

REDWOOD TRUST INC  
Form 10-K  
February 27, 2012

**UNITED STATES OF AMERICA  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-K**

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**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the Fiscal Year Ended: December 31, 2011**

**OR**

o

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from to  
Commission file number 1-13759**

**REDWOOD TRUST, INC.**

(Exact Name of Registrant as Specified in Its Charter)

Maryland  
(State or Other Jurisdiction of  
Incorporation or Organization)

68-0329422  
(I.R.S. Employer  
Identification No.)

**One Belvedere Place, Suite 300  
Mill Valley, California 94941**

(Address of Principal Executive Offices) (Zip Code)

**(415) 389-7373**

(Registrant's Telephone Number, Including Area Code)

Securities Registered Pursuant to Section 12(b) of the Act:

| Title of Each Class:                     | Name of Exchange on Which Registered: |
|------------------------------------------|---------------------------------------|
| Common Stock, par value \$0.01 per share | New York Stock Exchange               |

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer  Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  
 No

At June 30, 2011, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was \$1,166,765,364 based on the closing sale price as reported on the New York Stock Exchange.

The number of shares of the registrant's Common Stock outstanding on February 24, 2012 was 78,544,682.

## **DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's definitive Proxy Statement to be filed with the Securities and Exchange Commission under Regulation 14A within 120 days after the end of registrant's fiscal year covered by this Annual Report are incorporated by reference into Part III.

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**REDWOOD TRUST, INC.**

**2011 ANNUAL REPORT ON FORM 10-K**

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## **PART I**

### **ITEM 1. BUSINESS**

#### **Introduction**

Redwood Trust, Inc., together with its subsidiaries, is a financial institution that seeks to invest in real estate related assets that have the potential to provide attractive cash flows over a long period of time and support our goal of distributing attractive levels of dividends to our stockholders.

We primarily invest in residential mortgage loans, commercial loans and other forms of commercial real estate financing, and in securities collateralized by real estate loans (which are securities issued in securitization transactions and which are also referred to as mortgage-backed securities). Our investments in residential mortgage loans are generally made with a view towards securitizing those loans through a Sequoia securitization entity or selling those loans to third parties. Our investments in commercial loans are generally held for investment and not secured by real property. The mortgage-backed securities we typically invest in include senior securities, which are those interests in a mortgage securitization that generally have the first right to cash flows and are generally last to absorb losses, and subordinate securities, which are those interests in a mortgage securitization that generally have the last right to cash flows and are generally first in line to absorb losses. Some of the securities we invest in are re-REMIC support securities, which are securities that are generally created through the resecuritization of senior mortgage-backed securities. Re-REMIC support securities are subordinate to, and provide credit support for, the senior re-REMIC securities issued in a resecuritization. We also invest in other assets, securities, and instruments that are related to residential and commercial real estate.

Securities collateralized by residential mortgage loans, which we also refer to as residential securities, that we invest in are generally acquired by us from third parties or by retaining mortgage-backed securities issued by Sequoia securitization trusts, which are securitization entities we sponsor. The process of sponsoring a Sequoia securitization includes the acquisition of residential loans, which are originated by third parties and generally funded with equity and short-term debt while being accumulated for securitization, the transfer of a pool of those loans to a Sequoia securitization entity, and the structuring and issuance by the Sequoia securitization entity of mortgage-backed securities collateralized by that pool of loans. Senior securities issued by Sequoia securitization entities are generally issued to third parties, while some or all of the subordinate securities issued by these entities are generally retained by us. From time to time we may also invest in senior interest-only ( IO ) securities issued by a Sequoia securitization entity. These IO securities receive interest payments (but no principal payments) related to securitized residential mortgage loans.

Our investments in commercial loans and other forms of commercial real estate financing generally result from our origination of subordinate financing for commercial real estate. Subordinate financing for commercial real estate can take the form of mezzanine loans or subordinate mortgage loans and can also take the form of preferred equity interests in special purpose entities that own commercial real estate. In addition to directly originating commercial loans and directly providing preferred equity financing, we may invest in commercial loans and financing originated by others (including through ownership of commercial mortgage-backed securities).

Our primary source of income is net interest income from our investments in real-estate related assets of the types described above. This net interest income consists of the interest income we earn from our investments less the interest expenses we incur on borrowed funds and other liabilities. We assume a range of risks in our investments and

the level of risk is influenced by the manner in which we finance our purchases of, and derive income from, our investments.

Throughout our history we have sponsored other investment entities that include a private limited partnership fund that we managed, the Redwood Opportunity Fund, LP (the Fund), as well as Acacia securitization entities, certain of which we continue to manage. The Fund was invested in real estate securities and the Acacia entities are primarily invested in a variety of real estate related assets. We are not currently seeking to sponsor other entities like the Fund or the Acacia securitization entities. During the third quarter of 2011, we engaged in a resecuritization transaction primarily for the purpose of obtaining permanent non-recourse financing on a portion of our residential securities portfolio. Many of the entities we have

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sponsored or managed are currently, or have been historically, recorded on our consolidated balance sheets for financial reporting purposes based upon applicable accounting guidance set forth by Generally Accepted Accounting Principles in the United States ( GAAP ). However, each of these securitization entities is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of ours, although we are exposed to certain financial risks associated with our role as the sponsor or manager of these entities.

For tax purposes, we are structured as a real estate investment trust (REIT). We are able to pass through substantially all of our earnings generated at our REIT to our stockholders without paying income tax at the corporate level. We pay income tax on the REIT taxable income we retain and on the income we earn at our taxable subsidiaries. Redwood was incorporated in the State of Maryland on April 11, 1994, and commenced operations on August 19, 1994. Our executive offices are located at One Belvedere Place, Suite 300, Mill Valley, California 94941.

References herein to Redwood, the company, we, us, and our include Redwood Trust, Inc. and its consolidated subsidiaries, unless the context otherwise requires. Financial information concerning our business is set forth in *Management's Discussion and Analysis of Financial Condition and Results of Operations*, the consolidated financial statements and notes thereto, and the supplemental financial information, which is included in Part II, Items 7, 7A, and 8 of this Annual Report on Form 10-K.

Our website can be found at [www.redwoodtrust.com](http://www.redwoodtrust.com). We make available, free of charge through the investor information section of our website, access to our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the U.S. Securities Exchange Act of 1934, as well as proxy statements, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the U.S. Securities and Exchange Commission (SEC). We also make available, free of charge, access to our charters for our Audit Committee, Compensation Committee, and Corporate Governance and Nominating Committee, our Corporate Governance Standards, and our Code of Ethics governing our directors, officers, and employees. Within the time period required by the SEC and the New York Stock Exchange, we will post on our website any amendment to the Code of Ethics and any waiver applicable to any executive officer, director, or senior officer (as defined in the Code). In addition, our website includes information concerning purchases and sales of our equity securities by our executive officers and directors, as well as disclosure relating to certain non-GAAP and financial measures (as defined in the SEC's Regulation G) that we may make public orally, telephonically, by webcast, by broadcast, or by similar means from time to time. Through the commercial section of our website, we also disclose information about our origination or acquisition of new commercial loans and other commercial investments, generally within five business days of origination or acquisition. We believe that this information may be of interest to investors in Redwood, although we may not always disclose on our website each new commercial loan or other new commercial investment we originate or acquire (or we may not disclose them on our website within the five business day period described above) due to, among other reasons, confidentiality obligations to the borrowers of those loans or counterparties to those investments. The information on our website is not part of this Annual Report on Form 10-K.

Our Investor Relations Department can be contacted at One Belvedere Place, Suite 300, Mill Valley, CA 94941, Attn: Investor Relations, telephone (866) 269-4976.

## **Cautionary Statement**

This Annual Report on Form 10-K and the documents incorporated by reference herein contain forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve numerous risks and uncertainties. Our actual results may differ from our beliefs,



expectations, estimates, and projections and, consequently, you should not rely on these forward-looking statements as predictions of future events. Forward-looking statements are not historical in nature and can be identified by words such as anticipate, estimate, will, should, expect, believe, intend, seek, plan and similar expressions or forms, or by references to strategy, plans, or intentions. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in this Annual Report on Form 10-K under the caption Risk Factors. Other risks, uncertainties, and factors that could cause actual results to differ

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materially from those projected are described below and may be described from time to time in reports we file with the SEC, including reports on Forms 10-Q and 8-K. We undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

Statements regarding the following subjects, among others, are forward-looking by their nature: (i) our statements relating to improving our capital efficiency in 2012, the use of warehouse funding for residential loans, the use leverage against our residential securities (which leverage we believe will be a prudent amount), obtaining debt financing for our commercial loans, and investing our capital at attractive yields; (ii) our statements relating to our goal of delivering a growing stream of dividends through our residential and commercial credit businesses and our statements that our platforms are scalable (and, therefore, should help us improve our returns as our business volume increases); (iii) our statements relating to our competitive position and our ability to compete in the future, including our ability to effectively compete to acquire residential mortgage-backed securities and residential mortgage loans and our ability to compete to originate and acquire commercial real estate loans and other commercial real estate investments; (iv) our statements relating to our future investment strategy, and our ability to find investments with attractive risk return profiles, including, without limitation, statements relating to our efforts to acquire residential mortgage loans, make commercial real estate investments (including our statement that our commercial platform will likely provide us with the best opportunity to invest capital in 2012), and make residential investments in residential securities (including that our expectation for 2012 is that we will invest \$100 million of capital in third-party residential mortgage-backed securities and \$75 to \$100 million of capital in new Sequoia securitizations with GAAP yields on new equity capital invested in residential securities during 2012 expected to range from 11% to 14%); (v) our statements that we expect, overall, to invest \$375 to \$500 million of capital in 2012 and that we can generate the capital needed for the vast majority of this overall 2012 investment activity and our intended 2012 dividends on existing shares of common stock through cash from operations, principal payments from our investments, asset sales, and obtaining debt financing on our commercial loan portfolio; (vi) our statement that we expect our expanding residential and commercial businesses to represent a larger portion of our net interest income in future periods and our statement that we expect that increased investment activity, net of funding costs, will positively affect net interest income beginning in the second half of 2012 and improve profitability in 2012; (vii) our statement that one of our objectives for 2012 is to acquire approximately \$2.0 billion of residential mortgage loans, our statements relating to acquiring the residential mortgage loans included in our pipeline of residential mortgage loans that we plan to purchase through our residential conduit program, including that, as of December 31, 2011 and February 15, 2012, there were \$460 million and \$461 million, respectively, of residential mortgage loans at various stages of origination that we planned to purchase; (viii) our statements relating to future residential loan securitization and sale transactions, the timing of the completion of those future transactions, and the number and size of those transactions we expect to complete in 2012 and future periods, which future transactions may not be completed when planned or at all, and, more generally, statements regarding the likelihood and timing of, and our participation in, future transactions of these types and our ability to finance residential loan acquisitions through the execution of these types of transactions, and the profitability of these transactions; (ix) our statement that we expect to reverse an estimated \$9 million, in aggregate, of negative net assets that relate to fourteen Sequoia securitization entities in future periods upon the retirement or deconsolidation of those entities; (x) our statement that we do not currently believe we will need to raise equity capital during the first half of 2012 and our statement that we may not need to raise equity capital in a material way in the second half of 2012; (xi) our statements relating to our estimates of our investment capacity (including that we estimate our investment capacity was \$214 million at December 31, 2011), our short-term borrowing capacity (including the statement that we plan to finance residential mortgage loans held for future securitization or sale through short-term warehouse debt facilities), our excess capital, and the amount of cash we need to cover short-term operations, working capital, and a liquidity cushion; (xii) our statements relating to future market and economic conditions and the future volume of transactions in those markets, including, without limitation, future conditions in the residential and commercial real estate markets and related financing markets (e.g., the CMBS market), and the related potential opportunities for our residential and commercial businesses; (xiii) our beliefs about, and our outlook

for, the future direction of housing market fundamentals, including, without limitation, home prices, demand for housing, delinquency rates, foreclosure rates, prepayment rates, inventory of homes for sale, and mortgage interest rates and their potential impact on our business and results

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of operations; (xiv) our beliefs about the future direction of commercial real estate fundamentals and statements regarding the competitive landscape for, and availability of, financing for commercial real estate and our beliefs about whether trends in these areas are positive for our business; (xv) our statements that we expect the increased level of commercial loan maturities coming due in the next several years will allow us to expand and sustain our commercial origination franchise and that we intend to hold (rather than sell) our commercial loans and investments; (xvi) our statement that we anticipate originating between \$200 and \$300 million of subordinate debt and other commercial investments in 2012 and our statement that our quarterly level of origination volume for these types of investments could be volatile; (xvii) our statement that we are attempting to obtain in 2012 debt financing for our portfolio of commercial real estate loans and investments and our statement that we believe any such financing we obtain will represent a prudent level of debt financing for those loans and assets; (xviii) our statement, in respect of certain risk management activities we carry out relating to residential mortgage loans we own or plan to acquire for future securitization or sale, that under normal market conditions and assuming we have hedged well, we would expect our risk management activities to reduce our risk exposure to changing interest rates so that the gain or loss in the value of our residential loans we own or plan to acquire would to varying degrees offset a loss or gain in value of these loans; (ixx) our statements relating to the impact on our business of legislative and regulatory changes that affect our business, the regulation of securitization transactions, and any reform of the GSEs, including Fannie Mae and Freddie Mac; (xx) our expectations regarding credit reserves, credit losses, the adequacy of credit support, and impairments and their impact on our investments (including as compared to our original expectations and credit reserve levels) and the timing of losses and impairments, and statements that the amount of credit reserves we designate may require changes in the future; (xxi) our expectations regarding future interest income and net interest income, future earnings, future earnings volatility, and future trends in operating expenses and the factors that may affect those trends, including that we expect the level of operating expense in the first quarter of 2012 to be similar to the level of operating expense in the fourth quarter of 2011; (xxiii) our Board of Directors' intention to pay a regular dividend of \$0.25 per share per quarter in 2012; and (xxii) our expectations and estimates relating to the characterization for income tax purposes of our 2011 dividend distributions and our expectations and estimates relating to tax accounting and our anticipation of additional credit losses for tax purposes in future periods (and the level of those expected losses).

Important factors, among others, that may affect our actual results include: general economic trends, the performance of the housing, commercial real estate, mortgage, credit, and broader financial markets, and their effects on the prices of earning assets and the credit status of borrowers; federal and state legislative and regulatory developments, and the actions of governmental authorities, including those affecting the mortgage industry or our business; our exposure to credit risk and the timing of credit losses within our portfolio; the concentration of the credit risks we are exposed to, including due to the structure of assets we hold and the geographical concentration of real estate underlying assets we own; our exposure to adjustable-rate and negative amortization mortgage loans; the efficacy and expense of our efforts to manage or hedge credit risk, interest rate risk, and other financial and operational risks; changes in credit ratings on assets we own and changes in the rating agencies' credit rating methodologies; changes in interest rates; changes in mortgage prepayment rates; the availability of assets for purchase at attractive prices and our ability to reinvest cash we hold; changes in the values of assets we own; changes in liquidity in the market for real estate securities and loans; our ability to finance the acquisition of real estate-related assets with short-term debt; the ability of counterparties to satisfy their obligations to us; our involvement in securitization transactions, the profitability of those transactions, and the risks we are exposed to in engaging in securitization transactions; exposure to claims and litigation, including litigation arising from our involvement in securitization transactions; whether we have sufficient liquid assets to meet short-term needs; our ability to successfully compete and retain or attract key personnel; our ability to adapt our business model and strategies to changing circumstances; changes in our investment, financing, and hedging strategies and new risks we may be exposed to if we expand our business activities; exposure to environmental liabilities and the effects of global climate change; failure to comply with applicable laws and regulations; our failure to maintain appropriate internal controls over financial reporting and disclosure controls and procedures; the impact on our

reputation that could result from our actions or omissions or from those of others; changes in accounting principles and tax rules; our ability to maintain our status as a REIT for tax purposes; limitations imposed on our business due to our

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REIT status and our status as exempt from registration under the Investment Company Act of 1940; decisions about raising, managing, and distributing capital; and other factors not presently identified.

This Annual Report on Form 10-K may contain statistics and other data that in some cases have been obtained from or compiled from information made available by servicers and other third-party service providers.

## **Certifications**

Our Chief Executive Officer and Chief Financial Officer have executed certifications dated February 23, 2012, as required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002, and we have included those certifications as exhibits to this Annual Report on Form 10-K. In addition, our Chief Executive Officer certified to the New York Stock Exchange (NYSE) on May 18, 2011 that he was unaware of any violations by Redwood Trust, Inc. of the NYSE's corporate governance listing standards in effect as of that date.

## **Employees**

As of December 31, 2011, Redwood employed 77 people.

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## ITEM 1A. RISK FACTORS

### **General economic trends and the performance of the housing, commercial real estate, mortgage finance, and broader financial markets may adversely affect our business and the value of, and returns on, real estate-related and other assets we own or may acquire.**

The values of, and the cash flows from, the assets we own are affected by developments in the U.S. economy. There is particular uncertainty about the pace and prospects for sustainable economic growth following the recent serious recession. A number of factors could contribute to the potential uncertainty, including, but not limited to, high current unemployment, rising government debt levels, prospective Federal Reserve policy shifts, the withdrawal of government interventions into the financial and real estate markets, changing U.S. consumer spending patterns, and changing expectations for inflation and deflation. Income growth and unemployment levels affect borrowers' ability to repay loans underlying our assets, and there is risk that economic growth and activity could be weaker than anticipated following the recent recession. Concerns and issues relating to the level of sovereign debt of various countries within the European Economic and Monetary Union, or Eurozone, and the potential economic consequences of those concerns and issues also contribute to this uncertainty.

Real estate values and the ability to generate returns by owning or taking credit risk on loans secured by real estate are important to our business. We currently still anticipate continued weakness in many residential and commercial real estate markets and related mortgage markets. Furthermore, that weakness could exceed our expectations, harming the value of our assets, earnings, and access to liquidity.

The economic downturn and the significant government interventions into the financial markets and fiscal stimulus spending in recent years have contributed to significantly increased U.S. budget deficits. This upward pressure on U.S. budget deficits has the potential to put upward pressure on U.S. interest rates. It is possible we would not fully anticipate such a shift or all the negative consequences of such a shift in the interest rate environment. Thus, higher long-term interest rates could adversely affect our overall business, income, and our ability to pay dividends, as discussed further below under Interest rate fluctuations can have various negative effects on us and could lead to reduced earnings and increased volatility in our earnings.

The Federal Reserve's aggressive easing program could have significant implications for financial asset pricing in general and for mortgage-related securities pricing, in particular. While market participants expect the Federal Reserve to abandon its low interest rate policy at some point, it is not possible to accurately predict the timing or implications of the Federal Reserve's rate hikes. Our business may be harmed by our inability to accurately anticipate developments on the interest rate front.

Over the last several years, government intervention has been important to support real estate markets, the overall U.S. economy, capital markets, and mortgage markets. We expect the government will gradually withdraw this support, although we remain uncertain about the timing, process, and implications of withdrawal. Until more information is available, it is difficult to accurately anticipate the timing of that withdrawal or anticipate the implications of that withdrawal. It is possible that our earnings, cash flows, dividends, and liquidity will be negatively affected by actions taken to implement this withdrawal.

Mortgage markets have received tremendous U.S. government support. In fact, the government's support of mortgage markets through its support of Fannie Mae and Freddie Mac expanded in late 2009, as the U.S. Treasury chose to

backstop these government-sponsored enterprises for three years (2010 – 2012), without limit. This outsized support for these entities has caused Fannie Mae and Freddie Mac to continue to dominate mortgage and securitization activity, inhibiting the return of private mortgage securitization. This support may continue for some time and could have potentially negative consequences to us, since we have traditionally taken an active role in assuming credit risk in the private sector mortgage market, often via securitization.



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**Federal and state legislative and regulatory developments and the actions of governmental authorities and entities may adversely affect our business and the value of, and the returns on, mortgages, mortgage-related securities, and other assets we own or may acquire in the future.**

As noted above, our business is affected by conditions in the residential and commercial real estate markets and the broader financial markets, as well as by the financial condition and resources of other participants in these markets. These markets and many of the participants in these markets are subject to, or regulated under, various federal and state laws and regulations. In some cases, the government or government sponsored entities directly participate in these markets. In particular, because issues relating to residential real estate and housing finance can be areas of political focus, federal and state governments may be more likely to take actions that affect residential real estate, the markets for financing residential real estate, and the participants in residential real estate-related industries than they would with respect to other industries. As a result of the government's statutory and regulatory oversight of the markets we participate in and the government's direct and indirect participation in these markets, federal and state governmental actions, policies, and directives can have an adverse effect on these markets and on our business and the value of, and the returns on, mortgages, mortgage-related securities, and other assets we own or may acquire in the future, which effects may be material.

As an example, based on data published in October 2011 by Inside Mortgage Finance, we believe that through financing or guarantees Fannie Mae, Freddie Mac, the Federal Housing Administration, and other governmental agencies accounted for more than 85% of the financing for new residential mortgage loans in 2009, 2010, and 2011. These entities, in turn, received capital support from the U.S. Treasury Department and fund their balance sheets via the capital markets, with investors generally relying on an implicit backstop from the U.S. federal government. As a result, most of the market for housing finance in the U.S. is controlled by the federal government and can be materially affected by decisions of federal policy makers, the President, and Congress, and they may establish or change existing laws, regulations, and policies to respond to political rather than market pressures. If the federal government determines to maintain or expand its current role in the markets for financing residential mortgage loans, it may adversely affect our business or our ability to effectively compete. Even if the federal government determines to decrease its role in the markets for financing residential mortgage loans, it may establish regulations for other market participants that have an adverse effect on our ability to effectively participate or compete or which may diminish or eliminate the returns on, mortgages, mortgage-related securities, and other assets we own or may acquire in the future.

During and since 2008, the federal government commenced implementation of programs designed to provide homeowners with assistance in avoiding residential mortgage loan foreclosures. In addition, certain mortgage lenders and servicers then voluntarily, or as part of settlements with law enforcement authorities, established loan modification programs relating to the mortgages they hold or service. Subsequently, the President has announced additional plans aimed at reducing foreclosures through loan modification and refinancing programs. In addition, members of Congress have at times indicated support for additional legislative relief for homeowners, including a proposed amendment to the bankruptcy laws to permit the forgiveness of principal on first lien mortgage loans in bankruptcy proceedings. Federal and state agencies and numerous state attorneys general have launched various investigations into the business practices of loan servicers and, in particular, into the propriety of many foreclosures that have recently taken place. In his 2011 State of the Union Address, the President announced a newly created governmental task force charged with, among other things, investigating misconduct and illegalities that contributed to both the credit crisis and the mortgage crisis (and this task force has subsequently issued numerous subpoenas to current and former participants in the mortgage-backed securities industry). In February 2012, attorneys general for 49 states together with the U.S. Department of Justice and the U.S. Department of Housing and Urban Development

announced a settlement with the five largest U.S. mortgage loan servicers relating to an investigation by those law enforcement authorities into nationwide foreclosure and mortgage servicing practices. Under the settlement, those five mortgage loan servicers have agreed to, among other things, commit a minimum of \$17 billion directly to mortgage borrowers through a series of relief effort options, including principal reduction, and adopt a comprehensive set of new servicing standards to protect homeowners from future abuses. Loan modification programs and changes to servicing standards, as well as future law enforcement and

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legislative or regulatory actions including possible amendments to the bankruptcy laws, may adversely affect the value of, and the returns on, the mortgage loans and the related mortgage securities we currently own or may acquire in the future.

The credit crisis, financial turmoil, and the economic recession that occurred over the past several years led to an unprecedented level of federal governmental intervention in the financial markets and into the affairs of particular financial institutions. These events revealed the extent to which the functioning of financial markets and the ability of particular counterparties to perform can be affected by, and be dependent on, the policies and actions of the government. They also prompted the federal government to offer attractive financing to certain industry participants, through programs such as the Public-Private Investment Program and the Term Asset-Backed Securities Loan Facility, which arguably gave a competitive advantage to firms taking advantage of these programs. Similar types of governmental interventions could occur in the future, and they may not be predictable and may not benefit us and, therefore, could adversely affect our relative financial position and our ability to compete.

Furthermore, the credit crisis and subsequent financial turmoil of the past several years prompted the federal government to put into place new statutory and regulatory frameworks and policies for reforming the U.S. financial system. These financial reforms are aimed at, among other things, promoting robust supervision and regulation of financial firms, establishing comprehensive supervision of financial markets, protecting consumers and investors from financial abuse, providing the U.S. government with additional tools to manage financial crises, and raising international regulatory standards and improving international cooperation, but their scope could be expanded beyond what has been currently enacted, implemented, and proposed. Implementation of financial reforms, whether through law, regulations, or policy, including changes to the manner in which financial institutions, financial products, and financial markets operate and are regulated and any related changes in the accounting standards that govern them, could adversely affect our business and results of operations by subjecting us to regulatory oversight, making it more expensive to conduct our business, reducing or eliminating any competitive advantage we may have, or limiting our ability to expand, or could have other adverse effects on us.

In addition, the Federal Reserve has taken certain actions (e.g., implementing a program to acquire agency and other mortgage securities and then subsequently initiating sales of certain of these securities) and may take other actions that could have significant implications for mortgage-related securities pricing and the returns we expect on our mortgage-related assets. Financial regulators globally are coordinating the implementation of capital regulations under the Basel III accord in an attempt to better coordinate and set capital standards for certain types of regulated financial institutions that appropriately account for risk, which may also have indirect impacts on our business and results of operations.

Ultimately, we cannot assure you that governmental actions will directly benefit our business or otherwise have a lasting and beneficial impact on the financial markets and, in fact, they may adversely affect us, possibly materially. We cannot predict whether or when such actions may occur or what unintended or unanticipated impacts, if any, such actions could have on our business, results of operations, and financial condition. Even after governmental actions have been taken and we believe we understand the impacts of those actions, we may not be able to effectively respond to them so as to avoid a negative impact on our business or results of operations.

**The nature of the assets we hold and the investments we make expose us to credit risk that could negatively impact the value of those assets and investments, our earnings, dividends, cash flows, and access to liquidity, and otherwise negatively affect our business.**

### **Overview of credit risk**

We assume credit risk through the ownership of securities backed by residential and commercial real estate loans and through direct investments in residential and commercial real estate loans. Credit losses on residential real estate loans can occur for many reasons, including: poor origination practices; fraud; faulty appraisals; documentation errors; poor underwriting; legal errors; poor servicing practices; weak economic conditions; increases in payments required to be made by borrowers; declines in the value of homes; earthquakes, the effects of global climate change (including flooding, drought, and severe weather) and other natural events; uninsured property loss; over-leveraging of the borrower; costs of remediation of

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environmental conditions, such as indoor mold; changes in zoning or building codes and the related costs of compliance; acts of war or terrorism; changes in legal protections for lenders and other changes in law or regulation; and personal events affecting borrowers, such as reduction in income, job loss, divorce, or health problems. In addition, the amount and timing of credit losses could be affected by loan modifications, delays in the liquidation process, documentation errors, and other action by servicers. Continued weakness in the U.S. economy or the housing market could cause our credit losses to increase beyond levels that we currently anticipate.

In addition, rising interest rates may increase the credit risks associated with certain residential real estate loans. For example, the interest rate is adjustable for many of the loans securitized by securitization entities we have sponsored and for a portion of the loans underlying residential securities we have acquired from securitizations sponsored by others. Accordingly, when short-term interest rates rise, required monthly payments from homeowners will rise under the terms of these adjustable-rate mortgages, and this may increase borrowers' delinquencies and defaults.

Credit losses on commercial real estate loans can occur for many of the reasons noted above for residential real estate loans. Losses on commercial real estate loans can also occur for other reasons including decreases in the net operating income from the underlying property, which could be adversely affected by a weak U.S. or international economy.

Moreover, the majority of our commercial real estate loans are not fully amortizing and, therefore, the borrower's ability to repay the principal when due may depend upon the ability of the borrower to refinance or sell the property at maturity.

Commercial real estate loans are particularly sensitive to changes in the local economy, so even minor local adverse economic events may adversely affect the performance of commercial real estate assets. We expect much of our future exposure to credit risk associated with commercial loans to be in the form of subordinate financing (e.g., mezzanine loans, b-notes, preferred equity, and subordinated interests in securitized pools). We directly originate commercial loans and may participate in loans originated by others (including through ownership of commercial mortgage-backed securities). Directly originating commercial loans exposes us to credit, legal, and other risks that may be greater than risks associated with loans we acquire or participate in that are originated by others. We may incur losses on commercial real estate loans and securities for reasons not necessarily related to an adverse change in the performance of the property. This includes bankruptcy by the owner of the property, issues regarding the form of ownership of the property, poor property management, origination errors, inaccurate appraisals, fraud, and non-timely actions by servicers. If and when these problems become apparent, we may have little or no recourse to the borrower, issuer of the securities, or seller of the loan and we may incur credit losses as a result.

**We may have heightened credit losses associated with certain securities and investments we own.**

Within a securitization of residential or commercial real estate loans, various securities are created, each of which has varying degrees of credit risk. We may own the securities with the most concentrated credit risk or the least concentrated credit risk within a securitization, in each case, assuming a certain amount of credit risk associated with the underlying real estate loans.

In general, losses on an asset securing a residential or commercial real estate loan included in a securitization will be borne first by the owner of the property (i.e., the owner will first lose the equity invested in the property) and, thereafter, by mezzanine or preferred equity investors, if any, then by a cash reserve fund or letter of credit, if any, then by the first-loss security holder, and then by holders of more senior securities. In the event the losses incurred upon default on the loan exceed any equity support, reserve fund, letter of credit, and classes of securities junior to those in which we invest (if any), we may not be able to recover all of our investment in the securities we hold. In addition, if the underlying properties have been overvalued by the originating appraiser or if the values subsequently decline and, as a result, less collateral is available to satisfy interest and principal payments due on the related

security, then the first-loss securities may suffer a total loss of principal, followed by losses on the second-loss and then third-loss securities (or other residential and commercial securities which we own).

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For loans or other investments we own directly (not through a securitization structure), we will most likely be in a position to incur credit losses should they occur only after losses are borne by the owner of the property (e.g., by a reduction in the owner's equity stake in the property). We may take actions available to us in an attempt to protect our position and mitigate the amount of credit losses, but these actions may not prove to be successful and could result in our increasing the amount of credit losses we ultimately incur on a loan.

### ***The nature of the assets underlying some of the securities and investments we hold could increase the credit risk of those securities.***

For certain types of loans underlying our securities, the loan rate or borrower payment rate may increase over time, increasing the potential for default. For example, a portion of the securities we acquire, or have an indirect interest in through our investment in the Acacia entities we sponsor, are backed by residential real estate loans that have negative amortization features. The rate at which interest accrues on these loans may change more frequently or to a greater extent than payment adjustments on an adjustable-rate loan, and adjustments of monthly payments may be subject to limitations or may be limited by the borrower's option to pay less than the full accrual rate. As a result, the amount of interest accruing on the remaining principal balance of the loans at the applicable adjustable mortgage loan rate may exceed the amount of the monthly payment. This is particularly a risk in a rising interest rate environment. Negative amortization occurs when the resulting excess (of interest owed over interest paid) is added to the unpaid principal balance of the related adjustable mortgage loan. For certain loans that have a negative amortization feature, the required monthly payment is increased after a specified number of months or after a maximum amount of negative amortization has occurred in order to amortize fully the loan by the end of its original term. Other negative amortizing loans limit the amount by which the monthly payment can be increased, which results in a larger final payment at maturity. As a result, negatively amortizing loans have performance characteristics similar to those of balloon loans. Negative amortization may result in increases in delinquencies, loan loss severity, and loan defaults, which may, in turn, result in payment delays and credit losses on our investments. Other types of loans and investments to which we are exposed, such as hybrid loans and teaser-rate adjustable-rate loans, may also have greater credit risk than more traditional amortizing mortgage loans.

Most or all of the commercial real estate loan assets we own are only partially amortizing or do not provide for any principal amortization prior to a balloon principal payment at maturity. Commercial loans that only partially amortize or that have a balloon principal payment at maturity have a higher risk of default at maturity than fully amortizing loans. Since most of the principal of these loans is repaid at maturity, the amount of loss upon default is generally greater than on other loans that provide for more principal amortization.

### ***We have concentrated credit risk in certain geographical regions and may be disproportionately affected by an economic or housing downturn, natural disaster, terrorist event, global warming, or any other adverse event specific to those regions.***

A decline in the economy or difficulties in certain real estate markets, such as a high level of foreclosures in a particular area, are likely to cause a decline in the value of residential and commercial properties. This, in turn, will increase the risk of delinquency, default, and foreclosure on real estate underlying securities and loans we hold with properties in those regions. This may then adversely affect our credit loss experience and other aspects of our business, including our ability to securitize (or otherwise dispose of) real estate loans and securities.

The occurrence of a natural disaster (such as an earthquake, tornado, hurricane, or a flood), or the effects of global climate change (including flooding, drought, and severe weather), may cause decreases in the value of real estate (including sudden or abrupt changes) and would likely reduce the value of the properties collateralizing the mortgage loans we own or those underlying the securities or other investments we own. Since certain natural disasters may not typically be covered by the standard hazard insurance policies maintained by borrowers, the borrowers may have to pay for repairs due to the disasters. Borrowers may not repair their property or may stop paying their mortgage loans under those circumstances, especially if the property is damaged. This would likely cause foreclosures to increase and lead to higher credit losses on our loans or investments or on the pool of mortgage loans underlying securities we own.



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A significant number of residential real estate loans that underlie the securities we own are secured by properties in California and, thus, we have a higher concentration of credit risk within California than in other states. Additional states where we have concentrations of residential loan credit risk include Florida and New York. Balances on commercial loans we originate or otherwise acquire are larger than residential loans and we will likely have a geographically concentrated commercial loan portfolio until our portfolio increases in size. While we intend to originate commercial loans throughout the country, we will likely have a portfolio that is concentrated in or near selected major metropolitan areas. Additional information on geographic distribution is set forth in Notes 6 and 7 to the Financial Statements.

### **The timing of credit losses can harm our economic returns.**

The timing of credit losses can be a material factor in our economic returns from residential and commercial loans, investments, and securities. If unanticipated losses occur within the first few years after a loan is originated, an investment is made, or a securitization is completed, those losses could have a greater negative impact on our investment returns than unanticipated losses on more seasoned loans, investments, or securities. In addition, higher levels of delinquencies and cumulative credit losses within a securitized loan pool can delay our receipt of principal and interest that is due to us under the terms of the securities backed by that pool. This would also lower our economic returns. The timing of credit losses could be affected by the creditworthiness of the borrower, the borrower's willingness and ability to continue to make payments, and new legislation, legal actions, or programs that allow for the modification of loans or ability for borrowers to get relief through bankruptcy or other avenues.

### **Our efforts to manage credit risks may fail.**

We attempt to manage risks of credit losses by continually evaluating our investments for impairment indicators and establishing reserves under GAAP for credit and other risks based upon our assessment of these risks. We cannot establish credit reserves for tax accounting purposes. The amount of capital and cash reserves that we hold to help us manage credit and other risks may prove to be insufficient to protect us from earnings volatility and liquidity issues. If these increased credit losses are greater than we anticipated and we need to increase our credit reserves, our GAAP earnings might be reduced. In the event that assets that have declined in value are deemed to be other-than-temporarily impaired, our GAAP earnings might be reduced. Increased credit losses may also adversely affect our cash flows, ability to invest, dividend distribution requirements and payments, asset fair values, access to short-term borrowings, and ability to securitize or finance assets.

Despite our efforts to manage credit risk, there are many aspects of credit risk that we cannot control. Our quality control and loss mitigation policies and procedures may not be successful in limiting future delinquencies, defaults, and losses, or they may not be cost effective. Our underwriting reviews may not be effective. The securitizations in which we have invested may not receive funds that we believe are due from mortgage insurance companies and other counterparties. Loan servicing companies may not cooperate with our loss mitigation efforts or those efforts may be ineffective. Service providers to securitizations, such as trustees, loans servicers, bond insurance providers, and custodians, may not perform in a manner that promotes our interests. The delay of residential foreclosures that may result from an attempt to fix procedural problems could delay resolution and increase ultimate loss severities, as a result.

The value of the homes collateralizing residential loans may decline. The value of the commercial properties collateralizing or underlying commercial loans or investments may decline. The frequency of default and the loss severity on loans upon default may be greater than we anticipate. Interest-only loans, negative amortization loans, adjustable-rate loans, larger balance loans, reduced documentation loans, subprime loans, alt-a loans, second lien loans, loans in certain locations, and loans that are partially collateralized by non-real estate assets may have increased

risks and severity of loss. If loans become real estate owned as a result of foreclosure, we bear the risk of not being able to sell the property and recovering our investment and of being exposed to the risks attendant to the ownership of real property.

Changes in consumer behavior, bankruptcy laws, tax laws, regulation of the mortgage industry, and other laws may exacerbate loan or investment losses. Changes in rules that would cause loans owned by a securitization entity to be modified may not be beneficial to our interests if the modifications reduce the interest we earn and increase the eventual severity of a loss. In some states and circumstances, the securitizations in which we invest have recourse as owner of the loan against the borrower's other assets and

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income in the event of loan default. However, in most cases, the value of the underlying property will be the sole effective source of funds for any recoveries. Other changes or actions by judges or legislators regarding mortgage loans and contracts, including the voiding of certain portions of these agreements, may reduce our earnings, impair our ability to mitigate losses, or increase the probability and severity of losses. Any expansion of our loss mitigation efforts as we grow our portfolio could increase our operating costs and the expanded loss mitigation efforts may not reduce our future credit losses.

***Credit ratings assigned to debt securities by the credit rating agencies may not accurately reflect the risks associated with those securities. Furthermore, downgrades in the credit ratings of bond insurers or any downgrades in the credit ratings of mortgage insurers could increase our credit risk, reduce our cash flows, or otherwise adversely affect our business and operations.***

We generally do not consider credit ratings in assessing our estimates of future cash flows and desirability of our investments (although our assessment of the quality of an investment may prove to be inaccurate and we may incur credit losses in excess of our initial expectations).

We note that the assignment of an investment grade rating to a security by a rating agency does not mean that there is not credit risk associated with the security or that the risk of a credit loss with respect to such security is necessarily remote. Most of the securities we own do have credit ratings and, to the extent we securitize loans and securities, we expect to rely on credit rating agencies to provide ratings on the securities created by these securitization entities (as we have in the past).

Rating agencies rate debt securities based upon their assessment of the safety of the receipt of principal and interest payments. Rating agencies do not consider the risks of fluctuations in fair value or other factors that may influence the value of debt securities and, therefore, the assigned credit rating may not fully reflect the true risks of an investment in securities. Also, rating agencies may fail to make timely adjustments to credit ratings based on available data or changes in economic outlook or may otherwise fail to make changes in credit ratings in response to subsequent events, so that our investments may be better or worse than the ratings indicate. Credit rating agencies may change their methods of evaluating credit risk and determining ratings on securities backed by real estate loans and securities.

These changes may occur quickly and often. The market's ability to understand and absorb these changes and the impact to the securitization market in general are difficult to predict. Such changes may have an impact on the amount of investment-grade and non-investment-grade securities that are created or placed on the market in the future.

Downgrades to the ratings of securities could have an adverse effect on the value of some of our investments and our cash flows from those investments. For example, the underlying documents of some of our equity investments in asset-backed securities state that certain average rating levels must be met on the securities held by the entity. If these average rating levels are not met, then cash that would otherwise be distributed to the equity holders or the lower-rated debt holders would instead be distributed to the more senior debt holders. Many of our equity and lower-rated security investments in securitizations have failed this average rating test, which, in turn, has adversely affected our cash flows from these investments.

Some of the securities we own are insured by bond insurers such as Ambac Financial Group Inc., MBIA Inc., and Financial Guaranty Insurance Co., which are commonly known as monoline insurers. These monoline insurers historically had triple-A credit ratings and this credit rating was passed on to any bonds that they insured. The high number of credit downgrades and other market turbulence revealed that these monoline insurers had greater credit risk

exposure than previously realized and the credit ratings of certain of these insurers were downgraded as a result. Any decline in the credit rating of a monoline insurer generally results in a corresponding decline in the credit ratings of the securities insured by that insurer.

Some of the loans held by our Sequoia securitization entities are insured in part by mortgage insurers. Mortgage insurance protects the lender or other holder of a loan up to a specified amount, in the event the borrower defaults on the loan. Mortgage insurance generally is required only when the principal amount of the loan at the time of origination is greater than 80% of the value of the property (loan-to-value). Any inability of the mortgage insurers to pay in full the insured portion of the loans that we hold would adversely affect the value of the securities we own that are backed by these loans, which could increase our credit risk, reduce our cash flows, or otherwise adversely affect our business.

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**Changes in prepayment rates of residential real estate loans could reduce our earnings, dividends, cash flows, and access to liquidity. Similarly, with respect to commercial real estate loans, borrowers' decisions to prepay or extend loans could reduce our earnings, dividends, cash flows, and access to liquidity.**

The economic returns we earn from most of the residential real estate securities and loans we own (directly or indirectly) are affected by the rate of prepayment of the underlying residential real estate loans. Prepayments are unpredictable and adverse changes in the rate of prepayment could reduce our cash flows, earnings, and dividends. Adverse changes in cash flows would likely reduce an asset's fair value, which could reduce our ability to borrow against that asset and may cause a market valuation adjustment for GAAP purposes, which could reduce our reported earnings. While we estimate prepayment rates to determine the effective yield of our assets and valuations, these estimates are not precise and prepayment rates do not necessarily change in a predictable manner as a function of interest rate changes. Prepayment rates can change rapidly. As a result, changes can cause volatility in our financial results, affect our ability to securitize assets, affect our ability to fund acquisitions, and have other negative impacts on our ability to generate and grow earnings.

We own a number of securities backed by residential loans that are particularly sensitive to changes in prepayments rates. These securities include interest-only securities (IOs) that we acquire from third parties and from our Sequoia entities. Faster prepayments than we anticipated on the underlying loans backing these IOs will have an adverse effect on our returns on these investments.

Many of the commercial real estate loans we originate or hold allow the borrower to make prepayments and some include provisions allowing the borrower to extend the term of the loan beyond the originally scheduled maturity. Because the decision to prepay or extend a commercial loan is controlled by the borrower, we may not accurately anticipate the timing of these events, which could affect the earnings and cash flows we anticipate and could impact our ability to finance these assets.

**Interest rate fluctuations can have various negative effects on us and could lead to reduced earnings and increased volatility in our earnings.**

Changes in interest rates, the interrelationships between various interest rates, and interest rate volatility could have negative effects on our earnings, the fair value of our assets and liabilities, loan prepayment rates, and our access to liquidity. Changes in interest rates can also harm the credit performance of our assets. We generally seek to hedge some but not all interest rate risks. Our hedging may not work effectively and we may change our hedging strategies or the degree or type of interest rate risk we assume.

Many of our securities have adjustable-rate coupons (coupons that reset within a year and at least once per year thereafter). The cash flows we receive from these assets may vary as a function of interest rates, as may the reported earnings generated by these assets. We may also acquire loans and securities as inventory prior to sale to a securitization entity or as a longer term investment. We may fund assets with a combination of equity plus floating rate debt. To the extent these assets have fixed or hybrid interest rates (or are adjustable with an adjustment period longer than our short-term debt), an interest rate mismatch would exist and we would earn less (and fair values may decline) if interest rates rise, at least for a time. We may or may not seek to mitigate interest rate mismatches for these assets with a hedging program using interest rate agreements and, to the extent we do use hedging techniques, they may not be successful.

Changes in prepayment rates of residential real estate loans could reduce our earnings, dividends, cash flows, and

Higher interest rates generally reduce the fair value of most of our assets, with the exception of our adjustable-rate assets. This may affect our earnings results, reduce our ability to re-securitize or sell our assets, or reduce our liquidity. Higher interest rates could reduce the ability of borrowers to make interest payments or to refinance their loans. Higher interest rates could reduce property values and increased credit losses could result. Higher interest rates could reduce mortgage originations, thus reducing our opportunities to acquire new assets.

When short-term interest rates are high relative to long-term interest rates, an increase in adjustable-rate residential loan prepayments may occur, which would likely reduce our returns from owning interest-only securities backed by adjustable-rate residential loans.

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When short-term interest rates vary, our premium amortization expense on loans acquired by Sequoia entities prior to July 2004 may significantly increase or decrease from one period to the next. Under the applicable GAAP accounting elections, the amortization expense for the current period is a function of actual and projected prepayments and the current London Interbank Offered Rate (LIBOR) interest rate. During a period when applicable rates change dramatically, the effect that the interest rate has on the amortization expense may become the more significant factor (over prepayments) and may alter the amount of premium amortized thereby creating volatility in our reported income for that period, all other factors being equal.

**We have significant investment and reinvestment risks.**

***New assets we acquire may not generate yields as attractive as yields on our current assets, which could result in a decline in our earnings per share over time.***

We believe the assets we acquire have the potential to generate attractive economic returns and GAAP yields, although there is risk that the acquisitions will not perform as expected. Realized cash flow could be significantly lower than expected and returns from new asset acquisitions could be negative, including both new assets that are backed by newly-originated loans, as well as new acquisitions that are backed by more seasoned loans.

In order to maintain our portfolio size and our earnings, we must reinvest in new assets a portion of the cash flows we receive from principal, interest, calls, and sales. We receive monthly payments from many of our assets, consisting of principal and interest. In addition, occasionally some of our residential securities are called (effectively sold). We may also sell assets from time to time as part of our portfolio and capital management strategies. Principal payments, calls, and sales reduce the size of our current portfolio and generate cash for us.

If the assets we acquire in the future earn lower GAAP yields than do the assets we currently own, our reported earnings per share could well decline over time as the older assets are paid down, are called, or are sold, assuming comparable expenses, credit costs, and market valuation adjustments. Under the effective yield method of accounting that we use for GAAP purposes for some of our assets, we recognize yields on assets based on our assumptions regarding future cash flows. A portion of the cash flows we receive may be used to reduce our basis in these assets. As a result of these various factors, our basis for GAAP amortization purposes may be lower than their current fair values. Assets with a lower GAAP basis than current fair values generate higher GAAP yields, yields that are not necessarily available on newly acquired assets. Future economic conditions, including credit results, prepayment patterns, and interest rate trends, are difficult to project with accuracy over the life of the assets we acquire, so there will be volatility in the reported returns over time.

**Our growth may be limited if assets are not available or not available at attractive prices.**

To reinvest proceeds from principal repayments and deploy capital we raise, we must acquire new assets. If the availability of new assets is limited, we may not be able to acquire assets that will generate attractive returns. Generally, asset supply can be reduced if originations of a particular product are reduced or if there are few sales in the secondary market of seasoned product from existing portfolios. In particular, assets we believe have a favorable risk/reward ratio may not be available for purchase.

We do not originate residential loans; rather, we rely on the origination market to supply the types of loans we wish to credit enhance. At times, due to heightened credit concerns, strengthened underwriting standards, and/or concerns about economic growth or housing values, the volume of originations may decrease significantly. From 2008 through

2011, the volume of loan originations was lower than in prior years and the volume may not return to previous levels in the foreseeable future. This reduced volume may make it difficult for us to acquire loans and securities.

We originate commercial loans, but we may not be willing to provide the level of proceeds or the coupon rate on loans that the borrower finds acceptable or that matches our competitors. While the overall industry-wide volume of commercial real estate loan originations and financings is increasing from prior low levels, it is not at the volume the industry has experienced in the past. And, the high-quality commercial assets we seek to originate loans on or finance are highly sought after by numerous lenders.



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The supply of new non-agency securitized assets available for purchase could continue to be adversely affected if the economics of executing securitizations continue to be challenging or if the regulations governing the execution of securitizations discourage or preclude certain potential market participants from engaging in these transactions. A key factor in the economics of securitization is a highly liquid market for triple-A rated securities. The events in recent years revealed that the liquidity of this market may be severely disrupted at times. Losses experienced by holders of triple-A rated securities in non-agency mortgage-backed securities have dampened the demand for investment grade securities backed by real estate loans and securities. Investor demand in the foreseeable future for these securities may not reach previous levels. Without a robust market for triple-A rated securities, the supply of real estate subordinate securities could be significantly diminished. In addition, the risks associated with the acquisition of loans for the purpose of securitization may increase significantly and we may reduce our loan acquisitions or choose not to acquire any loans during these periods.

**Investments in diverse types of assets and businesses could expose us to new, different, or increased risks.**

We have invested in and may in the future invest in a variety of real estate and non-real estate related assets that may not be closely related to our current core business. Additionally, we may enter various securitizations, services, and other operating businesses that may not be closely related to our current business. Any of these actions may expose us to new, different, or increased investment, operational, financial, or management risks. We may invest in various types of non-real estate related assets. We may invest directly or indirectly in real property. We may invest in non-real estate asset-backed securities (ABS), corporate debt, or equity. We have invested in diverse types of IOs from residential and commercial securitizations sponsored by us or by others. The higher credit and prepayment risks associated with these types of investments may increase our exposure to losses. We may invest in non-U.S. assets that may expose us to currency risks (which we may choose not to hedge) and different types of credit, prepayment, hedging, interest rate, liquidity, legal, and other risks. We may originate first mortgage commercial loans primarily for the sale to others (while retaining a subordinate interest in these loans or retaining subordinate financing for the same property) and this would expose us to certain representation and warranty, aggregation, market value, and other risks on loan balances in excess of our potential investments.

In addition, when investing in assets or businesses we are exposed to the risk that those assets, or interest income or revenue generated by those assets or businesses, result in our not meeting the requirements to maintain our REIT status or our status as exempt from registration under the Investment Company Act of 1940 as amended (Investment Company Act), as further described below in the risk factors titled Redwood has elected to be a REIT and, as such, is required to meet certain tests in order to maintain its REIT status. This adds complexity and costs to running our business and exposes us to additional risks and Conducting our business in a manner so that we are exempt from registration under and compliance with the Investment Company Act may reduce our flexibility and could limit our ability to pursue certain opportunities. At the same time, failure to continue to qualify for exemption from the Investment Company Act could adversely affect us.

***We may change our investment strategy or financing plans, which may result in riskier investments and diminished returns.***

We may change our investment strategy or financing plans at any time, which could result in our making investments that are different from, and possibly riskier than, the investments we have previously made or described. A change in our investment strategy or financing plans may increase our exposure to interest rate and default risk and real estate market fluctuations. Decisions to employ additional leverage could increase the risk inherent in our investment strategy. Furthermore, a change in our investment strategy could result in our making investments in new asset

Investments in diverse types of assets and businesses could expose us to new, different, or increased risks.

categories or in different proportions among asset categories than we previously have. For example, we could in the future determine to invest a greater proportion of our assets in securities backed by subprime residential mortgage loans. These changes could result in our making riskier investments, which could ultimately have an adverse effect on our financial returns. Alternatively, we could determine to change our investment strategy or financing plans to be more risk averse, resulting in potentially lower returns, which could also have an adverse effect on our financial returns.

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**The performance of the assets we own and the investments we make will vary and may not meet our earnings or cash flow expectations. In addition, the cash flows and earnings from, and market values of, securities, loans, and other assets we own are variable.**

We actively manage the risks associated with acquiring, originating, holding, and managing real estate loans and securities and other real estate-related investments. No amount of risk management or mitigation, however, can change the variable nature of the cash flows of, fair values of, and financial results generated by these loans, securities, and other assets. Changes in the credit performance of, or the prepayments on, these investments, including real estate loans and the loans underlying these securities, and changes in interest rates impact the cash flows on these securities and investments, and the impact could be significant for our loans, securities, and other assets with concentrated risks. Changes in cash flows lead to changes in our return on investment and also to potential variability in and level of reported income. The revenue recognized on most of our assets is based on an estimate of the yield over the remaining life of the asset. Thus, changes in our estimates of expected cash flow from an asset will result in changes in our reported earnings on that asset in the current reporting period. We may be forced to recognize adverse changes in expected future cash flows as a current expense, further adding to earnings volatility.

For other assets, our revenue and income are based on changes in the fair value of the asset. As market conditions, liquidity, perceptions, supply, demand, and the fundamentals of each asset change, the fair values can vary widely, causing volatility in our reported earnings. Fair values for illiquid assets can be difficult to ascertain accurately, which may also lead to volatility and uncertainty of earnings.

***Changes in the fair values of our assets, liabilities, and derivatives can have various negative effects on us, including reduced earnings, increased earnings volatility, and volatility in our book value.***

Fair values for our assets, liabilities, and derivatives can be volatile. The fair values can change rapidly and significantly and changes can result from changes in interest rates, perceived risk, supply, demand, and actual and projected cash flows, prepayments, and credit performance. A decrease in fair value may not necessarily be the result of deterioration in future cash flows. Fair values for illiquid assets can be difficult to estimate, which may lead to volatility and uncertainty of earnings.

For GAAP purposes, we mark to market some, but not all, of the assets and liabilities on our consolidated balance sheet. In addition, valuation adjustments on certain consolidated assets and many of our derivatives are reflected in our consolidated statement of income. Assets that are funded with certain liabilities and hedges may have differing mark-to-market treatment than the liability or hedge. If we sell an asset that has not been marked to market through our consolidated statement of income at a reduced market price relative to its cost basis, our reported earnings will be reduced.

A decrease in the fair value of the securities we own may result in a reduction in our book value due to the accounting standards we are required to apply. Reporting a low book value could have adverse effects even if that book value is not indicative of the actual value of our net investments in assets and securitization entities. The adverse effects could include the inability to meet or agree upon covenants with counterparties, the inability to enter into derivative contracts, and a reduction in the market price of our common stock.

There are potentially significant differences between the value of our investments in certain securitization entities (e.g., Sequoia and Acacia entities) under GAAP presentation and the economic value of our investments in these entities. Discrepancies arise as a result of market dynamics, the limitations of the measurement techniques required by GAAP, and the consolidation accounting principles under GAAP.

***Our calculations of the fair value of the securities we own or consolidate are based upon assumptions that are inherently subjective and involve a high degree of management judgment.***

We report our securities at fair value on our consolidated balance sheets. In computing the fair values for illiquid securities, such as the securities we own or consolidate and for which there are few, if any, observable third-party trades, we make a number of market-based assumptions, including assumptions regarding future interest rates, prepayment rates, discount rates, credit loss rates, and the timing of credit losses. These assumptions are inherently subjective and involve a high degree of management judgment. Use of different assumptions could materially affect our fair value calculations and our results of operations and financial

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condition. Further discussion of the risk of our ownership and valuation of illiquid securities is set forth below in the risk factor titled Investments we make, hedging transactions that we enter into, and the manner in which we finance our investments and operations expose us to various risks, including liquidity risk, risks associated with the use of leverage, market risks, and counterparty risk.

Although we rely on our internal calculations to compute the fair value of securities we own, we also request and consider indications of value (marks) from third-party dealers to assist us in our valuation process. Market disruptions in recent years have resulted in fewer third-party generated data points than were available to us in the past for us to consider in connection with our estimates of the fair value of our securities, which limits our ability to use these third-party data points to assist us in our valuation process.

**Investments we make, hedging transactions that we enter into, and the manner in which we finance our investments and operations expose us to various risks, including liquidity risk, risks associated with the use of leverage, market risks, and counterparty risk.**

**Many of our investments have limited liquidity.**

Many of the asset-backed securities we own are generally illiquid that is, there is not a significant pool of potential investors that are likely to invest in these, or similar, securities. This illiquidity can also exist for the residential loans we hold and commercial loans we originate. In fact, at times, the vast majority of the assets we own are illiquid. In turbulent markets, it is likely that the securities, loans, and other assets we own may become even less liquid. As a result, we may not be able to sell certain assets at opportune times or at attractive prices or we may incur significant losses upon sale of these assets, should we choose to sell them.

As a result of the limited liquidity that can exist for securities and loans we acquire and originate and for securities our securitization entities issue, there may be little trading information available to verify the values at which we report these assets and liabilities on our financial statements. This makes the estimates of fair value reflected in our financial statements more assumption-based. Thus, to the extent that our assumptions are not accurate, our reported earnings and book values may not reflect the values we ultimately realize from our portfolio.

**Our use of short-term financial leverage could expose us to increased risks.**

We fund our residential loans we acquire in anticipation of a securitization with a combination of equity and short-term debt. In addition, we also make investments in securities and loans financed with short-term debt. By incurring this leverage we expect to generate more attractive returns on our invested equity capital. However, as a result of leverage (whether for the accumulation of loans or related to a longer-term investment), we could also incur significant losses if our borrowing costs increase relative to the earnings on our assets and costs of our hedges. Financing facilities may also force us to sell assets under adverse market conditions to meet lenders margin calls, for example, in the event of a decrease in the fair values of the assets pledged as collateral. Liquidation of the collateral could create negative tax consequences and raise REIT qualification issues.

Although we typically seek a variety of financing facilities from several counterparties, we cannot assure you that we would be able to establish short-term financing facilities or renew them when they mature. The failure to renew facilities could force us to sell assets in adverse market conditions. Liquidity in debt markets, including repurchase facilities and commercial paper markets, can be withdrawn suddenly, making it difficult or expensive to renew short-term borrowings as they mature.

Our calculations of the fair value of the securities we own or consolidate are based upon assumptions that are inherent

***The use of short-term financial leverage is critical to certain aspects of our business and we may continue to expand our dependence on short-term debt in the future. The inability to access financial leverage through warehouse and repurchase facilities, credit facilities, or other forms of debt financing may inhibit our ability to execute our business plan. In that case, our inability to access funding could have a material adverse effect on our results of operations, financial condition, and business.***

Our ability to fund our business and our investment strategy depends to a critical extent on our securing warehouse, repurchase, or other forms of debt financing (or leverage) on acceptable terms. For example, pending the securitization of a pool of mortgage loans we generally fund the acquisition of mortgage loans through borrowings from warehouse, repurchase, and credit facilities, and other forms of short-term financing.

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We cannot assure you that we will be successful in establishing sufficient sources of short-term debt when needed. In addition, because of the short-term nature, lenders may decline to renew our short-term debt upon maturity or expiration, and it may be difficult for us to obtain continued short-term financing. During certain periods, lenders may curtail their willingness to provide financing. To the extent our business or investment strategy calls for us to access financing and counterparties are unable or unwilling to lend to us, then our business and results of operations will be adversely affected. Furthermore, to the extent we do employ leverage and subsequently default or are unable to renew the facilities when they mature, we may suffer adverse consequences. In addition, it is possible that lenders who provide us with financing could experience changes in their ability to advance funds to us, independent of our performance or the performance of our investments, in which case funds we had planned to be able to access may not be available to us.

***Hedging activities may reduce earnings, may fail to reduce earnings volatility, and may fail to protect our capital in difficult economic environments.***

We attempt to hedge certain interest rate risks (and, at times, prepayment risks and fair values) by balancing the characteristics of our assets and associated (existing and anticipated) liabilities with respect to those risks and entering into various interest rate agreements. The number and scope of the interest rate agreements we utilize may vary significantly over time. We generally attempt to enter into interest rate agreements that provide an appropriate and efficient method for hedging certain risks.

The use of interest rate agreements and other instruments to hedge certain of our risks may well have the effect over time of lowering long-term earnings to the extent these risks do not materialize. To the extent that we hedge, it is usually to protect us from some of the effects of short-term interest rate volatility, to lower short-term earnings volatility, to stabilize liability costs or fair values, to stabilize our economic returns from or meet rating agency requirements with respect to a securitization transaction, or to stabilize the future cost of anticipated issuance of securities by a securitization entity. Hedging may not achieve our desired goals. Pipeline hedging for loans we have planned to purchase may not be effective due to loan fallout or other reasons. Using interest rate agreements as a hedge may increase short-term earnings volatility, especially if we do not elect certain accounting treatments for our hedges. Reductions in fair values of interest rate agreements may not be offset by increases in fair values of the assets or liabilities being hedged. Conversely, increases in fair values of interest rate agreements may not fully offset declines in fair values of assets or liabilities being hedged. Changes in fair values of interest rate agreements may require us to pledge significant amounts of collateral or cash.

We also may hedge by taking short, forward, or long positions in U.S. Treasuries, mortgage securities, or other cash instruments. We may take both long and short positions in credit derivative transactions linked to real estate assets.

These derivatives may have additional risks to us, such as: liquidity risk, due to fact that there may not be a ready market into which we could sell them if needed; basis risk, which could result in a decline in value or a requirement to make a cash payment as a result of changes in interest rates; and the risk that a counterparty to a derivative is not willing or able to perform its obligations to us due to its financial condition or otherwise.

Our quarterly earnings may be subject to fluctuations from period to period as a result of the accounting treatment for certain derivatives or for assets or liabilities that do not necessarily match those used for derivatives, or as a result of our failure to meet the requirements necessary to obtain specific hedge accounting treatment for certain derivatives.

***We may enter into derivative contracts that expose us to contingent liabilities and those contingent liabilities may not appear on our balance sheet. We may invest in synthetic securities, credit default swaps, and other credit derivatives, which expose us to additional risks.***

We may enter into derivative contracts that could require us to make cash payments in certain circumstances. Potential payment obligations would be contingent liabilities and may not appear on our balance sheet. Our ability to satisfy these contingent liabilities depends on the liquidity of our assets and our access to capital and cash. The need to fund these contingent liabilities could adversely impact our financial condition.



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We may invest in synthetic securities, credit default swaps, and other credit derivatives that reference other real estate securities or indices. These investments may present risks in excess of those resulting from the referenced security or index. These investments are typically contractual relationships with counterparties and not acquisitions of referenced securities or other assets. In these types of investments, we have no right directly to enforce compliance with the terms of the referenced security or other assets and we have no voting or other consensual rights of ownership with respect to the referenced security or other assets. In the event of insolvency of a counterparty, we will be treated as a general creditor of the counterparty and will have no claim of title with respect to the referenced security.

The markets for these types of investments have, in some cases, only existed for relatively few years and may not be liquid. Many of these investments incorporate pay as you go credit events, which could require us to make significant cash payments with little advance notice. The terms of certain types of investments could make it more difficult to assign such an instrument or determine the loss pursuant to the underlying agreement. In a credit default swap, the party wishing to buy protection will pay a premium. When interest rates change, the spreads change, or the prevailing credit premiums on credit default swaps change, the amount of the termination payment due could change by a substantial amount. In an illiquid market, the determination of this change could be difficult to ascertain and, as a result, we may not achieve the desired benefit of entering into this contractual relationship.

To date, we have entered into a limited number of these types of derivatives contracts. We may over time increase our exposure to these types of investments as the market for them grows and during times when acquiring other real estate loans and securities may be difficult and we may find credit default swaps and other forms of synthetic securities to be a more efficient method of providing credit enhancement on specific pools of real estate loans; however, we may also be limited in the amount of these types of investments we can make, including for reasons described below in the risk factors titled Redwood has elected to be a REIT and, as such, is required to meet certain tests in order to maintain its REIT status. This adds complexity and costs to running our business and exposes us to additional risks and Conducting our business in a manner so that we are exempt from registration under and compliance with the Investment Company Act of 1940, as amended (Investment Company Act) may reduce our flexibility and could limit our ability to pursue certain opportunities. At the same time, failure to continue to qualify for exemption from the Investment Company Act could adversely affect us. We may attempt to manage the risks associated with these investments including counterparty risks, but our efforts may prove to be insufficient in enabling us to generate the returns anticipated.

**Our results could be adversely affected by counterparty credit risk.**

We have credit risks that are generally related to the counterparties with which we do business. There is a risk that counterparties will fail to perform under their contractual arrangements with us and this risk is usually more pronounced during an economic downturn. Counterparties may seek to eliminate credit exposure by entering into offsetting, or back-to-back, hedging transactions, and the ability of a counterparty to settle a synthetic transaction may be dependent on whether the counterparties to the back-to-back transactions perform their delivery obligations. Those risks of non-performance may differ materially from the risks entailed in exchange-traded transactions, which generally are backed by clearing organization guarantees, daily mark-to-market and settlement of positions, and segregation and minimum capital requirements applicable to intermediaries. Transactions entered into directly between parties generally do not benefit from those protections, and expose the parties to the risk of counterparty default. Furthermore, there may be practical and timing problems associated with enforcing our rights to assets in the case of an insolvency of a counterparty.

In the event a counterparty to our short-term borrowings becomes insolvent, we may fail to recover the full value of our pledged collateral, thus reducing our earnings and liquidity. In the event a counterparty to our interest rate agreements, credit default swaps, or other derivatives becomes insolvent or interprets our agreements with it in a

manner unfavorable to us, our ability to realize benefits from the hedge transaction may be diminished, any cash or collateral we pledged to the counterparty may be unrecoverable, and we may be forced to unwind these agreements at a loss. In the event that one of our servicers becomes insolvent or fails to perform, loan delinquencies and credit losses may increase and we may not receive the funds to which we are entitled. We attempt to diversify our counterparty exposure and (except with respect to loan representations and warranties) attempt to limit our counterparty exposure to counterparties with

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investment-grade credit ratings, although we may not always be able to do so. Our counterparty risk management strategy may prove ineffective and, accordingly, our earnings and cash flows could be adversely affected.

**Adverse changes to the credit rating of the U.S. government or to the credit rating of one or more of the Eurozone nations by one or more of the major credit rating agencies could negatively impact the availability and cost to us of short-term debt financing and could adversely affect our business and results of operations.**

In July 2011, Moody's Investors Service (Moody's) placed the credit rating of the U.S. government on review for possible downgrade and also placed on review for possible downgrade the ratings of financial institutions and financial instruments directly linked to the U.S. government, including, without limitation, Fannie Mae and Freddie Mac. Similarly, in April 2011, Standard and Poor's (S&P) changed the outlook on the U.S. government's credit rating from stable to negative, in July 2011, S&P placed the credit rating of the U.S. government on negative credit watch, and in August 2011, S&P downgraded the credit rating of the U.S. government to AA+ from AAA. These ratings actions were taken in part in response to the possibility that in August 2011 the U.S. government would default on U.S. Treasury obligations (although the U.S. did not, in fact, default on its obligations in August 2011) and in part in response to pessimism regarding the ability of the U.S. government to stabilize the dynamics of its borrowing and debt obligations.

In response to the economic situation facing the European Economic and Monetary Union, or Eurozone, based on factors including tightening credit conditions, higher risk premiums on Eurozone sovereigns and disagreement among European policy makers on how best to address the declining market confidence with respect to the Eurozone, on January 13, 2012, S&P downgraded the long-term credit ratings of nine members of the Eurozone, including Austria, Cyprus, France, Italy, Malta, Portugal, Slovakia, Slovenia and Spain, and indicated that its outlooks on the ratings on Austria, Belgium, Cyprus, Estonia, France, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovenia and Spain are negative. In addition, S&P lowered the long-term issuer credit rating on the European Financial Stability Facility from AAA to AA+. Similarly, in February 2012, Moody's cited weak economic growth and uncertainty over the Eurozone's prospects for reform of its fiscal and economic framework in downgrading the long-term credit ratings of Italy, Malta, Portugal, Slovakia, Slovenia, and Spain, and indicated that its outlook on the ratings of Austria, France, and the United Kingdom was being changed to negative.

It is difficult to predict the impact of any change in the credit rating of the U.S. government or of any change in the credit rating of one or more Eurozone nations; however, any change in the outlook for, or rating of, the U.S. government's creditworthiness or the creditworthiness of Eurozone nations would likely have adverse impacts on, among other things, the financial markets, the cost of borrowing, the financial strength of counterparties we transact business with, and the value of assets we hold. Any such adverse impacts could negatively impact the availability to us of short-term debt financing, our cost of short-term debt financing, our business, and our results of operations.

**Through certain of our wholly-owned subsidiaries we have engaged in the past, and continue to engage, in securitization transactions relating to residential mortgage loans. We have in the past also engaged in, and may in the future engage in, other types of securitization transactions or similar transactions. In addition, we have and continue to invest in mortgage-backed securities and other ABS issued in securitization transactions sponsored by**

**other companies. These types of transactions and investments expose us to potentially material risks.**

Engaging in securitization transactions and other similar transactions generally requires us to incur short-term debt, either on a recourse or non-recourse basis, to finance the accumulation of loans or other assets prior to securitization.

This type of debt may not be available to us, including in circumstances where a line of credit had previously been committed to us. In addition, the terms of any available debt may be unfavorable to us or impose restrictive covenants that could limit our business and operations or the violation of which could lead to losses and inhibit our ability to borrow in the future. We expect to pledge assets we acquire to secure the short-term debt we incur. To the extent this debt is recourse to us, if the fair value of the assets pledged as collateral declines, we would be required to increase the amount of collateral pledged to secure the debt or to repay all or a portion of the debt. Furthermore, if we are unable to complete the

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securitization of these types of assets, we would likely need to sell the assets on potentially unfavorable terms instead of completing the planned securitization, which could result in a loss. In addition, when we acquire assets for a securitization, we make assumptions about the cash flows that will be generated from those assets. Widening ABS interest rate spreads, rising ABS yields, incorrect estimation of rating agency securitization requirements, poor hedging practices or results, changes in applicable law and regulations, and other factors could result in a securitization execution that is less favorable to us than initially assumed, which would typically result in a loss.

Prior to acquiring assets for securitization transactions or making other investments, we may undertake due diligence efforts with respect to various aspects of the asset or investment. When conducting due diligence, we rely on resources and data available to us, which may be limited, and we rely on investigations by third parties. To the extent we conduct due diligence on investments, our due diligence efforts may not reveal matters which could lead to losses. If we do not conduct adequate due diligence, or the scope of our due diligence is limited, we may incur losses.

When engaging in securitization transactions, we typically make representations and warranties to the securitization entities that purchase loans or other assets from us regarding, among other things, certain characteristics of those assets. If our representations and warranties are inaccurate with respect to any asset, we may be obligated to repurchase that asset, which may result in a loss. Even if we obtain representations and warranties from the parties from whom we acquired the loans or other assets they may not parallel the representations and warranties we make or may otherwise not protect us from losses. For example, if representations and warranties we obtain from those parties do not parallel the representations and warranties we make, or if the representations and warranties made to us are not enforceable or if we cannot collect damages for a breach (e.g., due to the financial condition of the party that made the representation or warranty to us), we may incur losses.

Our business may also include originating and acquiring commercial real estate loans or other commercial real estate investments and selling them, or participations in them, to third parties (which third parties may, in turn, securitize these loan assets). When selling loans or other assets to third parties, we would typically make representations and warranties to the purchasers of those loans or other assets regarding, among other things, certain characteristics of those loans or other assets. If our representations and warranties are inaccurate with respect to any loan or asset, we may be obligated to repurchase that loan, which may result in a loss.

Loans and other assets that are held by securitization entities are serviced by third-party loan servicers. Should a servicer experience financial or operational difficulties, it may not be able to perform these obligations or these obligations may be limited in nature, including any obligation to advance payments of amounts due from delinquent loan obligors. For example, typically a servicer's obligation to make advances on behalf of a delinquent loan obligor is limited to the extent that it does not expect to recover the advances from the ultimate disposition of the collateral pledged to secure the loan.

In addition, as with any external service provider, we are subject to the risks associated with inadequate or untimely services for other reasons such as fraud, negligence, errors, miscalculations, or other reasons. In the current economic environment, many loan servicers are experiencing higher volumes of delinquent loans than they have in the past and, as a result, there is a risk that their operational infrastructures cannot properly process this increased volume. For example, many loan servicers have been accused of improprieties in the handling of the foreclosure process with respect to residential mortgage loans that have gone into default. To the extent a third party loan servicer fails to fully and properly perform its obligations, ABS that we hold as investments may experience losses and securitizations that we have sponsored may experience poor performance, and our ability to engage in future securitization transactions could be harmed.

Through certain of our wholly-owned subsidiaries we have engaged in the past, and continue to engage, in securitization

For some of the loans that we securitize, we hold the right to service those loans and we retain a sub-servicer to service those loans. In these circumstances we are exposed to certain risks, including, without limitation, that the sub-servicer may not properly service the loan in compliance with applicable law and regulation or the contractual provisions governing their sub-servicing role and that we would be held liable for the sub-servicer's improper acts or omissions. In addition, in these circumstances we are obligated to fund any obligation to make advances on behalf of a delinquent loan obligor. To the extent that there are significant

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amounts of advances that need to be funded in respect of loans where we own the servicing right, it could have a material adverse effect on our business and financial results.

There has also recently been debate as to whether there are defects in the legal process and legal documents governing transactions in which securitization trusts and other secondary purchasers take legal ownership of residential mortgage debt and establish their rights as first priority lien holders on underlying mortgaged property. To the extent there are problems with the manner in which title and lien priority rights were established or transferred, ABS that we hold as investments may experience losses and securitizations that we have sponsored may experience poor performance, which could expose us to losses and could damage our ability to engage in future securitization transactions.

We also rely on corporate trustees to act on behalf of us and other holders of ABS in enforcing our rights as security holders. Under the terms of most ABS we hold, we do not have the right to directly enforce remedies against the issuer of the security, but instead must rely on a trustee to act on behalf of us and other security holders. Should a trustee not be required to take action under the terms of the securities, or fail to take action, we could experience losses.

**Our ability to execute future securitizations of residential mortgage loans could be delayed, limited, or precluded by legislative and regulatory reforms applicable to asset-backed securities and the institutions that sponsor, service, rate, or otherwise participate in or contribute to the successful execution of a securitization transaction. Other factors could also limit, delay, or preclude our ability to execute securitization transactions. These legislative, regulatory, and other factors could also reduce the returns we would otherwise expect to earn in connection with executing securitization transactions.**

In July 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). Provisions of the Dodd-Frank Act require, among other things, significant revisions to the legal and regulatory framework under which ABS, including residential mortgage-backed securities (RMBS), are issued through the execution of securitization transactions. Some of the provisions of the Dodd-Frank Act have become effective or been implemented, while others are in the process of being implemented or will become effective soon. In addition, prior to the passage of the Dodd-Frank Act, the Securities and Exchange Commission (SEC) and the Federal Deposit Insurance Corporation (FDIC) had already published proposed regulations relating to the issuance of ABS, including RMBS, and the FDIC's proposed regulations have subsequently become effective. Additional federal or state laws and regulations that could affect our ability to execute future securitization transactions could be proposed, enacted, or implemented. In addition, various federal and state agencies and law enforcement authorities, as well as private litigants, have initiated and may, in the future, initiate additional broad-based enforcement actions or claims, the resolution of which may include industry-wide changes to the way residential mortgage loans are originated, transferred, serviced, and securitized, and any of these changes could also affect our ability to execute future securitization transactions. For an example, please refer to the risk factor above titled "Federal and state legislative and regulatory developments and the actions of governmental authorities and entities may adversely affect our business and the value of, and the returns on, mortgages, mortgage-related securities, and other assets we own or may acquire in the future" for a description of the settlement of a recent enforcement action that resulted in changes to mortgage loan servicing standards.

Our ability to execute future securitizations of residential mortgage loans could be delayed, limited, or precluded by

It is difficult to predict with certainty how the Dodd-Frank Act and the other regulations that have been proposed or recently implemented will affect our future ability to successfully execute securitizations of residential mortgage loans, due to, among other things, the fact that federal agencies have not yet finalized all of the regulations implementing the Dodd-Frank Act. For example, a consortium of federal regulators have published a joint Notice of Proposed Rulemaking (NPR) related to securitization. The proposed rule, among other things, would require securitization sponsors to retain an economic interest in the assets they securitize, which risk retention requirement is intended to incent sponsors to focus on the quality of the assets being securitized and align the interests of sponsors with those of investors in securitizations. These laws, regulations, and enforcement actions and private litigation settlements could effectively preclude us from executing securitization transactions, delay our execution of these types of transactions, or reduce the returns we would otherwise expect to earn from executing securitization transactions.



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Rating agencies can affect our ability to execute a securitization transaction, or reduce the returns we would otherwise expect to earn from executing securitization transactions, not only by deciding not to publish ratings for our securitization transactions (or deciding not to consent to the inclusion of those ratings in the prospectuses or other documents we file with the SEC relating to securitization transactions), but also by altering the criteria and process they follow in publishing ratings. Rating agencies could alter their ratings processes or criteria after we have accumulated loans for securitization in a manner that effectively reduces the value of those previously acquired loans or requires that we incur additional costs to comply with those processes and criteria.

Furthermore, other matters, such as (i) accounting standards applicable to securitization transactions and (ii) capital and leverage requirements applicable to banks and other regulated financial institutions holdings of ABS, could result in less investor demand for securities issued through securitization transactions we execute or increased competition from other institutions that originate, acquire, and hold residential mortgage loans and execute securitization transactions.

**Our ability to profitably execute future securitizations of residential mortgage loans is dependent on numerous factors and if we are not able to achieve our desired level of profitability or if we incur losses in connection with executing future securitizations it would have a material adverse impact on our business and results of operations.**

There are a number of factors that can have a significant impact on whether a securitization transaction that we execute is profitable to us or results in a loss. One of these factors is the price we pay for the mortgage loans that we securitize, which is impacted by the level of competition in the marketplace for acquiring residential mortgage loans and the relative desirability to originators of retaining residential mortgage loans as investments or selling them to third parties such as us. Another factor that impacts the profitability of a securitization transaction is the cost to us of the short-term debt that we use to finance our holdings of residential mortgage loans prior to securitization, which cost is affected by a number of factors including the availability of this type of financing to us, the interest rate on this type of financing, the duration of the financing we incur, and the percentage of our mortgage loans that third parties are willing to provide short-term financing for.

After we acquire residential mortgage loans that we intend to securitize, we can also suffer losses if the value of those loans declines prior to securitization. Declines in the value of a residential mortgage loan can be due to, among other things, changes in interest rates and changes in the credit quality of the loan. To the extent we seek to hedge against a decline in loan value due to changes in interest rates, there is a cost of hedging that also affects whether a securitization is profitable. Other factors that can significantly affect whether a securitization transaction is profitable to us includes the criteria and conditions that rating agencies apply and require when they assign ratings to the mortgage-backed securities issued in our securitization transactions, including the percentage of mortgage-backed securities issued in a securitization transaction that the rating agencies will assign a triple-A rating to, which is also referred to as a rating agency subordination level. Rating agency subordination levels can be impacted by numerous factors, including, without limitation, the credit quality of the loans securitized, and the structure of the securitization transaction and other applicable rating agency criteria. All other factors being equal, the greater the percentage of the mortgage-backed securities issued in a securitization transaction that the rating agencies will assign a triple-A rating to, the more profitable the transaction will be to us.

The price that investors in mortgage-backed securities will pay for securities issued in our securitization transactions also has a significant impact on the profitability of the transactions to us, and these prices are impacted by numerous

Our ability to profitably execute future securitizations of residential mortgage loans is dependent on numerous factors

market forces and factors. In addition, transaction costs incurred in executing transactions impact the profitability of our securitization transactions and any liability that we may incur in connection with executing a transaction can cause a loss to us. To the extent that we are not able to profitably execute future securitizations of residential mortgage loans, including for the reasons described above or for other reasons, it would have a material adverse impact on our business and results of operations.

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**Our past and future securitization activities or other past and future business or operating activities or practices could expose us to litigation, which may adversely affect our business and results of operations.**

Through certain of our wholly-owned subsidiaries we have in the past engaged in securitization transactions relating to residential mortgage loans and other types of assets. In the future we expect to continue to engage in securitization transactions relating to residential mortgage loans and may also engage in other types of securitization transactions or similar transactions. Our outstanding Sequoia securitization entities issued ABS backed by residential mortgage loans held by these Sequoia entities. Our outstanding Acacia securitization entities issued ABS backed by securities and other assets held by these Acacia entities. As a result of declining property values, increasing defaults, changes in interest rates, and other factors, the cash flows from the loans held by the Sequoia entities and the securities and other assets held by the Acacia entities may be insufficient to repay in full the principal amount of ABS issued by these securitization entities. We are not directly liable for any of the ABS issued by these entities. Nonetheless, third parties who hold the ABS issued by these entities may try to hold us liable for any losses they experience, including through claims under federal and state securities laws or claims for breaches of representations and warranties we made in connection with engaging in these securitization transactions.

For example, as discussed below in Part I, Item 3 of this Annual Report on Form 10-K, on October 15, 2010, the Federal Home Loan Bank of Chicago filed a claim in the Circuit Court of Cook County, Illinois against us and our subsidiary, Sequoia Residential Funding, Inc. The complaint relates in part to RMBS that were issued by a Sequoia securitization entity and alleges that, at the time of issuance, we, Sequoia Residential Funding, Inc. and the underwriters made various misstatements and omissions about these RMBS in violation of Illinois state law. We have also been named in other similar lawsuits. A further discussion of these lawsuits is set forth in Note 14 to the Financial Statements.

Other aspects of our business operations or practices could also expose us to litigation. In the ordinary course of our business we enter into agreements relating to, among other things, loans we acquire and investments we make, assets and loans we sell, financing transactions, third parties we retain to provide us with goods and services, and our leased office space. We also regularly enter into confidentiality agreements with third parties under which we receive confidential information. If we breach any of these agreements, we could be subject to claims for damages and related litigation. We are also subject to various laws and regulations relating to our business and operations, including, without limitation, privacy laws and regulations and labor and employment laws and regulations, and if we fail to comply with these laws and regulations we could also be subjected to claims for damages and litigation.

Defending a lawsuit can consume significant resources and may divert management's attention from our operations. To the extent we are unsuccessful in our defense of any lawsuit, we could suffer losses which could be material.

**Our cash balances and cash flows may be insufficient relative to our cash needs.**

We need cash to make interest payments, to post as collateral to counterparties and lenders who provide us with short-term debt financing and who engage in other transactions with us, for working capital, to fund minimum REIT dividend distribution requirements, to comply with financial covenants and regulatory requirements, and for other needs and purposes. We may also need cash to repay short-term borrowings when due or in the event the fair values of assets that serve as collateral for that debt decline, the terms of short-term debt become less attractive, or for other reasons. In addition, we may need to use cash to post margin calls on various derivative instruments we enter into as

the value of these derivatives change.

Our sources of cash flow include the principal and interest payments on the loans and securities we own, asset sales, securitizations, short-term borrowing, issuing long-term debt, and raising equity. Our sources of cash may not be sufficient to satisfy our cash needs. Cash flows from principal repayments could be reduced if prepayments slow or if credit quality deteriorates. Cash flows from most of our investments in collateralized debt obligations (CDOs) (including investments in Acacia entities) have been disrupted due to credit rating agencies downgrading securities owned by the securitization entity below certain average rating tests. For some of our assets, cash flows are locked-out and we receive less than our pro-rata share of principal payment cash flows in the early years of the investment. For some loans, borrowers have the option to make payments that are less than they would if those loans were fully amortizing over their terms.

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Our minimum dividend distribution requirements could exceed our cash flows if our income as calculated for tax purposes significantly exceeds our net cash flows. This could occur when taxable income (including non-cash income such as discount amortization and interest accrued on negative amortizing loans) exceeds cash flows received. The Internal Revenue Code provides a limited relief provision concerning certain items of non-cash income; however, this provision may not sufficiently reduce our dividend distribution requirement. In the event that our liquidity needs exceed our access to liquidity, we may need to sell assets at an inopportune time, thus reducing our earnings. In an adverse cash flow situation, we may not be able to sell assets effectively and our REIT status or our solvency could be threatened.

### **We are subject to competition and we may not compete successfully.**

We are subject to competition in seeking investments, originating commercial loans, acquiring residential loans for securitization, engaging in securitization transactions, and in other aspects of our business. Our competitors include other mortgage REITs, Fannie Mae, Freddie Mac, banks, broker-dealers, insurance companies, and other financial institutions, as well as investment funds and other investors in real estate-related assets. In addition, other companies may be formed that will compete with us. Some of our competitors have greater resources than us and we may not be able to compete successfully with them. Furthermore, competition for investments, making loans, and engaging in securitization transactions may lead to a decrease in the opportunities and returns available to us.

In addition, there are significant competitive threats to our business from governmental actions and initiatives that have already been undertaken or which may be undertaken in the future. Sustained competition from governmental actions and initiatives could have a material adverse effect on us. For example, Fannie Mae and Freddie Mac are, among other things, engaged in the business of acquiring loans and engaging in securitizations transactions. Until 2008, competition from Fannie Mae and Freddie Mac was limited to some extent due to the fact that they were statutorily prohibited from purchasing loans for single unit residences in the continental United States with a principal amount in excess of \$417,000, while much of our business had historically focused on acquiring residential loans with a principal amount in excess of \$417,000. In February 2008, Congress passed an economic stimulus package that temporarily increased the size of certain loans these entities could purchase to up to \$729,750, if the loans were made to secure real estate purchases in certain high-cost areas. At the end of September 2011, this \$729,750 loan size limit was reduced to \$625,000, which is an amount that continues to be above the historical \$417,000 loan size limit. In addition, in September 2008, Fannie Mae and Freddie Mac were placed into conservatorship and have become, in effect, instruments of the U.S. federal government. As long as there is governmental support for these entities to continue to operate and provide financing to a significant portion of the mortgage finance market, they will represent significant business competition due to, among other things, their large size and low cost of funding. To the extent that laws, regulations, or policies governing the business activities of Fannie Mae and Freddie Mac are not changed to limit their role in housing finance (such as a change in these loan size limits), the competition from these two governmental entities will remain significant. In addition, to the extent that property values decline while these loan size limits remain the same, it may have the same effect as an increase in this limit, as a greater percentage of loans would likely be within the size limit. Any increase in the loan size limit, or in the overall percentage of loans that are within the limit, allows Fannie Mae and Freddie Mac to compete against us to a greater extent than they had been able to compete previously and our business could be adversely affected.

Further discussion of how our inability to regularly engage in residential mortgage securitization transactions could adversely affect our earnings and growth, including as a result of competition from Fannie Mae, Freddie Mac, and other firms, is set forth below in the risk factor titled Our business model and business strategies, and the actions we take (or fail to take) to implement them and adapt them to changing circumstances involve risk and may not be successful. Continued disruption in the mortgage securitization market may adversely affect our earnings and growth.

**Our future success depends on our ability to attract and retain key personnel.**

Our future success depends on the continued service and availability of skilled personnel, including members of our executive management team such as our chief executive officer and our president. There can be no assurance that we will be able to attract and retain key personnel.

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**Our business model and business strategies, and the actions we take (or fail to take) to implement them and adapt them to changing circumstances involve risk and may not be successful. Continued disruption in the mortgage securitization market may adversely affect our earnings and growth.**

Due to the recent credit crisis and downturn in the U.S. real estate markets and the economy, the mortgage industry and the related capital markets are undergoing significant changes, including due to the significant governmental interventions in these areas and changes to the laws and regulations that govern the banking and mortgage finance industry. Our methods of, and model for, doing business and financing our investments are changing and if we fail to develop, enhance, and implement strategies to adapt to changing conditions in the mortgage industry and capital markets, our financial condition and earnings may be adversely affected. Furthermore, changes we make to our business to respond to changing circumstances may expose us to new or different risks than we were previously exposed to and we may not effectively identify or manage those risks.

Similarly, the competitive landscape in which we operate in and the products and investments for which we compete are also affected by changing conditions. There may be trends or sudden changes in our industry, regulatory environment, changes in the role of government sponsored entities, changes in the role of credit rating agencies or their rating criteria or processes, or the U.S. economy more generally. If we do not effectively respond to these changes or if our strategies to respond to these changes are not successful, our ability to effectively compete in the marketplace may be negatively impacted, which would likely result in our financial condition and earnings being adversely affected.

We have historically depended upon the issuance of mortgage-backed securities by the securitization entities we sponsor as a funding source for our residential real estate-related business. However, due to market conditions, we did not engage in residential mortgage securitization transactions in 2008 or 2009 and we only engaged in one residential mortgage securitization transaction in 2010 and two residential mortgage securitization transactions in 2011. We do not know when, or if, market conditions will allow us to more regularly engage in securitization transactions and the continued disruption of this market may adversely affect our earnings and growth. If more regular residential mortgage securitization activity does resume among market participants other than government sponsored entities, we do not know if it will be on terms and conditions that will permit us to participate or be favorable to us. Even if conditions are favorable to us, we may not be able to return to the volume of securitization activity we previously conducted.

**Initiating new business activities or significantly expanding existing business activities may expose us to new risks and will increase our cost of doing business.**

Initiating new business activities or significantly expanding existing business activities are two ways to grow our business and respond to changing circumstances in our industry; however, they may expose us to new risks and regulatory compliance requirements. We cannot be certain that we will be able to manage these risks and compliance requirements effectively. Furthermore, our efforts may not succeed and any revenues we earn from any new or expanded business initiative may not be sufficient to offset the initial and ongoing costs of that initiative, which would result in a loss with respect to that initiative. For example, efforts we have made and continue to make to significantly expand our investing activity in commercial real-estate related assets and to develop new methods for acquiring residential real estate-related investment assets may expose us to new risks, may not succeed, and may not generate sufficient revenue to offset our related costs. As another example, we have a subsidiary, Redwood Asset Management,

Our business model and business strategies, and the actions we take (or fail to take) to implement them ~~and~~ adapt

Inc., that engages in the investment advisory business. Any new asset management activities that we engage in may increase our exposure to litigation, fiduciary responsibilities, conflicts of interest arising from our investment activities and the activities of the entities we manage, and other risks.

In connection with initiating new business activities or expanding existing business activities, or for other business reasons, we may create new subsidiaries. Generally, these subsidiaries would be wholly-owned by Redwood. The creation of those subsidiaries may increase our administrative costs and expose us to other legal and reporting obligations, including, for example, because they may be incorporated in states other than Maryland or may be established in a foreign jurisdiction. Any new subsidiary we create may be designated as a taxable subsidiary. Taxable subsidiaries are wholly-owned subsidiaries of a REIT that pay corporate income



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tax on the income they generate. That is, a taxable subsidiary is not able to deduct its dividends paid to its parent in determining its taxable income and any dividends paid to the parent are generally recognized as income at the parent level.

**We may change our policies, procedures, practices, products, leverage, hedging strategies, or internal risk-adjusted capital guidelines in ways that may increase our risk exposure.**

We may alter our policies, procedures, practices, products, leverage, internal risk-adjusted capital guidelines, and other aspects of our business. We may enter into new businesses, relationships, or partnerships or pursue acquisitions of other companies or a variety of different types of assets. These changes may increase the nature or magnitude of the risks to which we are exposed.

**We may not be able to obtain or maintain the governmental licenses required to operate our business and we may fail to comply with various state and federal laws and regulations applicable to our business of acquiring residential mortgage loans making commercial real estate loans.**

While we are not required to obtain licenses to purchase mortgage-backed securities, the purchase of residential mortgage loans in the secondary market may, in some circumstances, require us to maintain various state licenses. Acquiring the right to service residential mortgage loans may also, in some circumstances, require us to maintain various state licenses even though we currently do not expect to directly engage in loan servicing ourselves. Similarly, certain commercial real estate lending activities that we engage in also require us to obtain and maintain various state licenses. As a result, we could be delayed in conducting certain business if we were first required to obtain a state license. There is no assurance that we will be able to obtain all of the licenses we need or that we would not experience significant delays in obtaining these licenses. Furthermore, once licenses are issued we are required to comply with various information reporting and other regulatory requirements to maintain those licenses, and there is no assurance that we will be able to satisfy those requirements or other regulatory requirements applicable to our business of acquiring residential mortgage loans on an ongoing basis. Our failure to obtain or maintain required licenses or our failure to comply with regulatory requirements that are applicable to our business of acquiring residential mortgage loans may restrict our business and investment options and could harm our business and expose us to penalties or other claims.

**With respect to mortgage loans we own, or which we have purchased and subsequently sold, we may be subject to liability for potential violations of predatory lending laws or similar laws, which could adversely impact our results of operations, financial condition, and business.**

Various federal, state, and local laws have been enacted that are designed to discourage predatory lending practices. For example, the federal Home Ownership and Equity Protection Act of 1994 (HOEPA) prohibits inclusion of certain provisions in residential mortgage loans that have mortgage rates or origination costs in excess of prescribed levels and requires that borrowers be given certain disclosures prior to origination. Some states have enacted, or may enact, similar laws or regulations, which in some cases impose restrictions and requirements greater than those in HOEPA. In addition, under the anti-predatory lending laws of some states, the origination of certain residential mortgage loans, including loans that are not classified as high cost loans under applicable law, must satisfy a net tangible benefits test

We may change our policies, procedures, practices, products, leverage, hedging strategies, or internal risk-adjusted

with respect to the borrower. This test may be highly subjective and open to interpretation. As a result, a court may determine that a residential mortgage loan did not meet the test even if the originator reasonably believed that the test had been satisfied. Failure of residential mortgage loan originators or servicers to comply with these laws, could subject us, as an assignee or purchaser of these loans, to monetary penalties and could result in rescission of the affected residential mortgage loans, which could adversely impact our results of operations, financial condition, and business.

**Environmental protection laws that apply to properties that secure or underlie our loan portfolio could result in losses to us. We may also be exposed to environmental liabilities with respect to properties to which we take title, which could adversely affect our results of operations, financial condition, and business.**

Under the laws of several states, contamination of a property may give rise to a lien on the property to secure recovery of the cleanup costs. In certain of these states, such a lien has priority over the lien of an existing mortgage against the property, which could impair the security for a loan we hold or could reduce the

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value of property underlying loans we have made. In addition, under the laws of some states and under the federal Comprehensive Environmental Response, Compensation and Liability Act of 1980, we may be liable for costs of addressing releases or threatened releases of hazardous substances that require remedy at a property securing or underlying a loan we hold if our agents or employees have become sufficiently involved in the hazardous waste aspects of the operations of the borrower of that loan, regardless of whether or not the environmental damage or threat was caused by us or the borrower.

In the course of our business, we may take title to residential or commercial real estate. If we do take title, we could be subject to environmental liabilities with respect to the property, including liability to a governmental entity or third parties for property damage, personal injury, investigation, and clean-up costs. In addition, we may be required to investigate or clean up hazardous or toxic substances or chemical releases, at a property. The costs associated with investigation or remediation activities could be substantial. If we ever become subject to significant environmental liabilities, our results of operations, financial condition, and business could be materially and adversely affected.

### **Our technology infrastructure and systems are important and any significant disruption or breach of the security of this infrastructure or these systems could have an adverse effect on our business. We also rely on technology infrastructure and systems of third parties who provide services to us and with whom we transact business.**

In order to analyze, acquire, and manage our investments and manage the operations and risks associated with our business, assets, and liabilities, we rely upon computer hardware and software systems. Some of these systems are located at our office and some are maintained by third party vendors. We also rely on technology infrastructure and systems of third parties who provide services to us and with whom we transact business. Any significant interruption in the availability or functionality of these systems could have an adverse effect on our operations. In addition, any breach of the security of these systems could have an adverse effect on our operations. Steps we have taken to provide for the security of our systems and data may not effectively prevent others from obtaining improper access to our systems data. Improper access could expose us to risks of data loss, litigation, and liabilities to third parties, and otherwise disrupt our operations. For example, our systems and the systems of third parties who provide services to us and with whom we transact business may contain non-public personal information that an identity thief could utilize in engaging in fraudulent activity or theft. We may be liable for losses suffered by individuals whose identities are stolen as a result of a breach of the security of these systems, and any such liability could be material.

### **Our business could be adversely affected if we have deficiencies in our disclosure controls and procedures or internal controls over financial reporting.**

The design and effectiveness of our disclosure controls and procedures and internal controls over financial reporting may not prevent all errors, misstatements, or misrepresentations. While management continues to review the effectiveness of our disclosure controls and procedures and internal controls over financial reporting, there can be no assurance that our disclosure controls and procedures or internal controls over financial reporting will be effective in accomplishing all control objectives all of the time. Deficiencies, particularly material weaknesses, in internal controls over financial reporting which may occur in the future could result in misstatements of our results of operations, restatements of our financial statements, a decline in our stock price, or an otherwise material and adverse effect on our business, reputation, results of operation, financial condition, or liquidity.

Environmental protection laws that apply to properties that secure or underlie our loan portfolio could result in losses

## **Our risk management efforts may not be effective.**

We could incur substantial losses and our business operations could be disrupted if we are unable to effectively identify, manage, monitor, and mitigate financial risks, such as credit risk, interest rate risk, prepayment risk, liquidity risk, and other market-related risks, as well as operational risks related to our business, assets, and liabilities. Our risk management policies, procedures, and techniques may not be sufficient to identify all of the risks we are exposed to, mitigate the risks we have identified, or to identify additional risks to which we may become subject in the future.

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Some of our risk management efforts are carried out by entering into interest rate swaps and other derivatives intended to hedge against certain interest rate and other financial risks. These swaps and derivatives and generally entered into under agreements in which we make various representations and warranties and covenants and which contain various events of default or termination events. If we breach these agreements or if they otherwise terminate, we may suffer losses and we may, thereafter, not be hedged against certain financial risks that we had intended to hedge against. In addition, if we breach these agreements or they otherwise terminate, the circumstances that resulted in the breach or termination, or other circumstances, may prevent us from using other similar agreements that are already in place or from entering into replacement agreements to hedge against financial risk.

### **We could be harmed by misconduct or fraud that is difficult to detect.**

We are exposed to risks relating to misconduct by our employees, contractors we use, or other third parties with whom we have relationships. For example, our employees could execute unauthorized transactions; use our assets improperly or without authorization; perform improper activities; use confidential information for improper purposes; or mis-record or otherwise try to hide improper activities from us. This type of misconduct could also relate to assets we manage for others through our investment advisory subsidiary. This type of misconduct can be difficult to detect and if not prevented or detected could result in claims or enforcement actions against us or losses. Accordingly, misconduct by employees, contractors, or others could subject us to financial losses or regulatory sanctions and seriously harm our reputation. Our controls may not be effective in detecting this type of activity.

### **Inadvertent errors could subject us to financial loss, litigation, or regulatory action.**

Our employees, contractors we use, or other third parties with whom we have relationships may make inadvertent errors that could subject us to financial losses, claims, or enforcement actions. These types of errors could include, but are not limited to, mistakes in executing, recording, or reporting transactions we enter into for ourselves or with respect to assets we manage for others. Inadvertent errors expose us to the risk of material losses until the errors are detected and remedied prior to the incurrence of any loss. The risk of errors may be greater for business activities that are new for us or have non-standardized terms.

### **Our business may be adversely affected if our reputation is harmed.**

Our business is subject to significant reputational risks. If we fail, or appear to fail, to address various issues that may affect our reputation, our business could be harmed. Issues could include real or perceived legal or regulatory violations or be the result of a failure in governance, risk-management, technology, or operations. Similarly, market rumors and actual or perceived association with counterparties whose own reputation is under question could harm our business. Claims of employee misconduct, wrongful termination, adverse publicity, conflict of interests, ethical issues, or failure to protect private information could also cause significant reputational damages. Such reputational damage could result not only in an immediate financial loss, but could also result in a loss of business relationships, the ability to raise capital, and the ability to access liquidity through borrowing facilities.

**Our financial results are determined and reported in accordance with accounting principles (and related conventions and interpretations) and are based on estimates and assumptions made in accordance with those principles, conventions, and interpretations. Furthermore, the amount of**

**dividends we are required to distribute is driven by the determination of our income in accordance with the Internal Revenue Code rather than generally accepted accounting principles, or GAAP.**

***Our reported GAAP financial results differ from the taxable income results that drive our dividend distribution requirements and, therefore, our GAAP results may not be an accurate indicator of future taxable income and dividend distributions.***

Generally, the cumulative income we report on an asset will be the same for GAAP and tax purposes, although the timing of this recognition over the life of the asset could be materially different. There are, however, certain permanent differences in the recognition of certain expenses under the respective accounting principles applied for GAAP and tax purposes and these differences could be material. Thus, the amount of

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GAAP earnings reported in any given period may not be indicative of future dividend distributions. A further explanation of differences between our GAAP and taxable income is presented in Management's Discussion and Analysis, which is set forth in Part II, Item 7 of this Annual Report on Form 10-K.

Our minimum dividend distribution requirements are determined under the REIT tax laws and are based on our taxable income as calculated for tax purposes pursuant to the Internal Revenue Code. Note that our Board of Directors may also decide to distribute more than is required based on these determinations. One should not expect that our retained GAAP earnings will equal cumulative distributions as the Board of Directors' dividend distribution decisions, permanent differences in GAAP and tax accounting, and even temporary differences will result in material differences in these balances.

***Over time, accounting principles, conventions, rules, and interpretations may change, which could affect our reported GAAP and taxable earnings and stockholders' equity.***

Accounting rules for the various aspects of our business change from time to time. Changes in GAAP, or the accepted interpretation of these accounting principles, can affect our reported income, earnings, and stockholders' equity. In addition, changes in tax accounting rules or the interpretations thereof could affect our taxable income and our dividend distribution requirements.

**Redwood has elected to be a REIT and, as such, is required to meet certain tests in order to maintain its REIT status. This adds complexity and costs to running our business and exposes us to additional risks.**

***Failure to qualify as a REIT would adversely affect our income and dividend distributions and could adversely affect the value of our common stock.***

We believe that we have met all requirements for qualification as a REIT for federal income tax purposes for all tax years since 1994 and we intend to continue to operate so as to qualify as a REIT in the future. However, many of the requirements for qualification as a REIT are highly technical and complex and require an analysis of particular facts and an application of the legal requirements to those facts in situations where there is only limited judicial and administrative guidance. Thus, no assurance can be given that the Internal Revenue Service or a court would agree with our conclusion that we have qualified as a REIT or that our factual situation and the law will allow us to remain qualified as a REIT. Furthermore, in an environment where assets may quickly change in value, previous planning for compliance with REIT qualification rules may be disrupted. If we failed to qualify as a REIT for federal income tax purposes and did not meet the requirements for statutory relief, we would be subject to federal income tax at regular corporate rates on all of our income and we could possibly be disqualified as a REIT for four years thereafter. If we were to become subject to federal income tax, we might not have, at that time, the liquid assets to pay the taxes due, which could result in our liquidating assets at unattractive prices. Failure to qualify as a REIT would adversely affect our dividend distributions and could adversely affect the value of our common stock.

***Maintaining REIT status and avoiding the generation of excess exclusion income may reduce our flexibility and could limit our ability to pursue certain opportunities. Failure to appropriately structure our business and***

***transactions to comply with laws and regulations applicable to REITs could have adverse consequences.***

To maintain REIT status, we must follow certain rules and meet certain tests. In doing so, our flexibility to manage our operations may be reduced. For instance:

If we make frequent asset sales from our REIT entities to persons deemed customers, we could be viewed as a dealer, and thus subject to 100% prohibited transaction taxes or other entity-level taxes on income from such transactions. Compliance with the REIT income and asset rules may limit the type or extent of financing or hedging that we can undertake.

Our ability to own non-real estate related assets and earn non-real estate related income is limited. Our ability to own equity interests in other entities is limited. If we fail to comply with these limits, we may be forced to liquidate attractive investments on short notice on unfavorable terms in order to maintain our REIT status.

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Our ability to invest in taxable subsidiaries is limited under the REIT rules. Maintaining compliance with this limit could require us to constrain the growth of our taxable REIT subsidiaries (TRS) in the future. Meeting minimum REIT dividend distribution requirements could reduce our liquidity. Earning non-cash REIT taxable income could necessitate our selling assets, incurring debt, or raising new equity in order to fund dividend distributions.

A REIT is limited in its ability to earn income that is treated as compensation for services. Furthermore, the rules we must follow and the tests we must satisfy to maintain our REIT status may change, or the interpretation of these rules and tests by the Internal Revenue Service may change.

In addition, historically, our stated goal has been to not generate excess inclusion income that would be taxable as unrelated business taxable income (UBTI) to our tax-exempt stockholders. Achieving this goal has limited, and may continue to limit, our flexibility in pursuing certain transactions or has resulted in, and may continue to result in, our having to pursue certain transactions through a taxable subsidiary, which reduces the net returns on these transactions by the associated tax liabilities. Despite our efforts to do so, we may not be able to avoid creating or distributing UBTI to our stockholders.

### **Changes in tax rules could adversely affect REITs and could adversely affect the value of our common stock.**

The requirements for maintaining REIT status or the taxation of REITs could change in a manner adverse to our operations. Rules regarding the taxation of dividends are enacted from time to time and future legislative or regulatory changes may limit the tax benefits afforded to REITs, either of which may reduce some of a REIT's competitive edge relative to non-REIT corporations. For example, federal legislation enacted in 2003 generally reduced the maximum federal tax rate for dividends payable to domestic stockholders that are individuals, trusts, and estates to 15% (extended through 2012); however, this legislation did not, as a general matter, reduce tax rates on dividends paid by REITs. Any future adverse changes could negatively affect our business and reduce the value of our common stock.

***The application of the tax code to our business is complicated and we may not interpret and apply some of the rules and regulations correctly. In addition, we may not make all available elections, which could result in our not being able to fully benefit from available deductions or benefits. Furthermore, the elections, interpretations and applications we do make could be deemed by the Internal Revenue Service (IRS) to be incorrect, and such rulings could have adverse impacts on our GAAP earnings and potentially on our REIT status.***

The U.S. tax code may change and/or the interpretation of the rules and regulations by the IRS may change. In circumstances where the application of these rules and regulations affecting our business is not clear, we may have to interpret them and their application to us. We seek the advice of outside tax advisors in arriving at these interpretations, but our interpretations may prove to be wrong, which could have adverse consequences.

Our tax payments and dividend distributions, when based on required dividend distributions, are based in large part on our estimate of taxable income which includes the application and interpretation of a variety of tax rules and regulations. While there are some relief provisions should we incorrectly interpret certain rules and regulations, we may not be able to fully take advantage of these provisions and this could have an effect on our REIT status. In addition, our GAAP earnings include tax provisions and benefits based on our estimates of taxable income and should

Changes in tax rules could adversely affect REITs and could adversely affect the value of our common stock.

our estimates prove to be wrong, we would have to make an adjustment to our taxable provisions and this adjustment could be material.

**Our decisions about raising, managing, and distributing our capital may adversely affect our business and results of operations. Furthermore, our growth may be limited if we are not able to raise additional capital.**

As a REIT we are required to distribute at least 90% of our REIT taxable income. Thus, we do not generally have the ability to retain earnings and we rely on our ability to raise capital to grow. We may raise capital through the issuance of new shares of our common stock, either through our direct stock purchase and dividend reinvestment plan or through secondary offerings. We may also raise capital by issuing other types of

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securities, such as preferred stock or convertible subordinated notes, or by taking on debt. As of January 1, 2012, we have approximately 21,455,318 million additional shares of stock authorized for issuance under our charter, which establishes a limit on the amount of capital we can raise through issuances of shares of stock unless we seek and receive approval from our stockholders to increase the authorized number of our shares in our charter. Also, certain stock change of ownership tests, which could impact our future use of tax losses, may limit our ability to raise significant amounts of equity capital.

In addition, we may not be able to raise capital at times when we see opportunities to employ capital. Many of the same factors that could make the pricing for investments in real estate loans and securities attractive, such as the availability of assets from distressed owners who need to liquidate them at reduced prices, and uncertainty about credit risk, housing, and the economy, may limit investors' and lenders' willingness to provide us with additional capital. There may be other reasons we are not able to raise capital and, as a result, may not be able to finance growth in our business and in our portfolio of assets. If we are unable to raise capital and expand our portfolio of investments, our growth may be limited, we may have to forgo attractive investment opportunities, and our operating expenses may increase significantly relative to our capital base.

To the extent we have capital that is available for investment, we have broad discretion over how to invest that capital and you will be relying on the judgment of our management regarding its use. To the extent we invest capital in our business or in portfolio assets, we may not be successful in achieving favorable returns.

**Conducting our business in a manner so that we are exempt from registration under and compliance with the Investment Company Act of 1940, as amended (Investment Company Act), may reduce our flexibility and could limit our ability to pursue certain opportunities. At the same time, failure to continue to qualify for exemption from the Investment Company Act could adversely affect us.**

Under the Investment Company Act, an investment company is required to register with the SEC and is subject to extensive restrictive and potentially adverse regulations relating to, among other things, operating methods, management, capital structure, dividends, and transactions with affiliates. However, companies primarily engaged in the business of acquiring mortgages and other liens on and interests in real estate are exempt from the requirements of the Investment Company Act. We believe that we have conducted our business so that we are exempt from the Investment Company Act. In order to continue to do so, however, we must, among other things, maintain at least 55% of our assets in certain qualifying real estate assets (the 55% Requirement) and we are also required to maintain an additional 25% of our assets in such qualifying real estate assets or certain other types of real estate-related assets (the 25% Requirement). Rapid changes in the values of assets we own, however, can disrupt prior efforts to conduct our business to meet these requirements. Our efforts to comply with the 55% Requirement and the 25% Requirement may reduce our flexibility and could limit our ability to pursue certain opportunities.

If we failed to meet the 55% Requirement and the 25% Requirement, we could, among other things, be required either (i) to change the manner in which we conduct our operations to avoid being required to register as an investment company or (ii) to register as an investment company, either of which could adversely affect us by, among other things, requiring us to dispose of certain assets or to change the structure of our business in ways that we may not believe to be in our best interests. Legislative or regulatory changes relating to the Investment Company Act or which affect our efforts to comply with the 55% Requirement and the 25% Requirement could also result in these or other adverse effects on us, including, without limitation, those discussed further below.

Our decisions about raising, managing, and distributing our capital may adversely affect our business and results of

If we were deemed an unregistered investment company, we could be subject to monetary penalties and injunctive relief and we could be unable to enforce contracts with third parties and third parties could seek to obtain rescission of transactions undertaken during the period we were deemed an unregistered investment company, unless the court found that under the circumstances, enforcement (or denial of rescission) would produce a more equitable result than no enforcement (or grant of rescission) and would not be inconsistent with the Investment Company Act.

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***A recently initiated SEC review of the section of the Investment Company Act and the regulations and regulatory interpretations promulgated thereunder that we rely on to exempt us from regulation under the Investment Company Act could eventually result in regulatory changes, which could require us to change our business and operations in order for us to continue to rely on that exemption or operate without the benefit of that exemption.***

On August 31, 2011, the SEC published a Concept Release within which it reviewed interpretive issues under the Investment Company Act relating to the status under the Investment Company Act of companies that are engaged in the business of acquiring mortgages and mortgage-related instruments and that rely on the exemption set forth in Section 3(c)(5)(C) of the Investment Company Act from requirements under the Investment Company Act. Among other things, the SEC is concerned that certain types of mortgage-related pools today appear to resemble in many respects investment companies such as closed-end funds and may not be the kinds of companies that were intended to be excluded from regulation under the Investment Company Act by Section 3(c)(5)(C). Although we believe that we are properly relying on Section 3(c)(5)(C) of the Investment Company Act to exempt us from regulation under the Investment Company Act, this SEC review could eventually affect our ability to rely on that exemption or could eventually require us to change our business and operations in order for us to continue to rely on that exemption. Even if the SEC review of this exemption does not eventually have these effects on us, in the interim, while the SEC is carrying out its review, any uncertainty created by the SEC's review could negatively impact the ability of companies, such as us, that rely on this exemption to raise capital or borrow money, which could negatively impact our business and results of operations.

**Provisions in our charter and bylaws and provisions of Maryland law may limit a change in control or deter a takeover that might otherwise result in a premium price being paid to our stockholders for their shares in Redwood.**

In order to maintain our qualifications as a REIT, not more than 50% in value of our outstanding capital stock may be owned, actually or constructively, by five or fewer individuals (defined in the Internal Revenue Code to include certain entities). In order to protect us against risk of losing our status as a REIT due to concentration of ownership among our stockholders and for other reasons, our charter generally prohibits any single stockholder, or any group of affiliated stockholders, from beneficially owning more than 9.8% of the outstanding shares of any class of our stock, unless our Board of Directors waives or modifies this ownership limit. This limitation may have the effect of precluding an acquisition of control of us by a third party without the consent of our Board of Directors. As of February 23, 2012, our Board of Directors has granted a waiver to one institutional shareholder to own shares in excess of this 9.8% limit, which waiver is subject to certain terms and conditions. Our Board of Directors may amend this existing waiver to permit additional share ownership or may grant waivers to additional stockholders at any time.

Certain other provisions contained in our charter and bylaws and in the Maryland General Corporation Law (MGCL) may have the effect of discouraging a third-party from making an acquisition proposal for us and may therefore inhibit a change in control. For example, our charter includes provisions granting our Board of Directors the authority to issue preferred stock from time to time and to establish the terms, preferences, and rights of the preferred stock without the approval of our stockholders. In addition, provisions in our charter and the MGCL restrict our stockholders' ability to remove directors and fill vacancies on our Board of Directors and restrict unsolicited share acquisitions. Our charter provides that our Board of Directors is divided into three classes serving staggered terms of office of three years each, and thus at least two annual meetings of stockholders, instead of one, generally would be

required to effect a change in a majority of our directors. These provisions and others may deter offers to acquire our stock or large blocks of our stock upon terms attractive to our stockholders, thereby limiting the opportunity for stockholders to receive a premium for their shares over then-prevailing market prices.

**The ability to take action against our directors and officers is limited by our charter and bylaws and provisions of Maryland law and we may (or, in some cases, are obligated to) indemnify our current and former directors and officers against certain losses relating to their service to us.**

Our charter limits the liability of our directors and officers to us and to shareholders for pecuniary damages to the fullest extent permitted by Maryland law. In addition, our charter authorizes our Board of

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Directors to indemnify our officers and directors (and those of our subsidiaries or affiliates) for losses relating to their service to us to the full extent required or permitted by Maryland law. Our bylaws require us to indemnify our officers and directors (and those of our subsidiaries and affiliates) to the maximum extent permitted by Maryland law in the defense of any proceeding to which he or she is made, or threatened to be made, a party because of his or her service to us. In addition, we have entered into, and may in the future enter into, indemnification agreements with our directors and certain of our officers and the directors and certain of the officers of certain of our subsidiaries and affiliates which obligate us to indemnify them against certain losses relating to their service to us and the related costs of defense.

### **Investing in our common stock may involve a high degree of risk. Investors in our common stock may experience losses, volatility, and poor liquidity, and we may reduce our dividends in a variety of circumstances.**

An investment in our common stock may involve a high degree of risk, particularly when compared to other types of investments. Risks related to the economy, the financial markets, our industry, our investing activity, our other business activities, our financial results, the amount of dividends we distribute, the manner in which we conduct our business, and the way we have structured and limited our operations could result in a reduction in, or the elimination of, the value of our common stock. The level of risk associated with an investment in our common stock may not be suitable for the risk tolerance of many investors. Investors may experience volatile returns and material losses. In addition, the trading volume of our common stock (*i.e.*, its liquidity) may be insufficient to allow investors to sell their common stock when they want to or at a price they consider reasonable.

Our earnings, cash flows, book value, and dividends can be volatile and difficult to predict. Investors in our common stock should not rely on our estimates, projections, or predictions, or on management's beliefs about future events. In particular, the sustainability of our earnings and our cash flows will depend on numerous factors, including our level of investment activity, our access to debt and equity financing, the returns we earn, the amount and timing of credit losses, prepayments, the expense of running our business, and other factors, including risk factors described herein. As a consequence, although we seek to pay a regular common stock dividend rate that is sustainable, we may reduce our regular dividend rate, or stop paying dividends, in the future for a variety of reasons. We may not provide public warnings of dividend reductions prior to their occurrence. Although we have paid special dividends in the past, we have not paid a special dividend since 2007 and we may not do so in the future. Changes to the amount of dividends we distribute may result in a reduction in the value of our common stock.

### **A limited number of institutional shareholders own a significant percentage of our common stock, which could have adverse consequences to other holders of our common stock.**

As of December 31, 2011, based on filings of Schedules 13D and 13G with the SEC, we believe that four institutional shareholders each owned in excess of 5% of our outstanding common stock and we believe based on data obtained from other public sources that, overall, 25 institutional shareholders owned, in the aggregate, approximately two-thirds of our outstanding common stock. Furthermore, one or more of these investors or other investors could significantly increase their ownership of our common stock. Significant ownership stakes held by these individual institutions or other investors could have adverse consequences for other stockholders because each of these stockholders will have a significant influence over the outcome of matters submitted to a vote of our stockholders, including the election of our directors and transactions involving a change in control. In addition, should any of these significant shareholders determine to liquidate all or a significant portion of their holdings of our common stock, it

The ability to take action against our directors and officers is limited by our charter and bylaws and provisions of Mar

could have an adverse effect on the market price of our common stock.

Although, under our charter, stockholders are generally precluded from beneficially owning more than 9.8% of our outstanding common stock, we have granted a limited waiver of this restriction to one institutional shareholder. We may amend this agreement or enter into other agreements with other shareholders in the future, in each case in a manner which may allow for increases in the concentration of the ownership of our common stock held by one or more stockholders.



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**Future sales of our common stock by us or by our officers and directors may have adverse consequences for investors.**

We may issue additional shares of common stock in subsequent public offerings or private placements. In addition, we may issue additional shares of common stock to participants in our direct stock purchase and dividend reinvestment plan and to our directors, officers, and employees under our employee stock purchase plan and our incentive plan, including upon the exercise of, or in respect of, distributions on equity awards previously granted thereunder. We are not required to offer any such shares to existing stockholders on a preemptive basis. Therefore, it may not be possible for existing stockholders to participate in future share issuances, which may dilute existing stockholders' interests in us. In addition, if market participants buy shares in issuances by us in the future, it may reduce or eliminate any purchases of our common stock they might otherwise make in the open market, which in turn could have the effect of reducing the volume of shares of our common stock traded in the marketplace, which could have the effect of reducing the market price and liquidity of our common stock.

As of December 31, 2011, our current directors and executive officers beneficially owned, in the aggregate, approximately 1.71% of our common stock. Sales of shares of our common stock by certain of these individuals are required to be publicly reported and are tracked by many market participants as a factor in making their own investment decisions. As a result, future sales by these individuals could negatively affect the market price of our common stock.

**There is a risk that you may not receive dividend distributions or that dividend distributions may decrease over time. Changes in the amount of dividend distributions we pay or in the tax characterization of dividend distributions we pay may adversely affect the market price of our common stock.**

Our dividend distributions are driven by a variety of factors, including our minimum dividend distribution requirements under the REIT tax laws and our REIT taxable income as calculated for tax purposes pursuant to the Internal Revenue Code. We generally intend to distribute to our stockholders at least 90% of our REIT taxable income, although our reported financial results for GAAP purposes may differ materially from our REIT taxable income.

For 2011, we maintained our regular dividend at a rate of \$0.25 per share per quarter and in November 2011 our Board of Directors announced its intention to continue to pay regular dividends during 2012 at a rate of \$0.25 per share per quarter. Our ability to pay a dividend of \$0.25 per share per quarter in 2012 may be adversely affected by a number of factors, including the risk factors described herein. These same factors may affect our ability to pay other future dividends. In addition, to the extent we determine that future dividends would represent a return of capital to investors, rather than the distribution of income, we may determine to discontinue dividend payments until such time that dividends would again represent a distribution of income. Any reduction or elimination of our payment of dividend distributions would not only reduce the amount of dividends you would receive as a holder of our common stock, but could also have the effect of reducing the market price of our common stock. In addition, the characterization of our dividend — be it ordinary income, capital gains, or a return of capital — could have an impact on the market price of our common stock.

**The market price of our common stock could be negatively affected by various factors, including broad market fluctuations.**

The market price of our common stock may be negatively affected by various factors, which change from time to time. Some of these factors are:

Our actual or anticipated financial condition, performance, and prospects and those of our competitors.

The market for similar securities issued by other REITs and other competitors of ours.

Changes in recommendations or in estimated financial results published by securities analysts who provide research to the marketplace on us, our competitors, or our industry.

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General economic and financial market conditions, including, among other things, actual and projected interest rates, prepayments, and credit performance and the markets for the types of assets we hold or invest in.

Proposals to significantly change the manner in which financial markets, financial institutions, and related industries, or financial products are regulated under applicable law, or the enactment of such proposals into law or regulation.

Other events or circumstances which undermine confidence in the financial markets or otherwise have a broad impact on financial markets, such as the sudden instability or collapse of large financial institutions or other significant corporations (whether due to fraud or other factors), terrorist attacks, natural or man-made disasters, or threatened or actual armed conflicts.

Furthermore, these fluctuations do not always relate directly to the financial performance of the companies whose stock prices may be affected. As a result of these and other factors, investors who own our common stock could experience a decrease in the value of their investment, including decreases unrelated to our financial results or prospects.

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## **ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

## **ITEM 2. PROPERTIES**

At December 31, 2011, we had two separately issued leases in effect for our principal executive and administrative office located at One Belvedere Place, Mill Valley, California 94941. In the third quarter of 2011, we entered into a single, co-terminus lease agreement for our principal executive and administrative office that will replace our existing leases. The new lease, which goes into effect in the second quarter of 2012, will expire in 2018. The 2012 rent obligation for this lease is \$1.6 million. Additionally, we have one lease for administrative offices at 1114 Avenue of the Americas 34 Floor, New York, NY 10036, which expires in 2015. The 2012 rent obligation for this lease is \$0.3 million.

## **ITEM 3. LEGAL PROCEEDINGS**

On December 23, 2009, the Federal Home Loan Bank of Seattle (the FHLB-Seattle) filed a claim in Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. (SRF), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the FHLB-Seattle Defendants). The FHLB-Seattle alleges claims under the Securities Act of Washington (Section 21.20.005, et seq.) and seeks to rescind the purchase of a mortgage pass-through certificate (or, residential mortgage backed securities, RMBS) issued through our Sequoia RMBS platform as part of the Sequoia Mortgage Trust 2005-4 securitization transaction and purchased by the FHLB-Seattle. The FHLB-Seattle also seeks to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received), as well as attorneys' fees and costs. On June 10, 2010, the FHLB-Seattle filed an amended complaint. Subsequently, on October 18, 2010, the FHLB-Seattle Defendants filed motions to dismiss the FHLB-Seattle's complaint. Redwood Trust, Inc. and SRF additionally moved to dismiss the complaint for lack of personal jurisdiction. The FHLB-Seattle alleges that the FHLB-Seattle Defendants' offering materials for this RMBS contained materially untrue statements and omitted material facts about this RMBS and the loans securitized in this transaction. Among other things, the FHLB-Seattle alleges that the FHLB-Seattle Defendants made untrue statements or omissions regarding the (1) loan-to-value ratios of these mortgage loans and the appraisals of the properties that secured these mortgage loans, (2) occupancy status of those properties, (3) underwriting standards of the originators of these mortgage loans, and (4) ratings assigned to this RMBS. In a series of rulings issued between June 23, 2011 and August 15, 2011, the Washington State Superior Court dismissed the allegations relating to occupancy status and denied other grounds for dismissal. On July 19, 2011, the Court granted Redwood Trust, Inc. and SRF's motion to dismiss for lack of personal jurisdiction. Redwood Trust, Inc. does not know whether the FHLB-Seattle will appeal or otherwise contest the dismissal, or file a claim in another jurisdiction. The Sequoia RMBS that is the subject of the FHLB-Seattle's claim was issued with an original principal amount of approximately \$133 million and, at December 31, 2011, had a remaining outstanding principal amount of approximately \$28 million. We believe that this claim is without merit and we intend to defend any action related to it vigorously. In connection with the issuance of the Sequoia RMBS that is the subject of the FHLB-Seattle's claim, Redwood agreed to indemnify the underwriters of this RMBS for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. The FHLB-Seattle's claims against the underwriters of this RMBS were not dismissed for lack of personal jurisdiction. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

On August 18, 2010, Redwood Trust, Inc.'s subsidiary, SRF, received service of process with respect to a claim filed on July 15, 2010 in Superior Court for the State of California in San Francisco (case number CGC-10-501610) by The Charles Schwab Corporation (Schwab). In the complaint, Schwab is suing SRF and 26 other named defendants (collectively, the Schwab Defendants) in relation to RMBS sold or issued by the Schwab Defendants. With respect to SRF, Schwab alleges a cause of action of negligent misrepresentation under California state law and seeks unspecified damages and attorneys' fees and costs with respect to a RMBS issued through the Sequoia RMBS platform as part of the Sequoia Mortgage Trust 2005-4 securitization transaction (which is the same transaction at issue in the litigation initiated by the FHLB-Seattle described in the preceding paragraph). Among other things, Schwab alleges that the offering materials for this

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Sequoia RMBS contained materially untrue statements or omissions regarding this RMBS and the loans securitized in this securitization transaction, including untrue statements or omissions regarding the (1) loan-to-value ratios of these mortgage loans and the appraisals of the properties that secured these mortgage loans, (2) occupancy status of those properties, (3) underwriting standards of the originators of these mortgage loans, and (4) ratings assigned to this RMBS. On September 22, 2011, the Schwab Defendants moved to dismiss the complaint, and on January 27, 2011, the California State Superior Court denied the motion on several grounds, and with respect to certain other grounds gave Schwab the opportunity to amend the complaint. The Sequoia RMBS that is the subject of Schwab's claim was issued with an original principal amount of approximately \$14.8 million and, at December 31, 2011, had a remaining outstanding principal amount of approximately \$3.1 million. We believe that this case is without merit and we intend to defend the action vigorously. In connection with the issuance of the Sequoia RMBS that is the subject of Schwab's claim, Redwood agreed to indemnify the underwriters of this RMBS for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses.

Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

On July 12, 2010, two notices of Election to Void Sale of Securities pursuant to Illinois Securities Law (815 ILCS Section 5/13(A)) were received from the Federal Home Loan Bank of Chicago ( FHLB-Chicago ). In the notices, the FHLB-Chicago sought to void its purchase of two RMBS that were issued in 2006 by a securitization trust with respect to which Redwood Trust, Inc.'s subsidiary, SRF, was the depositor. Subsequently, on October 15, 2010, the FHLB-Chicago filed a claim in the Circuit Court of Cook County, Illinois (case number 10-CH-45033) against SRF and more than 45 other named defendants (collectively, the FHLB-Chicago Defendants ) in relation to RMBS sold or issued by the FHLB-Chicago Defendants or by entities controlled by the FHLB-Chicago Defendants. In an amended complaint filed on March 16, 2011, FHLB-Chicago added as defendants Redwood Trust, Inc. and another one of our subsidiaries, RWT Holdings, Inc. With respect to Redwood Trust, Inc. and SRF, the FHLB-Chicago alleges that the offering materials for two RMBS issued through the Sequoia RMBS platform as part of the Sequoia Mortgage Trust 2006-1 securitization transaction contained untrue and misleading statements and material misrepresentations in violation of Illinois Securities Law (815 ILCS Sections 5/12(F)-(H)) and North Carolina Securities Law (N.C.G.S.A. §78A-8(2) & §78A-56(a)) and also alleges a claim of negligent misrepresentations under Illinois common law. On some of the causes of action, the FHLB-Chicago seeks to rescind the purchase of these RMBS and to collect interest on the original purchase price at the statutory interest rate of 10% per annum from the date of original purchase (net of interest received). On one cause of action, the FHLB-Chicago seeks unspecified damages. The FHLB-Chicago also seeks attorneys' fees and costs. Among other things, the FHLB-Chicago alleges that the offering materials for this RMBS contained materially untrue statements or omissions regarding this RMBS and the loans securitized in this transaction, including untrue statements or omissions regarding the (1) loan-to-value ratios of these mortgage loans and the appraisals of the properties that secured these mortgage loans, (2) occupancy status of those properties, (3) underwriting standards of the originators of these mortgage loans, (4) ratings assigned to these RMBS, and (5) due diligence performed on these mortgage loans. The first of these two Sequoia RMBS was issued with an original principal amount of approximately \$105 million and, at December 31, 2011, had a remaining outstanding principal amount of approximately \$42 million. The second of these two Sequoia RMBS was issued with an original principal amount of approximately \$379 million and, at December 31, 2011, had a remaining outstanding principal balance of approximately \$152 million. On March 27, 2011, the FHLB-Chicago Defendants moved to dismiss the amended complaint, which motions are now pending. We believe that this case is without merit, and we intend to defend the action vigorously. In connection with the issuance of the Sequoia RMBS that is the subject of the FHLB-Chicago's claim, Redwood agreed to indemnify the underwriters of these RMBS for certain losses and expenses they might incur as a result of claims made against them relating to these RMBS, including, without limitation, certain legal expenses.

Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.



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In May 2010, we received an Order from the SEC, pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934. The SEC's Order required us to provide information regarding, among other things, our trading practices and valuation policies relating to our business of sponsoring and managing collateralized debt obligation issuers. We have responded to the Order. The Order from the SEC indicates that it should not be construed as an indication by the SEC or its staff that any violations of law have occurred. The SEC could, however, as a result of our response to this Order or otherwise, allege that we violated applicable law or regulation in the conduct of our collateralized debt obligation business.

In November 2009, we received a subpoena from the National Credit Union Administration (NCUA), which is the federal agency that charters and supervises federal credit unions, as part of its investigation of the circumstances relating to the U.S. Central Federal Credit Union being placed into conservatorship in March 2009, including the U.S. Central Federal Credit Union's investment in various RMBS. The NCUA requested information relating to, among other things, two RMBS (i) issued by a securitization trust with respect to which SRF was the depositor and (ii) purchased at the time of issuance by the U.S. Central Federal Credit Union. We have responded to the subpoena. The subpoena from the NCUA states that it should not be construed as an indication by the NCUA or its staff that any violation of law has occurred. The NCUA could, however, as a result of our response to this subpoena or otherwise, allege that we did violate applicable law or regulation in the conduct of our securitization business.

Other than as disclosed in the preceding paragraphs of this Item 3, there are no material pending legal proceedings, or material changes with respect to pending legal proceedings, in each case, to which we or any of our subsidiaries is a party or of which our property is the subject.

## **ITEM 4. Mine Safety Disclosures**

Not applicable.



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RELATED STOCKHOLDER MATTERS, AND ISSUER  
PURCHASES OF EQUITY SECURITIES**

Our common stock is listed and traded on the NYSE under the symbol RWT. At February 24, 2012, our common stock was held by approximately 1,056 holders of record and the total number of beneficial stockholders holding stock through depository companies was approximately 27,101 at February 4, 2012. At February 24, 2012, there were 78,544,682 shares of common stock outstanding.

The high and low sales prices of shares of our common stock, as reported by the Bloomberg Financial Markets service, and the cash dividends declared on our common stock for each full quarterly period during 2011 and 2010 were as follows:

|                                     | Stock Prices |          | Common Dividends Declared |              |           | Dividend Type |
|-------------------------------------|--------------|----------|---------------------------|--------------|-----------|---------------|
|                                     | High         | Low      | Record Date               | Payable Date | Per Share |               |
| <u>Year Ended December 31, 2011</u> |              |          |                           |              |           |               |
| Fourth Quarter                      | \$ 12.01     | \$ 9.74  | 12/15/2011                | 12/27/2011   | \$ 0.25   | Regular       |
| Third Quarter                       | \$ 15.41     | \$ 11.17 | 9/30/2011                 | 10/21/2011   | \$ 0.25   | Regular       |
| Second Quarter                      | \$ 15.93     | \$ 14.66 | 6/30/2011                 | 7/21/2011    | \$ 0.25   | Regular       |
| First Quarter                       | \$ 17.16     | \$ 14.82 | 3/31/2011                 | 4/21/2011    | \$ 0.25   | Regular       |
| <u>Year Ended December 31, 2010</u> |              |          |                           |              |           |               |
| Fourth Quarter                      | \$ 15.55     | \$ 13.80 | 12/31/2010                | 1/21/2011    | \$ 0.25   | Regular       |
| Third Quarter                       | \$ 16.25     | \$ 13.49 | 9/30/2010                 | 10/21/2010   | \$ 0.25   | Regular       |
| Second Quarter                      | \$ 17.25     | \$ 13.75 | 6/30/2010                 | 7/21/2010    | \$ 0.25   | Regular       |
| First Quarter                       | \$ 15.84     | \$ 13.22 | 3/31/2010                 | 4/21/2010    | \$ 0.25   | Regular       |

All dividend distributions are made with the authorization of the board of directors at its discretion and will depend on such items as our REIT taxable earnings, financial condition, maintenance of REIT status, and other factors that the board of directors may deem relevant from time to time. The holders of our common stock share proportionally on a per share basis in all declared dividends on common stock. As reported on a Current Report on Form 8-K on January 30, 2012, for dividend distributions made in 2011, 25% are expected to be characterized as ordinary income and 75% will be characterized as a return of capital for income tax purposes.

We announced a stock repurchase plan on November 5, 2007, for the repurchase of up to a total of 5,000,000 shares.

This plan replaced all previous share repurchase plans and has no expiration date. The following table contains information on the shares of our common stock that we purchased during the year ended December 31, 2011, as well as other restricted share activity as footnoted in the table below.

| Total Number of Shares | Average Price per Share | Total Number of Shares Purchased as | Maximum Number (or Approximate |
|------------------------|-------------------------|-------------------------------------|--------------------------------|
|------------------------|-------------------------|-------------------------------------|--------------------------------|

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|                                        | Purchased              | Paid     | Part of Publicly Announced Plans or Programs | Dollar Value) of Shares that May Yet be Purchased Under the Plans or Programs |
|----------------------------------------|------------------------|----------|----------------------------------------------|-------------------------------------------------------------------------------|
| January 1, 2011 - January 31, 2011     | 6,741 <sup>(1)</sup>   | \$ 14.93 |                                              | 4,658,071                                                                     |
| February 1, 2011 - February 28, 2011   |                        |          |                                              | 4,658,071                                                                     |
| March 1, 2011 - March 31, 2011         | 29 <sup>(2)</sup>      | 0.01     |                                              | 4,658,071                                                                     |
| April 1, 2011 - June 30, 2011          |                        |          |                                              | 4,658,071                                                                     |
| July 1, 2011 - July 31, 2011           | 123 <sup>(1)</sup>     | 15.12    |                                              | 4,658,071                                                                     |
| August 1, 2011 - August 31, 2011       | 223,220 <sup>(3)</sup> | 12.09    | 222,386                                      | 4,435,685                                                                     |
| September 1, 2011 - September 30, 2011 | 36 <sup>(2)</sup>      | 0.01     |                                              | 4,435,685                                                                     |
| October 1, 2011 - October 31, 2011     |                        |          |                                              | 4,435,685                                                                     |
| November 1, 2011 - November 30, 2011   | 429,700                | 9.98     | 429,700                                      | 4,005,985                                                                     |
| December 1, 2011 - December 31, 2011   | 33 <sup>(2)</sup>      | 0.01     |                                              | 4,005,985                                                                     |
| Total                                  | 659,882                | \$ 10.73 | 652,086                                      | 4,005,985                                                                     |

(1) The 6,741 and 123 shares repurchased in January 2011 and July 2011, respectively, represent shares reacquired to satisfy tax withholding requirements on the vesting of restricted shares.

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- (2) The 29, 36, and 33 shares acquired in March 2011, September 2011, and December 2011, respectively, represent unvested shares forfeited upon termination of employees.
- (3) Includes 834 shares acquired in August 2011 due to unvested shares forfeited upon termination of employees. The following table provides information, as of December 31, 2011, with respect to compensation plans under which equity securities of the registrant are authorized for issuance.

| Plan Category                                         | Plan Name                         | Number of Securities to Be Issued upon Exercise of Outstanding Options, Warrants and Rights <sup>(1)</sup> | Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights <sup>(2)</sup> | Number of Securities Remaining Available for Future Issuance <sup>(3)</sup> |
|-------------------------------------------------------|-----------------------------------|------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------|
| Equity compensation plan approved by security holders | 2002 Incentive Plan               | 2,856,950                                                                                                  | \$ 53.91                                                                                   | 298,634                                                                     |
| Equity compensation plan approved by security holders | 2002 Employee Stock Purchase Plan |                                                                                                            |                                                                                            | 47,788                                                                      |
| Total                                                 |                                   | 2,856,950                                                                                                  | \$ 53.91                                                                                   | 346,422                                                                     |

At December 31, 2011, 2,476,171 shares of common stock may be issued pursuant to outstanding deferred stock units (of which 1,068,283 are vested and 1,407,888 are unvested) and 380,779 shares of common stock may be issued pursuant to outstanding options to purchase common stock (of which all are vested). This does not include shares of common stock that may be issued pursuant to 592,479 outstanding and unvested performance stock units.

- (1) Performance stock units are performance-based equity awards under which the number of shares of common stock that may be issued at the time of vesting will generally range from 0% to 200% of the number of PSUs granted based on the level of satisfaction of the applicable performance-based vesting condition over the vesting period, with the number of performance stock units granted being adjusted to reflect the value of any dividends paid on shares of common stock during the vesting period.

- (2) At December 31, 2011, the weighted average exercise price of outstanding options to purchase common stock was \$53.91. Under our 2002 Incentive Plan no exercise price is applicable to deferred stock units.

- Number of securities remaining available for future issuance does not reflect the awards made under the 2002 Incentive Plan since December 31, 2011 and does not include issuance of shares of common stock under the 2002 Employee Stock Purchase Plan since December 31, 2011.

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The following graph presents a cumulative total return comparison of our common stock, over the last five years, to the S&P Composite-500 Stock Index and the National Association of Real Estate Investment Trusts, Inc. (NAREIT) Mortgage REIT index. The total returns reflect stock price appreciation and the reinvestment of dividends for our common stock and for each of the comparative indices, assuming that \$100 was invested in each on December 31, 2006. The information has been obtained from sources believed to be reliable; but neither its accuracy nor its completeness is guaranteed. The total return performance shown on the graph is not necessarily indicative of future performance of our common stock.

**Five Year Cumulative Total Return Comparison  
December 31, 2006 through December 31, 2011**

|                            | 2006   | 2007   | 2008  | 2009  | 2010  | 2011  |
|----------------------------|--------|--------|-------|-------|-------|-------|
| Redwood Trust, Inc         | 100.00 | 67.51  | 33.59 | 34.76 | 38.36 | 28.26 |
| NAREIT Mortgage REIT Index | 100.00 | 58.08  | 39.84 | 49.67 | 60.88 | 59.37 |
| S&P Composite-500 Index    | 100.00 | 105.50 | 66.46 | 84.05 | 96.72 | 98.76 |

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The following selected financial data is qualified in its entirety by, and should be read in conjunction with, the more detailed information contained in the Consolidated Financial Statements and Notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Annual Report on Form 10-K and in our Annual Reports on Form 10-K as of and for each of the years ended December 31, 2010, 2009, 2008, and 2007. Certain amounts for prior periods have been reclassified to conform to the 2011 presentation.

| (In Thousands, Except Per Share Data)                                       | 2011        | 2010        | 2009        | 2008         | 2007           |
|-----------------------------------------------------------------------------|-------------|-------------|-------------|--------------|----------------|
| Selected Statement of Operations Data:                                      |             |             |             |              |                |
| Interest income                                                             | \$217,179   | \$230,054   | \$287,877   | \$567,545    | \$868,348      |
| Interest expense                                                            | (99,037 )   | (84,664 )   | (132,003 )  | (416,669 )   | (651,762 )     |
| Net interest income                                                         | 118,142     | 145,390     | 155,874     | 150,876      | 216,586        |
| Provision for loan losses                                                   | (16,151 )   | (24,135 )   | (49,573 )   | (55,111 )    | (12,808 )      |
| Market valuation adjustments, net                                           | (40,017 )   | (19,554 )   | (87,628 )   | (492,902 )   | (1,261,449 )   |
| Net interest income (loss) after provision and market valuation adjustments | 61,974      | 101,701     | 18,673      | (397,137 )   | (1,057,671 )   |
| Operating expenses                                                          | (47,682 )   | (53,715 )   | (46,995 )   | (60,906 )    | (58,555 )      |
| Realized gains on sales and calls, net                                      | 10,946      | 63,496      | 63,166      | 8,511        | 12,781         |
| (Provision for) benefit from income taxes                                   | (42 )       | (280 )      | 4,268       | 3,210        | (5,192 )       |
| Net income (loss)                                                           | 25,196      | 111,202     | 39,112      | (446,322 )   | (1,108,637 )   |
| Less: Net (loss) income attributable to noncontrolling interest             | (1,147 )    | 1,150       | (83 )       | (1,936 )     |                |
| Net Income (Loss) Attributable to Redwood Trust, Inc.                       | \$26,343    | \$110,052   | \$39,195    | \$(444,386 ) | \$(1,108,637 ) |
| Average common shares basic                                                 | 78,299,510  | 77,841,634  | 68,458,009  | 33,022,622   | 27,928,234     |
| Earnings (loss) per share basic                                             | \$0.31      | \$1.37      | \$0.56      | \$(13.46 )   | \$(39.70 )     |
| Average common shares diluted                                               | 78,299,510  | 78,810,949  | 68,990,891  | 33,022,622   | 27,928,234     |
| Earnings (loss) per share diluted                                           | \$0.31      | \$1.36      | \$0.55      | \$(13.46 )   | \$(39.70 )     |
| Regular dividends declared per common share                                 | \$1.00      | \$1.00      | \$1.00      | \$3.00       | \$3.00         |
| Special dividends declared per common share                                 | \$          | \$          | \$          | \$           | \$2.00         |
| Total dividends declared per common share                                   | \$1.00      | \$1.00      | \$1.00      | \$3.00       | \$5.00         |
| Selected Balance Sheet Data (at December 31):                               |             |             |             |              |                |
| Earning assets                                                              | \$5,613,753 | \$5,049,254 | \$5,090,188 | \$5,436,184  | \$9,695,240    |
| Total assets                                                                | \$5,743,298 | \$5,143,688 | \$5,252,650 | \$5,581,749  | \$9,938,472    |
| Short-term debt                                                             | \$428,056   | \$44,137    | \$          | \$           | \$7,561        |
| Asset-backed securities issued                                              | \$219,551   | \$          | \$          | \$           | \$             |
| Resecuritization                                                            |             |             |             |              |                |

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|                                               |             |             |             |             |              |
|-----------------------------------------------|-------------|-------------|-------------|-------------|--------------|
| Asset-backed securities issued Sequoia        | \$3,710,423 | \$3,458,501 | \$3,644,933 | \$4,508,127 | \$6,946,166  |
| Asset-backed securities issued Acacia         | \$209,381   | \$303,077   | \$297,596   | \$346,931   | \$3,383,113  |
| Long-term debt                                | \$139,500   | \$139,500   | \$140,000   | \$150,000   | \$150,000    |
| Total liabilities                             | \$4,850,714 | \$4,068,096 | \$4,263,559 | \$5,257,286 | \$10,656,751 |
| Noncontrolling interest                       | \$          | \$10,839    | \$17,370    | \$22,611    | \$           |
| Total stockholders equity (deficit)           | \$892,584   | \$1,064,753 | \$971,721   | \$301,852   | \$(718,279 ) |
| Number of common shares outstanding           | 78,555,908  | 78,124,668  | 77,737,130  | 33,470,557  | 32,385,073   |
| Book value per common share                   | \$11.36     | \$13.63     | \$12.50     | \$9.02      | \$(22.18 )   |
| Other Selected Data:                          |             |             |             |             |              |
| Average assets                                | \$5,357,065 | \$5,196,293 | \$5,329,461 | \$8,026,050 | \$12,177,451 |
| Average debt and ABS issued outstanding       | \$4,148,421 | \$4,011,855 | \$4,461,745 | \$7,386,690 | \$11,322,898 |
| Average stockholders equity                   | \$1,003,523 | \$1,008,126 | \$729,032   | \$556,354   | \$723,807    |
| Net income (loss)/average stockholders equity | 2.6         | % 10.9      | % 5.4       | % (79.9 )%  | (153.2 )%    |

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## **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

### **Our Business**

Redwood invests in, finances, and manages real estate assets. We seek to invest in assets that have the potential to generate sufficient long-term cash flow returns to support our goal of distributing an attractive level of dividends per share to shareholders over time.

We primarily invest in residential mortgage loans, commercial loans and other forms of commercial real estate financing, and in securities collateralized by real estate loans (which are securities issued in securitization transactions and which are also referred to as mortgage-backed securities). Our investments in residential mortgage loans are generally made with a view towards securitizing those loans through a Sequoia securitization entity or selling those loans to third parties. Our investments in commercial loans are generally held for investment and not secured by real property. The mortgage-backed securities we typically invest in include senior securities, which are those interests in a mortgage securitization that generally have the first right to cash flows and are generally last to absorb losses, and subordinate securities, which are those interests in a mortgage securitization that generally have the last right to cash flows and are generally first in line to absorb losses. Some of the securities we invest in are re-REMIC support securities, which are securities that are generally created through the resecuritization of senior mortgage-backed securities. Re-REMIC support securities are subordinate to, and provide credit support for, the senior re-REMIC securities issued in a resecuritization. We also invest in other assets, securities, and instruments that are related to residential and commercial real estate.

Securities collateralized by residential mortgage loans, which we also refer to as residential securities, that we invest in are generally acquired by us from third parties or by retaining mortgage-backed securities issued by Sequoia securitization trusts, which are securitization entities we sponsor. The process of sponsoring a Sequoia securitization includes the acquisition of residential loans, which are originated by third parties and generally funded with equity and short-term debt while being accumulated for securitization, the transfer of a pool of those loans to a Sequoia securitization entity, and the structuring and issuance by the Sequoia securitization entity of mortgage-backed securities collateralized by that pool of loans. Senior securities issued by Sequoia securitization entities are generally issued to third parties, while some or all of the subordinate securities issued by these entities are generally retained by us. From time to time we may also invest in senior interest-only ( IO ) securities issued by a Sequoia securitization entity. These IO securities receive interest payments (but no principal payments) related to securitized residential mortgage loans.

Our investments in commercial loans and other forms of commercial real estate financing generally result from our origination of subordinate financing for commercial real estate. Subordinate financing for commercial real estate can take the form of mezzanine loans or subordinate mortgage loans and can also take the form of preferred equity interests in special purpose entities that own commercial real estate. In addition to directly originating commercial loans and directly providing preferred equity financing, we may invest in commercial loans and financing originated by others (including through ownership of commercial mortgage-backed securities).

Our primary source of income is net interest income from our investments in real-estate related assets of the types described above. This net interest income consists of the interest income we earn from our investments less the interest expenses we incur on borrowed funds and other liabilities. We assume a range of risks in our investments and the level of risk is influenced by the manner in which we finance our purchases of, and derive income from, our

investments.

Throughout our history we have sponsored other investment entities that include a private limited partnership fund that we managed, the Redwood Opportunity Fund, LP (the Fund), as well as Acacia securitization entities, certain of which we continue to manage. The Fund was invested in real estate securities and the Acacia entities are primarily invested in a variety of real estate related assets. We are not currently seeking to sponsor other entities like the Fund or the Acacia securitization entities. During the third quarter of 2011, we engaged in a resecuritization transaction primarily for the purpose of obtaining permanent non-recourse financing on a portion of our residential securities portfolio. Many of the entities we have sponsored or managed are currently, or have been historically, recorded on our consolidated balance sheets for

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financial reporting purposes based upon applicable accounting guidance set forth by Generally Accepted Accounting Principles in the United States ( GAAP ). However, each of these securitization entities is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of ours, although we are exposed to certain financial risks associated with our role as the sponsor or manager of these entities.

For tax purposes, we are structured as a REIT. As a REIT, we are able to pass through substantially all of our earnings to our stockholders without paying income tax at the corporate level. We pay income tax on the REIT taxable income we retain and on the income we earn at our taxable subsidiaries.

**Business Update Fourth Quarter 2011**

We continued to make operational progress in the fourth quarter of 2011. We added warehouse financing lines for the residential loan business and continued to add loan sellers. We originated \$60 million of commercial loans in the fourth quarter, more than in any quarter since we began rebuilding our commercial platform in 2009. Still, progress is not apparent in our financial results. We reported a GAAP loss of \$3 million, or \$0.03 per share, for the fourth quarter of 2011, as compared to net income of \$1 million, or \$0.01 per share, for the third quarter of 2011. This loss reflected impairments on securities and a higher loan loss provision, as well as continued (albeit lower) negative market valuation adjustments related to the cost of managing risks associated with our pipeline of residential loans that we either purchased or planned to purchase.

Book value declined by \$0.86 per share in the fourth quarter to \$11.36 at December 31, 2011, as compared to \$12.22 at September 30, 2011. The \$67 million decline in book value during the quarter was attributable to unrealized losses on securities (\$44 million or roughly two-thirds of the decline) and the impact of paying out dividends in excess of earnings (\$23 million or roughly one-third of the decline). From January 1, 2012 through mid-February 2012, we estimate that approximately \$22 million of the unrealized losses on securities in the fourth quarter was recovered due to the recent rally in RMBS prices.

Looking ahead, our focus for 2012 includes: (i) improving our capital efficiency and enhancing the returns on our existing investments by funding all residential loans through warehouse lines, applying prudent financial leverage to our residential securities portfolio, and obtaining debt financing for our commercial loan portfolio; (ii) fully investing our excess capital at attractive yields; and, (iii) continuing to enhance the franchise value of our residential and commercial loan businesses. We expect, overall, to invest \$375 to \$500 million of capital in 2012 and believe we can generate the capital needed for the vast majority of this overall 2012 investment activity as well as our intended 2012 dividends on existing shares of common stock through cash from operations, principal payments from our investments, asset sales, and debt financing we expect to obtain for our commercial loan portfolio.

We expect that our planned increase in investment activity, net of our additional funding costs (excluding the Other Consolidated Entities), would positively affect net interest income in the second half of 2012. We also expect an increased pace of loan acquisitions in our residential loan business in 2012 and an increased number of residential securitizations relative to 2011. We may additionally sell some of our residential loans to whole loan buyers rather than securitize them. Still, we expect it will take time to fully benefit from investing our excess capital and, although we expect an improvement in profitability over the course of 2012, we project that any improvement would be more apparent towards the end of 2012.

### **Residential Loan Business**

We continue to make steady operating progress in our residential loan business adding loan sellers, buying loans, and establishing financing relationships. We currently have twenty active sellers. We acquired \$175 million (principal balance) of loans in the fourth quarter of 2011, as compared to \$405 million in loans purchased in the third quarter of 2011. At December 31, 2011, there were \$393 million held-for-sale residential loans recorded on our consolidated balance sheet and another \$460 million in loans at various stages of origination that we planned to purchase. We did not sponsor a residential securitization in the fourth quarter of 2011. Rather, we prepared for the \$416 million securitization that we completed in January 2012. At February 15, 2012, loans purchased and held on our balance sheet for future securitization totaled \$240 million and the pipeline of residential mortgage loans we plan to purchase totaled \$461 million.

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Of the \$428 million in short-term debt on our balance sheet at December 31, 2011, \$307 million related to warehouse facilities used to finance the accumulation of residential loans. We plan to finance residential loans with warehouse facilities to reduce the equity capital needed to fund loans. This may enable us to invest additional equity capital in higher-yielding residential securities and commercial loans.

In the long run, we believe our loan conduit and securitization platform will deliver attractive value to shareholders both as a potential profit center from its stand-alone activities and as a source of attractive investment securities for our portfolio business. The stand-alone activities could include the acquisition of residential whole loans from originators for sale to newly-created Sequoia securitization entities that create and sell securities backed by these loans. We may also sell these whole loans through bulk sale transactions if pricing is more attractive than issuing a securitization.

We may also use our conduit sourcing relationships to acquire and sell loans for a fee under private label investor programs and potentially for sourcing loans for sale to Government Sponsored Enterprises (GSEs). Our residential loan business has garnered interest from policymakers, federal regulators, and other market participants, and facilitated business opportunities that we may not have otherwise had the chance to consider.

Our objective for 2012 is to acquire approximately \$2 billion of residential loans from thirty to forty originators. We are now planning four to six securitization transactions, including one transaction that we completed in January 2012. Our business decision either to securitize or sell as whole loans the residential loans we accumulate remains fluid and will be based on balancing our best value execution and the potential franchise value of building out our securitization platform.

### **Residential Portfolio Business**

Prices for residential mortgage-backed securities (RMBS) generally trended downward from April 2011 through December 2011. A generally greater aversion to risk by investors appeared to be the biggest driver of the price declines, although decreased availability of financing for RMBS acquisitions may have also played a role. Over the period from April through December 2011, the steepest price declines in RMBS were in those backed by lower-quality subprime and Alt-A collateral. Market pricing for RMBS has since firmed in early 2012.

During the fourth quarter of 2011, we invested \$38 million in third-party RMBS. We did not acquire securities created through our residential loan business in the fourth quarter, as we did not sponsor a securitization in the fourth quarter of 2011. We continue to work to source attractive third-party RMBS investments through competitive bidding against Wall Street firms and other market participants, as we have done throughout our history. Competition from other bidders is likely to be significant in 2012, however, as the overall supply of private-label RMBS continues to decline. The outstanding balance of private-label RMBS has declined from over \$2 trillion in 2007 to approximately \$1 trillion today. We have issued the only four new private-label residential securitizations backed by prime residential loans since the onset of the financial crisis. The limited supply dynamic may support asset prices (barring idiosyncratic and other risks, which could materialize), but over time will likely produce a headwind to sourcing attractive residential securities investments solely through the competitive bidding process.

For 2012, we expect to invest \$100 million of capital in third-party RMBS and \$75 to \$100 million of capital in new Sequoia securitizations. Through February 15, 2012, we made \$104 million of long-term investments in RMBS that included \$66 million of third-party RMBS, and \$38 million of securities from our Sequoia securitization in January 2012. We financed these investments with a combination of short-term debt and \$50 million of equity. We did not sell assets in the fourth quarter of 2011. In the first quarter of 2012, through February 15, 2012, we sold \$42 million market value of RMBS for an anticipated \$5 million realized gain for GAAP reporting purposes.

We expect the GAAP yields on new equity capital invested in residential securities during 2012 to range from 11% to 14%, after giving effect to our planned use of short-term debt financing for these investments. These figures are estimates, as the markets and our investment opportunities remain fluid. We generally intend to more efficiently deploy the equity capital held against our securities portfolio in 2012 by using what we believe to be modest short-term debt financing and in some cases selling securities that no longer fit our portfolio strategy.

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### **Commercial Loan Business**

We believe we have made good progress in our commercial loan business and our commercial origination platform continues to grow. In 2011, the first full year of operations for this origination platform, we originated \$128 million of commercial mezzanine loans and ended the year with a portfolio of fourteen loans totaling \$158 million. This included \$60 million of investments we made in the fourth quarter of 2011. Through February 15, 2012, we originated three additional investments through this platform, including mezzanine loans and preferred equity investments, of \$13 million. Our commercial portfolio is currently funded entirely by equity capital. The annualized GAAP yield on this portfolio at December 31, 2011, was 10%, before any potential credit costs. To enhance this yield and free up equity capital for additional investments, we are attempting to obtain what we believe to be a prudent amount of debt financing for this portfolio in 2012.

While there are headwinds in the economy and certain sectors of the commercial market are struggling, the credit fundamentals for the higher-quality, stabilized properties that we seek to finance continue to improve. We expect that the increased level of loan maturities occurring in the next several years across the industry will allow us to expand and sustain our commercial origination franchise, given our relationships and our willingness to hold credit risk on our balance sheet.

Our origination platform sources investment opportunities nationally, including origination through a network of mortgage banking correspondents that currently includes fifteen different firms. By working closely with banks, insurance companies, and other originators, we reviewed over seven hundred lending opportunities in 2011. Cumulatively, through February 15, 2012, we have originated mezzanine commercial loans in conjunction with eleven different senior lenders and we are recognized in the industry as a reliable provider of mezzanine financing for high-quality, long-term, stabilized properties. As a result of the franchise and relationships we have built over the last two years through our commercial loan business, we are optimistic about our opportunities as the current market cycle evolves.

We currently anticipate originating between \$200 and \$300 million of subordinate debt investments in 2012, while continuing to maintain our disciplined approach to underwriting as we work to expand this origination platform. Our origination volume may be volatile from quarter to quarter due to the timing and availability of investment opportunities.

## **Outlook**

We want to return to delivering a growing stream of dividends through our residential and commercial credit businesses. Our REIT structure, while valuable and efficient from a tax perspective, can present a hurdle to growth, as we are required to pay out at least 90% of our earnings as dividends. To efficiently fund growth and create shareholder value, we ultimately need to be in a position to issue equity at a price per share that is above our GAAP book value per share. To do so, we need to demonstrate to investors the franchise value of our businesses by delivering to shareholders sustainable and attractive returns. We believe that generating sustainable returns requires a significant market opportunity for new investments and competitive advantages. We believe that to generate attractive returns we have to make sound risk-adjusted credit investments and appropriately manage the liability and equity aspects of our balance sheet.

Our investment opportunities lie in the \$13.5 trillion market for residential and commercial mortgages. Our core strength is a deep knowledge of residential and commercial credit and structuring. We have long-standing relationships with lenders and investors in senior residential and commercial securities and we believe we have an

outstanding brand. We are patient, long-term investors willing to hold long-term illiquid investments that we expect will generate attractive returns.

Our macro outlook for the broad investment landscape over the next few years shapes our operating strategies. On the investment supply side, we believe the current period of consumer and business de-leveraging will continue for some time. As a consequence, less real estate-related debt (outside of that guaranteed by the United States government) will be originated by banks and other financial institutions and the supply of new assets created through financial structuring has been vastly diminished or eliminated, depending on the product. On the investment demand side, we are likely to be competing for investments in a

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near zero interest rate environment against banks, fixed income funds, and hedge funds, whose managers are searching for attractive risk-adjusted yields for the significant amounts of capital they are investing.

To grow our businesses and generate attractive returns for shareholders over the long-term, we have concluded that we must be willing to create our own investments through our residential and commercial business platforms. This requires building out these platforms by broadening our lender and senior securities investor relationships, expanding our systems and supporting operations, and effectively and efficiently financing, hedging, and structuring to create new investments. Up-front expenses of building out these platforms negatively impacted our 2011 earnings and we will continue to incur expense in future periods relating to these build-outs. From a competitive standpoint, however, we believe our businesses have some advantages over other firms that are in or working to enter our industry. Further, we believe our platforms are scalable, which should help to improve our financial results as we work to increase our investment volume during 2012 and future years.

When we made the decision to build our residential conduit and securitization platform in late 2009, it was in part premised on our expectation that the U.S. federal government would reduce its participation in the residential mortgage market and that new bank regulations related to the Dodd-Frank Wall Street Reform and Consumer Protection Act and that the implementation of Basel III bank capital requirements would incent banks to also scale back their participation in this market to the advantage of smaller non-bank competitors. In the fourth quarter of 2011, we saw these assumptions begin to play out as (i) the temporary increase in the GSE conforming loan size limits was allowed to expire on October 1, 2011; (ii) certain banking institutions either discontinued or scaled back their correspondent lending channels related to increased capital requirements under Basel III; and, (iii) the Federal Home Loan Mortgage Corporation (Freddie Mac) began exploring a new risk-sharing program for its residential business.

While we believe that these are positive developments for our business, we would like to see them develop more quickly than they currently are.

Our commercial platform will likely provide us with the best opportunity to invest capital in 2012. Unlike with our residential conduit platform, we are not competing directly against the GSEs when funding mortgages and there is approximately \$1.4 trillion of commercial real estate debt maturing over the next four years. In our opinion, it is unlikely that the commercial banking industry, life insurance companies, or the CMBS market will be able or willing to fully meet the refinancing demand that will result from these maturing debts. Additionally, the stabilized income-producing property sector that we seek to finance is currently continuing to experience a broad-based recovery in credit fundamentals and property valuations have begun to improve.

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Our reported GAAP net loss was \$3 million (negative \$0.03 per share) for the fourth quarter of 2011, as compared to net income of \$15 million (\$0.18 per share) for the fourth quarter of 2010. Our reported GAAP net income was \$26 million (\$0.31 per share) for 2011, as compared to \$110 million (\$1.36 per share) for 2010. We declared and paid regular quarterly dividends of \$0.25 per share for all four quarters of 2011 and 2010. On February 22, 2012, our Board of Directors declared a regular dividend of \$0.25 per share for the first quarter of 2012, that will be paid on March 30, 2012.

The following table presents the components of our GAAP net (loss) income for the three and twelve months ended December 31, 2011 and 2010.

**Table 1 Net Income (Loss)**

| (In Thousands, Except Share Data)                                    | Three Months Ended |            | Years Ended  |            |
|----------------------------------------------------------------------|--------------------|------------|--------------|------------|
|                                                                      | December 31,       |            | December 31, |            |
|                                                                      | 2011               | 2010       | 2011         | 2010       |
| Interest income                                                      | \$56,495           | \$55,753   | \$217,179    | \$230,054  |
| Interest expense                                                     | (29,115 )          | (21,624 )  | (99,037 )    | (84,664 )  |
| Net interest income                                                  | 27,380             | 34,129     | 118,142      | 145,390    |
| Provision for loan losses                                            | (7,784 )           | (7,902 )   | (16,151 )    | (24,135 )  |
| Market valuation adjustments, net                                    | (9,682 )           | 380        | (40,017 )    | (19,554 )  |
| Net interest income after provision and market valuation adjustments | 9,914              | 26,607     | 61,974       | 101,701    |
| Operating expenses                                                   | (12,574 )          | (12,937 )  | (47,682 )    | (53,715 )  |
| Realized gains on sales and calls, net                               | 102                | 1,512      | 10,946       | 63,496     |
| Provision for income taxes                                           |                    | (26 )      | (42 )        | (280 )     |
| Less: Net income (loss) attributable to noncontrolling interest      |                    | 447        | (1,147 )     | 1,150      |
| Net (Loss) Income                                                    | \$(2,558 )         | \$14,709   | \$26,343     | \$110,052  |
| Diluted weighted average common shares outstanding                   | 78,369,879         | 78,944,301 | 78,299,510   | 78,810,949 |
| Net (loss) earnings per share                                        | \$(0.03 )          |            |              |            |