



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

CHAPTER 06:

CAREER RISK AND THE HUMAN FACTOR: WHY MIDDLE MANAGERS OFTEN PERPETUATE THE STATUS QUO

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In the quarterly risk committee meeting of a mid-sized regional bank, the portfolio manager reviewing commercial real estate exposures faced a familiar dilemma. The downtown office complex in his portfolio showed declining occupancy, delayed rent payments, and a market value that had clearly fallen below the outstanding loan balance. The facts were undeniable, yet the easiest path forward remained obvious: classify the loan as “special mention” rather than “substandard,” request updated financials, and revisit the situation next quarter.

This manager understood the consequences of both choices. Downgrading the loan would trigger reserve requirements, regulatory attention, and uncomfortable conversations with senior leadership about how the portfolio had deteriorated under his watch. Maintaining the current classification, however, simply deferred these conversations while hoping market conditions might improve. In the calculus of career preservation, the choice seemed clear.

This scenario, replicated across thousands of institutions and millions of individual decisions, represents the human dimension of the pretend-and-extend crisis that swept through commercial real estate lending from 2022 through 2024. While regulatory frameworks and accounting standards provided the mechanics for systemic avoidance, the driving force was fundamentally human: the career risk associated with delivering unwelcome news in organizational cultures that had not adequately prepared for such challenges.

Fear-Based Decision Making

The Federal Reserve Bank of New York's research documented that undercapitalized banks systematically assigned lower default probabilities to distressed loans and granted extensions more frequently than their better-capitalized peers. Behind these statistical patterns lie countless individual decisions made by risk officers, loan committee members, and asset managers who understood that their career trajectories depended on how they navigated deteriorating portfolio conditions.

The fear driving these decisions operates on multiple levels. At the most immediate level, middle managers recognize that surfacing problems often makes them the messenger associated with bad news. In organizations lacking strong challenge cultures, the professional who identifies asset quality deterioration may find themselves scrutinized more heavily than the underlying portfolio problems they identified.

This dynamic becomes particularly acute during periods of widespread stress when senior leadership faces pressure from regulators, boards, and shareholders. The temptation to treat individual cases of deterioration as isolated incidents rather than symptoms of broader portfolio challenges creates powerful incentives for middle managers to minimize problem recognition. The manager who consistently flags concerns may be perceived as overly pessimistic or lacking confidence in the institution's portfolio quality.

Performance review structures often inadvertently reinforce these incentives. Compensation systems that emphasize portfolio growth, fee generation, or loan volume naturally create tension with risk identification responsibilities. When individual performance metrics conflict with institutional risk management objectives, rational actors will optimize for personal success rather than organizational truth-telling.

The behavioral economics underlying these decisions amplify natural human risk aversion when personal stakes are involved. Research consistently demonstrates that individuals become more conservative when their own career prospects are directly affected by their decisions. In the context of commercial real estate portfolio management, this translated into systematic bias toward maintaining optimistic assumptions rather than confronting uncomfortable realities about asset quality deterioration.

The ‘No One Got Fired for Waiting’ Mentality

Across the banking industry, a pervasive cultural assumption emerged that inaction carried less career risk than premature problem recognition. This “wait and see” approach became institutionalized through informal networks that shared stories of colleagues who had been penalized for early loss recognition, contrasted with those who had successfully managed through difficult periods by extending maturities and maintaining optimistic projections.

The logic appeared superficially sound: commercial real estate markets are cyclical, temporary dislocations

resolve over time, and patient capital management often produces better outcomes than panic-driven decisions. However, this reasoning failed to account for the structural changes affecting commercial real estate fundamentals in the post-pandemic environment, where remote work patterns, retail consumption shifts, and supply chain reconfigurations created permanent rather than temporary challenges.

Status quo preservation became the default option because it distributed accountability across time and multiple decision points rather than concentrating it in individual moments of recognition. The manager who extended a troubled loan's maturity could argue they were providing the borrower time to stabilize operations and market conditions time to recover. The alternative—forcing immediate recognition of impairment—created concentrated accountability that carried obvious career risks.

This mentality was reinforced by organizational memory of previous cycles where patience had been rewarded and early problem recognition had proven premature. Industry veterans could point to examples from the 2008 financial crisis, the 1990s real estate downturn, or earlier cycles where institutions that avoided premature loss recognition outperformed those that moved aggressively to clean up portfolios.

Disconnect Between Risk Teams and Lending Officers
The structural positioning of risk management functions within many institutions created inherent conflicts that discouraged aggressive problem recognition. Risk professionals often found themselves culturally and organizationally subordinate to revenue-generating business lines, creating systematic pressure to accommodate rather than challenge lending decisions.

This subordination manifested in multiple ways: risk officers might report through business line management rather than independently to senior leadership, their compensation might be

tied to business line performance rather than risk identification effectiveness, or their career advancement might depend on maintaining positive relationships with lending officers rather than providing independent risk assessment.

The knowledge asymmetries between risk teams and lending officers further complicated these dynamics. Lending officers maintained ongoing relationships with borrowers, understood deal structures and market contexts that might not be fully captured in risk management systems, and possessed institutional credibility based on their revenue generation responsibilities. Risk officers, despite their analytical capabilities, often lacked the contextual knowledge and organizational influence necessary to effectively challenge lending decisions.

Cultural expectations reinforced these structural disadvantages. Risk teams were expected to provide analytical support and compliance oversight rather than business judgment that might conflict with lending officer assessments. The risk professional who consistently challenged lending decisions risked being labeled as obstructionist or lacking understanding of business realities.

Cultural Rot from the Top

The tone established by senior leadership ultimately determined whether organizations rewarded transparency or penalized uncomfortable truths. Institutions that successfully navigated the extend-and-pretend period typically maintained cultures where challenge was expected and truth-telling was protected, even when it delivered unwelcome messages about portfolio quality or market conditions.

Conversely, organizations that struggled often exhibited cultural patterns where senior leadership discouraged dissent, minimized external challenges to portfolio quality, or created informal pressure for optimistic assessments that conflicted with observable market conditions. These cultural signals

traveled quickly through organizational hierarchies, shaping individual decisions about risk identification and problem escalation.

The contrast between “challenge cultures” and “go-along-to-get-along” environments became particularly apparent during periods of stress. Organizations with strong challenge cultures maintained systematic processes for surfacing concerns, protecting individuals who raised difficult questions, and ensuring that uncomfortable information reached decision-makers in time to enable effective responses.

Leadership behavior during previous difficult periods often established expectations that shaped responses to new challenges. Senior executives who had historically penalized early problem recognition or rewarded optimistic projections that later proved incorrect created organizational memories that influenced future decision-making patterns.

Link to Extend-and-Pretend Patterns

The human dynamics driving career risk calculations directly contributed to the systematic patterns documented in the Federal Reserve research. When the data showed that weakly capitalized banks assigned 0.9 percentage point lower default probabilities to distressed loans and granted extensions 0.2 percentage points more frequently, these statistical patterns reflected thousands of individual decisions made by managers facing career risk trade-offs.

Someone in each institution was choosing not to challenge optimistic assumptions about borrower recovery prospects, property value sustainability, or market condition improvements. These choices, while individually rational from a career preservation perspective, aggregated into systematic institutional behaviors that delayed loss recognition and contributed to the buildup of financial fragility.

The research revealed that this behavior was concentrated among institutions facing capital pressures, suggesting that career risk calculations



intensified when organizational stress increased. As institutions faced external pressure from regulators, shareholders, or market conditions, internal pressure on individual managers to avoid adding to institutional challenges correspondingly intensified.

The Path Forward

Creating organizational cultures that reward truth-telling requires systematic changes to incentive structures, reporting relationships, and leadership behavior. Institutions must develop career protection mechanisms for individuals who surface uncomfortable truths, establish independent pathways for risk escalation, and ensure that performance evaluation systems reward long-term risk identification rather than short-term problem avoidance.

Four Corners Valuations serves as an independent voice in this cultural transformation. As external valuation professionals, we are uniquely positioned to provide objective assessments without the career risk calculations that can compromise internal decision-making. Our role extends beyond technical analysis to include cultural partnership—helping institutions see clearly through organizational dynamics that might otherwise obscure emerging risks.

The human factor in extend-and-pretend behavior cannot be addressed through regulatory changes or system modifications alone. It requires conscious cultural evolution that protects and rewards individuals willing to deliver difficult messages. Organizations that successfully navigate this transformation will be better positioned for long-term stability and performance, while those that continue rewarding silence over truth will remain vulnerable to the next crisis that demands uncomfortable recognition.



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