer finance by providing a type of lending not performed by mainstream financial institutions. Broadly speaking, pawnshop loans have three features: the loans are for very small amounts and short maturities, they are fully collateralized by personal property, and interest and other charges are extremely high relative to other types of lending.

Most pawnshop loans are for relatively small amounts. For example, in Indiana, Oklahoma, and Oregon, average loan sizes range from $40 to $60 (Table 2). In most states, pawnbrokers make loans with one-month or two-month maturities. However, it is not uncommon for customers to renew these loans by paying the interest on the loan at the end of the month. Brokers report many pledges are redeemed within a week or two. The typical pledge, however, is redeemed in two to three months.

Because pawnbrokers lend only on the basis of collateral, brokers do not gather information to determine credit risk. If any screening occurs, it is to ensure the customer owns the item being pledged. Otherwise, the broker's efforts are directed toward properly evaluating the collateral. Once this is determined, a cash loan is advanced immediately upon the completion of the pawn ticket. A typical pawnshop loan requires less than ten minutes.

Default rates on pawnshop loans are quite high. Default rates as a percentage of the number of loans range from 14 to 22 percent (Table 2). Default rates as a percentage of the value of loans are somewhat less, however, suggesting that default rates are higher on smaller loans.[9]

To prevent a loss in case of default, a broker lends a customer a percentage of the value the broker believes the collateral would bring in a sale. The loan-to-collateral ratio varies over time and across pawnshops, but typically the amount loaned is 50 to 60 percent of the resale value of the collateral. Though brokers almost always make a one-time profit from a default, almost all say they prefer customers repay the loan. Such customers are likely to return to the same pawnshop for future credit needs. Indeed, brokers report about 70 to 80 percent of their customers are repeat customers. Moreover, credit customers often purchase goods the shop sells and, if they blame the broker for the loss of their collateral, they are less likely to patronize the shop.

Commonly pawned items include jewelry, electronic and photographic equipment, musical instruments, and firearms. These items maintain their value over a reasonable period of time and are easy to store, especially jewelry. In some states, loans are made on automobiles, with the customer leaving the title for security. The mix of collateral varies across regions. For example, in regions of the country where firearms are more common, they more often collateralize pawnshop loans.

Examination of police records in one northeastern city showed that, over an eight-day period, one pawnshop made 221 loans for $10,790. The average loan was $46, and the size of loans ranged from $5 to $500. Of the items pledged, 68 percent were watches and jewelry; 21 percent television, stereo, or video equipment; 4 percent musical instruments; 2.7 percent camera equipment; and 2.7 percent firearms. This pattern of activity is probably fairly typical.

Another feature of pawnshop credit is its high cost (Table 2). Each of the states listed in this table imposes a ceiling on pawnshop interest rates.[10] The ceiling interest rates in these states for an average size loan range from 0.5 percent per month in Pennsylvania to 20 percent per month in Oklahoma.[11] In addition, several of the states allow storage and insurance fees, which

Table 2
Characteristics of Pawnshop Loans

	Ind.	N.J.	Okla.	Ore.	Pa.
Average loan size	$43.11	n.a.	$41.00	$61.31	n.a.
Default rate, number of loans	20.6%	n.a.	22.2%	13.9%	n.a.
Default rate, value of loans	13.8%	n.a.	19.6%	9.3%	n.a.
Legal interest rate ceiling (monthly)	3.0%	3.0%	20%	3.9%	.5%
Interest charge on two-month $51 loan	$3.06	$3.06	$20.40	$3.06	$ .51
Permissible storage & insurance fees (for item left on pledge two months)	$3.00	none	none	$5.00	$2.55
Implicit APR interest rate on two-month $51 loan (includes storage & other fees)	71.3%	36.0%	240.0%	94.8%	36.0%

Source: State regulatory agencies, 1987 and 1988.

raise the effective price of the loan. For each state, the dollar outlay for a two-month, $51 loan plus applicable fees is shown in Table 2.[12] For comparison with other types of consumer credit, annual percentage interest rates (APR) inclusive of fees are also illustrated. Thus, for borrowers from pawnshops in these states, effective interest rates range from 36 percent APR in New Jersey and Pennsylvania to 240 percent APR in Oklahoma. Such high rates are not uncommon. In more than half of the states, pawnshops levy effective interest rates of 120 percent APR or more on average-size loans.

III. Explaining Trends in the Pawnbroking Industry

This section offers explanations for the three notable developments in the U.S. pawnbroking industry discussed in the first section: (1) the number of pawnshops per capita is currently larger than it was at the beginning of the century; (2) the industry is now heavily concentrated in the Southern and Central Mountain states; and (3) the industry appeared to grow throughout the United States in the 1980s. In addressing these observations, this section begins with the current regional concentration of pawnshops and then turns to examine long-run and recent growth trends in the industry.

Explaining the geographic distribution of U.S. pawnshops

Over the last century the pawnbroking industry in the United States has shifted from the Northeast to the Southern and Central Mountain states. The current concentration of the industry in these states is most likely related to structural features of the industry, state regulations, and consumer demand for pawnshop credit.

The pawnbroking industry has two important features: significant customer transportation costs and relatively low barriers to new firms entering the industry. To obtain a pawnshop loan or redeem collateral, a customer must physically transport the collateral to or from the pawnshop. With an average loan of only $50, the transportation costs per dollar of credit are significant, and customers tend to use the closest shop. Because regulatory barriers to entry are low, new pawnshops enter areas that promise high profits. As they enter, lending per shop falls, because many customers will switch to patronize the most convenient shop. As lending falls, pawnshop profits fall because each pawnshop must cover its fixed costs from a smaller cash flow.

This industrial structure suggests that states with more generous usury laws should have higher numbers of pawnshops per capita. With high ceiling rates, a pawnshop with a large customer base could make extraordinary profits. These profit opportunities would encourage new pawnshops to open, until each pawnshop has a sufficiently small customer base that it no longer makes unusually high rates of return. Similarly, states that do not require the return to customers of any surplus from a default should have more pawnshops per capita because such a law should favorably affect pawnshop profits.

In addition to industrial structure and regulation, customer demand for pawnshop credit should also affect the number of pawnshops per capita. In states where a large percentage of the population is excluded from mainstream credit markets, demand for pawnshop services should be strong. Given customers' transportation costs, one would expect this demand to be met by numerous pawnshops located strategically throughout the state.

To examine the links between pawnshops per capita, pawnshop regulations, and state demographic characteristics, this article employs cross-sectional regression analysis for 28 states using 1987-88 data. The number of pawnshops per million capita (PPC) in each of the states is the dependent variable. Two explanatory variables represent the effect of state regulations on pawnshops per capita: the state pawnshop interest rate ceiling (INT) and a dummy variable (SUR) for states with rules requiring any surplus from the sale of the collateral be returned to the pledger.[13]

There are no data directly measuring the percentage of a state's population whose risk characteristics exclude them from bank or finance company credit. However, based on the earlier discussion of pawnshop customers, measures of state poverty and education levels should serve as crude proxies. Accordingly, the explanatory variables include the percentage of persons in the state below the national poverty standard (POV) and the percentage of people 25 years old and over in the state attaining at least four years of high school education (ED).[14]

The results from the regression are:

$$\underset{}{PPC}=11.5+\underset{(62.7)}{429.8}\,INT+\underset{(115.8)}{203.7}\,POV-\underset{(56.6)}{166.6}\,ED+\underset{(7.8)}{7.9}\,SUR$$

(Standard errors in parentheses - $R^2=0.78$)

The signs on the interest rate, poverty, and education variables are as expected and are statistically significant at reasonably high levels of confidence.[15] The sign on the surplus rule is not consistent with expectations, but the standard error indicates little confidence can be attached to the estimate. The independent variables explain about 78 percent of the variation in pawnshops per capita observed among the 28 states in the sample.

According to these results, three factors explain the disproportionate concentration of pawnshops in the Southern and Central Mountain states: more generous usury ceilings, higher poverty rates, and lower education levels. Presumably, in states with higher poverty rates and lower education levels, a larger percentage of people must pay the higher cost of borrowing from pawnshops because their risk characteristics exclude them from bank or finance company credit.

Explaining the long-run growth in U.S. pawnbroking

The contrast between the almost total decline of the British pawnbroking industry over this century and the expansion of the American industry is striking. While part of this contrast may be attributable to differences in general social conditions or banking systems, the main explanation is undoubtedly the combined effect of differences in usury laws and falling personal transportation costs.

In England before the mid-1980s, the pawnshop interest rate ceiling was set nationally and remained under 35 percent APR for over a century.[16] In the United States, where pawnshop usury laws are established at the state level, numerous states in recent decades have maintained usury ceilings of well over 120 percent APR, some have had no ceiling rate, and others have not enforced their pawnshop usury laws. In states with enforced usury ceilings consistently below 50 percent APR, pawnbroking has declined over this century, as illustrated by the sharp drop in the number of shops in the older major urban areas. In states with more generous usury laws, pawnbroking has flourished.

Adding to the effect of less binding usury laws has been a significant decline in personal transportation costs. Even with very high interest rates, a pawnshop needs a substantial number of customers to operate profitably. In the early part of this century, pawnbroking was probably not viable outside the major urban areas because high transportation costs prevented a pawnshop from drawing customers from more than a few miles away. It was for this reason that William Patterson wrote in his 1899 study of the pawnbroking industry, "The business of the pawnbroker requires not only an urban population, but a dense urban population, such as is found in the greater centers of industry. . . . Outside of the North Atlantic Section there are but few states with even two cities of sufficient size to support the business (Patterson 1899a, p. 256)." With the advent of the automobile and a well-developed highway system this is no longer true. Pawnshops are well represented in the rural areas of many of the southern and western states, and these shops commonly draw customers from a 50-mile radius, something unthinkable 70 years ago.

The growth of U.S. pawnbroking over the century is therefore a result of two interrelated factors, falling transportation costs and generous usury laws. One is not sufficient without the other. States in the Northeast and Great Lakes region of the United States also experienced falling transportation costs, but because of more restrictive usury laws, pawnshops are rarely found in the small cities and rural areas of these states. Similarly, without the low-cost personal transportation brought by the automobile, pawnshops would probably not exist outside of urban areas in any region of the country regardless of usury laws.

Growth in pawnbroking in the 1980s

Explaining the growth of U.S. pawnbroking in the 1980s requires an appeal to different factors, for state usury laws and transportation costs did not change appreciably over the decade. Rather, explanations of the growth of pawnbroking in the 1980s focus on the effects of bank deregulation, falling average real wages of production workers, and increases in the poverty rate.

Prior to 1980, service fees and minimum-balance requirements on checking and savings accounts either did not exist or were much lower than today. Following the enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980, banks moved toward pricing services to cover costs, making it more expensive for depositors to maintain small-balance accounts. In addition, in response to a more competitive banking environment, banks closed unprofitable branches, many of which were located in low-income neighborhoods.

Perhaps as a result of these changes, from 1977 to 1983 the percentage of low-income families who did not maintain bank accounts increased. A recent Federal Reserve study showed that 28 percent of the families in the lowest quintile for family income did not maintain any depository accounts in 1977. By 1983, 36 percent of families in this group did not maintain either checking or savings accounts (Canner and Maland 1987).

Such developments may have contributed to the growth of pawnbroking because individuals without bank accounts would be unlikely to pass bank or finance company credit checks and could be forced to turn to pawnshops for loans. Policymakers have also expressed concern that changes in the banking system in the 1980s may have excluded many low-income consumers from mainstream credit. For example, on October 2, 1986, the Federal Financial Institutions Examination Council, consisting of representatives of the Federal Reserve Board of Governors and other federal agencies that regulate financial institutions, stated

> Some institutions have begun to explicitly price their products, consolidate or eliminate services they believe to be unprofitable, and close branch offices. . . . Considerable concern has developed about the potential impact of these changes in effectively denying or reducing convenient access of many individuals to the payments system and to safe depositories for small savings. Because credit availability is often dependent on an account relationship with a financial institution, access to credit for low-income or young consumers may also be adversely affected. *(Federal Reserve Bulletin* April 1987, p. 268)

Other factors contributing to the growth in pawnbroking in the 1980s could be the decline in average real wages for production workers and increases in the national poverty rate. In 1978, the average weekly earnings for a production worker in nonagricultural private sector employment was $204. By 1988, this average had dropped to $181 (in constant 1978 prices). Over this same period, the national poverty rate rose from 11.4 percent to 13.1 percent, an increase of 7.5 million people below the poverty line.

Regardless of whether these trends reflected changes in demographics or a fundamental transformation of labor markets, they may signal an increase in the percentage of Americans excluded from mainstream credit markets. If so, the growth in pawnbroking in the 1980s could reflect increased demand for credit alternatives to banks and finance companies.

IV. Policy Implications

This study of pawnbroking raises policy issues for regulators of financial institutions and policymakers at all levels of government. At the national level, the issue is whether changes in bank regulations and labor markets have forced many low-income consumers to pay much higher prices to meet their credit needs. At the state and local levels, the issue is whether pawnshop customers are better served by a low usury ceiling or a relatively high one.

Some might interpret this study as supporting the need for policy measures to encourage the provision of bank services in low-income neighborhoods and to guarantee that all consumers can afford to maintain a basic transaction account. If an increasing percentage of society is unable to afford bank accounts and, consequently, is losing access to mainstream credit markets, there is a cause for concern. In states where pawnshops are rare, most people will not have an institutional alternative if excluded from bank and finance company credit. Thus, losing access to those mainstream credit institutions could be disruptive and costly. In states where pawnshops are a ready alternative, pawnshop credit tends to be far more expensive than credit from mainstream institutions. Thus again, losing access to mainstream credit markets is costly for consumers.

Given the limited data, however, the link between the recent growth in pawnshops and changes in access to bank accounts is open to question. Statements about trends in the ownership of bank accounts and the growth of pawnshops are, at this point, based on only a few observations. Even accepting the trends, it need not apply that one is causing the other. In particular, given that pawnshops mainly provide very small collateralized loans and mainstream financial institutions provide comparatively large consumer loans or open-ended lines of credit, such as credit cards, the growth of pawnbroking could be unrelated to changes in the banking industry.

In any case, the large number of pawnshops in states with generous usury laws reveals a strong demand for small consumer loans not met by other credit institutions. It also emphasizes the critical importance of pawnshop usury laws, which were drafted to protect unsophisticated consumers and to ensure access to moderately priced small loans.[17] Economists have generally criticized state usury laws as detrimental to low-income consumers. Financial institutions under binding interest rate ceilings tend to allocate credit to only the most credit-worthy borrowers, who generally belong to middle-income or high-income groups.[18] This is not the case with pawnshops, however, because all customers provide collateral, eliminating the need to distinguish high-risk from low-risk borrowers. Rather, the major effect of a low pawnshop usury ceiling is to reduce the number of shops in the state.

In the case of pawnbroking, therefore, state regulators face a somewhat different trade-off than that faced in regulating mainstream credit institutions. A high interest rate ceiling provides individuals excluded from mainstream credit institutions access to a convenient, but expensive, alternative. A low ceiling rate reduces the cost of this alternative, but also makes access to pawnshops prohibitively inconvenient for many.

V. Summary

Measured by the percentage of population served, pawnshops are an important and growing source of consumer credit. Pawnshop loans are differentiated in key ways from those of other credit institutions. The average loan is very small, around $50. The interest rate is comparatively high, often as much as 240 percent APR. Collateral in the possession of the pawnshop fully insulates it from credit risk. And, the default rate on pawnshop loans is relatively high, around 10 to 20 percent.

Most pawnshop customers come from low-income economic groups and are probably ineligible for bank or finance company credit. Pawnshops are heavily concentrated in the Sunbelt and Central Mountain states, which tend to have the most generous pawnshop usury ceilings. Factors such as financial deregulation and an increase in the national poverty rate both may explain some of the growth of pawnshop activities in the 1980s. Further study of the role that pawnbroking plays in credit markets may assist policymakers in understanding the effects of financial deregulation and the costs to consumers who are excluded from mainstream credit markets.

Endnotes

[1] Unfortunately, the Federal Reserve's Survey of Consumer Finance does not classify participants obtaining credit from pawnshops. They are simply identified as obtaining credit from a nontraditional source, including individual-to-individual loans as well as pawnshops.

[2] From May 1989 to February 1990, the authors interviewed pawnbrokers in Missouri, New York, Oklahoma, Oregon, and Pennsylvania.

[3] An appendix, available from the authors, presents the methodology behind these estimates.

[4] This estimate was constructed by contacting state regulatory agencies and counting yellow page listings for states without pawnshop oversight agencies. The actual count was 6,853. For the states for which both official and yellow page counts exist, the two numbers are very close.

[5] In the late nineteenth century, charitable organizations in the United States formed nonprofit pawnshops in several major cities to serve the credit needs of the working class. All of these have now closed except the Provident Loan Society in New York City, which makes loans from a number of branches at an interest rate of 23 percent a year. Its 1894 founders included such financial luminaries as Solomon Loeb, J.P. Morgan, and Cornelius Vanderbilt.

[6] In response to the popular belief that pawnshops act as fronts for burglars, all brokers adamantly insist that they do not knowingly accept stolen goods as collateral. They point out it is not in their interest because the police can seize the goods and the pawnshop owner loses the collateral and the loaned money. In addition, given the police report requirement, it would not be in the interest of a thief to pawn a stolen good.

Although many items, especially jewelry, do not have serial numbers and would be difficult to identify from police reports, the data appear to support the brokers' claims. For example, Oklahoma reports that in 1987 the police seized only 0.15 percent of pawned goods for being stolen property.

[7] An interesting example is Delaware, where it is illegal for a pawnbroker to accept a customer's false teeth or artificial limb as collateral.

[8] In states such as Alabama, Florida, Iowa, and South Dakota, which set no pawnshop interest rate ceilings, interest rates on a $51 loan commonly range from 18 to 28 percent a month.

[9] Because pawn tickets are legally transferable in almost all states, the reported default rate need not represent the default rate of the original borrowers. If a debtor is unable to redeem his collateral, for example, he may be able to sell the ticket if the pledged item is worth more than the principal and interest needed to redeem it. Outside of New York City, however, where businesses advertise offering to purchase pawn tickets, reported default rates probably only slightly under-represent actual default rates.

[10] A survey by the authors determined that pawnshops in these states generally charge the ceiling rate.

[11] In Oklahoma, as in several other states, the pawnshop usury ceiling depends on the size of the loan, with lower rates for larger loans. For example, in Oklahoma a pawnshop can levy a 20 percent monthly interest rate on a loan up to $150, a 15 percent monthly interest rate on that amount over $150 but less than $250, and so on.

[12] The table uses $51 rather than $50 because in some states the regulated storage or interest fees may vary at exactly $50.

[13] In states without usury limits, the number of pawnshops per capita could affect the interest rate as well as vice versa, so to prevent any simultaneity bias the regression employed only data from the 28 states with clear binding usury laws.

[14] The *1988 Statistical Abstract of the United States* is the source for the state education and population data. Plotnick 1988 is the source for the poverty data.

[15] In the 28 states, the average number of pawnshops per million inhabitants was 29.2. The mean of the independent variables was 9.0 percent for the monthly interest rate, 13.4 percent for the poverty rate, and 31.0 for the percentage of citizens completing their high school education.

[16] England abolished its pawnbroking usury ceiling in the mid-1980s, and the industry has grown in recent years. In 1980, for example, there were 115 pawnshops in England. By 1987, the number had risen to 175 (Lohr 1987).

[17] It does not appear usury laws were intended to limit pawnshop profits, and because there is free entry into pawnbroking one would not expect to find higher pawnshop profits in states with generous usury laws. In a high-ceiling state, more pawnshops enter the market, leaving fewer customers per shop and raising the fixed costs per customer.

[18] Nathan 1980 surveys this literature.

References

Andreason, Alan R. 1975. *The Disadvantaged Consumer.* New York: Free Press.

Canner, Glenn, and Ellen Maland. 1987. "Basic Banking," *Federal Reserve Bulletin,* April, pp. 255-69.

Levine, Samuel. 1911. *A Treatise on the Law of Pawnbroking as Governed by the Principles of Common Law, and as Modified by the Statutes of the Different States of the United States, and the Ordinances of the Municipalities Regulating Pawnbroking.* New York.

____________. 1913. *The Business of Pawnbroking: A Guide and a Defense.* New York: D. Halpern Company.

Lohr, Steve. 1987. "Pawnbrokers in Britain Draw Affluent Clientele," *New York Times,* September 7, pp. 25-26.

Nathan, Harold C. 1980. "Economic Analysis of Usury Laws," *Journal of Bank Research,* Winter, pp. 200-11.

Patterson, William R. 1899a. *The Relationship of State and Municipality to Pawnbroking in Europe and the United States.* Unpublished Ph.D. dissertation, University of Pennsylvania.

____________. 1899b. "Pawnbroking in Europe and the United States," U.S. Department of Labor *Bulletin* 21.

Plotnick, Robert D. 1988. "Poverty and Income Transfer Policy at the State Level," University of Wisconsin-Madison Institute for Research on Poverty, Discussion Paper no. 869-88, November.