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

CHAPTER 02:
HOW DID WE GET HERE? A TIMELINE OF AVOIDANCE

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The Quiet Decision

It was a Tuesday morning in February 2022 when Jennifer Martinez, the chief credit officer at First Regional Bank of the Midwest, faced what seemed like a routine decision. A $15 mil-lion office loan on a downtown Chicago property was approaching maturity in ninety days. The borrower, a respected local developer, had been current on payments throughout the pandemic, but the building's occupancy had dropped from 92% to 68%. Market valuations were soft, and the loan-to-value ratio had crept upward.

Three months earlier, the decision would have been straightforward: either the borrower would refinance with improved terms reflecting the new reality, or the bank would begin workout discussions. But something had shifted in the intervening weeks.

The Federal Re-serve had just begun raising interest rates, and the bank's securities portfolio was showing paper losses that would soon require difficult conversations with regulators. The office building, while impaired, was still generating positive cash flow.

Martinez made the call that countless lending officers across America were making in those same weeks: extend the loan for another year, maintain the existing classification, and hope the market would recover. It was a decision that seemed prudent in isolation but would become part of a systemic pattern that redefined commercial real estate risk across the banking sector.

The Backdrop: When Crisis Became Opportunity (2020-2021)

The COVID-19 pandemic initially appeared to threaten the commercial real estate market with catastrophic force. Total commercial real estate mortgage borrowing and lending fell dramatically, decreasing 52 percent from the record $891 billion in 2021 to significantly lower levels as uncertainty gripped markets. Office buildings emptied, retail spaces shut-tered, and hospitality properties faced occupancy rates that would have spelled disaster in any previous economic cycle.

Yet the expected wave of commercial real estate defaults never materialized. Federal emer-gency lending programs, enhanced unemployment benefits, and unprecedented monetary stimulus provided borrowers with the liquidity to service their debt obligations. More im-portantly, regulatory guidance from federal banking agencies encouraged forbearance and loan modifications, explicitly acknowledging that pandemic-related disruptions should not automatically trigger adverse classifications.

During this period, lenders demonstrated remarkable patience with borrowers. Forbear-ance agreements became commonplace, with many institutions granting temporary pay-ment deferrals and interest rate reductions. The logic was sound: commercial real estate cycles are long, and temporary disruptions should not force premature liquidations in a severely distressed market.

This initial period of accommodation established important precedents. Lenders learned that regulators would support reasonable workout arrangements during times of economic stress. They discovered that many borrowers could weather significant occupancy declines without defaulting. Most critically, they experienced firsthand that extending loan maturi-ties could buy time for markets to recover without triggering immediate losses.

The pandemic-era forbearance programs created a template for managing distressed commercial real estate that would prove influential long after the initial health crisis sub-sided. Banks developed internal processes for evaluating modification requests, estab-lished relationships with workout specialists, and refined their approaches to loan classifi-cation during periods of stress.

The Inflection Point: When Accommodation Became Avoidance (2022 Q1)

The first quarter of 2022 marked a fundamental shift in the commercial real estate lending landscape, though the change was so gradual that few observers recognized its signifi-cance at the time. The Federal Reserve's aggressive interest rate increases, designed to combat inflation, created an unexpected secondary effect: they placed enormous pressure on bank balance sheets through unrealized losses in securities portfolios.

For banks with significant commercial real estate exposure, this created a perfect storm. Rising rates made refinancing more expensive for borrowers, reducing the likelihood of suc-cessful loan payoffs at maturity. Simultaneously, the same rate increases were creating pa-per losses in bank investment portfolios that threatened regulatory capital ratios. Banks faced a difficult choice: recognize losses on commercial real estate loans and compound their securities-related capital pressures, or find ways to avoid recognizing those losses while working toward eventual recovery.

The behavioral shift that emerged during this period was subtle but systematic. Banks fueled loan maturity extensions, giving rise to a wave of debt coming due soon that created significant future obligations. Rather than conducting rigorous reassessments of loan quality at maturity, many institutions began defaulting to extension arrangements that maintained existing risk classifications.

This pattern was particularly pronounced among banks with weaker capital positions. When faced with marginal commercial real estate credits, these institutions were more like-ly to extend maturities, assign lower default probabilities, and avoid the loss recognition that would have accompanied more conservative classifications. The practice was not overtly deceptive, but it represented a subtle stretching of traditional underwriting and classification standards.

The timing was not coincidental. Federal Reserve research would later document that this behavioral shift coincided precisely with the onset of monetary tightening and the emer-gence of securities portfolio losses. Banks that had been forthright about commercial real estate risks during the pandemic suddenly became more optimistic about the same credits as their own capital positions came under pressure.

Pattern Formation: The Anatomy of Avoidance (2022-2023)

As 2022 progressed into 2023, what had begun as isolated decisions by individual lending officers evolved into a systematic pattern of behavior across the banking industry. Research conducted by the Federal Reserve Bank of New York would eventually quantify this phe-nomenon with striking precision, revealing behavioral patterns that challenged convention-al assumptions about bank risk management.

The data painted a clear picture of institutional behavior under stress. Banks with weaker capital positions consistently assigned lower default probabilities to their commercial real estate portfolios compared to well-capitalized institutions evaluating identical market con-ditions. The magnitude of this difference was significant: undercapitalized banks typically assessed default probabilities that were nearly one percentage point lower than their stronger counterparts.

Even more telling was the pattern of loan extensions. When commercial real estate loans reached maturity, banks with capital constraints were substantially more likely to grant ex-tensions rather than require refinancing or initiate workout procedures. This behavior was not random or occasional but systematic, suggesting institutional policies that favored ex-tension arrangements over critical reassessment of credit quality.

The research design that uncovered these patterns was particularly compelling because it included placebo tests that confirmed the behavior was genuinely new. The same banks had not exhibited these patterns before 2022, and they did not apply the same optimistic assessments to newly originated loans. The extend-and-pretend behavior was specifically concentrated among existing loans approaching maturity during the period of capital stress.

Real Estate Investment Trusts provided an important control group that validated these findings. REITs, which face different capital requirements and accounting standards than banks, did not exhibit the same patterns of behavioral change during this period. Their loan modification and extension decisions remained consistent with historical norms, suggest-ing that the banking sector's behavioral shift reflected institutional pressures rather than rational responses to market conditions.

$13.6 billion across 441 loans were modified in 2023 across various commercial real es-tate loan programs, representing a dramatic increase in workout activity. This surge in mod-ifications reflected not just market stress but also the systematic preference for extensions over more definitive resolution strategies.

The Systemic Build-Up: Creating Tomorrow's Crisis Today

By the fourth quarter of 2023, the cumulative effect of three years of extend-and-pretend behavior had created a quantifiable threat to financial stability. The maturity wall that emerged from this period represented one of the most significant concentrations of com-mercial real estate risk in banking history, with implications that extended far beyond indi-vidual institution portfolios.

The numbers were stark: 27% of bank capital was now tied to commercial real estate loans with maturities within three years, compared to just 16% in 2020. This represented not just an increase in exposure but a fundamental shift in the temporal distribution of risk. Rather than spreading maturities across time, the banking sector had concentrated refinancing requirements into a narrow window that would test both borrower capacity and market li-quidity simultaneously.

At the national level, 16% of all bank-held commercial real estate debt was approaching maturity in the near term. This concentration was particularly pronounced in certain proper-ty types and geographic markets where pandemic-related disruptions had been most se-vere. Office properties in major metropolitan areas, retail centers in suburban markets, and hospitality assets across various regions all faced refinancing challenges that would have been manageable if spread over time but appeared daunting when compressed into a brief period.

The creation of this maturity wall was not the result of conscious industry coordination but rather the aggregate effect of thousands of individual decisions to extend rather than re-solve. Each extension seemed reasonable in isolation, particularly when viewed against the backdrop of pandemic-related disruptions and the hope for market recovery. Collectively, however, these decisions had transformed a manageable flow of maturities into a concen-trated wave of refinancing requirements.

The geographic distribution of this risk was uneven, with smaller regional and community banks bearing disproportionate exposure. These institutions had been most aggressive in their commercial real estate lending during the pre-pandemic expansion and were now most vulnerable to the capital pressures that drove extend-and-pretend behavior. Many had commercial real estate concentrations that exceeded supervisory guidelines, making them particularly sensitive to losses that would result from realistic loss recognition.

Roughly 75% of the CRE pipeline consists of bridge-to-bridge or bridge refinance requests, indicating that much of the current lending activity was focused on managing existing ex-posures rather than financing new development. This suggested that the banking sector was increasingly preoccupied with managing legacy risks rather than supporting new eco-nomic activity.

The Architecture of Avoidance: How It Happened

The extend-and-pretend phenomenon that emerged during this period was not the result of overt deception or regulatory violation. Instead, it represented a systematic exploitation of the inherent flexibility within commercial real estate lending standards and classification requirements. Banks did not falsify information but rather interpreted ambiguous situa-tions in the most favorable possible light.

Loan classification standards provided significant discretion for institutions evaluating commercial real estate credits. A property with declining occupancy and reduced cash flow could reasonably be classified as "pass" if the borrower remained current and market con-ditions were expected to improve. The same property could equally reasonably be classified as "watch" or "substandard" if the evaluation emphasized downside risks and market chal-lenges. During the extend-and-pretend period, banks systematically chose the more opti-mistic classification.

Maturity extension decisions followed similar patterns. Regulatory guidance permitted ex-tensions for borrowers experiencing temporary difficulties, particularly when those difficul-ties could be attributed to external economic disruptions. Banks interpreted this guidance broadly, treating market-wide challenges in commercial real estate as temporary disrup-tions that justified extension arrangements even when fundamental property performance had deteriorated significantly.

Risk assessment methodologies also provided opportunities for optimistic interpretation. Commercial real estate valuations inherently involve assumptions about future market conditions, rental rates, and occupancy levels. During the extend-and-pretend period, banks consistently adopted assumptions that supported existing loan classifications and extension decisions, even when market evidence suggested more conservative projections would be appropriate.

The behavioral patterns identified by Federal Reserve research revealed the systematic na-ture of these interpretive choices. Banks facing capital pressure did not randomly become more optimistic about commercial real estate; they specifically became more optimistic about loans approaching maturity that would require loss recognition if realistically as-sessed. This precision suggested institutional awareness of the connection between loan classification decisions and regulatory capital requirements.

The Closing Insight: Recognizing the Drift

The extend-and-pretend era in commercial real estate lending was not marked by dramatic headlines or sudden policy changes. It emerged through the accumulation of countless small decisions that individually appeared prudent but collectively created systemic risk. This gradual drift toward avoidance was perhaps more dangerous than an acute crisis be-cause it was largely invisible until its effects became embedded in the financial system.

Understanding this period requires recognizing that banks did not intentionally deceive reg-ulators or investors. Instead, they gradually shifted their interpretation of existing standards in response to capital pressures and market conditions. This behavioral evolution was ra-tional from the perspective of individual institutions seeking to manage short-term regula-tory requirements, but it created longer-term systemic vulnerabilities that transcended any single bank's risk management capabilities.

The maturity wall that emerged from this period represents more than a scheduling problem for commercial real estate borrowers. It embodies the accumulated consequences of sys-tematic risk avoidance across the banking sector. When these loans mature, they will re-quire realistic assessment under market conditions that may be significantly different from those that justified their original extensions.

The extend-and-pretend period also revealed important insights about bank behavior under stress. When faced with capital pressures, institutions demonstrated a pronounced ten-dency to interpret ambiguous loan quality issues optimistically rather than conservatively. This behavioral pattern has implications that extend beyond commercial real estate to other areas of bank lending where discretionary judgment plays a significant role in risk assess-ment.

Financial institutions that recognize these patterns in their own portfolios have an oppor-tunity to address potential issues proactively rather than waiting for maturity walls to force difficult decisions. This recognition requires honest assessment of loan quality, realistic evaluation of market conditions, and acknowledgment of the behavioral biases that may have influenced previous classification and extension decisions.

The commercial real estate market will eventually absorb the maturity wall created during the extend-and-pretend period, but the process will likely be more challenging than it would have been if risks had been recognized and addressed incrementally over time. Banks that begin this recognition process early, while markets remain relatively stable, will be better positioned to manage the ultimate resolution of these accumulated risks.

A Call for Transparent Assessment

The extend-and-pretend era in commercial real estate lending offers important lessons for risk management and regulatory oversight. Most significantly, it demonstrates how behav-ioral changes in response to capital pressure can create systemic risks that transcend indi-vidual institution decision-making. The maturity wall that emerged from this period was not the result of coordinated action but rather the aggregate effect of thousands of similar re-sponses to similar pressures.

For commercial real estate lenders, portfolio managers, and bank executives currently managing these accumulated risks, the path forward requires honest assessment of exist-ing exposures and realistic evaluation of resolution strategies. This assessment should acknowledge the behavioral factors that influenced previous decisions while focusing on current market conditions and realistic projections of future performance.

The experience also highlights the value of independent, third-party assessment of com-mercial real estate portfolios. When institutional pressures create incentives for optimistic interpretation of loan quality, external validation becomes particularly important for accu-rate risk assessment. Professional valuation services can provide objective analysis that cuts through the accumulated assumptions and extensions that may obscure underlying property performance.

As the commercial real estate maturity wall approaches, institutions that proactively ad-dress potential issues will be better positioned than those that continue extending and hop-ing for market recovery. This proactive approach requires partnership with valuation pro-fessionals who can provide asset-level analysis independent of the institutional pressures that created the current concentration of risk.

For those institutions ready to move beyond extend-and-pretend toward comprehensive risk assessment, Four Corners Valuations offers the expertise and independence neces-sary to evaluate commercial real estate portfolios with clarity and precision. Our analysis provides the foundation for informed decision-making about loan modifications, workout strategies, and capital planning that can help transform accumulated risks into managea-ble outcomes.

The extend-and-pretend era may be ending, but its consequences will shape commercial real estate lending for years to come. Institutions that recognize this reality and act accord-ingly will emerge stronger from the resolution process that lies ahead.

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