



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

### CHAPTER 15:

### THE MIDDLE MARKET BLIND SPOT

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Regional banks face a peculiar dilemma in the middle market that has become increasingly acute as commercial real estate fundamentals deteriorate. For loans typically ranging from \$500,000 to \$5 million, traditional valuation tools create an uncomfortable choice: broker price opinions that provide insufficient analytical depth for meaningful risk assessment, or full narrative appraisals that consume disproportionate resources relative to transaction economics. This valuation gap has created a blind spot where credit decisions rely on incomplete information, contributing to the delayed recognition of problems that eventually cascade across portfolios.

The consequences of this blind spot extend beyond individual credit decisions. Banks are major lenders in the CRE market, providing nearly \$3 trillion in financing to the sector, with \$2.8 trillion of commercial real estate (CRE) loans, made at high valuations and low interest rates, set to mature in the next five years. In this environment, inadequate collateral assessment tools contribute to the extend-and-pretend strategies that regulators and analysts increasingly worry could amplify systemic risk across the regional banking sector.

#### The Economics of the Gap

The middle market lending segment presents unique challenges that neither BPOs nor full appraisals adequately address. A BPO/BOV is not held to the same standard as an appraisal, but it is typically much faster and much less expensive, yet this cost advantage comes with analytical limitations that can prove costly when market conditions shift rapidly.

Consider the typical economics: A BPO might cost \$500-800 and provide results within days, while a full narrative appraisal could cost \$3,000-6,000 and require several weeks. For a \$2 million loan, the appraisal represents 0.15-0.30% of the transaction value—not prohibitive, but potentially non-competitive in fee-sensitive middle market transactions. The BPO represents 0.025-0.04% of transaction value—clearly more attractive, but often insufficient for meaningful risk assessment.

This cost-benefit tension creates operational pressure to rely on BPOs for transactions where additional analytical depth would provide meaningful risk management benefits. The result is credit committees making decisions with limited visibility into collateral quality, market positioning, or potential value volatility.

The problem becomes acute during market stress periods. BPOs typically rely on recent comparable sales and basic property characteristics, providing little insight into market dynamics, tenant credit quality, or property-specific risks that could affect future performance. When comparable sales data becomes stale or unrepresentative—common during market transitions—BPOs offer false precision rather than meaningful guidance.

#### What BPOs Miss in Middle Market Lending

The analytical limitations of BPOs become most problematic precisely where middle market lending concentrates risk: properties with modest complexity that nonetheless require nuanced evaluation to assess accurately. These properties

fall into several categories where BPO methodologies consistently underperform:

**Mixed-Use and Multi-Tenant Properties:** A suburban office building with ground-floor retail and multiple tenants presents analytical challenges that BPOs struggle to address. Lease rollover risk, tenant mix stability, and market positioning relative to competing properties require analysis that goes beyond simple comparable sales methodology.

**Properties in Transitional Markets:** Many middle market loans finance properties in secondary and tertiary markets where transaction volume may be limited and market dynamics differ meaningfully from primary markets. BPOs often rely on comparable sales from dissimilar markets, creating false precision around values that may not reflect local market conditions.

**Properties with Deferred Maintenance or Capital Needs:** BPOs typically focus on gross asset values without adequate consideration of capital expenditure requirements that could significantly affect net asset values. This oversight becomes particularly problematic for older properties or those with deferred maintenance issues that require significant near-term investment.

**Income-Producing Properties with Complex Lease Structures:** Properties with percentage rent provisions, tenant improvement allowances, or other complex lease terms require cash flow analysis that extends beyond BPO scope. These analytical gaps become particularly problematic when evaluating loan modification requests or assessing default risk.

**Special Purpose or Limited Market Properties:** While clearly complex properties require full appraisals, many middle market loans finance properties with modest special-purpose characteristics that nonetheless affect marketability and value. Auto service facilities, single-tenant net-lease properties, or properties with environmental considerations require analytical attention that BPOs cannot provide.

### The Full Appraisal Impediment

While full narrative appraisals provide comprehensive analytical coverage, their cost and timeline characteristics often make them impractical for middle market transactions, particularly in competitive lending environments. The impediments extend beyond simple economics to operational and strategic considerations:

**Timeline Misalignment:** Middle market borrowers often require relatively rapid credit decisions to compete effectively for property acquisitions or respond to refinancing opportunities. Multi-week appraisal timelines can eliminate competitive positioning, forcing banks to choose between losing business or making credit decisions with incomplete collateral assessment.

**Proportionality Concerns:** For routine refinancings of stabilized properties with strong borrower relationships, full appraisals may provide analytical depth that exceeds decision-making requirements while consuming resources that could be deployed more efficiently across the loan pipeline.

**Regulatory Threshold Confusion:** The regulatory requirement for certified appraisals on transactions exceeding \$500,000 creates artificial decision points that may not align with risk-based analytical needs. Banks often interpret this threshold as a ceiling for appraisal requirements rather than a floor, missing opportunities for enhanced risk assessment on complex transactions below the regulatory threshold.

**Vendor Management Complexity:** Maintaining relationships with certified appraisers capable of handling diverse property types across multiple markets requires administrative infrastructure that smaller regional banks may find challenging to maintain efficiently.

**These operational impediments often result in binary decision-making:** accept BPO limitations for competitive reasons, or invest in full appraisals that may exceed analytical requirements for straightforward transactions.

### The Cascade Effect

The middle market valuation gap creates systemic problems that extend beyond individual credit decisions. When banks lack adequate tools for middle-tier risk assessment, several concerning patterns emerge:

**Delayed Problem Recognition:** Inadequate collateral assessment tools delay recognition of emerging problems, allowing deteriorating credit situations to worsen before intervention becomes necessary. This delay often transforms manageable credit issues into more significant losses.

**Portfolio Correlation Blindness:** BPOs provide limited insight into market dynamics that could affect multiple properties simultaneously. Banks may maintain comfortable diversification assumptions while actual correlation risks increase during market stress periods.

**Extend-and-Pretend Incentives:** When collateral assessment tools provide insufficient clarity, banks face pressure to extend existing credits rather than confront valuation uncertainty. This dynamic contributes to the extend-and-pretend strategies that regulators worry could amplify regional bank stress.

**Capital Allocation Inefficiencies:** Without adequate collateral assessment tools, banks may misprice credit risk, over-allocating capital to apparently attractive transactions while under-recognizing concentration risks in deteriorating market segments.

**Examination Vulnerabilities:** Regulatory examinations increasingly focus on collateral assessment adequacy. Banks relying too heavily on BPOs for material transactions may face criticism for inadequate risk management practices, potentially affecting regulatory ratings and operational flexibility.

### The Middle-Tier Solution Framework

Addressing the middle market valuation gap requires developing structured solutions that balance analytical

depth, cost efficiency, and timeline practicality. Rather than viewing BPOs and full appraisals as the only options, banks should consider hybrid approaches that provide enhanced analytical coverage at intermediate cost and timeline points.

**Enhanced Evaluation Products:** Structured evaluation formats that provide more analytical depth than traditional BPOs while maintaining cost and timeline advantages. These might include standardized property inspections, basic cash flow analysis, and market positioning assessment within form-based reporting structures.

**Modular Analysis Approaches:** Valuation products that allow banks to select specific analytical components based on transaction characteristics and risk tolerance. A stabilized office building refinancing might require market analysis and physical inspection but not detailed cash flow modeling, while a transitional property might require enhanced cash flow analysis and market positioning assessment.

**Technology-Enhanced BPOs:** Integration of automated valuation models, market data analytics, and standardized property assessment tools to enhance traditional BPO analytical capabilities while maintaining cost and timeline advantages.

**Risk-Calibrated Scope Decisions:** Decision frameworks that systematically match valuation scope to transaction risk characteristics rather than relying solely on loan size thresholds. Complex middle market transactions might warrant full appraisals regardless of size, while routine transactions might utilize enhanced evaluation formats.

**Professional Development Investments:** Training loan officers and credit analysts to recognize property characteristics and market conditions that suggest enhanced valuation analysis would provide meaningful decision-making benefits, regardless of regulatory requirements.

### Implementation Strategies for Regional Banks

Regional banks face particular challenges in implementing middle-tier valuation solutions due to resource constraints and operational complexity. Successful implementation requires systematic approaches

that balance risk management enhancement with operational efficiency:

**Vendor Relationship Development:** Rather than maintaining separate relationships for BPOs and full appraisals, banks should develop relationships with valuation professionals capable of providing scaled analytical products across the risk spectrum. This reduces vendor management complexity while ensuring analytical continuity across different valuation scope decisions.

**Internal Guidelines and Training:** Credit officers need clear frameworks for recognizing when enhanced valuation analysis would provide meaningful decision-making benefits. This includes property complexity indicators, market condition factors, and borrower risk characteristics that suggest intermediate analytical solutions would optimize risk-return trade-offs.

**Cost-Benefit Analysis Integration:** Banks should explicitly model the cost-benefit characteristics of different valuation approaches, recognizing that enhanced analytical depth may provide meaningful risk management benefits even when not required by regulatory thresholds.

**Portfolio Risk Integration:** Middle-tier valuation solutions should be integrated with broader portfolio risk management frameworks, ensuring that collateral assessment depth aligns with concentration management and stress testing requirements.

**Technology Platform Integration:** Valuation data should integrate seamlessly with credit management and portfolio monitoring systems, ensuring that enhanced analytical information supports ongoing relationship management and risk assessment activities.

### Beyond the Binary Choice

The most sophisticated regional banks are moving beyond binary thinking around valuation scope decisions, recognizing that optimal collateral assessment requires matching analytical tools to specific risk characteristics rather than applying uniform approaches across diverse transaction types.

This evolution involves several operational shifts:

**Risk-Based Decision Frameworks:** Rather than

defaulting to BPOs for cost reasons or full appraisals for regulatory compliance, banks are developing frameworks that systematically assess when intermediate analytical solutions would provide optimal risk-return characteristics.

**Dynamic Scope Adjustment:** The same transaction might warrant different analytical depth based on market conditions, borrower characteristics, or portfolio concentration considerations. Banks are developing capabilities to adjust valuation scope based on evolving risk factors rather than static transaction characteristics.

**Analytical Quality Focus:** Rather than treating valuation as a compliance requirement, banks are positioning collateral assessment as a core component of credit risk management, ensuring that analytical depth aligns with decision-making requirements.

**Integration with Relationship Management:** Enhanced collateral assessment capabilities support more sophisticated client conversations around property positioning, market dynamics, and value optimization strategies, creating relationship management benefits that extend beyond credit risk mitigation.

The regional banks that successfully address the middle market valuation gap will find themselves better positioned for both current market challenges and future growth opportunities. Remote work, higher interest rates and other factors have made commercial real estate lending more challenging for banks, particularly community banks, but these same conditions create opportunities for institutions that maintain superior risk assessment capabilities while competitors struggle with inadequate analytical tools.

The middle market blind spot isn't just about valuation methodology—it's about institutional sophistication in matching analytical resources to decision requirements. The banks that master this matching process will discover competitive advantages that extend well beyond simple cost optimization, positioning themselves for sustainable growth in an increasingly complex commercial real estate environment.

Addressing this blind spot requires acknowledging that

the binary choice between BPOs and full appraisals reflects analytical limitations rather than market realities. The middle market demands middle-tier solutions that balance speed, cost, and analytical depth in ways that optimize risk-adjusted returns rather than simply minimize immediate expenses.



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