



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

CHAPTER 03: THE INTEREST RATE TRAP

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The Federal Reserve's aggressive monetary tightening campaign beginning in early 2022 was designed to combat inflation and restore price stability. However, this necessary policy shift created an unintended consequence that would profoundly shape commercial real estate lending behavior: it established a powerful, silent incentive mechanism within banks that favored extend-and-pretend strategies over prudent loss recognition. When rising interest rates collided with banks' securities portfolios, the resulting marked-to-market capital erosion created institutional pressures that would ultimately drive credit misallocation across the CRE sector.

The Setup: Rising Rates, Shrinking Capital

The Fed's rate hiking cycle began in March 2022, with the federal funds rate climbing from near-zero to over 5% by mid-2023. This represented the most aggressive tightening in decades. This monetary shift had immediate and dramatic effects on banks' fixed-income securities holdings, particularly their held-to-maturity (HTM) and available-for-sale (AFS) portfolios accumulated during the ultra-low rate environment of 2020-2021.

Banks had loaded up on long-duration government and agency securities when yields were compressed, viewing these assets as safe, liquid investments. As rates surged, the market value of these portfolios plummeted. A 10-year Treasury purchased at a 1.5% yield in 2021 lost approximately 20% of its market value as rates approached 4.5%. For banks holding hundreds of billions in such securities, the aggregate losses were staggering.

These unrealized losses created a peculiar form of capital erosion. The losses significantly impacted banks' marked-to-market Tier 1 capital ratios while having limited immediate regulatory consequences. This divergence between economic reality and regulatory reporting would prove critical in shaping subsequent lending decisions.

A Hidden Vulnerability: Marked-to-Market vs. Regulatory Optics

Recent research from the Federal Reserve Bank of New York staff provides crucial insights into this dynamic. The analysis reveals that while marked-to-market losses on securities portfolios did not formally impact most banks' regulatory capital ratios, these losses still generated significant institutional concern. This regulatory relief existed thanks to accounting rules that allow HTM securities to be carried at book value.

The key insight lies in understanding the difference between regulatory compliance and market perception. Credit rating agencies, uninsured depositors, and sophisticated counterparties don't ignore economic reality simply because accounting rules provide regulatory relief. Banks facing substantial marked-to-market capital gaps found themselves vulnerable to depositor scrutiny, rating downgrades, and counterparty risk reassessment.

The NY Fed research employs an empirical approach to identify "undercapitalized" banks based on these marked-to-market losses, revealing a clear behavioral pattern. Institutions with negative marked-to-market capital gaps exhibited distinctly different lending behaviors than their

well-capitalized peers. These were banks whose economic capital position had been meaningfully impaired by rising rates.

Incentive Distortion: Why Banks Chose to Extend

The data reveals a striking correlation: banks with marked-to-market capital impairment disproportionately extended distressed CRE loans rather than recognizing losses. Specifically, undercapitalized banks were 0.2 percentage points more likely to extend a distressed loan compared to well-capitalized institutions. Perhaps more tellingly, these same banks assigned probability of default (PD) estimates that were 0.9 percentage points lower than their better-capitalized peers when evaluating similar credits.

This wasn't aggressive growth strategy. It was defensive maneuvering. Banks facing capital pressure had powerful incentives to avoid loan defaults that would trigger additional loss recognition and further erode their already-strained capital positions. Extending a distressed loan, even one with questionable prospects, allowed banks to maintain the fiction of performing status while buying time for potential market recovery.

The mechanism was elegantly perverse: banks most vulnerable to capital erosion became most reluctant to recognize additional losses, creating a systematic bias toward forbearance precisely when prudent risk management would dictate the opposite approach. This dynamic was particularly pronounced in CRE, where loan sizes are large, collateral values are subjective, and workout timelines are extended.

Regulatory Blind Spots and Institutional Design

The extend-and-pretend phenomenon wasn't solely the result of individual bank decision-making. It was enabled by institutional design features that created divergences between economic reality and reported metrics. Accounting rules allowing HTM securities to avoid mark-to-market treatment provided regulatory relief but couldn't eliminate economic risk. Similarly, regulatory frameworks that focus on book capital ratios rather than market-based measures created space for this divergence to persist.

The distinction between banks subject to Accumulated Other Comprehensive Income (AOCI) treatment and those exempt further complicated the picture. Larger institutions generally subject to AOCI requirements faced more immediate regulatory pressure from securities losses, while smaller banks exempt from these rules experienced the full force of the incentive distortion described above.

This regulatory architecture inadvertently created conditions where delayed recognition of risk became institutionally rational, particularly for legacy loans originated during more benign market conditions. Banks could extend distressed CRE credits while maintaining regulatory compliance, even as their economic capital position deteriorated.

The Mechanics of Misallocation

The extend-and-pretend bias didn't occur in isolation. It systematically misallocated credit within the CRE market. Banks with impaired marked-to-market capital were effectively subsidizing distressed borrowers at the expense of new, potentially more productive credit opportunities. Resources that might have been directed toward emerging sectors or stronger sponsors instead flowed toward maintaining existing exposures of questionable quality.

This misallocation had broader economic implications. Zombie lending keeps economically unviable projects artificially alive and prevents necessary market clearing and resource reallocation. In CRE markets, this dynamic can be particularly pernicious, as it supports inflated asset

values and delays necessary adjustments in rental rates, development patterns, and capital deployment.

The aggregate effect was a form of credit market rigidity that impeded the normal process of creative destruction. Rather than allowing distressed assets to find new ownership or alternative uses, extend-and-pretend strategies preserved the status quo, potentially amplifying future adjustment costs.

A Trap Laid Quietly

The interest rate environment that emerged post-2022 created what can only be described as a trap for banks holding long-duration, illiquid CRE assets. The Fed's necessary monetary tightening inadvertently established powerful institutional incentives for forbearance over recognition, extension over resolution.

Extend-and-pretend wasn't merely a tactical choice. It became an institutional reflex conditioned by the intersection of accounting rules, regulatory frameworks, market perception, and monetary policy. Banks facing marked-to-market capital impairment found themselves in a position where the rational individual response (avoid additional losses) created systematic inefficiencies in credit allocation.

This dynamic reveals a fundamental tension in banking regulation and monetary policy transmission. While higher interest rates were intended to tighten financial conditions and reduce risk-taking, they simultaneously created conditions that incentivized banks to avoid recognizing existing risks. The result was a form of regulatory arbitrage that allowed economic problems to persist beneath the surface of compliant financial statements.

Understanding this trap is crucial for assessing the true health of CRE markets and the banking system more broadly. The marked-to-market capital impairment that drove extend-and-pretend behavior represents a hidden vulnerability that traditional regulatory metrics may not fully capture. As the interest rate cycle continues to

evolve, the resolution of this tension between economic reality and accounting treatment will likely prove decisive in determining the ultimate scope of CRE market adjustment.

Taking Action: Beyond the Trap

Financial institutions must move beyond regulatory compliance to assess their true economic capital position and embedded portfolio risks. This requires:

1. Comprehensive Balance Sheet Analysis: Evaluate marked-to-market impacts across all asset classes, not just regulatory capital ratios.
2. Portfolio Risk Assessment: Identify concentration risks and quality deterioration masked by extension strategies, particularly in legacy CRE positions.
3. Professional Valuation Partnership: Work with certified valuation experts like Four Corners Valuations to obtain independent assessments of collateral values and loan quality, providing the clarity needed to make informed risk management decisions.

The interest rate trap may have been laid quietly, but escaping it requires deliberate, informed action based on economic reality rather than accounting convenience.



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