The Risk Calculus of Art Loans: Lending Against Value in an Extraordinary Market

by Stephen D. Brodie

Various publications have recently noted a sharp increase in the number of loans secured by fine art as collateral. Over the past couple of years, Herrick has represented several banks and other lenders, as well as some borrowers, in closing many such deals. We have also advised several potential lenders, new to this field, in formulating a credit policy for art loans. It almost looks as if art lending is an idea whose time has come, an easy business that has been heretofore overlooked for some strange reason. In fact, it is not uncommon for private banks to make these loans at interest rates not far above the rates they charge on their securities-based (margin) loans, making it appear that art loans are not even that risky. The truth, however, is more complicated. The recent escalation in prices for art generally, and for contemporary art in particular, has sparked new interest in this kind of financing, as collectors and dealers have sought to monetize these increasingly valuable assets. Karen Boyer, a Manhattan art advisor, notes: "More and more of my clients are perceiving art loans as an easy and inexpensive source of capital, whether they are using the funds to buy more art or invest in their own businesses." Additionally, according to Michael Plummer and Jeff Rabin of ArtVest Partners, a financial art advisory firm in New York:

> *The globalization of the art market has significantly increased the number of collectors from China, Latin America, and the Middle East, where local financial markets are perceived to be more volatile than the global art market. These collectors/investors are inclined to hold a much greater percentage of their wealth in tangible assets than Americans (a difference between 18% in the UAE, the highest, to 9% in the U.S., according to a recent Barclay's survey). A consequence of their increasing influence, we believe, will be pressure on lenders to be more flexible and far-reaching in their lending capabilities to remain competitive and relevant. For example, we are aware of one global private bank that has recently undertaken a major push to provide art loans out of their Hong Kong operation.*

At the same time, fears of a bubble have increased anxiety about extending credit against art collateral. This article will examine how and why art lending gets done as it does today, despite the risks involved, most of which are either especially acute in, or actually unique to, situations where a loan is secured by art.

Unique Risks

The first thing most people observe when they begin to think more seriously about an art loan is that (other than jewelry or precious gems, both of which are rarely accepted as security for a loan) there is no form of collateral having great value that is as mobile as fine art. Unlike a ship or a plane, for example, art carries no flag of registry or identifying marks or numbers. Unlike real estate, art can be (and surprisingly often is) stolen. In addition, art has sometimes been forged well enough to fool even top scholars in the field, as was well documented by Jonathan Lopez in *The Man Who Made Vermeers: Unvarnishing the Legend of Master Forger Han van Meegeren* (Houghton Mifflin Harcourt Publ'g Co. 2009). And, if that isn't enough, no other form of collateral is vulnerable to a precipitous loss of value owing to a change in the preponderance of scholarly opinion as to its source. Nonetheless, private banks usually allow their clients to retain possession of art collateral, and do not require any title insurance to address the risk of a break somewhere in the chain of title. Under U.S. law, a theft might well void the client's title (and the lender's security interest), even if the client is an innocent purchaser who had paid an arm's length price. There is no insurance against a forgery or a change in experts' attribution of a work to a lesser artist, or to the "school of" a famous artist, rather than the famous artist. Of course, one can demonstrate that, overall, the risks of art collateral disappearing, provenance proving to be flawed, forgery, and misattribution are all somewhat remote. This argument may be cold comfort to credit officers at banks that have thus far declined to get into this business, but it is a sound conclusion statistically, and lenders who are active in the field are well aware of it.

Valuation Risk

What is not at all remote, however, is the valuation risk inherent in every art loan. Determining the "true" value of art today is a much discussed and controversial subject, both in and out of the lending sphere. But concerns about collateral value are hardly unique to art lending. The danger of not knowing what your collateral will be worth in the future (when you might actually need it) is a concern with any kind of secured loan. Whether it's real estate, stock in a closely held business, a plane, a yacht, or art, lenders routinely obtain appraisals, establish advance rates (i.e., percentages of appraised value against which they will extend credit), and then determine the amount they are prepared to lend against a particular pool of collateral. Federal law generally requires that a real estate appraisal for loan collateral purposes be made by an independent appraiser, that the date of valuation be not more than one year prior to the date of the loan, and that the loan-to-value ratio be less than 85%. The credit policies of banks for other types of secured loans follow similar guidelines. Although the problem is not specific to art, the valuation risk posed by art as collateral is probably greater than with any other kind of property. One difference is that the value of an artwork is so highly dependent upon taste, cultural trends, speculation, and a host of entirely subjective factors. But the special difficulties presented in valuing art go beyond even that. As Artvest Partners said in their Fall 2011 newsletter: "The art market is remarkably different from all other asset classes—it is opaque, illiquid, unregulated, non-commoditized and emotional." *Investing in Contemporary Art–What You Need to Know*, ArtVest Investment Advice for the Art Market, Fall 2011 at 4.

Much has been written in recent years about the economics of the art market, particularly the contemporary art market. Although the subject is interesting for many reasons, for this analysis, the important consideration is that if today's prices are inflated, as many believe, a lender's risk is correspondingly enlarged. This is because when a lender accepts an appraisal, it is relying upon a "snapshot" valuation in order to "size" its loan by application of the industry-standard 40-50% advance rate. And even though a proper appraisal for loan collateral purposes will be on the conservative side, no appraisal can ever be wholly disconnected from the overall market at the time in question. As Victor Wiener, who was executive director of the

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Appraisers Association of America for 21 years, said (in reference to paintings selling at prices above $100 million) in an article entitled, *Appraising Art in the Stratosphere: The Dynamics of Steve Wynn's Elbow and Other Valuation Situations*, Journal of Advanced Appraisal Studies (2011) at 65: "Whether these prices represent the high end of a bubble or not, appraisers are obliged to take such high sales into consideration and, in some cases, they may be reflected on insurance appraisals or appraisals done for collateral loan transactions."

Regardless of the methodology, a perfectly executed appraisal will only provide an estimate of value as of a specific date. Later in the same article, Wiener comments that it is the professional responsibility of an appraiser to perform a market analysis in determining value. He then says: "If the situation is such that an actual sale is an anomaly, the appraiser has a responsibility to comment on this. In determining true market conditions, an appraiser must determine whether a specific sale is likely to take place a second time, on or about the effective date of valuation." *Id.* at 69. Wiener says that the goal is to identify bubbles. But many people think that the essence of a bubble is that you can't be sure it exists until it bursts.

The future of a market as "opaque" and "emotional" as contemporary art is all but impossible to predict. No appraisal can predict the direction (or directions) from which the winds of change will next be blowing—and they are always blowing and often changing. And contemporary art, which is often offered as collateral for loans at the present time (because so many older works are not in private hands), is by far the most susceptible to changes in culture and taste. This limitation is true for appraisals of any kind of asset. But there is better visibility of the future with real estate (whether commercial or residential) and businesses of almost any type, where income and expenses, and profitability over time, can be measured with coverage ratios and other financial tests.

Another, perhaps more fundamental, weakness in valuing art collateral is that even top-notch appraisers (with good contacts among dealers) cannot see the entire market. Auction prices are, of course, readily available, but it is widely believed that no more than half of all art sales are made at auction. By way of comparison, this is quite different from real estate, where, because deeds are public record, prices paid generally become public information. Moreover, for most types of business, appraisers can look at balance sheets, income statements, and cash flows to get a relatively firm handle on current value. The opacity of the art market means that all appraisals are necessarily somewhat flawed before you even get to a bank's real problem—the inherent volatility brought on by the non-economic forces that influence or determine the value of any kind of art, particularly contemporary art.

In today's art market, it is almost impossible to feel sure-footed when deciding how to weigh the credit support provided by art collateral. One of the New York art appraisers used by JPMorgan Chase's private bank said earlier this year that "[t]he market is currently extremely strong and international in scope. The factors contributing to this, international as well as national, are varied, and the market could, therefore, change at any time. It is also, however, extremely particular, and what is 'in' one day may not be 'in' another day."

Moreover, there are many who believe that the contemporary art market is subject, at present, to significant manipulation. Concerns abound about financial manipulation by art investment funds and speculators trying to drive prices up or down for their own purposes. But "manipulation" can mean more than just this. In his 2008 book on the contemporary art market, *The $12 Million Stuffed Shark* (St. Martin's Press 2008 at 26), Don Thompson noted that:

> Of the several artists who had serious gallery shows in New York and London in the 1980's, no more than twenty were offered in evening auctions at Christie's or Sotheby's in 2007 ... in the end, what is judged to be valuable contemporary art is determined first by major dealers, later by branded auction houses, a bit by museum curators who stage special shows, very little by art critics, and hardly at all by the buyers. High prices are created by branded dealers presenting particular artists, by a few artists successfully promoting themselves, and by brilliant marketing on the part of brilliant auction houses.

In his 2011 book, *Art of the Deal: Contemporary Art in a Global Financial Market* (Princeton Univ. Press 2011 at 5), Noah Horowitz pointed out that it is "worth remembering that global art price levels, commonly believed to have shattered previous records for years on end during the latest boom, actually drew level with their peak of 1990 in 2007-2008.... Nor should we ignore the fact that three of the top five most expensive art works ever sold at auction in real terms still hail from the 1980's." The story behind this is that there was a bubble that burst in the early and mid-1990's. One can, of course, look at that fact in two different ways: with historical perspective, today's prices don't seem quite so high; but whatever was up in the late 1980's and 1990 did indeed come down. It all speaks of volatility.

A New Paradigm?

Evident as the possibility (or probability) of a bubble may be, it is only one side of this story. There are arguably forces abroad in our economy and culture that may be making for a paradigm shift. Horowitz points out that:

> There has never been such an intense and widespread focus on the economics of art as there is today; market information is more exhaustive and accessible, leading people to be more savvy about the benefits of art as a specifically financial asset... The net effect is that more money, from more places, has been poured into the art market than ever before, inspiring ever more creative ways to put this capital to work. *Id.* at 7.

Horowitz goes on to analyze various statistics and to conclude that "contemporary art has never been more popular, and there has been a generational shift in the focus of art collecting from objects of an established past to those of a present that is still in formation...." *Id.* at 8. In addition, Boyer believes that, "[a]s lending against art continues to become more accepted and popular, it will add some much needed liquidity to a historically illiquid market, further strengthening the market as a whole." After the bursting of the dot-com bubble, however, no one should insist too strenuously that we are looking at a new paradigm of any kind. But history shows that even very big things sometimes change, and there are plainly sweeping changes occurring in the world today that may be making contemporary art more desirable, and more important, than ever before. Social media, globalization, and celebrity culture all appear to be involved. Consider this observation by Horowitz (*id.* at 9):

> Lastly, contemporary art has become a global phenomenon. This has profoundly shifted the dynamic of the trade.... Even if we acknowledge that record prices are always relative, there is no denying that influential buyers and sellers of art have seeped well beyond the conventional Euro-American axis, enabling contemporary art to transgress linguistic and cultural boundaries in a way that few other outlets can: it has become a veritable social glue. This is particularly vital nowadays, for in a globalized world split by social, political, and religious strife, contemporary art is a leveling force offering a tabula rasa relieved of history and anchored to the spirit of progress, innovation, and inclusivity. More types of art are being seen, produced, and collected by more artists and audiences internationally than in any previous period, and the more diverse and pluralistic this work becomes, the more these attributes are reinforced.

The Risk Calculus

All of this is enough to make a lender's head spin. Although paradigm shift is an interesting, or even a compelling, possibility, and may, in fact, influence the thinking of certain niche, asset-based art lenders, it is not likely to contribute materially to a private bank lender's thought process. So, can lenders truly get comfortable applying their customary 40-50% advance rates to values that run a patent risk of not standing the test of time?

A private bank that is willing to lend against art collateral (often consisting of contemporary art) does so with several important safeguards built into the deal. First, the borrower is typically an ultra-high net worth individual (or at least a high net worth individual), with the ability, at the time the loan is made, to pay it off or to post good quality, additional, or substitute collateral if there is a problem. Second, most art loans require compliance with ongoing net worth and liquidity covenants that are tested at least once a year. Third, the lender will often insist that its security consist of a diversified pool of art collateral so that it does not bear a concentration risk if a particular artist falls out of favor. Fourth, the vast majority of all art loans are short-term, typically with one- or two-year maturities. Fifth, in our experience, most art lenders impose an ongoing loan-to-value maintenance test on the borrower, with post-closing appraisal rights (at the borrower's expense), at least once a year. And lastly, the lender only advances at a rate of not more than half of the appraised value. Another factor for private banks is that they receive (or will have the opportunity to receive) substantial supporting business from the wealthy collectors to whom they lend.

But what about the non-bank lenders? They are not cross-selling to their borrowers, and they are often lending on a non-recourse basis to people who are not financially strong enough to easily pay off their loans or to provide other acceptable collateral if there is a default. What they receive is more fees and interest rates that are much higher than those charged by private banks, and they almost always take possession of the collateral, thereby eliminating entirely the mobility risk, which is a risk that the banks generally have to endure.

The Future

The trend of increasing demand for loans of this kind seems likely to continue until a bubble bursts or some macro-economic forces precipitate a retrenchment. Accordingly, one might expect to see some evolution in the way the art lending business is done. While it would be foolish to make predictions that depend on the performance of the economy or yet unseen cultural trends, one can note a couple of directions in which things may move, all other things being equal. There is at least talk of some new asset-based art lenders entering the field, charging interest rates in between those of the banks and the existing niche lenders. Title insurance is currently available to lenders, but it is quite expensive and excludes from coverage issues of attribution and authenticity. If premiums come down, title insurance is likely to become a more widespread requirement.

This year, Herrick closed a private bank loan that presented various issues, including provenance and attribution. The lender insisted on title insurance, as it provided a solid mitigant to at least one of the bank's key concerns. This proved to be just enough to adjust the risk calculus in favor of doing the deal.

The most likely application of title insurance in the future may be with asset-based lenders, who would surely be eager to eliminate provenance as a risk if they could make it "market" to do that. No matter what happens with interest rates or title insurance, it seems safe to expect that the dangers and mitigants involved in art lending risk calculus will remain the same for the foreseeable future.