Art & Finance Report 2016

4th edition

EXPERT
OPINION

Phillip Ashley Klein
US Art & Finance
Coordinator

Patricia Pernes
Tax Consultant
US Art & Finance Group

Michael L. Klein
Consultant
US Art & Finance Group

Art-secured lending in the US—industry trends & developments

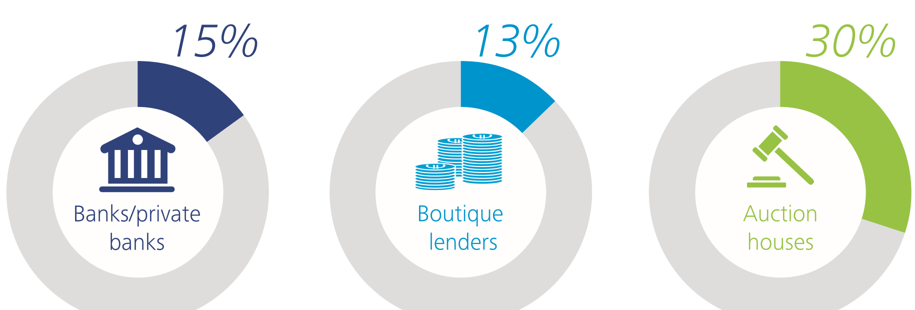
Deloitte US has conducted an in-depth analysis of the art-secured lending market in the US

The US art-secured lending market is expanding rapidly, aided by low interest rates, an expanding art market, and an attractive legal environment provided by the Uniform Commercial Code (UCC). We estimate that the overall market stands at US$15B to US$19B (value of average loans outstanding).

Of the three market segments, private banks (e.g., U.S. Trust, Citi Private Bank, J.P. Morgan Private Bank, Northern Trust Wealth Management, Emigrant Bank Fine Art Finance, Wells Fargo Private Bank, Morgan Stanley Wealth Management, Goldman Sachs Private Wealth Management, Deutsche Bank Private Wealth Management, and U.S. Bank Private Client Group) dominate the market with a loan book size of US$13B to US$15B with a 5-year annual growth rate of 13 percent.

Auction houses (Christie's, Sotheby's, Heritage, Phillips, and Bonhams) are a distant second with US$1B to US$1.4B in lending capacity with a staggering 5-year annual growth rate of 30 percent. Boutique collateralized lenders (e.g., NewOak, Art & Finance Partners, Art Capital Group, Athena, and Special Opportunity Funds) have a market size of US$700K to US$1.2B with 15 percent 5-year annual growth.

Figure 23. 5-year average annual growth rate by market segment



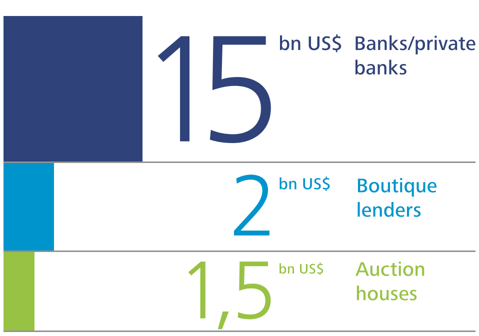
Source: Deloitte Luxembourg & ArtTactic Art & Finance Report 2016

Table 2: US Art-secured lending stakeholders

Client segment	Lenders	Loan portfolio size	Avg. interest rates	5-yr annual growth rate
Banks/ private banks	- U.S. Trust - J.P. Morgan - Citi Private Bank - Goldman Sachs - Emigrant Bank - Northern Trust - Morgan Stanley Wealth Management - BNY Mellon Private Bank - CIT Private Bank	US$13B to 15B	Libor + 1 to 3%	15%
Boutique lenders	- Borro - NewOak - Athena - Art & Finance Partners - Artemis - Special Opportunity Hedge Funds - Family Offices	US$700K to 1.2B	Libor + 7 to 15%	13%
Auction houses	- Sotheby's - Christie's - Heritage Auctions - Phillips - Bonhams	US$1B to 1.4B	Libor + 5 to 7%	30%

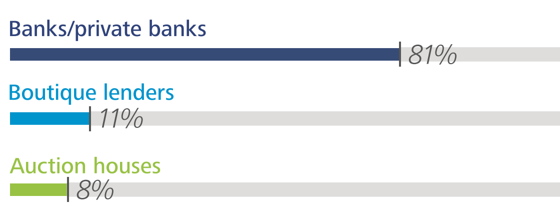
Source: Deloitte Luxembourg & ArtTactic Art & Finance Report 2016

Figure 24. Market size (value of outstanding loans in billions US$)



Source: Deloitte Luxembourg & ArtTactic Art & Finance Report 2016

Figure 25. Market share by segment



Source: Deloitte Luxembourg & ArtTactic Art & Finance Report 2016

The US art-secured lending market is growing significantly. We estimate the US art-secured lending market has grown by 15 to 20 percent annually over the last five years (measured by value of loans outstanding). Growth is being driven primarily by private banks responding to clients who increasingly view their art collection as a source of capital in a low interest-rate environment. Several private banks have entered or re-entered the art-secured lending market in the last three years. The second major growth driver comes from auction houses that have expanded or launched art-secured lending services. Albeit the smallest, a potentially important driver of future growth has been the expansion of non-recourse asset-backed lending from hedge funds and boutiques, like Athena, Art & Finance Partners, and Borro. Speaking on industry growth, Keith Banks, CEO of U.S. Trust, says collectors are now "more keenly attuned to art as an asset for both its aesthetic and economic value, and more are leveraging their collections to create liquidity to take advantage of opportunities across all parts of the spectrum."

The US continues to dwarf other markets. One multi-national bank we spoke with boasts US$2 billion lent against art in the US, but zero outstanding art loans in Europe. This is primarily driven by the legal environment of the UCC under which lenders register their security interest in the collateral and borrowers remain in possession. Because the physical location of the work of art is the operative factor, multinational banks allow non-domiciled clients to transfer art to the US to collateralize a loan. The pragmatism of the UCC is mirrored in the mindset of US collectors. Michael Plummer of Artvest Partners LLC explains that in Europe there is a strong negative connotation surrounding borrowing against one's art, equivalent to going to the pawnshop, which came out of the hard times families went through following WWII. But "art-secured lending grew out of New York City's financial culture," Plummer says. Unlocking the liquidity of one's art for investment purposes is the US mindset.

Private banks are growing the art-secured lending business. The four largest art lenders, Bank of America (U.S. Trust), J.P. Morgan Private Bank, Citi Private Bank, and Wells Fargo Private Bank, have collectively grown their art-secured lending businesses by 15 to 20 percent annually over the last five years. Credit exposure remains highly concentrated in real estate, allowing banks to lend more aggressively against alternative forms of collateral, such as art. Loans in this space tend to be full-recourse, fully secured, and priced based on the credit worthiness of the borrower rather than the value of the underlying collateral. Suzanne Gyorgy, Head of Citi Art Advisory, notes that the broader art market's rapid rise is causing banks to use art-secured lending as an entry point into new client relationships. Private banks also increasingly view art-secured lending as a revenue driver rather than simply an accommodation for existing clients. John Arena, Bank of America Senior Credit Executive for Fine Art, notes that Bank of America has seen significant growth in its art-secured lending business and "is expanding into new art genres and mediums, such as Latin American and Cuban art." Several private banks are in the early stages of developing a more fully integrated suite of services (e.g., lending, wealth planning, and advisory) to meet the evolving demands of their clients.

New private banks are lending against art. While old-line lenders like U.S. Trust, Citi Private Bank, and J.P. Morgan still dominate the space, new players have entered the market. Northern Trust Wealth Management recently began lending against art and is one of the only private banks willing to fully collateralize their loans. Dan Desmond of the recently launched Blue Rider Group within Morgan Stanley Wealth Management notes that his firm now provides art loans to larger clients, while Goldman Sachs Private Wealth Management has in recent years significantly expanded the firm's custom credit business (which includes art loans). Several private banks like UBS offer art loans via a third-party arrangement with Emigrant Bank Fine Art Finance in New York City. Other institutions are using club deals where the lead lender syndicates the loan to other banks as a way to reduce exposure. A scan of UCC filings indicates that these club deals are proliferating, with many of the largest art lenders participating. Deloitte expects the number of club deals to increase significantly in the near term as more private banks aim to service art collectors with a lower capital commitment.

© SUMO/*Cool Man Cool*, 2015, Acrylique & aérosol sur toile, 120x80cm

Collectors are more comfortable with monetizing their art. According to a recent Barclays report, 10 percent of US wealth is held in pleasure assets like art, wine, and classic cars. This is reflected in wealth advisors paying more attention to how these assets, and especially art, behave when held as a capital asset. Our Deloitte Art & Finance Survey has shown over the years that collectors increasingly view their art with an eye on investment. This cultural shift is congruent with the rapid expansion and professionalization of the art market more broadly. John Arena of Bank of America says, "collectors are more comfortable using their art to unlock capital to buy more art or invest in a fund or new business. Borrowers now use interest-only revolving credit lines, which allows them to repay the loan as cash is generated from recurring income sources or liquidity events." Michael Plummer of Artvest explains that the stigma previously associated with using art as collateral has largely disappeared and the practice is becoming more commonplace in estate planning situations. Andy Augenblick, President of Emigrant Bank Fine Art Finance, sees "older collectors borrowing against their art like a reverse mortgage to access to equity in their collection. They can defer repayment of the loan until death and benefit from the step-up in tax basis so they don't have to pay capital gains tax by selling during their lifetime. We also see divorcing couples borrowing to fund a divorce settlement. Often the art is marital property. One spouse wants the art. The other spouse wants to receive half the value of the collection which is funded through an art loan."

New players in the middle market. While private banks dominate the space, the emergence of boutique lenders and mid-market private banks presents more options for borrowers who may want to borrow on a non-recourse basis. Collateralized debt funds, auction houses, and asset-backed lenders lend at higher rates but are far more flexible and creative in deal structuring. Following its 2015 acquisition of OneWest Bank of California, CIT Group's Private Bank, led by Jay Sanders, former head of Structured Lending at Merrill Lynch, is developing a suite of art banking services including term loans for collectors and gallerists with much lower minimums than other private banks. Andrea Danese, CEO of recently launched Athena Art Finance, notes that "better data and increased market transparency lets new players complete more complex transactions." Eric Manley, Managing Director at NewOak, a New York based investment bank, said that his firm sees "good deal flow since they launched a coverage group focused on art and exotic assets back in 2009."

Auction houses are acting more like financial institutions. Leading auction houses are accelerating their move into financial and advisory services in an effort to achieve growth in a business beset by competitive pressure and margin compression. Sotheby's Financial Services is by far the largest asset-backed art lender in terms of both committed capital and annual loan originations. In 2015, the firm expanded the credit facility with GE Capital dedicated to its finance business to approximately US$1 billion—an 88 percent increase from their previous line. During the same year, the company's average loan portfolio

One major auction house we spoke with contemplated securing art loans with short-term commercial paper, but ultimately deemed the liquidity risk too high

grew 26% to US$733 million versus the prior year and the finance business revenues reached $65 million, a 38% increase compared to 2014. "Even though the lending service was historically used primarily as a tool to attract consignments, it is now treated as a standalone finance business with its own performance targets," noted Jan Prasens, Managing Director of Sotheby's Financial Services. Christie's has historically opted not to use firm capital for art-secured lending, instead referring clients to boutique lenders, but the house is again considering expanding its financial services division via capital partnerships. Smaller houses, like Heritage Auctions, have set up credit lines with financial institutions to aggressively compete for consignments, or as Mike Haynes, Heritage Auctions CFO, puts it, "to accommodate clients who simply want to monetize their art without removing it from the wall." Auction houses are moving down market, now offering bridge loans as small as US$40,000 to secure consignments for day sales. As the market matures, we expect to see art-secured lending as a core service of every major auction house.

Art loan securitization faces hurdles. Lenders are exploring the possibility of securitizing art loans as a way to lower the financial risk of carrying art on their balance sheet. Securitization could take the form of Art Collateralized Debt Obligations (ACDO) or an Art Credit-Default Swap (ACDS). Such structures would enable lending institutions to transfer the financial risks to market participants who want the exposure and fee payments. One major auction house we spoke with contemplated securing art loans with short-term commercial paper, but ultimately deemed the liquidity risk too high. Still, Andrea Danese of the recently launched boutique lender Athena has ambitions to create a market for securitized art-backed debt. For now, however, the broad consensus from credit executives, hedge fund managers, and auction house professionals we spoke with is that art loan securitization is not on the near horizon. Our belief is that the art collateralized debt market will start with bespoke deals between auction houses and hedge funds or art funds. We do not expect large lending institutions or private banks to securitize art loans any time soon.

Risk mitigation tools are slow to catch on. Lenders find that the provisions of the UCC offset the need for safeguards such as title insurance, a sign that art-secured lending is fairly low risk. Pip Deely, member of the New Museum's NEW INC tech incubator explains that the real risks of art-secured lending do not involve possession. Eric Manley of NewOak noted that lenders would rather rely on appraisers for valuation, attribution, and authenticity than add an insurance rider. Furthermore, most banks we spoke with say that borrowers are simply unwilling to digest the extra 1.5 to 2.5 percent in fees for a policy. One exception that may call for a policy is in succession situations. John Arena of Bank of America only uses title insurance "if a client is in an estate planning situation where the fiduciary or heirs are unaware of the provenance or how the art came into the deceased's possession."

The art-secured lending space is ripe for innovation

- *Alternate sources of credit:* "post credit crisis, collectors are more concerned about liquidity, which has given rise to alternative sources of credit like peer-to-peer platforms," says Eric Manley, Managing Director at NewOak.
- *More robust data tools:* better data tools are being developed to aggregate art prices and performance metrics into a language that financial institutions and investors are more familiar with.

- *Blockchain:* banks are beginning to examine blockchain technology to improve the loan process. "As a programmable protocol, it will provide more flexibility for creating loan structures and ease in monitoring interest payments," says Pip Deely of the New Museum's NEW INC tech incubator.
- *Bridging the gap:* Fintech and peer-to-peer lending could connect smaller loan providers and niche lenders to the larger banks to provide loans in the US$10K–US$250K range.

Potential growth headwinds in the art-secured lending market

- *Interest rates:* a rise in interest rates will raise the opportunity costs of holding cash-negative assets like art, which may put downward pressure on overall demand for art loans in the future.
- *Tight credit:* art-backed lending increased in 2009, as borrowers monetized their art to meet short-term liquidity needs; however, a systemic drop in financial system liquidity would reverberate strongly in the art-secured lending market.
- *A fall in art prices:* could cause margin calls on outstanding loans, as was the case in 2008 and earlier in 1990. Causes could range from a drop in the value of an artist's name to a poor auction season. Lenders would ask borrowers to pay down loans or collateralize more art to keep the loan.
- *Default:* a sizable art loan default could cause certain private banks to reassess their strategy and tighten lending practices.
- *Underwriting:* laxity in underwriting standards could lead to mistakes and potential defaults.

Recent developments in US art-secured lending

Sotheby's,[29] under its Sotheby's Financial Services branch, increased its overall credit facilities by US$484 million to now total approximately US$1 billion (US$1.3 billion for all of Sotheby's), providing for a dramatic increase in the amount of credit it can offer clients. The auction house is growing its finance business through collaboration with GE Capital, its administrative and collateral agent. GE Capital Markets, JP Morgan Securities, and HSBC Bank are joint bookrunners.

Bank of America[30] is seeking to double the art loan amount it has outstanding, currently at US$3 billion, according to Bloomberg on 20 October 2015. The expansion strategy is based on offering basement interest rates to UHNW clients. Based on regulatory filings, the institution is shown to have provided art loans to prominent finance industry clients, most recently Steven Wynn, who, according to Bloomberg, secured a loan at under 1 percent in exchange for pledged works. This is congruent with actions taken last year alongside art loan industry competitors like Citigroup Inc., JPMorgan Chase & Co., and Goldman Sachs.

Athena Art Finance Corporation[31] launched in October 2015 with US$280 million of equity capital led by Carlyle Group and Pictet Group, a Geneva wealth and asset manager. Based in New York and looking to expand its physical presence to London and Geneva in 2016, Athena will offer loans exclusively collateralized by high value works of fine art to UHNW individuals and family offices. Loans will start at US$1 million at 50 percent Loan To Value (LTV) and range from typical terms of six months to seven years.

Blue Rider Group,[32] launched by Morgan Stanley in July 2015, will provide financial services to the art community. The bank began to increase its lending book in 2013 with growth benchmarks set for 2015 and beyond. The group will function under a family office approach and, in addition to financial services, will provide advisory services to collectors, artists, artist foundations, galleries, museums, non-profits, and academic institutions seeking to manage their broader investment portfolios.

29 *www.privateartinvestor.com/art-finance/sothebys-increases-its-lending-power-to-attract-customers/; http://www.monitordaily.com/news-posts/ge-capital-agents-sothebys-credit-facility/*

30 *www.bloomberg.com/news/articles/2015-10-20/the-1-find-deal-from-banks-to-match-their-status-1-art-loans; http://www.bloomberg.com/news/articles/2014-05-06/goldman-sachs-supports-cohen-with-loan-backed-by-fine-art*

31 *www.finalternatives.com/node/31888; http://www.nytimes.com/2015/10/09/business/dealbook/carlyle-in-art-financing-venture.html?_r=1*

32 *https://news.artnet.com/market/blue-rider-group-morgan-stanley-interview-344885; http://www.morganstanleypwa.com/blueridergroup/; www.reuters.com/article/us-morganstanley-wealth-idUSBRE9B305Y20131204*

ArtAssure, the specialist asset lender, has shifted its strategic focus to follow the auction seasons, offering prospective sellers advances of up to 50 percent of the loan to value of the collection's auction estimate for collections or items valued above US$500,000. The rates are congruent with the specialist lender rate of between 10 and 15 percent.

Borro, the online personal asset lender, has introduced a new term loan product, providing loans for periods of 18-36 months, with monthly interest rates from 0.99 percent. Clients can secure loans of up to US$10 million with a minimum value of US$100,000. The company's newly launched mobile app expedites the loan application process and eligible customers can have money in their bank account in less than 24 hours. Unbolted is a new UK p2p platform asset lending company offering loans and sale advance loans for prospective auction buyers. Requiring no credit, only proof of UK residency, the company lends against works with a secondary market in the UK, with loans from £20,000 to £1,000,000.

Willstone Management, having previously secured a US$100 million credit line from a pair of New York hedge funds, has re-thought the opening of its second office, and set its sights on China rather than, as previously intended, New York, citing Chinese stock market volatility as an opportunity for business growth.

Rosenthal&Rosenthal, a privately held financing company that offers specialized asset-based lending to art dealers and galleries, welcomed a new head of asset-based lending in March 2015. Rob Miller intends to double the company's ABL unit from a US$300-million portfolio over the next few years. The company offers a variety of art financial products, including acquisition loans, revolving credit loans against collateral and 3-6 month bridge loans. The loan size ranges from US$800,000 to US$8 million at around 40 percent LTV at 8-13 percent rates.

New European Developments

The Fine Art Fund Group is launching a new business, Fine Art Financial Services, which will provide loans secured against high quality works of art and jewelry. Fine Art Financial Services is open for investment from March 2016 and expects to be making loans available by May 2016. Fine Art Financial Services will provide art-backed lending solutions, ranging from US$250,000 to US$50,000,000, for collectors and owners of art and jewelry who may have immediate liquidity needs or require longer-term financing to facilitate the release of investment capital from collections.

Peer-to-peer lending against art and collectibles new addition to the art secured lending market: The market for art secured lending has been growing in the last 5 years, with advent of more traditional bank lending as well as the growth of asset based lenders, such as Borro. The newest addition to the art secured lending space is Unbolted, an online-only, peer-to-peer (p2p) lending platform allows borrowers to receive immediate funds against their personal assets. With the US p2p lending market alone expected to reach $350 billion by 2025[33], there is clearly potential to develop a p2p model also around lending against personal assets such as art and other collectibles. However, the challenges outlined in this report such as lack of market liquidity, fair market valuation, authenticity and provenance issues will remain significant obstacles for this industry to grow.

Vastari and Overstone have come together to provide a new art-secured lending service, whereby collectors, corporates bodies, and family offices can leverage against their works of art in exchange for the right to place the star pieces on short or long-term loan with major institutions interested in exhibiting the artwork. The Pledge Loan product focuses on deal sizes starting at US$3 million. Overstone undertakes the financial side of the deal, conducting stringent due diligence and connecting the borrower with reputed non-bank lenders. Vastari will conduct a survey to identify the appropriate institution for displaying the work of art and connect the two parties.

33 Source: Research & Markets http://www.researchandmarkets.com/research/qhjr6v/us_alternative