REDWOOD TRUST INC
Form 10-Q
May 07, 2008

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: March 31, 2008

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(g) 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 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 o No x

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

Large Accelerated Filer x Accelerated Filer o Non-Accelerated Filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

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

Common Stock, $0.01 par value per share	32,845,816 as of May 6, 2008

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REDWOOD TRUST, INC.

2008 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)	March 31, 2008	December 31, 2007
ASSETS		
Real estate loans	$6,774,987	$7,204,151
Real estate securities FVO	949,139	
Real estate securities AFS	242,030	2,110,080
Other real estate investments	3,437	11,521
Non-real estate investments	78,770	79,125
Cash and cash equivalents	256,895	290,363
Total earning assets	8,305,258	9,695,240
Restricted cash	149,253	118,064
Accrued interest receivable	37,533	45,553
Derivative assets	3,964	5,598
Deferred tax asset	8,481	8,875
Deferred asset-backed securities issuance costs	16,498	39,909
Other assets	24,994	25,233
Total Assets	$8,545,981	$9,938,472
LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT)		
LIABILITIES		
Redwood debt	$2,086	$7,561
Asset-backed securities issued Sequoia	6,544,491	6,946,166

Asset-backed securities issued Acacia FVO	1,046,160	3,383,113
Accrued interest payable	43,882	53,796
Derivative liabilities	134,210	81,385
Accrued expenses and other liabilities	15,526	10,441
Dividends payable	24,532	24,289
Subordinated notes	150,000	150,000
Total liabilities	7,960,887	10,656,751
Commitments and contingencies (Note 20)		
STOCKHOLDERS EQUITY (DEFICIT)		
Common stock, par value $0.01 per share, 50,000,000 shares authorized; 32,709,963 and 32,385,073 issued and outstanding	326	324
Additional paid-in capital	1,119,554	1,108,148
Accumulated other comprehensive loss	(93,291)	(573,766)
Cumulative earnings (losses)	537,318	(299,626)
Cumulative distributions to stockholders	(978,813)	(953,359)
Total stockholders equity (deficit)	585,094	(718,279)
Total Liabilities and Stockholders Equity (Deficit)	$8,545,981	$9,938,472

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF (LOSS) INCOME

(In Thousands, Except Share Data)	Three Months Ended March 31,	
(Unaudited)	2008	2007
Interest Income		
Real estate loans	$ 87,565	$ 126,850
Real estate securities	74,436	83,458
Other real estate investments	2,092	2,465
Non-real estate investments	732	
Cash and cash equivalents	3,181	2,332
Total interest income	168,006	215,105
Management fees	1,482	1,180
Interest Expense		
Redwood debt	(182)	(31,094)
Asset-backed securities issued	(126,047)	(136,105)
Subordinated notes	(2,533)	(2,057)
Total interest expense	(128,762)	(169,256)
Net Interest Income Before Market Valuation Adjustments	40,726	47,029
Market valuation adjustments, net	(193,932)	(10,264)
Net Interest (Loss) Income	(153,206)	36,765

Operating expenses	(16,368)	(17,802)
Realized gains on sales and calls, net	42	1,146
Other expense	(255)	
Net (loss) income before provision for income taxes	(169,787)	20,109
Provision for income taxes	(1,800)	(1,800)
Net (Loss) Income	$ (171,587)	$ 18,309
Basic (loss) earnings per share:	$ (5.28)	$ 0.68
Diluted (loss) earnings per share:	$ (5.28)	$ 0.66
Regular dividends declared per common share	$ 0.75	$ 0.75
Special dividends declared per common share	$	$
Total dividends declared per common share	$ 0.75	$ 0.75
Basic weighted average shares outstanding	32,511,445	26,855,681
Diluted weighted average shares outstanding	32,511,445	27,684,029

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 LOSS

(In Thousands) (Unaudited)	Three Months Ended March 31, 2008	2007
Net (Loss) Income	$(171,587)	$ 18,309
Other Comprehensive Income (Loss)		
Net unrealized losses on available-for-sale securities	(52,272)	(92,685)
Reclassification adjustment for net losses (gains) included in net (loss) income	73,294	(113)
Unrealized losses on cash flow hedges, net		(6,138)
Reclassification of net realized cash flow hedge losses (gains) to interest expense on asset-backed securities issued and realized losses (gains) on sales and calls	1,246	(405)
Total Other Comprehensive Income (Loss)	22,268	(99,341)
Comprehensive Loss	$(149,319)	$ (81,032)

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY (DEFICIT)

For the Three Months Ended March 31, 2008

(In Thousands, Except Share Data) (Unaudited)	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Other Comprehensive (Loss) Income	Cumulative (Losses) Earnings	Cumulative Distributions to Stockholders	Total
December 31, 2007	32,385,073	$324	$1,108,148	$(573,766)	$(299,626)	$(953,359)	$(718,279)
Net (loss)					(171,587)		(171,587)
Adoption of SFAS No. 159				458,207	1,008,531		1,466,738
Net unrealized gain/reclassification on assets AFS				21,022			21,022
Net unrealized gain/reclassification on interest rate agreements				1,246			1,246
Issuance of common stock:							
Dividend reinvestment & stock purchase plans	273,740	2	9,389				9,391
Employee option & stock purchase plan	51,150		611				611
Non-cash equity award compensation			1,406				1,406
Common dividends declared						(25,454)	(25,454)
March 31, 2008	32,709,963	$326	$1,119,554	$(93,291)	$537,318	$(978,813)	$585,094

For the Three Months Ended March 31, 2007

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)	Three Months Ended March 31,	
	2008	2007
Cash Flows from Operating Activities:		
Net (loss) income	$(171,587)	$18,309
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Amortization of premiums, discounts, and debt issuance costs	(7,664)	(14,189)
Depreciation and amortization of non-financial assets	266	342
Provision for credit losses	8,058	3,829
Non-cash equity award compensation	1,406	5,117
Net recognized losses and valuation adjustments	193,890	9,118
Net change in:		
Accrued interest receivable	8,020	5,955
Deferred income taxes	394	(315)
Other assets	6,180	(4,807)
Accrued interest payable	(9,914)	1,119
Accrued expenses and other liabilities	5,085	119
Net cash provided by operating activities	34,134	24,597
Cash Flows from Investing Activities:		
Purchases of real estate loans held-for-investment		(414,422)
Principal payments on real estate loans held-for-investment	399,844	1,042,027
Purchases of real estate securities available-for-sale	(54,875)	(650,124)
Proceeds from sales of real estate securities available-for-sale		120,049
Principal payments on real estate securities available-for-sale	17,936	70,043
Net purchases of real estate securities FVO	(3,341)	
Principal payments on real estate securities FVO	56,290	
Purchases of other real estate investments trading[1]		(40,818)
Principal payments on other real estate investments trading[1]	1,008	2,284
Principal payments on non-real estate investments	354	
Net increase in restricted cash	(31,189)	(227,947)
Net cash provided (used) by investing activities	386,027	(98,908)
Cash Flows from Financing Activities:		
Net (repayments) borrowings on Redwood debt	(5,475)	23,575
Proceeds from issuance of asset-backed securities		1,359,833
Deferred asset-backed security issuance costs		(5,869)
Repayments on asset-backed securities	(431,228)	(1,377,883)
Net purchases of interest rate agreements	(1,718)	(601)
Net proceeds from issuance of common stock	10,002	18,727
Dividends paid	(25,210)	(19,831)
Net cash used in financing activities	(453,629)	(2,049)
Net decrease in cash and cash equivalents	(33,468)	(76,360)
Cash and cash equivalents at beginning of period	290,363	168,016

Cash and cash equivalents at end of period	$256,895	$91,656
Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest	$137,214	$166,977
Cash paid for taxes	$	$450
Non-Cash Financing Activity:		
Dividends declared but not paid at period-end	$24,532	$20,347

(1) Cash flows on other real estate investments were reclassified from cash flows from operating activities to investing activities with the adoption of FAS 159 as management concluded that it is appropriate to record the cash flows associated with the portfolio in investing activities due to the nature of, and purpose of its investment.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS March 31, 2008 (Unaudited)

Note 1. Redwood Trust

Redwood Trust, Inc., together with its subsidiaries (Redwood, we, or us), invests in, finances, and manages real estate assets. We invest in residential and commercial real estate loans and in asset-backed securities backed by real estate loans. Our primary focus is credit-enhancing residential and commercial real estate loans. We credit-enhance loans by acquiring and managing the first-loss and other credit-sensitive securities that bear the bulk of the credit risk of securitized loans.

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. For tax purposes, we are structured as a real estate investment trust (REIT).

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 March 31, 2008 and December 31, 2007 and for the three months ended March 31, 2008 and 2007.

These consolidated financial statements include the accounts of Redwood Trust, Inc. (Redwood Trust) and its direct and indirect wholly-owned subsidiaries (collectively, Redwood). All intercompany balances and transactions have been eliminated in consolidation. A number of Redwood Trust s subsidiaries are qualifying REIT subsidiaries and the remainder are taxable subsidiaries. References to the Redwood REIT mean Redwood Trust and its qualifying REIT subsidiaries, excluding taxable subsidiaries.

We currently operate two securitization programs. Our Sequoia program is used for the securitization of residential mortgage loans. References to Sequoia refer collectively to all the Sequoia securitization entities. Our Acacia program is used for the securitization of mortgage-backed securities and other types of financial assets. References to Acacia refer collectively to all of the Acacia CDO securitization entities.

Under the provisions of Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140), we treat the securitizations we sponsor as financings, as under these provisions we have retained effective control over these loans and securities. Control is maintained through our active management of the assets in the securitization entities, our retained asset transfer discretion, our ability to direct certain servicing decisions, or a combination of the foregoing. Accordingly, the underlying loans and securities owned by these securitization entities are shown on our consolidated balance sheets under real estate loans and real estate securities and the asset-back securities (ABS) issued to third parties are shown on our consolidated balance sheets under ABS issued. In our consolidated statements of (loss) income, we record interest income on the loans and securities and interest expense on the ABS issued. Any Sequoia ABS acquired by Redwood or Acacia from Sequoia entities and any Acacia ABS acquired by Redwood for its own portfolio are eliminated in consolidation and thus are not shown separately on our consolidated balance sheets and the associated income and expense are not shown separately on our consolidated statements of (loss) income.

In December 2007, we invested in a distressed assets fund, the Opportunity Fund, as a partner and we are the manager. As we hold majority ownership, we have been deemed primary beneficiary of the Opportunity Fund. Minority interest has been consolidated into accrued expenses and other liabilities and other expense on our consolidated balance sheets and consolidated statements of (loss) income, respectively.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
March 31, 2008
(Unaudited)

Note 3. Summary of Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles in the United States (GAAP) requires us to make a significant number of estimates. These include estimates of fair value of certain assets and liabilities, amount and timing of credit losses, prepayment rates, the period of time during which we anticipate an increase in the fair values of real estate securities sufficient to recover unrealized losses in those securities, and other items 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., market values due to changes in supply and demand, credit performance, prepayments, interest rates, or other reasons; yields due to changes in credit outlook and loan prepayments) will occur in the near term. Our estimates are inherently subjective in nature and actual results could differ from our estimates and the differences may be material. Our fair values reflect what we believe we could realize if we chose to sell our assets and or pay if we chose to transfer liabilities at the measurement date in an orderly manner. Most of the assets and liabilities consolidated on our balance sheet (in particular our credit-enhancement securities and CDOs) are illiquid. Consequently, establishing fair values for these assets and liabilities is inherently subjective and is dependent upon our estimates and modeling assumptions and indications of value obtained from brokers and dealers. As a consequence of limited trading visibility late in 2007 and early in 2008 and the significant uncertainties regarding credit loss levels, there is a wide variance of opinion related to the assumptions underpinning our market valuation inputs. We expect that the market valuations will continue to be highly volatile. Nonetheless, we believe the fair value and other estimates used in preparation of our financial statements represent appropriate values and income recognition and is in conformity with GAAP for these assets and liabilities even in this uncertain market.

Real Estate Loans

Residential and Commercial Real Estate Loans: Held-for-Investment

Real estate loans include residential and commercial real estate loans. Real estate loans held-for-investment are carried at their unpaid principal balances adjusted for net unamortized premiums or discounts and net of any allowance for credit losses.

Coupon interest is recognized as revenue when earned and deemed collectible. We accrue interest on loans until they are more than 90 days past due at which point they are placed on nonaccrual status. Loans are charged off upon foreclosure of the underlying collateral. At that point the net realizable value of the loan is classified as real estate owned (REO) on the balance sheet within other assets. Purchase discounts and premiums related to real estate loans are amortized into interest income over their estimated lives to generate an effective yield, considering the actual and future estimated prepayments of the loans pursuant to the provisions discussed below. Gains or losses on the sale of real estate loans are based on the specific identification method.

Pursuant to Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Cost of Leases* (FAS 91), we use the interest method to determine an effective yield and amortize the premium or discount on loans. For loans acquired prior to July 1, 2004, we use coupon interest rates as they change over time and anticipated principal payments to determine an effective yield to amortize the premium or discount. For 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 to calculate an effective yield to amortize the premium or discount.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

March 31, 2008
(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

We may exercise our right to call ABS issued by Sequoia and may subsequently sell the underlying loans to third parties. For balance sheet purposes, we reclassify held-for-investment loans to held-for-sale loans once we determine which loans will be sold to third parties.

Residential and Commercial Real Estate Loans: Held-for-Sale

Residential and commercial real estate loans that we are marketing for sale to independent third parties are classified as real estate loans held-for-sale. These are carried at the lower of cost or fair value on a loan-by-loan basis. Any market valuation adjustments on these loans are recognized in market valuation adjustments, net in our consolidated statements of (loss) income.

Real Estate Loans   Reserve for Credit Losses

For consolidated real estate loans held-for-investment, we establish and maintain credit reserves based on estimates of credit losses inherent in these loan portfolios as of the reporting date. To calculate the credit reserve, 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 of the consolidated loans, loan pools, or individual loans. See *Note 11* for a discussion of the reserves for credit losses.

We follow the guidelines of Staff Accounting Bulletin No. 102, *Selected Loan Loss Allowance Methodology and Documentation* (SAB 102), Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5), Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114), and Statement of Financial Accounting Standards No. 118, *Accounting by Creditors for Impairment of a Loan-Income Recognition and Disclosures* (FAS 118) in setting credit reserves for our real estate loans.

We consider the following factors in making such determinations:

Ongoing analyses of loans, including, but not limited to, the age of loans, underwriting standards, business climate, economic conditions, geographical considerations, and other observable data;
Historical loss rates and past performance of similar loans;
Relevant environmental factors;
Relevant market research and publicly available third-party reference loss rates;
Trends in delinquencies and charge-offs;
Effects and changes in credit concentrations;
Information supporting the 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 applicable default amounts, the timing of the defaults, and severity of losses upon the defaults, we estimate expected losses for each pool of loans over its expected life. We then estimate the timing of these losses and the losses probable to occur over an effective loss confirmation period. This period is defined as the range of time between the probable 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 credit reserves because we believe those losses exist as of the reported date of the financial statements. We re-evaluate the level of our credit reserves on at least a quarterly basis, and we record provision, charge-offs, and recoveries monthly.

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NOTES TO FINANCIAL STATEMENTS March 31, 2008 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

We do not maintain a loan repurchase reserve, as any risk of loss due to loan repurchases (i.e., due to breach of representations) would normally be covered by recourse to the companies from whom we acquired the loans.

Real Estate Securities Available-for-Sale (AFS)

Real estate securities classified as available-for-sale (AFS) include residential, commercial, and CDO securities and are carried at their estimated fair values. Cumulative unrealized gains and losses are reported as a component of accumulated other comprehensive loss in our consolidated statements of stockholders equity (deficit). Upon sale or other-than-temporary impairment, this accumulated other comprehensive loss is reclassified into earnings on the specific identification method.

Coupon interest is recognized as revenue when earned and deemed collectible. Purchase discounts and premiums related to the securities are amortized into interest income over their estimated lives to generate an effective yield, considering the actual and future estimated prepayments of the securities pursuant to the provisions discussed below. Gains or losses on the sale of securities are based on the specific identification method.

When recognizing revenue on AFS securities, we employ the interest method to account for purchase premiums, discounts, and fees associated with these securities. For securities rated AAA or AA, we use the interest method as prescribed under FAS 91, while for securities rated A or lower we use the interest method as prescribed under the Emerging Issues Task Force of the Financial Accounting Standards Board 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets* (EITF 99-20). The use of these methods requires us to project cash flows over the remaining life of each asset. These projections include assumptions about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. We review and make adjustments to 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. Actual maturities of AFS securities are generally shorter than stated contractual maturities and stated maturities are generally greater than ten years. Actual maturities of the AFS securities are affected by the contractual lives of the underlying mortgages, periodic payments of principal, and prepayments of principal. There can be no assurance that our assumptions used to estimate future cash flows or the current period s yield for each asset would not change in the near term, and the change could be material.

Yields recognized for GAAP for each security vary as a function of credit results, prepayment rates, and, for our securities with variable rate coupons, interest rates. For the securities we acquire, if estimated future credit losses are less than our prior estimate, credit losses occur later than expected, or prepayment rates are faster than expected (meaning the present value of projected cash flows is greater than previously expected), the yield over the remaining life of the security may be adjusted upwards. If estimated future credit losses exceed our prior expectations, credit losses occur more quickly than expected, or prepayments occur more slowly than expected (meaning the present value of projected cash flows is less than previously expected), the yield over the remaining life of the security may be adjusted downward. In cases where the fair value of our securities is below our cost basis we may have an other-than-temporary impairment.

For determining other-than-temporary impairment on our real estate securities accounted for as AFS securities, we use the guidelines prescribed under EITF 99-20, Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115), and Staff Accounting Bulletin No. 5(m), *Other-Than-Temporary Impairment for Certain Investments in Debt and Equity Securities* (SAB 5(m)). Other-than-temporary impairments are reported under market valuation adjustments, net in our consolidated statements of (loss) income. We assess whether a drop in fair value below our cost of the real estate security should be deemed as other-than-temporary impairment. If we have the ability and intent to hold

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS March 31, 2008 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

a real estate security for a reasonable period of time sufficient for a forecasted recovery of fair value up to (or beyond) the cost of the investment, we do not deem that unrealized loss an other-than-temporary impairment.

Real Estate Securities Fair Value Option (FVO)

Real estate securities classified within the fair value option (FVO) of Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FAS 159) (see *Note 4*) include residential, commercial, and CDO securities and are carried at their estimated fair values. Coupon interest is recognized as revenue when earned and deemed collectible and changes in fair value (gains and losses) are reported through our consolidated statements of (loss) income in market valuation adjustments, net.

Other Real Estate Investments

Other real estate investments include interest-only securities (IOs), net interest margin securities (NIMs), and residual securities (residuals). Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Investments* (FAS 155), states that IOs, NIMs, and residuals may contain embedded derivatives which would require bifurcation and separate valuation through the income statement. At the conclusion of the first quarter of 2007 we elected to treat these investments as trading instruments under FAS 115 rather than bifurcate the embedded derivative component under FAS 155. Trading instruments are reported on our consolidated balance sheet at their estimated fair values with changes in fair values reported through our consolidated statements of (loss) income in market valuation adjustments, net.

Total income recognized in current period earnings on these investments equals coupon interest earned plus the change in fair value. Interest income is equal to the instruments yields based on market expectations.

As of January 1, 2008 we adopted the FVO for the residuals, NIMs and IOs owned by Acacia and these are now included under FVO securities.

Non-Real Estate Investments

Non-real estate investments represents a guaranteed investment contract (GIC) entered into by an Acacia securitization entity that we consolidate for financial statements purposes. We have classified this investment as a trading security prior to 2008 and as a FVO security subsequent to January 1, 2008. Non-real estate investments are recorded on our consolidated balance sheets at their estimated fair values. Management considers the GIC s fair value to approximate contract value, as the interest rate is variable at LIBOR minus a spread and resets on a monthly basis. Changes in fair value are reported through our consolidated statements of (loss) income through market valuation adjustments, net. See *Note 9* for a further discussion of our non-real estate investments.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less.

Derivative Financial Instruments

All derivative financial instruments are reported at fair value on our consolidated balance sheets regardless of their accounting treatment. Those with a positive value to us are reported as an asset and those with a negative value to us are reported as a liability. Whether changes in the fair value of these instruments are reported through our income statement depends on the type of derivative and the accounting treatment chosen.

We currently enter into interest rate agreements to help manage some of our interest rate risks. We designate an interest rate agreement as (1) a hedge of the fair value of a recognized asset or liability or of an

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

unrecognized firm commitment (fair value hedge), (2) 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), (3) held for trading (trading instrument) under Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133), or (4) as a FVO derivative under FAS 159. Net purchases and proceeds from interest rate agreements are classified within cash flows as financing activities within the consolidated statements of cash flows.

In a cash flow hedge, the effective portion of the change in the fair value of the hedging derivative is recorded in accumulated other comprehensive loss and is subsequently reclassified into earnings when the hedging relationship is terminated. The ineffective portion of the cash flow hedge is recognized immediately in earnings. We use the dollar-offset method to determine the amount of ineffectiveness, and we anticipate having some ineffectiveness in our hedging program, as not all terms of our hedges and not all terms of our hedged items match perfectly.

We will discontinue hedge accounting and account for them as trading instruments when (1) we determine that the derivative is no longer expected to be effective in offsetting changes in the fair value or cash flows of the designated hedged item; (2) the derivative expires or is sold, terminated, or exercised; (3) the derivative is de-designated as a fair value or cash flow hedge; or (4) it is probable that the forecasted transaction will not occur by the end of the originally specified time period.

Upon adoption of FAS 159, hedges in Acacia securitization entities were de-designated as cash flow hedges, as we elected to account for the ABS issued by Acacia as FVO liabilities from January 1, 2008. Since the hedged item still exists, the fair value of these hedges at the time of de-designation remained in accumulated other comprehensive loss and will be amortized through interest expense over the remaining lives of the Acacia ABS issued.

The changes in fair value of FVO derivatives and other derivatives accounted for as trading instruments are reported in the consolidated statements of (loss) income through market valuation adjustments, net.

As of each period end, we may also have outstanding commitments to purchase real estate loans. These commitments are accounted for as derivatives under Statement of Financial Accounting Standards No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (FAS 149). These are classified as trading instruments and changes in fair value of the purchase commitments are reported through market valuation adjustments, net in the consolidated statements of (loss) income.

We may enter into credit default swaps from time to time. A credit default swap is an agreement to provide (receive) credit event protection based on a financial index or specific security in exchange for receiving (paying) a fixed-rate fee or premium over the term of the contract. Under FAS 133, credit default swaps are accounted for as trading instruments. As of January 1, 2008 we accounted for these under the FVO as they were all owned by Acacia. In both cases changes in fair value are reported in the consolidated statements of (loss) income through market valuation adjustments, net.

See *Note 10* for a further discussion of our derivative financial instruments.

Restricted Cash

Restricted cash includes principal and interest payments from real estate loans and securities owned by consolidated securitization entities that are collateral for, or payable to, owners of ABS issued by those entities and cash pledged as collateral on interest rate agreements. Restricted cash may also include cash retained in Acacia or Sequoia securitization trusts and cash contributed to and held within the Opportunity Fund by investors, prior to purchase of loans and securities or the payments on or redemption of outstanding ABS issued.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
March 31, 2008
(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Accrued Interest Receivable

Accrued interest receivable represents interest that is due and payable to us. This is generally received within the next month.

Deferred Tax Assets

Income recognition for GAAP and tax differ in material respects. As a result, we may recognize taxable income in periods prior to recognizing the income for GAAP. When this occurs, we pay the tax liability and establish a deferred tax asset for GAAP. When the income is then realized under GAAP in future periods, the deferred tax asset is recognized as an expense. Our deferred tax assets are generated by differences in GAAP and tax income at our taxable subsidiaries.

Deferred Asset-Backed Securities Issuance Costs

ABS issuance costs are costs associated with the issuance of ABS from securitization entities we sponsor. These costs typically include underwriting, rating agency, legal, accounting, and other fees. Deferred ABS issuance costs are reported on our consolidated balance sheets as deferred charges and are amortized as an adjustment to consolidated interest expense using the interest method based on the actual and estimated repayment schedules of the related ABS issued under the principles prescribed in Accounting Practice Bulletin 21, *Interest on Receivables and Payables* (APB 21). As of January 1, 2008, the deferred issuance costs associated with Acacia were included in the fair value of ABS issued by Acacia. As a result, these costs were included in our one time adjustment upon adoption of FAS 159 and reclassified into retained earnings. See *Note 4* for further details.

Other Assets

Other assets on our consolidated balance sheets include real estate owned (REO), fixed assets, purchased interest, principal receivable, and other prepaid expenses. REO is reported at the lower of cost or fair value. All other assets are reported at cost.

Redwood Debt

Redwood debt is currently all short-term debt collateralized by loans and securities. We report this debt at its unpaid principal balance.

Asset-Backed Securities Issued

The majority of the liabilities reported on our consolidated balance sheets represent ABS issued by bankruptcy-remote securitization entities sponsored by Redwood.

Sequoia and Acacia assets are held in the custody of trustees. 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. ABS obligations are payable solely from the assets of these entities and are not obligations of Redwood.

Sequoia ABS Issued

These ABS issued are carried at their unpaid principal balances net of any unamortized discount or premium. Deferred ABS issuance costs and premiums relating to Sequoia are amortized into interest expense over the lives of the ABS issued.

Acacia ABS Issued

Effective January 1, 2008, the Acacia ABS issued are accounted for under the fair value option and therefore carried at fair value on our consolidated balance sheets. Deferred ABS issuance costs and premiums

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS March 31, 2008 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

are not recognized for these ABS and changes in fair value (gains or losses) are reported in the consolidated statements of (loss) income through market valuation adjustments, net. Prior to January 1, 2008 Acacia ABS issued were accounted for under the same method as Sequoia ABS issued.

Subordinated Notes

Subordinated notes include trust preferred securities and subordinated notes. Both are unsecured debt, requiring quarterly interest payments at a floating rate equal to LIBOR plus a spread until they are redeemed in whole, or mature at a future date. These notes contain an earlier optional redemption date without penalty. Subordinated notes are reported on our consolidated balance sheet at cost.

(Loss) Earnings per Share

Basic (loss) earnings per share are computed by dividing net (loss) income by the weighted average number of common shares outstanding during the period. Diluted (loss) earnings per share are computed by dividing net (loss) income by the weighted average number of common shares and potential common shares outstanding during the period. Potential common shares outstanding are calculated using the treasury stock method, which assumes that all dilutive common stock equivalents are exercised and the funds generated by the exercises are used to buy back outstanding common stock at the average market price of the common stock during the reporting period. In accordance with Statement of Financial Accounting Standards No. 128, *Earnings per Share* (FAS 128), if there is a loss from continuing operations, the common stock equivalents are deemed antidilutive and diluted (loss) earnings per share is calculated in the same manner as basic (loss) earnings per share.

The following table provides a reconciliation of denominators of the basic and diluted (loss) earnings per share computations, for the three months ended March 31, 2008 and 2007.

Basic and Diluted (Loss) Earnings per Share

	Three Months Ended March 31,	
	2008	2007
Denominators:		
Denominator for basic (loss) earnings per share is equal to the weighted average number of common shares outstanding during the period	32,511,445	26,855,681
Adjustments for diluted (loss) earnings per share are:		
Net effect of dilutive stock options		828,348
Denominator for diluted (loss) earnings per share	32,511,445	27,684,029
Basic (Loss) Earnings Per Share:	$(5.28)	$0.68
Diluted (Loss) Earnings Per Share:	$(5.28)	$0.66

Pursuant to EITF 03-6, *Participating Securities and the Two Class Method under FASB No. 128* (EITF 03-6), we determined that there was no allocation of income for our outstanding stock options as they were antidilutive, as defined by this principle, for the three months ended March 31, 2008 and 2007. For the three months ended March 31, 2008, Redwood had a net loss, and therefore the number of outstanding stock options, deferred stock units, and restricted stock (collectively, equity awards) that were antidilutive totaled 1,319,346. For the three months ended March 31, 2007, the number of outstanding equity awards that were antidilutive totaled 61,042. There were no other participating securities, as defined by EITF 03-6, during the three months ended March 31, 2008 and 2007.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS March 31, 2008 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Other Comprehensive Income (Loss)

Current period net unrealized gains and losses on real estate securities available-for-sale and interest rate agreements classified as cash flow hedges are reported as components of other comprehensive income (loss) on our consolidated statements of comprehensive loss. Net unrealized gains and losses on securities and interest rate agreements held by our taxable subsidiaries that are reported in other comprehensive income (loss) are adjusted for the effects of tax and may create deferred tax assets or liabilities.

Stock-Based Compensation

As of March 31, 2008 and December 31, 2007, we had one stock-based employee compensation plan and one employee stock purchase plan. These plans, and associated equity awards, are described more fully in *Note 18*.

We adopted Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* (FAS 123R), on January 1, 2006. With the adoption of FAS 123R, the grant date fair value of all remaining unvested stock compensation awards (stock options, deferred stock units, and restricted stock) are expensed on the consolidated statements of (loss) income over the remaining vesting period.

The Black-Scholes option-pricing model was used in determining fair values of option grants accounted for under FAS 123R. The model requires the use of inputs such as strike price and assumptions such as expected life, risk free rate of return, and stock price volatility.. The stock price volatility assumption is based on the historical volatility of our common stock. Certain options have dividend equivalent rights (DERs) and, as provided for under FAS 123R, the assumed dividend yield was zero for these options. Other options granted have no DERs and the assumed dividend yield was determined to be 10%. There were no options granted for the three months ended March 31, 2008 and the options granted in the three months ended March 31, 2007 were reload options (as further discussed in *Note 18*).

The following table describes the weighted average of assumptions used for calculating the value of options granted for the three months ended March 31, 2008 and 2007.

Weighted Average Assumptions Used for Valuation of Options under FAS 123R Granted During Period

	Three Months Ended March 31, 2008	2007	
Stock price volatility		25.5	%
Risk free rate of return (5 yr Treasury Rate)		4.58	%
Average life		6 years	
Dividend yield		10.00	%

Recent Accounting Pronouncements

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, *The Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51,* (FAS 160). FAS 160 establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. FAS 160 clarifies that a noncontrolling interest in a subsidiary should be reported as a component of equity in the consolidated financial statements and requires disclosure, on the face of the consolidated statement of (loss) income, of the amounts of consolidated net income attributable to the parent and to the noncontrolled interest. FAS 160 is effective beginning January 1, 2009, with early adoption not permitted. FAS 160 is to be applied prospectively, except for the presentation and disclosure requirements, which upon adoption will be applied retrospectively for all periods presented. We are currently evaluating the disclosure requirements of FAS 160.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS March 31, 2008 (Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

In February 2008, the FASB issued FASB Staff Position 140-3, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions,* (FSP 140-3). FSP 140-3 provides that a transferor and a transferee must account for a transfer of a financial asset and a repurchase financing with the same counterparty (or consolidated affiliates of either counterparty) as a linked transaction if the transfer and repurchase financing were entered into contemporaneously or in contemplation of each other unless certain specified criteria are met. Under FSP 140-3, a repurchase financing is a transaction in which the buyer (initial transferee) of a financial asset obtains financing from the seller (initial transferor) and transfers the financial asset back to the seller as collateral until the financing is repaid. FSP 140-3 is effective beginning January 1, 2009, with early adoption not permitted. FSP 140-3 is to be applied prospectively to initial transfers and repurchase financings for which the initial transfer is executed on or after the beginning of the fiscal year in which this FSP is initially applied.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an Amendment of FASB Statement No. 133*, (FAS 161). FAS 161 amends and expands the disclosure requirements of FAS 133 to provide greater transparency about how and why an entity uses derivative instruments, how derivative instruments and related hedge items are accounted for under FAS 133 and its related interpretations, and how derivative instruments and related hedged items affect an entity s financial position, results of operations, and cash flows. To meet those objectives, FAS 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. FAS 161 is effective January 1, 2009, and early adoption is encouraged. We are currently evaluating the impact FAS No. 161, although we do not expect a significant impact on our financial position, results of operations or cash flows.

Note 4. Adoption of FAS 159

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FAS 159). This gives us the option of electing to measure eligible financial assets, financial liabilities, and commitments at fair value (i.e., the fair value option or FVO), on an instrument-by-instrument basis. The election to use FVO is available when we first recognize a financial asset or financial liability or enter into a firm commitment or upon the election of FVO on existing instruments on January 1, 2008. Subsequent changes in the fair value of assets, liabilities, and commitments valued under the FVO are recorded in our consolidated statements of income.

On January 1, 2008, we elected to apply the FVO under FAS 159 to the assets and liabilities of our consolidated Acacia securitization entities and all investment grade securities (IGS) at Redwood. Prior to the application of FAS 159, we were required, for financial reporting purposes, to mark-to-market the assets, but not the liabilities, of the Acacia entities, even though the assets and liabilities were paired within the same legal structure and the ABS issued by each Acacia entity would be repaid directly and solely from the cash flows generated by the assets of that entity.

Electing the FVO for the assets and liabilities (including derivatives) of Acacia will enable us to mitigate the volatility in earnings and book value that results from the use of different measurement attributes, to correlate more closely the values of the assets and liabilities that are paired within the same securitization entity, and to reduce the complexity of accounting especially with regards to derivatives under FAS 133. We elected the fair value option for the IGS at Redwood since we expect to pair these investments with a liability for which we will also elect the FVO.

We did not elect the fair value option for the assets and liabilities of Sequoia as these are currently accounted for using similar measurement attributes and, as a result, there is less need to mitigate volatility in earnings and book value. We also did not elect the fair value option for our credit enhancement security

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
March 31, 2008

(Unaudited)

Note 4. Adoption of FAS 159 (continued)

(CES) investments at Redwood that are funded with equity. There is no paired liability for these assets and our intent upon the acquisition of these assets is to hold them to maturity and generate long-term cash flows. Thus, changes in fair values of these investments from period to period through our statements of income, as would be required under the FVO, would not, in our opinion, be appropriate.

As noted above, FAS 159 allows for a one-time election to record the cumulative unrealized gains and losses on those assets, liabilities, and commitments for which the FVO is elected and were existing at the time of initial application of FAS 159. Adjustments resulting from the one-time election are reflected on the balance sheet and have no impact on our consolidated statements of income. Subsequent changes in fair values are recorded in our consolidated statements of income. On January 1, 2008, as a result of the one-time election, we reclassified $459 million of net unrealized gains and losses on Acacia assets and IGS at Redwood to retained earnings from accumulated other comprehensive loss. On that date, we also recorded in retained earnings the $1.5 billion difference between reported values and fair values of the Acacia liabilities.. In addition, as part of the revaluation of the Acacia liabilities to fair value we reclassified to retained earnings the unamortized deferred bond issuance costs of $21 million.. As a result of the adoption of FAS 159 and this one-time election, we recorded a cumulative effect adjustment of $1.5 billion as an increase to stockholders equity as of January 1, 2008. There was no deferred tax impact of this increase since the net unrealized losses in accumulated other comprehensive loss that were reclassified to retained earnings were generated at the Redwood REIT, which distributes predominantly all of its taxable income each year.

The following table presents the consolidated balance sheet at December 31, 2007, the transition adjustments, and the consolidated balance sheet at January 1, 2008 following the application of FAS 159.

Adoption of FAS 159

(In Millions)	December 31, 2007 Redwood Consolidated	Transition Adjustment	January 1, 2008 Redwood Consolidated
Real estate loans	$ 7,204	$	$ 7,204
Real estate securities and other investments	2,201		2,201
Cash and cash equivalents	290		290
Total earning assets	9,695		9,695
Restricted cash	118		118
Other assets	126	(21)	105
Total Assets	$ 9,939	$ (21)	$ 9,918
Redwood debt	$ 8	$	$ 8
Asset-backed securities issued	10,329	(1,490)	8,839
Subordinated notes	150		150
Other liabilities	170		170
Total liabilities	10,657	(1,490)	9,167
Common stock and additional paid-in capital	1,108		1,108
Accumulated other comprehensive (loss) income	(574)	459	(115)
Retained earnings	(1,252)	1,010	(242)
Total stockholders (deficit) equity	(718)	1,469	751

Total Liabilities and Stockholders Equity	$ 9,939	$ (21)	$ 9,918

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS March 31, 2008 (Unaudited)

Note 5. Fair Value of Financial Instruments

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (FAS 157). This new standard sought to consolidate and clarify the definition of fair value that is used throughout GAAP. FAS 157 defines fair value, establishes a methodology for measuring fair value, establishes a hierarchy of information used in measuring fair value, and enhances the disclosure of information about fair value measurements. FAS 157 provides that the exit price, which is the price at which an asset could be sold or a liability could be transferred in an orderly process, should be used to fair value the asset or liability. FAS 157 also provides that market data, to the extent available, and not internally generated or entity specific information, should be used to determine fair value. We adopted FAS 157 on January 1, 2008. The financial impact on Redwood of the adoption of FAS 157 was not significant since our valuation methodology used in prior periods did not need to be revised to comply with FAS 157.

FAS 157 also provided a set of disclosures, the most significant being the requirements to disclose the valuations based on a frame work that would group the valuations into a three-level hierarchy based on the ability to observe the significant inputs into the valuation:

Level 1: Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2: Inputs other than quoted prices included in Level 1 that are observable for the asset or liability either directly or through corroboration with observable market data.

Level 3: Unobservable inputs (e.g., an entity s own data or assumptions).

Level 3 inputs includes situations where there is little, if any, market activity for the asset or liability. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement. Our assessment of the significance of a particular input to the fair value measurement requires judgment, and considers factors specific to the asset or liability. There are also additional requirements to provide a roll forward of the items in Level 3 along with additional discussions on how these valuations are developed.

We estimate fair values of our financial instruments using available market information and other appropriate valuation methodologies. These fair value estimates generally incorporate discounted future cash flows at current market discount rates for comparable investments. We validate our fair value estimates on at least a quarterly basis by obtaining fair value estimates from dealers, to the extent available, for securities who make a market in these financial instruments and look at recent acquisitions and sales if any (even if they occur after the reporting date). We believe the estimates we use reasonably reflect the values we may be able to receive should we choose to sell them. Many factors must be considered in order to estimate fair values, including, but not limited to interest rates, prepayment rates, amount and timing of credit losses, supply and demand, liquidity, and other market factors. Accordingly, our estimates are inherently subjective in nature and involve uncertainty and judgment to interpret relevant market and other data.

Market participants typically place a higher value on bonds with higher ratings and similar loan types should have higher prices and tighter spreads than bonds with lower ratings. Market participants currently also see more value in older vintage bonds where the collateral is more seasoned and there is a better chance that historical home price appreciation has resulted in an increased level of support for the value of the bonds. Our expectation is that, external prices should be within the range or close to our internally developed bid and ask values as the fair values are based on market participant assumptions.

Methodologies we use to estimate fair values for various asset types are described below.

Real estate loans

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS March 31, 2008 (Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

Residential real estate loan fair values are determined by available market quotes and discounted cash flow analyses. Commercial real estate loan fair values are determined by appraisals on underlying collateral and discounted cash flow analyses.

Real estate securities

Real estate securities are represented by residential, commercial, CDO and other asset-backed securities. Real estate securities fair values are determined by discounted cash flow analyses and other valuation techniques using market pricing assumptions confirmed by third party dealer/pricing indications to the extent available. Significant inputs in the valuation analysis are predominantly Level 3, due to the nature of these instruments and the lack of readily available market quotes. These instruments trade infrequently and therefore have little or no price transparency. Relevant market indicators that are factored in the analyses include bid/ask spreads, credit losses, interest rates, and prepayment speeds. Estimated fair values are based on applying the market indicators to generate discounted cash flows.

Other real estate investments

Other real estate investments fair values are determined by discounted cash flow analyses and other valuation techniques using market pricing assumptions confirmed by third party dealer/pricing indications.

Non-real estate investments

Non-real estate investments fair values approximate carrying values as the coupon rates are indexed to LIBOR resetting monthly.

Derivative assets and liabilities

Our derivative instruments include interest rate agreements and credit default swaps. Fair values of derivative instruments are determined using valuation models and are verified by valuations provided by dealers active in derivative markets. Valuation models require a variety of inputs, including contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates, and correlations of such inputs. Model inputs for interest rate agreements can generally be verified and model selection does not involve significant management judgment (these are Level 2 inputs). For other derivatives, valuations are based on various factors such as liquidity, bid/offer spreads, and credit considerations for which we rely on available market evidence. In the absence of such evidence, management s best estimate is used for these other derivatives, including credit default swaps (these are Level 3 inputs).

Cash and cash equivalents

Includes cash on hand and highly liquid investments with original maturities of three months or less. Fair values equal carrying values.

Restricted cash

Restricted cash primarily includes interest-earning cash balances in ABS entities and the Opportunity Fund for the purpose of distribution to bondholders and reinvestment. Due to the short-term nature of the restrictions, fair values approximate carrying values.

Accrued interest receivable and payable

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS March 31, 2008 (Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

Includes interest due and receivable on assets and due and payable on our liabilities. Due to the short-term nature of when these interest payments will be received or paid, fair values approximate carrying values.

Redwood debt

All Redwood debt is adjustable and matures within one year; fair values approximate carrying values.

ABS issued

ABS issued fair values are determined by discounted cash flow analyses and other valuation techniques using market pricing assumptions confirmed by third party dealer/pricing indications to the extent available. Significant inputs in the valuation analysis are predominantly Level 3, due to the nature of these instruments and the lack of readily available market quotes. These instruments trade infrequently and therefore have little or no price transparency. Relevant market indicators that are factored in the analyses include dealer marks to the extent available, bid/ask spreads, external spreads, collateral credit losses, interest rates and collateral prepayment speeds. Estimated fair values are based on applying the market indicators to generate discounted cash flows.

Subordinated notes

Fair values are determined using comparable market indicators of current pricing.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS March 31, 2008 (Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

The following table presents the carrying values and estimated fair values of our financial instruments as of March 31, 2008 and December 31, 2007.

Fair Value of Financial Instruments

(In Thousands)	March 31, 2008 Carrying Value	March 31, 2008 Fair Value	December 31, 2007 Carrying Value	December 31, 2007 Fair Value
ASSETS				
Real estate loans (held-for-investment)	$ 6,751,743	$ 5,851,167	$ 7,199,618	$ 6,860,574
Real estate loans (held-for-sale)	4,443	4,443	4,533	4,533
Real estate loans FVO	18,801	18,801		
Real estate securities FVO	949,139	949,139		
Real estate securities AFS	242,030	242,030	2,110,080	2,110,080
Other real estate investments (trading)	3,437	3,437	11,521	11,521
Non-real estate investments	78,770	78,770	79,125	79,125
Cash and equivalents	256,895	256,895	290,363	290,363
Derivative assets	3,964	3,964	5,598	5,598
Restricted cash	149,253	149,253	118,064	118,064
Accrued interest receivable	37,533	37,533	45,553	45,553
LIABILITIES				
Redwood debt	2,086	2,086	7,561	7,561
ABS Issued				
ABS issued Sequoia	6,544,491	5,642,142	6,946,166	6,693,087
ABS issued Acacia FVO (1)	1,046,160	1,046,160	3,383,113	1,893,441
Total ABS issued	7,590,651	6,688,302	10,329,279	8,586,528
Derivative liabilities	134,210	134,210	81,385	81,385
Accrued interest payable	43,882	43,882	53,796	53,796
Subordinated notes	150,000	72,000	150,000	94,000

(1) Acacia ABS issued is FVO as of January 1, 2008 and was at amortized cost at December 31, 2007 and prior.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
March 31, 2008
(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

The following table presents information about the assets and liabilities consolidated on our financial statements that are reported at fair value on a recurring basis as of March 31, 2008, and indicates the fair value hierarchy of the valuation techniques utilized to measure fair value.

Assets and Liabilities Measured at Fair Value on a Recurring Basis as of March 31, 2008

(In Thousands)	Carrying Value	Fair Value Measurements Using Quoted Prices In Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Real estate loans (held-for-sale)	$ 4,443	$	$	$ 4,443
Real estate loans FVO	18,801			18,801
Real estate securities FVO	949,139			949,139
Real estate securities AFS	242,030			242,030
Other real estate investments (trading)	3,437			3,437
Non-real estate investments	78,770			78,770
Derivative assets	3,964		3,892	72
Liabilities				
ABS issued Acacia	1,046,160			1,046,160
Derivative liabilities	134,210		61,709	72,501

The following table presents information for total net interest income on those assets and liabilities under the FVO.

Net Interest Income on FVO Assets and Liabilities

(In Thousands)	Net Interest Income on FVO Assets and Liabilities Three Months Ended March 31, 2008 Change in Market	Interest Income	Total Net Interest

	Value	(Expense)	Income
Assets			
Real estate loans FVO	$ (4,660)	$ 371	$ (4,289)
Real estate securities FVO	(795,283)	45,462	(749,821)
Non-real estate investments		732	732
Derivative assets	(197)		(197)
Liabilities			
ABS issued Acacia	809,841	(44,052)	765,789
Derivative liabilities	(49,587)		(49,587)
Net Interest Income on FVO Assets and Liabilities	$ (39,886)	2,513	(37,373)

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS March 31, 2008 (Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

The following table presents the components of market valuation adjustments, net, recorded in our consolidated statements of (loss) income.

Market Valuation Adjustments, Net

Three Months Ended March 31, 2008	
(In Thousands)	
Total FVO Market Valuation Adjustments	$ (39,886)
Other Market Valuation Adjustments	
Impairments on AFS securities	(144,098)
Derivative instruments	(6,392)
Other real estate investments (trading)	(2,697)
Real estate loans (HFI/HFS)	(859)
Market Valuation Adjustments, Net	$ (193,932)

The following table presents additional information about assets and liabilities reported at fair value on our consolidated balance sheets on a recurring basis and for which Level 3 inputs were utilized to determine fair value. These changes in fair value are after the adoption of FAS 159 on January 1, 2008.

Changes in Level 3 Assets and Liabilities Measured at Fair Value on a Recurring Basis

(In Thousands)	Beginning Balance 1/1/2008	Principal Transactions: Investment	Total Realized and Unrealized Gains or (Losses) Realized Gains or (Losses)	Unrealized Gains or (Losses)	Purchases, Sales, Other Settlements and Issuances, Net	Ending Balance 3/31/2008
Assets						
Real estate loans (held-for-sale)	$4,533	$(16)	$(74)	$	$	$4,443
Real estate loans FVO	25,426	(116)	(4,660)	(1,849)	$	18,801
Real estate securities FVO	1,792,990	(56,290)	(795,283)	$	7,722	949,139
Real estate securities AFS	317,090	(7,071)	(144,098)	21,193	54,916	242,030
Other real estate investments (trading)	11,521	(1,008)	(2,697)	$	(4,379)	3,437
Non-real estate investments	79,125	(355)	$	$	$	78,770
Derivative assets	114	$	(42)	$	$	72
Liabilities						
Acacia ABS issued	1,893,441	(30,165)	(809,841)	$	(7,275)	1,046,160
Derivative liabilities	57,397	$	18,325	$	(3,221)	72,501

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NOTES TO FINANCIAL STATEMENTS March 31, 2008 (Unaudited)

Note 6. Real Estate Loans

We acquire residential and commercial real estate loans from third party originators. The majority of these loans are sold to securitization entities sponsored by us under our Sequoia and Acacia programs which, in turn, issue ABS. The remainder of the loans we invest in are held and financed with Redwood debt and equity.

The following table summarizes the carrying value of the residential and commercial real estate loans, as reported on our consolidated balance sheets at March 31, 2008 and December 31, 2007.

Real Estate Loans

(In Thousands)

	March 31, 2008	December 31, 2007
Residential real estate loans held-for-sale	$ 4,443	$ 4,533
Residential real estate loans held-for-investment	6,751,491	7,173,940
Total residential real estate loans	6,755,934	7,178,473
Commercial real estate loans FVO	18,801	
Commercial real estate loans held-for-investment	252	25,678
Total Real Estate Loans	$ 6,774,987	$ 7,204,151

At March 31, 2008, we had $5 million (of outstanding principal) of residential loans in held-for-sale, with a lower of cost or fair value of $4 million, (carrying value) as we are actively marketing these loans for sale. At December 31, 2007 there was $6 million (of outstanding principal) for these loans with a lower of cost or fair value of $5 million. The following table provides additional information on the real estate loans classified as held-for-investment as of March 31, 2008 and December 31, 2007.

Real Estate Loans Held-for-Investment

March 31, 2008 (In Thousands)	Residential Real Estate Loans	Commercial Real Estate Loans	Total
Current face	$ 6,697,241	$ 11,103	$ 6,708,344
Unamortized premium (discount)	78,694	(362)	78,332
Discount designated as credit reserve		(8,141)	(8,141)
Amortized cost	6,775,935	2,600	6,778,535
Reserve for credit losses	(24,444)	(2,348)	(26,792)
Carrying Value	$ 6,751,491	$ 252	$ 6,751,743

December 31, 2007 (In Thousands)	Residential Real Estate Loans	Commercial Real Estate Loans	Total
Current face	$ 7,106,018	$ 38,111	$ 7,144,129
Unamortized premium (discount)	86,204	(1,944)	84,260
Discount designated as credit reserve		(8,141)	(8,141)
Amortized cost	7,192,222	28,026	7,220,248
Reserve for credit losses	(18,282)	(2,348)	(20,630)
Carrying Value	$ 7,173,940	$ 25,678	$ 7,199,618

Of the $6.7 billion of face and $79 million of unamortized premium on our residential real estate loans at March 31, 2008, $2.4 billion of face and $60 million of unamortized premium relates to residential loans acquired prior to July 1, 2004. For these residential loans, we use coupon interest rates as they change over

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS
March 31, 2008
(Unaudited)

Note 6. Real Estate Loans (continued)

time and anticipated principal payments to determine an effective yield to amortize the premium or discount. During the first quarter of 2008, 7% of these residential loans prepaid and we amortized 10% of the premium. Of the $7.1 billion of face and $86 million of unamortized premium on our residential real estate loans at December 31, 2007, $2.5 billion of face and $66 million of unamortized premium relates to residential loans acquired prior to July 1, 2004. For residential loans acquired after July 1, 2004, the face and unamortized premium was $4.3 billion and $19 million at March 31, 2008, respectively, and $4.6 billion and $20 million at December 31, 2007, respectively. For these residential loans, we use the initial coupon interest rate of the loans (without regard to future changes in the underlying indices) and anticipated principal payments to calculate an effective yield to amortize the premium or discount.

Residential real estate loans are either sold to securitization entities sponsored by us under our Sequoia program which, in turn, issue ABS or are held and financed with Redwood debt and equity.

On January 1, 2008 the commercial loans within Acacia were included in the fair value option elections of FAS 159 and are subsequently recorded at fair value. Prior to 2008 these were recorded as held-for-investment real estate loans.

Commercial Real Estate Loans FVO

March 31, 2008 (In Thousands)	Commercial Real Estate Loans
Current face	$ 26,890
Market value discount	(8,089)
Carrying Value	$ 18,801

The table below presents information regarding real estate loans pledged and unpledged under our borrowing agreements at March 31, 2008 and December 31, 2007.

Real Estate Loans Pledged and Unpledged

	March 31, 2008		December 31, 2007	
(In Thousands)	Face Value	Carrying Value	Face Value	Carrying Value
Unpledged	$16,588	$4,695	$16,606	$4,785
Owned by securitization entities, financed through the issuance of ABS	6,724,131	6,770,292	7,133,022	7,199,366
Total	$6,740,719	$6,774,987	$7,149,628	$7,204,151

Unpledged real estate loans at March 31, 2008 consist of held-for-sale residential loans with a face value of $5 million and a carrying value of $4 million and two commercial loans with a face value of $11 million and a carrying value of $0.3 million.

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Note 7. Real Estate Securities

The real estate securities shown on our consolidated balance sheets include residential, commercial, and CDO securities acquired from securitizations sponsored by others.

Real Estate Securities at Redwood and Opportunity Fund

The table below presents the carrying value (which equals fair value as these are available-for-sale securities (AFS) or fair value option (FVO)) of our securities at Redwood and the Opportunity Fund that are included in our consolidated balance sheets as of March 31, 2008 and December 31, 2007, (but not owned by Acacia) by type of securities, and by credit rating of investment-grade (IGS) and below investment-grade (CES).

Real Estate Securities at Redwood and Opportunity Fund

March 31, 2008 (In Thousands)	AFS Redwood CES	IGS	AFS Opportunity Fund CES	IGS	Total AFS Securities	FVO CES	Redwood IGS	Total Securities
Residential securities:								
Prime	$ 77,806	$ 18,324	$	$	$ 96,130	$	$ 1,850	$ 97,980
Alt-a	9,113			457	9,570		5,280	14,850
Subprime	937			8,643	9,580	341	396	10,317
Total residential securities	87,856	18,324		9,100	115,280	341	7,526	123,147
Commercial securities	99,523				99,523			99,523
CDO securities	686			26,541	27,227		15,504	42,731
Total Securities	$ 188,065	$ 18,324	$	$ 35,641	$ 242,030	$ 341	$ 23,030	$ 265,401

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 7. Real Estate Securities (continued)

The table below presents the components comprising the carrying value of available-for-sale IGS at Redwood and the Opportunity Fund reported on our consolidated balance sheets at March 31, 2008 and December 31, 2007.

Investment-Grade Securities (AFS) at Redwood and Opportunity Fund

March 31, 2008 (In Thousands)	Residential	Commercial	CDO	Total IGS
Current face	$ 56,494	$	$ 89,645	$ 146,139
Unamortized discount, net	(22,015)		(43,959)	(65,974)
Discount designated as credit reserve	(20)		(15,000)	(15,020)
Amortized cost	34,459		30,686	65,145
Gross unrealized gains	13			13
Gross unrealized losses	(7,048)		(4,145)	(11,193)
Carrying Value	$ 27,424	$	$ 26,541	$ 53,965

December 31, 2007 (In Thousands)	Residential	Commercial	CDO	Total IGS
Current face	$ 31,255	$	$ 109,726	$ 140,981
Unamortized discount, net	(3,991)		(66,451)	(70,442)
Discount designated as credit reserve	(12,012)			(12,012)
Amortized cost	15,252		43,275	58,527
Gross unrealized gains	469			469
Gross unrealized losses	(370)		(12,750)	(13,120)
Carrying Value	$ 15,351	$	$ 30,525	$ 45,876

At March 31, 2008, the Opportunity Fund had $36 million IGS consisting of $9 million residential IGS with a face value of $13 million and $27 million CDO IGS with a face value of $90 million. At December 31, 2007, the Opportunity Fund had $15 million IGS consisting of $3 million residential IGS with a face value of $4 million and $12 million CDO IGS with a face value of $49 million.

The amount of designated credit reserve equals the estimate of credit losses within the underlying loan pool on the CES that we expect to incur over the life of the securities. This estimate is determined based upon various factors affecting these assets, including economic conditions, characteristics of the underlying loans, delinquency status, past performance of similar loans, external credit reserves and priority of cashflows and credit loss attribution within securitizations. We use a variety of internal and external credit risk cash flow modeling and portfolio analytical tools to assist in our assessments. We review our assessments at least quarterly on each individual underlying loan pool and determine the appropriate level of credit reserve required for each security we own. The designated credit reserve is specific to each security.

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NOTES TO FINANCIAL STATEMENTS March 31, 2008 (Unaudited)

Note 7. Real Estate Securities (continued)

The following table presents the aggregate changes in our amortized discount and the portion of the discount designated as credit reserve on IGS for the three months ended March 31, 2008. We did not have any designated credit reserves on any securities in this portfolio prior to the third quarter of 2007.

Changes in Unamortized Discount and Designated Credit Reserves on Residential, Commercial, and CDO IGS at Redwood and the Opportunity Fund

Three Months Ended March 31, 2008 (In Thousands)	Residential	Commercial	CDO	Total
Beginning balance of unamortized discount, net	$569,566	$ 2,814	$143,575	$715,955
Reclassification due to FVO adoption	(568,283)	(2,814)	(112,750)	(683,847)
Amortization of discount	(382)		(435)	(817)
Discount on acquistions	21,114		13,569	34,683
Ending Balance of Unamortized Discount, Net	$22,015	$	$43,959	$65,974
Beginning balance of designated credit reserve	$46,641	$	$49,283	$95,924
Reclassification due to FVO adoption	(46,641)		(49,283)	(95,924)
Discount designated as credit reserve on acquistions	20		15,000	15,020
Ending Balance of Designated Credit Reserve	$20	$	$15,000	$15,020

The IGS at the Opportunity Fund had an unamortized discount balance of $62 million and $32 million at March 31, 2008 and December 31, 2007, respectively.

The table below presents the components comprising the carrying value of available-for-sale CES reported on our consolidated balance sheets at March 31, 2008 and December 31, 2007. These securities are all owned at Redwood.

Credit-Enhancement Securities AFS at Redwood

March 31, 2008 (In Thousands)	Residential	Commercial	CDO	Total CES
Current face	$ 778,211	$ 523,118	$ 26,563	$ 1,327,892

Unamortized discount, net	(61,699)	(36,955)	(3,513)	(102,167)
Discount designated as credit reserve	(586,154)	(378,388)	(22,374)	(986,916)
Amortized cost	130,358	107,775	676	238,809
Gross unrealized gains	3,238	2,078	10	5,326
Gross unrealized losses	(45,740)	(10,330)		(56,070)
Carrying Value	$ 87,856	$ 99,523	$ 686	$ 188,065

December 31, 2007 (In Thousands)	Residential	Commercial	CDO	Total CES
Current face	$ 791,431	$ 523,156	$ 26,501	$ 1,341,088
Unamortized discount, net	(90,441)	(17,867)	(3,096)	(111,404)
Discount designated as credit reserve	(510,133)	(318,456)	(21,855)	(850,444)
Amortized cost	190,857	186,833	1,550	379,240
Gross unrealized gains	10,936	4,923	822	16,681
Gross unrealized losses	(50,783)	(43,248)		(94,031)
Carrying Value	$ 151,010	$ 148,508	$ 2,372	$ 301,890

The loans underlying all of our residential CES totaled $151 billion at March 31, 2008, and consist of $127 billion prime, $18 billion alt-a, and $6 billion subprime. These loans are located nationwide with a large

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Note 7. Real Estate Securities (continued)

concentration in California (49%). During the first quarter of 2008, realized residential credit losses were $31 million of principal value, a rate that equals eight basis points (0.08%) on an annualized basis of the balance of the loans. Serious delinquencies (90+ days, in foreclosure or REO) at March 31, 2008 were 3.06% of current balance and 1.46% of original balance. For loans in prime pools, delinquencies were 1.27% of current balance and 0.60% of original balance. Alt-a pools had delinquencies of 9.51% of current balance and 4.49% of original balance. Subprime pools had delinquencies of 22.13% of current balance and 17.21% of original balance.

When there are other-than-temporary impairments, the balance of the unamortized discount, credit reserve, or a combination of both will increase by the amount of the impairment charge. In the table below, the amount of impairment is first added to the credit reserve and then the amount we believe is based on factors other than an adverse change in cash flow is moved into the unamortized discount balance.

The following table presents the aggregate changes in our unamortized discount and the portion of the discount designated as credit reserve for the three months ended March 31, 2008 and 2007.

Changes in Unamortized Discount and Designated Credit Reserves on Residential, Commercial, and CDO CES at Redwood

Three Months Ended March 31, 2008 (In Thousands)	Residential	Commercial	CDO	Total
Beginning balance of unamortized discount, net	$316,552	$95,695	$12,730	$424,977
Reclassification due to FVO adoption	(226,112)	(77,828)	(9,634)	(313,574)
Amortization of (discount) premium	(11,570)	1,523		(10,047)
Calls, sales, and other	(43)	48,354	32	48,343
Re-designation between credit reserve and discount	(17,963)	(30,789)	385	(48,367)
Discount on acquistions	835			835
Ending Balance of Unamortized Discount, Net	$61,699	$36,955	$3,513	$102,167
Beginning balance of designated credit reserve	$676,848	$318,456	$51,334	$1,046,638
Reclassification due to FVO adoption	(166,715)		(29,479)	(196,194)
Realized credit losses	(30,662)	(38)		(30,700)
Calls, sales, and other				
Impairments on AFS securities	65,483	29,181	904	95,568
Re-designation between credit reserve and discount	17,963	30,789	(385)	48,367
Discount designated as credit reserve on acquistions	23,237			23,237
Ending Balance of Designated Credit Reserve	$586,154	$378,388	$22,374	$986,916

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NOTES TO FINANCIAL STATEMENTS March 31, 2008 (Unaudited)

Note 7. Real Estate Securities (continued)

Three Months Ended March 31, 2007 (In Thousands)	Residential	Commercial	CDO	Total
Beginning balance of unamortized discount, net	$144,842	$71,424	$ 6,889	$223,155
Amortization of (discount) premium	(18,892)	9		(18,883)
Calls, sales, and other	2,370			2,370
Re-designation between credit reserve and discount	22,312	(397)		21,915
Upgrades to investment-grade securities		160	115	275
Discount on acquistions	8,037	259		8,296
Ending Balance of Unamortized Discount, Net	$158,669	$71,455	$ 7,004	$237,128
Beginning balance of designated credit reserve	$372,247	$295,340	$	$667,587
Realized credit losses	(3,805)	(1,271)		(5,076)

Calls, sales, and other	(1,516)			(1,516)
Re-designation between credit reserve and discount	(22,312)	397		(21,915)
Discount designated as credit reserve on acquistions	48,149			48,149
Ending Balance of Designated Credit Reserve	$ 392,763	$ 294,466	$	$ 687,229

For the three months ended March 31, 2008, we recognized other-than-temporary impairments of $144 million through market valuation adjustments in our consolidated statements of (loss) income. For the three months ended March 31, 2007, we recognized other-than-temporary impairments of $2 million. Securities are deemed other-than-temporarily impaired if there has been an adverse change in the underlying cash flows generated by a security, if we do not have the intent and ability to hold the security, or if we believe the security will not recover its value within a reasonable period of time. All these factors contributed to the assessment of other-than-temporary impairments in the first quarter of 2008. Most of the impairments in the first quarter of 2007 were due to adverse changes in cash flows.

Securities with an unrealized loss position are deemed temporarily impaired as there has been no adverse change in the underlying cash flows projected to be generated by a security, we have the intent and ability to hold the security, and we believe the impaired security will recover its value within a reasonable period of time.

The following table shows the gross unrealized losses, fair values, and length of time that any of our AFS real estate securities have been in a continuous unrealized loss position as of March 31, 2008 and December 31, 2007. At March 31, 2008, of our total 539 AFS securities, 224 were in unrealized losses positions, and 6 of these have been in a continuous unrealized loss position for twelve months or longer. At December 31, 2007, of our total 1,722 securities, 855 were in unrealized loss positions, and 188 of these had been in a continuous loss position for twelve months or longer. The number of AFS securities reported on our consolidated balance sheets declined as a result of the FVO election on January 1, 2008.

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Note 7. Real Estate Securities (continued)

Securities with Unrealized Losses (AFS) at Redwood and Opportunity Fund

March 31, 2008 (In Thousands)	Less Than 12 Months		12 Months or More		Total	
	Fair Market Value	Unrealized Losses	Fair Market Value	Unrealized Losses	Fair Market Value	Unrealized Losses
Residential	$ 82,384	$ (51,750)	$ 811	$ (1,038)	$ 83,195	$ (52,788)
Commercial	25,409	(9,036)	1,635	(1,294)	27,044	(10,330)

CDO	27,215	(4,145)			27,215	(4,145)
Total Securities	$ 135,008	$ (64,931)	$ 2,446	$ (2,332)	$ 137,454	$ (67,263)

	Less Than 12 Months		12 Months or More		Total	
December 31, 2007 (In Thousands)	Fair Market Value	Unrealized Losses	Fair Market Value	Unrealized Losses	Fair Market Value	Unrealized Losses
Residential	$ 627,419	$ (303,546)	$ 220,728	$ (94,576)	$ 848,147	$ (398,122)
Commercial	288,173	(112,769)	93,308	(37,373)	381,481	(150,142)
CDO	29,363	(12,750)			29,363	(12,750)
Total Securities	$ 944,955	$ (429,065)	$ 314,036	$ (131,949)	$ 1,258,991	$ (561,014)

The table below presents the components comprising the carrying value of fair value option securities at Redwood reported on our consolidated balance sheets at March 31, 2008.

Securities FVO at Redwood

March 31, 2008 (In Thousands)	Residential CES	IGS	CDO CES	IGS	Total FVO
Redwood					
Current face	$ 12,083	$ 17,488	$	$ 60,975	$ 90,546
Market value discount	(11,742)	(9,962)		(45,471)	(67,175)
Carrying Value	$ 341	$ 7,526	$	$ 15,504	$ 23,371

During the three months ended March 31, 2008 we acquired $28 million of IGS at Redwood for which we did not elect the fair value option. The reason we did not elect the fair value option was because these securities are funded with equity and there is no paired liability to offset changes in fair value through the income statement.

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NOTES TO FINANCIAL STATEMENTS March 31, 2008 (Unaudited)

Note 7. Real Estate Securities (continued)

Real Estate Securities at Acacia

The table below presents the fair value of our securities at Acacia that are included in our consolidated balance sheets as of March 31, 2008 and December 31, 2007, by type of securities, and by credit rating of investment-grade (IGS) and below investment-grade (CES).

	March 31, 2008			December 31, 2007		
	FVO			AFS		
(In Thousands)	CES	IGS	Total	CES	IGS	Total
Residential securities:						
Prime	$ 77,414	$ 233,619	$ 311,033	$ 193,676	$ 514,045	$ 707,721
Alt-a	14,633	204,891	219,524	48,661	416,726	465,387
Subprime	10,877	150,229	161,106	8,598	211,342	219,940
Total residential securities	102,924	588,739	691,663	250,935	1,142,113	1,393,048
Commercial securities	112,554	62,781	175,335	188,327	89,676	278,003
CDO securities	6,027	52,743	58,770	8,169	83,094	91,263
Total Securities	$ 221,505	$ 704,263	$ 925,768	$ 447,431	$ 1,314,883	$ 1,762,314

The table below presents the components comprising the carrying value of fair value option real estate securities at Acacia reported on our consolidated balance sheets at March 31, 2008.

The table below presents the components comprising the carrying value of available-for-sale real estate CES and IGS at Acacia reported on our consolidated balance sheets at December 31, 2007.

Gross Realized Gains and Losses

Gross unrealized gains and losses represent the difference between the amortized cost and the fair value of individual securities sold.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS March 31, 2008 (Unaudited)

Note 7. Real Estate Securities (continued)

The table below presents the gross realized gains and losses on securities and the realized gains on calls on securities for the three months ended March 31, 2008 and 2007.

Gross Realized Gains and Losses on Real Estate Securities

Three Months Ended
March 31,

(In Thousands)	2008	2007
Gross realized gains on sales of securities	$	$ 669
Gross realized losses on sales of securities		(1,453)
Gains on calls of securities	42	843
Total Realized Gains on Sales and Calls of Securities	$ 42	$ 59

The table below presents information regarding our securities pledged under borrowing agreements and owned by securitization entities as of March 31, 2008 and December 31, 2007.

Securities Pledged and Unpledged

(In Thousands)	March 31, 2008	December 31, 2007
Unpledged	$ 262,502	$ 338,942
Pledged for Redwood debt	2,899	8,824
Owned by Acacia securitization entities, financed through issuance of ABS	925,768	1,762,314
Carrying Value	$ 1,191,169	$ 2,110,080

Note 8. Other Real Estate Investments

Other real estate investments (OREI) shown on our consolidated balance sheets at March 31, 2008 include IOs, NIMs, and residuals at Redwood only and, at December 31, 2007, all such investments owned by Redwood and Acacia. We have elected to classify OREI as trading instruments under GAAP. OREI are carried at fair value on our consolidated balance sheets and changes in fair value flow through market valuation adjustments, net on our consolidated statements of (loss) income. As part of our fair value option elections, on January 1, 2008 OREI at Acacia securitization entities were reclassified as FVO securities.

The table below presents the carrying value (which equals fair value as these are classified as trading instruments) of OREI as of March 31, 2008 and December 31, 2007.

Other Real Estate Investments   Trading Instruments

March 31, 2008 (In Thousands)	Prime	Alt-a	Subprime	Total
Residential				
IOs	$	$	$	$
NIMs		1,991		1,991
Residuals		1,446		1,446
Total Other Real Estate Investments	$	$ 3,437	$	$ 3,437

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Note 8. Other Real Estate Investments (continued)

December 31, 2007 (In Thousands)	Prime	Alt-a	Subprime	Total
Residential				
IOs	$ 1,410	$ 202	$	$ 1,612
NIMs		5,826	1,310	7,136
Residuals		2,527	246	2,773
Total Other Real Estate Investments	$ 1,410	$ 8,555	$ 1,556	$ 11,521

The fair value of our OREI declined $3 million and $5 million for the three months ended March 31, 2008 and 2007, respectively. As of March 31, 2008, all our OREI were funded with equity. As of December 31, 2007, less than $1 million of OREI were owned by securitization entities and financed through the issuance of ABS and the remaining $11 million were funded with equity.

Note 9. Non-Real Estate Investments

Non-real estate investments represents a $79 million guaranteed investment contract (GIC) owned by an Acacia securitization entity that we consolidate for financial statements purposes. This GIC represents a deposit certificate issued by a rated investment bank. This GIC serves as the collateral to cover potential losses on a credit default swap (CDS) also entered into by this same Acacia entity. The CDS references BBB and A-rated residential mortgage-backed securities issued in 2006. In the event that any of these referenced securities incurs a credit loss, the GIC can then be drawn upon by the CDS counterparty to cover the amount of such loss. Since the acquisition of this asset, it has been drawn down by $1 million as the notional amount of the related CDS has been reduced. We have classified this investment as a trading instrument prior to 2008 and as FVO effective January 1, 2008. This investment is recorded on our consolidated balance sheets at its estimated fair value. Management currently considers the GIC s fair value to approximate contract value, as the interest rate is variable at LIBOR less 5 basis points and resets on a monthly basis. The carrying and fair value was $79 million of this investment as of March 31, 2008. Changes in fair value are reported through our consolidated statements of (loss) income through market valuation adjustments.

Note 10. Derivative Financial Instruments

We report our derivative financial instruments at fair value as determined using third-party models and confirmed by Wall Street dealers. This is regardless of the accounting treatment for the derivatives (trading instrument, FVO, or FAS 133).

As of March 31, 2008 and December 31, 2007, the net fair value of derivative financial instruments was negative $130 million and negative $76 million, respectively.

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Note 10. Derivative Financial Instruments (continued)

The following table shows the aggregate fair value and notional amount of our derivative financial instruments as of March 31, 2008 and December 31, 2007.

(In Thousands)	March 31, 2008 Fair Value	March 31, 2008 Notional Amount	December 31, 2007 Fair Value	December 31, 2007 Notional Amount
Trading Instruments				
Interest rate caps purchased	$ 3,128	$ 714,400	$ 3,788	$ 707,900
Interest rate caps sold	(864)	250,000	(1,061)	250,000
Interest rate corridors purchased				844,805
Interest rate swaps	(60,011)	1,168,885	(1,553)	186,733
Credit default swaps	(72,499)	78,584	(57,397)	78,771
Cash Flow Hedges				
Interest rate swaps			(19,564)	994,562
Total Derivative Financial Instruments	$ (130,246)	$ 2,211,869	$ (75,787)	$ 3,062,771

Of the negative $130 million value of derivative financial instruments at March 31, 2008, $4 million was recorded as derivative assets and $134 million as derivative liabilities on our consolidated balance sheet. Of the negative $76 million value of derivative financial instruments at December 31, 2007, $5 million was recorded as derivative assets and $81 million as derivative liabilities.

Interest Rate Agreements

We maintain an overall interest rate risk management strategy that incorporates the use of interest rate agreements for a variety of reasons, including minimizing significant fluctuations in earnings or market values on certain assets or liabilities that may be caused by interest rate volatility. Currently, the majority of our interest rate agreements are used to match the duration of liabilities to assets. Interest rate agreements we use as part of our interest rate risk management strategy may include interest rate options, swaps, options on swaps, futures contracts, options on futures contracts, and options on forward purchases. We currently account for our interest rate agreements as either cash flow hedges, trading instruments, or as FVO derivatives.

The following table presents the interest income and expense of our interest rate agreements accounted for as cash flow hedges for the three months ended March 31, 2008 and 2007.

Impact on Net Interest Income (Expense) of our Interest Rate Agreements Accounted for as Cash Flow Hedges

(In Thousands)	Three Months Ended March 31, 2008	2007
Net interest income on cash flow interest rate agreements	$	$ 2,399
Realized net losses due to net ineffective portion of hedges		(81)
Realized net losses reclassified from other comprehensive (loss) income	(1,246)	(672)
Total	$ (1,246)	$ 1,646

We did not have any interest rate agreements designated as cash flow hedges during the three months ended March 31, 2008. During the three months ended March 31, 2007, interest rate agreements designated as cash flow hedges had net receipts of $2 million.

In a cash flow hedge, the effective portion of the change in the fair value of the hedging derivative is recorded in accumulated other comprehensive loss and is subsequently reclassified into earnings when the

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Note 10. Derivative Financial Instruments (continued)

hedging relationship is terminated. The ineffective portion of the cash flow hedge is recognized immediately in earnings. For the three months ended March 31, 2007 the amount of ineffectiveness was less than $1 million of income recorded against interest expense in our consolidated income statement. For the three months ended March 31, 2008 there were no interest rate agreements designated as cash flow hedges.

Interest rate agreements accounted for as cash flow hedges may be terminated prior to the completion of the forecasted transactions. In these cases, and when the forecasted transaction is still likely to occur, the net gain or loss on the interest rate agreements remains in accumulated other comprehensive loss and is reclassified from accumulated other comprehensive loss to our consolidated statements of (loss) income during the period the forecasted transaction occurs. For the three months ended March 31, 2008 we reclassified zero from other comprehensive loss and for the three months ended March 31, 2007, we reclassified less than negative $1 million.

When the interest rate agreement is accounted for as a trading instrument or elected for the fair value option (for those derivatives in Acacia securitization entities), changes in the fair value of the interest rate agreement and all associated income and expenses are reported in earnings through net recognized valuation adjustments. We had net valuation adjustments on interest rate agreements for the three months ended March 31, 2008 and 2007 of negative $38 million and less than negative $1 million, respectively.

In the case when the hedge is terminated and the forecasted transaction is not expected to occur, we immediately recognize the gain or loss through gains on sales, net in our consolidated statements of (loss) income through recognized market valuation adjustments. For the three months ended March 31, 2008, there were no such instances. For the three months ended March 31, 2007, there was one such instance which resulted in a gain of $1.1 million.

Our total unrealized gain or loss on interest rate agreements included in accumulated other comprehensive loss at March 31, 2008 was negative $31 million and at December 31, 2007, was negative $33 million.

Credit Default Swaps (CDS)

A CDS is an agreement to provide (receive) credit event protection based on a financial index or specific security in exchange for receiving (paying) a fixed-rate fee or premium over the term of the contract. In the first quarter of 2007, we began entering into these agreements where we agreed to provide credit event protection in exchange for a premium. In essence, these instruments enable us to credit-enhance a specific pool of loans. We included these CDS in our Acacia CDO Option Arm 1 which closed in the second quarter of 2007.

Credit default swaps in the Acacia securitization entities are accounted for as FVO swaps as of January 1, 2008 and, were accounted for as trading instruments prior to 2008. These are reported at fair value with the changes in fair value and any net receipts/payments recognized through our income statement. The value of these contracts decrease for a variety of reasons, including when the probability of the occurrence of a specific credit event increases, when the market s perceptions of default risk in general change, or when there are changes in the supply and demand of these instruments. During the three months ended March 31, 2008, the fair value of these credit default swaps decreased $18 million, primarily as the result of widening spreads in these types of instruments.

Counterparty Credit Risk

We incur credit risk to the extent that the counterparties to the derivative financial instruments do not perform their obligations under the agreements. If one of the counterparties does not perform, we may not receive the cash to which we would otherwise be entitled under the agreement. In order to mitigate this risk we only enter into agreements that are either a) transacted on a national exchange or b) transacted with

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Note 10. Derivative Financial Instruments (continued)

counterparties that are either i) designated by the U.S. Department of Treasury as a primary government dealer, ii) affiliates of primary government dealers, or iii) rated BBB or higher. Furthermore, we generally enter into agreements with several different counterparties in order to diversify our credit risk exposure. At March 31, 2008 and December 31, 2007, we had $3 million credit exposure on interest rate agreements.

Note 11. Reserves for Credit Losses

We establish reserves for credit losses on our real estate loans held-for-investment based on our estimate of losses inherent in our loan portfolio. At both March 31, 2008 and December 31, 2007, all held-for-investment loans were owned by Sequoia entities. For the three months ended March 31, 2008, we had a total credit loss provision of $8 million, an increase from the $1 million in provision for the three months ended March 31, 2007.

The following table summarizes the activity in reserves for credit losses for our consolidated residential real estate loans held-for-investment for the three months ended March 31, 2008 and 2007.

Residential Real Estate Loan Reserves for Credit Losses

	Three Months Ended March 31,	
(In Thousands)	2008	2007
Balance at beginning of period	$ 18,282	$ 20,119
Provision for credit losses	8,058	1,481
Charge-offs	(1,896)	(1,646)
Balance at End of Period	$ 24,444	$ 19,954

Delinquencies in our consolidated residential real estate loan portfolio were $84 million and $68 million as of March 31, 2008 and December 31, 2007, respectively. Delinquencies include loans delinquent more than 90 days and in foreclosure. As a percentage of our current residential real estate loan balances, delinquencies stood at 1.25% and 0.96% at March 31, 2008 and December 31, 2007, respectively. As a percentage of the original balances, delinquencies stood at 0.30% and 0.24% at March 31, 2008 and December 31, 2007, respectively.

Our residential loan servicers advance payment on delinquent loans to the extent they deem them recoverable. We accrue interest on loans until they are more than 90 days past due or deemed uncollectible, at which point they are placed on nonaccrual status. When a loan becomes REO, we estimate the specific loss, based on estimated net proceeds from the sale of the property (including accrued but unpaid interest), and charge this specific estimated loss against the reserve for credit losses. Subsequent changes in value are then recorded through market valuation adjustments, net in our consolidated income statements. The carrying value of REO as of March 31, 2008 was $16 million of which $7 million related to transfers into REO in the first quarter of 2008 and $6 million were REO liquidations reducing the balance. The carrying value of REO as of December 31, 2007 was $15 million of which $14 million related to transfers into REO in 2007 and $1 million from transfers in 2006. The transfers in the first quarter of 2008 were $9 million of principal on which we recorded a loan loss expense of $2 million.

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Note 11. Reserves for Credit Losses (continued)

The following table summarizes the activity in reserves for credit losses for our commercial real estate loans held-for-investment for the three months ended March 31, 2008 and 2007.

Commercial Real Estate Loan Reserves for Credit Losses

	Three Months Ended March 31,	
(In Thousands)	2008	2007
Balance at beginning of period	$ 2,348	$
Provision for (reversal of) credit losses		2,348
Charge-offs		
Balance at End of Period	$ 2,348	$ 2,348

During the first quarter of 2007, we fully reserved for an anticipated loss on a junior mezzanine commercial loan financing a condominium-conversion project in the amount of $2 million. The reserve for credit losses on commercial loans relates to that loan.

Note 12. Other Assets

Other assets as of March 31, 2008 and December 31, 2007 are summarized in the following table.

Other Assets

(In Thousands)	March 31, 2008	December 31, 2007
Real estate owned (REO)	$ 16,371	$ 15,118
Fixed assets and leasehold improvements	5,256	5,666
Principal receivable	1,838	2,819
Other	1,529	1,630
Total Other Assets	$ 24,994	$ 25,233

Note 13. Redwood Debt

We enter into repurchase agreements, bank borrowings, and other forms of collateralized (and generally uncommitted) borrowings with several banks and major investment banking firms. We also issued commercial paper for financing residential and real estate loans during 2007. We refer to these borrowings as Redwood debt. We report Redwood debt at its unpaid principal balance. We also have other types of recourse debt such as subordinated notes (See *Note 15*).

REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 13. Redwood Debt (continued)

The table below summarizes the outstanding balances of Redwood debt as of March 31, 2008 and December 31, 2007 by collateral type.

Redwood Debt

(In Thousands)	March 31, 2008 Number of Facilities	Outstanding	Limit	Maturity
Facilities by collateral				
Real estate loans	1	$	$ 1,000,000	10/08
Real estate securities	1	2,086	2,086	
Unsecured line of credit	1		10,000	5/08
Total Facilities	3	$ 2,086	$ 1,012,086	

(In Thousands)	December 31, 2007 Number of Facilities	Outstanding	Limit	Maturity
Facilities by collateral				
Real estate loans	1	$	$ 1,000,000	10/08
Real estate securities	1	7,561	7,561	
Unsecured line of credit	1		10,000	1/08
Total Facilities	3	$ 7,561	$ 1,017,561	

Borrowings under these facilities generally bear interest based on a specified margin over the one-month LIBOR interest rate. They are uncommitted and mature within a year. For the three months ended March 31, 2008, the average balance of Redwood debt was $21 million, with a weighted-average interest cost of 3.39%. For the three months ended December 31, 2007 the average balance of Redwood debt was $27 million, with a weighted-average interest cost of 5.63%. At March 31, 2008 and December 31, 2007, accrued interest payable on Redwood debt was $1,400 and $12,000, respectively.

Due to the decline in mortgage market economic conditions that began in 2007, we determined that we did not need the same level of available Redwood debt facilities as we had at the beginning of that year. Therefore, we did not renew the majority of our facilities as they expired and we closed our Madrona facility in December 2007. In addition, in this current economic climate, we are only showing the limit equal to existing borrowings on facilities for which we do not have a documented commitment. We believe, however, we could increase our borrowings on these facilities to the extent we had appropriate collateral.

The table below summarizes Redwood debt by weighted average interest rates and by collateral type in Redwood debt at March 31, 2008 and December 31, 2007.

Redwood Debt

(In Thousands)	March 31, 2008 Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity	December 31, 2007 Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity
Real estate loan collateral	$			$		
Securities collateral	2,086	2.94 %	24	7,561	5.25 %	22
Total Redwood Debt	$ 2,086	2.94 %	24	$ 7,561	5.25 %	22

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NOTES TO FINANCIAL STATEMENTS March 31, 2008 (Unaudited)

Note 13. Redwood Debt (continued)

Redwood debt as of March 31, 2008 and December 31, 2007 matured within 30 days of the period end.

As of March 31, 2008 for active agreements, we were in breach on one of our International Swaps and Derivatives Association (ISDA) agreement covenants with a counterparty due to a decline in total reported net worth. We have subsequently received a waiver from this counterparty. We were also in breach on five other ISDAs due to the net worth covenants. There was no impact to our financial statements for these events.

We continue to be in compliance with our other covenants on our borrowing arrangements and credit facilities. These covenants generally relate to our tangible net worth, liquidity reserves, and leverage requirements. While we generally do not anticipate having any problems in meeting most of our covenants on these arrangements, the decline and future volatility in our reported net worth has required us to renegotiate covenants and temporarily reduce the number of counterparties with whom we transact business. It is our intention to renew facilities, including amend the net worth covenants as needed, as well as pursue additional facilitie s and other types of financing including committed facilities.

Note 14. Asset-Backed Securities Issued

The Sequoia and Acacia securitization entities sponsored by us issue ABS issued to raise the funds to acquire assets from us and others. Each series of ABS issued consists of various classes that pay interest at variable or fixed rates. Substantially all of the variable-rate ABS issued are indexed to one, three, or six-month LIBOR, with interest paid monthly or quarterly. A lesser amount of the ABS issued is fixed for a term and then adjusts to a LIBOR rate (hybrid ABS issued) or is fixed for its entire term. Some of the ABS issued are IOs and have coupons set at a fixed-rate or a fixed spread, while others earn a coupon based on the spread between collateral owned by and the ABS issued by a securitization entity.

The maturity of each class of ABS issued is directly affected by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption (call) according to the specific terms of the respective governing documents. As a result, the actual maturity of an ABS is likely to occur earlier than its stated maturity.

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Note 14. Asset-Backed Securities Issued (continued)

The carrying value components of the collateral for ABS issued and outstanding as of March 31, 2008 and December 31, 2007 are summarized in the table below.

Collateral for Asset-Backed Securities Issued

	March 31, 2008			December 31, 2007		
(In Thousands)	Sequoia	Acacia	Total	Sequoia	Acacia	Total
Real estate loans	$6,751,491	$18,801	$6,770,292	$7,173,940	$25,426	$7,199,366
Real estate securities		925,768	925,768		1,762,314	1,762,314
Other real estate investments					293	293
Non-real estate investments		78,770	78,770		79,125	79,125
Real estate owned (REO)	15,184		15,184	13,744		13,744
Restricted cash	315	137,758	138,073	337	112,793	113,130
Accrued interest receivable	32,284	7,232	39,516	37,907	9,928	47,835
	$6,799,274	$1,168,329	$7,967,603	$7,225,928	$1,989,879	$9,215,807

Total Collateral for ABS Issued

The components of ABS issued by consolidated securitization entities as of March 31, 2008 and December 31, 2007, along with other selected information, are summarized in the table below.

Asset-Backed Securities Issued

(In Thousands)	March 31, 2008	December 31, 2007
Sequoia ABS issued certificates with principal value	$ 6,511,149	$ 6,904,937
Sequoia ABS issued interest-only certificates	29,516	35,220
Unamortized premium on Sequoia ABS	3,826	6,009
Total Sequoia ABS issued		