

TEFAF

ART DEALER FINANCE 2018



CHAPTER 1

INTRODUCTION

How do art dealers finance their day-to-day business activities? What sources are currently being used and what types of funding are available? How do these businesses, often with unpredictable sales patterns, sustain their financial health during the ups and downs of the art market cycle? These are aspects of the art business which are seldom discussed, hence very little information or data currently exists on this topic.

Through interviews with 142 of the dealers and galleries participating in the TEFAF art fairs, we have gained insights into this influential group of dealers and how they currently manage their finances. Although, the sample is not necessarily representative of the dealer and gallery population as a whole, particularly due to the stringent vetting and selection criteria of the TEFAF art fairs - it does represent the category of dealer and gallery that financial institutions and lending providers would potentially consider 'acceptable' risks for lending purposes.

The other aspect of the research, looks at gallery/dealer financing from a lender's perspective. In discussions and interviews with key finance providers (private banks, commercial banks and asset-based lenders), this report also looks at some of the key challenges that this industry faces when providing finance to the art dealer community, and what can be done to address these frictions.

Throughout the report we have included opinions, thought-pieces and Q&As with experts involved in the art lending and financing industry from provider, legal and financial perspective.

We hope this new digital report will become a resource for galleries and dealers, to raise awareness of what finance options are available and when they might be appropriate to use. For the providers of finance, we believe the report will give some insight into how art dealers are currently financing their activities, and articulating some of the challenges

that are stopping the market from reaching its full potential.

As much as we have tried to provide answers to some key questions and objectives for this research, the findings also bring up a range of issues that remain unresolved. We hope others might be encouraged by the findings and the challenges, and help the industry work towards new finance solutions, products and services - fit for the 21st century art gallery and dealer model.

I would like to thank all of the TEFAF galleries and dealers that participated in the survey, as well as all the finance providers that we have been interviewing over the last two months. Also, a big thank you to our expert contributors who added a new and different dimension to the report findings by sharing their insight, knowledge and expertise.

I hope you find this an enjoyable read!

Anders Petterson

Founder and Managing Director, ArtTactic



CHAPTER 2

KEY FINDINGS

SMALL MARKET WITH A BIG POTENTIAL?

Art-based finance to dealers account for under 10% of the overall art-secured lending market: The current value of loans to galleries and dealers is estimated to be between \$1.4 billion and \$2.1 billion, or 8-10% of the global art secured lending market, which in 2017 was estimated to be between \$17-20bn [1] in loans outstanding against art.

US art dealers benefit from a more developed asset-based art finance market: Although it is difficult to put a precise figure on the geographical share of the art secured lending market, lenders and finance providers estimated that more than 90% of global art secured lending to art dealers is to be underwritten in the US, where most of the art secured lending business is taking place at the moment.

Less than 10% of dealer inventory value in 2017 financed by debt: The findings of this report estimate that leverage (value of loans against art) accounts for between 5-8% of the gross dealer sales (inventory) [2]. This is significantly lower than other retail industries, where the average leverage ratio is between 46-70% [3].

1 Source: Art & Finance Report 2017, Deloitte and ArtTactic. These figures include both recourse and asset-based loans.

2 This estimate has used the findings from the The Art Market Report 2018 from Art Basel and UBS, which estimated dealer sales to be \$33.7 billion in 2017. We have used a conservative 30% margin to calculate the gross inventory value, which equates to \$25.9 billion. To calculate the debt-to-asset ratio we have used dealer related financing of \$1.4 - \$2.1 billion as a share of the gross asset value. This gives us a debt-to-asset value of 5-8%.

3 Source: <https://www.moodys.com/sites/p...> and The Art Market Report 2018 Art Basel and UBS, p.59

IS THE LACK OF AN INTERNATIONAL LEGAL FRAMEWORK THE MAIN IMPEDIMENT TO GROWTH?

The US art-based lending market benefits from a more advantageous legal framework:

The Uniform Commercial Code (UCC) allows the borrower to keep possession of the art works while the loan is still outstanding, which is of great advantage for dealers. This makes this type of financing significantly more attractive than in countries where the lenders are more likely to take physical possession of the art work.

The European legal framework remains fragmented: Although there are proposed changes to the law in different European countries around the registration of charges over chattels, similar to the UCC code in the US, the lack of a pan-European uniform legal framework remains a hindrance for the future development of the European art-secured lending market.

Experts believe an international legal framework could be the greatest catalyst for the art lending industry: According to art lending experts, if international jurisdictions like the UK, the Euro Zone, and Hong Kong created a legal framework akin to the Uniform Commercial Code in the US, which would enable lenders to protect their interest in tangible assets while allowing borrowers to maintain possession, this could act as real catalyst for growth.

WHAT ROLE DOES DEBT FINANCING PLAY IN THE DEALER INDUSTRY?

Low leverage among dealers: The average debt-to-asset ratio among the 142 TEFAF dealers surveyed was 7% (including real estate) and 5% excluding real estate. The majority, 64% of dealers said they had 0-9% in debt-to-asset ratio, including real estate (56%, of the dealers and galleries surveyed said they had no debt at all).

Higher leverage ratio among dealers who have used art-secured lending: The average debt-to-asset ratio for dealers who have used art secured lending is 15% (including real-estate), and 11% excluding real-estate. This is more than double the average of the overall gallery sample. However, with 75% of this group of dealers saying they obtained the art-secured loans through Private Banks, it suggests that the higher leverage is a sign of dealers who are able to use their own personal wealth (including art) to obtain inexpensive funding through their private banking relationships.

Higher leverage among galleries dealing in Impressionist, Modern and Contemporary art: Comparing the use of leverage (excluding real estate) between different art market sectors, there are signs that dealers who tend to focus on Impressionist, Modern and Contemporary art have higher leverage than dealers focusing on other collecting categories. This observation is likely to correspond with the fact that most art secured lenders would concentrate on the largest and most liquid segments of the art market. In 2017, Impressionist and Modern together with Post-War and Contemporary art accounted for 50.8% of Sotheby's, Christie's and Phillips annual auction turnover, up from 46.1% in 2016.

Dealers perceive the risk of art finance too high given the unpredictability of sales: 36% of the art dealers said that they perceived the risk of using loans against their inventory high to very high. The main reason for this was the lumpiness and unpredictability of the art market when it comes to gallery sales.

Half of the dealers are 'concerned' about a major liquidity event. Although, the majority of dealers surveyed have managed to build up a strong capital base and are using retained earnings as a way of growing and running their businesses, there are still concerns about a major liquidity event. 25% of dealers surveyed said they were 'somewhat concerned', 17% of art dealers were 'concerned' and a further 8% said they were 'very concerned' about their liquidity in an art market downturn. This suggests that despite galleries having adapted to the unpredictability and volatility of art sales over the years, a major liquidity event such as the downturn in 2009, remains a significant threat to dealer businesses.

HOW ARE DEALERS CURRENTLY FINANCING THEIR BUSINESS ACTIVITIES?

Retained earnings: The large majority of art dealers are using their retained earnings to fund most of their business activities; from running the space, buying inventory, working capital and running an ongoing programme of exhibitions and art fairs. 90% of the dealers said they would finance their inventory through retained earnings.

Private investors: Survey findings signal that co-investment from private investors is often preferred to debt-financing for opportunistic investments. 63% of the dealers said they often involve co-investors when they see new business or investment opportunities. 28% of the dealers surveyed also said that they would use private investors to finance inventory, and 6% of the dealers said they would involve private investors in financing gallery space and real estate.

Bank financing: 29% of the dealers said they used commercial bank loans for financing their working capital needs, another 14% have involved commercial banks in their real estate, and 11% and 12% of the dealers are using commercial loans to manage their inventory and investment opportunities. Some dealers also draw on their private banking relationships for art related financing.

Art-based lending: Despite 15% of dealers saying that they had used art work(s) as a collateral for a loan, either exclusively (non-recourse) or as part of a broader pool of assets (recourse), only a small group of dealers^[4] (4%) say they regularly use art secured loans as a way of financing different aspects of their business.

4 This low figure might be affected by the nature of the TEFAF dealer sample, which is largely European. As the US art secured lending market is significantly more developed, one would expect this percentage to be higher among US dealers.□

CHALLENGES FACING THE ART LENDING MARKET:

Underwriting process bureaucratic and slow: 44% of the art dealers surveyed blamed the lengthy and bureaucratic process in obtaining a loan for the lack of interest in looking at art related financing options. However, lenders say that dealers are often ill-prepared to meet the requirements of KYC, money laundering, credit checks and other due diligence required by the lending institution.

Cost of finance too high: 21% of the art dealers surveyed said that the cost of financing is too high. With asset-based lenders charging anything between 6-24%, asset-based loans are not necessarily suited for long-term financing needs, but could be a viable alternative source for acquisition finance. Even at double-digit interest rates, asset-based financing could be attractive compared to funds provided by investors that may want a significantly higher share of the sales proceeds.

Valuation and due-diligence: 13% of dealers said they did not want the parties to lending transactions to have proprietary information about inventory. Based on interviews with lenders, one of the key stumbling blocks in the underwriting process, is the valuation of art work(s). There is an inherent mistrust among dealers in the valuation used by lenders, often as a result of dealers' perception of retail prices as the market value, whilst lenders would tend to go for the more conservative auction value.

Title and authenticity: Based on interviews with lenders, one of the key challenges in the due-diligence process, is to establish clear title (i.e. legal ownership) of the art work as well as its authenticity. A number of cases were mentioned where consigned works had been presented as collateral for loans, as well as instances of fakes and forgeries. These present binary risks to the lender, who could potentially be left with an object with defective title or an object with zero value. New technology based on the blockchain might provide a solution to this decade old problem in the art market.

FUTURE DEMAND?

Close to a third of dealers expressed interest in art-secured loans: Despite only 4% of dealers regularly using art-based financing, it is interesting to note that 31% of dealers said they would be interested in art secured loans.

Acquisition finance is at the top of the list: 87% of the dealers surveyed said they would like better access to acquisition finance. Dealers currently rely on either retained earnings (59% of the dealers said so) or co-investment from private investors (63% of dealers) for

financing acquisition and new business opportunities.

Access to dealer credit remains poor: 57% said that access to credit for dealers was poor or very poor, which suggests there is a demand for better access among dealers. The threshold to gain access to this funding is high, however, either because of the perceived cost, the cumbersome process or the perceived risk of loan against art. There is a potential to increase the sources of credit available to support further growth of art dealers (and their businesses) in the future but more information and education around the opportunities and risks associated with art secured lending is required, alongside a move towards greater transparency and professionalisation.

Close to 30% of the dealers said that lack of credit hampers growth: 28% of dealers said that lack of access to credit had affected their ability to grow business, with a further 18% saying they were unsure.



CHAPTER 3

ART FINANCE AND LENDING – AN HISTORIC PERSPECTIVE

By Michael Plummer, Managing Director, TEFAF New York

As a Managing Director of TEFAF New York and a Principal of Artvest Partners, as well as having experience at both Sotheby's and Christie's in Art Lending, I have been involved at the intersection of Art & Finance for nearly the last forty years. I began my career working on one of the industry's first term loans, a six-figure credit facility that Sotheby's provided to a dealer, a loan that because of the high inflation at the time resulted in an interest rate in the high teens. Nonetheless, the dealer in question found his market so buoyant, and his clients so eager for his wares, that it became a productive, multi-year arrangement for him... and for the auction house.

New York City has been the leading center in art financing from the start and remains so to this day. As you will read in these pages, some of this stems from a supportive legal structure in the form of a UCC (Uniform Commercial Code) lien system that allows property to be centrally registered and left in the possession of its owners, whether private collectors or dealers. Regardless, I have come to believe there is another, more deep-rooted cultural reason: That Americans do not like to see the capital in their art lay fallow when it can be put to work to make money in other ways. Why, the thinking goes, leave \$X million hanging on the walls when one can get a loan at 3.5% interest from a private bank and invest the proceeds in a business where the returns might be 15% or higher? It just makes financial and business sense.

Several years ago, the well-know hedge fund pioneer and American

collector Michael Steinhardt went public about an estimated \$100 million loan against his art collection from JP Morgan Chase that he used to purchase the former American Stock Exchange building. He claimed at the time that it was an easier and less expensive financing than a more conventional commercial real estate loan secured by the property.

The generally acknowledged pioneer for asset-backed art lending to the dealer community in the US is Rosenthal & Rosenthal. A well-regarded, family owned receivable-factoring business that has its origins in servicing the garment industry, Rosenthal & Rosenthal expanded into asset-backed lending for art in the 1970s and became an important source of capital for the Trade much before Sotheby's, or anyone else, became a meaningful player in the art finance business.

When in 2007 I became Chief Operating Officer in 2007 of Christie's Financial Services, an initiative of that auction house to provide art fund investments and a global lending program, there was a deep cultural divide on art lending on either side of the Atlantic. Where in the US such financing was seen as smart business, in Europe and the UK, there seemed to be a negative aura at worst, and at best, a wariness about the viability of such borrowing on a large scale. Hence while some in this report argue that the lack of availability of a UCC-type lien in the UK, Europe and Asia dampens borrowing activity in these regions, I posit that the lack of such a structure might equally be a reflection of a general reluctance to make these types of activities a priority. For instance, none of the largest European Private banks have art lending programs on the scale of the US-based institutions such Citibank, Bank of America / US Trust, and JP Morgan, each of them institutions with multi-billion dollar loan portfolios.

One important, and historical, aspect of art market credit that is often overlooked is the working capital provided by the larger auction houses. In general, auction houses have always served as a quick source of liquidity for the Trade, and at any typical various owner sale, 50% or more of the property on offer is dealer provided material. This is not at all a bad thing, but a ready and relatively predictable source of cash for dealers – and a critical source of material for the auction houses -- when other elements of a dealer's inventory may be selling more slowly, or on offer at higher "retail" pricing.

Thus for centuries the auction houses have remained an essential source of liquidity for dealers, not just for these auction room sales, but also in the form subsidized working capital that takes the form of thirty-day trade credit, extended payment terms, consignment advances and, in more recent decades, guarantees. Our Artvest estimate is that at any one point in time this adds an additional one to two billion into the art trading economy. Yet this source of capital is

little seen or noticed by most market observers. This is also a reason that when significant market corrections occur, such as those in 1980, 1990 and 2008 and a liquidity crunch hits the art market, it has a multiplier effect: collectors are slow to pay auction houses, auction houses are slow to pay dealers, and dealers stop buying new inventory at auction. In its most extreme state it becomes a vicious, and highly destructive circle. There have been moments in these downturns when even the auction houses themselves have had dangerous brushes with illiquidity.

As a related matter, as art is considered an illiquid asset, meaning that it is not traded daily on an open exchange as are bonds, equities and other financial instruments, the concept of the liquidation value of art (or distressed sale value) has developed overtime that this value is only fifty percent of the low estimate of its auction value. While this is a very rough rule of thumb, and some would argue that it is overly conservative, it is meant to account for other art market realities such as price volatility, high transactions costs (for example auction fees) and the potential for carrying costs should an object not be sold within a few days or months, which is a real possibility in the liquidation of art collateral.

Some feel that the low LTV (loan-to-value ratio) for art loans is more conservative than patterns of default would support for an asset class that has become much more established (and arguably less risky) as a store of value. From the dealers' perspective, the current LTV structure is often inadequate for their business needs. In a crude simplification it goes something like this: The dealer expects to sell his work at retail value, or 100%. The auction house low estimate is pegged at wholesale value, or 50%. The lender then lends against 50% of the low estimate, or in other words 25% of the value the dealer ultimately expects to sell his inventory for. Thus, in too many instances for the dealer, the math just does not add up.

In addition to the bad math of LTV ratios, dealers have a significant challenge in finding lenders who lend against art in their specialized sector of the market. While it is relatively easy to find lenders in deep and liquid markets like Impressionist & Modern Paintings and Contemporary Art, it is quite another thing to source asset-backed lenders in 19th Century Art, Old Master Paintings and Drawings, Decorative Works of Art and Antiquities. Dealers in these segments have long resorted to finding financial backers or partners, giving up a proportional amount of the profit in exchange for a share in the expenditure. While this also reduces each dealer's downside risk in any single work of art, it also slows the growth of his/her business. All things being equal, if a dealer could borrow half of the acquisition cost at 9%, rather than bring in a partner with whom he/she has to share 50% of the profit, the dealer would keep 91% of the profits of every

transaction rather than only 50%. In actual economic terms, this lack of financing, or leverage, acts as a substantial tax on the growth of dealer businesses when compared to other, more fully developed retail industries such as automobiles, real estate and general commercial goods.

So where is art dealer financing headed? There was a transformation in the art industry in the early 00s with regard to the perception of art as an asset and a store of value. This was driven in part by new collectors from the BRIC countries entering the market, by the instability of financial markets in the global financial crash of 2008/2009, by the ready availability of art pricing data and indices, and by the sustained growth of wealth in the ranks of the so-called 1%. And it is a trend that is unlikely to reverse itself in the next ten years.

Yet support services in the art industry (art financing is just one of them) have yet to catch up to the nearly 200% increase in the value of annual art market turnover from 2003 to 2017 (2003 being the beginning of the current art business cycle). While it is inevitable that this now robust and highly active sub-sector of the investment community will attract new technologies, sources of capital, entrepreneurs and innovative business solutions, it is difficult at this moment to see which one or two of them might reach the type of critical mass that tips the scale, and solves anyone of these inherent structural challenges to become a real game-changer.

But the art industry is evolving much more quickly today than it ever has before in its history. Perhaps by the time the TEFAF Art Market Report focuses yet again on this business segment there will be a new and innovative player in dealer financing, one that breaks through these structural challenges and provides this market with this important tool for growth and stability that it needs.



CHAPTER 4

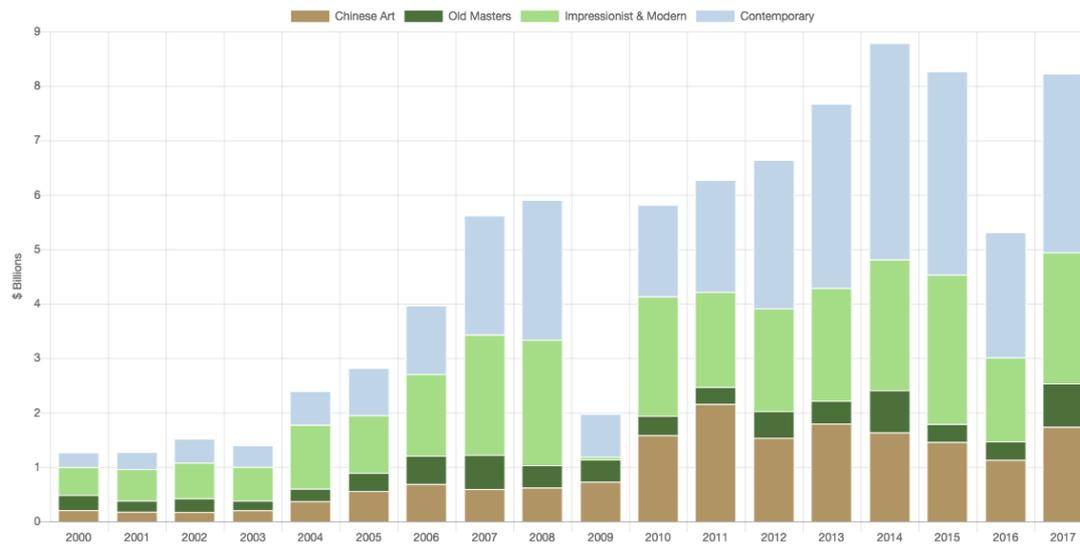
ART FINANCE – GLOBAL PERSPECTIVE 2018

Key trends fuelling the interest in the art finance market

Art Market Expansion 2000 – 2017: The art market has evolved from a niche, connoisseur-driven collectibles market to a multi- billion global industry.

Since the turn of the millennium, the global art market has experienced strong growth and has been subject to an important transformation. During this 17 year period, global art sales have been fuelled by wealth creation, a rapidly growing population of High Net Worth Individuals and further supported by the expansion of the global art market infrastructure. There have been significant investments in galleries, auctions, art fairs, museums, foundations, biennials and new online ventures, which has propelled further demand for support services such as logistics and storage, insurance, legal, and also financial services - the core topic of this report.

Christie's and Sotheby's Auctions Sales (USD) by Category 2000–2017



Source: ArtTactic

The Value of Art: Changing taste and preferences drive the current market

With the advent of new wealth entering the art market, changing taste and motivation for buying art was inevitable. The most noticeable change over the last decade was the growth of the contemporary art market, particularly from 2004 onwards – it is now the biggest sales category for major international auction houses. Increasing demand for the more speculative and liquid contemporary art segment, could potentially signal a change in the reason people are buying art. In the 2017 Art & Finance report by Deloitte and ArtTactic, 50% of the collectors surveyed said that their key motivation when buying art was investment return and a further 36% also wanted portfolio diversification. Trends in recent years suggest that more focus is being put on the economic value of art and its investment potential, which again has triggered a broader acceptance and interest in art as an asset class.

Art as an asset class: Managing, protecting and leveraging the value of art.

With prices for art works approaching half a billion dollars [5], it is clear that art is more than just an aesthetic object. The economic value associated with an art object plays an important role for why people buy, sell and own art today, which means that issues around managing, protecting, enhancing and leveraging this value are also increasing in significance.

Recent findings from the Deloitte Art & Finance Report 2017 estimates global UHNWI art and collectible wealth to be \$1.62 trillion, with the potential to grow to \$2.71 trillion by 2026. 69% of wealth managers surveyed for the Art & Finance report, said they were looking to incorporate art into their overall wealth reporting, signalling a stronger focus on art as a viable asset class within the private wealth management community.

- 5 The most expensive art work sold at auction was Leonardo's 'Salvator Mundi', which sold for \$450 million at Christie's New York in November 2017.



CHAPTER 5

ART SECURED LENDING: A SMALL MARKET WITH A BIG POTENTIAL?

An estimated 1% of art and collectible private wealth is being leveraged [6] today - a tiny figure compared to other industries. In the Deloitte Art & Finance survey in 2016, an estimated 58% of collectors said they would be interested in using their art collection (or parts of it) as a collateral for a loan that could be used for buying more art, 31% said they would use it to finance other business opportunities and 17% said they would use it to refinance existing loans. This signals that for wealthy individuals, there is a significant interest in extracting 'dead' capital locked up in art works, and is also the reason we see the private art secured lending market (particularly from private banks) being significantly larger than the art secured lending market for art dealers and galleries.

There is demand for art-secured finance among art dealers too. This year's survey of 142 TEFAF dealers showed that 31% of the respondents said they would be interested in art secured lending. With an average of 7% debt-to-asset ratio (including real-estate) across the galleries/dealers surveyed, there seems to be room and demand for more debt financing. But why is the leverage so low? What are the key challenges facing the art secured lending market and what is being done to overcome these? Should art be leveraged, and are we increasing the risk in the art market by doing so? These are some of the broader questions we will attempt to address in this research, and we will particularly look at these questions in the context of the financing of art dealers and galleries.

Size and Structure of the Art Lending Market

Based on existing research and new interviews with art finance providers, we estimate the current value of loans underwritten to galleries and dealers to be between \$1.4 billion and \$2.1 billion, or 8-10% of the global art secured lending market. Although it is difficult to put a precise figure on the geographical share of this market, lenders we have spoken to said that over 90% of art secured finance to art galleries/dealers would be underwritten in the US. Some of the reasons for this skew in the market are discussed by Claire Hillier, COO of Borro; it also stems from the differences in legal framework discussed below and by Tim Maxwell, Partner, Boodle Hatfield.

7 Source: Art & Finance Report 2016 and 2017 by Deloitte and ArtTactic. The estimates are based on the findings from the Art & Finance Report 2016, adjusted for the average annual growth rate of 13.3% across the different lending sources and providers.□

8 Based on interviews with private banks, commercial banks and asset-based lenders, these estimates are based on average % share of art loans currently underwritten to art dealers and galleries. For the private banks, these would typically be art-based recourse loans provided to the owner of the gallery/ dealership, who would be a private wealth client of the bank.□

Legal Framework and New Regulations

Based on interviews, art secured lenders estimate that more than 90% of the current art secured lending business takes place in the US. The European art lending market could start picking up pace, if and when, the legal framework becomes more robust around the issue of protecting security interests, in other words protecting a security interest in an asset (mortgaged as a collateral) from claims by other parties. A lien is protected by registering it with the appropriate statutory authority so that it is legally enforceable and any subsequent claim on that asset is given a junior status.

It is exactly this framework, which has given the US a lead in the art secured lending market, supported by the Uniform Commercial Code (UCC). The UCC allows the borrower to keep possession of the art works while the loan is still outstanding. This is possible because the lender can register its security interest in the art on a public register under the Uniform Commercial Code (UCC), thereby putting the world on notice that the art is subject to a charge (or lien).

The European art lending market has been affected by two main factors: 1) the notion of art as an asset class is less developed in Europe than it is in the US and 2) there is no uniform system of registration of charges over chattels such as the US Uniform Commercial Code. Each European country has its own system, many of which are unsuited to a 21st century art secured lending market.

As outlined in the Deloitte Art & Finance Report, however, several European countries have introduced a register of charges against chattels, and with new insurance products coming to the market, one would anticipate the European art secured lending industry to start to gradually catch up with its US counterpart.



CHAPTER 6

ART DEALER MARKET: SIZE, STRUCTURE AND FINANCING

The gallery and dealer market remains the primary engine of the global art market accounting for more than half of global art market sales.

In this year's Art Basel Art Market Report 2018, the total number of art dealers was estimated to be over 296,000 globally, accounting for an estimated \$33.7 billion in annual sales (53% of global art market sales). The report shows that there is a significant skewness in terms of size of these dealerships, with 6,500 dealers representing over 75% of the value of sales in the sector. With regard to the distribution of galleries, US dealers accounted for an estimated 23.3% of the dealer population [9], followed by European galleries accounting for 16.2%, and Asian dealers accounting for an estimated 13.9%, the remaining 46.6% is spread around the world.

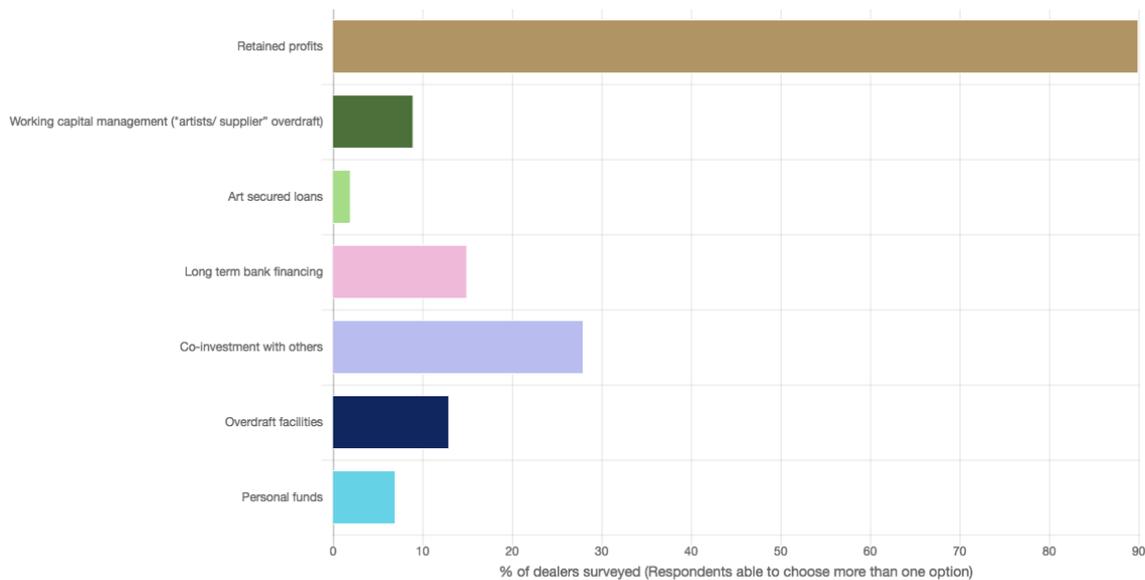
9 Source: TEFAF Report 2016

How do art dealers currently finance their inventory?

Based on interviews with art finance providers, combined with the overall size of the art lending market estimated by Deloitte [11], we have judged the total loans outstanding to art dealers to be in the region of \$1.4 billion to \$2.1 billion. This includes both private banking loans to gallery owners, commercial loans, as well as asset based loans from boutique lenders and auction houses. We assume that the art secured finance (asset-based or bank loans) are mainly used for acquisition purposes. The estimate below may

slightly overstate the amount of debt financing of inventory, as debt financing is also used for other activities such as working capital, exhibitions and art fairs, real estate and other business opportunities. The findings suggest, however, that leverage (value of loans against art) accounts for between 5% and 8% of the gross dealer sales (inventory) [12], which corresponds with the average overall debt-to-asset ratio (including real-estate) reported by dealers of 7%.

These findings also suggest that compared to many other retail industries, which typically see leverage between 46-70% [13], the art market operates with a low level of leverage, and art dealers predominantly finance their business and inventory out of retained profit – further confirmed by the TEFAF dealer survey in the next section of the report.



Legend

Retained profits	90%
Working capital management ("artists/ supplier" overdraft)	9%
Art secured loans	2%
Long term bank financing	15%
Co-investment with others	28%
Overdraft facilities	13%
Personal funds	7%

Source: TEFAF Art Dealer Finance Survey 2018

% of dealers surveyed (Respondents able to choose more than one option)



CHAPTER 7

WHO TOOK PART IN THE SURVEY?

Online Survey

A total of 142 dealers and galleries were surveyed during January and February 2018. This constitutes more than half of the annual TEFAF gallery and dealer participation. The aim of this research is to capture the financing trends and needs of high-end dealers in the art and collectibles market.

Limitations

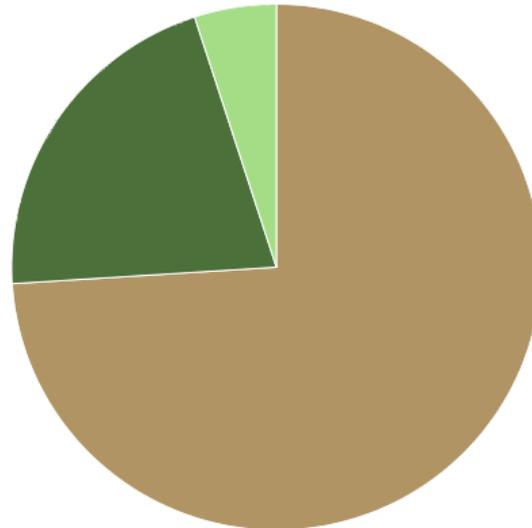
Although we have broken down the sample by location, there is a larger sample of European galleries (reflecting the overall distribution of TEFAF dealers), which combined with a less developed market for art secured lending in Europe, compared to the US, might explain and provide some context to the findings, such as the low level of art-secured lending and financing among dealers.

Location

74% of the dealers and galleries surveyed are based in Europe and 21% in the United States, with a further 5% based in Asia or Latin America. Europe has a less supportive legal framework for art financing and art secured lending, therefore the findings of this survey will have to be viewed and analysed in light of this. To look at the potential differences, we have analysed the results based on dealer location as well as size in terms of annual sales.

Legend

Europe	74%
US	21%
Other	5%

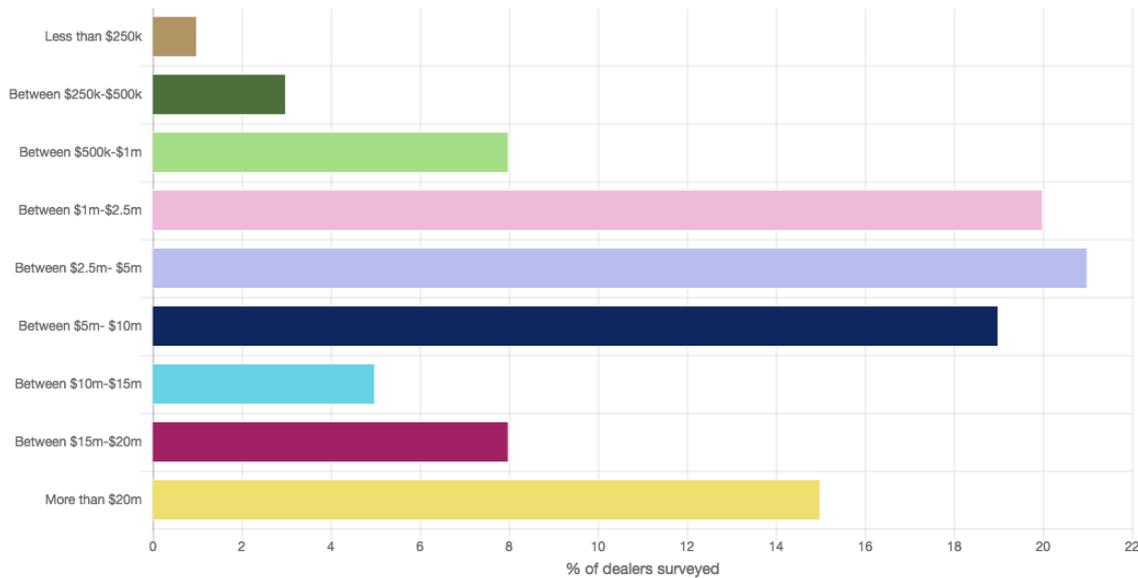


Source: TEFAF Art Dealer Finance Survey 2018

% of dealers surveyed

Annual Sales

47% of the gallery and dealer sample have an annual turnover over \$5 million per year, with a further 15% stating that their annual turnover was in excess of \$20 million per year. Smaller galleries, with a turnover of less than \$1 million accounted for 12%, whilst the bulk of the dealers, 41%, fall in the \$1 million to \$5 million bracket.



Legend

Less than \$250k	1%
Between \$250k-\$500k	3%
Between \$500k-\$1m	8%
Between \$1m-\$2.5m	20%
Between \$2.5m-\$5m	21%
Between \$5m-\$10m	19%
Between \$10m-\$15m	5%
Between \$15m-\$20m	8%
More than \$20m	15%

Source: TEFAF Art Dealer Finance Survey 2018

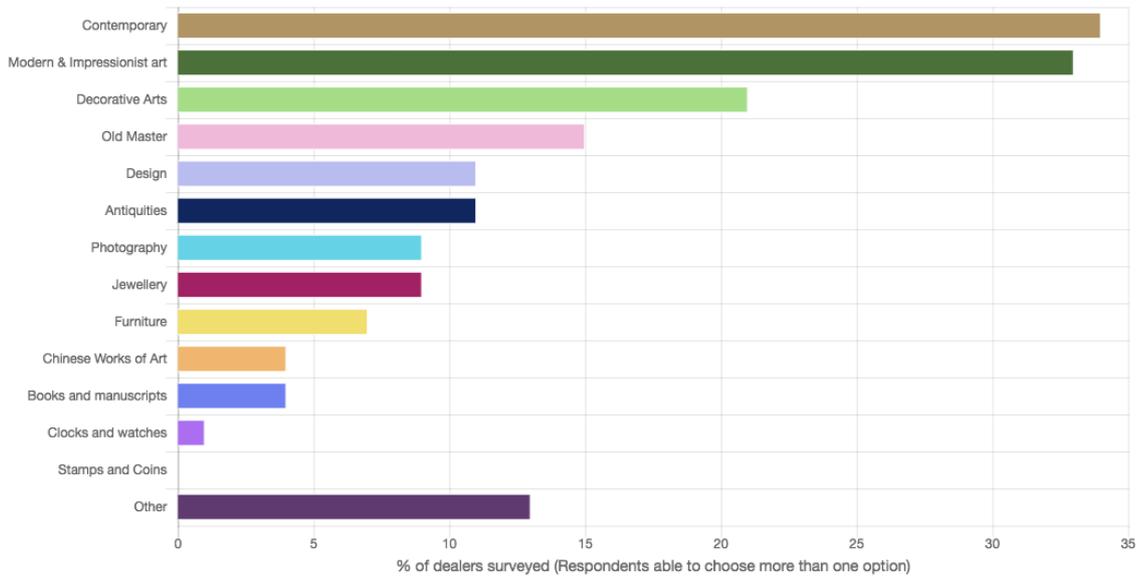
% of dealers surveyed

Number of Employees

20% of the dealers surveyed were one-person enterprises, followed by 30% who stated they employed between 1 and 3 people, then 33% who said they employed 4 - 9 people, 14% said they employed 10 - 49 people and 3.7% said they employed more than 50 people in their gallery.

Collecting Segment

34% who said they focused on Contemporary Art. This was followed by 33% who said they predominantly concentrated on Impressionist & Modern art. 15.3% said they mainly dealt with Old Masters, 21% with Decorative Arts, 11% focused on Design and 11% on Antiquities.



Legend

Contemporary	34%
Modern & Impressionist art	33%
Decorative Arts	21%
Old Master	15%
Design	11%
Antiquities	11%
Photography	9%
Jewellery	9%
Furniture	7%
Chinese Works of Art	4%
Books and manuscripts	4%
Clocks and watches	1%
Stamps and Coins	0%
Other	13%

Source: TEFAF Art Dealer Finance Survey 2018

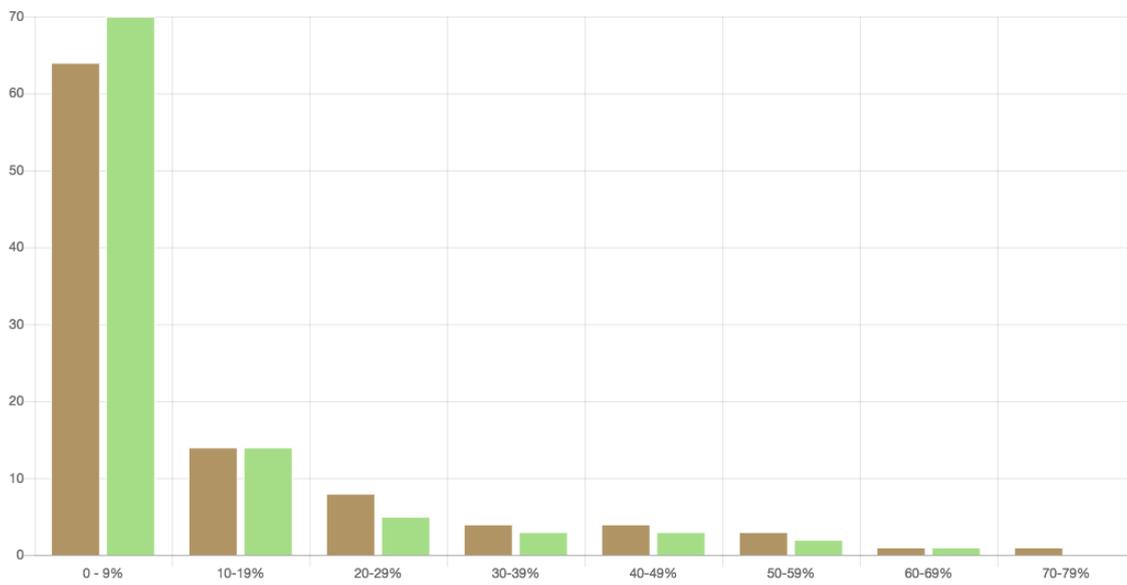
% of dealers surveyed (Respondents able to choose more than one option)



CHAPTER 7

WHAT IS THE CURRENT SITUATION? ARE DEALERS USING LEVERAGE AND HOW?

How much leverage is there among art dealers and galleries currently?



Legend

Label	Including Real Estate	Excluding Real Estate
0 - 9%	64%	70%
10-19%	14%	14%
20-29%	8%	5%
30-39%	4%	3%
40-49%	4%	3%
50-59%	3%	2%
60-69%	1%	1%
70-79%	1%	0%

Source: TEFAF Art Dealer Finance Survey 2018

Percent %

Low leverage among dealers

The average debt-to-asset ratio among the 142 TEFAF dealers surveyed was 7% (including real estate) and 5% excluding real estate. The majority, 64% of dealers said they had 0% - 9% in debt-to-asset ratio, including real estate (56%, of the dealers and galleries surveyed said they had no debt at all). This was followed by 14% of dealers who said they had between 10% and 19% of their capital structure financed by debt (including real estate), 8% said that 20% - 29% of their assets were financed by leverage, and 13% of the dealers said that more than 30% of their assets were financed by debt.

US dealers see slightly higher average leverage than their European counterparts

The average debt-to-asset ratio among the US art dealers [14] was 9% (including real estate), with 75% of these stating that their debt-to-asset ratio was between 0% and 9% (62.5% stated they have no debt in their capital structure at all). Also, the leverage ratios do not change substantially depending on the size of the business by annual turnover, or for dealers with turnover over \$5 million - 63% said that they had 0% - 9% debt-to-asset ratio (with more than half, 53%, stating that they had no debt at all), a similar result to dealers with annual turnover of less than \$5 million.

14 This could be a sample effect as the number of US dealers participating in the survey accounted for a third of the number of European dealers.

Higher leverage among dealers who have used art-secured lending

The average debt-to-asset ratio for dealers who have used art secured lending is 15% (including real-estate), and 11% excluding real-estate. This is more than double the average of the overall gallery sample. With 75% of these dealers, however, saying they obtained the art-secured loans through Private Banks, suggests that the higher leverage is a sign of dealers who are comfortable with more leverage and have access to inexpensive funding through their private banking relationship.

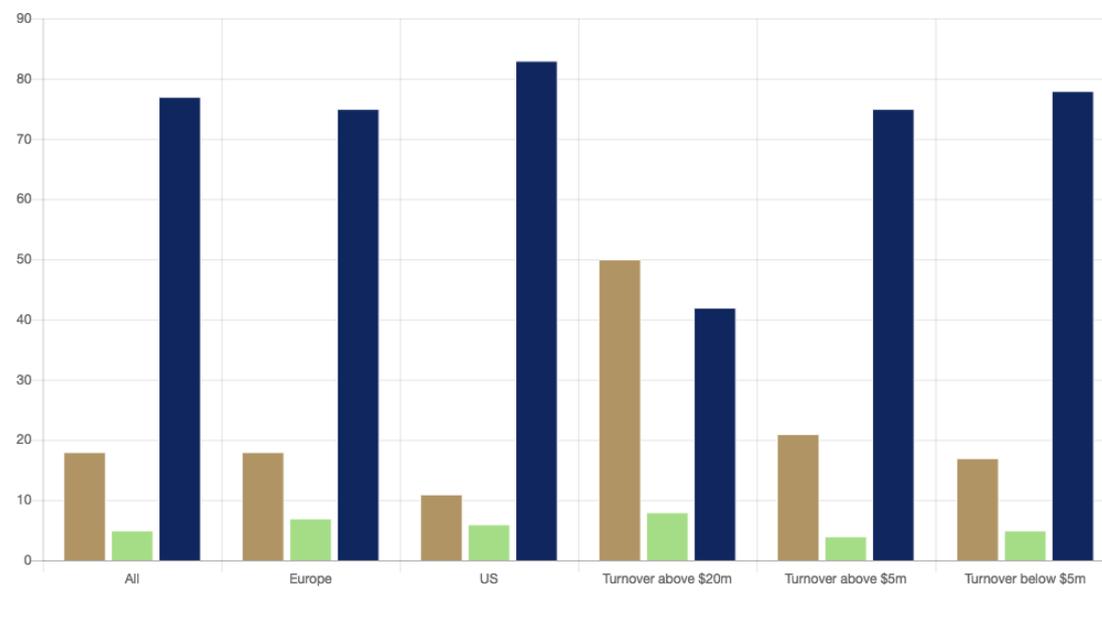
More debt-financing among dealers in Impressionist, Modern and Contemporary art:

50% of the dealers selling Impressionist, Modern and Contemporary art said they had between a 0% and 9% debt-to-asset ratio (lower than the 64% for the overall sample). 20% of these dealers (compared to 14% of the overall sample) stated that the ratio was between 10% and 19%, and 18% stated that the debt-to-asset ratio (including real estate) would be 20% - 39% (again higher than 12% of the dealers in overall sample). There are clearly some dealers who actively use leverage in their business, 10% of Impressionist, Modern and Contemporary art dealers state that their debt-to-asset ratio is at 40% to 60% (including real estate). However, if we exclude real estate, these debt-to-asset ratios

are only slightly higher than the overall sample of dealers, which suggests that most of the leverage in this segment of the market is linked to real estate (i.e. gallery space).

Comparing the use of leverage (excluding real estate) between different art market sectors, there are signs that dealers who focus on Impressionist, Modern and Contemporary art have higher leverage than dealers focusing on other collecting categories. This observation is likely to correspond with the fact that most art secured lenders would concentrate on the largest and most liquid segments of the art market. In 2017, Impressionist and Modern together with Post-War and Contemporary art accounted for 50.8% of Sotheby's, Christie's and Phillips annual auction turnover, up from 46.1% in 2016.

What type of loans are galleries using?



Legend

Label	Yes	I tried, but I wasn't able to	No
All	18%	5%	77%
Europe	18%	7%	75%
US	11%	6%	83%
Turnover above \$20m	50%	8%	42%
Turnover above \$5m	21%	4%	75%
Turnover below \$5m	17%	5%	78%

Source: TEFAF Art Dealer Finance Survey 2018

% of dealers surveyed

A large majority of art dealers have never obtained a commercial bank loan for their business:

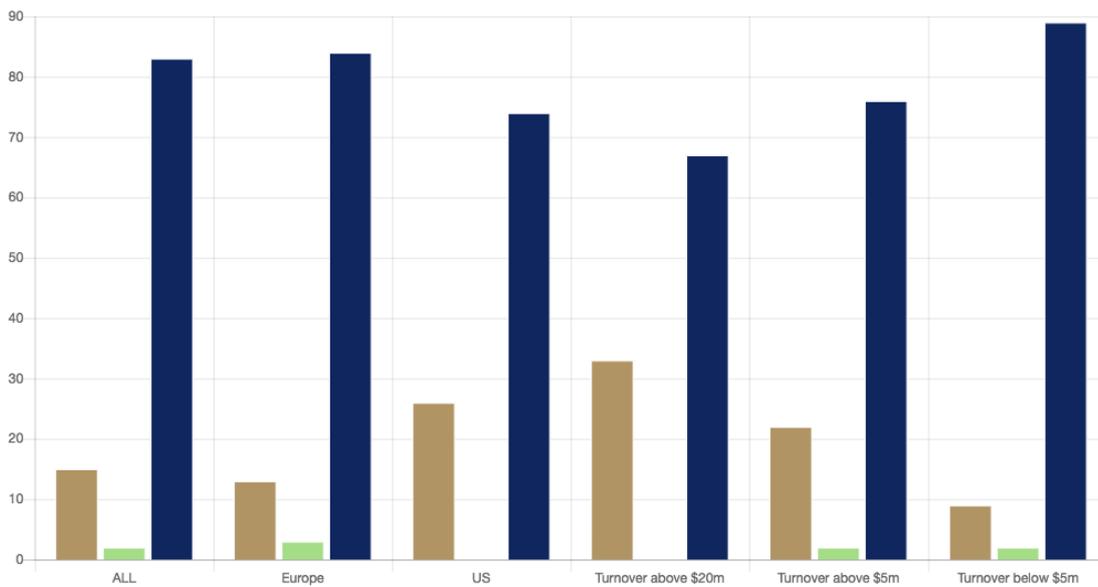
With overall debt-to-asset ratio of 7% (including real estate), it is already evident that dealers are generally extremely careful of funding their business using any kind of debt. Among the US galleries, 83% said they have never used such method of financing (11% said they had and 6% said they had tried to, but failed). Among the European galleries, a larger share, 18%, said they have used a commercial loan for their business, although 75% still

said they have never taken out a commercial bank loan against the income and assets of their business. Commercial loans are often underwritten against the nature and riskiness of the business, and as dealers often face the uncertainty of lumpy and irregular cash flows (sales typically peak around art fairs), this type of loans could be hard to obtain unless a long-standing relationship or track record is in place. Although commercial lenders will look at the inventory as one possible backstop, they do not like to underwrite loans based on an asset they do not fully understand and have difficulties valuing and assessing, and therefore the number of commercial lenders offering loans to art dealers is relatively small.

Big galleries are actively using commercial banks as part of their funding mix

Among dealers with the largest income in the survey sample (with annual sales above \$20 million), the use of commercial bank loans is much more common. 50% of these galleries said they actively used these types of loan to fund their businesses, secured against their income and other assets. It looks like galleries with annual sales over \$10 million are more likely to use and maybe also obtain commercial bank loans (30% of these galleries said so). This could also suggest that banks are generally reluctant to provide commercial loans to galleries unless they are above a certain size.

Have you ever obtained credit (loan) secured against art work(s) exclusively or as part of a portfolio?



Legend

Label	Yes	I tried, but I wasn't able to	No
ALL	15%	2%	83%
Europe	13%	3%	84%
US	26%	0.00%	74%
Turnover above \$20m	33%	0%	67%
Turnover above \$5m	22%	2%	76%
Turnover below \$5m	9%	2%	89%

Source: TEFAF Art Dealer Finance Survey 2018

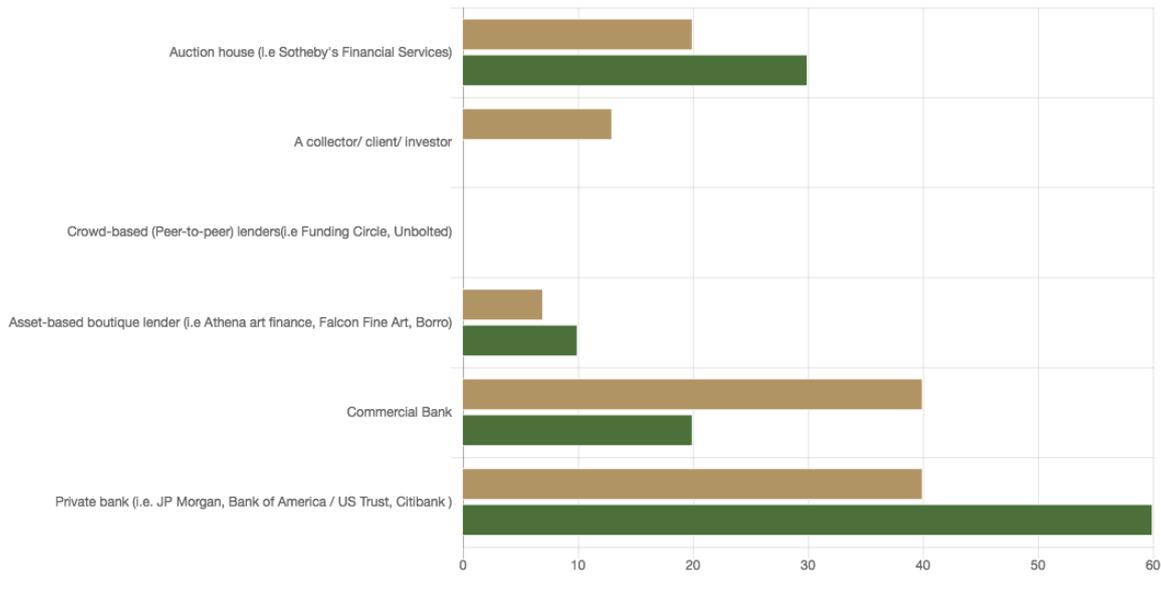
US dealers more likely to obtain a loan against an art work compared to European dealers:

It is clear that the larger and more developed art secured lending market in the US, enables US dealers to leverage the value of art works. In discussion with private banks that offer loans against art, these loans tend to be against the personal collection of the dealer/business owner, rather than the standard dealer inventory. 26% of the US dealers said they had obtained loans against art work(s) exclusively (non-recourse) or as part of a portfolio of other assets, compared to 13% of European galleries. This is supported by a larger market for asset-based lending in the US, with a larger number of active providers, such as Athena Art Finance, AOI Advisors, Borro, Artemis and TCP Finance being among the active players in the US market. 33% of larger dealers (above \$20 million in annual sales) are more likely to use art works as collateral in obtaining either re-course or non-recourse financing.

Larger dealers take advantage of both private banking relationships and asset-based lenders

Among larger dealers (above \$5 million in annual sales), 60% would draw their financing from traditional private banks such as (Citibank, JP Morgan, US Trust, Goldman Sachs and Deutsche Bank etc.), the rest would come from asset-based lenders, either auction

houses (Sotheby’s is particularly active in this area) or boutique lenders such as the asset-based lenders mentioned above. Large dealers with significant personal wealth tend to actively use their private wealth (including art) to raise cost-effective funding for their gallery business through their private banking relationship.



Legend

Label

- Auction house (i.e Sotheby's Financial Services)
- A collector/ client/ investor
- Crowd-based (Peer-to-peer) lenders(i.e Funding Circle, Unbolted)
- Asset-based boutique lender (i.e Athena art finance, Falcon Fine Art, Borro)
- Commercial Bank
- Private bank (i.e. JP Morgan, Bank of America / US Trust, Citibank)

All	Above \$5m
20.00%	30.00%
13%	0.00%
0.00%	0.00%
7%	10.00%
40.00%	20.00%
40.00%	60.00%

Source: TEFAF Art Dealer Finance Survey 2018

% of dealers surveyed (Respondents able to choose more than one option)



CHAPTER 7

SHOULD THE UNPREDICTABLE ART MARKET BE CAUTIOUS WHEN IT COMES TO DEBT FINANCING?

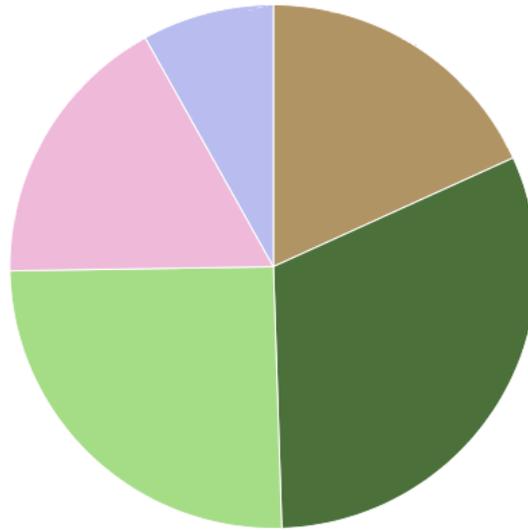
Leverage in the art market

Leverage in the art market remains low (7% average debt-to-asset ratio based on the survey of TEFAF dealers). Maybe this is the primary reason why the art market and the dealer industry showed remarkable resilience during the financial crisis in 2009 and the years that followed. Building a business on retained profit is a stable and conservative way of growing a business, and maybe this is the right *modus operandi* for the often unpredictable and volatile art industry.

Although, the majority of dealers surveyed have managed to build up a strong capital base and are using retained earnings as a way of growing and running the business, there are still concerns about a major liquidity event: 25% of dealers surveyed said they were 'somewhat concerned', 17% of art dealers were 'concerned' with a further 8% said they were 'very concerned' about their liquidity in an art market downturn. This suggests that despite galleries having adapted to the unpredictability and volatility of art sales over the years, a major liquidity events such as the downturn in 2009, remains a significant threat to dealer businesses.

Legend

Not at all concerned	18%
Slightly concerned	31.03%
Somewhat concerned	25.29%
Concerned	17.24%
Very concerned	8.05%

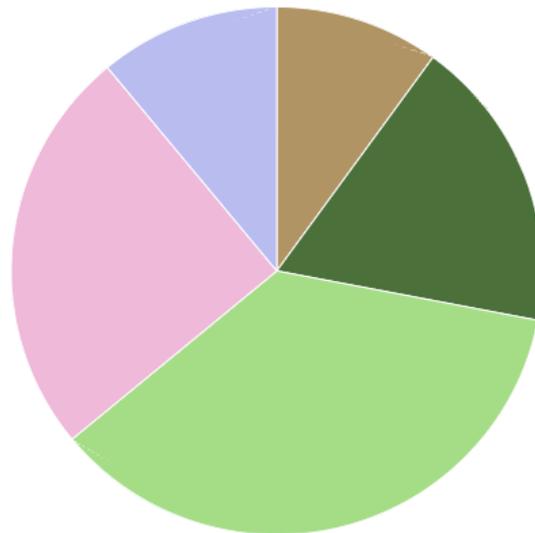


Source: TEFAF Art Dealer Finance Survey 2018

Percent %

Legend

Very Low	10%
Low	18%
Moderate	36%
High	25%
Very High	11%



Source: TEFAF Art Dealer Finance Survey 2018

Continued

72% of the art dealers surveyed said that they perceived the risk of using loans against their inventory as moderate to very high. 36% dealers said they perceived this risk to be high to very high.

Below are some of the common reasons why art dealers say they don't use debt financing in their business:□

- **Volatile and lumpy sales - the nature of uncertainty and unpredictability in the art market when it comes to gallery sales:** "We never know when money is coming, we can't count on it. We are sitting on great assets, but we have no idea when we will be able to sell them, it is totally unpredictable."
- **Volatile art prices:** Fluctuation in art market prices and the art market overall. This volatility seems to have increased in recent years, making it risky to rely on

financing using art as a collateral.

- **Economic crisis / art market collapse:** The recall of art loans in the event of an economic crisis would have a cascading effect on the art market, further depressing the value of works of art. Some dealers said they had vivid memories of the 1990s and that leverage would further increase the stakes and risks in the art market.

However, lenders interviewed for this report, would argue that the risks outlined above are exactly the reason why dealers should consider art financing (despite the fact that it often makes their underwriting process harder), as a way of improving their financial management and day-to-day operations. For art dealers, some level of leverage could be an effective way of releasing the 'locked-up' value of sleeping stock, and would allow high quality art works to be used as collateral to improve an art dealer's cash flow management, and ride out periods of lumpy sales, as well as potentially fund new acquisitions. If done in a strategic and conservative manner, this might provide galleries with more financial flexibility.

How can the art-secured lending market grow beyond its current niche/

In recent months, we have heard about dealers running into disputes with art lenders[x], often these disputes arise on the back of lack of clarity about title, i.e. where consigned works (rather than owned works) are used as collateral for a loan. Sometimes it is the business arrangements themselves, where lenders are not only pure lenders, but are also taking part of a success fee on the sale of an object that has been financed by a loan. In a market place already affected by reputational issues around conflict of interest and questionable practices, what can be done to address this? Some would argue more regulation and standardisation is required.

0 Source: The Art Newspaper - <https://www.theartnewspaper.co..>



CHAPTER 8

ART FINANCE PRODUCTS & PROVIDERS

Introduction

Although the large majority of art dealers and galleries are financing their business predominantly through retained earnings and cash generated by the business, there is clearly appetite among art dealers to look at alternative sources of finance (31% of the art dealers surveyed said so), but what type of financing is currently available to dealers and galleries? This section takes us through some of the options that are available.

Private Banking Loans

This type of finance is available for a smaller, selective group of the biggest and most resourceful art dealers. It is common to use their personal wealth (including their private art collections) and private banking relationships to obtain bank financing for their business. Among the larger TEFAF dealers surveyed (above \$5 million in annual sales), 60% draw their financing from traditional private banks such as (Citibank, JP Morgan, US Trust, Goldman Sachs and Deutsche Bank etc.). These loans are offered on a recourse basis, and can be obtained at attractive rates between LIBOR+ 2.5% - 3.5%. Sizes vary from \$1 million to \$30 million. We estimate that this type of loan provided to art dealers account for an estimated \$450 - \$500 million of outstanding art related loans.

Commercial Bank Loans

These loans are underwritten on the basis of the fundamental strength of the gallery (ability to generate cash flow), and like private banking loans, are only available to the biggest art businesses that can demonstrate this - few galleries have the financial record

and history to obtain business financing. In most cases the nature of the inventory and the credit worthiness of the owner would also be taken into account. The research conducted showed that the commercial banking relationship is often originated through the private banking arm. These commercial loans are often structured as evergreen credit facilities, which galleries/dealers can draw upon for working capital needs, acquisition opportunities and other financing needs. The rates on these loans would be in the same level as private banking related loans. We estimate that this type of loan provided to art dealers account for an estimated \$250 - \$350 million^[15] of outstanding art related loans.

15 These estimates are based on interviews with commercial lenders actively lending to gallery and art dealer businesses.□

Asset-based loans

Asset-based loans are often provided by niche lenders with the ability to tailor financing packages for clients who wish to obtain immediate access to liquidity from their art assets. Asset-based loans tend to be underwritten on the basis of the quality and value of the collateral (i.e. the art work). The structure and nature of these loans varies, with charges from 6% to 14%. The level of interest rates reflects either 1) the level of guarantees that can be provided or 2) the nature of the art asset itself.

Asset-based lending is not seen as synonymous with secured lending. A secured loan, according to the definition by Stephen Brodie□, "...is simply one for which there is collateral, whereas an asset-based loan is one in which the lender relies for substantially all of its credit support on the realizable (i.e., in a forced liquidation scenario) value of its collateral. Non-recourse lending is an extreme version of asset based lending wherein the lender agrees that it will look solely to the collateral and will forgo the right to pursue recourse against the other assets or general credit of a borrower or a guarantor, absent certain "bad acts" such as a voluntary bankruptcy filing or fraud."

Although, only a small portion of the TEFAF dealers surveyed said they had used asset-based loans for financing, interviews with the providers of asset-based loans said that the art dealer community accounts for between 40% and 60% of the value of the loans provided. The prime source of this funding comes from US boutique art lenders, with the European asset-based lenders predominantly focusing their business on private individuals. Although these loans are considerably more expensive than financing provided by private and commercial banks, they do provide a cheaper alternative to the more expensive private (individual) investment alternative that 63% of dealers rely on when financing business and acquisition opportunities. We estimate that this types of loan provided to art dealers account for an estimated \$400 - \$700 million^[16] of outstanding art related loans.

16 These estimates are based on the findings in the Deloitte Art & Finance Report 2016/2017 combined with the findings from interviews of asset based lenders in Europe and US serving the art dealer community.

Auction House Finance

In an increasingly competitive auction market and the ability for auction houses to offer their clients (buyers and sellers) finance products and services, has become an important factor. Most larger auction houses are offering auction advances to consignors and extended payment terms to the buyers. The leading provider of auction related financing is Sotheby's Financial Services (SFS), with over 25 years of experience in art lending and more than \$4 billion in loans made to date. In January 2014, Sotheby's established a separate capital structure for SFS through which client loans were predominantly funded with borrowings drawn from a dedicated revolving credit facility. Whilst most auction houses would link the loan and collateral to a future sale, according to Sotheby's Financial Services, two thirds of loans provided are term loans with no commitment to sell any collateral. We estimate that this type of loan provided to art dealers account for an estimated \$300 - \$500 million of outstanding art related loans.

Peer-to-peer Loans

Although the peer-to-peer lending market grew to an estimated \$4.5 billion in 2016, with the likes of Zopa and Funding Circle leading the way. The move to asset-backed peer-to-peer loans is relatively new and aims to reduce some of the risk associated with unsecured peer-to-peer business loans, by securing the loan against the borrower's assets, which could be art and collectibles. So far this has been a relatively unexplored territory for dealers and galleries, although some peer-to-peer lending companies have started to see an interest in providing finance to smaller auction houses, galleries and dealers, see interview with Ashwin Parameswaran, Unbolted. Typically peer-to-peer lenders operate in the market for smaller loans, between \$10,000 and \$100,000, which would normally be considered too small for the traditional asset-based lenders.

An overview of the products and providers:

**The list of art lending providers in the table below should not be seen as an endorsement of these companies and their services, but an example and overview of some of the active providers in the market at the moment.*

ART-BACKED FINANCE PRODUCTS - WHAT, WHEN & WHY?

Term loans

A term loan is a loan for a specific amount that has a specified repayment schedule and a fixed or floating interest rate, usually lasting from 6 months to 3 years.

WHY?

- Creates liquidity from sleeping stock and inventory

- Helps with dealer inventory financing
- Helps manage timing of capital gains and at the same time keeps other business assets insulated from art assets
- Typically no requirement to sell the underlying collateral (art work) – although some finance products are offered with that in mind (see sales advance loans)
- Increases buying power for acquisitions

Bridge financing

Bridge loans are a means to unlock liquidity in the short term whilst waiting for the sale transaction of a single piece or an entire collection to conclude.

WHY?

- Finances existing inventory or new acquisitions; increase buying power
- Bridges sales that can include both auction and private transactions
- Typically for one to 6 months
- Generally more expensive than longer term loans
- Paid off the day the piece is sold

Sales Advance loans

Certain lenders are willing to offer an advance up to 70% of the reserve price to be sold. This means that the borrower will receive a significant portion of the expected sale proceeds immediately even if the sale is not scheduled for weeks or months.

WHY?

- Creates liquidity in advance of a sale
- Mechanism for an orderly liquidation of assets for estate planning purposes
- Lines of credit

Credit Facility (revolving credit)

A revolving line of credit allows the client to put up art collateral to establish a drawdown facility that can be used at their discretion and for any purpose. Typically, an agreement dictates the ways and amounts that can be withdrawn at any one time, such as the minimum value of the collateral portfolio.

WHY?

- Keeps art assets fully deployed; pay down facility as other assets are sold or add collateral to increase credit availability
- Interest is charged on the drawdown amount at any given time.

Sale and leaseback

Sale and leaseback can provide art dealers with a cash flow boost. By selling art works to a

funder and agreeing to lease it back for a pre-determined time period in return for fixed monthly rental payments, you can unlock capital that's currently tied up in idle stock or inventory. A dealer would have the option to purchase it back at any time during the lease.

WHY?

- Creates liquidity from sleeping stock and inventory
- Monthly rental payments
- Option to purchase the work back at any time



CHAPTER 9

CHALLENGES: WHY IS ASSET-BASED ART FINANCING STILL NOT COMMONPLACE?

Why is asset-based art financing still not commonplace?

Based on the survey findings and feedback from dealers, the main reasons that the majority of those surveyed are using very little or no leverage, seems to have two aspects: 1) the way that dealers themselves look at and run their businesses and 2) the way that banks and other financial institutions look at the dealer business. These two aspects have an impact both in terms of demand, and supply of dealer financing.

How do dealers look at their own business? Research carried out by ArtTactic shows that profit and growth are not always the main drivers behind a gallery or dealer business. As dealer businesses are often built around an individual, often, more emotive and personal factors are of importance, such as strong relationships with museums and private clients, the focus on quality exhibitions, curatorship and connoisseurship are often mentioned as core motivations. The apparent lack of emphasis on the 'commercial' is also likely to limit a dealer's appetite to try to optimise their capital structure, by using leverage. Based on the feedback from dealers, many cherish the aspect of having control, and fear interference in their business by third parties (such as banks or lenders). Many dealers also mentioned that banks do not properly understand the art market and the art business, and efforts to try to obtain a loan from these institutions are not worth the bother.

How do traditional lenders look at gallery and art dealer businesses: From a lender's perspective, art dealer businesses are hard to assess in terms of risk. Their cash flows are often irregular and lumpy, and the working capital needs are often high (physical spaces, exhibitions, art fairs etc.). Also, the value and quality of a dealer's most valuable asset (the inventory) is difficult for financial institution to assess. An inherent lack of understanding

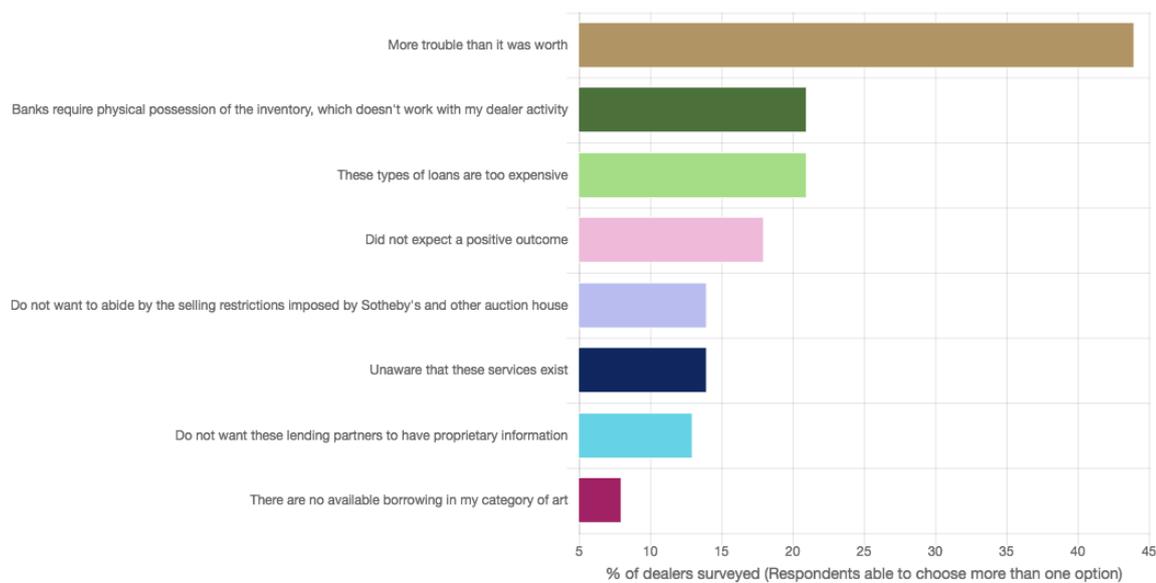
of the art market, and as reported in Deloitte Art & Finance Report 2017, concerns around valuations, liquidity, lack of regulation remain key sticking points for traditional banks to embrace art dealer financing services. It is exactly due to these hurdles in the traditional lending industry, that has given rise to a number of new generation asset-based lenders emerging in recent years.

However, despite the increasing number of art-backed lenders, only 15% of the TEFAF art dealers surveyed said they had used art backed-lending. This was significantly higher in the US as it was used by 26% of US dealers compared to 13% of the European art galleries.

So why are galleries and art dealers generally cautious or reluctant to embrace this type of financing alternative?

What are the key stumbling blocks?

Key Challenges and How to Address These:



Legend

More trouble than it was worth	44%
Banks require physical possession of the inventory, which doesn't work with my dealer activity	21%
These types of loans are too expensive	21%
Did not expect a positive outcome	18%
Do not want to abide by the selling restrictions imposed by Sotheby's and other auction house	14%
Unaware that these services exist	14%
Do not want these lending partners to have proprietary information	13%
There are no available borrowing in my category of art	8%

Source: TEFAF Art Dealer Finance Survey 2018

% of dealers surveyed (Respondents able to choose more than one option)

Lack of speed and bureaucratic underwriting process:

Problem

44% of art dealers surveyed blamed the lengthy and bureaucratic process in obtaining a loan for the lack of interest in looking at art related financing options. A further 18% said that they were reluctant to go down this route because they expected the outcome to be unsuccessful.□

Solution

More clarity about the process and what is expected from the borrower from the outset, which includes Know-Your-Customer (KYC), money laundering (ML), credit rating, valuation and art work due diligence. Although some of these processes might seem intrusive, they are really no different from the process one would have to go through when buying a house. There are also different types of financial products available for dealers from purchase/ acquisition finance to credit facilities secured against stock, which could be used for opportunistic purchases.□

INDUSTRY VOICES

THE ART-SECURED LOAN PROCESS

Freya Stewart, CEO Art Lending, The Fine Art Group



With a clear understanding of the underwriting and execution process required to obtain an art-secured loan, potential borrowers can assess which lender(s) and which type of loan may be available and most suitable for them, taking into account their particular needs and circumstances.□□ The process flow summarised below seeks to identify both the key requirements of an art-secured lender and certain questions potential borrowers may wish to discuss with lenders in order to select the most suitable lender for their needs.□□ At a high level, some of the fundamental differences between lenders include: whether the lender requires detailed financial information□and liquidity/credit rating criteria□ concerning the borrower, in addition to assessing their art collateral; the speed with which the lender can fund loan monies; the type of product and commercial terms a lender can offer; whether the lender requires possession of the collateral during the loan; and the level of client service and confidentiality of process that the lender offers.

Cost of finance too high

Problem

21% of the art dealers surveyed said the cost of financing is too high. With asset-based lenders charging anything between 6% to 14%, asset-based loans are not necessarily

suited for long-term financing needs, but could be a viable alternative source for acquisition finance. Even at double-digit interest rates, asset-based financing could be attractive compared to investment from co-investors that might want a significantly higher share of sale proceeds.□

Solution

58% of dealers surveyed do not have any debt in their capital structure and with 84% of these dealers using their retained profit for inventory purchases and acquisition finance – more education and information is needed about why art financing could be a viable alternative to using retained earnings – when it might be beneficial and what these products would look like.

INDUSTRY VOICES

How Art-Secured Financing Supports the Art Market Trade

Andrea Danese, CEO and Co-Founder, Athena Art Finance Corp, Nigel Glenday, Managing Director, Strategy, Athena Art Finance Corp.



*Andrea Danese, CEO and Co-Founder, Athena Art Finance Corp.
Nigel Glenday, Managing Director, Strategy, Athena Art Finance Corp.*

As the art market has expanded over the past several decades, art-secured lending has emerged as an additional tool for collectors and dealers to create liquidity around an otherwise illiquid asset. While art-secured financing allows individual collectors to expand their art purchasing power or redeploy capital into other projects, the financial case for the gallery and dealer community is equally compelling.

The dealer business model is often a capital-intensive one, in which sourcing capital comes at a premium. However, owned inventory can be an untapped and overlooked capital source for dealers. A credit facility secured by existing and/or to-be-acquired inventory can enable a dealer to reallocate capital across their business, whether for new acquisitions on a principal basis, supporting third-party auction guarantees, advancing funds to a consignor, bridging consignor and buyer payments, extending payment terms, or general working capital needs, among many other objectives.

The art trade values speed, flexibility and discretion. Dealers can protect these advantages by setting up a credit line upfront with existing stock thereby delivering just-in-time capital when needed. Importantly, this can offer a *lower* cost alternative (or even a supplement) to more costly equity co-investment capital and can be expanded overtime as inventory grows in scale and in value.

While some galleries operate with a purely capital-light model (acting as agent for their clients), others more frequently act on a principal basis, in which a dealer buys, holds and realizes an artwork's value over time. This is an activity for which inventory-secured financing through a credit line can be an especially valuable tool.

Take a practical example: A dealer is acquiring a given artwork to hold in inventory for eventual re-sale. Financing the purchase can take the form of the dealer's own equity and/or capital from third-parties. Currently, the most common form of third-party capital in the art trade is from an equity co-investor (often an individual, another dealer or a fund) that shares pro rata in the profits from the art's eventual re-sale. Depending on the dealer's profit expectations however, this can be the most expensive form of outside capital.

A potentially more attractive alternative is an inventory-secured loan or credit line, which instead finances up to 50% of the purchase price (or more with a line set up secured by existing inventory) at a specified interest rate. The art lender accepts a lower rate of return than would an equity co-investor, in return for downside value protection by receiving its loan principal first once any inventory is eventually sold.

Here, inventory-secured financing provides the dealer with three clear benefits: first, the dealer can acquire an artwork (or collection) priced at a *multiple* of the value of their contributed cash equity; second, can earn an even greater share of the now *increased* re-sale upside; and, third, preserves discretion with the lender (when independent and non-conflicted) acting a silent partner in the transaction.

This example is only one of a number of ways art-secured lending can support the activities of the art market trade. Even when acting as an agent, dealers can face considerable working capital needs in bridging payments between consignors and buyers. An art-secured loan can be used to advance funds to a consignor pre-sale, to bridge payment to a consignor while waiting for buyer payment post-sale or to manage general operating expenses.

Similarly, dealer transactions with an auction house can be facilitated through an art-secured loan. Financing can backstop a third-party guarantee (irrevocable bid) made at auction, enabling a dealer to provide more guarantees with the same equity amount. While in some cases an auction house may offer financing in-house, an independent firm permits a dealer to more readily transact across multiple auction houses (or multiple dealers) using a single financing source.

The critical element in accessing art-secured credit is the nature of the art itself. Artwork used as financing collateral must have a clear re-sale market, typically as evidenced by an artist's track record at public auction and/or private sale. The benefit of this "art-first" approach is that available credit is determined purely by the expected re-sale value of the art, rather than the financial strength of the gallery. This allows even well-capitalized dealers to access incremental, opportunistic capital when called for. Notably, this is where traditional bank financing sources struggle with gallery and dealer business models, which do not fit neatly into small business lending criteria.

At its core, the lender's business model is the management of risk to safeguard capital while providing credit to its clients. While the art market presents unique risk

management challenges, several developments are afoot that will help lenders better mitigate the risks in art lending generally.

Artwork valuation is often cited as the single biggest challenge in the art market, as it is for any virtually illiquid asset. Independent lenders (who do not themselves also act as dealers, thus preserving discretion and limiting conflicts of interest) can face an information challenge when it comes to artwork valuation and due diligence, as dealers might know more about the re-sale market for a given artwork than a lender. This is not an uncommon situation; it arises frequently when lenders provide credit to highly specialized businesses or support investor groups that are acquiring a new company.

Tools that provide greater analytical rigor and objectivity to the valuation process, based on public and private transaction histories, and aid information sharing between dealers and lenders, will not only assist in managing the risks of art lending, but, in doing so, will help deliver significantly more lending capital to the market, with faster turnarounds. Improved transaction data analytics, future price modeling (including crowdsourcing methods) and independent verification of title, provenance and condition (including new projects employing blockchain technology) are all initiatives that are underway to address this need.

Art-secured financing is designed to be a means to *lower* capital costs for art trade. Wider adoption will follow as the market for art-secured lending continues to professionalize and the financial benefits to the trade become increasingly apparent. Ultimately, improved risk management tools that assist the massive non-art-specialized capital sources mitigate unique art market risks will help deliver credit in greater quantity and at lower cost to this vibrant and ever-evolving market.□

Valuation and due-diligence

Problem

13% of dealers said they did not want parties to the lending transactions to have proprietary information about their inventory. Based on interviews with lenders, one of the key stumbling blocks in the underwriting process, is related to valuation of the art work(s). Many dealers do not want to give valuers/ appraisers (which could be auction houses, advisors, other dealers or appraisers) information about what they have in their inventory. There is also an inherent mistrust among dealers in the valuations used by the lender, one dealer said: "They have a very difficult time understanding the actual value and have a history of valuing stock at a low price. There is a lack of expertise of the lenders on the true value of my stock." This highlights the different perception about value between lenders and dealers. An art dealer would typically think about market value in terms of the retail price whilst a lender would typically use the more conservative auction market as a reference for market value.

Solution

As the art market often struggles to clearly separate roles for individuals and companies in

the market place (valuation and advisory or valuations and auctions), it is understandable that dealers are concerned about sharing inventory information with these third parties. Objective valuations will become an important tool in the development of the art lending market. The increasing need for standardisation of valuations, risk management and a due diligence framework was also mentioned as one of the key priorities in the Deloitte Art & Finance Report 2017.□

INDUSTRY VOICES

Risks, Challenges and Opportunities in the Art Secured Lending Market

Dr. Tim Hunter, Vice President, Falcon Fine Art Ltd.



Title and authenticity

Problem

Based on interviews with lenders, one of the key challenges in the due-diligence process, is to establish the clear title (i.e. legal ownership) of the art work as well as its authenticity. A number of cases were mentioned where consigned works had been presented as collateral for loans, as well as instances of fakes and forgeries. Both are binary risks to the lender, who could potentially be left with an object with defective title or an object of zero value.

Solution

Although there are insurance policies for defective title, this issue raises a wider need for a title registry for art works. The idea of a title registry has been discussed for many years, but with the advent of new technology such as blockchain, this could be about to change.□

INDUSTRY VOICES

Blockchain, the holy Grail?

Nanne Dekking, Chairman, TEFAF and CEO and Founder, Artory.



Although I do not deal with blockchain technology in my position as TEFAF's Chairman of the Board (yet), my day-to-day job as founder and CEO of Artory lies at the intersection of art and technology. Informed by many years in private sales with Sotheby's and others, my dual roles focus on the importance of trust in the art market—specifically, trust regarding provenance and authenticity.

In addition to a whole range of critical, but subjective intangibles, provenance and authenticity are the main determinants of any artwork's value. Every other concern is secondary if we cannot rule out that a piece may be a forgery, or that it could have been looted from its rightful owner in the past. And right now, it is still impossible to have complete confidence about these aspects of many artworks.

It does not have to be this way. A few other markets rely on provenance and authenticity, too. Consider cars and real estate. In those markets, ownership transfers through a document known as a title. The title matters because it links to a title registry, or a secure public database tracking each asset.

The title registry acts as a layer of security against fraud. By checking the ownership information on the title against the ownership information in the registry, a potential buyer can always verify that the asset is legitimate, and that the reseller has the legal right to offer it. This confidence raises the asset's value and expands the pool of potential buyers.

However, even though we in the arts sometimes use the phrase "chain of title" as a synonym for "provenance," the fact is that no title registry for artworks has ever existed. But if it could do so much good for the buy and sell sides of the business, why hasn't it?

First, we all know that information about art sales tends to be treated as highly sensitive, especially in the private market. Many collectors fiercely guard their privacy, and art dealers often benefit from cultivating an air of mystery about their artists and artworks. These tendencies often make both parties hesitant to publicly disclose details about their artworks and transactions.

Second, the art market still lacks a standardized set of best practices, especially when it comes to systemizing data. Provenance information tends to be incomplete at best. Much reliable information has simply been lost to history. Even in the relatively rare cases where comprehensive paperwork traces a work all the way back to its author, that information generally has not been subjected to the type of stringent vetting process on which we pride ourselves at TEFAF. This makes honest mistakes and bad behavior constant threats to the integrity of provenance and authenticity.

So what is blockchain technology, and how could it solve these longstanding problems?

The blockchain is often defined as a "distributed" or "decentralized" digital ledger. The words "distributed" and "decentralized" refer to the fact that the ledger—simply a list of transactions—is maintained simultaneously on many different computers in different locations with different owners. This networked element also means the information is not controlled by just one central authority, like a bank, corporation, or government.

So how can we trust the information on all these different computers to be consistent and accurate? Instead of adding each new transaction to the ledger individually, many

transactions are packaged together in “blocks.” Before a new block can be added to the chain, though, it must be verified through cryptography—basically, the solving of complex math problems through computer science. Once one computer solves the cryptographic problem for a corresponding block, the other computers on the blockchain network can verify the block and add it to the ledger with a time stamp.

These verified blocks of data cannot be deleted. The only way to amend or cancel out a previous transaction on the ledger is to add new information documenting the change. So a blockchain can only ever grow in size, and its every verified transaction remains permanently viewable.

This innovative process also provides an unparalleled level of security for digital transactions. If a single bad actor tried to falsify information on a single computer in the network, the others would detect the fraud and reject the changes. Similarly, if some disaster were to destroy one computer in the network, the data on the blockchain would survive thanks to the many other computers also maintaining the ledger.

The final important element of blockchain is privacy. Because cryptography verifies the transactions on the blockchain, those involved in the transactions do not have to disclose sensitive information like their identities or financial details. The technology eliminates the need for invasive, traditional auditing.

If we put these innovations together, then, what is the blockchain? A system for properly vetting, permanently memorializing, and expertly protecting transaction data, while simultaneously allowing the data’s owner to stay anonymous if he/she wishes. This combination overcomes every traditional obstacle to an artwork title registry, opening the door to a new era of trust in provenance and authenticity.

The newfound level of confidence could expand the art market by welcoming many new buyers who are better prepared, more skeptical, and more risk-averse than their predecessors. A decentralized title registry would also benefit service providers like fine art insurers and art finance lenders. With more certainty than ever that a collector’s assets are authentically created and legitimately owned, these third parties could offer more generous rates and do more business.

Of course, even a blockchain enthusiast like me recognizes that the technology has obstacles to overcome. A blockchain is only as trustworthy as the data comprising it, so it will be crucial to rigorously vet anyone permitted to submit transaction information. Pieces in traditional media can eventually be physically linked to the corresponding digital ledger to further prevent fraud with information that can be added to the blockchain record as tagging or verifiable imaging technologies evolve. Although it will be difficult to ever definitively confirm some provenance and authenticity information generated in the distant past, it does put accountability on the seller, instilling more trust in the buyer. You can imagine how a blockchain title registry would benefit contemporary artworks, as they will be irrefutably tracked back to the artist’s studio. And therefore, making current practice of relying on obscure vetting committees to authenticate works after an artist’s death obsolete.

Despite these challenges, I believe that the blockchain will revolutionize the art market. The sooner our industry moves ahead with this technology, the more quickly it will

be able to reap the rewards from its potential.□

Lack of professionalism limits dealers access to debt financing

Problem

Most lenders are reluctant to extend credit to art dealers as ordinary business borrowers.□ Even the lenders who are comfortable taking art as collateral, are usually unwilling to make loans to art dealers where a key component of the credit support is the performance of the gallery, as a business, in and of itself, i.e., the ability to reliably generate the cash flow needed to service the debt. This is what is sometimes referred to as “cash flow lending.”

Solution

The adoption of better business practices among dealers, which includes the respect for the legitimate needs of an institutional lender for transparency and reliable financial information. These practices include audited financial statements from reputable and independent accounting firms, chief financial officers who are far more than mere bookkeepers or controllers, as well as internal controls and systems managed by more than just the principal of the gallery.□ Many of these things have become common even in the low end of the middle-market today, but they are notably lacking among all but the top US art galleries, according to commercial bankers who are active in this space.□□



CHAPTER 10

THE OPPORTUNITY

31%

of dealers said they had a finance need – a further 18% are unsure

57%

said that access to credit for dealers was poor/very poor

28%

of dealers said that lack of access to credit had affected their business growth, with a further 18% saying they were unsure.

87%

of dealers are looking for acquisition finance...

Is there a real need for dealer finance?

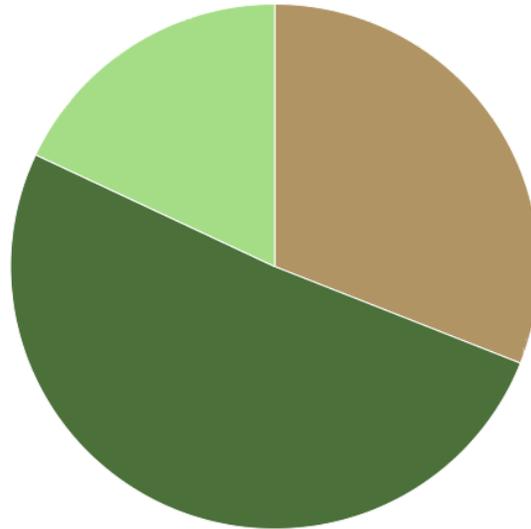
Despite the low leverage among art dealers, 31% of the TEFAF dealers surveyed said that they have a need for finance, and a further 18% said they didn't know. This implies that almost half of the dealer community sees or could see a potential need for a range of different finance options in addition to their current method of financing their business

predominantly through retained earnings or personal funds.

This demand for finance was significantly higher for dealers with sales between \$1 million and \$5 million, where 37% said they have a need for gallery/business related finance, and a further 20% said they didn't know.

Legend

Yes	31%
No	51%
Don't know	18%



Source: TEFAF Art Dealer Finance Survey 2018

Why do some dealers say they still do not need finance?

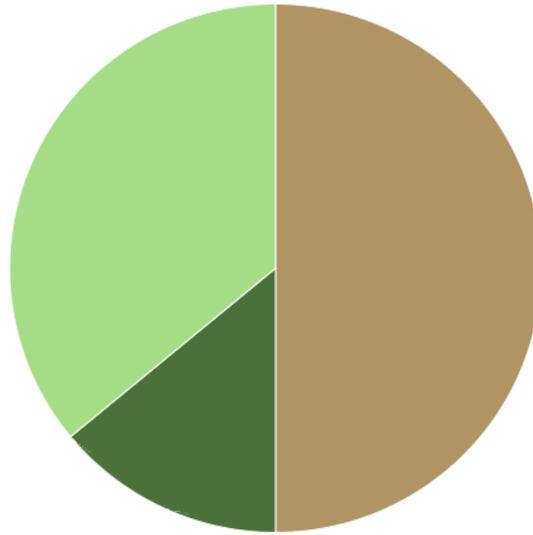
A large number of dealers surveyed have their own capital and are using retained profit to manage cash flows and make opportunistic investments, without the need for external financing. If we combine this with the desire to maintain control and freedom of the business, i.e. not wanting interference in their business from third party financial providers, the benefit of external financing currently does not seem to outweigh the costs and disadvantages for a majority of the galleries.

What is an optimal capital structure for an art gallery/dealer?

The optimal capital structure for an art dealer varies greatly from one dealer to the next. Although half of dealers say they feel they are managing cash and liquidity in the most optimal manner, 14% said they don't and another 36% found it difficult to define what 'optimal' means in the dealer industry. This could suggest that more research and effort should be invested into a better understanding of the dealer and gallery business; to help art dealers develop a model for thinking about their capital structure based on the specificity of the business itself and the nature of the art market. This would also potentially help making the finance industry more comfortable with art businesses, as more insight and data will become available to support underwriting and risk management decisions.

Legend

■ Yes	50%
■ No	14%
■ I don't know what is considered optimal in our industry	36%



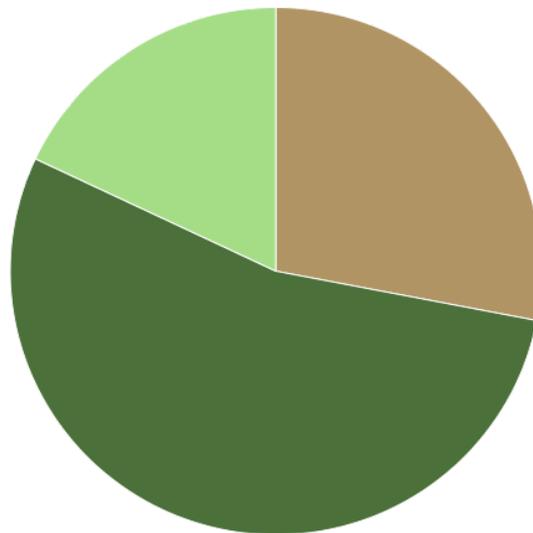
Source: TEFAF Art Dealer Finance Survey 2018

Has a lack of efficiency sourced credit affected the growth of your business?

It is evident that lack of financing options has affected a substantial number of the dealers surveyed, with 28% of the dealers agreeing, and a further 18% saying they did not know. Among dealers with annual turnover of \$1 million to \$5 million, 30% said they felt that lack of efficiently sourced credit had hampered the growth of the business, with a further 27% of the dealers saying they did not know.

Legend

■ Yes	28%
■ No	54%
■ I don't know	18%

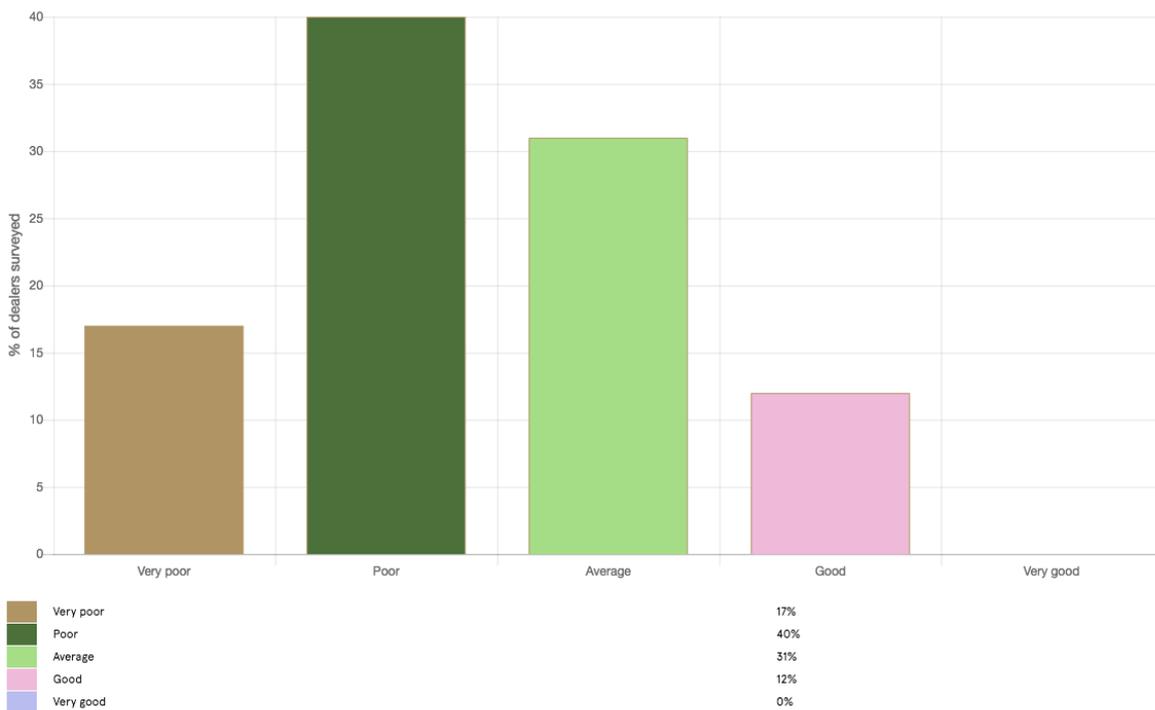


Source: TEFAF Art Dealer Finance Survey 2018

How do you feel about liquidity and credit availability in the art market as compared to other industries?

Compared to other industries, the majority of dealers, 57%, said that the availability of finance and credit was poor to very poor, with a further 31% saying the availability was

average. Only 12% of dealers stated that the access and availability of finance for dealers was good – none said it was very good.

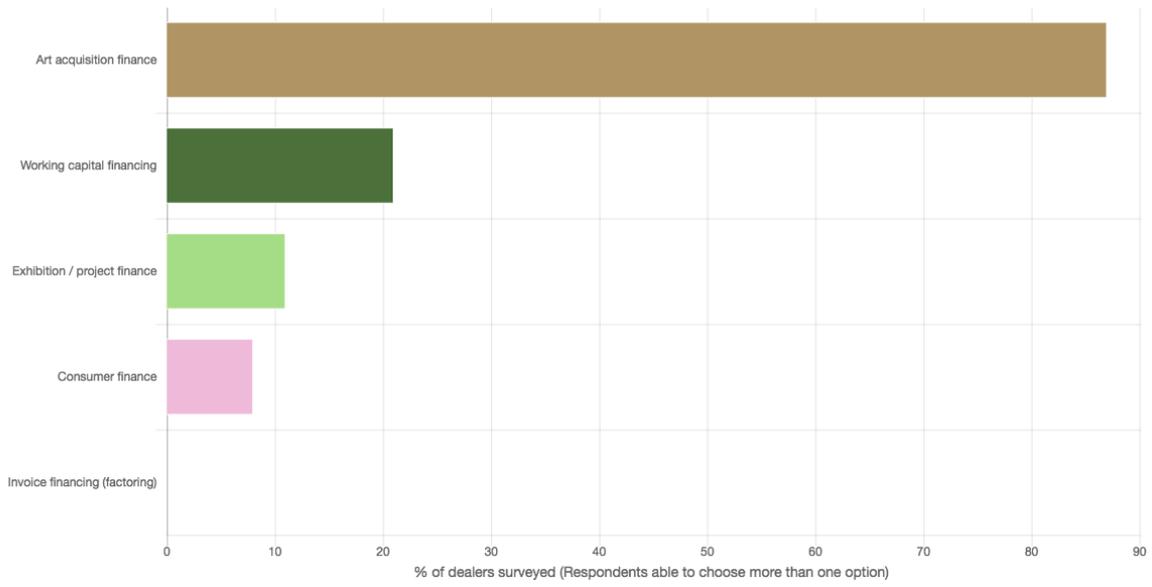


Source: TEFAF Art Dealer Finance Survey 2018

% of dealers surveyed

What type of finance products are art dealers and galleries looking for?

As the majority of acquisitions (59%) today are financed through retained earnings and a further 63% of dealers say they would seek financing through co-investment with other investors, there seems to be strong appetite for art acquisition finance, with 87% of the dealers surveyed saying that this would be a most desirable product and service, followed by 21% of dealers who said they were looking for working capital finance.



Legend

■ Art acquisition finance	87
■ Working capital financing	21
■ Exhibition / project finance	11
■ Consumer finance	8
■ Invoice financing (factoring)	0

Source: TEFAF Art Dealer Finance Survey 2018

% of dealers surveyed (Respondents able to choose more than one option)

INDUSTRY VOICES

ART & FINANCE: A DECADE AND COUNTING

Adriano Picinati di Torcello, Directeur, Global Art & Finance
Coordinator, Deloitte



Ten years ago, in October 2008, at our first Deloitte Art & Finance conference in Luxembourg, we pointed out that the transformation of the art market could be a source of economic diversification for a country. This was awkward timing for such a conference when the world was entering into one of the biggest financial crises of its history, but it proved to be a good moment for entrepreneurial and visionary ideas. Deloitte Luxembourg was one of the first organizations to position itself in this field - a topic that was at the same time familiar but also new - to increase awareness about this new reality and to accompany this transformation.

The topic felt familiar because relationships between art, business, culture, and finance have existed for years. For example, some financial stakeholders were already offering art-related wealth management services such as art-secured lending or art financing services. The matter of art investment had also already been tested, and art patrons had been financing art and culture for several hundred years.

Yet, Art & Finance still felt novel, as new forces are at work in the Art & Finance space such as globalization of the art world, penetration of new technologies, democratization of culture, and the search for spiritual consumption. Furthermore, we are experiencing an increase in the population of UHNWIs, increasing prices for iconic art works, and a new economic reality for the cultural world. There has been a sociological evolution of the role of culture - culture has never been so important to ensure global cohesion, economic development, and quality of life. A better world - a world of happiness - has a very strong cultural component in the same way it needs climate control, gender equality, and human rights.

The concurrence of these forces creates a unique combination in history, which supports the revolution taking place in the Art & Finance space. This space encompasses three interconnected sectors: the financial sector, the art business sector, and the cultural sector. Three areas that are increasingly interdependent and have a lot to gain by increasing their interaction, they depend on each other; they need each other even if they serve different objectives, different needs, and operate with different regulations.

Wealth, technology, and cultural knowledge are shaping a new Art & Finance space at a global level where the boundaries between private and public stakeholders are blurred.

After 10 years of research, observation, surveys, and discussions, we can confirm that the

dynamic that we highlighted a decade ago is a long-term revolution; it is a gradual transformation.

This transformation creates a need for new financing solutions in the Art & Finance space. In the recent past, we have seen more players offering the possibility to get a loan using art as collateral, the volume of business has also strongly increased, whilst still very concentrated in the US market. We have also noticed the development of financial guarantees to support liquidity in the market. Now if we take into account the wealth allocated to art inventory whether the owner is private, corporate, or public entities, the potential growth could be quite important, especially with the growing recognition of art as a special asset and the recognition of initiatives to reinforce trust in the art market.

Over the long term, we can expect the emergence of financing tools and products combining the monetization of collections of cultural entities, social impact investment, hedging possibilities, and marketplaces to offer liquidity and technologies to create appropriate financing solutions for the art and finance space.

Those new tools will support the cultural sector to play its role as an economic driver, as well as supporting a better society. We are at the verge of a new financing story in the Art & Finance space provided we have strong leadership, we are capable to think outside the box, and apply entrepreneurial spirit to make it happen. The future will tell, and we are convinced that an interesting story will emerge.

BLOCKCHAIN, THE HOLY GRAIL?

Nanne Dekking, Chairman, TEFAF and CEO and Founder, Artory.



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It does not have to be this way. A few other markets rely on provenance and authenticity, too. Consider cars and real estate. In those markets, ownership transfers through a document known as a title. The title matters because it links to a title registry, or a secure public database tracking each asset.

The title registry acts as a layer of security against fraud. By checking the ownership information on the title against the ownership information in the registry, a potential buyer can always verify that the asset is legitimate, and that the reseller has the legal right to offer it. This confidence raises the asset's value and expands the pool of potential buyers.

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Second, the art market still lacks a standardized set of best practices, especially when it comes to systemizing data. Provenance information tends to be incomplete at best. Much reliable information has simply been lost to history. Even in the relatively rare cases where comprehensive paperwork traces a work all the way back to its author, that information generally has not been subjected to the type of stringent vetting process on which we pride ourselves at TEFAF. This makes honest mistakes and bad behavior constant threats to the integrity of provenance and authenticity.

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Despite these challenges, I believe that the blockchain will revolutionize the art market. The sooner our industry moves ahead with this technology, the more quickly it will be able to reap the rewards from its potential. □

HOW ART-SECURED FINANCING SUPPORTS THE ART MARKET TRADE

Andrea Danese, CEO and Co-Founder, Athena Art Finance Corp, Nigel Glenday, Managing Director, Strategy, Athena Art Finance Corp.



*Andrea Danese, CEO and Co-Founder, Athena Art Finance Corp.
Nigel Glenday, Managing Director, Strategy, Athena Art Finance Corp.*

As the art market has expanded over the past several decades, art-secured lending has emerged as an additional tool for collectors and dealers to create liquidity around an otherwise illiquid asset. While art-secured financing allows individual collectors to expand their art purchasing power or redeploy capital into other projects, the financial case for the gallery and dealer community is equally compelling.

The dealer business model is often a capital-intensive one, in which sourcing capital comes at a premium. However, owned inventory can be an untapped and overlooked capital source for dealers. A credit facility secured by existing and/or to-be-acquired inventory can enable a dealer to reallocate capital across their business, whether for new acquisitions on a principal basis, supporting third-party auction guarantees, advancing funds to a consignor, bridging consignor and buyer payments, extending payment terms, or general working capital needs, among many other objectives.

The art trade values speed, flexibility and discretion. Dealers can protect these advantages by setting up a credit line upfront with existing stock thereby delivering just-in-time capital when needed. Importantly, this can offer a *lower* cost alternative (or even a supplement) to more costly equity co-investment capital and can be expanded overtime as inventory grows in scale and in value.

While some galleries operate with a purely capital-light model (acting as agent for their clients), others more frequently act on a principal basis, in which a dealer buys, holds and realizes an artwork's value over time. This is an activity for which inventory-secured financing through a credit line can be an especially valuable tool.

Take a practical example: A dealer is acquiring a given artwork to hold in inventory for eventual re-sale. Financing the purchase can take the form of the dealer's own equity and/or capital from third-parties. Currently, the most common form of third-party capital in the art trade is from an equity co-investor (often an individual, another dealer or a fund) that shares pro rata in the profits from the art's eventual re-sale. Depending on the dealer's profit expectations however, this can be the most expensive form of outside capital.

A potentially more attractive alternative is an inventory-secured loan or credit line, which

instead finances up to 50% of the purchase price (or more with a line set up secured by existing inventory) at a specified interest rate. The art lender accepts a lower rate of return than would an equity co-investor, in return for downside value protection by receiving its loan principal first once any inventory is eventually sold.

Here, inventory-secured financing provides the dealer with three clear benefits: first, the dealer can acquire an artwork (or collection) priced at a *multiple* of the value of their contributed cash equity; second, can earn an even greater share of the now *increased* re-sale upside; and, third, preserves discretion with the lender (when independent and non-conflicted) acting a silent partner in the transaction.

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The critical element in accessing art-secured credit is the nature of the art itself. Artwork used as financing collateral must have a clear re-sale market, typically as evidenced by an artist's track record at public auction and/or private sale. The benefit of this "art-first" approach is that available credit is determined purely by the expected re-sale value of the art, rather than the financial strength of the gallery. This allows even well-capitalized dealers to access incremental, opportunistic capital when called for. Notably, this is where traditional bank financing sources struggle with gallery and dealer business models, which do not fit neatly into small business lending criteria.

At its core, the lender's business model is the management of risk to safeguard capital while providing credit to its clients. While the art market presents unique risk management challenges, several developments are afoot that will help lenders better mitigate the risks in art lending generally.

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Tools that provide greater analytical rigor and objectivity to the valuation process, based on public and private transaction histories, and aid information sharing between dealers and lenders, will not only assist in managing the risks of art lending, but, in doing so, will

help deliver significantly more lending capital to the market, with faster turnarounds. Improved transaction data analytics, future price modeling (including crowdsourcing methods) and independent verification of title, provenance and condition (including new projects employing blockchain technology) are all initiatives that are underway to address this need.

Art-secured financing is designed to be a means to *lower* capital costs for art trade. Wider adoption will follow as the market for art-secured lending continues to professionalize and the financial benefits to the trade become increasingly apparent. Ultimately, improved risk management tools that assist the massive non-art-specialized capital sources mitigate unique art market risks will help deliver credit in greater quantity and at lower cost to this vibrant and ever-evolving market.□

OPPORTUNITIES FOR ART LENDING REFORMS IN THE UK

Tim Maxwell, Partner Boodle Hatfield LLP



The UK art market was estimated to be worth just under £10 billion in 2017, making it the third largest globally, at roughly half the value of the US art market. In 2017, Deloitte estimated the global art lending market to be in the region of \$17 – \$20 billion. As a jurisdiction with a sophisticated financial and legal system, the UK *should* command a significant proportion of the art lending market. The UK art lending market, however, is tiny, both in comparison to the relative size of the UK art market and its counterpart in the US. There is significant interest in art lending in the UK, but the market appears to have been hampered by the current legal frameworks. These have ensured that in the UK, lending against art has remained niche and relatively expensive. It is often seen as a last resort by collectors. A large asset-backed lending market is, therefore, being neglected and under-utilised. Reforms have been proposed, which would substantially improve the position, but they have not, as yet, been enacted into law.

From a borrower's perspective, the major perceived drawback of art lending is that most UK lenders will insist on the artwork being physically transferred into their possession (pledged), so that it can be placed in a vault. By comparison, in the US, the lender registers their security interest over an individual's artwork under the Uniform Commercial Code (UCC). The registration ensures that, even though the borrower can keep the artwork for their enjoyment, third parties are put on notice that a loan is secured over the work and the lender's position is secured.

In the UK, there is scope for a similar practice through the use of a Bill of Sale, allowing the borrower to transfer ownership of the artwork to the lender as security, whilst retaining physical possession. In other words, the borrower can obtain a loan secured against a piece of art without relinquishing the piece to a lender. Bills of Sale then have to be registered at the High Court. So far so good, but when the Law Commission (the government body responsible for law reform) examined the register in 2014, of the 260 Bills of Sale registered (not relating to motor vehicles for which they are more commonly used), only one was for an artwork.

Bills of Sale appear to be rarely used due to the complexity and risks of the statutory framework. Bills of Sale are governed by the Bills of Sale Act 1878 and the Bills of Sale Act (1878) Amendment Act 1882 which are totally unsuited to modern commercial requirements. The faults with this legislation were identified almost immediately and have been recognised for a considerable time. The Law Commission have highlighted the following most notable weaknesses:

- Bills of Sale fail to offer adequate protections to borrowers or to third parties who acquire interests in the goods
- Bills of Sale impose unnecessarily burdensome formalities for creating and registering security, which result in significant costs for lenders
- If the formalities are not properly complied with, this can result in neither the security nor the loan being enforceable
- Bills of Sale work only within rigidly defined boundaries, which stifle the ability of unincorporated businesses and high net worth individuals to use their goods as security
- The many criticisms of the Bill of Sale regime, both in concept and operation, are well-justified. Because of these drawbacks, most lenders require possession of the artwork, which makes the prospect far less attractive to the borrower. To a large extent, this appears to be inhibiting the art-lending market and preventing an alternative source of liquidity from entering mainstream financing arrangements.

The Law Commission was asked to review the Bills of Sale legislation in 2014. Initially, based on the usage of the Bills of Sale register, this identified perceived failings and abuses in the logbook-lending market over vehicles. The potential for other asset-backed lending was not appreciated, but has been identified over the consultation period, and is now a recognised collateral benefit of the proposed reforms. The Law Commission has published a proposed draft bill, for a new Goods Mortgages Act:

<https://www.lawcom.gov.uk/proj...>

The draft bill is designed to:

1. Simplify paperwork and provide a central register
2. Protect borrowers fairly from repossession
3. Protect innocent purchasers of goods unaware of security interests
4. Save costs on archaic registration requirements
5. Remove restrictions on more sophisticated secured lending
6. Allow security to be taken to allow further advances or revolving credit rather than the asset only being allowed to secure one charge

Put simply, the new legislation would allow individuals and unincorporated bodies to use goods (tangible moveable property) which they own as security for a loan, whilst retaining possession over those goods.

The Law Commission have done an excellent job in identifying the flaws, suggesting reform (with stakeholders) and drafting proposed legislation. The high point, to date, for reforming the bills of sale legislation was inclusion in the Queen's Speech in 2017. The

reform, however, appears to have stalled at the point of implementation.

The proposed legislation was complete, save for identifying how registration would be dealt with practically. The current register is paper-based and notoriously difficult to search. It is hoped that the new register will be electronic but this is a key part of the reform. It may be that there is no appetite within the Government for establishing and maintaining another public register. The benefits of at least the base data being provided by the Government, however, are clear in terms of data integrity and access. The Treasury, perhaps, remain to be convinced of the potential benefits of a better functioning art lending market and no doubt stakeholder views would encourage this. As they stand, the reforms are a step in the right direction, but the key to the market remains a functioning register like the one offered in the US.

It has just been announced that the Scottish Law Commission has recommended reforms to their asset-backed lending market (which is perceived by informed commentators to be behind even that of England and Wales). It is hoped by those involved that these reforms will be introduced during 2018. Perhaps this will provide the final impetus needed to get the reforms over the line across the UK.

OUTLOOK: ART LENDING INDUSTRY IN THE NEXT FIVE YEARS

Evan Beard, National Art Services Executive at US Trust and John Arena, Senior Credit Executive for Fine Art Product at Bank of America



What would you say are the key macro factors (global, economic, political) that will shape the art lending industry in the next 5 years and why?

It was in 17th-century Holland when a Baltic merchant named Herman Becker had the idea to extend loans secured by pictures to Dutch artists like Rembrandt van Rijn and Jan Lievens. □ It's only taken 350 years for this idea to mature into something you could begin to call an industry. Only recently has our sector really come into its own – with total art loans growing from a couple of billion to approximately \$17 to 20 billion over the last decade according to Deloitte. We believe the next five years will be defined by five key macro factors:

Global economic growth: art lending is almost entirely US based but relies on a healthy, expanding international art market. The performance of global capital markets, particularly in the US, Eurozone, and Asia, will drive collector sentiment and capital flows towards art. Global growth will also determine the level of demand for reallocation of capital unlocked from art loans.

Expansion of the collector base: the information economy, the rise of global finance, and the reopening of economies like China, Russia, and Brazil, where wealth is more concentrated than in social democracies, has minted a new class of super-rich. Wealth stratification has no doubt created social challenges, but it has also expanded the collector base exponentially. We expect more of these collectors to utilize art lending. Education is another major driver of the collector base. Educational attainment is highly correlated with cultural appreciation. □ Future growth of the global collector base is a function of continued growth in educational opportunities worldwide.

Monetary policy: our sector has benefitted from a protracted era of historically low interest rates. Most collectors who leverage their art do so as an arbitrage: unlocking capital at a low cost of capital to re-deploy into a dividend-bearing asset like commercial real estate or private equity. As interest rates rise, the opportunity cost of holding non-interest bearing assets like art goes up (as fixed income yields improve) and the cost of redeploying capital via an art loan also goes up. A more hawkish Fed policy could slow art lending growth.

Collector philosophy: perhaps the biggest driver of growth has been a mindset shift by

collectors who once viewed their art purely as a hobby or aesthetic pursuit and now view it as a strategic asset. New wealth (and new collectors) increasingly hail from market-driven industries like hedge funds, private equity, and real estate. These collectors are credit-savvy, financially-minded, and more inclined to unlock capital from their art. We expect this trend to continue.

Global geo-political stability: while art itself tangible, its value is intangible. The price of art is based on a belief – a belief that owning a work of genius bestows cultural capital, social prestige, aesthetic pleasure, and intellectual enrichment. The art market, perhaps more than any other segment of the global economy, is driven by sentiment. A geo-political shock like outbreak of war on the Korean peninsula could put the international art market on hold. The greatest geo-political risk we see is if recent trade grappling turns into something more widespread that impedes the global flow of capital and credit.

In your view, what are the main micro factors (art & finance industry specific) that will determine the evolution/ direction of the art finance market in the coming years?

Coming down from the clouds, we see four specific factors that could define our evolution:

International Legal Framework: we believe the greatest growth catalyst would be if international jurisdictions like the UK, the Euro Zone, and Hong Kong, would create a legal framework akin to the Uniform Commercial Code in the US that would enable lenders to perfect their interest in tangible assets while allowing borrowers to maintain possession. The art lending sector is almost 100% US based and there exists extraordinary demand overseas for this service. Think of all those landed estates in England full of pictures. The international growth potential of our industry is largely in the hands of EU and Asia-Pac regulators and policy makers.

Non-recourse Innovation: there are two segments in the art lending space – recourse lenders like U.S. Trust and non-recourse lenders like Sotheby's and Athena. We believe that the professionalization of the non-recourse segment has been a positive development. We expect much future innovation to occur in the non-recourse segment as collateralized debt funds, auction houses, and boutique lenders find new solutions like pre-approved lots to finance at auction, dealer inventory lines, or securitization.

Private Equity, Real Estate, Hedge Fund Sector: collectors from these three industry segments are most inclined to borrow against their art. The continued health and growth of these industries will drive overall art lending demand.

Tax Reform: the elimination of the 1031 Like-Kind exchange for art due to the recent U.S. Tax Reform Act makes it more expensive to sell works of art with a low cost basis. We expect more collectors will use an art credit facility to create liquidity to avoid the 28% capital gains rate on collectibles.

Data: the greater overall availability of art market data is positive development for the art lending space. Transparency and data availability improves the ability of risk and credit committees to expand collateral types, evaluate depth of market, measure correlation profiles, and track art market performance.

PEER-TO-PEER LENDING

Ashwin Parameswaran, Co-Founder, Unbolted



Could you tell us a bit about who your target clients are, and why?

Our target clients are mid-market auction houses, dealers and individuals to whom we provide finance secured by any assets with an easily ascertained secondary market value. These could be artworks, watches, classic cars, rare books, antiques etc.

Although there are a plethora of players serving the £1m+ loan market, businesses and individuals who require financing in the hundreds of thousands (or even the tens of thousands) have very few options. Our digital and peer-to-peer model allows us to service these loans profitably at an economical cost to the borrower, hence the focus on this segment of the market.

Could you give us an example of a user case where a gallery or dealer might benefit from a peer-to-peer loan?

A typical use case is a dealer or gallery who has hundreds of thousands tied up in working capital at any moment of time. Small dealers often have to resort to informal high-cost financing arrangements. Working capital constraints also prevent them from taking advantage of opportunities to purchase assets at attractive prices.

We provide them with working capital finance at attractive rates at short notice so that they can scale up their business and take advantage of opportunities when they arise.

What are typical loan amounts and terms (maturity/interest/LTV) of these loans?

As most of our loans are working capital finance, our typical loan terms are for less than 12 months (although this does not prevent us from doing longer-term loans).

LTV depends on both the asset and the maturity and can range from 30-40% to 70-75% depending on the asset in question. For example, a diversified portfolio of liquid watches

would command an LTV at the higher end of that range whereas a concentrated contemporary art loan would command a LTV at the lower end.

Interest rates depend on the loan amount. A typical loan of £100,000 would attract an interest rate of around 1.50% per month for short-term financing.

What are the biggest challenges you face when underwriting art related loans? (Valuation, authentication, etc.)

We rarely deal with artwork where the authenticity/provenance is doubtful. The primary challenges are ascertaining the liquidity, volatility and valuation of the artwork in order to determine the valuation and the LTV at which we can lend on any particular asset.

What is the difference between what you offer and a traditional asset-based art lender (like Borro, Falcon, Athena)?

Traditional lenders focus on loans much above £1m whereas we focus almost exclusively on loans below £1m, a segment that we feel is under-served. Unlike some of the traditional lenders, we do not shy away from doing regulated consumer loans either.

What role in the art lending landscape do you think peer-to-peer lending will have in the future?

As is the case with business financing, peer-to-peer lending focuses on providing financing to segments of the market that are not served well by the mainstream players (whether they be banks, private banks or specialist lenders). The lean, digital approach enables peer-to-peer lenders to profitably fulfil much smaller loans than other lenders can.□

How big do you think the market potential is for peer-to-peer lending against art/collectibles?

Putting a number on the market potential is difficult. When it is made into law, the Goods Mortgages Bill will provide a significant fillip to the market in the United Kingdom. It will enable smaller-size peer-to-peer loans against moveable personal assets to be fulfilled profitably and without the lender having to take possession of the asset.

RISKS, CHALLENGES AND OPPORTUNITIES IN THE ART SECURED LENDING MARKET

Dr. Tim Hunter, Vice President, Falcon Fine Art Ltd.



Tell us a bit about the due diligence process that Falcon undertakes when lending against an art work and the challenges that each step presents?

Falcon's due diligence process is very thorough, but I would also say fairly straight forward, covering both the artworks and the borrower. With regard to the art it is vital that each work is authentic and correctly attributed (and where necessary outside experts are consulted).

Provenance is researched (including war-time provenance) and each work is checked by the Art Loss Register. We also require proof of title. The condition of the artworks is also assessed and art works are valued by independent appraisers.□

As mentioned, we also carry out due diligence on the borrower, in accordance with KYC (Know Your Client) guidelines. As a responsible lender we want to ensure that we lend to people of good reputation and who have a clear idea of how they will repay the financing on its maturity.□

From a risk perspective, what are the key differences lending to an art dealer vs a private individual

The risks are similar but there is a key difference. Whereas a private collector will normally be content□to keep his/her artworks on their wall (or in some cases in storage) during the financing period, a dealer will typically want to move the artworks to different locations: to their gallery, to art fairs, museum exhibitions and sometimes to the house of a prospective buyer. This presents problems for a financier who needs to know where the collateral is at all times. Moving art also increases the risk of damage and meaning insurers have to be constantly appraised of the situation. These things can be accommodated, but it undoubtedly makes the financing more complicated.

What are the key challenges lending to an art dealer, and how can these be addressed/solved?

In some ways providing art dealers with art-backed financing is easier than private individuals as the artworks are normally high quality and much of the due diligence work

concerning provenance, condition etc., has already been done to a high standard. The main challenge is that the dealer usually also wants to present the artwork for sale, which necessitates moving the artworks (as already mentioned). Also, regarding title, sometimes a work is jointly owned by several parties and this can cause complications. It is advisable for dealers considering art-backed lending that they use pieces unencumbered by other loans or third-party involvement. Very often, the use of art financing can prove an attractive alternative compared with the more traditional joint ownership model. For dealers, the ability to pay a pre-determined level of interest may be far more preferable than having to give away a share of the resale profit.

Valuation - what value is being used for lending purposes? And typically what is the % LTV applied to this value? What are the biggest challenges with valuation, and what is a possible solution to this?

Correct valuation of the artworks is, of course, crucial to the lender, and the difficulty of arriving at a value for art is one of the reasons that banks are typically reluctant to lend solely against artworks. At Falcon we are fortunate to have in-house art expertise and a great deal of experience in valuing artworks. We always commission two independent valuations from a wide variety of experts in their respective fields. We value at current market level (the price you would expect the artwork to make if it was sold at auction in the current market). We will then normally lend at 40% to 50% of this value. Obviously, valuations are completely confidential and the process is extremely discrete - sometimes borrowers will not want certain experts to know that a particular work of art is being used as collateral and we always respect these wishes.

In your view, what do you think are the factors that would enable a more efficient art lending/finance market for dealers and galleries?

Undoubtedly some form of central register (along the lines of the American UCC filing) for loans against works of art would make lending to dealers much easier. There is currently legislation moving slowly through parliament that will address this, but we do not know how long it will take to become law. Also, the different laws pertaining to the export of works of art in each European country make it complicated to move collateralised artworks between jurisdictions. A more consistent approach within the EU would help, although Brexit will add a further complication here. Art-backed lending can be a complicated process and that is why there are still only a handful of specialised lenders in Europe who can offer this service.

THE ART-SECURED LOAN PROCESS

Freya Stewart, CEO Art Lending, The Fine Art Group



With a clear understanding of the underwriting and execution process required to obtain an art-secured loan, potential borrowers can assess which lender(s) and which type of loan may be available and most suitable for them, taking into account their particular needs and circumstances. The process flow summarised below seeks to identify both the key requirements of an art-secured lender and certain questions potential borrowers may wish to discuss with lenders in order to select the most suitable lender for their needs. At a high level, some of the fundamental differences between lenders include: whether the lender requires detailed financial information and liquidity/credit rating criteria concerning the borrower, in addition to assessing their art collateral; the speed with which the lender can fund loan monies; the type of product and commercial terms a lender can offer; whether the lender requires possession of the collateral during the loan; and the level of client service and confidentiality of process that the lender offers.

THE IMPORTANCE OF THE PERSONAL TOUCH

Allen Perl, Partner, Perl Grossman & Associates LLP



Interview with Allen Perl, Partner, Perl Grossman & Associates LLP

What have been the biggest shifts/ changes in the way galleries/ dealers finance their businesses over the years? What finance model is the most viable in your view?

Over 35 years that I have been working with art dealers, the cost of inventory and operations has gone up dramatically. This has meant that it is nearly impossible for an art dealer to build stock or inventory without outside financing. A lot of art dealers, particularly Old Master dealers, now typically go for joint-ownership in artworks. I believe this is often a healthier way for galleries to finance inventory compared to debt financing.

In what way?

Let's use a very specific scenario; there is a painting available for \$1 million, and the art dealer has a credit facility for \$1 million. The question is, do you want to put all of your eggs in one basket? Imagine the targeted selling price of \$1.5 million, you ship the piece, increase your insurance coverage, and have it restored, which could take nine months. As these costs increase, your margin diminishes. When the piece is ready for sale, you may be forced to pull the trigger quicker than you envisaged, due to the costs or if the amount you have tied up in capital becomes too great. However, dealers working with joint ventures, have smaller costs and double the clientele exposure. As you are going 6, 9, 12 months into it, it's not as stifling or choking to the individual dealer.□

Traditional banks are generally reluctant to lend to gallery and dealer businesses. What aspects of the business is it that they find too risky or hard to understand?

The problem arises at the underwriting stage – where there is a significant gap between the art dealer and the bank. An underwriter has in most cases no relationship with the customer, often having a hard time understanding the business and the dealer's reputation. It can be very hard for the front line banker who has the personal relationship with the dealer to translate that relationship back to the underwriting team, who are looking at the investments of the bank and deciding whether or not to renew.

Is there anything the art dealer community can do to address these challenges?

It's really hard in my opinion, although there are good accounting firms etc. who can attest to the books and records of the art dealer, the bigger problem is that the bankers often are unable to really create strong bonds with the art dealer community. Most businesses, including banks, are being driven to gather new business rather than strengthen their current business. I think if you serve your existing customer well, whoever that may be, they are going to be at the source of your new business, and banks in my opinion have lost this perspective. If you are intimately involved with your customer, you can become intimately involved with his associates (art dealers hang out with art dealers etc.), and the bankers who are involved with all of these different individuals that all know each other, are going to know a lot more about what's going on, than simply looking at a series of quarterly, semi-annual or annual financial reports. It's about being there, knowing your client, and stopping by unannounced for a cup of coffee. If you go to a client's for a cup of coffee rather than a surprise audit, you are going to see what's actually going on - is the environment the same as a staged appointment, where there maybe a lot of window dressing?□

What could banks and financial institutions do?

It's about the banks understanding the art business, fostering relationships, and allowing the front line banker to really strengthen their relationships, and use that as the method for reporting back. It's not going in once a year and having a meeting, its developing a relationship with your client. For example, if a business situation goes sour (it happens and unfortunately everyone is subject to it), when you are dealing with someone you have a relationship with, who is honourable, you can try to work out a solution that nobody envisioned. During the ebbs and flows of the economy, where the art market is strong and weak, and we have these cycles, you know who is out there beating the bushes, or which people are crushed under the pressure and just can't cope. The more you know the individual, you are going to have a good inclination as to how to work through a situation that nobody ever envisioned. How relationships are fostered over time really helps that kind of understanding.

THE NEED FOR A REGULATED, STANDARDISED APPROACH TO DUE DILIGENCE AND RISK ASSESSMENT

Harco van den Oever, Founder and CEO, Overstone Art Services



In an era of consolidation, growth is no longer an option, but a major priority. A successful London gallery recently had the opportunity to acquire a collection of works by an important artist with substantial upside and the possibility to become a major actor in the market for that artist. The business challenge? Finding the liquidity required to make the acquisition, without enough cash reserves, and whilst trying to avoid sharing too much of the upside by partnering with a co-investor. The business issue? A lack of lenders willing to extend credit on the back of art at a reasonable cost.□

Art-backed lending has been available for decades, nevertheless, it is still a very niche offering. Even today, with an estimated \$17-\$20 billion [1]□of extended art backed loans, between 0.5% and 1% of the art in private hands is being used as collateral□. Compare that to other markets, such as cars, where an estimated 60% is being leveraged, art is effectively the last, utterly unleveraged, asset.

In fairness, art has many particularities that will ensure it will never go to 60%, but surely, there is scope for improvement, as 46% [2]□of collectors say they would be interested in using their art collection as collateral for a loan

So, what is really the main issue? One, a lack of regulatory oversight; most major, low interest lenders, will not touch this space until it is regulated. Two, the lack of a standardised way to assess the risk profile of the collateral. Most lenders don't understand the price risk of an art work, let alone understand the risks specific to art as collateral, e.g. authenticity, condition, title etc.

Let's address these two points separately. There is a general trend towards regulation on all asset classes, and some form of governmental oversight is eventually inevitable. Self-regulation, being generally non-binding, has proven many times not to be sufficient, particularly when written by insiders with vested interests. The art market is widely perceived as suffering from price manipulation, conflicts of interest and being generally

opaque. It is true that much legislation covers the market, however, its application is less prevalent. A Government or independent body led regulation would force more transparency and lead to more trust. Although regulation might hurt those players unable to adapt, it would open an entirely new scale of business that has so far eluded the art finance market and thus borrowers as well as the wider market.

Considering art from the risk assessment perspective is complicated. There is a completely fragmented market of condition reports, title claims and insurance, conflicting opinions from experts and valuers, art advisors and dealers. It is little wonder that many non-art market insiders, find art a complex asset class.□

This is a real shame, as a regulated, standardised approach to due diligence and risk assessment would transform this market for the benefit of all. Collectors and dealers could expand their financial reach, lenders would be able to both reduce the amount of capital required to put aside against these deals, and also retain and acquire new clients with a product that enables a unique level of personal interaction.

Efforts are being made to address this, including the recently launched Responsible Art Market (RAM)□ initiative or the launch of Overstone's own art due diligence platform.

Although a work of art is and will always be fundamentally an emotional asset, the evaluation of risk can and should be much more objective and data driven. At Overstone, we assess two main groups of risks. Firstly we look at object specific risks – focusing on authenticity, condition and title. Traditional due-diligence methods are used in establishing the art work's current status i.e. are authenticity reports available and are these from recognised leading experts? Is there are clear title (ownership) to the art work? And finally focusing on the condition of the art work itself – such as age, materials or pigments used and how these may change over time and how this could affect its value? The key in the due-diligence process is to assess, score and report on those risks in a consistent, standardised way driven by a combination of data and expert experience and knowledge.□

The second type of risk is□related to price and liquidity risk. With the advent of more data in the art market, combined with machine learning and artificial intelligence, there is an increasing focus on developing new models to assess price and liquidity risk around specific artist markets, as well as the specific art work. Although much of this work is still in its infancy, we believe more investment will be made into this area in coming years, and will be an important component in understanding, quantifying and pricing risks when art is being used, i.e. as a collateral for a loan.

We believe the art secured lending market would benefit from standardised way of collecting data, measuring and reporting risks. A lender should be able to look at a set of scores in order to assess the risk profile of an art work or group of works.

A regulated, standardised art-backed lending industry will help grow the market and therefore the economy. It's that simple.

[1] Source: Art & Finance 2017 - Deloitte and ArtTactic, p.159

[2] Source: Art & Finance 2014 - Deloitte and ArtTactic, p.59

TRENDS IN THE ASSET-BASED ART LENDING MARKET IN THE UK AND US

Claire Hillier, Chief Commercial Officer, Borro



What are the challenges in the market for dealers?

Many mid-tier dealers are experiencing tighter margins, especially in centers of art commerce like London and New York. Increases in gallery rent, overhead, staff, shipping and insurance contribute financial pressure across all areas. As more and more transactions take place at an ever-increasing number of global art fairs, rather than in brick and mortar establishments, these challenges are only exacerbated. We have found that dealers are looking for new financial solutions to these obstacles.

What are the challenges you are seeing across the board in the art lending market?

- Stigma regarding financing fine art, and antiquated discomfort with viewing art as a store of value.□
- Lack of imagination in the possible application in this financing facility
- Lack of awareness amongst collectors, dealers, and advisors.
- Some collectors don't want to surrender the work for the duration of the loan
- Due diligence – clear title, provenance, authentication.
- Vulnerabilities associated with changes in market conditions.

What art finance products do you offer to art dealers?

Borro's art financing offers dealers quick, easy access to capital to seize on time-sensitive buying opportunities, and enabling otherwise-dormant inventory to assist in their efforts to maximize profits over time. We were recently approached by a Mayfair-based dealer who had purchased two works of art via private sale, and wanted to wait a period of time before selling at auction. Instead of having the pieces languish in storage, the dealer leveraged them at 50% LTV over 12 months, providing a much needed cash injection into their business before a series of major art fairs. In cases where dealers have large holdings of a particular artist or estate, rather than flooding the market, they can call upon our financing facility to leverage a portion of their inventory while selling at a managed pace.□□

What % of your loan book do you estimate is to dealers?

By value, we would estimate approx. 50- 60% is through a dealer.

Is there any difference between US and UK?

We see much more interest from the dealer sector in the US market leading me to believe that art dealer lending is much more common in the US than the UK, I think this is for a number of reasons. Art lending feels more 'normal' in the US market, it's been around for longer and there is certainly less stigma attached to the concept of raising finance secured against assets. A comment I hear, often in the UK, market is that dealers frequently partner with other dealers on transactions to allow them to purchase more works - this could be because the market is smaller and competition is greater so there is almost a 'if you can't beat 'em join 'em attitude'. I suspect this is a contributor to lower dealer art lending numbers in the UK.

Lastly, I do believe the UCC provides added security for lenders when providing finance to dealers in the US market. UCC and the legal framework makes it far easier to allow dealers to retain possession of the pledged art, many dealers are not looking to hold onto a piece for long periods of time and often need access to show potential buyers. Unfortunately there is no such system in the UK market meaning many lenders take possession for the duration of the agreement- which I don't think works well for some dealers. There are several lenders that permit retention of the piece but these lenders typically service the mid to high end of the market (\$2m-\$30m) and require personal guarantees to limit their risk which isn't entirely practical when a dealer needs speed.

What trends do you think might affect the art lending market going forward?

- Elimination of the 1031 Exchange in the U.S. has led to an increased interest in our financing facility for it enables the collector or their estate to monetize an artwork that has gone up significantly in value while avoiding capital gains tax triggers.
- In the art lending space, clients have greater flexibility to buy and hold, helping them to better manage the timing of sales. Thus, they can still extract liquidity from their collections without over-transacting.
- The rise in volume of transactions in the contemporary space via auction houses (mid-season sales), online platforms, and the proliferation of art fairs indicates a need and/or desire for liquidity in this space.
- Increasing appetite for financing options available to dealers, including acquisition finance for auction purchases, sales advances for liquidity before sale dates/auction pay-outs, as well as desire for longer term loans in the \$100,000-\$500,000 range.

WHY MOST FINANCINGS FOR US ART DEALERS LOOK EXACTLY LIKE LOANS TO COLLECTORS

Stephen Brodie, Partner, BLANKROME



Many art gallery businesses in the United State have annual revenues of between \$20 million and \$100 million. This is a range that is often a “sweet spot” for the middle-market divisions of commercial banks in places like New York. These banks regularly provide revolving credit facilities to mid-sized businesses, which are secured by all of the borrower’s inventory and accounts receivable. But facilities of this kind are rarely made available to art dealers, even though their need for liquidity is no less real than that of other businesses of similar size. This article will explore the reasons why this is true, and propose some ways in which art dealers might adapt to make themselves more attractive to commercial bank lenders.

Lending to US Art Dealers.

The foregoing is not intended to suggest that art dealers in this country cannot obtain financing. Private banks in New York and other cities, as well as Athena Art Finance Corp. and Borro Inc. and other asset-based lenders, are active in making loans to art dealers. But these loans are almost identical in structure to the loans provided by the same lenders to art collectors. In the case of the asset-based lenders, credit is extended against the security of a limited number of specific works, which are usually held in a storage facility under the lender’s control. Only a handful of the most successful dealers are able to qualify for the type of middle-market, revolving credit facilities described above, wherein the collateral consists of a gallery’s inventory and accounts receivable, generally, and the inventory is held at locations that are disclosed to the bank but are often controlled by the gallery. In addition, galleries that own real estate and are willing to pledge their inventory and accounts are sometimes able to obtain mortgage financing from banks on more favorable terms than a mortgage of the real estate alone would have permitted. In other words, US lenders are plainly reluctant to extend credit to art dealers as ordinary business borrowers. Even the lenders who are comfortable taking art as collateral (and many are not, for the reasons explained below), are usually unwilling to make loans to art dealers where a key component of the credit support is the performance of the gallery, as a business, in and of itself, i.e., the ability to reliably generate the cash flow needed to service the debt. This is what is sometimes referred to

as “cash flow lending.”

Cash Flow Lending v. Asset-Based Lending.

Cash flow lending is what enables successful middle-market businesses to maximize their access to working capital financing.□ These are very often secured loans, but they are not “asset-based.”□ The difference is that in the case of an asset-based facility, the lender relies on its collateral as the primary source of repayment; whereas a cash flow lender will also derive important credit support from the proven, strong performance of a borrower’s business in selling its goods or services.□ Cash flow lenders can often tolerate “air balls,” i.e., shortfalls in the value of the collateral supporting the available credit.□ Asset-based lenders will never allow that; they adhere strictly to “borrowing base” requirements, which limit the lender’s commitment to extend credit to a percentage (called an “advance rate”) of the value of the borrower’s “eligible” collateral.□ Eligibility criteria for inventory include clean title, suitable location, absence of liens and other claims, good physical condition and similar common sense considerations for a creditor whose approach to making such a loan is that it almost doesn’t care if the loan goes into default, because the lender is confident that it has sufficient, readily marketable, collateral that can be liquidated to satisfy the debt.□

There are, of course, hybrid structures, which incorporate some of the features of both types of lending. These are sometimes called “ABL-lite” facilities.□ In these situations, banks will lend against the security of a borrowing base but will not require “full dominion” over the cash coming into the borrower’s bank accounts, and will test the outstanding indebtedness against the borrowing base on a monthly or even quarterly basis, rather than every day, as would be done with a full-dominion, asset-based loan.

Bank Loans to Top US Dealers.

Importantly, there is a handful of top US art dealers who have been able to obtain these “ABL lite” credit facilities that are commonly found in the middle-market commercial world.□ The reason for this is that these dealers have adopted many of the “best practices” of the contemporary commercial world, and operate in a financially sophisticated manner that permits them to transcend some of the inherent risks to a lender in relying on fine art as its collateral.□ These practices include audited financial statements from reputable and independent accounting firms, chief financial officers who are far more than mere bookkeepers or controllers, as well as internal controls and systems managed by more than just the principal of the gallery.□ Many of these things have become common even in the low end of the middle-market today, but they are notably lacking among all but the top US art galleries, according to commercial bankers who are active in this space.□

These best practices are important to banks because an inherent weakness in the commercial banking business is that, as a practical matter, they are critically dependent upon what their clients tell them about how a borrower’s business is performing.□ This makes transparency and the reliability of financial reporting essential to the middle-market lender.□ Thus, if an art dealer or any other business is deficient in this regard, meaningful credit support can usually only be found in the value of its inventory and accounts receivable collateral.

Art as Collateral; Risk.

Most art dealers have some accounts receivable to offer as collateral, but these ordinarily constitute a small portion of their assets. Moreover, the credit-worthiness of the dealer's account debtors (a critical consideration for a lender advancing monies on the basis of accounts receivable) would often be quite difficult to assess.□ Thus, it is an art dealer's inventory could serve as the primary basis for a working capital financing.□ As indicated above in the explanation of borrowing base eligibility criteria, the best inventory collateral consists of goods that can be reliably and easily sold, preferably on a regulated and well-established market.□ For example, it would be relatively easy for a lender to liquidate consumer products with major brand names (e.g., Colgate or Crest toothpaste), if a drugstore borrower went into default.□ If we contrast that scenario with having to sell off the fine art inventory of a New York gallery, the difficulty faced by a lender to the gallery becomes clear.□ Rather than needing to sell something tangible, of easily determined value and nearly universal utility, art lenders forced to sell their collateral would be seeking to dispose of unique "goods" that are rarely traded, with little or no practical value.□ This is almost the polar opposite of needing to liquidate some name-brand toothpaste.

Unfortunately, the challenges of using art as collateral do not stop there.□ In fact, here are some risks for a lender that are unique to fine art.□ No other high-value asset carries the same potential for being faked or attributed to the wrong source.□ People in the art world are all well-familiar with these issues, but they are all but unheard of in the wider world of secured lending.□

The other special risk attendant to taking art as collateral is title.□ This is a less well-understood problem than authenticity or misattribution. When the subject is raised, most people think only in terms of World War II restitution claims. But the fact is that there is a multitude of title issues of an everyday nature that can (and sometimes do) impair good title, some of which do not manifest themselves for many years (e.g., questions as to whether the grant of an artwork was a loan or a gift, rights of first refusal which appear only in sparse bilateral documentation and, perhaps above all, ordinary theft, unrelated to major historical events). In considering the difficulty posed by this risk for a lender, first remember that if the collateral grantor does not have good title, the lender probably has no security interest in anything. Then consider that parties to art transactions have traditionally (i) been obsessed with secrecy (or confidentiality), and (ii) accepted, as a matter of course, remarkably thin legal documentation when compared with transactions involving other valuable assets. Similarly, the buying and selling of fine art has, more often than not, involved the use of agents for undisclosed principals (often a dealer acting on behalf of the real buyer or seller, or on behalf of another dealer also acting as an agent), to such an extent that in the famous “Red Elvis Case” decided in Connecticut state court in 2005 and affirmed on appeal by the Supreme Court of Connecticut in 2007, the court found that industry norms dictated that only when “circumstances surrounding the sale cast severe doubt on the ownership of an artwork are merchants and buyers required to obtain documentary assurances that the seller had good title.” *Lindholm v. Brant, No. X05CV020189393, 2005 WL 2364884 (Conn. Super. Ct. Aug. 29, 2005), aff’d, 283 Conn. 65 (2007)*. Although there are indications that such practices are slowly evolving to where the true identities of a buyer and a seller are often disclosed, at least to each other, for those who are accustomed to consumer goods or other things that are commonly used as collateral, title to art remains, at best, a troublesome subject.

Art Lending to Collectors.

As indicated above, major US private banks often make loans secured by specific works from an ultra-high net worth client’s art collection.□ Usually, these banks are relying primarily on the overall financial strength of their borrowers, rather than the quality of the art collateral itself.□ However, that collateral does allow the bank to increase the size of its loan, to reduce the interest rate or otherwise sweeten the terms of the deal for its client.□ Moreover, with the collateral pool consisting of a limited number of works, as opposed to a gallery’s ever-changing and larger inventory, private banks lenders can perform some reasonable due diligence to mitigate the risks attendant to the art collateral, and often find some meaningful credit support therefrom, as a result.

While true asset-based lending is all but non-existent as against the full inventories of art dealers, there are non-bank lenders that will often make loans to gallerists secured by a pool of specific dealer-owned pieces that can be released and replaced with other specific works as sales occur.□ This is the main financing option that has evolved to fill dealers' need for working capital, because all but the most prominent art dealers in the United States cannot qualify for the kinds of larger revolving credit facilities described above, which are commonly made available by banks to businesses in other industries in the middle-market commercial world.□ In other words, most dealers who obtain debt financing do so in exactly the way that an individual art collector might, without deriving any benefit from the fact that the dealer has a going-concern business, ready to stand behind its obligations to its lender.

A Way Forward.

The example set by the few US dealers who have succeeded in obtaining bank financing based upon the value of their full inventory is significant.□ It demonstrates that with the adoption of better business practices which, among other things, evince a healthy respect for the legitimate needs of an institutional lender for transparency and reliable financial information, the prospects for an art dealer to obtain enhanced working capital financing from US banks are real, notwithstanding the obvious weakness of having to rely upon fine art inventory as collateral.□

In addition to the audited statements, better accountants and other upgrades in reporting and in the administration of a gallery's finances, there are certain other steps that would surely serve US art dealers well.□ For example, New York and certain other states have laws that deem the commissions owed by dealers to artists to be trust funds (i.e., monies belonging to the artists are held, in trust, by the gallerist, as "trustee," until they are paid over to the artists).□ Among other things, this means that such funds are not supposed to be commingled with the gallery's own money.□ Some people say that these laws are "more honored in the breach than in the observance."□ That may be an exaggeration; however, commingling of this sort is not uncommon and is plainly a bad business practice with which US banks are familiar. And it makes the banks skeptical about whether the account balances and cash in hand shown on the books of some dealers really belongs to the dealer, or to artists whom the dealer represents.

Another common form of commingling can perhaps be more easily remedied.□ Article 9 of the Uniform Commercial Code provides for the filing of a UCC financing statement by a consignor (as the secured party) against its consignee (as debtor).□ This is intended to protect a consignor from the claims of the secured inventory lenders of a consignee in the event of the consignee's insolvency.□ Leaving aside the question of whether or not a consignment to an art gallery in a place (like New York) where it is widely known that galleries deal substantially in the sale of consigned art, gives rise to a bona-fide Article 9 consignment for legal purposes, the filing nonetheless creates a public record of what is ~~not~~ dealer-owned inventory.□ This kind of independent, corroborating information would be of real value to a bank when asked to accept a borrower's representation that its "eligible" borrowing base inventory collateral was, in fact, dealer-owned and not merely the subject of a consignment.□ But the filing of UCC consignment financing statements is not a practice that galleries seem to require, or even encourage.

Finally, there would be another, less obvious, benefit to adopting these best practices: An art dealer's inventory would very likely become more acceptable as collateral, to both cash flow lenders and even, to some extent, to asset-based lenders, like Athena and Borro. Credit officers at banks and other lenders are keenly aware of all the inherent risks of art as collateral, and their concerns are exacerbated by what they see as a culture in the art business that is lacking in respect for the norms of transparency and standards of due diligence that are found in the rest of the commercial world. Fairly or unfairly, one inference that lenders inevitably draw is that what passes muster for many art dealers under the "connoisseurship-based" due diligence, concerning issues of title, authenticity and attribution, could be improved. Thus, if the culture abroad in the art business seemed more mature and disciplined, lenders' confidence in a gallery's due diligence concerning its fine art inventory would likely be enhanced. In this regard, it is worth noting that while there is no insurance (and there probably can never be insurance) available for authenticity and attribution risk, there is title insurance available for art. Aris Title Insurance Corporation is under new leadership and has expressed interest in developing programs for dealers that would allow a gallery's buyers to title insure their purchases at commercial rates. This would, of course, require dealers to maintain certain standards and best practices in performing due diligence on the sales that they originate, but title insurance would also be a huge step forward in removing "eligibility" clouds from the borrowing base of a dealer's inventory.

Conclusion.

The point of all of this is not that art dealers should change their ways to please banks. Rather, the availability of greater and more reliable sources of credit for gallerists could benefit the entire industry. More working capital would mean that more emerging artists could be promoted effectively, additional opportunities could be realized to purchase works that are perceived to be under-valued, exhibiting at some additional, perhaps overseas, art fairs could become feasible. The full list could go on for pages. The real point of upgrading these business practices was made perfectly by Andrea Danese, CEO of Athena Art Finance Corp., who, in talking about doing business with art dealers, said, *"Debt financing has a natural place in the capital structure of many galleries and dealers. There is significant financial upside for the art trade to embrace a well-structured debt financing option and, by extension, to standardize certain business practices."* Note that this is the perspective of an asset-based lender. No commercial banker could disagree or say it any better.

There are undoubtedly some good reasons why the art trade has traditionally been conducted the way that it has, but some dealers have seen the wisdom in stepping up and into the middle-market commercial world of the 21st century. These dealers have been rewarded with greater access to debt capital, and the same could certainly happen for others who make the leap. Changes to time-honored ways of doing business are slow to occur and difficult to implement in any field. The art world is no different, and may even be more challenged in this regard, because it is so opaque. Nonetheless, the availability of additional and more flexible sources of capital is quite visible, and there is, after all, such a thing as an idea whose time has come.

GLOSSARY

Retained earnings

Retained earnings are profits earned by a business which are not paid out (as dividend), but are reinvested within the business as a source of finance.

Section 1031 Like-kind Exchange

Under Section **1031** of the Internal Revenue Code, owners of business or investment properties, through the use of a Qualified Intermediary, can sell one property and purchase a similar or "**like-kind**" property while deferring capital gains.

Lien

Liens can be granted on art works (or asset) which have loans secured against them, and provide the lender with the ability to seize the art work (or asset) should the borrower default on payment.

Blockchain

The blockchain is a public ledger of records - known as blocks, which are linked and secured using cryptography. The blockchain is managed and validated by a peer-to-peer network. The possible applications of blockchain in the art market have recently been focusing on the need for a global title registry for art works.

KYC or "Know Your Client"

is the process of a business identifying and verifying the identity of its clients. The term is also used to refer to the bank and anti-money laundering regulations which governs these activities. Know your customer processes are also employed by companies of all sizes for the purpose of ensuring their proposed agents, consultants, or distributors are anti-bribery compliant.

Leverage ratio

is the level of debt compared to its assets. A leverage ratio of 0.5 or 50% would imply that more than 50% of the company's assets are financed by debt.

Loan-to-value

The loan-to-value (LTV) ratio is a financial term used by lenders to express the ratio of a loan to the value of an asset. The term is commonly used by banks to represent the ratio between the loan amount and the value of an art work. This is the way lenders protect themselves against a default scenario or a downturn in the market, and is also the reason why valuation is always a contentious issue in art secured lending transactions, particularly with regards to the subjectivity often related to art valuations

Non-recourse loan

A nonrecourse loan is a type of loan secured by collateral, which could be an art work. If the borrower defaults, the issuer can seize the collateral but cannot seek out the borrower for any further compensation, even if the collateral does not cover the full value of the defaulted amount.

The Law Commission

is the statutory independent body created by the Law Commissions Act 1965 to keep the law of England and Wales under review and to recommend reform where it is needed. The aim of the Commission is to ensure that the law is fair, modern, simple and cost effective.

Securitization

is the financial practice of pooling various types of debt such as mortgages, auto loans or credit card debt obligations (or other non-debt assets which generate receivables) and selling their related cash flows to third party investors as new securities

Recourse loan

Is a loan that is backed by a pool of collateral (assets) from the borrower. This type of debt allows the lender to collect the debtor's assets in the case of default as opposed to foreclosing on a particular property or asset as with a home loan or auto loan

Asset-based loan

Asset-based lending is a loan secured by an asset. This means, that if

the borrower defaults on the loan, the asset is taken. A mortgage is an example of an asset-based loan, and loans secured by an art work or group of art works are characterised as an asset-based loan. Asset-based lending in this more specific sense is made possible in legal systems which allow borrowers to pledge.

Uniform Commercial Code (UCC)

In the USA, it is not unusual for lenders against art to leave the collateral in the borrower's possession. This can be done, because the lender may register its security interest in the art on a public register under the Uniform Commercial Code (UCC), thereby putting third parties on notice that the collateral is encumbered. Registration has the effect of perfecting the lender's security interest, by giving it priority over the claims of other creditors (assuming no other creditor has a prior valid security interest in the collateral).