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The Chicago Financial Environment

Chicago is one of the great and exciting cities of the world. It is a city whose citizens cannot help but feel its throbbing pulse and whose visitors typically speak enthusiastically about its impressive economic vitality. The rebirth of our city's heart and the tremendous expansion of its outlying manufacturing, service industries, shopping centers, and residential activity provide much of the stimulus. And we have outstanding art, opera, and one of the world's great symphonies. Our universities are unexcelled. So are our parks. All of this is a base of justifiable civic and regional pride--an environment in which economic vigor and a strong financial structure can and do flourish.

Anyone who has endeavored to analyze something as complex as a financial environment knows it is hard to get ahold of. We all have some notion of what we mean by the term financial environment. Yet precise definition is something that is difficult to achieve. And depending on your vantage point the characteristics considered to make one financial environment "better" than another may vary widely.

Embodied in the concept of a financial environment are at least two distinct elements. The first is the capability of the financial community to satisfy local individual and business needs. And the second is whether the financial community can appropriately be called a financial center. The first element concerns the production of financial service for local consumption; the second the production of financial service for export.

Any city with a large population and commensurate commercial and industrial activity will provide a sizable financial service base. Geographical convenience alone brings this about.

But the simple fact that there is a concentration of users of financial services does not insure that all the financial demands of individuals and businesses will or can be satisfied locally or that production of financial services for export to any significant extent will take place. On the West Coast, for example, Los Angeles is a much larger city than San Francisco in terms of population; yet San Francisco is generally considered the greater financial center of the two. In the Southwest, Dallas is generally considered the financial center although Houston is larger.

As I have been alluding to, the essence of a financial center can be summarized under the two terms "specialization" and "production for export." So, it is clear that Chicago's prominence as a manufacturing and transportation center assured the development of financial activities on a large absolute scale. Indeed, as in the case of New York--or in the earlier case of London--Chicago's industrial and commercial development has been functionally related to its development as a financial center. But beyond this, Chicago does indeed visibly specialize in financial services in the sense of producing them in a volume greater than proportional to local needs and exporting them over an area much broader than its own geographical limits.

Such concentrations in the production of financial services as do arise result from the interplay of many factors, most of which are subsumed under the well-known economic categories of "economies of scale" and "external economies." Economies of scale generally refers to the ability of larger size firms to produce at lower average costs, while external economies refers to the benefits accruing to firms because they are located in a geographically compact area. While I intend no full-blown discussion of these principles, it does seem worthwhile pointing out that such economies do appear to exist in the production of financial services. These economies favor large cities and further suggest why Chicago is a strong financial center.

Ideally, it would be helpful to have complete Chicago data bearing directly on the degree to which Chicago is a financial center as measured by the criteria mentioned already: degree of specialization in production of financial services, as measured possibly by the percentage of employment, value added, or output associated with financial industries relative to all economic activity and production for export. Unfortunately such specific data are not readily available, although some employment data by major industry and geographic location can be obtained.

I want to start out, therefore, by taking a broad, qualitative overview of the institutions and financial activity that highlight Chicago's present stature as the financial center of the Midwest, its stature as the second largest financial center in the country--indeed, its stature as one of the most important financial centers in the entire world.

There are several types of financial activity in which Chicago occupies a position of undisputed dominance. They clearly help rank Chicago as a leading financial center. No sophisticated analysis of the data is required to demonstrate Chicago's preeminence, for example, in providing markets for trading commodity futures. Across the country these exchanges have experienced unprecedented trading over the past several months. There were 23.5 million contracts traded on all commodity exchanges during fiscal 1973, up over 50 percent from the comparable year-earlier level and in dollar value more than double the value for 1972. This dollar value was more than two and one-half times as large as the value of all equities traded on the New York Stock Exchange during the same period. During fiscal 1973, the three commodity exchanges in Chicago accounted for 80 percent of the contracts traded on all commodity exchanges in the nation.

The spectacular gains in contracts traded shown in recent months by commodities exchanges must be viewed, of course, in the context of recent temporary surges in commodity prices and relative stagnation in equities markets. But they are, even so, most impressive.

An innovative spirit and willingness to buck substantial odds seem to have paid off in leadership by the Chicago financial community in two other areas. One of these is the new Chicago Board Options Exchange. Since the Options Exchange opened on April 26, 1973, trading volume has increased from an average of almost 1,600 contracts per day during May 1973--the first full month of trading--to almost 12,000 per day during the first two weeks in October. This reflects both the increase in the number of stocks with respect to which options were available (from 16 at the opening to more than 30 currently) and increases in the volume of trading of existing options.

As you are undoubtedly aware, the purchase of an option on the Chicago Board Options Exchange is tantamount to purchasing the right to buy one hundred shares of a common stock at a given price during a particular period of time. Thus, although the actual equities do not change hands, the rights to buy do and the volume of underlying common stock involved is one hundred times the number of contracts bought and sold. With this in mind and with reports that the list of issues on the exchange might grow to perhaps 60 by the end of 1973 it is not startling that some observers are predicting daily volume on the Chicago Board Options Exchange representing more than the daily average volume on the American Stock Exchange. The current average daily trading volume already represents 1.2 million shares.

The Chicago Board Options Exchange is an important recent development for Chicago. Four years of effort and $2.5 million were spent on development prior to the opening date last spring. Now that it is operating and is being much heralded, at least three other exchanges have indicated an interest in providing similar trading in options.

Another example of the initiative which the Chicago financial community has shown in recognizing the potential demand for a financial service and devising a means to satisfy that demand is the development over the past two years of the International Monetary Market of the Chicago Mercantile Exchange. This exchange's stated purpose is to provide "breadth, depth, and resiliency" to the market in which forward contracts in foreign exchange are traded. It set out to achieve these ends by focusing all market decisions at one geographic point and by serving all segments of the market, including speculators with whom the banks trading in foreign exchange had been reluctant to deal. Although still in its developing stages, the International Monetary Market has experienced encouraging growth and appears to be well on its way toward achieving a permanent place on the national financial scene. Despite reservations on the part of some observers as to the role of speculative positions in the foreign exchange market, it is clear that the International Monetary Market is serving an important function.

The awakening of international banking activities of Chicago banks has occurred only during the past fifteen years or so. Yet international banking in the Chicago area dates back to the mid-19th century--a fact that is often overlooked. The heavy participation by foreign investors in the railroad boom of the 1860's led to close financial relationships between Chicago banks and the European banking houses. With the extension of the railroads and the subsequent development of Chicago into the grain and meat-packing capital of the world in the 1870's and 80's, local banks began to participate extensively in export financing. Extensive correspondent relationships between Chicago and foreign banks were developed in this period--and also the establishment of several branches of foreign banks in Chicago.

But the broadly based growth of international banking in Chicago is a much more recent phenomenon. The fact that Chicago has lagged behind New York as a center of international banking activity is probably in part because of the intrinsic disadvantages of its inland location. But, to a large extent, it is simply because of its belated reentry into the field. The Midwest's position as an exporter of agricultural commodities and manufactured goods and its ability to directly export them from the land-locked Midwest following completion of the St. Lawrence seaway was bound, sooner or later, to attract Midwest banks into financing foreign trade. This did in fact occur, beginning in the late 1950's, with Chicago banks taking the lead. As American-based multinational corporations expanded foreign operations in the 1960's, several Chicago banks moved to establish branches abroad. Introduction of the Government's Voluntary Foreign Credit Restraint program in 1965 put Midwest banks at a temporary disadvantage relative to banks in New York because individual bank lending ceilings were based on the level of foreign credit in the past. But despite these ceilings (and they have been relaxed more recently) the growth of international activities by banks in Chicago and other large Midwest cities has moved forward in unprecedented fashion.

Since 1962, when the first current foreign branch of a Chicago bank opened in London, the number of foreign branches of Chicago banks has increased to 42. At the same time, three foreign banks currently have affiliated banks in Chicago and 17 foreign banks have representative offices. With the new Illinois law which became effective just last month permitting foreign banks to establish branches in the central downtown business district of Chicago, the number of foreign banks with banking offices in Chicago is likely to increase significantly over the coming months and years. Illinois state banking authorities have already received applications to establish branches in Chicago from 6 highly respected foreign banks. One has already been approved and the branch opened this past Monday. Indications are that a number of others will be making applications in the near future. In addition to foreign branches of United States banks and United States branches of foreign banks, five U. S. banks have Edge Act corporations in Chicago and 4 Chicago banks have 6 such corporations located in other U. S. cities to handle international business.

Such an interest by Chicago banks in international banking business and by foreign banks in locating in Chicago is reflected in certain balance sheet items of Chicago area banks. From mid-1968 to mid-1973, for example, demand deposit claims of foreign-owned banks against Chicago banks almost doubled. Over the same time period, deposit claims of Chicago area banks against foreign banks increased five times. In large part, this reflects the growth of international correspondent relationships of Chicago area banks as they enlarged their international activities. With respect to loan and investment activities abroad, Chicago area offices, though still limited by the Voluntary Foreign Credit Restraint program, increased claims against foreigners to over $1.1 billion in August of this year.

One measure, however imperfect, of the capability of a financial center to meet any type of financial demand that might be placed on it is the size of its largest institutions. Unfortunately, the structure of U. S. banking dictated by state laws varies widely from state to state and therefore makes suspect direct comparisons of the relative importance of different financial centers using summary measures such as the total deposits of their largest banks. Even with this reservation, however, a listing of U. S. banks in descending order of deposit size shows the Bank of America of San Francisco first with the next six positions occupied by New York banks and the eighth position by Security Pacific National Bank of Los Angeles. The ninth and tenth spots are occupied by Continental Illinois and First

National Bank, respectively, both of Chicago. California has statewide branching; New York will have it by 1976. Illinois, on the other hand, does not permit branches at all.

So these rankings overstate the prominence of New York and West Coast banking institutions, especially if the ability to service large sophisticated customers is considered to be an important aspect of being a financial center. It is clear that all the deposits of the more than 1,000 branches of the Bank of America or all the deposits of the more than 200 branches of the First National City Bank in New York are not available to service credit demands of large customers in San Francisco or New York. They are retail-oriented banks and a large proportion of their resources is committed to lending in the local small business and consumer loan markets. If banks in the various cities were ranked by the deposits they have available for meeting loan demands in the city itself, Chicago banks would stand considerably higher. Nevertheless, the very centralization of the management of these branch systems in New York and San Francisco is itself an example of a service being rendered by a financial center to a broader area. To that extent, we may infer that branching restrictions have impeded Chicago's development as a financial center.

I do not mean to ignore other banks in Chicago and their significant contributions to Chicago's financial environment. As of December 31, 1972 the city of Chicago had eleven banks in the largest 300 United States banks according to deposit size. Five of these banks had total deposit liabilities of more than $1 billion each and aggregate total deposits of over $26.5 billion. Of all cities in the United States only New York had a larger number of banks among the top 300 according to deposit size. In terms of total deposits of all its commercial banks, Chicago ranked third--even with no branching--behind New York and San Francisco.

The Illinois branching prohibition is not the only statutory impediment to Chicago's development as a financial center. Illinois law also prohibits the formation of multibank holding companies, a means by which banks in other states with restrictive branching laws achieve some of the benefits of branching. Without entering into the current discussion over the merits or demerits of these structural restrictions--and clearly their effect on the financial development of Chicago is less significant than the broader issue of public interest--one can say that, in their absence, Chicago banks would form the nuclei of statewide banking organizations of one form or the other. Late in the 1960s several of the larger Chicago banks saw what they perceived to be an escape from the severe restrictions on the geographical scope of at least a part of their operations: the one-bank holding company. So long as they controlled only one bank, such companies were exempt from regulation by the Federal Reserve and could engage in nonbank activities without limitation on their nature or location.

It was a foregone conclusion, of course, that once a substantial number of large banks attempted to utilize the one-bank holding company to escape legal restrictions, legislation would be enacted to limit that opportunity. Thus, the Bank Holding Company Act Amendments of 1970 subjected one-bank holding companies to Federal Reserve regulation, restricted them to those activities "closely related to banking," and established a strict public interest test for proposed acquisitions. Nevertheless, in its adminstration of the amended Bank Holding Company Act, the Board of Governors has not seen fit to impose geographical restrictions on nonbanking activities, and Chicago banks have taken full advantage of this freedom to acquire, or establish de novo, financial service organizations with offices throughout the country.

At present 42 of the 95 banks in the city of Chicago, including the 13 largest, are subsidiaries of one-bank holding companies. Their $23 billion of domestic deposits represent over half of the total domestic deposits of all banks in Illinois. Among the excursions by the largest Chicago banks into nonbanking activities with a broad geographical dispersion of operations have been the acquisition of two large mortgage companies, a Florida trust company, and the establishment of an investment advisor to a real estate investment trust in California. Pending is a proposal to acquire a consumer finance company with offices in more than 30 states. A large Midwestern bank outside Chicago has applied for permission to acquire a savings and loan association in Arizona and another to establish de novo a mortgage guaranty insurance company to compete with existing companies in the national market. If these applications are approved Chicago banks can be expected to come forward with similar proposals.

As a partial offset to the limitations of restrictive branching and holding company laws in Illinois, an extensive correspondent banking network throughout the Midwest has developed over the years, with Chicago banks taking the dominant role. Through this correspondent network smaller banks receive both credit and non-credit services from their larger city correspondents. Some of these services are simply not available at the local level. Some others may be available but in inferior quality or at unattractive prices. Chicago area banks compete vigorously to supply these outlying banks with demand deposit accounting, investment and portfolio advice, computer time, and other services.

In addition to the flow of services from the city correspondent banks, the correspondent network permits Chicago banks to draw on the resources of smaller banks through such devices as the Federal funds market. Smaller banks are typically net sellers in this market and use their city correspondents to effectuate their sales. During periods of tight money and relatively high interest rates, smaller banks many times find the Federal funds market relatively more attractive and increase their net sales. In the first half of 1973, for example, net purchases of five large Chicago banks averaged over $2 billion per day. Net sales of Federal funds by smaller banks in the Seventh Federal Reserve District alone averaged $1 billion a day.

Other Chicago financial institutions--some of which are among the largest institutions of their kind--expand the range of financial services available in Chicago. A list of the largest finance companies in the U. S., for example, shows Chicago with a consumer finance company, a commercial finance company, and a sales finance company among the leaders. There are almost a dozen brokers and/or dealers headquartered in Chicago who managed or comanaged over 130 bond and equity issues in the calendar year 1972. Chicago's government security and equities markets are second only to New York. In addition, the insurance industry plays a large role in Chicago financial scene with several of the Nation's leaders headquartered here. And I haven't even mentioned the strength of Chicago's financial giants in the savings and loan field.

In this brief sketch of the past development and present status of the Chicago financial environment, I have had to touch lightly on a large number of important events and to ignore in their entirety certain others. I have only tried to put in perspective where our city now stands as a financial center and how it got there. Before passing the baton to the other speakers on our program, however, I would like to pose several questions that may serve as a prod to the discussions that follow. First, is it important whether Chicago is a financial center? The answer is yes. One might overstate the case somewhat by asserting that Chicago's future as a viable city may depend on it. Although the trend is still in its incipiency and there is uncertainty as to its eventual outcome, the past decade has seen some erosion of Chicago's industrial base. For a variety of reasons, some related to labor costs, others to deteriorating social overhead, crime, and a general decline in the amenities of urban living, companies have been migrating to the suburbs, small towns, and other cities--often outside the Chicago area entirely--where problems are more easily solved. One obvious remedy, albeit no panacea, for Chicago's problems would be to develop further specialization in financial services to help replace some of the industrial activity it is losing. A similar substitution of financial activities for declining industrial activities has been observable for years in both London and New York, particularly the latter.

Of course, it is a big jump from noting these developments elsewhere to advocating a conscious strategy to enhance Chicago's developments as a financial center. Several questions occur immediately: How much effect can deliberate policies, public or private, have on the outcome in the face of the awesome forces of the marketplace? Even if Chicago were to realize its maximum potential as a financial center, would the employment and income thereby generated serve to offset much of the industrial emigration? Just what can be done to assist or lubricate Chicago's development in the desired direction? What costs would such actions entail and what would be the ultimate benefits to the Chicago business community and the public at large?

One must guard against local chauvinism in weighing the alternatives. As in the case of international trade, it is easy to fall into the protectionist fallacy that everything can and should be produced locally. We should remember that our city, like all others, has comparative advantages in producing some goods and services and comparative disadvantages in producing others, and not tilt with windmills in an attempt to make Chicago a self-sufficient island.

On the other hand, several factors argue against a too casual consideration of all conceivable pros and cons in weighing proposals that might affect Chicago's future as a financial center. One is that the intercity competition for the status and benefits of being a financial center is essentially a zero-sum game--i.e., Chicago's gain would be Detroit's and Omaha's loss (or New York's loss)--so what does it matter. Another is that, in contrast to commercial or industrial development, where location depends heavily on such intrinsic factors as readily available transportation, tax rates and access to natural resources and population, the location of financial activity is much more likely to depend on historical accident or on initiatives taken at some time in the distant past. The essentially spaceless character of such highly organized and impersonal markets as those for short-term Treasury securities or the equities of large corporations means that they can locate anywhere satisfactory facilities are available--particularly in these days of exciting new developments in electronic data transfer. However, once a market is firmly established in one place, sunk costs of physical facilities and the gradual development of external economies tend to make the original location decision irreversible.

In summary, I must conclude that Chicago has a great future as a financial center. But that future will rest largely on our innovativeness in competing vigorously with not only New York and London and Frankfurt and Tokyo, but also with our sister cities in the Midwest--Detroit, Milwaukee, Indianapolis, St. Louis, Minneapolis, Kansas City, just to name a few. Chicago's future as a financial center will see development unanticipated by anyone in this assembly. We all know that the continued growth and prosperity of Chicago's financial community will depend more on its ability and willingness to continue to innovate and take new risks than on any argument that, because of its large population and industrial base, Chicago "ought to" rival New York as a financial center. We are number 2 in our nation, but like in the auto rental business let's be sure "we try harder." It is the key to greater achievement.