Illinois & Michigan Canal scrip issued by the State Bank of Illinois. Source: Chicago Historical Society.

notes of “country banks,” many of which were backed by bonds from the South. The discounting of non-Chicago notes and the continued collapse of the country bank notes’ value led to calls for the abolition of all banks in the state. Instead, the problems were addressed with reforms in the free banking laws.

With the passage of the National Bank Act (1863), Chicago added five new nationally chartered institutions, all developed out of existing private banking houses. Illinois encouraged large “unit” banks as epitomized by the Central Trust Company of Illinois, which opened in Chicago in 1902 as a “big bank for small people.” Its president, former U.S. comptroller Charles Dawes, opposed branch bank legislation at the state and national levels. The national banks were created first and foremost to finance the Civil War, and thus gained important advantages over state banks in securities acquisition and sales. In 1891, for example, Chicago’s First National Bank took $1.2 million in the city’s bond issue—the entire amount. When the bank’s bond department could not handle mortgage or real-estate loans, the bank organized a “security affiliate,” First Trust and Savings Bank, to deal specifically in securities. This represented a revolution in securities financing and was quickly copied by New York institutions, which referred to it as “the Chicago Plan.” Later, during the Great Depression, critics of the banking system pointed to the interlocking of banks with securities affiliates as a cause of the weakness that led to the banking collapse in the 1930s. In fact, this system strengthened the banks by giving them more flexibility in their portfolios. Since only the state bank was allowed to have branches, its failure effectively ended branching in Illinois.

Chicago bankers also led the way in creating a system of preventing panics through the Chicago Clearing House. James B. Forgan of First National Bank initiated the new clearing system in 1905 and ran it effectively. Clearinghouses allowed the city’s banks to settle all their outstanding obligations with each other at the end of each business day. This enhanced information transmission among the banks and reduced the risk of panics. After the panic of 1907, however, many concluded that only a national “lender of last resort” could prevent future panics, leading to a reform movement. Forgan served on the Currency Commission of the American Bankers Association and helped shape the reform legislation that became the Federal Reserve Act of 1913. Forgan, meanwhile, had found a way around the branch bank restrictions by establishing new, but clearly related, unit banks in areas outlying Chicago, thus forming an early “chain” bank—the second most efficient form of banking next to branching. Chain banks, unlike branch banks, might have the same owners, but they could not commingle assets or liabilities: each, essentially, had to stand on its own. This was a weaker structure than branching, because branch banks could shift assets around to “trouble spots.”

After the creation of the “Fed,” Chicago was designated a headquarters city of a Federal Reserve District Bank, and the city’s national banks soon opted to have Chicago designated a central reserve city in the new system, under which all national banks had to carry a 25 percent reserve. That attracted the balances of banks designated as country banks to Chicago, which, by 1914, had $205 million in interbank balances, or nearly six times more than

Crowd gathered outside the Milwaukee Avenue Bank at 739–47 (formerly 409–15) Milwaukee Avenue during its August 1906 failure. Photographer: Unknown. Source: Chicago Historical Society.

in 1887. George Reynolds' Continental and Commercial National Bank of Chicago was the leader in handling correspondent business. Banks already had started to specialize in either commercial operations, which financed agriculture, trade, and businesses, or large-scale capital investment, often through a syndicate of many institutions, to build railroads or other capital-intensive enterprises.

After 1900, Chicago emerged as a major source of investment funds. By this time, a difference had emerged between "investment banks" (such as J. P. Morgan), which dealt extensively with providing start-up capital for large, new enterprises, and commercial banks, which provided loans for BUSINESS operations on a more short-term basis. From 1900 to 1928, Chicago's banks, most of which were commercial banks, underwent a period of rapid expansion, with aggregate net worth growing nearly sixfold. During that same period, the nation's percentage of total banks made up of national banks shrank from 60 percent to 36 percent, indicating the strong advantages offered by state charters, including lower capitalization requirements. Like bankers in other major cities, Chicago's financial leaders had no reason to see a threat in the near future: in the 1920s alone, Chicago banks marketed $2.5 million in public utilities, and at the end of the decade Chicago stood behind only New York and London as a great money center.

But the correspondent system that had generated much of that growth rebounded negatively to the city's banks when the agricultural downturn of the 1920s caused the collapse of many unit banks in farm states. Their balance withdrawals started to weaken Chicago's major institutions. After the Great Crash of 1929, a national banking panic materialized. Research suggests that the complaints about banks' "speculation" causing the crash were exactly wrong: banks with securities affiliates, such as First National, were less likely to fail than banks *not* involved in the market. There were exceptions, of course: the collapse of Samuel Insull's Midwest utilities empire helped weaken the Continental Illinois Bank. From 1929 to 1930, more than 30 Chicago banks went out of business. In addition, more than 100 banks sought to strengthen themselves through mergers. In 1931, the collapse of Insull-related securities spread through the banking community, with runs forcing 25 banks to close in a matter of days. Research has suggested that most of the failures between 1930 and 1933 resulted more from weakening portfolios related to government securities they held than to declining real-estate prices that might indicate poor management of mortgage lending.

By 1933, President Franklin Roosevelt concluded that only a national "bank holiday" would restore the system. Soon thereafter Congress changed most of the banking laws. Banks could not have securities affiliates under the Glass-Steagall Act. The Federal Deposit Insurance Corporation (FDIC) was formed, although subsequent research has shown conclusively that the state deposit insurance schemes of the 1920s contributed to the banking problems in the agricultural states. The