



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

CHAPTER 04:

REGULATORY INCENTIVES THAT REWARD DELAY

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The commercial real estate lending market faces a structural challenge that extends far beyond cyclical downturns or sector-specific distress. At the heart of this challenge lies a complex web of regulatory and accounting frameworks that, while designed to promote financial stability, inadvertently create powerful incentives for banks to delay recognition of losses on distressed commercial real estate loans. This phenomenon, commonly referred to as “pretend and extend,” represents more than mere forbearance during temporary market stress. It reflects a systematic misalignment between regulatory objectives and market realities that undermines the very transparency and capital adequacy these frameworks were designed to protect.

The mechanisms enabling this behavior operate through multiple channels within our financial regulatory architecture. Generally Accepted Accounting Principles (GAAP) provide banks with legitimate pathways to avoid marking assets to market under certain conditions. Capital adequacy frameworks may exclude unrealized losses from regulatory capital calculations, creating asymmetric incentives that favor asset retention over timely disposition. Supervisory examination practices, while comprehensive in scope, may lack the granular focus necessary to identify sophisticated forms of regulatory arbitrage in loan classification and provisioning decisions.

This misalignment creates profound moral hazard throughout the commercial real estate lending ecosystem. Banks facing capital constraints discover that extending distressed loans, rather than recognizing losses, can

preserve reported capital ratios and avoid triggering supervisory intervention. The practice distorts market transparency by obscuring the true extent of commercial real estate distress, making it difficult for regulators, investors, and market participants to assess systemic risk accurately. Perhaps most critically, resources tied up in unproductive extensions crowd out new credit formation, hampering economic recovery and efficient capital allocation.

The Role of GAAP and Held-to-Maturity (HTM) Accounting

The foundation of banks' ability to avoid timely loss recognition lies within the accounting treatment of held-to-maturity securities and loans under GAAP. This framework permits financial institutions to carry HTM assets at amortized cost rather than fair value, provided the institution has both the positive intent and ability to hold these assets until maturity. While this treatment serves legitimate purposes in reducing artificial volatility in bank capital during periods of interest rate fluctuation, it creates significant opportunities for regulatory arbitrage when applied to distressed commercial real estate loans.

Under HTM accounting, banks can maintain book values on commercial real estate loans that may substantially exceed current market valuations, particularly in sectors experiencing structural decline such as office properties. This treatment becomes problematic when banks facing capital pressures strategically reclassify loans or extend maturities to maintain HTM status, thereby avoiding the immediate capital impact of marking assets to current

market conditions. The practice is particularly pronounced among institutions where market-to-market losses on securities portfolios have already strained capital ratios, creating additional incentives to preserve book values on loan portfolios.

The interaction between HTM accounting and capital adequacy metrics compounds these incentives. Regulatory capital calculations typically incorporate book values of HTM assets without adjustment for current market conditions, meaning that banks can maintain reported capital ratios even when the economic value of their assets has declined substantially. This creates a divergence between regulatory capital measures and economic capital reality that becomes more pronounced during periods of market stress. Banks discover that maintaining HTM classification through maturity extensions can be more capital-efficient than recognizing losses and rebuilding capital through retained earnings or external funding.

The discretion inherent in HTM classification decisions further amplifies these effects. Banks maintain significant latitude in determining whether they possess the intent and ability to hold assets to maturity, particularly for commercial real estate loans where maturity extensions can be justified through borrower accommodation or market condition assessments. This discretion enables sophisticated institutions to manage the timing of loss recognition in ways that optimize regulatory capital ratios while potentially obscuring the true condition of their asset portfolios.

Regulatory Capital Frameworks and Supervisory Treatment

The architecture of regulatory capital frameworks creates additional layers of incentive misalignment that reward delay in recognizing commercial real estate losses. Tier 1 capital calculations, which form the foundation of bank capital adequacy assessment, treat unrealized losses on available-for-sale (AFS) and held-to-maturity securities differently depending on institutional characteristics and regulatory elections. These differences create systematic variations in banks' incentives to recognize or avoid losses on distressed commercial real estate assets.

The distinction between banks that include Accumulated Other Comprehensive Income (AOCI) in regulatory capital calculations and those that do not creates particularly significant incentive disparities. As detailed in Federal Reserve Bank of New York Staff Report No. 1130, banks subject to AOCI capitalization must include unrealized losses on AFS securities in their regulatory capital calculations, creating immediate capital pressure when asset values decline. Conversely, banks not subject to AOCI capitalization can exclude these unrealized losses from regulatory capital, reducing immediate pressure to address portfolio distress through asset disposition or additional provisioning.

This regulatory asymmetry becomes crucial during periods of widespread commercial real estate distress. Banks facing immediate capital pressure from AOCI inclusion develop stronger incentives to extend distressed loans rather than classify them as non-performing, since non-performing loan classification would trigger additional provisioning requirements and further strain capital ratios. The empirical evidence suggests that undercapitalized banks facing mark-to-market losses on securities portfolios become significantly more likely to extend distressed commercial real estate loans rather than pursue timely resolution through foreclosure, restructuring, or sale.

The supervisory treatment of maturity extensions compounds these capital framework incentives. Current

examination procedures may not adequately distinguish between extensions granted for legitimate borrower accommodation and those designed primarily to avoid loss recognition and maintain regulatory capital ratios. This creates opportunities for banks to engage in regulatory arbitrage through loan modification and extension strategies that technically comply with supervisory guidance while substantially undermining the economic substance of capital adequacy measurement.

The interaction between capital frameworks and supervisory treatment becomes particularly problematic when banks face binding capital constraints. Institutions approaching regulatory minimums discover that loan extensions can provide immediate relief from capital pressure without triggering the supervisory intervention that would accompany formal non-performing asset classification. This creates a systematic bias toward forbearance that may be rational from individual bank perspectives but generates systemic risks through the accumulation of unrecognized losses across the banking system.

CECL Implementation and Discretion in Default Probability Assignments

The implementation of Current Expected Credit Loss (CECL) accounting standards represents a significant evolution in loss recognition methodology, designed to address many of the pro-cyclical effects associated with incurred loss models. CECL requires banks to recognize expected losses over the entire life of loans at origination and to update these estimates as conditions change, theoretically creating more forward-looking and timely loss recognition. However, the substantial discretion inherent in CECL implementation has created new opportunities for banks to manage the timing and magnitude of loss recognition in ways that may undermine the standard's objectives.

The forward-looking nature of CECL depends critically on banks' assessments of default probabilities, loss given default rates, and exposure at default calculations. These assessments require significant judgment regarding

future economic conditions, borrower performance, and collateral values. While this judgment is necessary given the inherent uncertainty in credit risk assessment, it also creates opportunities for banks facing capital pressures to make systematically optimistic assumptions that reduce required provisions and preserve reported capital ratios.

Empirical analysis reveals systematic patterns in how banks exercise this discretion that suggest regulatory arbitrage rather than genuine differences in credit risk assessment capabilities. Research indicates that undercapitalized banks assign default probabilities that are approximately 0.9 percentage points lower than better-capitalized institutions when evaluating similarly distressed commercial real estate loans. This difference cannot be explained by differences in portfolio composition, geographic concentration, or historical loss experience, suggesting that capital pressures systematically influence provisioning decisions under CECL.

The discretion in CECL implementation becomes particularly problematic in commercial real estate lending, where collateral valuations and borrower cash flow projections involve substantial uncertainty. Banks can justify reduced provisioning through optimistic assumptions about property value recovery, tenant lease renewals, or borrower operational improvements that may have low probability of realization but cannot be definitively disproven at the time of assessment. This creates opportunities for sophisticated institutions to maintain artificially low provisions while technically complying with CECL requirements.

The interaction between CECL discretion and maturity extension strategies compounds these effects. Banks can justify both loan extensions and reduced provisioning through coordinated assumptions about borrower prospects and collateral performance that may be internally consistent but systematically optimistic. This coordination enables banks to avoid both non-performing asset classification and adequate provisioning while maintaining plausible documentation for supervisory review.

Empirical Signals of Systemic Misclassification

The divergence between market indicators of commercial real estate distress and banks' reported asset quality metrics provides compelling evidence of systematic under-recognition of losses across the banking system. This divergence has persisted and widened during periods when commercial real estate fundamentals have deteriorated substantially, suggesting that regulatory and accounting frameworks are failing to capture the true extent of portfolio distress at many institutions.

Market-based measures of commercial real estate performance, particularly office REIT valuations and commercial mortgage-backed securities pricing, have reflected substantial distress in certain property sectors for extended periods. Office REITs have experienced value declines exceeding 40 percent in many markets, while CMBS spreads have widened to levels typically associated with significant credit stress. These market signals reflect fundamental changes in commercial real estate demand patterns, including structural shifts in office utilization, retail consumption patterns, and property cash flow generation capabilities.

In contrast, banks' reported non-performing loan ratios and charge-off rates for commercial real estate portfolios have remained at historically moderate levels throughout periods of severe market distress. This divergence cannot be explained by differences in portfolio composition, since banks maintain substantial exposure to the same property types and geographic markets reflected in public market valuations. The persistence of this divergence suggests systematic differences in loss recognition timing and methodology between market participants and bank regulatory reporting.

The Federal Reserve Bank of New York Staff Report No. 1130 provides empirical evidence supporting concerns about systematic under-recognition of commercial real estate losses among weakly capitalized institutions. The analysis demonstrates that banks facing capital constraints report artificially low charge-off rates and default probabilities on commercial real estate loans

relative to better-capitalized peers, even after controlling for portfolio characteristics and regional economic conditions. These findings suggest that capital pressures systematically influence banks' asset quality reporting in ways that obscure true portfolio condition.

The implications extend beyond individual bank reporting to systemic risk assessment and monetary policy implementation. Regulatory authorities rely on banks' reported asset quality metrics to assess system-wide credit conditions and calibrate supervisory responses. Systematic under-reporting of commercial real estate distress impairs regulators' ability to identify emerging systemic risks and may delay necessary policy interventions until problems become more severe and difficult to address.

Policy Implications

The accumulation of evidence regarding systematic under-recognition of commercial real estate losses reveals fundamental flaws in the current regulatory and accounting architecture that require comprehensive policy responses. These frameworks, developed primarily to address different types of financial stability risks, have created unintended consequences that may undermine their core objectives of promoting transparency, capital adequacy, and systemic stability.

Current regulatory frameworks reward delay in loss recognition through multiple channels that operate simultaneously and reinforce each other. HTM accounting treatment enables banks to avoid marking distressed assets to current market conditions. Capital adequacy frameworks may exclude unrealized losses from regulatory calculations, reducing immediate pressure for timely resolution. CECL implementation provides substantial discretion in provisioning decisions that banks can exploit to manage reported capital ratios. Supervisory examination procedures may lack sufficient focus on identifying sophisticated forms of regulatory arbitrage in asset classification and extension decisions.

The policy implications extend beyond technical adjustments to specific regulatory or accounting

standards. The current system creates moral hazard that encourages banks to maintain exposures to declining assets rather than facilitating orderly resolution and reallocation of capital to more productive uses. This misallocation becomes self-reinforcing as banks with substantial unrealized losses develop stronger incentives to extend additional credit to distressed borrowers rather than recognize losses and pursue alternative strategies.

Reform efforts must address the fundamental misalignment between regulatory incentives and economic substance that enables pretend and extend behavior. This requires coordinated changes across accounting standards, capital adequacy frameworks, and supervisory examination procedures that eliminate opportunities for regulatory arbitrage while preserving legitimate risk management flexibility. The complexity of these interactions means that piecemeal reforms may simply redirect regulatory arbitrage toward different channels rather than addressing underlying incentive problems.

The urgency of reform is amplified by the potential for current practices to amplify future financial instability. Banks that delay loss recognition through systematic extensions may appear adequately capitalized during benign conditions but face severe capital shortfalls when economic conditions deteriorate and borrowers can no longer service extended obligations. The concentration of these practices among institutions already facing capital constraints creates systemic vulnerabilities that may not be apparent until aggregate stress testing reveals the accumulated impact of years of delayed loss recognition.

Call to Action

The evidence presented demands immediate attention from regulators, accounting standard setters, and supervisory policymakers who possess the authority and expertise necessary to address these systemic vulnerabilities. The current regulatory architecture, while sophisticated in many respects, contains fundamental design flaws that reward delay in recognizing commercial real estate losses and create moral hazard throughout

the banking system. These flaws cannot be addressed through minor technical adjustments or enhanced supervisory guidance alone, but require comprehensive reconsideration of how loss recognition, capital adequacy, and supervisory oversight interact to shape bank behavior.

Accounting standard setters must examine how HTM classification and CECL implementation create opportunities for banks to manage loss recognition timing in ways that undermine transparency and capital adequacy. This examination should focus particularly on the discretion available to banks in asset classification decisions and the adequacy of current disclosure requirements for revealing the economic substance of loan extensions and modifications. The goal should be standards that provide legitimate flexibility for sound risk management while eliminating opportunities for regulatory arbitrage that obscures true asset quality.

Bank regulators must reassess how capital adequacy frameworks interact with accounting standards to create systematic incentives for delaying loss recognition. The differences in AOCI treatment between different categories of banks create particularly problematic disparities that reward regulatory arbitrage over sound risk management. Capital frameworks should be

redesigned to ensure that regulatory capital measures reflect economic reality rather than accounting artifacts, with particular attention to how unrealized losses on all categories of assets affect true loss-absorbing capacity.

Supervisory authorities must develop examination procedures and enforcement mechanisms that can identify and address sophisticated forms of regulatory arbitrage in commercial real estate lending. This requires enhanced focus on the economic substance of loan extensions and modifications, rather than merely their technical compliance with existing guidance. Examiners need tools and training that enable them to distinguish between legitimate borrower accommodation and extensions designed primarily to avoid loss recognition and preserve regulatory capital ratios.

The stakes extend far beyond technical compliance with regulatory standards. The integrity of our financial system depends on accurate recognition and disclosure of risks, particularly in sectors as systemically important as commercial real estate. Current practices that reward delay in loss recognition undermine market confidence, distort capital allocation, and create vulnerabilities that may not become apparent until economic stress reveals the accumulated impact of years of regulatory arbitrage.

Clear, enforceable standards for recognizing and disclosing distress in commercial real estate lending are essential to restoring proper market functioning and ensuring future financial stability. The time for incremental adjustments has passed. What is required now is fundamental reform of the regulatory and accounting architecture that shapes bank behavior, guided by the principle that financial stability depends ultimately on transparency, adequate capitalization, and market discipline rather than regulatory forbearance and accounting accommodation.



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