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Thilo Klein

Microfinance 2.0

Group Formation and Repayment Performance
in Online Lending Platforms During
the US Credit Crunch



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Abstract

We examine the role of reputation-based intermediaries on the world's largest peer-to-peer online lending platform. This marketplace as well as other recently opened lending websites allow people to auction microcredit over the Internet and are in line with the disintermediation in financial transactions through the power of enabling technologies. On the online market, the screening of potential borrowers and the monitoring of loan repayments can be delegated to designated group leaders. We find that, despite superior private information, these financial intermediaries perform worse than the average lender with respect to borrower selection. We attribute this to deliberately sending wrong signals. Bivariate probit estimates of the effect of group membership on loan default indicate positive self-selection into group loans. That is, borrow-

ers with worse observed and unobserved characteristics are more likely to choose this contract form. We provide evidence that this is due to a misleading group reputation system that is driven by a short-term incentive design, which was introduced by the platform to expand the market and was discontinued in September 2007. We further find that, after controlling for this group growth driven selection effect, group affiliation per se significantly reduces the probability of loan default.