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Martina Greiner
University of Georgia

Hui Wang
University of Georgia

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Building Consumer-to-Consumer Trust in e-Finance Marketplaces

Martina E. Greiner
University of Georgia
mgreiner@uga.edu

Hui Wang
University of Georgia
huiwang@uga.edu

Abstract

Online market exchanges are usually characterized by uncertainty and risks. Establishing trust and providing trust-building mechanisms are thus crucial for marketplace providers to reduce uncertainty and risks of online transactions. Business models that focus on consumer-to-consumer (C2C) transactions are growing and prospering. For these business models, establishing trust between consumers is important. Research in e-Commerce has mainly focused on trust-building mechanisms between vendors and consumers, but did not pay as much attention to mechanisms to build trust between individual consumers on C2C platforms. The objective of this study is to empirically investigate and test trust-building mechanisms for C2C platforms using data from the e-Finance marketplace Prosper. Our results give empirical support that trust-building mechanisms such as structural assurances, economic and social cues, as well as content quality influence trusting behavior. We contribute to literature and practice by investigating trust building in C2C relationships. Our findings help online marketplace providers to build successful C2C platforms.

Keywords: Community, C2C marketplace, e-Finance, trust

Introduction

The Web and Internet have created many possibilities for new business models. eBay, for example, an online auction marketplace for buying and selling products has successfully connected individual sellers and buyers around the globe. A specialized e-Commerce model that has more recently been created is a finance model which facilitates borrowing and lending between individuals on an electronic market. Prosper, for instance, is an online auction marketplace which functions similarly to eBay, however, instead of listing and bidding on items, people list and bid on loans using Prosper's platform. Business models that involve these kinds of C2C relationships have seemed to be growing and prospering. Transactions in online marketplace are routinely characterized by uncertainty and risk of opportunism due to the anonymous nature of online exchanges. Sufficient trust between individual sellers and buyers is thus critical to the existence of the market, and subsequently, the profitability of the market builder.

In this "e-Finance" model, trust is arguably more important than in other e-Commerce models for a few reasons. First, lenders and borrowers usually get involved in a longer term relationship than sellers and buyers on markets of regular commodities because loans normally take a few years to pay off. Second, lenders usually risk more money in a loan than buyers in a common online transaction for things like books or even computers. For instance, on Prosper the average amount of loans is \$5,026. Third, in an e-Finance market, funding is a scarce resource that the borrowers need to compete with each other to obtain. On Prosper, the borrower-to-lender ratio is approximately 3:1, whereas in other e-Commerce markets such as eBay and Amazon marketplace, the ratio of sellers-to-buyers will probably be higher. In addition, the average loan request on Prosper is \$5,730, while the average bid is only \$108. Given these reasons, lenders need to establish reasonable trust in the borrowers to be willing to risk their money. Conversely, it is important for the individual borrowers to provide credibility signals to differentiate themselves from others and give incentives to lenders to engage in trusting behavior (Ba and Pavlou 2002). Consequently, a better understanding of trust behaviors and the mechanisms to develop trust is crucial to businesses that profit from e-Commerce models. Our research question is what trust-building mechanisms induce trusting behavior.

Our paper makes several contributions. First, we add to the knowledge of online trust behaviors on C2C platforms. Two, we purport and verify the importance of trust in an e-Finance environment. Third, we make suggestions about how trust can be enhanced in e-Commerce marketplaces.

The rest of the paper is organized as follows: First, we introduce Prosper e-Finance business model. Then, we provide an overview of the trust literature and develop our research model that investigates the extent to which trust-building mechanisms influence trusting behavior. Subsequently, we use publicly available data from Prosper to test our research model and present our results. We conclude with a discussion about the results and limitations of the study.

C2C Lending Platform Prosper.com

An e-Finance Model

Prosper is an online auction marketplace for people-to-people lending. Individuals who need a loan can post requests for loans (called listings) on Prosper’s Website, individuals who are willing to lend their money to earn interests will then make their bids by specifying the amount they want to lend and the interest rate by which they want to get paid. Prosper generates revenue by collecting a one-time 1% or 2% fee on funded loans from borrowers, and assessing a 0.5% or 1.0% annual loan servicing fee to lenders. As of February 14, 2007, it has attracted 180,185 registered members, supported 90,398 listings (7,404 completed, 42,678 expired, and 141 pending verification, 36,669 withdrawn, 707 cancelled, and 2799 active), 919,342 bids, and generated 7,408 loans which altogether raised 37,234,040 dollars. The average amount of a loan is \$5026. Prosper managed to attract many new members and enjoys exponential growth for members, listings, and bids. Since its first member registration on 10/31/2005, the average increase of new members has increased from 112 per month in 2005, to 11,231 per month in 2006, and 30,124 per month in 2007. In 2005, the average monthly new listings are 30, in 2006, this number is 6,151, and in 2007, this number has reached 11,022. The average new bids per month is 236 in 2005, 54,849 in 2006, and 173,789 in 2007. As of February 14, 2007, 40,390 members have posted a request for loan, 14,074 placed a bid for lending, and 13,453 generated loans. On average, there are 15 bids per listing of loan request.

How it works

A listing for a loan request remains open for certain days. During which bids for lending compete by the interest rates they ask. When it gets fully funded, a borrower may choose to complete the listing and get funded or keep the listing active (open) for lower interest rates. If a listing runs out of time and is not yet 100% funded, no loan will be created. Prosper encourages group and community building to develop trust between lenders and borrows and to facilitate borrowing and lending activities on Prosper. In addition, Prosper provides security and background check on borrowers.

Prosper claims to create loans with lower interest rates than loans through banks due to the absence of services fees paid to banks. For personal loans on a 36 month term, the average borrower’s credit score and the average interest rates they got on Prosper are listed in the following table.

Table 1. Credit grade and average interest rates

| Credit Grade | Number of People | Percentage | Average Borrower Rate |
|---------------------|-------------------------|-------------------|------------------------------|
| AA | 656 | 8.86% | 9.14% |
| A | 577 | 7.79% | 11.07% |
| B | 762 | 10.29% | 13.92% |
| C | 1074 | 14.50% | 16.75% |
| D | 1182 | 15.96% | 20.14% |
| E | 1432 | 19.33% | 25.00% |
| HR | 1587 | 21.42% | 24.26% |
| NC | 138 | 1.86% | 22.44% |

Borrowing and lending in communities is not a new phenomenon. However, the Internet supports lending on a much larger scale and can reach a worldwide audience. The advantage of C2C e-Finance is that it reduces the reliance on institutions such as banks to receive credit or interest. However, banks are able to provide insurance for borrowers and lenders that individuals may not be able to provide. Thus, trust in the individual borrower is important for C2C e-Finance marketplaces. In order to attract people, these marketplaces need to find mechanisms that facilitate trust between the borrowers and lenders.

Trust

Trust and trust-building mechanisms are important in e-Commerce because they can reduce the perceived uncertainty and risk associated with anonymous online exchanges (Ba and Pavlou 2002; Chen et al. 2004; Gefen et al. 2003; Pavlou and Gefen 2004). Despite its importance, there is yet no universally accepted definition of the concept trust (Chen and Dhillon 2003; Rousseau et al. 1998). Recent studies rely on the theory of reasoned action (TRA) to conceptualize trust and suggest path models of trust formation (Appan and Mellarkod 2003; Gefen et al. 2003). TRA suggests that behavior is driven by behavior intentions that are influenced by one’s attitude towards performing the behavior (Fishbein and Ajzen 1975). Attitude is formed on the base of one’s beliefs about the consequences of performing the behavior and the desirability of the consequences. All other external factors influence attitudes, intentions, and behaviors through these beliefs. Taking TRA as a framework, we conceptualize trust as the willingness to depend based on the attitude and specific beliefs about the other party (McKnight et al. 2000; Rousseau et al. 1998).

Trust-Building Mechanisms

Trust is the product of many sources, and differences in these antecedents often depend on the stage of trust development (Ba and Pavlou 2002; McKnight et al. 1998). In this study, we focus on initial trust for several reasons. First, Prosper is a relatively new marketplace and its first member registered in October 2005. Thus we can not assume long-term interactions between members. Second, compared with eBay and Amazon marketplace, the number of transactions per member is smaller on Prosper. Out of the 7285 members with completed listings, only 117 members had multiple listings. Thus, familiarity between the members cannot be assumed. We are focusing on three sources of trust that have been shown to be relevant for initial trust development: institution-based trust, cognitive-based trust, and quality (McKnight et al. 2002; McKnight et al. 1998).

Trust Consequences

Prior studies support that higher levels of trust are associated with higher trusting behavior (Pavlou and Gefen 2004). In our study, trusting behavior is represented by bidding to lend in response to listings. Bidding to lend indicates that the lender perceives the borrower as trustworthy enough to depend on despite the risk and uncertainty associated with the lending behavior.

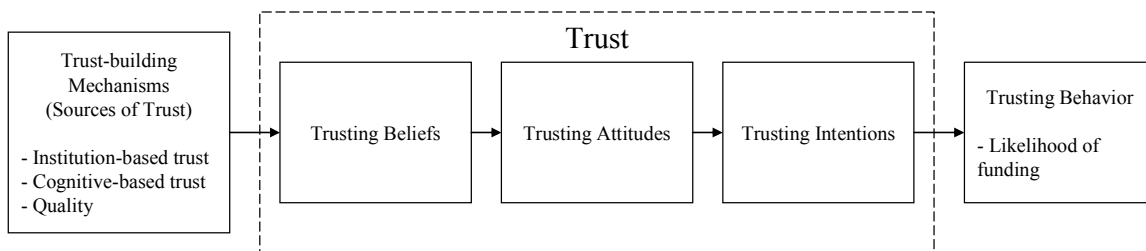


Figure 1. Conceptual model

In the next section, we develop our research model. Since we are relying on secondary data provided by Prosper we are not able to measure the trust constructs. Therefore, we focus on the external factors which lead to trust and the trusting behavior which are the consequences of trust.

Development of Research Model

Institutional-Based Trust

Structural assurance is one component of institutional-based trust and refers to one's beliefs that a third party (i.e., in our context Prosper) provides structures such as guarantees and regulations which enhance the likelihood of a successful outcome (McKnight et al. 1998). Structural assurances work as signaling mechanisms and reduce uncertainty and risk. An important structural assurance Prosper offers is the verification of borrowers' bank accounts that are used for automatic withdrawal of monthly payments of the loans. The existence of a verified bank account should increase trust and provide an incentive for lenders to bid for the loan.

Hypothesis 1: The existence of a verified bank account increases the likelihood of funding.

Cognitive Based Trust

Cognitive-based trust is formed through first impressions based on categorization processes and illusions of control (McKnight et al. 1998). Individuals use categorization processes to assign person to groups and then deriving trusting beliefs from the group to the individual. Illusions of control describe how individuals assess trustworthiness by observing and watching for cues that confirm their initial belief about the party (McKnight et al. 1998). If lenders are not able to judge whether the borrower is able and willing to payback the loan, they may use peripheral cues to evaluate the trustworthiness of the borrower. Prior research looked at peripheral cues such as feedback ratings (Ba and Pavlou 2002; Chen et al. 2004), domain name (Hong 2006), identification of authors, or availability of author information (Shek et al. 2003). Prosper offers several opportunities for borrowers to provide information about themselves that signals credibility.

Economic Cues derived from Borrower Information

Availability of borrower information has the potential to decrease uncertainty and allows a lender to better evaluate the competence, integrity, and predictability of a borrower. Economic criteria such as credit grades, debt to income ratio, and homeownership are commonly used to estimate the ability and willingness of a borrower to pay back its loan in time. Lenders will take those criteria into account when considering whether to bid for a listing. Prosper obtains the credit score of each borrower from the credit bureau Experian. Conversely, Prosper reports payment and delinquency information back to Experian. Thus, lenders can infer borrowers' accountability from their credit grades. Since payment performance on Prosper has consequences on the credit score, borrowers are interested in paying the loans on time. Higher credit grades thus should positively affect the likelihood of funding.

Hypothesis 2: The likelihood of funding increases with higher credit grades.

Debt to income ratio gives information about the ability of a borrower to pay back additional debts. The higher the debt to income ratio, the less likely a lender will perceive a borrower to be able to pay back the loan, and therefore, the smaller the likelihood of funding.

Hypothesis 3: The likelihood of funding decreases with higher debt to income ratio.

Homeownership might show lenders that the borrower is a responsible person and able to handle loans. The lender might thus place more trust in a borrower with homeownership.

Hypothesis 4: Borrowers' homeownership increases the likelihood of funding.

Social Cues derived from the Social Environment of the Borrower

Prosper provides the opportunity for its members to join groups which are organized and maintained by group leaders. Groups are evaluated based on the repayment history of loans associated with the group. Group members are thus interested to see that their fellow members fulfill their payment obligations. Hence, lenders might perceive listings associated with a group as more trustworthy than listings that are not associated with a group.

Hypothesis 5: Group membership increases the likelihood of funding.

Each group receives a rating based on their members' payment performance. Groups that outperform an expected default rate receive higher ratings. Lenders might infer from the group performance that of the individual borrowers who belong to the group. Lenders might also believe that group members will socially influence other group members to pay back their loans in order to maintain a high group rating. Hence, borrowers who belong to a group with a higher rating may be perceived as more trustworthy than those who belong to a group with a lower rating.

Hypothesis 6: The likelihood of funding increases with higher group ratings.

Group leaders are able to earn money if a listing associated with their group gets funded or repays on-time. This reward gives an incentive to the group to ensure that group members fulfill their payment obligations. This incentive is likely to be higher, the higher the reward rate is. A lender might thus place more trust in a group with higher group leader reward rates.

Hypothesis 7: The likelihood of funding increases with higher group leader reward rates.

Borrowers can invite other Prosper members to leave an endorsement on their listing to give the listing more credibility. A lender might perceive a borrower who has managed to obtain endorsements as more trustworthy because other members have shown trust in the borrower. It also shows that the borrower belongs to a social network which might lend additional credibility. Endorsements for listings might thus give the perception of trustworthiness.

Hypothesis 8: Endorsements from other community members increase the likelihood of funding.

Quality of Listing

Quality has been studied as an antecedent to trust (Huerta and Ryan 2003; McKnight et al. 2002; Rieh and Belkin 1998). People derive their trust perception about whatever they know about the other person (McKnight et al. 1998). Thus, if lenders perceive a listing to be of high quality, they might associate positive attributes to the borrower which positively influence trust formation (McKnight et al. 2002). Hence, quality increases trust (Hong 2006; Huerta and Ryan 2003; McKnight et al. 2002).

Like trust, quality has been conceptualized in many different ways and no global definition exists (Reeves and Bednar 1994). Since we are using secondary data provided by Prosper, measuring quality as conformance to pre-defined specifications seems most appropriate. We used three quantitative measures – readability of listing description, formality of title, and availability of listing image – to investigate the influence of quality on trusting behavior.

Quantitative readability scores such as Flesh Reading Ease test use formula to derive readability scores based on the number of words, sentences, and syllables. Higher scores indicate ease to read. Lenders might perceive listings that are easier to read as more attractive. Higher scores on the Flesch Reading Ease test might thus positively influence funding.

Hypothesis 9: The readability of the listing description will increase the likelihood of funding.

Listing title is one of the first pieces of information that a lender searching for listings sees. The title might immediately form a first impression about the whole listing and triggers a lender to either further evaluate the listing or disregard it. A sloppy title might lead a lender to consider the borrower as less trustworthy and discourage the lender to consider the listing. Conversely, a professional title might attract a lender and leave a good impression. The formality of a title thus might increase funding chances.

Hypothesis 10: Formality of titles increases the likelihood of funding.

Like titles, images might form initial impressions about a listing and can be powerful to attract or appall lenders (Steinbrück et al. 2002). We therefore hypothesize that images are positively associated with likelihood of funding.

Hypothesis 11: Availability of images increases the likelihood of funding.

Control Variables - Profitability, Size, and Duration of the Listing

We include three control variables: profitability (maximum borrower rate), size (amount requested), and duration of the listing. A higher maximum rate a borrower is willing to pay might attract lenders. Based on economic principles, the higher the interest rate, the higher the potential profit for lenders. Size of the listing amount might also influence the likelihood of funding, because with an average bid amount of \$108, larger loans need to attract more total bids than smaller loans, and hence more difficult to get funded. In addition, listings that remain open for a longer duration give lenders more time to place bid and thus, duration is likely to be associated with higher funding.

In summary, we propose that structural assurances, economic cues, socials cues, and quality influence the perceived trustworthiness of a borrower and consequently the likelihood of a listing getting funded (see Figure 2).

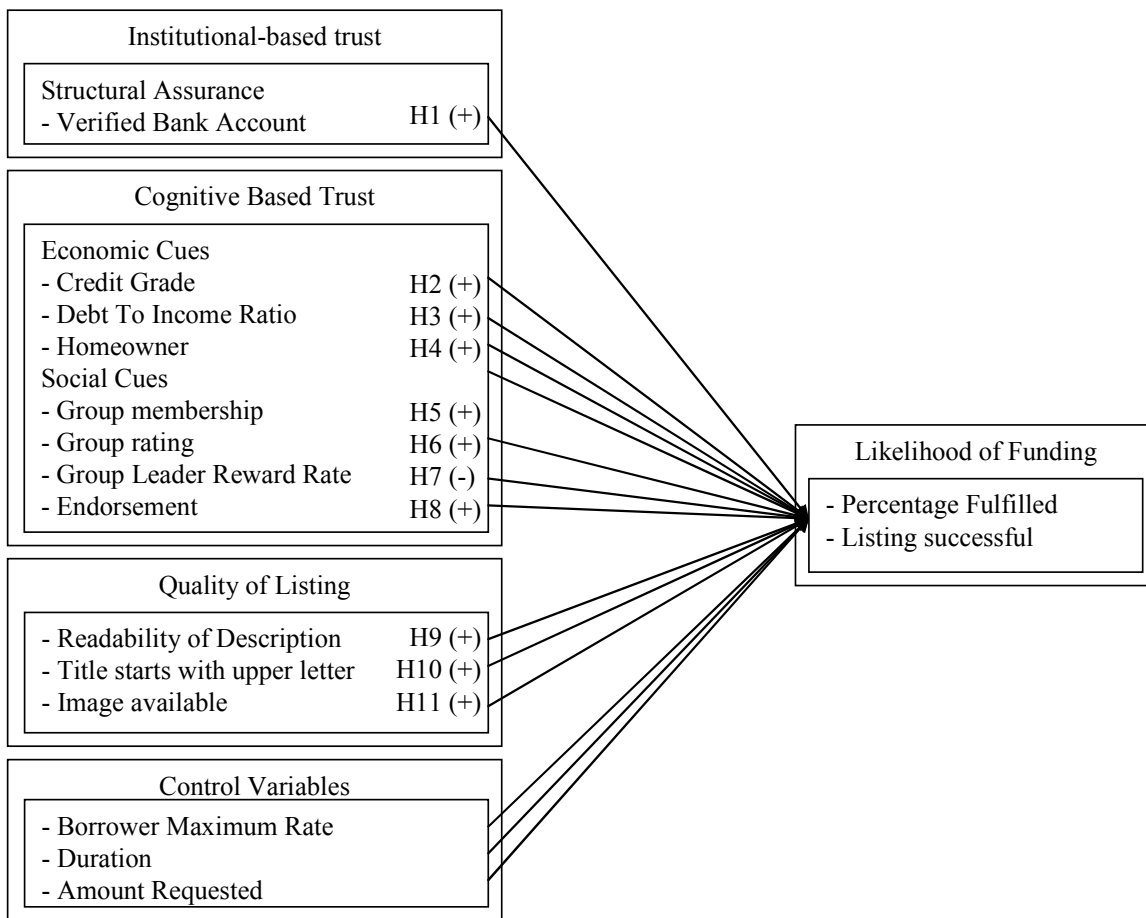


Figure 2. Research model

Methodology

Research Method

The data used for analysis, including listing, bid, and member information are available publicly on Prosper (www.prosper.com). Listings included in analysis start from the first listing on Prosper in November 2005 and go to February 2007. Listings included are either completed, expired, or pending bank or identity verification. These three categories are included because they all have a clear final outcome of the listing and bidding behavior – the completed and pending further

verification ones run to completion, and expired ones failed to fund in time. Other listings (withdrawn, cancelled, and active) are not appropriate to include because the outcomes of active listings are uncertain yet, and the reasons for listings cancelled by Prosper or withdrawn by borrower were not clear. As a result, we have 50,223 listings with 752,104 associated bids. Out of these, we randomly selected 3000 listings. Since the measure Debt to Income Ratio had 80 missing values, the final sample size was 2920.

In order to test the relationships between trust-building mechanisms and trusting behavior, we performed multiple linear regression and logistic regression using SPSS 14.0. We tested the influence of 11 independent variables (IV) on 2 dependent variables (DV), with 3 control variables (CV) included in the model. Table 2 shows the definitions and types for each variable.

Table 2. Description of measures

| Variable | Definition | Type |
|---|--|---------------------------------------|
| Dependent Variables | | |
| Percentage Funded | The percentage amount of the listing which has been funded. This can be calculated by dividing amount / amount requested. | Continuous (percentage) |
| Listing Completely Funded | Whether or not the listing was funded to a 100%. Listings that are completely funded will become a loan. | Categorical (0,1), 1 = Yes |
| Independent Variables | | |
| Verified Bank Account | Whether or not the borrower has a verified bank account at the time the listing was created. | Categorical (0, 1), 1=Yes |
| Group Membership | Whether or not the listing is associated with a group. | Categorical (0, 1), 1=Yes |
| Group Rating | The rating of the associated group. If the borrower does not belong to any group at the time of the listing, or the group is not rated, this value is 0. | Ordinal (0~5), 0 is low and 5 is high |
| Group Leader Reward Rate | The portion of the borrower rate which will be paid to the group leader. | Continuous (percentage) |
| Endorsement | Whether or not the borrower who created the listing has testimonies from other members. | Categorical (0, 1), 1=Yes |
| Credit Grade | Credit Grade of the borrower at the time the listing was created. If there is no report of Credit Grade, the value is 0. | Ordinal (0~7), 0 is low and 7 is high |
| Debt To Income Ratio | The debt to income ratio of the borrower at the time the listing was created. | Continuous (percentage) |
| Homeowner | Whether or not the borrower is a verified homeowner at the time the listing was created. | Categorical (0, 1), 1=Yes |
| Flesch Index | Indicator of the text readability of the listing description. | Continuous (0~100) |
| Formality of Title (Starts with Upper Letter) | Indicator of formality of the title of the listing. | Categorical (0,1) 1=Yes |
| Has Image | Whether or not the borrower has uploaded an image to describe the listing. 1=Yes | Categorical (0, 1) |
| Control Variables | | |
| Borrower Maximum Rate | The maximum interest rate the borrower is willing to pay when the listing was created. | Continuous |
| Duration | The number of days in which the listing is valid for. | Continuous |
| Amount Requested | The monetary amount that the borrower requested to borrow in the listing. | Continuous |

Results

Multiple regression was used for dependent variable Percentage Funded. Logistic regression was used for dependent variable Listing Completely Funded. Both analyses found significant ($p < .05$) relationships between 10 out of 14 predictors and the dependent variable. The adjusted R-square for Percentage Funded is 40.6%, which means that our model explained 40.6% of the variation in Percentage Funded in the sample data. The R-squares for Listing Completely Funded are 35.3% for Cox & Snell and 60.2% for Nagelkerke, respectively. Table 3 presents the regression output.

Table 3. Regression output (n.s. = non significant, * = $p < .05$, ** = $p < .01$, * = $p < .001$)**

| Predictor Variables | Percentage Funded (adj. R2 40.6%) | Listing Completely Funded (Cox & Snell R2 35.3%, Nagelkerke R2 60.2%) |
|---|-----------------------------------|--|
| | Beta | B |
| Verified Bank Account | .224*** | 3.417*** |
| Credit Grade | .455*** | 1.204*** |
| Debt To Income Ratio | .019n.s. | .000n.s. |
| Homeowner | .037* | .459* |
| Group Membership | .009n.s. | .036n.s. |
| Group Rating | .079*** | .161*** |
| Group Leader Reward Rate | -.112*** | -.420** |
| Endorsement | .053*** | .494* |
| Flesch Index | -.005n.s. | .001n.s. |
| Formality of Title (Starts with Upper Letter) | .042** | .819*** |
| Has Image | .063*** | .671*** |
| Borrower Maximum Rate | .287*** | .241** |
| Duration | .025n.s. | .085*** |
| Amount Requested | -.123*** | .000*** |

Conclusion

Discussion

The regression results in Table 3 support 7 of the 11 hypotheses about the influence of trust-building mechanisms on trusting behaviors. The results of the hypothesis testing are summarized in Table 4.

Table 4. Results of hypothesis testing (significance at $p < .05$)

| Hypothesis | | Findings Percentage Funded | Listing Funded Completely |
|-------------------|---|-----------------------------------|----------------------------------|
| H1 (+) | The existence of a verified bank account increases the likelihood of funding. | Supported | Supported |
| H2 (+) | The likelihood of funding increases with higher credit grades. | Supported | Supported |
| H3 (-) | The likelihood of funding decreases with higher debt to income ratio. | Not Supported | Not Supported |
| H4 (+) | Borrower's homeownership increases the likelihood of funding. | Supported | Supported |
| H5 (+) | Group membership increases the likelihood of funding. | Not Supported | Not Supported |
| H6 (+) | The likelihood of funding increases with higher group ratings. | Supported | Supported |
| H7 (+) | The likelihood of funding increases with higher group leader reward rates. | Reversed | Reversed |
| H8 (+) | Endorsements from other community members increase the likelihood of funding. | Supported | Supported |
| H9 (+) | The readability of the listing description will increase the likelihood of funding. | Not Supported | Not Supported |
| H10 (+) | Formality of titles increases the likelihood of funding. | Supported | Supported |
| H11 (+) | Availability of images increases the likelihood of funding. | Supported | Supported |

Hypotheses 1, 2, 4, 6, 8, 10, and 11 are supported as previously predicted and discussed. Thus, we found empirical support that the presence of a bank account, higher credit grades, homeownership, higher group ratings, endorsements from other community members, formality of the listing title, and availability of the images increase the likelihood of funding, a trusting behavior. We did not find support for hypotheses 3, 5, and 9. Hence, there is no empirical support for influence of higher debt to income ratio, group membership, and description readability on funding on trusting behavior. For hypothesis 7 we predicted a positive influence of group reward rate on the likelihood of funding because a higher group leader reward rate might be considered by the lender as a signal of credibility. However, the direction of this relationship was reversed in the empirical data, i.e., with higher group leader reward rates, the likelihood of funding decreased. To understand this effect, we need to understand how the group leaders are paid. The reward rate is subtracted from the lender rate, that is, with higher group reward rates, the interests of the lenders decrease. This may explain the negative effect of higher group leader reward rates on the likelihood of funding. This effect is conform to the effect of the control variable 'Maximum Borrower Rate' – the higher the interest a lender is able to get, the higher the likelihood of funding and vice versa. Decreasing profitability of the listing thus seems to outweigh the effect of the credibility signal of the group reward rate.

Limitations

One limitation of the study is that we were not able to measure trust directly. We investigated the sources of trust and their influence on trusting behavior and treated the mechanisms in between as a black box. This means that some of the effects we are seeing in the results may not be attributed to trust. We tried to compensate this limitation by including three control variables, Borrowers Maximum Rate, Listing Duration, and Amount Requested, to account for some influences not accounted for by trust. Moreover, trust building mechanisms and the links with the antecedents and outcomes have been widely used and empirically tested (Gefen et al. 2003; Pavlou and Fygenson 2006; Pavlou and Gefen 2004), therefore we feel confident that the predictors in our model influence trusting behaviors through trust mechanisms.

A second limitation of the study is its reliance on objective and quantitative measures. For example, the formality of listing titles is measured by differentiating whether or not the first letter of the title is capitalized; however, the content of the title is not included in the formality evaluation. Similarly, the readability score for listing descriptions does not measure content. Further analysis looking at the content of listing description, title, and image might be fruitful.

Implications and Conclusion

The primary contribution of our study is to show the importance and influence of trust-building mechanisms in C2C marketplaces. Due to the anonymous nature of the Internet, online exchanges are characterized by high risk and uncertainty. It is thus important for markets to develop mechanisms that counteract the uncertainties by developing ways to signal credibility and providing guarantees and warranties. Especially in C2C marketplaces, it is important for the marketplace to provide trust-building mechanisms which enable individuals to differentiate themselves by providing signals of credibility. Our study provides empirically support for the influence of trust-building mechanisms on trusting behavior. It shows that it is important that e-Finance marketplaces provide structural assurances (e.g., verified bank account), economic cues about the individual (e.g., credit grade, homeownership), and social cues derived from the social environment of the borrower (e.g., group membership in group with higher ratings and endorsements). The latter one provides support that the community a borrower belongs to is important because it may give them reputation and transfers trust from the group to the individual borrower. For the individual borrower it is also important to care for the quality of the listing (e.g., formality of the title and images). Our findings provide a better understanding of trust behaviors and the mechanisms to develop trust which are crucial to businesses that profit from e-Commerce models.

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