



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

CHAPTER 08:

SYSTEMIC RISKS OF COMPOUNDING DEFERRED LOSSES

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In July 2007, Citigroup CEO Chuck Prince famously declared that “as long as the music is playing, you’ve got to get up and dance.” Within months, the music had stopped, and the accumulation of deferred losses and mispriced risks that had been building throughout the credit boom converted into the most severe financial crisis since the Great Depression. Today’s commercial real estate market faces a parallel moment of reckoning, where years of extend-and-pretend practices have created a seemingly stable facade masking profound structural vulnerabilities.

The maturity wall documented by Federal Reserve research reveals the scale of accumulated risk: as of Q4 2023, CRE mortgages coming due within three years represent 27% of bank marked-to-market capital, up from 16% in 2020. This concentration of exposure creates unprecedented timing risk, where adverse market conditions or regulatory changes could force simultaneous recognition of losses across thousands of properties that have been sustained through repeated extensions and optimistic assumptions.

The illusion of stability that characterizes today’s commercial real estate landscape mirrors the deceptive calm that preceded previous financial crises. Loan portfolios appear current, properties maintain formal occupancy, and banks report manageable charge-off rates. Yet beneath this surface tranquility, fundamental indicators reveal deep structural problems that extensions have deferred but not resolved.

The Illusion of Stability

Current portfolio metrics present a misleading picture of commercial real estate health that obscures mounting vulnerabilities. Loans classified as “performing” often reflect administrative convenience rather than economic reality, as maturity extensions allow institutions to maintain favorable classifications for assets that would otherwise trigger adverse ratings. Properties showing technical occupancy may house tenants paying significantly below-market rates, operating under month-to-month arrangements, or deferring rent payments through informal forbearance agreements.

The gap between reported performance and underlying economics becomes apparent through careful analysis of cash flow trends, debt service coverage ratios, and capital investment requirements. Many “performing” loans exhibit debt service coverage ratios below 1.0, requiring continuous owner subsidies to maintain basic operations. Net operating income trends show persistent year-over-year declines despite broader market recovery in comparable assets. Deferred maintenance and capital improvement needs accumulate to levels that exceed reasonable projections of future cash flow generation.

These deteriorating fundamentals remain hidden within portfolio reporting systems designed to emphasize current payment status rather than long-term viability. The result is an artificial stability that

masks the true scope of problems requiring eventual resolution. Extensions provide temporary relief but do not address the underlying economic challenges that made extensions necessary in the first place.

The institutional incentives supporting this illusion create powerful momentum toward continued deferral. Risk officers face career consequences for forcing recognition of problems that colleagues hope might resolve through market recovery. Loan committee members find extensions easier to justify than workout processes that require difficult decisions about loss recognition and capital allocation. Senior management receives portfolio reports that emphasize current performance rather than forward-looking viability assessments.

Capital-at-Risk Compression

The Federal Reserve Bank of New York’s research reveals how extend-and-pretend practices have compressed future losses into an increasingly narrow time window. The maturity wall represents more than statistical curiosity; it constitutes a fundamental concentration of risk that amplifies the potential impact of adverse market conditions or regulatory changes.

This temporal compression of risk creates multiple vulnerabilities. Market disruptions that might normally affect loan portfolio performance gradually over several years could instead trigger simultaneous stress across large portions of bank capital. Regulatory

changes affecting capital requirements, loan classification standards, or appraisal methodologies could force immediate recognition of losses that have been deferred through repeated extensions.

The concentration effect becomes particularly dangerous when combined with the procyclical nature of commercial real estate markets. Property values, cap rates, and credit availability all tend to move in the same direction during market cycles. A synchronized adjustment across these variables could trigger rapid deterioration in loan performance metrics that have been artificially supported through forbearance and extension practices.

Banks with significant exposure to the maturity wall face limited options for managing this concentrated risk. Portfolio sales require recognizing current market values that may reflect substantial losses compared to carrying values. Refinancing strategies depend on borrower equity contributions and market credit availability that may not materialize under stressed conditions. Foreclosure proceedings force immediate loss recognition while generating assets that must be marketed during potentially unfavorable conditions.

Market-Wide Ramifications

The systemic nature of extend-and-pretend practices means that eventual loss recognition events will likely occur simultaneously across multiple institutions and markets. This coordination creates the potential for self-reinforcing cycles where forced asset sales depress market values, triggering additional losses that require further asset sales.

Cap rate expansion represents one of the most dangerous transmission mechanisms for systemic risk. As distressed properties enter the market through foreclosure or voluntary disposition, transaction prices reflect higher required returns that reset comparable property valuations across entire markets. This repricing affects not only the

institutions directly disposing of assets but all holders of similar properties who must adjust their portfolio valuations to reflect current market conditions.

The interconnectedness of commercial real estate markets amplifies these effects beyond traditional bank lending. Real Estate Investment Trusts holding similar properties face immediate mark-to-market adjustments when comparable sales establish new pricing benchmarks. Insurance companies and pension funds with significant real estate allocations must reassess their portfolio values based on observable market transactions. Private equity real estate funds face pressure from investors seeking updated valuations that reflect current market conditions.

Non-bank lenders that have gained market share during the extend-and-pretend period may prove particularly vulnerable to rapid market adjustments. These institutions often operate with less regulatory oversight and capital cushioning than traditional banks, potentially forcing faster recognition of losses when market conditions deteriorate.

Scenario Analysis Imperative

The concentration of risk in near-term maturities demands sophisticated scenario analysis that moves beyond traditional stress testing to encompass the potential for rapid, synchronized adjustments across multiple risk factors. Portfolio managers must evaluate how their exposures would perform under plausible combinations of adverse conditions rather than analyzing individual risk factors in isolation.

Interest rate sensitivity analysis becomes crucial given the leverage embedded in commercial real estate transactions. A 100 basis point increase in market rates could trigger substantial adjustments in property values while simultaneously increasing the cost of refinancing for borrowers with maturing loans. The combination of reduced asset values and higher financing costs could render many extension strategies economically unfeasible.

Occupancy and rental rate scenarios must account for the potential permanence of post-pandemic changes in space utilization. Office properties facing continued reductions in demand may not recover to pre-pandemic performance levels regardless of broader economic conditions. Retail properties confronting structural shifts in consumer behavior may require fundamental repositioning that current ownership and financing structures cannot support.

Regulatory scenario analysis should consider potential changes in supervisory expectations, capital requirements, or loan classification standards that could force earlier recognition of problems currently managed through extensions. Historical precedent suggests that regulatory tolerance for forbearance practices often shifts during periods of stress, creating additional pressure for loss recognition.

Historical Parallels and Contemporary Differences

The current situation bears uncomfortable similarities to conditions preceding the 2008 financial crisis, where delayed loss recognition and mispriced risk accumulated into systemic vulnerabilities. The extend-and-pretend practices of 2022-2024 echo the “delay and pray” strategies that characterized troubled loan management during the earlier crisis.

However, important differences distinguish the current environment from previous cycles. Bank capital levels are generally stronger today, providing greater capacity to absorb losses when recognition becomes unavoidable. Regulatory oversight has improved, offering earlier warning systems for emerging problems. The concentration of risk in commercial real estate, while significant, is less universal across institutions than the mortgage-related exposures that characterized the previous crisis.

These differences provide reasons for measured optimism but should not encourage complacency. The specific characteristics of post-pandemic commercial real estate challenges—particularly the

structural nature of office sector difficulties—may prove more persistent than cyclical problems that resolved through market recovery in previous cycles.

The Path Forward

The accumulated risks created by extend-and-pretend practices demand proactive recognition rather than continued deferral. Portfolio managers must conduct comprehensive stress testing that accounts for the potential concentration of losses in near-term maturity periods. Investment committees should require scenario analysis that demonstrates portfolio resilience under plausible adverse conditions.

Four Corners Valuations serves as your forward-looking risk partner in navigating these challenges. Our independent assessment capabilities identify where market-based pricing diverges from balance sheet assumptions, enabling proactive risk management before external pressures force reactive decisions. We provide the clarity necessary to distinguish between assets worth extending and those requiring alternative resolution strategies. The music will stop eventually. Institutions that prepare for that moment through honest assessment

and proactive planning will be positioned to navigate the adjustment successfully. Those that continue dancing may find themselves unprepared for the sudden silence.



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