



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

### CHAPTER 17:

### SMARTER LOAN STRUCTURES FOR FUTURE CYCLES

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Many of the problems facing commercial real estate portfolios today stem not just from macroeconomic conditions such as interest rate increases or demand shifts, but from structural deficiencies in how loans were originated and monitored. The extend-and-pretend phenomenon that has characterized recent years reflects not only lender reluctance to recognize losses but also loan structures that permitted ambiguity to persist unchecked.

Flexible loan structures that emerged during the low-rate era became overly permissive. Covenant thresholds were set generously, testing intervals were infrequent, and enforcement mechanisms lacked specificity. As lenders enter a new credit cycle, the critical question is how to build smarter frameworks that signal distress earlier and support resolution before risk compounds. The answer lies in reconceiving loan structures to incorporate dynamic triggers, forward-looking tests, and regular valuation discipline that reduce uncertainty and enforce accountability throughout the loan lifecycle.

#### The Failure of Static Covenants

Traditional loan agreements rely heavily on static financial covenants, particularly debt service coverage ratio (DSCR) and loan-to-value (LTV) tests. These covenants are typically measured quarterly or annually against fixed thresholds such as minimum DSCR of 1.25 or maximum LTV of 65 percent. While conceptually sound, static covenants have proven inadequate in volatile markets for several reasons.

Fixed test dates allow deterioration to go undetected

between measurement periods. A property may experience significant tenant departures, rental rate declines, or expense increases that materially affect performance, yet these changes remain invisible until the next scheduled covenant test. By the time a breach is identified, the borrower may be months into financial distress with limited options for remediation.

Static thresholds fail to account for changing market conditions. A DSCR of 1.25 may have provided adequate cushion when interest rates were at historic lows and cap rates compressed, but the same metric offers far less protection when refinancing costs double and property values decline. Covenants that do not adjust for external environment create false confidence during favorable periods and delayed recognition during downturns.

Valuation ambiguity further weakens enforcement when covenants depend on property appraisals. LTV tests require current valuations, but loan agreements often permit borrower-obtained appraisals or allow significant discretion in valuation methodology. This subjectivity enables optimistic assumptions that mask deterioration and defer covenant breaches. When enforcement finally occurs, disputes over appropriate valuation consume time and legal resources while the underlying asset continues to decline.

#### Smarter Tools for Dynamic Environments

Forward-thinking lenders are incorporating new structural mechanisms that address these weaknesses and create clarity throughout the loan term.

Exit Tests represent a fundamental shift in underwriting discipline. Rather than focusing solely on day-one metrics, exit tests require that projected DSCR or stabilized property value meet target thresholds at the loan's anticipated maturity or refinancing date. This forward-looking requirement forces both borrower and lender to articulate specific assumptions about future performance, including lease renewal expectations, capital expenditure requirements, and market conditions at exit.

Exit tests create accountability by establishing shared expectations at origination. When a borrower projects that a transitional property will achieve stabilized occupancy and rental rates sufficient to support refinancing, those projections become contractual benchmarks rather than marketing claims. If actual performance diverges from projections, both parties have a framework for discussing remediation or restructuring based on agreed-upon targets rather than negotiating from conflicting assumptions.

Dynamic DSCR Triggers introduce flexibility that aligns covenant enforcement with actual risk. These triggers scale based on observable factors such as interest rate changes, net operating income decline, or lease rollover exposure. For example, a loan might specify that if prevailing interest rates increase by more than 200 basis points from origination levels, the minimum DSCR threshold automatically increases by a corresponding amount to reflect higher refinancing risk. Similarly, if NOI declines by more than 15 percent from baseline,

additional reserves or appraisal updates activate automatically without requiring lender discretion or negotiation.

Dynamic triggers can also address lease rollover risk in properties with concentrated tenant exposure. When a significant lease approaches expiration, representing more than 20 percent of property income, the loan agreement might require establishment of re-tenancing reserves or trigger early refinancing discussions. These automated mechanisms remove subjective judgment and create predictable frameworks that borrowers can plan around.

Valuation Refresh Protocols establish regular revaluation intervals tied to asset class volatility or market conditions. Rather than relying on single appraisals at origination or covenant breach, these protocols require periodic valuation updates on schedules that reflect property risk profiles. Office properties in volatile markets might require annual revaluations, while stable multifamily assets could operate on biennial cycles. Industrial properties in high-growth logistics markets might warrant more frequent assessment to capture rapid value changes.

Use of multiple valuation sources mitigates model risk and reduces disputes. Protocols that combine internal valuations with periodic third-party appraisals create triangulation that builds confidence. When internal and external valuations diverge materially, investigation occurs while time remains for proactive intervention rather than after crisis conditions emerge. Documentation of valuation methodologies and assumption disclosure requirements ensure consistency and transparency.

Structured Maturity Management prevents the concentration risk inherent in traditional five-year or seven-year term loans where all principal comes due simultaneously. Rolling partial maturities or tiered repayment plans distribute refinancing risk across time. For example, a loan might structure 30 percent

of principal to mature in year five, another 30 percent in year six, and the final 40 percent in year seven. This approach allows borrowers to test refinancing markets incrementally and provides lenders with early signals about market receptivity before full exposure matures.

Alternatively, loans can incorporate step-down principal payments that reduce outstanding balances during the term, ensuring that maturity refinancing requirements are smaller and more achievable. These structures align particularly well with properties experiencing secular headwinds where gradual deleveraging improves long-term sustainability.

### Implementation in Practice

Embedding these tools into loan documentation requires deliberate term sheet design and credit policy updates. Lenders should develop standardized language for exit tests that specifies projection methodologies, performance milestones, and consequences for deviation. Dynamic trigger clauses must define calculation methodologies, data sources for external factors such as interest rates, and automatic actions that occur when thresholds are breached.

Credit policy updates should establish asset-class-specific requirements for which structures apply. Office loans above certain loan-to-value thresholds might mandate exit tests and annual revaluations. Transitional properties could require dynamic NOI triggers and enhanced reserve protocols. Establishing these requirements at the policy level ensures consistent application and removes negotiation from individual transactions.

Training for underwriters represents a critical implementation component. Many lending professionals have limited experience with dynamic covenant structures and may resist complexity. Effective training demonstrates how these tools reduce rather than increase work over the loan lifecycle by providing early warning systems that prevent crisis management. Case studies showing successful early interventions create institutional knowledge and build confidence in new approaches.

System flagging tools that support automated covenant monitoring enable dynamic structures to function without manual intervention. Portfolio surveillance systems should automatically calculate trigger thresholds, flag approaching test dates, and generate alerts when conditions warrant attention. Integration with market data feeds for interest rates, comparable sales, and rental rate trends allows systems to identify deteriorating conditions even between formal covenant test dates.

### Benefits of Smarter Structuring

These structural innovations deliver concrete benefits throughout the lending lifecycle. Early detection of distress occurs when dynamic triggers or regular revaluations identify problems while multiple resolution paths remain viable. Rather than discovering issues at maturity when options have narrowed to refinancing or foreclosure, lenders gain visibility when asset sales, equity infusions, or operational improvements can still preserve value.

Reduced reliance on subjective renegotiation follows from clear, predetermined frameworks. When covenant breaches trigger specific actions automatically, both parties understand consequences without requiring contentious negotiation. This predictability reduces legal costs and relationship friction while accelerating resolution timelines.

Clearer borrower communication and accountability emerge when expectations are articulated precisely at origination. Exit tests and dynamic triggers remove ambiguity about performance requirements, allowing borrowers to manage properties with full understanding of lender expectations. This clarity benefits high-quality borrowers who appreciate transparent frameworks and reduces adverse selection by deterring sponsors who prefer opacity.

Easier integration into risk dashboards and stress testing models reflects the quantifiable nature of dynamic structures. Portfolio managers can model how

interest rate changes or market deterioration would affect covenant compliance across portfolios, enabling proactive risk management. Stress testing becomes more sophisticated when loan structures incorporate observable triggers rather than requiring assumptions about subjective enforcement decisions.

### Conclusion: Building Discipline into Future Cycles

The extend-and-pretend phenomenon that has characterized recent commercial real estate lending reflects not only economic stress but also structural weaknesses that permitted ambiguity and deferred recognition. As lenders enter a new credit cycle, the opportunity exists to fundamentally improve loan structures through exit tests, dynamic DSCR triggers, valuation refresh protocols, and structured maturity management.

The call to action for underwriters, credit committee members, risk modeling teams, and portfolio surveillance managers is to rethink covenant frameworks and test thresholds before originating the next cycle of loans. Smarter structures implemented today will reduce uncertainty, enable earlier intervention, and support superior risk-adjusted returns throughout future market cycles.

These structural innovations require institutional commitment to training, system development, and consistent application. The near-term effort of redesigning templates and updating policies will be repaid through reduced losses, faster workouts, and enhanced portfolio transparency when the next period of stress inevitably arrives.

Four Corners Valuations provides high-frequency, field-informed collateral visibility that supports dynamic covenant monitoring and real-time credit risk alignment. Our valuation services integrate seamlessly with refresh protocols, exit test verification, and trigger-based revaluation requirements. By delivering objective, defensible property assessments throughout the loan lifecycle, we enhance lending discipline across

origination, monitoring, and workout phases. Our work enables lenders to structure clarity into future cycles by ensuring that covenant enforcement rests on current market reality rather than outdated assumptions.



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