**Market-Based Vs Bank-Based Financial Systems**

Market-based finance refers to the system of markets (eg equity and debt markets), non-bank financial institutions (including investment funds, hedge funds, pension funds and insurers) and infrastructure (such as central counterparties and payments providers) which, alongside banks, provide financial services to support the wider economy. It is an important component of both the global and UK financial systems.

In the bank-based financial model, savings flow to their productive uses predominantly through financial intermediaries. These intermediaries include banks, savings and loan associations, mutual funds and pensions funds. Banks take deposits from savers and use these to lend to borrowers. Mutual/pension funds (which likewise play a role in market-based systems) sell units to the public and invest these either in securities or to direct borrowers. The system is more relationship-based because the borrower needs to interact directly with fewer lenders. This is observable in most developing economies.

A balanced and developed finance system will have both well functioning financial intermediaries and market based institutions contributing to the economy’s growth. This is achieved through several channels:

(1) acquisition on information about firms;

(2) provision of risk-reducing arrangements;

(3) pooling of capital; and

(4) ease of making transactions. Information gathering is key to monitor the efficiency and productivity of projects. The system increases the pool of available funds and hedging of risks lead to better allocation to productive uses of funds mobilized from savers. With good governance, the financial systems can help to retain domestic savings at home.

**Market-Based Vs Bank-Based Financial Systems**

A financial system can be defined as either market-based or bank-based depending upon the manner in which funds are raised in the economy. A system that relies heavily on selling securities in the open market is considered to be a market-based system. Here, investors conduct their own due diligence and bear their own risk when they lend money to corporations.

On the other hand, a financial system in which investors invest their money in banks and these banks then invest the money in corporations is called a bank-based financial system. Here, the bank plays the role of a gatekeeper i.e. they inspect the financials of the company on behalf of the investor before making a final investment.

Both these methods of financing exist in almost every economy around the world. However, a system is called a market-based or bank-based system depending upon the predominant system of investing prevailing in that economy. This is generally measured by the percentage of banking services in the overall economy.

For instance, if we compare the United States and Europe, we discover that the United States is a market-based system whereas Europe is a bank-based system. This is because banking services as a percentage of GDP are almost twice as large as in the United States.

It is important to note that economies cannot change from a bank based to market-based economies overnight. Even the most advanced countries of the world like the ones in Western Europe take decades to transition from one system to another. Hence, this can be considered to be a semi-permanent characteristic of the market.