



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

### CHAPTER 13:

### REITS AND CMBS: HIDING IN PLAIN SIGHT

NOVEMBER 3, 2025 | REAGAN SCHWARZLOSE, FRICS | MAI | CRE | CCIM

The commercial real estate crisis isn't just hiding in bank balance sheets—it's operating in broad daylight across public markets and securitized structures, yet institutional investors continue to underestimate the embedded risks. While headlines focus on regional bank stress and extend-and-pretend lending practices, significant vulnerabilities have migrated into Real Estate Investment Trusts (REITs) and Commercial Mortgage-Backed Securities (CMBS), creating an illusion of market transparency that masks deeper structural fragilities.

The numbers tell a stark story. Office REITs have shed roughly 40% of their value since 2022, yet this dramatic repricing barely scratches the surface of underlying distortions. The real risk lies not in what markets are pricing, but in what they're choosing to ignore—or what complex structures are designed to obscure.

**The REIT Mirage: Public Markets, Private Problems**  
REITs occupy a unique position in the financial ecosystem, bridging private real estate markets with public equity valuations. This hybrid nature was once considered a strength, providing liquidity and transparency to an otherwise opaque asset class. Today, it's become a vulnerability that amplifies both market volatility and hidden leverage.

The extend-and-pretend dynamic hasn't disappeared with public market scrutiny—it's simply evolved. REIT managers, facing pressure to maintain distributions and occupancy metrics, have become sophisticated

practitioners of financial engineering. Lease modifications, tenant improvement allowances, and strategic property dispositions allow managers to smooth reported performance while deferring recognition of fundamental value destruction.

**Consider the mechanics:** A REIT facing declining rents in its office portfolio might negotiate lease extensions with struggling tenants at below-market rates, combined with substantial tenant improvement packages. The transaction preserves reported occupancy and nominally maintains rental income, but at the cost of depleted cash flows and increased capital expenditure. Financial statements reflect stability while economic reality deteriorates.

This dynamic is particularly pronounced given REITs' structural dependence on external financing. Unlike traditional corporations that might halt growth during stress periods, REITs must maintain distribution requirements and often face refinancing pressures on properties that may no longer support their original debt levels. The result is a system where public market participants receive information that appears transparent but reflects increasingly strained underlying fundamentals.

Current market conditions have intensified these pressures. REITs ended 2024 up 4.9% after falling 8.2% in the fourth quarter, with uncertainty around interest rates creating strong negative correlation with Treasury yields. This volatility reflects genuine

uncertainty about asset values, yet many institutional investors continue to rely on REIT valuations as proxies for broader commercial real estate health.

The banking connection adds another layer of complexity. Many REITs maintain significant credit relationships with the same regional and community banks facing their own commercial real estate stress. These relationships create natural incentives for mutual accommodation—banks may show flexibility on REIT credit lines while REITs provide deposits and maintain relationships that support bank commercial real estate portfolios. The result is a web of interconnected dependencies that obscures genuine price discovery.

#### **CMBS: Structured Opacity**

If REITs represent transparent markets with hidden complexity, CMBS markets embody structured complexity with hidden transparency. The very architecture of commercial mortgage securitization is designed to transform illiquid, heterogeneous real estate loans into tradable, rated securities. This transformation process, while providing valuable capital markets access, creates multiple opportunities for risk masking and delayed recognition.

The recent performance data is alarming. Office CMBS delinquency rates have spiked to a record 11%, surpassing financial crisis peaks, while "extend and pretend" has been a defining feature of 2024. Even more concerning, the default rate for high-quality

single-asset CMBS bonds reached 8.7% in 2024, nearly three times higher than two years prior.

Yet these headline statistics understate the true scope of stress within CMBS structures. The servicer modification process—designed to maximize recoveries for bondholders—has evolved into a sophisticated system for delaying loss recognition. Extending loan terms was the most popular CMBS modification type in 2024, with over 90% of modified loans by count receiving extensions.

This modification bias creates several problems for institutional investors attempting to assess portfolio risk:

**Timing Uncertainty:** Modified loans remain current for reporting purposes while underlying properties may be experiencing severe cash flow stress. Investors receive no early warning of problems that might affect multiple similar properties in their portfolios.

**Recovery Estimation:** Traditional models for estimating ultimate losses assume relatively predictable foreclosure timing. Extended modification periods make these models unreliable, particularly as they fail to account for additional property deterioration during extended workout periods.

**Correlation Risk:** Properties entering modification simultaneously often share common characteristics—urban office buildings, retail centers in specific markets, hotels in particular segments. The modification process obscures these correlations, creating false diversification assumptions.

**Subordination Erosion:** Junior tranches in CMBS structures depend on credit enhancement levels calculated when deals were originated. Extended modifications can erode these protections without triggering formal impairment recognition, leaving junior investors with less protection than they realize. The special servicing process compounds these issues. When loans transfer to special servicers, the primary

objective shifts from borrower accommodation to loss minimization. This transition often occurs after problems have festered, reducing ultimate recovery rates. Meanwhile, the complexity of special servicing creates information asymmetries between sophisticated institutional investors and those relying on trustee reports and rating agency surveillance.

#### The Interconnection Trap

The most significant risk facing institutional investors lies not in isolated REIT or CMBS exposure, but in the interconnections between these markets and traditional banking relationships. These connections create transmission mechanisms that can amplify localized stress into systemic problems.

Banks remain significant holders of both REIT equity and CMBS tranches, particularly community and regional banks whose commercial real estate concentrations already face regulatory scrutiny. When office REIT values decline, banks holding these securities face mark-to-market losses that affect regulatory capital ratios. Simultaneously, these same banks may be extending credit to commercial real estate borrowers whose properties compete directly with REIT holdings.

The feedback loops are self-reinforcing. As banks tighten commercial real estate lending standards, property owners increasingly turn to CMBS markets for refinancing. This increases CMBS origination at precisely the moment when property fundamentals are weakening. Meanwhile, stressed REIT managers may accelerate property dispositions, pressuring transaction markets that inform CMBS valuations.

Insurance companies and pension funds amplify these dynamics through their dual roles as REIT shareholders and CMBS investors. Many institutional investors maintain significant exposure to both asset classes, often managed by separate teams using different risk assessment frameworks. This creates correlation blindness—the tendency to treat related

risks as independent diversification opportunities.

#### Reassessing Portfolio Risk: Beyond Surface Metrics

For institutional investors, the current environment demands fundamental changes in risk assessment methodology. Traditional approaches that treat REITs as liquid real estate proxies and CMBS as diversified fixed income fail to capture the embedded option characteristics and timing uncertainties that define both asset classes.

**Cash Flow Stress Testing:** Rather than relying on historical performance metrics, investors should model REIT and CMBS performance under scenarios that reflect realistic property cash flow stress. This includes modeling the impact of lease rollovers at market rents, increased capital expenditure requirements, and realistic vacancy assumptions for different property types.

**Modification Timeline Analysis:** For CMBS holdings, investors should analyze the modification histories of comparable properties to estimate realistic timelines for problem recognition and resolution. Extended modification periods should be modeled as creating additional risk, not just delayed timing.

**Cross-Market Correlation Assessment:** Portfolio risk models should explicitly account for correlations between REIT equity performance and CMBS credit performance, particularly for similar property types and geographic markets. These correlations tend to increase during stress periods, precisely when diversification benefits are most needed.

**Banking Sector Transmission:** Investors with significant exposure to both commercial real estate securities and regional banking should model the potential for simultaneous stress across both sectors, particularly given shared property market dependencies.

**Interest Rate Sensitivity:** Both REITs and CMBS exhibit complex interest rate sensitivities that extend

beyond simple duration calculations. Rising rates affect property values, refinancing ability, and the attractiveness of real estate relative to fixed income alternatives. Investors should stress test portfolios across multiple rate scenarios.

### The Path Forward

The commercial real estate crisis operating within REITs and CMBS markets represents a different type of systemic risk than the residential mortgage problems that defined the 2008 financial crisis. Rather than being concentrated in specific institutions or geographic regions, today's risks are distributed across public markets and structured products that touch most institutional portfolios.

This distribution doesn't reduce systemic risk—it democratizes it. The same extend-and-pretend dynamics that allowed banks to defer commercial real estate losses have found new expression in public REIT management and CMBS modification processes. The transparency that public markets and structured products were supposed to provide has instead become a sophisticated system for obscuring risk timing and magnitude.

For institutional investors, the solution isn't to avoid these markets entirely, but to approach them with frameworks that acknowledge their embedded complexities. This means treating REIT investments as concentrated real estate bets rather than liquid market proxies, and approaching CMBS holdings with the analytical rigor typically reserved for direct property investments.

The crisis hiding in plain sight across REITs and CMBS markets won't be resolved by extend-and-pretend strategies, no matter how sophisticated their public market or structured product implementation. Recognition of this reality, and adjustment of portfolio risk frameworks accordingly, represents both a fiduciary imperative and an investment opportunity for institutional investors willing to move beyond surface-level analysis.

The question isn't whether these markets will eventually reflect underlying real estate fundamentals—it's whether institutional investors will position their portfolios to benefit from this inevitable repricing or become casualties of their own analytical blind spots. The choice remains theirs, but the window for complacent assumptions continues to narrow with

each quarterly earnings report and trustee statement that maintains the illusion that extend-and-pretend has somehow solved problems that it has merely deferred.

This analysis reflects market conditions and data available as of August 2025. Given the rapidly evolving nature of commercial real estate markets, investors should supplement this framework with current market intelligence and property-specific analysis when making investment decisions.



### Reagan R. Schwarzlose

FRICS | MAI | CRE | CCIM

CEO | Principal

- +1-480-440-2842 Ext. 06
- rschwarzlose@fourcv.com
- www.fourcv.com



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