



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

### CHAPTER 09:

### HOW REFUSING TO ADAPT ASSETS HARMS DOWNTOWNS AND DEEPENS THE HOUSING CRISIS

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In downtown Cleveland, a 15-story office building constructed in 1975 stands as a monument to institutional inertia. With occupancy below 30% and floors of darkened windows visible from blocks away, the property continues generating minimal rental income while requiring continuous owner subsidies for basic operations. Meanwhile, the city faces a housing shortage that has driven residential rents up 25% over three years, and zoning officials regularly field inquiries about office-to-residential conversion opportunities that never materialize due to capital structure constraints.

This building represents thousands of similar assets across American cities where extend-and-pretend practices have created a tragic misallocation of urban space. While financial institutions defer loss recognition through repeated maturity extensions, communities bear the mounting social costs of buildings trapped in economic limbo—assets that could address urgent housing needs but remain frozen in obsolete configurations by valuation disputes and financial avoidance.

The social dimension of extend-and-pretend behavior extends far beyond portfolio management concerns to encompass fundamental questions about urban vitality, housing affordability, and equitable development. When property owners and lenders refuse to acknowledge changing market realities, they effectively block community-serving adaptations that could transform struggling assets into productive civic resources.

#### Vacancy as Civic Blight

Chronically vacant office space in urban cores creates negative externalities that compound far beyond individual property boundaries. Buildings with visible vacancy rates above 40% signal economic distress that affects pedestrian traffic patterns, retail viability, and public safety perceptions throughout surrounding areas. These psychological effects prove particularly damaging in downtown environments where activity density drives economic vitality.

The reduction in foot traffic created by office vacancy triggers cascading effects throughout downtown ecosystems. Ground-floor retail businesses lose customer base as fewer workers populate surrounding areas during traditional business hours. Restaurants reduce operating hours or close permanently when lunch crowds disappear. Public transit systems experience ridership declines that threaten service levels and route viability.

Public safety concerns intensify as buildings remain partially occupied or poorly maintained. Reduced natural surveillance from office workers creates opportunities for criminal activity that affects broader neighborhood security. Property maintenance standards often decline as cash-strapped owners defer investments in lighting, landscaping, and security systems that contribute to public realm quality.

The visual impact of failing commercial properties sends powerful signals about neighborhood trajectory

that influence business investment decisions and residential location choices. Prospective tenants, investors, and residents interpret visible building distress as evidence of broader area decline, creating self-fulfilling prophecies where anticipated problems become realized outcomes through disinvestment and avoidance behaviors.

Municipal governments face increasing pressure to address these negative externalities through code enforcement, public safety resources, and economic development programs while simultaneously losing tax revenue from declining property assessments. This fiscal squeeze limits local capacity to respond effectively to problems created by private sector inaction.

#### The Missed Housing Opportunity

The persistence of obsolete office buildings during an acute housing shortage represents one of the most tragic missed opportunities in contemporary urban policy. Many Class B and C office properties possess characteristics that make them viable candidates for residential conversion: appropriate floor plates, adequate ceiling heights, existing plumbing and electrical infrastructure, and downtown locations with transit access.

Successful office-to-residential conversions in cities like Chicago, Philadelphia, and Seattle demonstrate the potential for transforming struggling commercial assets into community-serving housing. These

projects often produce units at price points below new construction costs while preserving existing building stock and maintaining downtown population density that supports retail and transit systems.

However, conversion projects remain stalled by valuation mismatches between current market reality and existing debt structures. Office buildings carrying loans based on pre-pandemic valuations cannot support the write-downs necessary to make conversion economics viable. Lenders maintaining optimistic assumptions about office market recovery resist restructuring that would enable alternative use scenarios.

The regulatory environment often compounds these financial obstacles. Zoning codes written for different market conditions may require lengthy approval processes for conversion projects. Building codes designed for new construction impose costly requirements on adaptive reuse projects that make conversions economically unfeasible under current capital structures.

The scale of this missed opportunity becomes apparent when considering housing demand pressures across American cities. The National Low Income Housing Coalition estimates a shortage of over 7 million affordable rental units nationally, while millions of square feet of office space remain functionally obsolete. The failure to connect these supply and demand imbalances represents a fundamental policy failure with profound social consequences.

### **Policy Gridlock from Financial Gridlock**

Municipal governments find themselves constrained by private sector financial decisions that prevent productive asset reuse. Cities cannot effectively plan for downtown revitalization when property owners maintain unrealistic valuations that preclude adaptive reuse projects. Local incentive programs for conversion projects fail when underlying economics remain distorted by extend-and-pretend practices.

Economic development officials face the frustration of promoting downtown housing initiatives while key properties remain locked in financial structures that prevent conversion. Tax increment financing districts cannot generate expected revenues when properties maintain artificial valuations that delay appropriate reassessment. Public-private partnership opportunities disappear when private partners lack realistic understanding of asset values and conversion potential.

The temporal mismatch between financial resolution and community planning needs creates particular challenges for urban policy makers. Housing shortages and downtown revitalization needs require immediate attention, while extend-and-pretend practices can defer property resolution for years. This delay prevents cities from implementing comprehensive development strategies that depend on predictable asset availability and realistic pricing.

Zoning reform efforts face similar constraints when property owners resist changes that might signal acknowledgment of obsolescence. Downtown districts cannot evolve to mixed-use configurations when commercial property owners maintain optimistic assumptions about future office demand that prevent residential zoning consideration.

### **The Extend-and-Pretend Feedback Loop**

The financial mechanisms supporting extend-and-pretend behavior create self-reinforcing cycles that prevent productive asset adaptation. Unrealistic loan underwriting based on outdated market assumptions enables property owners to avoid difficult decisions about alternative uses. Repeated maturity extensions provide false hope that office markets might recover sufficiently to justify current debt levels.

This feedback loop proves particularly damaging for properties with conversion potential. Buildings that could serve immediate community housing needs remain trapped in configurations that generate

insufficient income to service existing debt while lacking capital for necessary repositioning. The result is gradual deterioration that makes eventual conversion more expensive and less likely.

The institutional incentives supporting this cycle affect multiple stakeholders. Bank loan officers face career risks for forcing recognition of losses that might enable productive reuse. Property owners with negative equity positions lack incentives to invest in conversion projects that primarily benefit lenders. Municipal officials cannot plan effectively around assets with uncertain resolution timelines.

### **Catalyzing Adaptation**

Breaking the extend-and-pretend cycle requires coordinated action across multiple stakeholder groups. Cities must develop regulatory frameworks that facilitate rapid conversion approvals while ensuring appropriate safety and design standards. State governments should consider legislation that enables expedited foreclosure processes for properties with clear conversion potential.

Financial institutions need incentives to recognize current market realities rather than maintaining optimistic projections that prevent productive reuse. Regulatory guidance should encourage realistic asset valuation that enables rather than prevents adaptive reuse projects. Capital requirements might be adjusted to discourage indefinite extension of economically obsolete assets.

Public-private partnership models offer potential solutions that align community needs with financial realities. Cities like Chicago have developed acquisition and conversion programs that enable municipality-driven adaptive reuse when private markets fail to respond to housing needs. Calgary's downtown conversion incentive program demonstrates how targeted municipal support can unlock private investment in building adaptation.

Developer and investor communities must engage with realistic conversion economics rather than waiting for office market recovery that may never materialize. Early movers in the conversion market often benefit from favorable acquisition pricing and municipal support that may not be available to later entrants.

**The Path Forward**

The social costs of delay compound daily as housing shortages worsen and downtowns struggle with obsolete building stock. Every month that viable conversion candidates remain trapped in extend-and-pretend cycles represents lost housing opportunities and continued urban decline.

Four Corners Valuations provides crucial analysis for breaking these cycles by delivering realistic assessments of conversion potential and highest-and-best-use scenarios. Our evaluations help stakeholders understand when a property's optimal future lies in adaptation rather than continued office use, providing the clarity necessary for productive decision-making.

Communities cannot afford to wait for private markets to resolve these challenges independently. Proactive

policy interventions, realistic financial assessment, and coordinated stakeholder engagement offer pathways toward transforming struggling assets into community resources. The choice between productive adaptation and continued decay ultimately determines whether cities thrive or decline in the post-pandemic economy.



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