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Press Release

On Microlending Web Sites Such as Prosper.Com, Borrowers and Lenders Watch and Learn from Each Other

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BusinessWire - If you want to borrow money on Prosper.com or one of the other increasingly popular micro-lending Web sites, do what you can to have a good first day after listing, MIT Sloan School Assistant Professor Juanjuan Zhang advises.

That's because lenders look to see what others before them did and often base their actions on that information--a phenomenon known as observational learning, Zhang and researcher Peng Liu of Cornell University found in an extensive study of Prosper, the most widely used Internet microloan site.

"Lenders are more inclined to contribute funds to a borrower if other lenders have already lent money to that borrower," says Zhang, an expert in marketing and consumer behavior. "For the borrowers there is room for strategic action."

Zhang is a leading researcher in the study of observational learning--the tendency of individuals to watch the behavior of others, learn from it, and act accordingly. The phenomenon has important implications for marketers, consumers, and anyone involved in the exchange of goods and services.

Observational learning explains why in real estate, homes that languish on the market after their initial listing become increasingly difficult to sell. Potential buyers assume that earlier home buyers passed over the property for good reason.

Microlending Web sites, which have emerged in recent years as alternatives to conventional lenders, match lenders and borrowers in a process that is remarkably transparent. The openness of the sites can create unusual dynamics among parties to a loan.

Individuals who want to borrow money state their case in a public posting. Potential lenders can see what other lenders are offering.

"Lenders are automatically exposed to their peers' lending behaviors, so observational learning is enabled by the design of the site," Zhang says.

Zhang and Liu reached their conclusions after sifting through nearly three years of Prosper.com data and applying mathematical formulas that control for other possible explanations of lender behavior.

In an earlier study of the market for kidney transplants, Zhang found that observational learning explains why potential transplant recipients sometimes reject offers of healthy kidneys, which leads to the discarding of rare and valuable organs. Potential recipients believe there must be something wrong with kidneys if previous transplant recipients declined them, Zhang found in her research.

Observational learning is an active, rational process, involving information gathering and judgment. It differs from mimicking, which is automatic copying of behavior.

"With simple mimicking, I will join a line without knowing what people have lined up for," Zhang says.

For individuals using microlending sites, it is important to understand that observational learning is taking place, according to Zhang. Borrowers should price their loans to attract early bidders.

"Bids will accumulate and form what we call first day momentum," Zhang says.

Borrowers who offer high interest rates sometimes find the strategy has limits, she cautions. Sometimes lenders will conclude that the high rate is the only reason the proposal is attracting bids and that the quality of the loan is poor.

Lenders should study carefully the behavior of other lenders to make the best judgment possible about a loan, Zhang advises.

With the global financial crisis disrupting traditional credit markets, microlending Web sites are an important alternative, according to Zhang. She views them as the eBay of finance.

"There is risk of default on Prosper, as there are risks in buying from eBay," says Zhang. "But eBay provides efficiencies and facilitates peer-to-peer transactions. It is revolutionizing traditional goods buying markets. In the same way, microlending is changing the financial sector."

SOURCE: MIT Sloan School of Management

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