Skin in the Game in the Originate-to-Distribute Model: Evidence from the Online Social Lending Market

Discussion by

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Main Idea

- Part of a “wave” of studies using the propser.com online lending platform to provide evidence on lender-borrower interaction
- Advantage: ability to observe in full the info available to lenders (unlike std banking studies)
- Some very nice papers have been written using this data set (“Love and Loans” by Enrichetta Ravina)
- Focus here: “group leaders” who provide endorsement/certification to borrowers (and also participate in the loans sometimes)

Main Idea – Contd.

- Results: Group leaders help borrowers obtain credit, but if they get a reward/fee then their incentives are distorted and they tend to recommend less creditworthy borrowers who are more likely to default
- Implications (nice and natural) for financial mkt regulation with respect to originate-to-distribute mortgages (authors' focus) or with respect to underwriting (Maju Puri's earlier work)
- Besides the distinction between groups where the leader gets a reward and "pro-bono" groups, the authors also emphasize what they regard as a "natural experiment," the abolition of fees by prosper.com and how the behavior of for-reward group leaders changed following this "regulatory" reform

Questions regarding Group Leaders

- Who are they? What kind of people? What does it take to become group leader? Why are they trusted? Is the endorsement at the "group"/individual level or is it loan-specific?
- What are their incentives to provide endorsements if they do not receive a reward or lend to the borrower themselves?
- In what way are their endorsements different from endorsements by ordinary people?
- Can borrowers belong to more than one group?
- (Thrust of these comments – need a better description of the economic institutions involved)

Questions regarding Group Leaders (2)

- If the group leader is a lender himself, does this provide him with the right incentives?
- Compare with the literature on universal banking (to which M. Puri has contributed): Wouldn’t lenders be afflicted with potential conflicts of interest when making recommendations on borrowers owing them money? Can they try to shift some of the risk of the loan onto others?

Questions regarding the “Reform” (abolition of rewards)

- Reforms are rarely truly exogenous “natural experiments”
- What triggered the abolition of rewards? Any scandals or other events? Can prosper.com prevent payments between “consenting adults?”
- Did the group leaders remain the same following the reform?
- Was the explicit purpose to reduce the number of (unjustified) recommendations (which is what actually happened)?

Questions regarding the efficiency of the prosper.com market

- If fees generate adverse incentives, why were they observed in equilibrium?
- Why did recommendations by conflicted group leaders have positive effects on loan outcomes? Irrational or naïve investors/lenders?
- Why were borrowers willing to pay for these endorsements which were not supposed to be effective in equilibrium if lenders are rational?

Questions regarding the efficiency of the prosper.com market (2)

- The results that endorsements by for-reward group leader improve the loan's prospects (success, interest rates) is inconsistent with the results that the default risk associated with these loans is relatively high. Irrationality again? Is the market "fooled" on a consistent basis?
- Is this "irrationality" eliminated after the "reform?" – I think not
- Why do endorsements without bids work at all (especially in the group with rewards)?

Questions regarding the econometrics and empirical results

- The matching of borrowers and groups is, of course, endogenous and non-random
- It is therefore hard to make causal statements about the extent to which certain groups/mechanisms “work” and affect loan outcomes
- Any ideas how to rule out matching of bad borrowers with for-reward groups? (full info on borrower characteristics)
- Banking lit has attempted to do this in many contexts (including Puri’s work on the US before Glass Steagall, Giannetti-Yafeh in the context of syndicated loans)

And one final question regarding the econometrics…

- Are the actions of group leaders (endorsements, bids) endogenous and jointly determined with loan outcomes?

Overall…

- Neat data
- Really neat idea!
- Need to address a few results which appear to be counter-intuitive before the paper becomes fully convincing and its regulatory implications can be taken (more) seriously
- (A variety of additional references to be provided separately)