



Pretend and Extend: A Deep Dive into Commercial Real Estate Lending's Hidden Crisis.

CHAPTER 01:

WHAT IS PRETEND AND EXTEND?

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The mahogany conference table reflected the glow of downtown city lights as First Metropolitan Bank's risk committee convened for their quarterly review. On the agenda sat a familiar challenge: a \$75 million office loan secured by a Class A tower, originally underwritten at a 6.5% cap rate in 2019, now approaching its December maturity date. The property's occupancy had dropped to 72%, and comparable sales suggested cap rates had expanded to nearly 8.5%.

"What are our options here?" asked the chief risk officer, scrolling through the loan summary on her tablet. The relationship manager shifted uncomfortably. "Well, we could consider an extension while the borrower explores refinancing alternatives. The property still generates positive cash flow, and the sponsor has been cooperative throughout." From across the table, a voice cut through the deliberation: "Are we talking about pretend and extend here?"

The phrase hung in the air—a term that had largely disappeared from banking lexicons after the Global Financial Crisis but had quietly crept back into risk committee discussions across the country. As commercial real estate markets navigate unprecedented headwinds, this once-dormant concept has returned to the forefront of lending conversations, carrying both familiar echoes and new complexities.

Setting the Stage: Market Pressures Collide

The current commercial real estate landscape reflects a convergence of challenges that few market participants

anticipated just three years ago. The pandemic fundamentally altered demand patterns across property types, with office buildings bearing the most visible scars as remote work redefined workplace requirements. Simultaneously, the Federal Reserve's aggressive interest rate campaign to combat inflation pushed borrowing costs from historic lows to levels not seen since the early 2000s.

These dual forces have created a perfect storm for commercial real estate finance. Properties purchased or refinanced during the ultra-low interest rate environment of 2020-2021 now face refinancing into a world where debt service costs may have doubled. Meanwhile, property values in certain sectors have declined by 20% to 40%, creating negative equity situations that complicate traditional refinancing approaches.

Against this backdrop, the term "pretend and extend" has quietly re-entered the vocabulary of lenders, borrowers, and their advisors—not as an accusation, but as a description of an increasingly common response to market stress.

Defining the Phenomenon

Pretend and extend refers to the practice of extending loan maturities, or modifying loan terms, rather than addressing underlying credit deterioration or property devaluation. The "pretend" component suggests that lenders may avoid acknowledging the full extent of potential losses, while "extend" describes the tactical decision to delay resolution through maturity modifications or workout arrangements.

The phrase gained prominence during the Global Financial Crisis of 2008-2009, when banks faced widespread commercial real estate distress and regulatory pressure to maintain lending capacity. Rather than recognizing immediate losses that could trigger capital calls or regulatory intervention, many institutions chose to extend problematic loans, hoping that time and market recovery would restore borrower performance and property values.

Following the financial crisis, enhanced regulatory oversight, improved market conditions, and strengthened capital positions largely eliminated the need for such strategies. The phrase faded from common usage as markets stabilized and banks returned to more traditional underwriting and workout practices.

However, the post-2022 environment has created new conditions that echo, yet differ from, the crisis era. Today's pretend and extend discussions occur not in the context of systemic banking failure, but rather in response to rapid market shifts that have left fundamentally sound institutions managing portfolios of loans secured by properties whose values and cash flows have been materially impacted by structural economic changes.

Why the Practice Is Resurfacing

The resurgence of extend-and-pretend behavior stems from a complex interplay of market forces that distinguish the current environment from traditional credit cycles. Unlike previous downturns driven

primarily by oversupply or economic recession, today's challenges reflect fundamental shifts in how commercial real estate is used and valued.

Consider the regional bank managing a portfolio of suburban office properties. These assets, once considered stable income generators, now face persistent vacancy increases as tenants embrace hybrid work models. The bank's internal valuations, based on pre-pandemic assumptions, may overstate current market values by 25% or more. Recognizing these losses immediately would require significant provisions and potentially impact regulatory capital ratios.

Similarly, retail properties face ongoing challenges from e-commerce acceleration, while certain multifamily markets grapple with rent control expansions and regulatory changes that affect long-term cash flow projections. Each scenario creates pressure for lenders to avoid immediate loss recognition while hoping that market conditions will stabilize or improve.

The regulatory environment also influences these decisions. Banks operating under consent orders or facing upcoming examinations may be particularly sensitive to actions that could trigger additional regulatory scrutiny. Extending a performing loan with a cooperative borrower may appear more prudent than forcing a sale in a distressed market that could crystallize losses and attract regulatory attention.

The Mechanics of Modern Extensions

Today's extend-and-pretend behavior manifests in several forms, each reflecting different degrees of financial stress and strategic intention. The most straightforward approach involves simple maturity extensions, where lenders agree to extend loan terms for six to twelve months while borrowers pursue refinancing or property repositioning strategies. These extensions often include modified interest rates or additional collateral requirements but avoid fundamental restructuring.

More complex arrangements involve loan recasts, where

lenders modify amortization schedules, adjust interest rates, or temporarily reduce payment requirements to maintain borrower performance. These modifications allow lenders to avoid classifying loans as troubled debt restructurings while providing borrowers breathing room to address underlying property challenges.

The most problematic extensions involve situations where lenders knowingly avoid updating property valuations or probability of default assessments despite clear evidence of deterioration. In these cases, the "pretend" component becomes more pronounced, as institutions defer loss recognition through selective valuation practices or overly optimistic cash flow projections.

Some extensions represent legitimate workout strategies that preserve value for all parties. A well-located office building with temporary vacancy challenges may benefit from a strategic extension that allows for repositioning and re-leasing. However, other extensions merely delay inevitable losses while consuming additional resources and management attention.

What the Data Reveals

Recent research from the Federal Reserve Bank of New York provides concrete evidence of extend-and-pretend behavior in commercial real estate lending. Staff Report No. 1130 analyzes the relationship between bank capital positions and loan extension decisions, revealing patterns that suggest some institutions use extensions to manage regulatory capital pressures rather than address underlying credit issues.

The study found that banks with lower mark-to-market capital positions were significantly more likely to extend distressed commercial real estate loans. Specifically, these banks assigned probability of default ratings that were 0.9 percentage points lower than better-capitalized institutions facing similar loan situations. Additionally, banks with weaker capital positions extended loans at rates 0.2 percentage points higher than their peer institutions.

These findings suggest that capital constraints

influence lending decisions in ways that may not align with optimal credit risk management. Banks facing capital pressure appear more likely to extend problematic loans and assign more favorable risk ratings, potentially delaying necessary loss recognition.

The research also highlights the broader market pressures contributing to extension activity. Commercial real estate loan originations decreased by 4.8% in 2023, with some quarters showing declines of 5.3%, reflecting lenders' reduced appetite for new commercial real estate exposure. This contraction occurs precisely when property owners face a "maturity wall" of loans requiring refinancing, creating a supply-demand imbalance that encourages extension strategies.

Why This Matters for Key Stakeholders

The implications of widespread extend-and-pretend behavior extend beyond individual lending relationships to affect the broader commercial real estate finance ecosystem. For banks, the practice creates both regulatory and reputational risks that may compound over time. Regulatory examinations increasingly focus on asset quality and loss recognition timing, making it difficult to sustain artificial valuations or probability of default assignments that don't reflect current market conditions.

Banks that delay loss recognition also face the risk of larger eventual write-downs if market conditions continue to deteriorate. A loan extended at an inflated valuation may ultimately require a more significant provision when market reality finally forces recognition. Additionally, resources devoted to managing extended loans may prevent institutions from pursuing more profitable lending opportunities in recovering market segments.

Borrowers face their own challenges from extension strategies that don't address fundamental property issues. While extensions provide temporary relief from immediate refinancing pressure, they often come with higher interest rates, additional fees, and more restrictive terms that can strain cash flow. Borrowers may also find themselves trapped in relationships with lenders who lack

incentive to approve permanent refinancing solutions.

For regulators, widespread extend-and-pretend behavior creates systemic visibility challenges that complicate stress testing and risk assessment efforts. If banks across multiple markets are deferring loss recognition through extension strategies, the true extent of commercial real estate stress may not become apparent until market conditions force simultaneous recognition events. Valuation professionals occupy a critical position in this dynamic, as their assessments directly influence lending decisions and loss recognition timing. The pressure to support extension strategies through optimistic valuations conflicts with professional standards requiring independent, objective analyses based on current market conditions.

How Four Corners Valuations Supports Clarity

In an environment where accurate property valuation becomes increasingly critical for sound decision-making, Four Corners Valuations provides the independent perspective necessary to navigate extend-and-pretend pressures. Our approach centers on delivering objective, market-based assessments that support informed strategic decisions rather than predetermined outcomes.

Four Corners Valuations offers both streamlined evaluations for routine portfolio management and comprehensive USPAP-compliant appraisals when deeper analysis is warranted. This flexibility allows clients to match valuation rigor to decision complexity while maintaining consistent analytical standards across their portfolios.

Our team understands the nuanced challenges facing commercial real estate lenders in the current environment. We provide grounded insight on asset performance, market positioning, and value trends that inform risk management and capital allocation decisions. Rather than simply supporting existing assumptions, our analysis helps clients understand the true risk-return profile of their commercial real estate exposures.

By partnering with Four Corners Valuations, lenders gain access to valuation expertise that supports both regulatory compliance and strategic planning. Our commitment to independence and analytical rigor helps clients navigate the complex decisions surrounding loan extensions, workout strategies, and portfolio management in challenging market conditions.

Moving Forward: A Call to Strategic Reflection

As commercial real estate markets continue to evolve, the temptation to extend problematic loans rather than confront difficult valuation realities will persist. However, the most successful institutions will be those that use accurate, independent valuation insight to make informed decisions about when extensions serve legitimate strategic purposes and when they merely delay inevitable adjustments.

The question for today's commercial real estate finance professionals is not whether extend-and-pretend pressures exist—the data confirms their presence across the industry. Instead, the critical question becomes: Where might extend-and-pretend dynamics be affecting decision-making within your own portfolio, and how can you ensure that your approach serves long-term strategic interests rather than short-term convenience?

Four Corners Valuations stands ready to partner with lenders, borrowers, and their advisors in answering these questions through objective, market-grounded analyses that supports informed decision-making in an uncertain environment. The path forward requires clarity, courage, and the independent insight necessary to navigate complex markets successfully.



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