REDWOOD TRUST INC
Form 10-Q
November 07, 2013
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UNITED STATES OF AMERICA

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)**

OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended: September 30, 2013
OR

¨ **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	**68-0329422**

(State or Other Jurisdiction of	(I.R.S. Employer
Incorporation or Organization)	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)

Not Applicable

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, 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 x No ¨

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.

Large accelerated filer x 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 x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Common Stock, $0.01 par value per share	82,394,379 shares outstanding as of November 4, 2013

REDWOOD TRUST, INC.

2013 FORM 10-Q REPORT

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Data)

(Unaudited)	**September 30, 2013**	**December 31, 2012**
ASSETS		
Residential loans, held-for-sale (includes $727,278 and $556,283 at fair value)	$ 727,879	$ 562,658
Residential loans, held-for-investment	1,864,653	2,272,812
Commercial loans, held-for-sale (includes $27,413 and $0 at fair value)	27,413	8,500
Commercial loans, held-for-investment	352,440	304,510
Real estate securities, at fair value	1,324,678	1,108,753
Mortgage servicing rights, at fair value	60,234	5,315
Cash and cash equivalents	204,646	81,080
Total earning assets	4,561,943	4,343,628
Restricted cash	417	383
Accrued interest receivable	14,523	12,442
Derivative assets	4,852	2,972
Deferred securities issuance costs	14,694	9,293
Other assets	63,087	75,380
Total Assets (1)	$ 4,659,516	$ 4,444,098
LIABILITIES AND EQUITY		
Liabilities		
Short-term debt	$ 838,299	$ 551,918
Accrued interest payable	11,162	4,592
Derivative liabilities	32,697	51,081
Accrued expenses and other liabilities	36,918	26,902
Asset-backed securities issued	2,061,665	2,529,941
Long-term debt	471,605	139,500
Total liabilities (1)	3,452,346	3,303,934
Equity		

Common stock, par value $0.01 per share, 180,000,000 and 165,000,000 shares authorized; 82,388,502 and 81,716,416 issued and outstanding		824		817
Additional paid-in capital		1,757,680		1,744,554
Accumulated other comprehensive income		114,768		138,332
Cumulative earnings		781,164		633,052
Cumulative distributions to stockholders		(1,447,266)		(1,376,591)
Total equity		1,207,170		1,140,164
Total Liabilities and Equity	$	4,659,516	$	4,444,098

(1) Our consolidated balance sheets include assets of consolidated variable interest entities (VIEs) that can only be used to settle obligations of these VIEs and liabilities of consolidated VIEs for which creditors do not have recourse to the primary beneficiary (Redwood Trust, Inc.). At September 30, 2013 and December 31, 2012, assets of consolidated VIEs totaled $2,419,786 and $2,901,214, respectively, and liabilities of consolidated VIEs totaled $2,063,758 and $2,532,916, respectively. See *Note 4* for further discussion.

The accompanying notes are an integral part of these consolidated financial statements.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(In Thousands, Except Share Data)	**Three Months Ended September 30,**				**Nine Months Ended September 30,**			
(Unaudited)		**2013**		**2012**		**2013**		**2012**
Interest Income								
Residential loans	$	17,027	$	20,419	$	53,497	$	65,041
Commercial loans		10,740		7,482		30,534		18,363
Real estate securities		29,649		31,805		84,480		94,532
Cash and cash equivalents		4		17		153		52
Total interest income		57,420		59,723		168,664		177,988
Interest Expense								
Short-term debt		(5,227)		(2,737)		(13,721)		(6,863)
Asset-backed securities issued		(9,712)		(23,171)		(31,022)		(73,827)
Long-term debt		(6,894)		(2,377)		(16,908)		(7,132)
Total interest expense		(21,833)		(28,285)		(61,651)		(87,822)
Net Interest Income		35,587		31,438		107,013		90,166
Provision for loan losses		(1,727)		(1,319)		(493)		(254)
Other market valuation adjustments		462		2,164		(4,433)		1,440
Other-than-temporary impairments (1)		-		(1,207)		(1,666)		(1,842)
Other market valuation adjustments, net		462		957		(6,099)		(402)
Net Interest Income After Provision and Other Market Valuation Adjustments		34,322		31,076		100,421		89,510
Mortgage banking activities, net		(5,944)		12,303		98,608		13,642
Operating expenses		(21,853)		(17,102)		(65,095)		(46,900)
Realized gains, net		10,469		13,940		23,291		34,555
Net income before provision for income taxes		16,994		40,217		157,225		90,807
Benefit from (provision for) income taxes		4,935		(516)		(9,113)		(1,116)
Net Income Attributable to Redwood Trust, Inc.	$	21,929	$	39,701	$	148,112	$	89,691
Basic earnings per common share	$	0.26	$	0.48	$	1.76	$	1.10

Diluted earnings per common share	$	0.25	$	0.48	$	1.65	$	1.09
Regular dividends declared per common share	$	0.28	$	0.25	$	0.84	$	0.75
Basic weighted average shares outstanding		82,201,473		79,685,099		81,888,231		78,908,057
Diluted weighted average shares outstanding		84,422,039		80,764,380		93,233,865		80,175,660

(1) For the three months ended September 30, 2013, there were no other-than-temporary impairments. For the three months ended September 30, 2012, other-than-temporary impairments were $1,580 of which $373 were recognized in Accumulated Other Comprehensive Income. For the nine months ended September 30, 2013, other-than-temporary impairments were $1,666, none of which were recognized in Accumulated Other Comprehensive Income. For the nine months ended September 30, 2012, other-than-temporary impairments were $2,472, of which $630 were recognized in Accumulated Other Comprehensive Income.

The accompanying notes are an integral part of these consolidated financial statements.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In Thousands)	**Three Months Ended September 30,**		**Nine Months Ended September 30,**	
(Unaudited)	**2013**	**2012**	**2013**	**2012**
Net Income	$ 21,929	$ 39,701	$ 148,112	$ 89,691
Other comprehensive (loss) income:				
Net unrealized (loss) gain on available-for-sale securities	(633)	41,392	(29,615)	83,467
Reclassification of unrealized (gain) loss to net income	(6,962)	796	(19,211)	1,210
Net unrealized gain (loss) on interest rate agreements	4,018	2,346	25,043	(914)
Reclassification of unrealized loss on interest rate agreements to net income	62	1,126	219	3,260
Total other comprehensive (loss) income	(3,515)	45,660	(23,564)	87,023
Comprehensive Income Attributable to Redwood Trust, Inc.	$ 18,414	$ 85,361	$ 124,548	$ 176,714

The accompanying notes are an integral part of these consolidated financial statements.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

For the Nine Months Ended September 30, 2013

s, Except Share Data)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	
2012	81,716,416	$ 817	$ 1,744,554	$ 138,332	$ 633,052	$ (1,376,591)	$
	-	-	-	-	148,112	-	
ensive (loss) income	-	-	-	(23,564)	-	-	
mmon stock:							
estment & stock	374,371	4	7,073	-	-	-	
k purchase and	297,715	3	(5,390)	-	-	-	
y award compensation	-	-	11,443	-	-	-	
lends declared	-	-	-	-	-	(70,675)	
, 2013	82,388,502	$ 824	$ 1,757,680	$ 114,768	$ 781,164	$ (1,447,266)	$

Months Ended September 30, 2012

s, Except Share Data)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Cumulative Earnings	Cumulative Distributions to Stockholders	
2011	78,555,908	$ 786	$ 1,697,979	$ (13,151)	$ 501,283	$ (1,294,313)	$
	-	-	-	-	89,691	-	
ensive income	-	-	-	87,023	-	-	
mmon stock:							
estment & stock	2,609,151	26	36,398	-	-	-	
k purchase and	361,262	3	(1,905)	-	-	-	
y award compensation	-	-	7,369	-	-	-	
lends declared	-	-	-	-	-	(61,337)	
, 2012	81,526,321	$ 815	$ 1,739,841	$ 73,872	$ 590,974	$ (1,355,650)	$

The accompanying notes are an integral part of these consolidated financial statements.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands) (Unaudited)	Nine Months Ended September 30, 2013	2012
Cash Flows From Operating Activities:		
Net income attributable to Redwood Trust, Inc.	$ 148,112	$ 89,691
Adjustments to reconcile net income to net cash used in operating activities:		
Amortization of premiums, discounts, and securities issuance costs, net	(18,060)	(18,045)
Depreciation and amortization of non-financial assets	310	1,727
Purchases of loans	(6,864,921)	(1,522,949)
Proceeds from sales of loans	6,254,382	1,051,778
Principal payments on loans	9,467	7,438
Net settlements of derivatives	55,694	(20,376)
Provision for loan losses	493	254
Non-cash equity award compensation	11,443	7,369
Market valuation adjustments, net	(76,425)	4,489
Realized gains, net	(34,322)	(52,003)
Net change in:		
Accrued interest receivable, deferred tax assets, and other assets	2,374	5,538
Accrued interest payable and accrued expenses and other liabilities	17,378	26,458
Net cash used in operating activities	(494,075)	(418,631)
Cash Flows From Investing Activities:		
Purchases of loans held-for-investment	(63,071)	(135,662)
Proceeds from sales of loans (1)	440	357,742
Principal payments on loans	415,576	425,344
Purchases of real estate securities	(142,628)	(338,058)
Proceeds from sales of real estate securities	213,139	172,265
Principal payments on real estate securities	124,030	173,849
Proceeds from deconsolidation	-	6,386
Purchase of mortgage servicing rights	(3,106)	-
Net increase in restricted cash	(34)	(27,600)
Net cash provided by investing activities	544,346	634,266
Cash Flows From Financing Activities:		
Proceeds from borrowings on short-term debt	5,745,892	1,043,767
Repayments on short-term debt	(5,459,511)	(949,609)
Proceeds from issuance of asset-backed securities	-	2,445

Repayments on asset-backed securities issued		(465,986)		(491,134)
Deferred securities issuance costs		(9,184)		-
Proceeds from issuance of long-term debt		332,119		-
Repayments on long-term debt		(14)		-
Net settlements of derivatives		(9)		(20,047)
Net proceeds from issuance of common stock		6,452		34,698
Taxes paid on equity award distributions		(5,789)		(2,210)
Dividends paid		(70,675)		(61,337)
Net cash provided by (used in) financing activities		73,295		(443,427)
Net increase (decrease) in cash and cash equivalents		123,566		(227,792)
Cash and cash equivalents at beginning of period		81,080		267,176
Cash and cash equivalents at end of period	$	204,646	$	39,384
Supplemental Cash Flow Information:				
Cash paid during the period for:				
Interest	$	60,394	$	89,727
Taxes		3,397		225
Supplemental Noncash Information:				
Real estate securities retained from whole loan securitizations	$	379,174	$	107,219
Retention of mortgage servicing rights from whole loan securitizations		41,128		3,849
Transfers from residential loans to real estate owned		3,448		4,825

(1) For the nine months ended September 30, 2012, the proceeds from sales of loans included in investing activities related to loans that were reclassified from loans held-for-investment to loans held-for-sale during the fourth quarter of 2011.

The accompanying notes are an integral part of these consolidated financial statements.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2013

(Unaudited)

Note 1. Redwood Trust

Redwood Trust, Inc., together with its subsidiaries (Redwood, we, or us), is an internally-managed specialty finance company focused on engaging in residential and commercial mortgage banking activities and investing in mortgage- and other real estate-related assets. We seek to generate fee and gain on sale income through our mortgage banking activities and to invest in real estate-related assets that have the potential to generate attractive cash flow returns over time. For tax purposes, Redwood Trust, Inc. is structured as a real estate investment trust (REIT).

Our investment portfolio includes investments in residential mortgage-backed securities issued in Sequoia securitization transactions, as well as residential securities issued by third parties. We also invest in other assets, securities, and instruments that are related to residential real estate, such as mortgage servicing rights (MSRs). Our investment portfolio also includes investments in commercial loans that are originated through our commercial mortgage banking activities and may include investments in commercial mortgage-backed securities (CMBS) or other forms of commercial real estate financing originated by others. We assume a range of risks in our investments and the level of risk is influenced by, among other factors, the manner in which we finance our purchases of, and derive income from, our investments.

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.

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at September 30, 2013 and December 31, 2012, and for the three and nine months ended September 30, 2013 and 2012. These consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) in the United States of America as prescribed by the Financial Accounting Standards Board s (FASB) Accounting Standards Codification (ASC) and using the Securities and Exchange Commission s (SEC) instructions to Form 10-Q. Certain prior year amounts have been reclassified in the consolidated financial statements and the related footnotes to conform to the 2013 presentation.

Organization

For tax purposes, Redwood Trust, Inc. is structured as a real estate investment trust (REIT). Our consolidated financial statements include the accounts of Redwood, its direct and indirect wholly-owned subsidiaries, and other entities in which we have a controlling financial interest. All significant intercompany balances and transactions have been eliminated. Our consolidated subsidiaries include both qualifying REIT subsidiaries and taxable subsidiaries. References to the REIT include Redwood and its qualifying REIT subsidiaries, excluding taxable subsidiaries.

We sponsor our Sequoia securitization program, which we use for the securitization of residential mortgage loans. References to Sequoia with respect to any time or period generally refer collectively to all the then consolidated

Sequoia securitization entities for the periods presented. We have also engaged in securitization transactions in order to obtain financing for certain of our securities and commercial loans. We previously engaged in other securitization transactions through the Acacia program, which was used for the securitization of mortgage-backed securities and other types of financial assets. References to Acacia generally refer collectively to the consolidated Acacia securitization entities for the periods presented.

Financial Information About Industry Segments

FASB ASC 280, *Segment Reporting*, establishes standards for reporting financial and descriptive information about an enterprise s reportable segments. We currently evaluate all of our residential and commercial real estate-related investments and management activities as one reportable industry segment, and, accordingly, we do not report distinct segment information.

Principles of Consolidation

We apply FASB guidance to determine whether we must consolidate transferred financial assets and variable interest entities (VIEs) for financial reporting purposes. We currently consolidate the assets and liabilities of the Sequoia securitization entities where we maintain an ongoing involvement, as well as an entity formed in connection with a resecuritization transaction we engaged

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2013

(Unaudited)

Note 2. Basis of Presentation (continued)

in during 2011 (Residential Resecuritization), and an entity formed in connection with a commercial securitization we engaged in during the fourth quarter of 2012 (Commercial Securitization). Prior to December 31, 2012, we consolidated the assets and liabilities of certain Acacia securitization entities. Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of Redwood, although we are exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities.

For financial reporting purposes, the underlying loans and securities owned at the consolidated Sequoia entities, the Residential Resecuritization entity, and the Commercial Securitization entity are shown under residential and commercial loans and real estate securities on our consolidated balance sheets. The asset-backed securities (ABS) issued to third parties by these entities are shown under ABS issued. In our consolidated statements of income, we record interest income on the loans and securities owned at these entities and interest expense on the ABS issued by these entities.

See *Note 4* for further discussion on principles of consolidation.

Note 3. Summary of Significant Accounting Policies

Use of Estimates

The preparation of financial statements requires us to make a number of significant estimates. These include estimates of fair value of certain assets and liabilities, amounts and timing of credit losses, prepayment rates, and other estimates that affect the reported amounts of certain assets and liabilities as of the date of the consolidated financial statements and the reported amounts of certain revenues and expenses during the reported period. It is likely that changes in these estimates (e.g., valuation changes due to supply and demand, credit performance, prepayments, interest rates, or other reasons) will occur in the near term. Our estimates are inherently subjective in nature and actual results could differ from our estimates and the differences could be material.

Fair Value Measurements

Our financial statements include assets and liabilities that are measured at their estimated fair values in accordance with GAAP. A fair value measurement represents the price at which an orderly transaction would occur between willing market participants at the measurement date. We develop fair values for financial assets or liabilities based on available inputs and pricing that is observed in the marketplace. Examples of market information that we attempt to obtain include the following:

- Quoted prices for the same or similar securities;
- Relevant reports issued by analysts and rating agencies;
- The current level of interest rates and any directional movements in relevant indices, such as credit risk indices;
- Information about the performance of the underlying mortgage loans, such as delinquency and foreclosure rates, loss experience, and prepayment rates;
- Indicative prices or yields from broker/dealers; and,
- Other relevant observable inputs, including nonperformance risk and liquidity premiums.

After considering all available indications of the appropriate rate of return that market participants would require, we consider the reasonableness of the range indicated by the results to determine an estimate that is most representative of fair value.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2013

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

The markets for many of the loans and securities that we invest in and issue are generally illiquid. Establishing fair values for illiquid assets and liabilities is inherently subjective and is often dependent upon our estimates and modeling assumptions. If we determine that either the volume and/or level of trading activity for an asset or liability has significantly decreased from normal market conditions, or price quotations or observable inputs are not associated with orderly transactions, the market inputs that we obtain might not be relevant. For example, broker or pricing service quotes might not be relevant if an active market does not exist for the financial asset or liability. The nature of the quote (for example, whether the quote is an indicative price or a binding offer) is also evaluated.

In circumstances where relevant market inputs cannot be obtained, increased analysis and management judgment are required to estimate fair value. This generally requires us to establish internal assumptions about future cash flows and appropriate risk-adjusted discount rates. Regardless of the valuation inputs we apply, the objective of fair value measurement is unchanged from what it would be if markets were operating at normal activity levels and/or transactions were orderly; that is, to determine the current exit price.

See *Note 5* for further discussion on fair value measurements.

Fair Value Option

We have the option to measure eligible financial assets, financial liabilities, and commitments at fair value on an instrument-by-instrument basis. This option is available when we first recognize a financial asset or financial liability or enter into a firm commitment. Subsequent changes in the fair value of assets, liabilities, and commitments where we have elected the fair value option are recorded in our consolidated statements of income.

Our decision to apply the fair value option for new financial instruments is generally based upon our funding strategy for the specific financial asset acquired. For example, securities that we anticipate funding with equity will generally be accounted for as available-for-sale (AFS) securities. Securities that we anticipate funding with a combination of debt and equity or those financed through the issuance of asset-backed liabilities will generally be accounted for in a manner consistent with the associated liabilities. Additionally, we may elect to apply the fair value option for loans we anticipate selling to Sequoia securitizations or third parties and for financial instruments that may not perform similarly to our traditional real estate investments or are particularly volatile or complex in structure.

See *Note 5* for further discussion on the fair value option.

Real Estate Loans

Residential and Commercial Loans Held-for-Sale

Residential and commercial loans held-for-sale include loans that we are marketing for sale to third parties, including transfers to securitization entities that we plan to sponsor and expect to be accounted for as sales for financial reporting purposes.

Residential and Commercial Loans Fair Value

We have established policies to elect the fair value option for residential and commercial loans that we purchase with the intent to sell to third parties or transfer to Sequoia securitizations. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Changes in fair value are recurring and are reported through our consolidated statements of income in mortgage banking activities, net for residential and commercial loans held at fair value.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2013

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Residential and Commercial Loans Lower of Cost or Fair Value

Certain residential and commercial loans, acquired prior to our fair value option policy elections, are carried at the lower of their cost or fair value. If the fair value of an individual loan or pool of loans held-for-sale is lower than its amortized cost basis, this difference is reported through our consolidated statements of income as a negative market valuation adjustment in mortgage banking activities, net. Coupon interest for loans held-for-sale is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due at which point it is placed on non-accrual status. Gains or losses on the sale of residential or commercial loans held-for-sale are based on the specific identification method for loans measured on an individual basis or in aggregate for those loans measured on a pool basis.

Residential and Commercial Loans Held-for-Investment

Loans held-for-investment include residential loans owned at consolidated Sequoia entities and commercial loans owned at the Commercial Securitization entity and by us, net of any allowance for loan losses. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due or has been individually impaired, at which point the loan is placed on nonaccrual status. Interest previously accrued for loans that have become greater than 90 days past due or individually impaired is reserved for in the allowance for loan losses. Residential loans delinquent more than 90 days or in foreclosure are characterized as a serious delinquency. Cash principal and interest that is advanced from servicers subsequent to a loan becoming greater than 90 days past due or individually impaired is accounted for as a reduction in the outstanding loan principal balance. When a seriously delinquent loan previously placed on nonaccrual status has cured, meaning all delinquent principal and interest have been remitted by the borrower, the loan is placed back on accrual status. Alternately, loans that have been individually impaired may be placed back on accrual status if restructured and after the loan is considered reperforming. A restructured loan is considered reperforming when the loan has been current for at least 12 months.

We use the interest method to determine an effective yield to amortize the premium or discount on real estate loans held-for-investment. For residential loans acquired prior to July 1, 2004, we use coupon interest rates as they change over time and anticipated principal payments to determine periodic amortization. For residential and commercial loans acquired after July 1, 2004, we use the initial coupon interest rate of the loans (without regard to future changes in the underlying indices) and anticipated principal payments, if any, to determine periodic amortization.

We reclassify loans held-for-investment as loans held-for-sale if we determine that these loans will be sold or transferred to third parties. This may occur, for example, if we exercise our right to call ABS issued by a Sequoia securitization trust and decide to subsequently sell the underlying loans to third parties.

See *Note 6* for further discussion on residential loans. See *Note 7* for further discussion on commercial loans.

Residential Loans Allowance for Loan Losses

For residential loans classified as held-for-investment, we establish and maintain an allowance for loan losses based on our estimate of credit losses inherent in our loan portfolios at the reporting date. To calculate the allowance for loan losses, we assess inherent losses by determining loss factors (defaults, the timing of defaults, and loss severities upon defaults) that can be specifically applied to each loan or pool of loans.

We consider the following factors in evaluating the allowance for loan losses:

- Ongoing analyses of loans, including, but not limited to, the age of loans and year of origination, underwriting standards, business climate, economic conditions, and other observable data;

- Historical loss rates and past performance of similar loans;

- Relevant market research and publicly available third-party reference loss rates;

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2013

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

- Trends in delinquencies and charge-offs;
- Effects and changes in credit concentrations;
- Information supporting a borrower s ability to meet obligations;
- Ongoing evaluations of fair values of collateral using current appraisals and other valuations; and,
- Discounted cash flow analyses.

Once we determine the amount of defaults, the timing of the defaults, and severity of losses upon the defaults, we estimate expected losses for each individual loan or pool of loans over its expected life. We then estimate the timing of these losses and the losses probable to occur over an appropriate loss confirmation period. This period is defined as the range of time between the occurrence of a credit loss (such as the initial deterioration of the borrower s financial condition) and the confirmation of that loss (the actual impairment or charge-off of the loan). The losses expected to occur within the estimated loss confirmation period are the basis of our allowance for loan losses, since we believe these losses exist at the reported date of the financial statements. We re-evaluate the adequacy of our allowance for loan losses quarterly.

As part of the loss mitigation efforts undertaken by servicers of residential loans owned at Sequoia securitization entities, a number of loan modifications have been completed to help make mortgage loans more affordable for certain borrowers. Loan modifications may include, but are not limited to: (i) conversion of a floating rate mortgage loan into a fixed rate mortgage loan; (ii) reduction in the contractual interest rate of a mortgage loan; (iii) forgiveness of a portion of the contractual interest and/or principal amounts owed on a mortgage loan; and, (iv) extension of the contractual maturity of a mortgage loan. We evaluate all loan modifications performed by servicers to determine if they constitute troubled debt restructurings (TDRs) according to GAAP. If a loan is determined to be a TDR, it is removed from the general loan pools used for calculating allowances for loan losses and assessed for impairment on an individual basis based upon any adverse change in the expected future cash flows resulting from the modification. This difference is recorded to the provision for loan losses in our consolidated statements of income.

When foreclosed property is received in full satisfaction for a defaulted loan, we estimate the fair value of the property, based on estimated net proceeds from the sale of the property (including servicer advances and other costs). To the extent that the fair value of the property is below the recorded investment of the loan, we record a charge against the allowance for loan losses for the difference. Foreclosed property is subsequently recorded as real estate owned (REO), a component of other assets on our consolidated balance sheets. Actual losses incurred on loans liquidated through a short-sale are also charged against the allowance for loan losses.

See *Note 6* for further discussion on the allowance for loan losses for residential loans.

Commercial Loans Allowance for Loan Losses

For commercial loans classified as held-for-investment, we establish and maintain a general allowance for loan losses inherent in our portfolio at the reporting date and, where appropriate, a specific allowance for loan losses for loans we have determined to be impaired at the reporting date. An individual loan is considered impaired when it is deemed probable that we will not be able to collect all amounts due according to the contractual terms of the loan.

Our methodology for assessing the adequacy of the allowance for loan losses begins with a formal review of each commercial loan in the portfolio and the assignment of an internal impairment status. Reviews are performed at least quarterly. We consider the following factors in evaluating each loan:

- Loan to value ratios upon origination or acquisition of the loan;

- The most recent financial information available for each loan and associated properties, including net operating income, debt service coverage ratios, occupancy rates, rent rolls, as well as any other loss factors we consider relevant, such as, but not limited to, specific loan trigger events that would indicate an adverse change in expected cash flows or payment delinquency;

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

- Economic trends, both macroeconomic as well as those directly affecting the properties associated with our loans, and the supply and demand of competing projects in the sub-market in which the subject property is located; and,

- The loan sponsor or borrowing entity s ability to ensure that properties associated with the loan are managed and operated sufficiently.

Loan reviews are completed by asset management and finance personnel and reviewed and approved by senior management.

Based on the assigned impairment status, a loan is categorized as Pass, Watch List, or Workout. Pass loans are defined as loans that are performing in accordance with the contractual terms of the loan agreement. Watch List loans are defined as performing loans for which the timing of cost recovery is under review. Workout loans are defined as loans that we believe have a credit impairment that may lead to a realized loss. Workout loans are typically assessed for impairment on an individual basis. Where an individual commercial loan is impaired, we record an allowance to reduce the carrying value of the loan to the current present value of expected future cash flows discounted at the loan s effective rate or if a loan is collateral dependent, we reduce the carrying value to the estimated fair market value of the loan, with a corresponding charge to provision for loan losses on our consolidated statements of income.

For all commercial loans that are not individually impaired, we assess the commercial loan portfolio in aggregate for loan losses based on our expectation of credit losses inherent in the portfolio at the reporting date. Our expectation of credit losses is informed by, among other things:

- Historical loss rates and past performance of similar loans in our own portfolio, if any;

- Publicly available third-party reference loss rates on similar loans; and,

- Trends in delinquencies and charge-offs in our own portfolio and among industry participants.

See *Note 7* for further discussion on the allowance for loan losses for commercial loans.

Repurchase Reserves

We do not currently maintain a loan repurchase reserve and management is not aware of any outstanding repurchase claims that would require the establishment of such a reserve.

We do not originate residential loans and believe that the risk of loss due to loan repurchases (i.e., due to a breach of representations and warranties) would generally be a contingency to the companies from whom we acquired the loans and therefore would be covered by our recourse to those companies.

In circumstances where we believe that there is a risk of loss due to a loan repurchase demand (i.e., due to an allegation of a breach of representations and warranties) and we do not believe that full recourse to the company from whom we acquired the loan exists or is enforceable, we will review the need for any loan repurchase reserve in accordance with FASB guidance on accounting for contingencies and establish reserves when, in the opinion of management, it is probable that a repurchase demand would result in a liability and the amount of loss, if any, can be reasonably estimated.

We have originated and sold commercial senior mortgage loans and have made standard representations and warranties upon sale of the loans to the loan purchasers, and in some cases, to securitization trusts. We review the need for a repurchase reserve related to these commercial loans on an ongoing basis and are not aware of any breaches of representations and warranties related to these loans.

Real Estate Securities, at Fair Value

We classify our real estate securities as trading or available-for-sale securities. We use the prime or non-prime designation to categorize our residential securities based upon the general credit characteristics of the residential loans underlying each security at the time of origination. For example, prime residential loans are generally characterized by lower loan-to-value (LTV) ratios at the time the loans were originated, and are made to borrowers with higher Fair Isaac Corporation (FICO) scores. Non-prime residential

REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

loans are generally characterized by higher LTV ratios at the time the loans were originated and may have been made to borrowers with lower credit scores or impaired credit histories (while exhibiting the ability to repay their loans) at the time the loan was originated. Regardless of whether or not the loans underlying a residential security were designated as prime or non-prime at origination, there is a risk that the borrower may not be able to repay the loan.

Trading Securities

We primarily denote trading securities as those securities where we have adopted the fair value option. Trading securities may include residential and commercial securities. Trading securities are carried at their estimated fair values. Coupon interest is recognized as interest income when earned and deemed collectible. Changes in the fair value of Sequoia interest only (IO) securities designated as trading securities are reported in mortgage banking activities, net, a component of our consolidated statements of income. Changes in the fair value of other trading securities are reported through our consolidated statements of income in other market valuation adjustments, net.

Available-for-Sale Securities

AFS securities may include certain residential and commercial securities. AFS securities are carried at their estimated fair values with cumulative unrealized gains and losses reported as a component of accumulated other comprehensive income in our consolidated statements of changes in equity. Coupon interest is recognized as interest income when earned and deemed collectible, and the interest method is used to determine an effective yield to amortize purchase premiums, discounts, and fees associated with these securities into income over time. This requires us to project cash flows over the remaining life of each security and make assumptions with regards to interest rates, prepayment rates, the timing and amount of credit losses, and other factors. We review our cash flow projections on an ongoing basis and monitor these projections based on input and analyses received from external sources, internal models, and our own judgment and experience.

For an AFS security where its estimated fair value at the reporting date is below its amortized cost basis, we evaluate the security for other-than-temporary impairment (OTTI). If we either (i) intend to sell the impaired security; (ii) will more likely than not be required to sell the impaired security before it recovers in value; or, (iii) do not expect to recover the impaired security s amortized cost basis even if we do not intend to sell the security the impairment is deemed an OTTI and we record the entire difference between the security s fair value and its amortized cost in our consolidated statements of income. Conversely, if none of these three conditions is met, we analyze the expected cash flows, or cost recovery of the security, to determine what, if any, OTTI is recognized through our consolidated statements of income. This analysis includes an assessment of any changes in the regulatory and/or economic environment that might affect the performance of the security.

If we conclude through our analysis that there has been no significant adverse change in our cash flow assumptions for the security, then the impairment is deemed temporary in nature and the associated difference between the security s fair value and its amortized cost basis is recorded as an unrealized loss through accumulated other comprehensive income, in our consolidated statements of changes in equity. Alternatively, if we conclude that there has been a significant adverse change in our cash flow assumptions for the security, then the impairment is deemed an OTTI and we perform an additional analysis to determine what portion of OTTI, if any, should be recorded through our consolidated statements of income. This analysis entails discounting the security s cash flows to a present value using the prior period yield for the security to determine an expected recoverable value. The difference between this expected recoverable value and the amortized cost basis of the security is deemed to be the credit component of the OTTI that is recorded in our consolidated statements of income. The amortized cost of the security is then adjusted to the expected recoverable value, and the difference between this expected recoverable value and the estimated fair value is deemed to be the non-credit component of the OTTI and is recorded to accumulated other comprehensive income. Future amortization and accretion for the security is computed based upon the new amortized cost basis.

See *Note 8* for further discussion on real estate securities.

REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

MSRs

We recognize MSRs through the acquisition of mortgage servicing rights released by third parties or through the retention of MSRs associated with residential loans that we have acquired and subsequently transferred to third parties. Typically, our MSRs are directly acquired from loan originators or created through the transfer of loans to a Sequoia residential mortgage securitization sponsored by us that meets the GAAP criteria for sale accounting.

Our MSRs are held and managed at Redwood Residential Acquisition Corporation, a wholly-owned subsidiary of RWT Holdings, Inc., which is a taxable REIT subsidiary of ours. We contract with a licensed sub-servicer to perform servicing functions for loans associated with our MSRs. MSRs are initially recognized and carried at their estimated fair values. Changes in the estimated fair value of MSRs are reported in mortgage banking activities, net, a component of our consolidated statements of income.

See *Note 17* for further discussion on MSRs.

Cash and Cash Equivalents

Cash and cash equivalents include non-restricted cash and highly liquid investments with original maturities of three months or less.

Restricted Cash

Restricted cash primarily includes principal and interest payments that are collateral for, or payable to, owners of ABS issued by consolidated securitization entities. Restricted cash may also include cash retained in the Sequoia securitization entities or in the Residential Resecuritization or Commercial Securitization entities prior to the payments on or redemptions of outstanding ABS issued.

Accrued Interest Receivable

Accrued interest receivable includes interest that is due and payable to us and deemed collectible. Cash interest is generally received within thirty days of recording the receivable. For financial assets where we have elected the fair value option, the associated accrued interest receivable on these assets is measured at fair value. For financial assets where we have not elected the fair value option, the associated accrued interest carrying values approximate fair values.

Derivative Financial Instruments

Derivative financial instruments we typically utilize include contractual interest rate agreements, financial futures contracts, and To Be Announced (TBA) contracts. All derivative financial instruments are recorded at fair value in our consolidated balance sheets. Derivatives with positive fair values to us are reported as assets and derivatives with negative fair values to us are reported as liabilities. We classify each of our derivative financial instruments as either (i) a trading instrument (no specific hedging designation for financial reporting purposes) or (ii) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge).

Changes in the fair values of derivatives accounted for as trading instruments, including any associated interest income or expense, are recorded in our consolidated statements of income through other market valuation adjustments, net. The valuation changes related to derivatives used to manage certain risks associated with the residential and commercial loans we own or plan to acquire and sell or securitize are excluded from other market valuation adjustments, net, and are included in mortgage banking activities, net, on our consolidated statements of income. Changes in the fair values of derivatives accounted for as cash flow hedges, to the extent they are effective, are recorded in accumulated other comprehensive income, a component of equity. Interest income or expense, and any ineffectiveness associated with these derivatives, are recorded as a component of net interest income in our consolidated statements of income. We measure the effective portion of cash flow hedges by comparing the change in fair value of the expected future variable cash flows of the derivative hedging instruments with the change in fair value of the expected future variable cash flows of the hedged item.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2013

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

We will discontinue cash flow hedge accounting if (i) we determine that the hedging derivative is no longer expected to be effective in offsetting changes in the cash flows of the designated hedged item; (ii) the derivative expires or is sold, terminated, or exercised; (iii) the derivative is de-designated as a cash flow hedge; or, (iv) it is probable that a forecasted transaction associated with the hedged item will not occur by the end of the originally specified time period. To the extent we de-designate or terminate a cash flow hedging relationship and the associated hedged item continues to exist, any unrealized gain or loss of the cash flow hedge at the time of de-designation remains in accumulated other comprehensive income and is amortized using the straight-line method through interest expense over the remaining life of the hedged item.

Interest Rate Agreements

Interest rate agreements that we currently utilize include swaps and swaptions. Interest rate swaps are agreements in which (i) one counterparty exchanges a stream of fixed interest payments for another counterparty s stream of variable interest cash flows; or, (ii) each counterparty exchanges variable interest cash flows that are referenced to different indices. Interest rate swaptions are agreements that provide the owner the right but not the obligation to enter into an underlying interest rate swap with a counterparty in the future. Interest rate caps are agreements in which the owner receives payments at the end of each period for which the prevailing interest rate exceeds an agreed upon strike price. We enter into interest rate agreements primarily to reduce significant changes in our income or equity caused by interest rate volatility. Certain of these interest rate agreements may be designated as cash flow hedges.

Eurodollar Futures, Financial Futures and TBA Contracts

Eurodollar futures are futures contracts on time deposits denominated in U.S. dollars at banks outside the United States. Eurodollar futures, unlike our other derivatives, have maturities of only three months. Therefore, in order to achieve the desired interest rate offset necessary to manage our risk, consecutively maturing contracts are required, resulting in a stated notional amount that is typically higher than our other derivatives. Treasury futures are futures contracts on benchmark U.S. Treasury rates. TBA contracts are forward contracts to purchase mortgage-backed securities that will be issued by a U.S. government sponsored enterprise (GSE) in the future. We purchase or sell these derivatives to offset to varying degrees changes in the values of mortgage products for which we have exposure to interest rate volatility.

See *Note 9* for further discussion on derivative financial instruments.

Deferred Tax Assets

Our deferred tax assets/liabilities are generated by temporary differences in GAAP and taxable income at our taxable subsidiaries. These differences generally reflect differing accounting treatments for GAAP and tax, such as accounting for mortgage servicing rights, discount and premium amortization, credit losses, equity awards, asset impairments, and certain valuation estimates. As a result of these differences, we may recognize taxable income in periods prior to when we recognize income for GAAP. When this occurs, we pay the tax liability as required and establish a deferred tax asset for GAAP. As the income is subsequently realized in future periods under GAAP, the deferred tax asset is reduced. We may also recognize GAAP income in periods prior to when we recognize income for tax. When this occurs, we establish a deferred tax liability for GAAP. As the income is subsequently realized in future periods for tax, the deferred tax liability is reduced.

In assessing the realizability of deferred tax assets, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. We consider historical and projected future taxable income and capital gains as well as tax planning strategies in making this assessment. We determine the extent to which realization of this deferred asset is not assured and establish a valuation allowance accordingly. The estimate of net deferred tax assets could change in future periods to the extent that actual or revised estimates of future taxable income during the carryforward periods change from current expectations.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Deferred Securities Issuance Costs

Securities issuance costs are expenses associated with the issuance of long-term debt, and the ABS issued from the Residential Resecuritization, the Commercial Securitization, and Sequoia securitization entities we sponsor and consolidate for financial reporting purposes. These expenses typically include underwriting, rating agency, legal, accounting, and other fees. ABS issuance costs associated with liabilities accounted for under the fair value option are expensed as incurred. ABS issuance costs associated with liabilities reported at cost are deferred. Deferred securities issuance costs are reported on our consolidated balance sheets as deferred charges (an asset) and are amortized as an adjustment to interest expense using the interest method, based upon the actual and estimated repayment schedules of the related securities issued.

Other Assets

Other assets include REO, margin receivable, income tax receivables, fixed assets, principal receivable, and other prepaid expenses.

REO property acquired through, or in lieu of, foreclosure is initially recorded at fair value, and subsequently reported at the lower of its carrying amount or fair value (less estimated cost to sell). Changes in the fair value of an REO property that has a fair value at or below its carrying amount are recorded in our consolidated statements of income as a component of other market valuation adjustments, net. Margin receivable reflects cash collateral we have posted with various counterparties relating to our derivative and lending agreements with those counterparties, as applicable.

See *Note 10* for further discussion on other assets.

Short-Term Debt

Short-term debt includes borrowings under master repurchase agreements and other forms of borrowings that expire within one year with various counterparties. These borrowings may be unsecured or collateralized by cash, loans, or securities. If the value (as determined by the applicable counterparty) of the collateral securing those borrowings decreases, we may be subject to margin calls during the period the borrowings are outstanding. In instances where we do not satisfy the margin calls within the required time frame, the counterparty may retain the collateral and pursue any outstanding debt amount from us.

See *Note 11* for further discussion on short-term debt.

Accrued Interest Payable

Accrued interest payable includes interest that is due and payable to third parties. Interest is generally paid within one to three months of recording the payable, based upon our remittance requirements, and is paid semi-annually for our convertible debt. For borrowings where we have elected the fair value option, the associated accrued interest on these liabilities is measured at fair value. For financial liabilities where we have not elected the fair value option, the associated accrued interest carrying values approximate fair values.

Asset-Backed Securities Issued

The majority of the liabilities reported on our consolidated balance sheets represent ABS issued by bankruptcy-remote entities sponsored by Redwood. Sequoia, Acacia, the Residential Resecuritization, and the Commercial Securitization assets are held in the custody of securitization trustees and are not owned by Redwood. These trustees collect principal and interest payments (less servicing and related fees) from the assets and make corresponding principal and interest payments to the ABS investors.

REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 3. Summary of Significant Accounting Policies (continued)

Sequoia ABS Issued

Sequoia ABS issued are carried at their unpaid principal balances net of any unamortized discount or premium.

Acacia ABS Issued

Prior to the fourth quarter of 2012, we consolidated certain Acacia securitization entities. Acacia ABS issued were accounted for under the fair value option and carried at their estimated fair values. Changes in fair value (gains or losses) were reported in our consolidated statements of income through other market valuation adjustments, net.

Residential Resecuritization ABS Issued

Residential Resecuritization ABS issued are carried at their unpaid principal balances net of any unamortized discount or premium.

Commercial Securitization ABS Issued

Commercial Securitization ABS issued are carried at their unpaid principal balances net of any unamortized discount or premium.

See *Note 12* for further discussion on ABS issued.

Long-Term Debt

Commercial Borrowings

Commercial borrowings include borrowings under a master repurchase agreement that expires in more than one year with a financial institution counterparty. These borrowings are collateralized by commercial loans. If the value (as determined by the applicable counterparty) of the collateral securing those borrowings decreases, we may be subject to margin calls during the period the borrowings are outstanding. In instances where we do not satisfy the margin calls within the required time frame, the counterparty may retain the collateral and pursue any outstanding debt amount from us.

Convertible Notes

Convertible notes include unsecured convertible senior notes and are carried at their unpaid principal balance. Interest on the notes is payable semiannually and the notes mature on April 15, 2018. If converted by a holder, upon conversion, the holder of the notes would receive shares of our common stock.

Trust Preferred Securities and Subordinated Notes

Trust preferred securities and subordinated notes are carried at their unpaid principal balance. This long-term debt is unsecured with quarterly interest payments determined based upon a floating rate equal to the three-month London Interbank Offered Rate (LIBOR) plus a margin until it is redeemed in whole or matures at a future date.

See *Note 13* for further discussion on long-term debt.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Equity

Accumulated Other Comprehensive Income (Loss)

Net unrealized gains and losses on real estate securities available-for-sale and interest rate agreements designated as cash flow hedges are reported as components of accumulated other comprehensive income on our consolidated statements of changes in equity and our consolidated statements of comprehensive income. Net unrealized gains and losses on securities and interest rate agreements held by our taxable subsidiaries that are reported in other comprehensive income are adjusted for the effects of taxation and may create deferred tax assets or liabilities.

Earnings Per Common Share

Basic earnings per common share (EPS) is computed by dividing net income allocated to common shareholders by the weighted average common shares outstanding. Net income allocated to common shareholders represents net income allocable to common shareholders, less income allocated to participating securities (as described herein). Diluted earnings per common share is computed by dividing income allocated to common shareholders by the weighted average common shares outstanding plus amounts representing the dilutive effect of share-based payment awards and the assumed conversion of convertible notes to common shares.

The two-class method is an earnings allocation formula under which EPS is calculated for common stock and participating securities according to dividends declared and participating rights in undistributed earnings. Under this method, all earnings (distributed and undistributed) are allocated between participating securities and common shares based on their respective rights to receive dividends or dividend equivalents. Accounting guidance on EPS defines vested and unvested share-based payment awards containing nonforfeitable rights to dividends or dividend equivalents as participating securities that are included in computing EPS under the two-class method.

See *Note 15* for further discussion on equity.

Incentive Plans

In May 2013, our shareholders approved an amendment and restatement to our previously amended 2002 Redwood Trust, Inc. Incentive Plan (Incentive Plan) for executive officers, employees, and non-employee directors. The amendment provided, among other things, for an increase in the number of shares available for distribution under the plan. The Incentive Plan authorizes our Board of Directors (or a committee appointed by our Board of Directors) to grant incentive stock options (ISOs), non-qualifying stock options (NQSOs), performance stock units (PSUs) deferred stock units (DSUs), restricted stock, performance shares, performance units, stock appreciation rights, limited stock appreciation rights (awards), and dividend equivalent rights (DERs) to eligible recipients other than non-employee directors. Long-term incentive awards granted under the Incentive Plan generally vest over a three- or four-year period. Awards made under the Incentive Plan to officers and other employees in lieu of the payment in cash of a portion of annual bonuses earned generally vest immediately, but are subject to a three-year mandatory holding period. Non-employee directors are also provided annual awards under the Incentive Plan that generally vest immediately.

For equity awards granted after December 1, 2008, the cost of the awards is amortized over the vesting period on a straight-line basis.

Employee Stock Purchase Plan

In May 2013, our shareholders approved an amendment to our previously amended 2002 Redwood Trust, Inc. Employee Stock Purchase Plan (ESPP) to increase the number of shares available under the ESPP. The purpose of the ESPP is to give our employees an opportunity to acquire an equity interest in the Company through the purchase of shares of common stock at a discount. The ESPP allows eligible employees to purchase common stock at 85% of its fair value, subject to certain limits. Fair value as defined under the ESPP is the lesser of the closing market price of the common stock on the first day of the calendar year or the last day of the calendar quarter.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Executive Deferred Compensation Plan

In May 2002, our Board of Directors approved our 2002 Executive Deferred Compensation Plan (EDCP). The EDCP allows eligible employees and directors to defer portions of current salary and certain other forms of compensation. The Company matches some deferrals. Compensation deferred under the EDCP is recorded as a liability on our consolidated balance sheets. The EDCP allows for the investment of deferrals in either an interest crediting account or DSUs.

401(k) Plan

We offer a tax-qualified 401(k) Plan to all employees for retirement savings. Under this Plan, employees are allowed to defer and invest up to 100% of their cash earnings, subject to the maximum 401(k) Plan contribution limit set forth by the Internal Revenue Service. We match some employee contributions to encourage participation and to provide a retirement planning benefit to employees. Vesting of the 401(k) Plan matching contributions is based on the employee s tenure at the Company, and over time an employee becomes increasingly vested in both prior and new matching contributions.

See *Note 16* for further discussion on equity compensation plans.

Taxes

We have elected to be taxed as a REIT under the Internal Revenue Code and the corresponding provisions of state law. To qualify as a REIT we must distribute at least 90% of our annual REIT taxable income to shareholders (not including taxable income retained in our taxable subsidiaries) within the time frame set forth in the tax code and also meet certain other requirements related to assets, income, and stock ownership. We assess our tax positions for all open tax years and record tax benefits only if tax positions meet a more-likely-than-not threshold in accordance with FASB guidance on accounting for uncertainty in income taxes. We classify interest and penalties on material uncertain tax positions as interest expense and operating expense, respectively, in our consolidated statements of income.

See *Note 19* for further discussion on taxes.

Recent Accounting Pronouncements

In December 2011, FASB issued Accounting Standards Update (ASU) 2011-11, *Disclosures about Offsetting Assets and Liabilities*. This ASU requires the presentation of gross and net information about transactions that are (1) offset in the financial statements or (2) subject to an enforceable master netting arrangement or similar agreement, regardless of whether the transactions are actually offset in the statement of financial position. The ASU is effective prospectively for fiscal years beginning on or after January 1, 2013. We adopted ASU 2011-11 in the first quarter of 2013 and, as a result, presented disclosures on financial assets and liabilities subject to master netting agreements, which can be found below in this *Note 3*.

In February 2013, the FASB issued ASU 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*, which adds new disclosure requirements for items reclassified out of accumulated other comprehensive income. The ASU does not amend any existing requirements for reporting net income or other comprehensive income in the financial statements and is effective prospectively for reporting periods beginning after December 15, 2012. We adopted ASU 2013-02 in the first quarter of 2013 and, as a result, expanded our disclosures related to items reclassified out of accumulated other comprehensive income. These disclosures can be found in *Note 15*.

Balance Sheet Netting

Certain of our derivatives, warehouse, and repurchase agreements are subject to master netting arrangements or similar agreements. Under GAAP, in certain circumstances we may elect to present certain financial assets and liabilities and collateral subject to master netting arrangements in a net position on our consolidated balance sheet. However, we do not report any of these financial assets or liabilities on a net basis, and instead present them on a gross basis on our consolidated balance sheet.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2013

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

The table below presents financial assets and liabilities that are subject to master netting arrangements or similar agreements categorized by financial instrument, together with corresponding financial instruments and corresponding collateral received or pledged at September 30, 2013 and December 31, 2012.

Offsetting of Financial Assets, Liabilities, and Collateral

eptember 30, 2013 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet (1)		Net Amount
				Financial Instruments	Cash Collateral (Received) Pledged	
ssets (2)						
nterest rate greements	$ 4,107	$ -	$ 4,107	$ (3,851)	$ (212)	$ 44
BAs	745	-	745	(745)	-	-
utures	-	-	-	-	-	-
otal Assets	$ 4,852	$ -	$ 4,852	$ (4,596)	$ (212)	$ 44
iabilities (2)						
nterest rate greements	$ (26,356)	$ -	$ (26,356)	$ 3,851	$ 22,505	$ -
BAs	(5,810)	-	(5,810)	745	4,726	(339)
utures	(531)	-	(531)	-	531	-
oan warehouse ebt	(461,584)	-	(461,584)	461,584	-	-
ecurity repurchase	(371,201)	-	(371,201)	371,201	-	-

greements												
Commercial orrowings		(50,119)		-		(50,119)		50,119		-		-
Total Liabilities	$	(915,601)	$	-	$	(915,601)	$	887,500	$	27,762	$	(339)

December 31, 2012 (In Thousands)		Gross Amounts of Recognized Assets (Liabilities)		Gross Amounts Offset in Consolidated Balance Sheet		Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet		Gross Amounts Not Offset in Consolidated Balance Sheet (1) Financial Instruments		Cash Collateral (Received) Pledged		Net Amount
Assets (2)												
nterest rate greements	$	2,972	$	-	$	2,972	$	(2,210)	$	-	$	762
TBAs		-		-		-		-		-		-
utures		-		-		-		-		-		-
Total Assets	$	2,972	$	-	$	2,972	$	(2,210)	$	-	$	762
Liabilities (2)												
nterest rate greements	$	(50,476)	$	-	$	(50,476)	$	2,210	$	48,266	$	-
TBAs		-		-		-		-		-		-
utures		(607)		-		(607)		-		607		-
oan warehouse ebt		(179,982)		-		(179,982)		179,982		-		-
ecurity repurchase greements		(371,936)		-		(371,936)		371,936		-		-
Total Liabilities	$	(603,001)	$	-	$	(603,001)	$	554,128	$	48,873	$	-

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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September 30, 2013

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

(1) Amounts presented in these columns are limited in total to the net amount of assets or liabilities presented in the prior column by instrument. In certain cases, there is excess cash collateral or financial assets we have pledged to a counterparty that exceed the financial liabilities subject to a master netting arrangement or similar agreement. Additionally, in certain cases, counterparties have pledged excess cash collateral to us that exceeds our corresponding financial assets. In each case, these excess amounts are excluded from the table although they are separately reported in our consolidated balance sheets as assets or liabilities, respectively.

(2) Interest rate agreements, TBAs, and futures are components of derivatives instruments on our consolidated balances sheets. Loan warehouse debt, which is secured by residential mortgage loans, and security repurchase agreements are components of short-term debt on our consolidated balance sheets. Commercial borrowings are a component of long-term debt on our consolidated balance sheets.

With respect to each category of financial instrument set forth in the table above, the assets and liabilities resulting from individual transactions between Redwood and a counterparty are subject to a master netting arrangement or similar agreement that provides for all such individual transactions to be treated as a single transaction and, in the event of the termination and close-out of such transactions, to be settled on a net basis and for settlement to include the proceeds of the liquidation of any corresponding collateral, subject to certain limitations on termination, settlement, and liquidation of collateral that may apply in the event of the bankruptcy or insolvency of a party which limitations should not inhibit the eventual practical realization of the principal benefits of the transactions or the master netting arrangement or similar agreement and any corresponding collateral.

Note 4. Principles of Consolidation

GAAP requires us to consider whether securitizations and other transfers of financial assets should be treated as sales or financings, as well as whether any VIEs for example, certain legal entities often used in securitization and other structured finance transactions should be included in our consolidated financial statements. The GAAP principles we apply require us to reassess our requirement to consolidate VIEs each quarter and therefore our determination may change based upon new facts and circumstances pertaining to each VIE. This could result in a material impact to our consolidated financial statements during subsequent reporting periods.

Analysis of Consolidated VIEs

The VIEs we are required to consolidate include certain Sequoia securitization entities, the Residential Resecuritization entity, and the Commercial Securitization entity. Each of these 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, manager, or depositor of these entities. Prior to the fourth quarter of 2012, we were also required to consolidate certain other securitization entities. The following table presents a summary of the assets and liabilities of these VIEs. Intercompany balances have been eliminated for purposes of this presentation.

Assets and Liabilities of Consolidated VIEs at September 30, 2013

September 30, 2013 (Dollars in Thousands)	**Sequoia Entities**	**Residential Resecuritization**	**Commercial Securitization**	**Total**
Residential loans, held-for-investment	$ 1,864,653	$ -	$ -	$ 1,864,653
Commercial loans, held-for-investment	-	-	269,255	269,255
Real estate securities, at fair value	-	275,763	-	275,763
Restricted cash	159	-	138	297
Accrued interest receivable	3,061	682	1,933	5,676
Other assets	4,050	-	92	4,142
Total Assets	$ 1,871,923	$ 276,445	$ 271,418	$ 2,419,786
Accrued interest payable	$ 1,322	$ 27	$ 744	$ 2,093
Asset-backed securities issued	1,790,687	112,179	158,799	2,061,665
Total Liabilities	$ 1,792,009	$ 112,206	$ 159,543	$ 2,063,758
Number of VIEs	24	1	1	26

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Note 4. Principles of Consolidation (continued)

We consolidate the assets and liabilities of certain Sequoia securitization entities, as we did not meet the GAAP sale criteria at the time we transferred financial assets to these entities. Our involvement in consolidated Sequoia entities continues in the following ways: (i) we continue to hold subordinate investments in each entity, and for certain entities, more senior investments; (ii) we maintain certain discretionary rights associated with our sponsorship of, or subordinate investments in, each entity; and (iii) we continue to hold a right to call the assets of certain entities (once they have been paid down below a specified threshold) at a price equal to, or in excess of, the current outstanding principal amount of the entity s asset-backed securities issued. These factors have resulted in our continuing to consolidate the assets and liabilities of these Sequoia entities in accordance with GAAP.

We consolidate the assets and liabilities of the Residential Resecuritization entity as we did not meet the GAAP sale criteria at the time the financial assets were transferred to this entity based on our role in the entity s inception and design. We transferred senior residential securities to Credit Suisse First Boston Mortgage Securities Corp., which subsequently sold them to CSMC 2011-9R, the Residential Resecuritization entity. In connection with this transaction, we acquired certain senior and subordinate securities that we continue to hold. We engaged in the Residential Resecuritization primarily for the purpose of obtaining permanent non-recourse financing on a portion of our senior residential securities portfolio.

We consolidate the assets and liabilities of the Commercial Securitization entity, as we did not meet the GAAP sale criteria at the time the financial assets were transferred to this entity based on our role in the entity s inception and design. We transferred subordinate commercial loans to RCMC 2012-CREL1, a securitization entity. In connection with this transaction, we acquired certain subordinate securities that we continue to hold. We engaged in the Commercial Securitization primarily for the purpose of obtaining permanent non-recourse financing on a portion of our commercial mezzanine portfolio. Our credit risk exposure is largely unchanged as a result of engaging in the transaction, as we remain economically exposed to the financed loans through our subordinate investment in the Commercial Securitization.

Analysis of Unconsolidated VIEs with Continuing Involvement

During 2012 and the nine months ended September 30, 2013, we transferred residential loans to 17 Sequoia securitization entities sponsored by us and accounted for these transfers as sales for financial reporting purposes. We also determined we were not the primary beneficiary of these VIEs as we lacked the power to direct the activities that will have the most significant economic impact on the entities. For the transferred loans where we held the servicing rights prior to the transfer and continue to hold the servicing rights, we recorded MSRs on our consolidated balance sheet at September 30, 2013, and classify those MSRs as Level 3 assets. We also retained senior and subordinate securities in these securitizations that we classify as Level 3 assets.

The following table presents information related to securitization transactions that occurred during the three and nine months ended September 30, 2013 and 2012.

Securitization Activity Related to Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
Principal balance of loans transferred	$ 1,210,604	$ 313,226	$ 5,253,314	$ 1,350,082
Trading securities retained, at fair value	8,702	5,139	100,552	31,925
AFS securities retained, at fair value	71,527	18,576	278,622	75,293
Gains on sale	-	4,023	-	15,632
MSRs recognized	12,514	1,241	41,128	3,849

Our continuing involvement in these securitizations is limited to customary servicing obligations associated with retaining residential MSRs (which we retain a third-party servicer to perform) and the receipt of interest income associated with the securities we retained. The following table summarizes the cash flows between us and the unconsolidated VIEs sponsored by us for the three and nine months ended September 30, 2013 and 2012.

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Note 4. Principles of Consolidation (continued)

Cash Flows Related to Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
Cash proceeds	$ 507,202	$ 299,582	$ 4,366,556	$ 1,271,655
MSR fees received	3,160	260	6,235	414