



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

### CHAPTER 12:

### THE COMMUNITY BANK DOMINO EFFECT: HOW EXTEND-AND-PRETEND AT SMALL LENDERS AMPLIFIES MARKET FRAGILITY

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Community banks remain the backbone of local economic development across the United States. They finance Main Street businesses, anchor regional job growth, and support the property markets that define the physical character of smaller cities and towns. Yet this deep integration with local economies carries a structural vulnerability that has grown acute in the current commercial real estate cycle.

Community banks often hold disproportionate exposure to commercial real estate loans, and these exposures are frequently concentrated in narrow geographic zones and specific property types. When combined with the widespread practice of extending and modifying distressed loans to delay losses, this concentration creates a dangerous feedback loop.

A localized shock in property values or tenant demand can rapidly erode capital adequacy, trigger depositor concern, and force fire sales that depress valuations further. What begins as a problem in a single submarket or asset class can metastasize into a regional contagion event with national systemic implications.

#### Data-Backed Exposure Risk

The scale of the problem is both clear and alarming. Recent analysis from the Federal Reserve Bank of New York indicates that as of Q4 2023, approximately 27 percent of aggregate bank capital across the system was tied to commercial real estate loans maturing within the subsequent three years. This figure,

however, obscures profound disparities between large institutions with diversified portfolios and small banks with concentrated exposures.

For community banks with assets under \$10 billion, CRE loans often represent well over 200 percent of total risk-based capital, and in many cases exceed 300 percent. These ratios far surpass the regulatory thresholds that typically invite heightened supervisory scrutiny. The problem is compounded by maturity clustering. Many of these loans were originated in the 2020 to 2022 period, when underwriting standards relaxed and valuation assumptions reflected pre-pandemic demand patterns.

As these loans mature over the next 18 to 36 months, borrowers will face sharply higher interest rates, tighter debt service coverage requirements, and lower appraised values. The simultaneous repricing of a large share of the loan book creates synchronized vulnerability. If even a modest fraction of these loans default or require restructuring, the resulting capital depletion can leave banks unable to absorb further losses or support new lending.

#### Geographic Clustering and Spillover Effects

The geographic dimension of this risk is especially troubling. Community banks by definition serve specific regions, and their lending patterns reflect the economic structure of those areas. In many small and mid-sized cities, a handful of property types dominate the commercial real estate landscape. Office buildings

in tertiary markets with persistent vacancies, retail strips facing long-term e-commerce pressures, and mixed-use developments that were overbuilt during the last cycle are common examples. When a community bank finances multiple properties within a single submarket or asset class, it effectively takes on correlated risk. A decline in office occupancy rates in one downtown corridor does not remain isolated. It depresses rents and valuations across neighboring buildings, triggers tenant defaults, and forces reappraisals that reveal loss of equity.

Adjacent retail and multifamily properties lose tenant traffic and face their own valuation pressures. Local appraisers, relying on comparable sales and income approaches, mark down values in cascading fashion. Credit underwriters at the bank, observing deterioration in multiple loans simultaneously, tighten standards and reduce new originations. This contraction in credit availability further depresses property sales and forces distressed owners to accept lower bids, which in turn reset the comparable sales baseline for future appraisals. The result is a self-reinforcing downward spiral in property values and credit availability, confined initially to a narrow geography but capable of spreading as investor confidence erodes.

#### Silent Risk Transfer Through Extensions

Faced with these pressures, many community banks have responded not by recognizing losses but by quietly extending loan terms or modifying payment

schedules. This practice, commonly referred to as “extend and pretend” or “amend and pretend,” allows banks to avoid immediate write-downs and the regulatory scrutiny that accompanies classified or nonperforming loans. On the surface, these extensions appear prudent. They give borrowers time to stabilize operations, refinance under better conditions, or wait for market recovery. In practice, however, they often serve to mask insolvency rather than resolve it.

Borrowers who cannot meet original debt service obligations are unlikely to regain financial health simply through the passage of time, particularly when underlying demand fundamentals have deteriorated permanently. By extending the maturity date or reducing payment requirements, banks effectively transfer risk from the present into the future. The loan remains classified as performing, but its true credit quality has degraded. The bank avoids immediate capital charges, but its loan book grows increasingly fragile. Over time, the accumulation of these hidden losses erodes the reliability of reported financial metrics. Investors, depositors, and regulators lose confidence in the stated health of the institution.

When a triggering event finally forces recognition of losses, the magnitude is larger and the bank’s capacity to absorb it is weaker. The silent risk transfer delays the day of reckoning but amplifies its eventual impact.

### Contagion Pathways

The failure of even a small number of community banks can trigger contagion effects that extend well beyond their immediate footprints. When a bank with concentrated CRE exposure fails or requires regulatory intervention, depositors at similarly situated institutions take notice. Uninsured depositors, in particular, become alert to concentration risk and may withdraw funds preemptively. This depositor flight forces banks to liquidate assets or seek emergency funding, further depressing asset prices and reinforcing the perception of systemic fragility.

The March 2023 regional banking crisis demonstrated how quickly confidence can evaporate when depositors perceive undisclosed risk. Community banks with high CRE concentrations are especially vulnerable to these dynamics because their depositor bases are often local and relationship-driven, but also less sticky than those of national institutions.

Beyond direct depositor runs, the failure of community banks can disrupt pricing signals across the broader commercial real estate market. Non-bank lenders, real estate investment trusts, and private credit funds rely on transaction data and appraisal benchmarks from traditional banks to set their own underwriting standards and pricing. When community banks engage in fire sales to meet liquidity needs, they establish new, lower comparable sales prices that propagate through the valuation chain. REITs mark down their portfolios, private equity sponsors face margin calls, and non-bank lenders tighten credit. The resulting credit contraction affects borrowers nationwide, not just those in the failed bank’s immediate geography. This interconnection between traditional banks and shadow banking channels means that localized failures can have national consequences.

### Governance and Oversight Gaps

Preventing this cascade requires proactive governance and regulatory oversight. Bank boards and audit committees must move beyond backward-looking metrics and adopt forward-looking scenario analysis. This means regularly stress-testing CRE portfolios against plausible adverse scenarios such as sustained high interest rates, declining occupancy trends, or regional economic downturns.

Boards should demand granular reporting on exposure concentrations by property type, geographic submarket, and loan maturity. They should scrutinize the quality of collateral valuations and question whether appraisals reflect current market conditions or outdated assumptions. Internal risk management functions must be empowered to challenge business

line leaders who prioritize loan growth over credit quality. Audit committees should ensure that loan loss reserves are adequate not just for current nonperforming loans but for the latent risk embedded in extended or modified loans that remain classified as performing. On the regulatory side, the FDIC and OCC must intensify their focus on concentration risk and underprovisioning, even in portfolios that appear to be performing. Examiners should flag banks with CRE exposures exceeding 300 percent of capital, particularly when those exposures are clustered in vulnerable property types or geographies. They should scrutinize the frequency and terms of loan modifications and extensions, questioning whether these actions represent genuine workout strategies or efforts to delay loss recognition.

Supervisory guidance should emphasize that concentration risk is not mitigated simply by having performing loans. The correlated nature of CRE risk means that a single adverse event can flip an entire portfolio from performing to distressed. Regulators must be willing to impose heightened capital requirements, restrict dividend payments, or require formal action plans when concentration risk is excessive, even if current financial metrics appear satisfactory.

### Call to Action

The time to act is now, before isolated defaults cascade into systemic disruption. Community banks must stop relying on extensions and modifications as primary risk management tools. Instead, they should proactively rebalance portfolios by selling non-core assets, participating loans out to other institutions, and limiting new originations in overexposed sectors. They should adopt rigorous scenario-based reviews that model the impact of adverse conditions on loan performance and capital adequacy. Most importantly, they must embrace early visibility into portfolio risk through independent, objective valuation processes that reflect current market realities rather than wishful assumptions.

Regulators, for their part, must recognize that forbearance and delayed loss recognition do not eliminate risk but merely postpone and amplify it. They should require banks with excessive concentrations to develop and execute concrete diversification plans with measurable milestones and accountability. By acting decisively now, both banks and regulators can prevent the pretend-and-extend cycle from evolving into a contagion event that destabilizes regional economies and erodes confidence in the community banking system.

the foundation for proactive risk management. In an environment where hidden risk can trigger cascading failures, early clarity is not optional. It is essential to protecting capital, preserving depositor trust, and ensuring that community banks continue to serve the communities they were built to support.

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This transparency supports better board decisions, strengthens regulatory confidence, and provides



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