Researcher documents the pitfalls of personal loans

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As an old proverb goes, "before borrowing money from a friend, decide which you need most."

New research from Carnegie Mellon University's George Loewenstein and the University of Vienna's Linda Dezsö provides evidence of the pitfalls of making or receiving personal loans. Published in the *Journal of Economic Psychology*, the study is the first to systematically investigate the contours and consequences of loans between peers, such as friends, siblings, and coworkers and shows how self-serving bias behavior affects future relationships.

"This research fits with a wide range of earlier research showing the pernicious effects of self-serving conceptions of fairness," said Loewenstein, the Herbert A. Simon University Professor of Psychology and Economics at CMU's Dietrich College of Humanities and Social Sciences. "It provides further evidence that people's tendency to confuse what is in their own interest with what is fair is a major source of disagreements between people."

For the study, 971 individuals completed a detailed survey on the most recent personal loans they had made and received within the past five years. Each participant completed a lending and borrowing section of the survey and answered questions about the characteristics of the loans – size, purpose, amount repaid, presence of interest and existence of a formal contract – and the relationship and history between the borrower and lender.

Two main findings emerged from the study. First, the researchers found that borrowers are subject to a wide range of self-serving biases when it comes to loans. For example, borrowers are more likely to believe that the loan was initiated by the lender, that the loan had been paid off as agreed upon, and to report that a loan which they were delinquent in repaying was really more of a 'gift' than a loan. Different recollections of the terms of the loan, and different perceptions of the degree to which the loan has been repaid, plant the seeds of misunderstanding between lender and borrower.

Second, although most of the loans reported by the people they surveyed did not result in misunderstandings between the parties, delinquent loans – loans that had not been paid off and were overdue – resulted in wide-ranging negative repercussions. Again, self-serving bias came into play; borrowers predicted that they would eventually pay off such loans, while lenders predicted they would never be paid. And lenders of delinquent loans reported lower feelings of closeness to, and trust in, the borrowers, and also reported that delinquent borrowers were avoiding encounters with them. Borrowers, for their part, seemed to be blithely unaware of the negative feelings aroused in lenders, and, on their own part, did not report any similar change in feelings toward the lenders.

"This research provides empirical backing for the many adages cautioning against lending to a friend: lending can be hazardous to a relationship," said Dezsö, a predoctoral candidate in economic psychology. "That doesn't mean you should never lend money to a friend – personal loans can be lifesavers in many situations in which commercial loans aren't feasible; but the research does strongly support the idea that it is a big mistake to borrow money from, or loan money to, a friend, if both parties aren't confident that the loan will be paid off in a timely fashion."

But, Dezsö adds, "Unfortunately our findings suggest that such confidence, even when it exists, is often misplaced."

Provided by Carnegie Mellon University

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