

REDWOOD TRUST INC  
Form 10-Q  
August 08, 2013  
Table of Contents

**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: June 30, 2013**  
                  **OR**

..           **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)**  
  
                  **OF THE SECURITIES EXCHANGE ACT OF 1934**  
                  **For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_.**  
  
                  **Commission File Number 1-13759**

**REDWOOD TRUST, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Maryland**

**68-0329422**

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(State or Other Jurisdiction of  
Incorporation or Organization)

(I.R.S. Employer  
Identification No.)

**One Belvedere Place, Suite 300**

**Mill Valley, California**  
(Address of Principal Executive Offices)

**94941**  
(Zip Code)

**(415) 389-7373**

(Registrant's Telephone Number, Including Area Code)

**Not Applicable**

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

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

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

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

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

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

Common Stock, \$0.01 par value per share

82,325,219 shares outstanding as of August 5,  
2013

Table of Contents

**REDWOOD TRUST, INC.**  
**2013 FORM 10-Q REPORT**  
**TABLE OF CONTENTS**

		<b>Page</b>
<b><u>PART I</u></b>		
Item 1.	<u>Financial Statements</u>	1
	<u>Consolidated Balance Sheets at June 30, 2013 (Unaudited) and December 31, 2012</u>	1
	<u>Consolidated Statements of Income for the Three and Six Months Ended June 30, 2013 and 2012 (Unaudited)</u>	2
	<u>Statements of Consolidated Comprehensive Income for the Three and Six Months Ended June 30, 2013 and 2012 (Unaudited)</u>	3
	<u>Consolidated Statements of Changes in Equity for the Six Months Ended June 30, 2013 and 2012 (Unaudited)</u>	4
	<u>Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2013 and 2012 (Unaudited)</u>	5
	<u>Notes to Consolidated Financial Statements</u>	6
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	59
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	111
Item 4.	<u>Controls and Procedures</u>	111
<b><u>PART II</u></b>		
Item 1.	<u>Legal Proceedings</u>	112
Item 1A.	<u>Risk Factors</u>	113
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	114
Item 3.	<u>Defaults Upon Senior Securities</u>	114
Item 4.	<u>Mine Safety Disclosures (Not Applicable)</u>	114
Item 5.	<u>Other Information</u>	114
Item 6.	<u>Exhibits</u>	115

Signatures

116

i

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****REDWOOD TRUST, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(In Thousands, Except Share Data)**

<b>(Unaudited)</b>	<b>June 30, 2013</b>		<b>December 31, 2012</b>	
<b>ASSETS</b>				
Residential loans, held-for-sale (includes \$1,220,490 and \$556,283 at fair value)	\$	1,221,098	\$	562,658
Residential loans, held-for-investment		1,998,178		2,272,812
Commercial loans, held-for-sale (includes \$149,470 and \$0 at fair value)		149,470		8,500
Commercial loans, held-for-investment		345,353		304,510
Real estate securities, at fair value		1,314,305		1,108,753
Mortgage servicing rights		43,098		5,315
Cash and cash equivalents		207,694		81,080
<b>Total earning assets</b>		<b>5,279,196</b>		<b>4,343,628</b>
Restricted cash		405		383
Accrued interest receivable		16,111		12,442
Derivative assets		43,341		2,972
Deferred securities issuance costs		15,976		9,293
Other assets		80,383		75,380
<b>Total Assets <sup>(1)</sup></b>	<b>\$</b>	<b>5,435,412</b>	<b>\$</b>	<b>4,444,098</b>
<b>LIABILITIES AND EQUITY</b>				
<b>Liabilities</b>				
Short-term debt	\$	1,445,961	\$	551,918
Accrued interest payable		8,682		4,592
Derivative liabilities		29,571		51,081
Accrued expenses and other liabilities		83,998		26,902
Asset-backed securities issued		2,214,296		2,529,941
Long-term debt		443,591		139,500
<b>Total liabilities <sup>(1)</sup></b>		<b>4,226,099</b>		<b>3,303,934</b>
<b>Equity</b>				

Common stock, par value \$0.01 per share, 180,000,000 and 165,000,000 shares authorized; 82,331,736 and 81,716,416 issued and outstanding	823	817
Additional paid-in capital	1,754,658	1,744,554
Accumulated other comprehensive income	118,283	138,332
Cumulative earnings	759,235	633,052
Cumulative distributions to stockholders	(1,423,686)	(1,376,591)
<b>Total equity</b>	<b>1,209,313</b>	<b>1,140,164</b>
<b>Total Liabilities and Equity</b>	<b>\$ 5,435,412</b>	<b>\$ 4,444,098</b>

- (1) Our consolidated balance sheets include assets of consolidated variable interest entities ( VIEs ) that can only be used to settle obligations of these VIEs and liabilities of consolidated VIEs for which creditors do not have recourse to the primary beneficiary (Redwood Trust, Inc.). At June 30, 2013 and December 31, 2012, assets of consolidated VIEs totaled \$2,573,802 and \$2,901,214, respectively, and liabilities of consolidated VIEs totaled \$2,216,586 and \$2,532,916, respectively. See Note 4 for further discussion.

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

Table of Contents

## REDWOOD TRUST, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME

(In Thousands, Except Share Data) (Unaudited)	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
<b>Interest Income</b>				
Residential loans	\$ 18,845	\$ 21,243	\$ 36,469	\$ 44,622
Commercial loans	9,623	5,534	19,794	10,881
Real estate securities	29,114	32,732	54,831	62,726
Cash and cash equivalents	137	14	149	35
Total interest income	57,719	59,523	111,243	118,264
<b>Interest Expense</b>				
Short-term debt	(4,686)	(2,299)	(8,494)	(4,126)
Asset-backed securities issued	(10,297)	(24,203)	(21,309)	(50,655)
Long-term debt	(6,480)	(2,379)	(10,014)	(4,755)
Total interest expense	(21,463)	(28,881)	(39,817)	(59,536)
<b>Net Interest Income</b>	36,256	30,642	71,426	58,728
Reversal of provision for loan losses	3,272	1,340	1,233	1,065
Other market valuation adjustments	(4,616)	217	(4,895)	(708)
Other-than-temporary impairments <sup>(1)</sup>	(1,642)	(303)	(1,666)	(635)
Other market valuation adjustments, net	(6,258)	(86)	(6,561)	(1,343)
<b>Net Interest Income After Provision and Other Market Valuation Adjustments</b>				
Mortgage banking activities, net	58,531	(3,607)	104,552	1,324
Operating expenses	(23,644)	(15,165)	(43,241)	(29,799)
Realized gains, net	556	6,995	12,823	20,615
<b>Net income before provision for income taxes</b>				
Provision for income taxes	(3,140)	(592)	(14,049)	(600)
<b>Net Income Attributable to Redwood Trust, Inc.</b>				
	\$ 65,573	\$ 19,527	\$ 126,183	\$ 49,990
Basic earnings per common share	\$ 0.78	\$ 0.24	\$ 1.50	\$ 0.62
Diluted earnings per common share	\$ 0.71	\$ 0.24	\$ 1.40	\$ 0.61
Regular dividends declared per common share	\$ 0.28	\$ 0.25	\$ 0.56	\$ 0.50

Basic weighted average shares outstanding	82,123,823	78,815,313	81,729,014	78,606,336
Diluted weighted average shares outstanding	96,171,713	78,815,313	91,647,400	79,965,406

(1) For the three months ended June 30, 2013, other-than-temporary impairments were \$1,642, none of which were recognized in Accumulated Other Comprehensive Income. For the three months ended June 30, 2012, other-than-temporary impairments were \$411, of which \$108 were recognized in Accumulated Other Comprehensive Income.

For the six months ended June 30, 2013, other-than-temporary impairments were \$1,666, none of which were recognized in Accumulated Other Comprehensive Income. For the six months ended June 30, 2012, other-than-temporary impairments were \$892, of which \$257 were recognized in Accumulated Other Comprehensive Income.

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



Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****STATEMENTS OF CONSOLIDATED COMPREHENSIVE INCOME**

<b>(In Thousands) (Unaudited)</b>	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
<b>Net Income</b>	\$ 65,573	\$ 19,527	\$ 126,183	\$ 49,990
Other comprehensive (loss) income:				
Net unrealized (loss) gain on available-for-sale securities	(38,012)	1,374	(28,982)	42,075
Reclassification of unrealized (gain) loss to net income	(242)	337	(12,249)	414
Net unrealized gain (loss) on interest rate agreements	13,585	(16,453)	21,025	(3,260)
Reclassification of unrealized loss on interest rate agreements to net income	69	1,098	157	2,134
<b>Total other comprehensive (loss) income</b>	<b>(24,600)</b>	<b>(13,644)</b>	<b>(20,049)</b>	<b>41,363</b>
<b>Comprehensive Income Attributable to Redwood Trust, Inc.</b>	<b>\$ 40,973</b>	<b>\$ 5,883</b>	<b>\$ 106,134</b>	<b>\$ 91,353</b>

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

Table of Contents

## REDWOOD TRUST, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

For the Six Months Ended June 30, 2013

In Thousands, Except Share Data) (Unaudited) December 31, 2012	Common Stock		Additional	Accumulated Other	Cumulative Earnings	Cumulative	Total
	Shares	Amount	Paid-In Capital	Comprehensive Income		Distributions to Stockholders	
Net income	81,716,416	\$ 817	\$ 1,744,554	\$ 138,332	\$ 633,052	\$ (1,376,591)	\$ 1,140,164
Other comprehensive (loss) income	-	-	-	(20,049)	-	-	(20,049)
Issuance of common stock:							
Dividend reinvestment & stock purchase plans	321,120	3	6,043	-	-	-	6,046
Employee stock purchase and incentive plans	294,200	3	(5,454)	-	-	-	(5,451)
Non-cash equity award compensation	-	-	9,515	-	-	-	9,515
Common dividends declared	-	-	-	-	-	(47,095)	(47,095)
<b>June 30, 2013</b>	<b>82,331,736</b>	<b>\$ 823</b>	<b>\$ 1,754,658</b>	<b>\$ 118,283</b>	<b>\$ 759,235</b>	<b>\$ (1,423,686)</b>	<b>\$ 1,209,313</b>

For the Six Months Ended June 30, 2012

In Thousands, Except Share Data) (Unaudited)	Common Stock		Additional	Accumulated Other	Cumulative Earnings	Cumulative	Total
	Shares	Amount	Paid-In Capital	Comprehensive Income (Loss)		Distributions to Stockholders	

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<b>December 31, 2011</b>	78,555,908	\$ 786	\$ 1,697,979	\$ (13,151)	\$ 501,283	\$ (1,294,313)	\$ 892,584
Net income	-	-	-	-	49,990	-	49,990
Other comprehensive income	-	-	-	41,363	-	-	41,363
<b>Issuance of common stock:</b>							
Dividend reinvestment & stock purchase plans	384,005	4	4,429	-	-	-	4,433
Employee stock purchase and incentive plans	322,915	3	(1,914)	-	-	-	(1,911)
Non-cash equity award compensation	-	-	5,217	-	-	-	5,217
Common dividends declared	-	-	-	-	-	(40,498)	(40,498)
<b>June 30, 2012</b>	<b>79,262,828</b>	<b>\$ 793</b>	<b>\$ 1,705,711</b>	<b>\$ 28,212</b>	<b>\$ 551,273</b>	<b>\$ (1,334,811)</b>	<b>\$ 951,178</b>

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

Table of Contents

**REDWOOD TRUST, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

<b>(In Thousands) (Unaudited)</b>	<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>
<b>Cash Flows From Operating Activities:</b>		
Net income attributable to Redwood Trust, Inc.	\$ 126,183	\$ 49,990
Adjustments to reconcile net income to net cash used in operating activities:		
Amortization of premiums, discounts, and securities issuance costs, net	(11,780)	(12,953)
Depreciation and amortization of non-financial assets	224	1,612
Purchases of loans	(5,457,558)	(998,906)
Proceeds from sales of loans	4,635,630	754,175
Principal payments on loans	5,169	4,102
Net settlements of derivatives	9,784	(17,160)
Reversal of provision for loan losses	(1,233)	(1,065)
Non-cash equity award compensation	9,515	5,217
Market valuation adjustments, net	(84,560)	12,959
Realized gains, net	(23,854)	(33,452)
Net change in:		
Accrued interest receivable, deferred tax assets, and other assets	(10,871)	(701)
Accrued interest payable and accrued expenses and other liabilities	61,186	16,606
<b>Net cash used in operating activities</b>	<b>(742,165)</b>	<b>(219,576)</b>
<b>Cash Flows From Investing Activities:</b>		
Purchases of loans held-for-investment	(54,539)	(95,508)
Proceeds from sales of loans <sup>(1)</sup>	440	386,143
Principal payments on loans	284,076	287,996
Purchases of real estate securities	(298,946)	(409,788)
Proceeds from sales of real estate securities	31,195	101,662
Principal payments on real estate securities	81,250	95,536
Proceeds from deconsolidation	-	6,386
Net increase in restricted cash	(22)	(3,566)
<b>Net cash provided by investing activities</b>	<b>43,454</b>	<b>368,861</b>
<b>Cash Flows From Financing Activities:</b>		
Proceeds from borrowings on short-term debt	3,989,557	707,051
Repayments on short-term debt	(3,095,514)	(679,688)
Proceeds from issuance of asset-backed securities	-	96
Repayments on asset-backed securities issued	(313,848)	(322,000)
Deferred securities issuance costs	(9,184)	-

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Proceeds from issuance of long-term debt	304,100	-
Repayments on long-term debt	(9)	-
Net settlements of derivatives	(5)	(12,195)
Net proceeds from issuance of common stock	3,064	292
Taxes paid on equity award distributions	(5,741)	-
Dividends paid	(47,095)	(40,498)
Net cash provided by (used in) financing activities	825,325	(346,942)
Net increase (decrease) in cash and cash equivalents	126,614	(197,657)
Cash and cash equivalents at beginning of period	81,080	267,176
Cash and cash equivalents at end of period	\$ 207,694	\$ 69,519

**Supplemental Disclosures:**

Cash paid for interest	\$ 37,581	\$ 59,152
Cash paid for taxes	1,097	155
Transfers from residential loans to real estate owned	2,687	3,406

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

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

**Table of Contents**

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 1. Redwood Trust**

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

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

Redwood was incorporated in the State of Maryland on April 11, 1994, and commenced operations on August 19, 1994. Our executive offices are located at One Belvedere Place, Suite 300, Mill Valley, California 94941.

**Note 2. Basis of Presentation**

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

Beginning in the second quarter of 2013, we are presenting market valuation changes for our retained Sequoia interest-only ( IO ) securities in mortgage banking activities and have conformed the presentation of prior periods for consistency of comparison. This change better aligns our reported results with the economics underlying our residential mortgage banking activities as we utilize our retained Sequoia IO securities as an economic hedge to manage interest rate risk on our inventory of residential mortgage loans held for future sale and those indentified for purchase. Certain other prior year amounts have been reclassified in the consolidated financial statements and the related footnotes to conform to the 2013 presentation.

***Organization***

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

eliminated. Our consolidated subsidiaries include both qualifying REIT subsidiaries and taxable subsidiaries. References to the REIT include Redwood and its qualifying REIT subsidiaries, excluding taxable subsidiaries.

We sponsor our Sequoia securitization program, which we use for the securitization of residential mortgage loans. References to Sequoia with respect to any time or period generally refer collectively to all the then consolidated Sequoia securitization entities for the periods presented. We have also engaged in securitization transactions in order to obtain financing for certain of our securities and commercial loans. We previously engaged in other securitization transactions through the Acacia program, which was used for the securitization of mortgage-backed securities and other types of financial assets. References to Acacia generally refer collectively to the consolidated Acacia securitization entities for the periods presented.

Table of Contents

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 2. Basis of Presentation (continued)**

*Financial Information About Industry Segments*

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

*Principles of Consolidation*

We apply FASB guidance to determine whether we must consolidate transferred financial assets and variable interest entities ( VIEs ) for financial reporting purposes. We currently consolidate the assets and liabilities of the Sequoia securitization entities where we maintain an ongoing involvement, as well as an entity formed in connection with a resecuritization transaction we engaged in during 2011 ( Residential Resecuritization ), and an entity formed in connection with a commercial securitization we engaged in during the fourth quarter of 2012 ( Commercial Securitization ). Prior to December 31, 2012, we consolidated the assets and liabilities of certain Acacia securitization entities. Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of Redwood, although we are exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities.

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

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

**Note 3. Summary of Significant Accounting Policies**

*Use of Estimates*



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

***Fair Value Measurements***

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

Quoted prices for the same or similar securities;

Relevant reports issued by analysts and rating agencies;

The current level of interest rates and any directional movements in relevant indices, such as credit risk indices;

Information about the performance of the underlying mortgage loans, such as delinquency and foreclosure rates, loss experience, and prepayment rates;

Indicative prices or yields from broker/dealers; and,

Table of Contents

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 3. Summary of Significant Accounting Policies (continued)**

Other relevant observable inputs, including nonperformance risk and liquidity premiums.

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

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

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

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

***Fair Value Option***

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

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

similarly to our traditional real estate investments or are particularly volatile or complex in structure.

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

### ***Real Estate Loans***

#### ***Residential and Commercial Loans Held-for-Sale***

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

#### ***Residential and Commercial Loans Lower of Cost or Fair Value***

Residential and commercial loans, except for those where we have elected the fair value option, are carried at the lower of their cost or fair value, as measured on an individual basis or, in the case of the loans we intend to pool for securitization based upon similar underwriting characteristics, on an aggregate basis. If the fair value of an individual loan or pool of loans held-for-sale is lower than its amortized cost basis, this difference is reported through our consolidated statements of income as a negative market valuation adjustment in mortgage banking activities, net for residential loans and as a negative other market valuation adjustment for commercial loans. Coupon interest for loans held-for-sale is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due at which point it is placed on non-accrual

Table of Contents

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 3. Summary of Significant Accounting Policies (continued)**

status. Gains or losses on the sale of residential or commercial loans are based on the specific identification method for loans measured on an individual basis or in aggregate for those loans measured on a pool basis.

*Residential and Commercial Loans Fair Value*

We have elected the fair value option for certain residential and commercial loans held-for-sale. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Changes in fair value are recurring and are reported through our consolidated statements of income in mortgage banking activities, net for residential and commercial loans held at fair value.

*Residential and Commercial Loans Held-for-Investment*

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

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

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

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

*Residential Loans Allowance for Loan Losses*

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

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

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

Historical loss rates and past performance of similar loans;

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

Trends in delinquencies and charge-offs;

Effects and changes in credit concentrations;

Table of Contents

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 3. Summary of Significant Accounting Policies (continued)**

Information supporting a borrower's ability to meet obligations;

Ongoing evaluations of fair values of collateral using current appraisals and other valuations; and,

Discounted cash flow analyses.

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

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

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

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

*Commercial Loans Allowance for Loan Losses*

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

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

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

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

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

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

Table of Contents

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 3. Summary of Significant Accounting Policies (continued)**

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

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

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

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

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

Trends in delinquencies and charge-offs in our own portfolio and among industry participants.  
See *Note 7* for further discussion on the allowance for loan losses for commercial loans.

*Repurchase Reserves*

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

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



and therefore would be covered by our recourse to those companies.

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

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

### ***Real Estate Securities, at Fair Value***

We classify our real estate securities as trading or available-for-sale securities. We use the prime or non-prime designation to categorize our residential securities based upon the general credit characteristics of the residential loans underlying each security at the time of origination. For example, prime residential loans are generally characterized by lower loan-to-value ( LTV ) ratios at the time the loans were originated, and are made to borrowers with higher Fair Isaac Corporation ( FICO ) scores. Non-prime residential loans are generally characterized by higher LTV ratios at the time the loans were originated and may have been made to borrowers with lower credit scores or impaired credit histories (while exhibiting the ability to repay their loans) at the time the loan was originated. Regardless of whether or not the loans underlying a residential security were designated as prime or non-prime at origination, there is a risk that the borrower may not be able to repay the loan.

Table of Contents

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 3. Summary of Significant Accounting Policies (continued)**

*Trading Securities*

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

*Available-for-Sale Securities*

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

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

If we conclude through our analysis that there has been no significant adverse change in our cash flow assumptions for the security, then the impairment is deemed temporary in nature and the associated difference between the security's fair value and its amortized cost basis is recorded as an unrealized loss through accumulated other comprehensive

income, in our consolidated statements of changes in equity. Alternatively, if we conclude that there has been a significant adverse change in our cash flow assumptions for the security, then the impairment is deemed an OTTI and we perform an additional analysis to determine what portion of OTTI, if any, should be recorded through our consolidated statements of income. This analysis entails discounting the security's cash flows to a present value using the prior period yield for the security to determine an expected recoverable value. The difference between this expected recoverable value and the amortized cost basis of the security is deemed to be the credit component of the OTTI that is recorded in our consolidated statements of income. The amortized cost of the security is then adjusted to the expected recoverable value, and the difference between this expected recoverable value and the estimated fair value is deemed to be the non-credit component of the OTTI and is recorded to accumulated other comprehensive income. Future amortization and accretion for the security is computed based upon the new amortized cost basis.

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

### ***MSRs***

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

Our MSRs are held and managed at Redwood Residential Acquisition Corporation, a wholly-owned subsidiary of RWT Holdings, Inc., which is a taxable REIT subsidiary of ours. We contract with a licensed sub-servicer to perform servicing functions for loans

**Table of Contents**

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 3. Summary of Significant Accounting Policies (continued)**

underlying our MSR. MSRs are initially recognized and carried at their estimated fair values. Changes in the fair value of MSRs are reported in mortgage banking activities, net, a component of our consolidated statements of income.

See *Note 17* for further discussion on MSRs.

***Cash and Cash Equivalents***

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

***Restricted Cash***

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

***Accrued Interest Receivable***

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

***Derivative Financial Instruments***

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

(cash flow hedge).

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

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

Table of Contents

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 3. Summary of Significant Accounting Policies (continued)**

*Interest Rate Agreements*

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

*Eurodollar Futures, Financial Futures and TBA Contracts*

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

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

*Deferred Tax Assets*

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

tax, the deferred tax liability is reduced.

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

### ***Deferred Securities Issuance Costs***

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

**Table of Contents**

**REDWOOD TRUST, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 3. Summary of Significant Accounting Policies (continued)**

***Other Assets***

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

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

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

***Short-Term Debt***

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

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

***Accrued Interest Payable***

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

***Asset-Backed Securities Issued***



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

*Sequoia ABS Issued*

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

*Acacia ABS Issued*

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

*Residential Resecuritization ABS Issued*

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

**Table of Contents**

**REDWOOD TRUST, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 3. Summary of Significant Accounting Policies (continued)**

*Commercial Securitization ABS Issued*

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

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

*Long-Term Debt*

*Commercial Borrowings*

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

*Convertible Notes*

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

*Trust Preferred Securities and Subordinated Notes*

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

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

*Equity*

*Accumulated Other Comprehensive Income (Loss)*

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

*Earnings Per Common Share*

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

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

**Table of Contents**

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 3. Summary of Significant Accounting Policies (continued)**

See *Note 15* for further discussion on equity.

***Incentive Plans***

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

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

***Employee Stock Purchase Plan***

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

***Executive Deferred Compensation Plan***

In May 2002, our Board of Directors approved our 2002 Executive Deferred Compensation Plan ( *EDCP* ). The EDCP allows eligible employees and directors to defer portions of current salary and certain other forms of compensation. The Company matches some deferrals. Compensation deferred under the EDCP is recorded as a liability on our

consolidated balance sheets. The EDCP allows for the investment of deferrals in either an interest crediting account or DSUs.

#### *401(k) Plan*

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

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

#### *Taxes*

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

**Table of Contents**

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 3. Summary of Significant Accounting Policies (continued)**

See *Note 19* for further discussion on taxes.

***Recent Accounting Pronouncements***

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

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

***Balance Sheet Netting***

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

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

***Offsetting of Financial Assets, Liabilities, and Collateral***

<b>June 30, 2013</b>	<b>Gross</b>	<b>Gross</b>	<b>Net Amounts of</b>	<b>Gross Amounts Not</b>		<b>Net Amount</b>
				<b>Amounts</b>	<b>Assets</b>	
<b>(In Thousands)</b>	<b>Amounts of</b>	<b>Offset in</b>	<b>in</b>	<b>Financial</b>	<b>Cash</b>	
<b>Assets <sup>(2)</sup></b>	<b>Recognized</b>	<b>Consolidated</b>	<b>Consolidated</b>	<b>Instruments</b>	<b>Collateral</b>	
	<b>(Liabilities)</b>	<b>Balance</b>	<b>Balance</b>		<b>(Received)</b>	
		<b>Sheet</b>	<b>Sheet</b>		<b>Pledged</b>	
Interest rate agreements	\$ 34,358	\$ -	\$ 34,358	\$ (11,092)	\$ (19,796)	\$ 3,470
TBA's	8,655	-	8,655	(1,139)	(4,624)	2,892
Futures	328	-	328	(328)	-	-
<b>Total Assets</b>	<b>\$ 43,341</b>	<b>\$ -</b>	<b>\$ 43,341</b>	<b>\$ (12,559)</b>	<b>\$ (24,420)</b>	<b>\$ 6,362</b>

Table of Contents

## REDWOOD TRUST, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(Unaudited)

## Note 3. Summary of Significant Accounting Policies (continued)

<b>Liabilities</b> <sup>(2)</sup>						
Interest rate agreements	\$ (27,785)	\$ -	\$ (27,785)	\$ 11,092	\$ 15,444	\$ (1,249)
TBAs	(1,139)	-	(1,139)	1,139	-	-
Futures	(647)	-	(647)	328	319	-
Loan warehouse debt	(1,082,726)	-	(1,082,726)	1,082,726	-	-
Security repurchase agreements	(363,235)	-	(363,235)	363,235	-	-
Commercial borrowings	(16,591)	-	(16,591)	16,591	-	-
<b>Total Liabilities</b>	<b>\$ (1,492,123)</b>	<b>\$ -</b>	<b>\$ (1,492,123)</b>	<b>\$ 1,475,111</b>	<b>\$ 15,763</b>	<b>\$ (1,249)</b>

December 31, 2012 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet <sup>(1)</sup>		
				Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
<b>Assets</b> <sup>(2)</sup>						
Interest rate agreements	\$ 2,972	\$ -	\$ 2,972	\$ (2,210)	\$ -	\$ 762
TBAs	-	-	-	-	-	-
Futures	-	-	-	-	-	-
<b>Total Assets</b>	<b>\$ 2,972</b>	<b>\$ -</b>	<b>\$ 2,972</b>	<b>\$ (2,210)</b>	<b>\$ -</b>	<b>\$ 762</b>
<b>Liabilities</b> <sup>(2)</sup>						
Interest rate agreements	\$ (50,476)	\$ -	\$ (50,476)	\$ 2,210	\$ 48,266	\$ -



TBAs	-	-	-	-	-	-
Futures	(607)	-	(607)	-	607	-
Loan warehouse debt	(179,982)	-	(179,982)	179,982	-	-
Security repurchase agreements	(371,936)	-	(371,936)	371,936	-	-
<b>Total Liabilities</b>	<b>\$ (603,001)</b>	<b>\$ -</b>	<b>\$ (603,001)</b>	<b>\$ 554,128</b>	<b>\$ 48,873</b>	<b>\$ -</b>

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

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

With respect to each category of financial instrument set forth in the table above, the assets and liabilities resulting from individual transactions between Redwood and a counterparty are subject to a master netting arrangement or similar agreement that provides for all such individual transactions to be treated as a single transaction and, in the event of the termination and close-out of such transactions, to be settled on a net basis and for settlement to include the proceeds of the liquidation of any corresponding collateral, subject to certain

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 3. Summary of Significant Accounting Policies (continued)**

limitations on termination, settlement, and liquidation of collateral that may apply in the event of the bankruptcy or insolvency of a party which limitations should not inhibit the eventual practical realization of the principal benefits of the transactions or the master netting arrangement or similar agreement and any corresponding collateral.

**Note 4. Principles of Consolidation**

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

***Analysis of Consolidated VIEs***

The VIEs we are required to consolidate include certain Sequoia securitization entities, the Residential Resecuritization entity, and the Commercial Securitization entity. Each of these entities is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of ours, although we are exposed to certain financial risks associated with our role as the sponsor or manager of these entities. Prior to the fourth quarter of 2012, we were also required to consolidate certain other securitization entities. The following table presents a summary of the assets and liabilities of these VIEs. Intercompany balances have been eliminated for purposes of this presentation.

***Assets and Liabilities of Consolidated VIEs at June 30, 2013*****June 30, 2013**

<b>(Dollars in Thousands)</b>	<b>Sequoia Entities</b>	<b>Residential Resecuritization</b>	<b>Commercial Securitization</b>	<b>Total</b>
Residential loans, held-for-investment	\$ 1,998,178	\$ -	\$ -	\$ 1,998,178
Commercial loans, held-for-investment	-	-	270,449	270,449
Real estate securities, at fair value	-	294,771	-	294,771
Restricted cash	148	2	138	288

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Accrued interest receivable	3,461	751	1,939	6,151
Other assets	3,965	-	-	3,965
<b>Total Assets</b>	<b>\$ 2,005,752</b>	<b>\$ 295,524</b>	<b>\$ 272,526</b>	<b>\$ 2,573,802</b>
Accrued interest payable	\$ 1,509	\$ 33	\$ 748	\$ 2,290
Asset-backed securities issued	1,920,614	134,156	159,526	2,214,296
<b>Total Liabilities</b>	<b>\$ 1,922,123</b>	<b>\$ 134,189</b>	<b>\$ 160,274</b>	<b>\$ 2,216,586</b>
<b>Number of VIEs</b>	<b>24</b>	<b>1</b>	<b>1</b>	<b>26</b>

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

We consolidate the assets and liabilities of the Residential Resecuritization entity as we did not meet the GAAP sale criteria at the time the financial assets were transferred to this entity based on our role in the entity's inception and design. We transferred senior residential securities to Credit Suisse First Boston Mortgage Securities Corp., which subsequently sold them to CSMC 2011-9R, the

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 4. Principles of Consolidation (continued)**

Residential Resecuritization entity. In connection with this transaction, we acquired certain senior and subordinate securities that we continue to hold. We engaged in the Residential Resecuritization primarily for the purpose of obtaining permanent non-recourse financing on a portion of our senior residential securities portfolio.

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

***Analysis of Unconsolidated VIEs with Continuing Involvement***

During 2012 and the six months ended June 30, 2013, we transferred residential loans to 14 Sequoia securitization entities sponsored by us and accounted for these transfers as sales for financial reporting purposes. We also determined we were not the primary beneficiary of these VIEs as we lacked the power to direct the activities that will have the most significant economic impact on the entities. For the transferred loans where we held the servicing rights prior to the transfer and continue to hold the servicing rights, we recorded MSR's on our consolidated balance sheet at June 30, 2013, and classify those MSR's as Level 3 assets. We also retained senior and subordinate securities in these securitizations that we classify as Level 3 assets.

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

***Securitization Activity Related to Unconsolidated VIEs Sponsored by Redwood***

<b>(In Thousands)</b>	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Principal balance of loans transferred	\$ 1,802,058	\$ 293,590	\$ 4,042,710	\$ 1,036,856
Trading securities retained, at fair value	40,642	5,610	91,850	26,786

AFS securities retained, at fair value	92,367	17,267	207,095	56,717
Gains on sale	-	4,243	-	11,609
MSRs recognized	16,148	1,029	28,614	2,608

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

*Cash Flows Related to Unconsolidated VIEs Sponsored by Redwood*

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Cash proceeds	\$ 1,705,504	\$ 277,269	\$ 3,859,354	\$ 972,073
MSR fees received	2,099	137	3,075	154
Funding of compensating interest	(145)	(13)	(263)	(16)
Cash flows received on retained securities	9,883	2,071	14,950	3,099

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 4. Principles of Consolidation (continued)**

The following table presents the key weighted-average assumptions to measure MSRs at the date of securitization.

***MSR Assumptions Related to Unconsolidated VIEs Sponsored by Redwood***

<b>At Date of Securitization</b>	<b>Issued During</b>			
	<b>Three Months Ended June 30, 2013</b>	<b>2012</b>	<b>Six Months Ended June 30, 2013</b>	<b>2012</b>
Prepayment speeds	5 - 12 %	5 - 21 %	5 - 14 %	5 - 19 %
Discount rates	12 %	10 %	12 %	9 %

The following table presents additional information at June 30, 2013 and December 31, 2012, related to unconsolidated securitizations sponsored by us during 2012 and the six months ended June 30, 2013.

***Unconsolidated VIEs Sponsored by Redwood***

<b>(In Thousands)</b>	<b>June 30, 2013</b>	<b>December 31, 2012</b>
On-balance sheet assets, at fair value:		
Interest-only securities, classified as trading	\$ 123,591	\$ 10,409
Subordinate securities, classified as AFS	318,789	113,681
Maximum loss exposure <sup>(1)</sup>	442,380	124,090
Principal balance of loans outstanding	5,383,219	1,736,331

(1) Maximum loss exposure from our involvement with unconsolidated VIEs pertains to the carrying value of our securities retained from these VIEs and represents estimated losses that would be incurred under severe, hypothetical circumstances, such as if the value of our interests and any associated collateral declines to zero. This does not include, for example, any potential exposure to representation and warranty claims associated with our initial transfer of loans into a securitization.

The following table presents key economic assumptions for assets retained from unconsolidated VIEs and the sensitivity of their fair values to immediate adverse changes in those assumptions at June 30, 2013 and December 31, 2012.

**Key Assumptions and Sensitivity Analysis for Assets Retained from Unconsolidated VIEs Sponsored by Redwood****June 30, 2013**

<b>(Dollars in Thousands)</b>	<b>MSRs</b>	<b>Senior Interest-only Securities</b>	<b>Subordinate Securities</b>
Fair value at June 30, 2013	\$ 43,098	\$ 123,591	\$ 318,789
Expected weighted-average life (in years)	8	6	13
Prepayment speed assumption (annual CPR)	8 %	13 %	14 %
Decrease in fair value from:			
10% adverse change	\$ 1,367	\$ 4,275	\$ 844
25% adverse change	3,284	34,398	1,974
Discount rate assumption	12 %	5 %	6 %
Decrease in fair value from:			
100 basis point increase	\$ 1,822	\$ 5,931	\$ 28,365
200 basis point increase	3,309	11,357	52,835
Credit loss assumption	N/A	0.22 %	0.22 %
Decrease in fair value from:			
10% higher losses	N/A	\$ 39	\$ 1,128
25% higher losses	N/A	98	2,816

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 4. Principles of Consolidation (continued)****December 31, 2012**

<b>(Dollars in Thousands)</b>	<b>MSRs</b>	<b>Senior Interest-only Securities</b>	<b>Subordinate Securities</b>
Fair value at December 31, 2012	\$ 5,315	\$ 10,409	\$ 113,681
Expected weighted-average life (in years)	3	3	10
Prepayment speed assumption (annual CPR)	33 %	29 %	24 %
Decrease in fair value from:			
10% adverse change	\$ 351	\$ 724	\$ 858
25% adverse change	812	1,674	1,909
Discount rate assumption	12 %	17 %	6 %
Decrease in fair value from:			
100 basis point increase	\$ 121	\$ 20	\$ 901
200 basis point increase	235	40	1,791
Credit loss assumption	N/A	0.48 %	0.47 %
Decrease in fair value from:			
10% higher losses	N/A	\$ 5	\$ 578
25% higher losses	N/A	12	1,446

***Continuing Involvement with VIEs with No Economic Interest***

During 2012, we sold all of our remaining economic interests in Acacia entities and, pursuant to an accounting analysis, deconsolidated the Acacia entities and derecognized the associated assets and liabilities for financial reporting purposes. We maintain limited continuing involvement through our role as collateral manager for all but one of these Acacia entities. Our role as collateral manager has, under the terms of the applicable management agreements, been significantly curtailed or eliminated with respect to the Acacia entities, as all but two of these entities have experienced events of default. Additionally, we will continue to receive the collateral management fee for these entities, which has decreased significantly and will continue to do so as the balance on which the fee is determined continues to decline.

***Analysis of Third-Party VIEs***



Third-party VIEs are securitization entities for which we maintain an economic interest but do not sponsor. Our economic interest may include several securities from the same third-party VIE, and in those cases, the consolidation analysis is performed in consideration of all of our interests. The following table presents a summary of our interests in third-party VIEs at June 30, 2013, grouped by collateral type and ownership interest.

***Third-Party VIE Summary***

**June 30, 2013**

<b>(Dollars in Thousands)</b>	<b>Fair Value</b>
Residential real estate securities at Redwood	
Senior	\$ 481,190
Re-REMIC	154,167
Subordinate	384,176
<b>Total Investments in Third-Party Real Estate Securities</b>	<b>\$ 1,019,533</b>

We determined that we are not the primary beneficiary of any third-party residential or commercial entities, as we do not have the required power to direct the activities that most significantly impact the economic performance of these entities. Specifically, we do

Table of Contents

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 4. Principles of Consolidation (continued)**

not service or manage these entities or otherwise hold decision making powers that are significant. As a result of this assessment, we do not consolidate any of the underlying assets and liabilities of these third-party VIEs we only account for our specific interests in them.

Our assessments of whether we are required to consolidate a VIE may change in subsequent reporting periods based upon changing facts and circumstances pertaining to each VIE. Any related accounting changes could result in a material impact to our financial statements.

**Note 5. Fair Value of Financial Instruments**

For financial reporting purposes, we follow a fair value hierarchy established under GAAP that is used to determine the fair value of financial instruments. This hierarchy prioritizes relevant market inputs in order to determine an exit price at the measurement date, or the price at which an asset could be sold or a liability could be transferred in an orderly process that is not a forced liquidation or distressed sale. Level 1 inputs are observable inputs that reflect quoted prices for identical assets or liabilities in active markets. Level 2 inputs are observable inputs other than quoted prices for an asset or liability that are obtained through corroboration with observable market data. Level 3 inputs are unobservable inputs (e.g., our own data or assumptions) that are used when there is little, if any, relevant market activity for the asset or liability required to be measured at fair value.

In certain cases, inputs used to measure fair value fall into different levels of the fair value hierarchy. In such cases, the level at which the fair value measurement 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 requires judgment and considers factors specific to the asset or liability being measured.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 5. Fair Value of Financial Instruments (continued)**

The following table presents the carrying values and estimated fair values of assets and liabilities that are required to be recorded or disclosed at fair value at June 30, 2013 and December 31, 2012.

<b>(In Thousands)</b>	<b>June 30, 2013</b>		<b>December 31, 2012</b>	
	<b>Carrying Value</b>	<b>Fair Value</b>	<b>Carrying Value</b>	<b>Fair Value</b>
<b>Assets</b>				
Residential loans, held-for-sale				
At fair value	\$ 1,219,368	\$ 1,219,368	\$ 553,576	\$ 553,576
At lower of cost or fair value	1,730	1,807	9,082	9,324
Residential loans, held-for-investment	1,998,178	1,801,052	2,272,812	2,062,352
Commercial loans, held-for-sale				
At fair value	149,470	149,470	-	-
At lower of cost or fair value	-	-	8,500	8,500
Commercial loans, held-for-investment	345,353	349,212	304,510	309,547
Trading securities	141,615	141,615	33,172	33,172
Available-for-sale securities	1,172,690	1,172,690	1,075,581	1,075,581
Mortgage servicing rights	43,098	43,098	5,315	5,315
Cash and cash equivalents	207,694	207,694	81,080	81,080
Restricted cash	405	405	383	383
Accrued interest receivable	16,111	16,111	12,442	12,442
Derivative assets	43,341	43,341	2,972	2,972
REO <sup>(1)</sup>	3,965	4,971	4,245	5,540
Margin receivable <sup>(1)</sup>	55,926	55,926	63,424	63,424
Other collateral posted <sup>(1)</sup>	5,000	5,000	-	-
<b>Liabilities</b>				
Short-term debt	\$ 1,445,961	\$ 1,445,961	\$ 551,918	\$ 551,918
Accrued interest payable	8,682	8,682	4,592	4,592
Derivative liabilities	29,571	29,571	51,081	51,081
ABS issued	2,214,296	1,991,401	2,529,941	2,372,971

Commercial borrowings	16,591	16,591	-	-
Convertible notes	287,500	283,547	-	-
Other long-term debt	139,500	104,625	139,500	90,675

(1) These assets are included in Other Assets on our consolidated balance sheets.

We elected the fair value option for \$41 million and \$92 million of residential senior securities and \$2.53 billion and \$5.07 billion of residential loans (principal balance) that we acquired during the three and six months ended June 30, 2013, respectively. During the three months ended June 30, 2013, we also elected the fair value option for \$150 million of commercial senior loans we acquired. We anticipate electing the fair value option residential senior securities and all future purchases of loans that we intend to sell to third parties or transfer to Sequoia securitizations. We have historically elected the fair value option for certain commercial loans and trading securities, as well as certain third-party residential securities.

Table of Contents

**REDWOOD TRUST, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 5. Fair Value of Financial Instruments (continued)**

The following table presents the assets and liabilities recorded that are reported at fair value on our consolidated balance sheets on a recurring basis at June 30, 2013, as well as the fair value hierarchy of the valuation inputs used to measure fair value.

*Assets and Liabilities Measured at Fair Value on a Recurring Basis at June 30, 2013*

<b>June 30, 2013 (In Thousands)</b>	<b>Carrying Value</b>	<b>Fair Value Measurements Using</b>		
		<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>Assets</b>				
Residential loans, at fair value	\$ 1,219,368	\$ -	\$ -	\$ 1,219,368
Commercial loans, at fair value	149,470	-	149,470	-
Trading securities	141,615	-	-	141,615
Available-for-sale securities	1,172,690	-	-	1,172,690
MSRs	43,098	-	-	43,098
Derivative assets	43,341	8,983	34,358	-
<b>Liabilities</b>				
Derivative liabilities	29,571	1,786	27,785	-

The following table presents additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the six months ended June 30, 2013.

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

<b>(In Thousands)</b>	<b>Assets</b>			
	<b>Residential Loans</b>	<b>Trading Securities</b>	<b>AFS Securities</b>	<b>MSRs</b>
Beginning balance - December 31, 2012	\$ 553,576	\$ 33,172	\$ 1,075,581	\$ 5,315
Principal paydowns	(2,486)	(31)	(81,218)	-
(Losses) gains in net income, net	(19,601)	33,558	26,722	9,169

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Unrealized losses in OCI, net	-	-	(41,230)	-
Acquisitions	5,154,352	91,850	207,096	28,614
Sales	(4,465,558)	(16,934)	(14,261)	-
Other settlements, net	(915)	-	-	-
<b>Ending Balance - June 30, 2013</b>	<b>\$ 1,219,368</b>	<b>\$ 141,615</b>	<b>\$ 1,172,690</b>	<b>\$ 43,098</b>

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 5. Fair Value of Financial Instruments (continued)**

The following table presents the portion of gains or losses included in our consolidated statements of income that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and held at both June 30, 2013 and 2012. Gains or losses incurred on assets or liabilities sold, matured, called, or fully written down during the three and six months ended June 30, 2013 and 2012 are not included in this presentation.

***Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at June 30, 2013 and 2012 Included in Net Income***

<b>(In Thousands)</b>	<b>Included in Net Income</b>			
	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
<b>Assets</b>				
Residential loans, at fair value	\$ (59,649)	\$ -	\$ (59,641)	\$ -
Commercial loans, at fair value	-	111	-	122
Trading securities	31,354	10,585	30,866	43,019
Available-for-sale securities	(1,642)	(303)	(1,665)	(635)
MSRs	9,450	(476)	9,532	(482)
<b>Liabilities</b>				
Derivative liabilities	-	(195)	-	(1,090)
ABS issued - Acacia	-	(12,973)	-	(45,026)

The following table presents information on assets recorded at fair value on a non-recurring basis at June 30, 2013. This table does not include the carrying value and gains or losses associated with the asset types below that were not recorded at fair value on our balance sheet at June 30, 2013.

***Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis at June 30, 2013***

June 30, 2013 (In Thousands)	Carrying Value	Fair Value Measurements Using			Gain (Loss) for	
		Level 1	Level 2	Level 3	Three Months Ended June 30, 2013	Six Months Ended June 30, 2013
<b>Assets</b>						
Residential loans, at lower of cost or fair value	\$ 1,122	\$ -	\$ -	\$ 1,122	\$ 37	\$ 42
REO	2,117	-	-	2,117	(368)	(459)



Table of Contents

## REDWOOD TRUST, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(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 income for the three and six months ended June 30, 2013 and 2012.

*Market Valuation Adjustments, Net*

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
<b>Other</b>				
Residential loans, at lower of cost or fair value	\$ 38	\$ 405	\$ 78	\$ 498
Commercial loans, at fair value	-	111	-	122
Trading securities	(4,140)	16,349	(4,707)	49,824
Impairments on AFS securities	(1,642)	(303)	(1,665)	(635)
REO	(558)	(162)	(331)	(144)
Other derivative instruments, net	44	(3,513)	64	(5,982)
ABS issued - Acacia	-	(12,973)	-	(45,026)
<b>Total other</b>	(6,258)	(86)	(6,561)	(1,343)
<b>Mortgage banking activities</b>				
Residential loans, at fair value	(41,405)	-	(6,535)	-
Commercial loans, at fair value	(345)	-	(345)	-
Trading securities	36,336	(5,363)	38,265	(4,674)
MSRs	8,827	(527)	9,169	(544)
Derivative instruments, net	49,544	(3,282)	50,567	(6,398)
<b>Total mortgage banking activities</b>	52,957	(9,172)	91,121	(11,616)
<b>Total Market Valuation Adjustments, Net</b>	\$ 46,699	\$ (9,258)	\$ 84,560	\$ (12,959)

*Valuation Policy*

We maintain a policy that specifies the methodology we use to value different types of financial instruments. Significant changes to the valuation methodology are reviewed by members of senior management to confirm the changes are appropriate and reasonable. Valuations based on information from external sources are performed on an instrument-by-instrument basis with the resulting amounts analyzed individually against internal calculations as well as in the aggregate by product type classification. Initial valuations are performed by our portfolio management group using the valuation process described below. A subset of our finance department then independently reviews all fair value estimates using available market, portfolio, and industry information to ensure they are reasonable. Finally, members of senior management review all fair value estimates, including an analysis of valuation changes from prior reporting periods.

#### ***Valuation Process***

We estimate fair values for financial assets or liabilities based on available observable and unobservable inputs observed in the marketplace. We primarily use two pricing valuation techniques: market comparable pricing and discounted cash flow analysis. Market comparable pricing is used to determine the estimated fair value of certain instruments by incorporating known inputs and performance metrics, such as observed prepayment rates, delinquencies, credit support, recent transaction prices, pending transactions, or prices of other similar instruments. Discounted cash flow analysis techniques generally consist of developing an estimate of future cash flows that are expected to occur over the life of an instrument and then discounting those cash flows at a rate of return that results in an estimate of fair value. After considering all available indications of the appropriate rate of return that market participants would require, we consider the reasonableness of the range indicated by the results to determine an estimate that is most representative of fair value. We also consider counterparty credit quality and risk as part of our fair value assessments.

Table of Contents

**REDWOOD TRUST, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 5. Fair Value of Financial Instruments (continued)**

The following table provides quantitative information about the significant unobservable inputs used in the valuation of our Level 3 assets and liabilities measured at fair value.

***Fair Value Methodology for Level 3 Financial Instruments***

<b>June 30, 2013 (Dollars in Thousands)</b>	<b>Fair Value</b>	<b>Unobservable Input</b>	<b>Range</b>	<b>Weighted Average</b>
<b>Assets</b>				
Residential loans, at fair value				
Loans priced to securitization	\$ 1,047,686	Discount rate	4 - 4 %	4 %
		Prepayment rate	10 - 10 %	10 %
		Default rate	1 - 1 %	1 %
		Loss severity	22 - 22 %	22 %
		Credit support	7 - 7 %	7 %
Loans priced to whole loan market	171,682	Pool fallout assumption	0 - 5 %	4 %
		Fallout assumption price discount	0 - 5 pts	4 pts
Residential loans, at lower of cost or fair value	1,122	Loss severity	15 - 28 %	21 %
Trading and AFS securities	1,314,305	Discount rate	5 - 18 %	7 %
		Prepayment speed	1 - 40 %	14 %
		Default rate	0 - 37 %	10 %
		Loss severity	20 - 64 %	38 %
		Credit support	0 - 59 %	6 %
MSRs	43,098	Discount rate	12 - 12 %	12 %
		Prepayment rate	6 - 50 %	8 %
REO	2,117	Historical loss adjustment	0 - 40 %	10 %

***Determination of Fair Value***

A description of the instruments measured at fair value as well as the general classification of such instruments pursuant to the Level 1, Level 2, and Level 3 valuation hierarchy is listed herein. We generally use both market comparable information and discounted cash flow modeling techniques to determine the fair value of our Level 3 assets and liabilities. Use of these techniques requires determination of relevant inputs and assumptions, some of which represent significant unobservable inputs as indicated in the preceding table. Accordingly, a significant increase or decrease in any of these inputs such as anticipated credit losses, prepayment speeds, interest rates, or other valuation assumptions in isolation, would likely result in a significantly lower or higher fair value measurement.

*Residential loans*

Estimated fair values for residential loans are determined based on either an exit price to securitization or the whole loan market. For loans valued based on an exit to securitization, significant inputs in the valuation analysis are predominantly Level 3 in nature, due to the limited availability of market quotes on newly issued RMBS and related inputs. Relevant market indicators that are factored into the analyses include third-party RMBS sales, pricing points for secondary sales of RMBS we have issued in past periods, yields for RMBS issued by government sponsored enterprises, indexed swap yields, credit rating agency guidance on expected credit enhancement levels for newly issued RMBS transactions, interest rates, and prepayment speeds (Level 3).

Table of Contents

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 5. Fair Value of Financial Instruments (continued)**

For loans valued based on an exit to the whole loan market, significant inputs in the valuation analysis are predominantly Level 3 in nature. Relevant market indicators that are factored into the analyses include prices on recent sales of our own whole loans, indexed swap yields, interest rates, prepayment speeds, and loss severities (Level 3). These assets would generally decrease in value based upon an increase in the loss severity assumption and would generally increase in value if the loss severity assumption were to decrease.

*Commercial loans*

Estimated fair values for commercial mezzanine loans are determined by both market comparable pricing and discounted cash flow analysis valuation techniques (Level 3). Our discounted cash flow models utilize certain significant unobservable inputs including the underwritten net operating income and debt coverage ratio assumptions and actual performance relative to those underwritten metrics. A decrease in these unobservable inputs will reduce the fair value of the commercial loans.

Estimated fair values for commercial senior mortgage loans are determined by an exit price to securitization. Certain significant inputs in the valuation analysis are Level 3 in nature. Relevant market indicators that are factored into the analyses include third-party CMBS sales, pricing points for secondary sales of CMBS, yields for synthetic instruments that use CMBS bonds as an underlying index, indexed swap yields, credit rating agency guidance on expected credit enhancement levels for newly issued CMBS transactions, and interest rates (Level 3). In certain cases, commercial senior mortgage loans are valued based on third-party offers for purchase into securitization (Level 2).

*Real estate securities*

Real estate securities include residential, commercial, and other asset-backed securities that are generally illiquid in nature and trade infrequently. For real estate securities, we utilize both market comparable pricing and discounted cash flow analysis valuation techniques. Significant inputs in the valuation analysis are predominantly Level 3 in nature, due to the lack of readily available market quotes and related inputs. Relevant market indicators that are factored into 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 (Level 3). These cash flow models use significant unobservable inputs such as a discount rate, prepayment rate, default rate, loss severity and credit support. The fair value of our securities would generally decrease in value based upon an increase in serious delinquencies. Conversely, the fair value of our securities would generally increase if the prepayment rate or credit support inputs were to increase.

As part of our securities valuation process, we request and consider indications of value from third-party securities dealers. For purposes of pricing our securities at June 30, 2013, we received dealer price indications on 76% of our securities. In the aggregate, our internal valuations of the securities for which we received dealer price indications were 3% lower than the aggregate dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis. In circumstances where relevant market inputs cannot be obtained, increased reliance on discounted cash flow analysis and management judgment are required to estimate fair value.

*Derivative assets and liabilities*

Our derivative instruments include interest rate agreements, TBAs, and financial futures. Fair values of derivative instruments are determined using quoted prices from active markets, when available, or valuation models and are supported by valuations provided by dealers active in derivative markets. TBA and financial futures fair values are generally obtained using quoted prices from active markets (Level 1). Our derivative valuation models for interest rate agreements require a variety of inputs, including contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates, and correlations of certain inputs. Model inputs for interest rate agreements can generally be verified and model selection does not involve significant management judgment (Level 2).

For other derivatives, valuations are based on various factors such as liquidity, bid/ask spreads, and credit considerations for which we rely on available market inputs. In the absence of such inputs, management's best estimate is used (Level 3). At June 30, 2013 and December 31, 2012, we had no Level 3 derivatives.

**Table of Contents**

**REDWOOD TRUST, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 5. Fair Value of Financial Instruments (continued)**

*Cash and cash equivalents*

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less. Fair values equal carrying values (Level 1).

*Restricted cash*

Restricted cash primarily includes interest-earning cash balances at consolidated Sequoia entities and at the Residential Resecuritization and Commercial Securitization entities for the purpose of distribution to investors and reinvestment. Due to the short-term nature of the restrictions, fair values approximate carrying values (Level 1).

*Accrued interest receivable and payable*

Accrued interest receivable and payable includes interest due on our assets 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 (Level 1).

*MSRs*

MSRs include the rights to service mortgage loans. 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 inputs include market discount rates, prepayment speeds of serviced loans, and the market cost of servicing. Changes in the fair value of MSRs occur primarily due to the collection/realization of expected cash flows, as well as changes in valuation inputs and assumptions. Estimated fair values are based on applying the inputs to generate the net present value of estimated MSR income, which is what we believe market participants would use to estimate fair value (Level 3). These discounted cash flow models utilize certain significant unobservable inputs including prepayment rate and discount rate assumptions. An increase in these unobservable inputs will reduce the fair value of the MSRs and alternatively, a decrease in these inputs will increase the values of the MSRs. Additionally, if prepayments occur at a rate greater than our estimate, the fair value of the MSRs will decrease accordingly.

As part of our MSR valuation process, we received a valuation estimate from a third-party valuations group. In the aggregate, our internal valuations of the MSRs were 1% lower than the third-party valuation.

*REO*

REO includes properties owned in satisfaction of foreclosed loans. Fair values are determined using available market quotes, appraisals, broker price opinions, comparable properties, or other indications of value (Level 3).

*Margin receivable*

Margin receivable reflects cash collateral we have posted with our various derivative and debt counterparties as required to satisfy margin requirements. Fair values approximate carrying values (Level 1).

*Short-term debt*

Short-term debt includes our credit facilities that mature within one year. Fair values approximate carrying values (Level 1).

*ABS issued*

ABS issued includes asset-backed securities issued through the Sequoia, Residential Resecuritization, and Commercial Securitization entities. These instruments are illiquid in nature and trade infrequently, if at all. For ABS issued, we utilize both market comparable pricing and discounted cash flow analysis valuation techniques. 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. Relevant market indicators factored into the analyses include dealer price indications to the extent available, bid/ask spreads, external spreads, collateral credit losses, interest rates, default rates, loss severities, and collateral prepayment speeds. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3). These liabilities would generally increase in



Table of Contents

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 5. Fair Value of Financial Instruments (continued)**

value based upon a decrease in default rates and would generally decrease in value if the prepayment rate or credit support input were to decrease.

As part of our ABS issued valuation process, we request and consider indications of value from third-party securities dealers. For purposes of pricing our ABS issued at June 30, 2013, we received dealer price indications on 38% of our ABS issued. In the aggregate, our internal valuations of the ABS issued for which we received dealer price indications were 1% higher than the aggregate dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis. In circumstances where relevant market inputs cannot be obtained, increased reliance on discounted cash flow analysis and management judgment are required to estimate fair value.

*Commercial borrowings*

Commercial borrowings include our commercial loan repurchase agreement that matures in more than one year. Fair values approximate carrying values (Level 1).

*Convertible notes*

Convertible notes include unsecured convertible senior notes. Fair values are determined using quoted prices in active markets (Level 1).

*Other long-term debt*

Other long-term debt includes trust preferred securities and subordinated notes. Estimated fair values are determined using discounted cash flow analysis valuation techniques. 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. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3).

**Note 6. Residential Loans**

We acquire residential loans from third-party originators. During the six months ended June 30, 2013, we purchased \$5.07 billion (principal balance) of residential loans primarily in connection with our Sequoia securitization program, for which we elected the fair value option. The following table summarizes the classifications and carrying value of the residential loans owned at Redwood and at consolidated Sequoia entities at June 30, 2013 and December 31, 2012.

**June 30, 2013**

<b>(In Thousands)</b>	<b>Redwood</b>	<b>Sequoia</b>	<b>Total</b>
Held-for-sale			
Fair value	\$ 1,219,368	\$ -	\$ 1,219,368
Lower of cost or fair value	1,730	-	1,730
Held-for-investment	-	1,998,178	1,998,178
<b>Total Residential Loans</b>	<b>\$ 1,221,098</b>	<b>\$ 1,998,178</b>	<b>\$ 3,219,276</b>

**December 31, 2012**

<b>(In Thousands)</b>	<b>Redwood</b>	<b>Sequoia</b>	<b>Total</b>
Held-for-sale			
Fair value	\$ 553,576	\$ -	\$ 553,576
Lower of cost or fair value	9,082	-	9,082
Held-for-investment	-	2,272,812	2,272,812
<b>Total Residential Loans</b>	<b>\$ 562,658</b>	<b>\$ 2,272,812</b>	<b>\$ 2,835,470</b>

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 6. Residential Loans (continued)**

We do not currently service any residential loans, although at June 30, 2013, we did own MSRs that provided us with the rights to service \$1.25 billion (principal balance) of consolidated residential loans purchased from third-party originators.

***Residential Loans Held-for-Sale******Residential Loans at Fair Value***

At June 30, 2013, there were 1,645 residential loans at fair value, with an aggregate outstanding principal balance of \$1.26 billion and an aggregate fair value of \$1.22 billion. During the three and six months ended June 30, 2013, we recorded \$41 million and \$7 million of negative valuation adjustments, respectively, on residential loans for which we elected the fair value option through mortgage banking activities, net, a component of our consolidated income statement. At December 31, 2012, there were 685 residential loans at fair value, with an aggregate outstanding principal balance of \$533 million and an aggregate fair value of \$554 million.

***Residential Loans at Lower of Cost or Fair Value***

At June 30, 2013, there were 10 residential loans at lower of cost or fair value with \$2 million in outstanding principal balance and a carrying value of \$2 million. At December 31, 2012, there were 17 residential loans at lower of cost or fair value with \$10 million in outstanding principal balance and a carrying value of \$9 million. During the three and six months ended June 30, 2013, we recorded valuation adjustments for residential loans held-for-sale of positive \$38 thousand and positive \$78 thousand, respectively. During the three and six months ended June 30, 2012, we recorded valuation adjustments for residential loans held-for-sale of positive \$405 thousand and positive \$498 thousand, respectively.

***Residential Loans Held-for-Investment***

The following table details the carrying value for residential loans held-for-investment at June 30, 2013 and December 31, 2012. These loans are owned at Sequoia securitization entities that we consolidate for financial reporting purposes.

**(In Thousands)****June 30, 2013****December 31, 2012**

Principal balance	\$	2,001,544	\$	2,278,069
Unamortized premium, net		19,784		23,247
Recorded investment		2,021,328		2,301,316
Allowance for loan losses		(23,150)		(28,504)
<b>Carrying Value</b>	<b>\$</b>	<b>1,998,178</b>	<b>\$</b>	<b>2,272,812</b>

Of the \$2.00 billion of principal balance and \$20 million of unamortized premium on loans held-for-investment at June 30, 2013, \$832 million of principal balance and \$13 million of unamortized premium relate to residential loans acquired prior to July 1, 2004. During the six months ended June 30, 2013, 9% of these residential loans prepaid and we amortized 18% of the premium based upon the accounting elections we apply. For residential loans acquired after July 1, 2004, the principal balance was \$1.20 billion and the unamortized premium was \$7 million. During the six months ended June 30, 2013, 14% of these loans prepaid and we amortized 9% of the premium.

Of the \$2.28 billion of principal balance and \$23 million of unamortized premium on loans held-for-investment at December 31, 2012, \$912 million of principal balance and \$16 million of unamortized premium relate to residential loans acquired prior to July 1, 2004. For residential loans acquired after July 1, 2004, the principal balance was \$1.37 billion and the unamortized premium was \$8 million.

#### ***Credit Characteristics of Residential Loans Held-for-Investment***

As a percentage of our recorded investment, 98% of residential loans held-for-investment at June 30, 2013, were first lien, predominately prime-quality loans at the time of origination. The remaining 2% of loans were second lien, home equity lines of credit.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 6. Residential Loans (continued)**

The weighted average original LTV ratio for our residential loans held-for-investment outstanding at June 30, 2013, was 65%. The weighted average FICO score for the borrowers of these loans was 734 at the time the loans were originated.

We consider the year of origination of our residential loans held-for-investment to be a general indicator of credit performance as loans originated in specific years have often possessed similar product and credit characteristics. The following table displays our recorded investment in residential loans held-for-investment at June 30, 2013 and December 31, 2012, organized by year of origination.

<b>(In Thousands)</b>	<b>June 30, 2013</b>		<b>December 31, 2012</b>	
2003 & Earlier	\$	1,017,135	\$	1,131,200
2004		545,935		569,379
2005		67,266		71,792
2006		157,349		164,333
2007		-		-
2008		-		-
2009		37,823		58,628
2010		121,581		197,964
2011		74,239		108,020
<b>Total Recorded Investment</b>	<b>\$</b>	<b>2,021,328</b>	<b>\$</b>	<b>2,301,316</b>

***Allowance for Loan Losses on Residential Loans***

For residential loans held-for-investment, we establish and maintain an allowance for loan losses. The allowance includes a component for pools of residential loans owned at Sequoia securitization entities that we collectively evaluated for impairment, and a component for loans individually evaluated for impairment that includes modified residential loans at Sequoia entities that have been determined to be troubled debt restructurings.

***Activity in the Allowance for Loan Losses on Residential Loans***

The following table summarizes the activity in the allowance for loan losses for the three and six months ended June 30, 2013 and 2012.

<b>(In Thousands)</b>	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Balance at beginning of period	\$ 29,064	\$ 59,155	\$ 28,504	\$ 66,881
Charge-offs, net	(1,751)	(1,991)	(2,545)	(5,139)
Reversal of provision for loan losses	(4,163)	(1,715)	(2,809)	(1,715)
Deconsolidation adjustment	-	-	-	(4,578)
<b>Balance at End of Period</b>	<b>\$ 23,150</b>	<b>\$ 55,449</b>	<b>\$ 23,150</b>	<b>\$ 55,449</b>

During both the three months ended June 30, 2013 and 2012, there were \$2 million of charge-offs of residential loans that reduced our allowance for loan losses. These charge-offs arose from \$5 million and \$4 million of defaulted loan principal, respectively. During the six months ended June 30, 2013 and 2012, there were \$3 million and \$5 million of charge-offs of residential loans, respectively, that reduced our allowance for loan losses. These charge-offs arose from \$7 million and \$14 million of defaulted loan principal, respectively.

#### ***Residential Loans Collectively Evaluated for Impairment***

We establish the collective component of the allowance for residential loan losses based primarily on the characteristics of the loan pools underlying the securitization entities that own the loans, including loan product types, credit characteristics, and

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 6. Residential Loans (continued)**

origination years. The collective analysis is further divided into two segments. The first segment reflects our estimate of losses on delinquent loans within each loan pool. These loss estimates are determined by applying the loss factors described in *Note 3* to the delinquent loans, including our expectations of the timing of defaults and the loss severities we expect once defaults occur. The second segment relates to our estimate of losses incurred on nondelinquent loans within each loan pool. This estimate is based on losses we expect to realize over a 23 month loss confirmation period, which is based on our historical loss experience as well as consideration of the loss factors described in *Note 3*.

The following table summarizes the balances for loans collectively evaluated for impairment at June 30, 2013 and December 31, 2012.

<b>(In Thousands)</b>	<b>June 30, 2013</b>		<b>December 31, 2012</b>	
Principal balance	\$	1,993,690	\$	2,272,104
Recorded investment		2,013,694		2,295,471
Related allowance		22,520		27,891

The following table summarizes the recorded investment and past due status of residential loans collectively evaluated for impairment at June 30, 2013 and December 31, 2012.

<b>(In Thousands)</b>	<b>30-59 Days Past Due</b>		<b>60-89 Days Past Due</b>		<b>90 + Days Past Due</b>		<b>Current</b>	<b>Total Loans</b>		
June 30, 2013	\$	22,968	\$	9,909	\$	65,476	\$	1,915,341	\$	2,013,694
December 31, 2012		29,345		17,593		62,937		2,185,596		2,295,471

***Residential Loans Individually Evaluated for Impairment***

As part of the loss mitigation efforts undertaken by servicers of residential loans owned at Sequoia securitization entities, a number of loan modifications have been completed to help make mortgage loans more affordable for qualifying borrowers and potentially reduce a future impairment. For the six months ended June 30, 2013 and 2012, the loan modifications determined to be TDRs were either: (i) conversions of a floating rate mortgage loan into a fixed rate mortgage loan; (ii) reductions in the contractual interest rates of a mortgage loan paired with capitalization of accrued interest; or (iii) principal forgiveness paired with interest rate reductions.

The following table presents the details of the loan modifications determined to be TDRs for the three and six months ended June 30, 2013 and 2012.

(Dollars in Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
<b>TDRs</b>				
Number of modifications	4	2	7	6
Pre-modification outstanding recorded investment	\$ 1,031	\$ 884	\$ 1,795	\$ 2,672
Post-modification outstanding recorded investment	1,145	626	1,941	2,425
Loan modification effect on net interest income after provision and other MVA	(140)	(118)	(309)	(597)
<b>TDRs that Subsequently Defaulted</b>				
Number of modifications	1	2	3	4
Recorded investment	\$ 178	\$ 603	\$ 587	\$ 1,702

If we determine that a restructured loan is a TDR, we remove it from the general loan pools used for determining the allowance for residential loan losses and assess it for impairment on an individual basis. This assessment is based primarily on whether an



Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 6. Residential Loans (continued)**

adverse change in the expected future cash flows resulted from the restructuring. The average recorded investment of loans individually evaluated for impairment for the three months ended June 30, 2013 and 2012, was \$7 million and \$15 million, respectively. For the three months ended June 30, 2013 and 2012, we recorded interest income of \$10 thousand and \$149 thousand, respectively, on individually impaired loans. The average recorded investment of loans individually evaluated for impairment for the six months ended June 30, 2013 and 2012, was \$7 million and \$15 million, respectively. For the six months ended June 30, 2013 and 2012, we recorded interest income of \$21 thousand and \$259 thousand, respectively, on individually impaired loans.

The following table summarizes the balances for loans individually evaluated for impairment, all of which had an allowance, at June 30, 2013 and December 31, 2012.

<b>(In Thousands)</b>	<b>June 30, 2013</b>	<b>December 31, 2012</b>
Principal balance	\$ 7,854	\$ 5,965
Recorded investment	7,634	5,845
Related allowance	630	613

The following table summarizes the recorded investment and past due status of residential loans individually evaluated for impairment at June 30, 2013 and December 31, 2012.

<b>(In Thousands)</b>	<b>30-59 Days Past Due</b>	<b>60-89 Days Past Due</b>	<b>90 + Days Past Due</b>	<b>Current</b>	<b>Total Loans</b>
June 30, 2013	\$ 1,021	\$ -	\$ 195	\$ 6,418	\$ 7,634
December 31, 2012	160	645	-	5,040	5,845

**Note 7. Commercial Loans**

We invest in commercial loans that we originate and service as well as loans that we acquire from third-party originators. The following table summarizes the classifications and carrying value of commercial loans at June 30, 2013 and December 31, 2012.

<b>(In Thousands)</b>	<b>June 30, 2013</b>	<b>December 31, 2012</b>
<b>Held-for-sale</b>		
Fair value	\$ 149,470	\$ -
Lower of cost or fair value	-	8,500
Held-for-investment	345,353	304,510
<b>Total Commercial Loans</b>	<b>\$ 494,823</b>	<b>\$ 313,010</b>

### *Commercial Loans Held-for-Sale*

Commercial loans held-for-sale include loans we originate and intend to sell to third parties.

### *Commercial Loans at Fair Value*

At June 30, 2013, there were 10 commercial loans at fair value, with an aggregate outstanding principal balance of \$150 million and an aggregate fair value of \$149 million. During the three and six months ended June 30, 2013, we recorded less than \$1 million of negative valuation adjustments on commercial loans for which we elected the fair value option through mortgage banking activities, net, a component of our consolidated income statement. At December 31, 2012, there were no commercial loans at fair value.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 7. Commercial Loans (continued)***Commercial Loans at Lower of Cost or Fair Value*

At June 30, 2013, there were no commercial loans held at the lower of cost or fair value. During both the six months ended June 30, 2013 and 2012, we did not record a valuation adjustment on commercial loans held-for-sale. At December 31, 2012, there was one senior commercial loan held-for-sale with \$9 million in outstanding principal balance and a lower of cost or fair value of \$9 million. During six months ended June 30, 2012, we did not record a valuation adjustment.

*Commercial Loans Held-for-Investment*

Commercial loans held-for-investment include loans we originate and preferred equity investments we make or, in either case, acquire from third parties. Through June 30, 2013, these loans have typically been mezzanine loans that are secured by a borrower's ownership interest in a single purpose entity that owns commercial property, rather than a lien on the commercial property. The preferred equity investments are typically preferred equity interests in a single purpose entity that owns commercial property and are included within, and referred to herein, as commercial loans held-for-investment due to the fact that their risks and payment characteristics are nearly equivalent to commercial mezzanine loans.

The following table provides additional information for our commercial loans held-for-investment at June 30, 2013 and December 31, 2012.

<b>(In Thousands)</b>	<b>June 30, 2013</b>		<b>December 31, 2012</b>	
Principal balance	\$	353,898	\$	312,400
Unamortized discount, net		(2,885)		(3,806)
Recorded investment		351,013		308,594
Allowance for loan losses		(5,660)		(4,084)
<b>Carrying Value</b>	<b>\$</b>	<b>345,353</b>	<b>\$</b>	<b>304,510</b>

At June 30, 2013, there were 48 commercial loans held-for-investment with an outstanding principal balance of \$354 million and a carrying value of \$345 million. Of the \$351 million of recorded investment in commercial loans

held-for-investment at June 30, 2013, 16% was originated in 2013, 45% was originated in 2012, 34% was originated in 2011, and 5% was originated in 2010. At December 31, 2012, there were 35 commercial loans held-for-investment with an outstanding principal balance of \$312 million and a carrying value of \$305 million. Of the \$309 million of recorded investment in commercial loans held-for-investment at December 31, 2012, 53% was originated in 2012, 38% was originated in 2011, 9% was originated in 2010, and less than 1% was acquired in 2004.

### *Allowance for Loan Losses on Commercial Loans*

For commercial loans classified as held-for-investment, we establish and maintain an allowance for loan losses. The allowance includes a component for loans collectively evaluated for impairment and a component for loans individually evaluated for impairment.

### *Activity in the Allowance for Loan Losses on Commercial Loans*

The following table summarizes the activity in the allowance for commercial loan losses for the three and six months ended June 30, 2013 and 2012.

<b>(In Thousands)</b>	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Balance at beginning of period	\$ 4,769	\$ 882	\$ 4,084	\$ 608
Charge-offs, net	-	-	-	-
Provision for loan losses	891	376	1,576	650
<b>Balance at End of Period</b>	<b>\$ 5,660</b>	<b>\$ 1,258</b>	<b>\$ 5,660</b>	<b>\$ 1,258</b>

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 7. Commercial Loans (continued)*****Commercial Loans Collectively Evaluated for Impairment***

We record an allowance for loan losses based on our estimate of credit losses inherent in our portfolio at the reporting date. Our estimate of credit losses is informed by loss rates and delinquency trends. At June 30, 2013 and December 31, 2012, all of the commercial loans collectively evaluated for impairment were current and were assigned an impairment status of Pass. The following table summarizes the balances for loans collectively evaluated for impairment at June 30, 2013 and December 31, 2012.

<b>(In Thousands)</b>	<b>June 30, 2013</b>		<b>December 31, 2012</b>	
Principal balance	\$	353,898	\$	312,400
Recorded investment		351,013		308,594
Related allowance		5,660		4,084

***Commercial Loans Individually Evaluated for Impairment***

We did not have any loans individually evaluated for impairment at either June 30, 2013 or December 31, 2012.

**Note 8. Real Estate Securities**

We invest in mortgage-backed securities. The following table presents the fair values of our real estate securities by collateral type at June 30, 2013 and December 31, 2012.

<b>(In Thousands)</b>	<b>June 30, 2013</b>		<b>December 31, 2012</b>	
Residential	\$	1,314,305	\$	1,094,684
Commercial		-		14,069
<b>Total Real Estate Securities</b>	\$	1,314,305	\$	1,108,753

Our residential securities are presented in accordance with their general position within a securitization structure based on their rights to cash flows. Senior securities are those interests in a securitization that have the first right to cash flows and are last in line to absorb losses. Re-REMIC securities, as presented herein, were created through the

resecuritization of certain senior interests to provide additional credit support to those interests. These re-REMIC securities are therefore subordinate to the remaining senior interest, but senior to any subordinate tranches of the securitization from which they were created. Subordinate securities are all interests below senior and re-REMIC interests.

Table of Contents

**REDWOOD TRUST, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 8. Real Estate Securities (continued)***Trading Securities*

We elected the fair value option for certain securities and classify them as trading securities. At June 30, 2013, our trading securities included \$141 million of interest-only securities, for which there is no principal balance, and \$242 thousand of residential subordinate securities. The unpaid principal balance of residential subordinate securities classified as trading was \$12 million at both June 30, 2013 and December 31, 2012. The following table presents trading securities by collateral type at June 30, 2013 and December 31, 2012.

<b>(In Thousands)</b>	<b>June 30, 2013</b>		<b>December 31, 2012</b>	
<b>Senior Securities</b>				
Residential prime	\$	123,591	\$	10,409
Residential non-prime		17,525		22,134
<b>Total Senior Securities</b>		141,116		32,543
<b>Subordinate Securities</b>				
Residential prime		354		468
Residential non-prime		145		161
<b>Total Subordinate Securities</b>		499		629
<b>Total Trading Securities</b>	\$	141,615	\$	33,172

*AFS Securities*

The following table presents the fair value of our available-for-sale securities held at Redwood by collateral type at June 30, 2013 and December 31, 2012.

<b>(In Thousands)</b>	<b>June 30, 2013</b>		<b>December 31, 2012</b>	
<b>Senior Securities</b>				

Residential prime	\$	410,159	\$	466,523
Residential non-prime		224,687		245,266
<b>Total Senior Securities</b>		634,846		711,789
<b>Re-REMIC Securities</b>		154,167		163,035
<b>Subordinate Securities</b>				
Residential prime		381,631		184,528
Residential non-prime		2,046		2,160
Commercial		-		14,069
<b>Total Subordinate Securities</b>		383,677		200,757
<b>Total AFS Securities</b>	\$	1,172,690	\$	1,075,581

Of the senior securities shown above at June 30, 2013 and December 31, 2012, included \$154 million and \$172 million, respectively, of prime securities, and \$141 million and \$152 million, respectively, of non-prime securities that were financed through the Residential Resecuritization entity, as discussed in *Note 4*.

We often purchase AFS securities at a discount to their outstanding principal balances. To the extent we purchase an AFS security that has a likelihood of incurring a loss, we do not amortize into income the portion of the purchase discount that we do not expect to collect due to the inherent credit risk of the security. We may also expense a portion of our investment in the security to the extent we believe that principal losses will exceed the purchase discount. We designate any amount of unpaid principal balance that we do not expect to receive and thus do not expect to earn or recover as a credit reserve on the security. Any remaining net unamortized discounts or premiums on the security are amortized into income over time using the interest method.



Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 8. Real Estate Securities (continued)**

At June 30, 2013, there were \$3 thousand of AFS residential securities with contractual maturities less than five years, \$3 million of AFS residential securities with contractual maturities greater than five years but less than ten years, and the remainder of our real estate securities had contractual maturities greater than ten years.

During the first quarter of 2013, we sold all of our commercial AFS securities, resulting in a realized gain of \$12 million. The following table presents the components of carrying value (which equals fair value) of residential AFS securities at June 30, 2013 and December 31, 2012.

*Carrying Value of Residential AFS Securities*

<b>(In Thousands)</b>	<b>June 30, 2013</b>	<b>December 31, 2012</b>
Principal balance	\$ 1,453,596	\$ 1,277,401
Credit reserve	(190,410)	(187,032)
Unamortized discount, net	(235,846)	(203,421)
Amortized cost	1,027,340	886,948
Gross unrealized gains	158,883	176,929
Gross unrealized losses	(13,533)	(2,365)
<b>Carrying Value</b>	<b>\$ 1,172,690</b>	<b>\$ 1,061,512</b>

The following table presents the changes for the three and six months ended June 30, 2013, in unamortized discount and designated credit reserves on residential AFS securities.

*Changes in Unamortized Discount and Designated Credit Reserves on Residential AFS Securities*

<b>(In Thousands)</b>	<b>Three Months Ended June 30, 2013</b>	
	<b>Credit Reserve</b>	<b>Unamortized Discount, Net</b>
Beginning balance	\$ 190,690	\$ 220,568

Amortization of net discount	-	(8,153)
Realized credit losses	(4,117)	-
Acquisitions	3,495	23,102
Sales, calls, other	(338)	(633)
Impairments	1,642	-
(Release of) transfers to credit reserves	(962)	962
<b>Ending Balance</b>	\$ 190,410	\$ 235,846

<b>(In Thousands)</b>	<b>Six Months Ended June 30, 2013</b>	
	<b>Credit Reserve</b>	<b>Unamortized Discount, Net</b>
Beginning balance	\$ 187,032	\$ 203,421
Amortization of net discount	-	(15,847)
Realized credit losses	(11,965)	-
Acquisitions	8,397	54,523
Sales, calls, other	(338)	(633)
Impairments	1,666	-
Transfers to (release of) credit reserves	5,618	(5,618)
<b>Ending Balance</b>	\$ 190,410	\$ 235,846

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 8. Real Estate Securities (continued)***Credit Characteristics of Residential AFS Securities*

Of the \$190 million of credit reserve on our residential securities at June 30, 2013, \$50 million was related to residential senior securities, \$44 million was related to residential re-REMIC securities, and \$96 million was related to residential subordinate securities. The loans underlying our \$410 million of prime residential senior securities totaled \$8 billion at June 30, 2013, and the loans underlying our \$225 million of non-prime residential senior securities totaled \$4 billion. Serious delinquencies on loans underlying our senior securities at June 30, 2013, were 10.08% of outstanding principal balances. The loans underlying our residential re-REMIC securities totaled \$5 billion at June 30, 2013, and consisted of \$5 billion prime and \$106 million non-prime credit quality collateral at time of origination. Serious delinquencies on loans underlying our re-REMIC securities at June 30, 2013, were 9.70% of outstanding principal balances. The loans underlying our residential subordinate securities totaled \$16 billion at June 30, 2013, and consisted of \$16 billion prime and \$431 million non-prime credit quality at time of origination. Serious delinquencies on loans underlying our subordinate securities at June 30, 2013, were 4.18% of outstanding principal balances.

*Residential AFS Securities with Unrealized Losses*

The following table presents the components comprising the total carrying value of residential AFS securities that were in a gross unrealized loss position at June 30, 2013 and December 31, 2012.

(In Thousands)	Less Than 12 Consecutive Months			12 Consecutive Months or Longer		
	Amortized Cost	Unrealized Losses	Fair Value	Amortized Cost	Unrealized Losses	Fair Value
June 30, 2013	\$ 299,244	\$ (11,837)	\$ 287,407	\$ 13,974	\$ (1,696)	\$ 12,278
December 31, 2012	22,803	(293)	22,510	26,729	(2,072)	24,657

At June 30, 2013, after giving effect to purchases, sales, and extinguishments due to credit losses, our consolidated balance sheet included 294 AFS securities, of which 47 were in an unrealized loss position and nine were in a continuous unrealized loss position for 12 consecutive months or longer. At December 31, 2012, our consolidated balance sheet included 284 AFS securities, of which 22 were in an unrealized loss position and 14 were in a continuous unrealized loss position for 12 consecutive months or longer.

***Evaluating AFS Securities for Other-than-Temporary Impairments***

When the fair value of an AFS security is below its cost basis, we evaluate the security for OTTI. Part of this evaluation is based upon adverse changes in the assumptions used to value the security. The table below summarizes the significant valuation assumptions we used for our AFS securities at June 30, 2013.

***Significant Valuation Assumptions***

<b>June 30, 2013</b>	<b>Range for Securities</b>	
	<b>Prime</b>	<b>Non-prime</b>
Prepayment rates	4 - 50 %	3 - 10 %
Loss severity	22 - 56 %	30 - 58 %
Projected losses	0 - 38 %	3 - 24 %

For an AFS security where its fair value has declined below its amortized cost basis, we evaluate the security for OTTI. The credit component of OTTI is recognized through our consolidated statements of income as a component of other market valuation adjustments, net, while the non-credit component of OTTI is recognized through accumulated other comprehensive income, a component of equity. The following table details the activity related to the credit component of OTTI (i.e., OTTI in either current earnings or retained earnings) for AFS securities that also had a non-credit component and were still held at June 30, 2013 and 2012. The balance of the credit component of OTTI at June 30, 2013 and 2012, includes all market valuation adjustments recorded through

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 8. Real Estate Securities (continued)**

the income statement for securities still held on our balance sheet at June 30, 2013 and 2012, as well as a portion of OTTI previously recognized in other comprehensive income.

***Activity of the Credit Component of Other-than-Temporary Impairments***

<b>(In Thousands)</b>	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Balance at beginning of period	\$ 45,611	\$ 73,698	\$ 50,852	\$ 78,126
Additions				
Initial credit impairments	-	55	-	161
Subsequent credit impairments	-	91	-	91
Reductions				
Securities sold, or expected to sell	(2,191)	-	(2,191)	-
Securities with no outstanding principal at period end	(746)	(6,790)	(5,987)	(11,324)
<b>Balance at End of Period</b>	<b>\$ 42,674</b>	<b>\$ 67,054</b>	<b>\$ 42,674</b>	<b>\$ 67,054</b>

The credit component of OTTI is reduced if we sell, intend to sell, or believe we will be required to sell previously credit-impaired debt securities. Additionally, the credit component of OTTI is reduced if we receive or expect to receive cash flows in excess of what we previously expected to receive over the remaining life of the credit-impaired debt security, the security matures, or the security experiences an event (such as full prepayment or principal losses) such that the outstanding principal is reduced to zero.

***Gross Realized Gains and Losses on AFS Securities***

Gains and losses from the sale of AFS securities are recorded as realized gains, net, in our consolidated statements of income. The following table presents the gross realized gains on sales and calls of AFS securities for the three and six months ended June 30, 2013 and 2012.

<b>(In Thousands)</b>	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Gross realized gains - sales	\$ 193	\$ 6,989	\$ 12,231	\$ 14,774
Gross realized gains - calls	333	-	333	113
Gross realized losses - sales	-	-	-	(1,600)
Gross realized losses - calls	-	-	-	-
<b>Total Realized Gains on Sales and Calls of AFS Securities, net</b>	<b>\$ 526</b>	<b>\$ 6,989</b>	<b>\$ 12,564</b>	<b>\$ 13,287</b>

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 9. Derivative Financial Instruments**

The following table presents the fair value and notional amount of derivative financial instruments held by us at June 30, 2013 and December 31, 2012.

(In Thousands)	June 30, 2013		December 31, 2012	
	Fair Value	Notional Amount	Fair Value	Notional Amount
<b>Assets - Risk Management</b>				
<b>Derivatives</b>				
Interest rate swaps	\$ 32,742	\$ 1,044,000	\$ 739	\$ 147,000
TBAs	8,655	345,000	-	-
Futures	328	30,000	-	-
Swaptions	1,616	615,000	2,233	575,000
<b>Total Assets</b>	\$ 43,341	\$ 2,034,000	\$ 2,972	\$ 722,000
<b>Liabilities - Cash Flow</b>				
<b>Hedges</b>				
Interest rate swaps	\$ (27,566)	\$ 139,500	\$ (48,581)	\$ 139,500
<b>Liabilities - Risk Management</b>				
<b>Derivatives</b>				
Interest rate swaps	(219)	20,500	(1,893)	357,500
TBAs	(1,139)	105,000	-	-
Futures	(647)	238,000	(607)	234,000
<b>Total Liabilities</b>	\$ (29,571)	\$ 503,000	\$ (51,081)	\$ 731,000
<b>Total Derivative Financial Instruments, Net</b>	\$ 13,770	\$ 2,537,000	\$ (48,109)	\$ 1,453,000

***Risk Management Derivatives***

To offset, to varying degrees, risks associated with certain assets and liabilities on our consolidated balance sheet, we may enter into derivative contracts.

*Certain Risks Related to Unsecuritized Residential and Commercial Loans at Redwood*

In order to manage certain risks associated with residential and commercial loans we own or plan to acquire, at June 30, 2013, we were party to interest rate agreements with an aggregate notional amount of \$1.7 billion, TBA contracts sold with an aggregate notional amount of \$450 million and financial futures contracts with an aggregate notional amount of \$268 million. Net market valuation adjustments on risk management derivatives related to unsecuritized loans we own or plan to acquire were positive \$50 million and negative \$3 million for the three months ended June 30, 2013 and 2012, respectively. Net market valuation adjustments on risk management derivatives related to unsecuritized loans we own or plan to acquire were positive \$51 million and negative \$7 million for the six months ended June 30, 2013 and 2012, respectively.

*Derivatives Designated as Cash Flow Hedges*

To hedge the variability in interest expense related to our long-term debt and certain adjustable-rate securitization entity liabilities that are included in our consolidated balance sheets for financial reporting purposes, we designated interest rate swaps as cash flow hedges during 2010 and during the second quarter of 2011 with an aggregate notional balance of \$165 million. During the first half of 2012, we unwound swaps with an aggregate notional balance of \$26 million that had been designated against certain adjustable-rate securitization entity liabilities.

For the three months ended June 30, 2013 and 2012, these cash flow hedges increased in value by \$14 million and decreased in value by \$16 million, respectively, which was recorded as an increase and decrease, respectively, to accumulated other comprehensive income, a component of equity. For the six months ended June 30, 2013 and 2012, these cash flow hedges increased in value by \$21



Table of Contents

**REDWOOD TRUST, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 9. Derivative Financial Instruments (continued)**

million and decreased in value by \$3 million, respectively. For interest rate agreements currently or previously designated as cash flow hedges, our total unrealized loss reported in accumulated other comprehensive income was \$27 million and \$48 million at June 30, 2013 and December 31, 2012, respectively. For the three months ended June 30, 2013 and 2012, we reclassified \$69 thousand and \$1 million, respectively, of unrealized losses on derivatives to interest expense. For the six months ended June 30, 2013 and 2012, we reclassified \$157 thousand and \$2 million, respectively, of unrealized losses on derivatives to interest expense. Accumulated other comprehensive loss of less than \$1 million will be amortized into interest expense, a component of our consolidated income statements, over the remaining life of the hedged liabilities.

The following table illustrates the impact on interest expense of our interest rate agreements accounted for as cash flow hedges for the three and six months ended June 30, 2013 and 2012.

***Impact on Interest Expense of Our Interest Rate Agreements Accounted for as Cash Flow Hedges***

<b>(In Thousands)</b>	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Net interest expense on cash flow interest rate agreements	\$ (1,470)	\$ (1,437)	\$ (2,934)	\$ (2,953)
Realized income (expense) due to ineffective portion of hedges	-	5	-	(34)
Realized net losses reclassified from other comprehensive income	(69)	(1,098)	(157)	(2,134)
<b>Total Interest Expense</b>	<b>\$ (1,539)</b>	<b>\$ (2,530)</b>	<b>\$ (3,091)</b>	<b>\$ (5,121)</b>

***Derivative Counterparty Credit Risk***

We incur credit risk to the extent that counterparties to our derivative financial instruments do not perform their obligations under specified contractual agreements. If a derivative counterparty does not perform, we may not receive the proceeds to which we may be entitled under these agreements. Each of our derivative counterparties must maintain compliance with International Swaps and Derivatives Association ( ISDA ) agreements (or receive a waiver of non-compliance after a specific assessment) in order to conduct derivative transactions with us. Additionally, we review derivative counterparty credit standings, and in the case of a deterioration of creditworthiness, appropriate remedial action is taken. To further mitigate counterparty risk, we exit derivatives contracts with counterparties that (i) do not maintain compliance with (or obtain a waiver from) the terms of their ISDA agreements with us; or (ii) do not maintain their status as a primary government dealer or affiliate by the U.S. Department of Treasury or do not meet internally established guidelines regarding credit worthiness. Our ISDA agreements currently require full bilateral collateralization of unrealized loss exposures with our derivative counterparties. Through a margin posting process, our positions are revalued with counterparties each business day and cash margin is generally transferred to either us or our derivative counterparties as collateral based upon the directional changes in fair value of the positions. We also attempt to transact with several different counterparties in order to reduce our specific counterparty exposure. We consider counterparty risk as part of our fair value assessments of all derivative financial instruments. At June 30, 2013, we assessed this risk as remote and did not record a specific valuation adjustment.

At June 30, 2013, we had outstanding derivative agreements with six counterparties and were in compliance with ISDA agreements governing our open derivative positions.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 10. Other Assets**

Other assets at June 30, 2013 and December 31, 2012, are summarized in the following table.

*Other Assets*

<b>(In Thousands)</b>	<b>June 30, 2013</b>	<b>December 31, 2012</b>
Margin receivable	\$ 55,926	\$ 63,424
Investment receivable	12,076	153
Other pledged collateral	5,000	-
REO	3,965	4,245
Prepaid expenses	1,219	1,684
Fixed assets and leasehold improvements	859	494
Income tax receivables	306	4,762
Other	1,032	618
<b>Total Other Assets</b>	<b>\$ 80,383</b>	<b>\$ 75,380</b>

REO consists of foreclosed properties received in satisfaction of defaulted real estate loans. The carrying value of REO at June 30, 2013, was \$4 million, which includes the net effect of \$3 million related to transfers into REO during the first half of 2013, offset by \$2 million of REO liquidations, and less than \$1 million of negative market valuation adjustments. At June 30, 2013 and December 31, 2012, there were 21 and 24 REO properties, respectively, recorded on our consolidated balance sheets, all of which were owned at consolidated Sequoia entities. Properties located in Ohio, Florida, Georgia, Illinois, and Michigan accounted for 76% of our REO properties at June 30, 2013.

Margin receivable resulted from margin calls from our swap, master repurchase agreements, and warehouse facility counterparties that required us to post collateral.

**Note 11. Short-Term Debt**

We enter into repurchase agreements, bank warehouse agreements, and other forms of collateralized (and generally uncommitted) short-term borrowings with several banks and major investment banking firms. At June 30, 2013, we had outstanding agreements with 11 counterparties and we were in compliance with all of the related covenants. Further information about these financial covenants is set forth in Part I, Item 2 *Management's Discussion and Analysis of Financial Condition and Results of Operations* of this Quarterly Report on Form 10-Q. The table below summarizes the facilities that are available to us and the balances of short-term debt at June 30, 2013 and

December 31, 2012, by the type of collateral securing the debt.

(Dollars in Thousands)	Number of Facilities	June 30, 2013		Maturity
		Outstanding	Limit	
<b>Collateral Type</b>				
Residential loans	4	\$ 1,082,726	\$ 1,350,000	7/2013 - 1/2014
Real estate securities	7	363,235	-	7/2013 - 8/2013
<b>Total</b>	11	\$ 1,445,961		

Table of Contents

## REDWOOD TRUST, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(Unaudited)

## Note 11. Short-Term Debt (continued)

(Dollars in Thousands)	Number of Facilities	December 31, 2012			
		Outstanding	Limit	Maturity	
<b>Collateral Type</b>					
Residential loans	4	\$ 179,982	\$ 800,000	1/2013 - 11/2013	
Real estate securities	7	371,936	-	1/2013 - 3/2013	
<b>Total</b>	11	\$ 551,918			

Borrowings under these facilities are generally charged interest based on a specified margin over the one-month LIBOR interest rate. At June 30, 2013, all of these borrowings were under uncommitted facilities and were due within 364 days (or less) of the borrowing date. The fair value of residential loans and real estate securities pledged as collateral was \$1.20 billion and \$455 million, respectively, at June 30, 2013. For the three and six months ended June 30, 2013, the average balance of short-term debt was \$1.05 billion and \$954 million, respectively. For the three and six months ended June 30, 2012, the average balance of short-term debt was \$474 million and \$418 million, respectively. At both June 30, 2013 and December 31, 2012, accrued interest payable on short-term debt was \$1 million.

*Characteristics of Short-Term Debt*

The table below summarizes short-term debt by weighted average interest rates and by collateral type at June 30, 2013 and December 31, 2012.

(Dollars in Thousands)	June 30, 2013			December 31, 2012		
	Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity	Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity
<b>Collateral Type</b>						
Residential loan collateral	\$ 1,082,726	1.76%	120	\$ 179,982	1.76%	212
Real estate securities collateral	363,235	1.76%	22	371,936	1.83%	23

<b>Total Short-Term Debt</b>	\$ 1,445,961	1.76%	95	\$ 551,918	1.81%	84
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**Remaining Maturities of Short-Term Debt**

The following table presents the remaining maturities of short-term debt at June 30, 2013 and December 31, 2012.

<b>(In Thousands)</b>	<b>June 30, 2013</b>		<b>December 31, 2012</b>	
Within 30 days	\$	663,659	\$	362,279
31 to 90 days		5,726		48,848
Over 90 days		776,576		140,791
<b>Total Short-Term Debt</b>	\$	1,445,961	\$	551,918

**Note 12. Asset-Backed Securities Issued**

Through our Sequoia securitization program, we sponsor securitization transactions in which ABS backed by residential mortgage loans are issued by Sequoia entities. ABS were also issued by securitization entities in the Residential Resecuritization and the Commercial Securitization. Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of Redwood, although we are exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 12. Asset-Backed Securities Issued (continued)**

As a general matter, ABS have been issued by these securitization entities to fund the acquisition of assets from us or from third parties. The ABS issued by these entities consist of various classes of securities that pay interest on a monthly or quarterly basis. Substantially all ABS issued pay variable rates of interest, which are indexed to one-, three-, or six-month LIBOR. Some ABS issued pay fixed rates of interest or pay hybrid rates, which are fixed rates that subsequently adjust to variable rates. ABS issued also includes some interest-only classes with coupons set at a fixed rate or a fixed spread to a benchmark rate, or set at a spread to the interest rates earned on the assets less the interest rates paid on the liabilities of a securitization entity.

The carrying value of ABS issued by consolidated securitization entities we sponsored at June 30, 2013 and December 31, 2012, along with other selected information, are summarized in the following table.

***Asset-Backed Securities Issued***

<b>(Dollars in Thousands)</b>	<b>June 30, 2013</b>			
	<b>Sequoia</b>	<b>Residential Resecuritization</b>	<b>Commercial Securitization</b>	<b>Total</b>
Certificates with principal balance	\$ 1,935,113	\$ 134,156	\$ 159,526	\$ 2,228,795
Interest-only certificates	4,903	-	-	4,903
Unamortized premium	-	-	-	-
Unamortized discount	(19,402)	-	-	(19,402)
<b>Total ABS Issued</b>	<b>\$ 1,920,614</b>	<b>\$ 134,156</b>	<b>\$ 159,526</b>	<b>\$ 2,214,296</b>
Range of weighted average interest rates, by series	0.40% to 4.20%	2.21%	5.62%	
Stated maturities	2014 - 2047	2046	2018	
Number of series	24	1	1	

<b>(Dollars in Thousands)</b>	<b>December 31, 2012</b>			
	<b>Sequoia</b>	<b>Residential Resecuritization</b>	<b>Commercial Securitization</b>	<b>Total</b>

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Certificates with principal balance	\$ 2,207,851	\$ 164,746	\$ 171,714	\$ 2,544,311
Interest-only certificates	7,769	-	-	7,769
Unamortized premium	921	-	-	921
Unamortized discount	(23,060)	-	-	(23,060)
<b>Total ABS Issued</b>	<b>\$ 2,193,481</b>	<b>\$ 164,746</b>	<b>\$ 171,714</b>	<b>\$ 2,529,941</b>

Range of weighted average interest

rates, by series	0.41% to 4.16%	2.21%	5.62%
Stated maturities	2014 - 2047	2046	2018
Number of series	24	1	1

The actual maturity of each class of ABS issued is primarily determined by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption prior to the stated maturity according to the terms of the respective governing documents of each ABS issuing entity. As a result, the actual maturity of ABS issued may occur earlier than its stated maturity. At June 30, 2013, \$2.18 billion of ABS issued (\$2.19 billion principal balance) had contractual maturities of over five years and \$38 million of ABS issued (\$38 million principal balance) had contractual maturities of one to five years. Amortization of deferred ABS issuance costs was less than \$1 million and \$1 million for the six months ended June 30, 2013 and 2012, respectively.



Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 12. Asset-Backed Securities Issued (continued)**

The following table summarizes the accrued interest payable on ABS issued at June 30, 2013 and December 31, 2012. Interest due on consolidated ABS issued is payable monthly.

*Accrued Interest Payable on Asset-Backed Securities Issued*

<b>(In Thousands)</b>	<b>June 30, 2013</b>		<b>December 31, 2012</b>	
Sequoia	\$	1,509	\$	2,103
Residential Resecuritization		33		40
Commercial Securitization		748		832
<b>Total Accrued Interest Payable on ABS Issued</b>	\$	2,290	\$	2,975

The following table summarizes the carrying value components of the collateral for ABS issued and outstanding at June 30, 2013 and December 31, 2012.

*Collateral for Asset-Backed Securities Issued*

<b>(In Thousands)</b>	<b>June 30, 2013</b>			
	<b>Sequoia</b>	<b>Residential Resecuritization</b>	<b>Commercial Securitization</b>	<b>Total</b>
Residential loans	\$ 1,998,178	\$ -	\$ -	\$ 1,998,178
Commercial loans	-	-	270,449	270,449
Real estate securities	-	294,771	-	294,771
Restricted cash	148	2	138	288
Accrued interest receivable	3,461	751	1,939	6,151
REO	3,965	-	-	3,965

<b>Total Collateral for ABS Issued</b>	\$	2,005,752	\$	295,524	\$	272,526	\$	2,573,802
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(In Thousands)	December 31, 2012				Total
	Sequoia	Residential Resecuritization	Commercial Securitization		
Residential loans	\$ 2,272,812	\$ -	\$ -	\$ -	\$ 2,272,812
Commercial loans	-	-	283,610	-	283,610
Real estate securities	-	324,606	-	-	324,606
Restricted cash	147	-	137	-	284
Accrued interest receivable	4,484	839	2,132	-	7,455
REO	4,245	-	-	-	4,245

<b>Total Collateral for ABS Issued</b>	\$	2,281,688	\$	325,445	\$	285,879	\$	2,893,012
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### Note 13. Long-Term Debt

#### *Commercial Borrowings*

At June 30, 2013, we had one commercial loan repurchase facility with an outstanding balance of \$17 million and a total borrowing limit of \$150 million, with a remaining maturity of 27 months. Borrowings under this facility are generally charged interest based on a specified margin over the one-month LIBOR interest rate. For the three and six months ended June 30, 2013, the average balance of this commercial borrowing was \$17 million and \$11 million, respectively. The fair value of commercial loans pledged as collateral was \$26 million at June 30, 2013. The interest expense yield on this borrowing was 5.50%

Table of Contents

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 13. Long-Term Debt (continued)**

and 5.59%, respectively, for the three and six months ended June 30, 2013. There was no balance on this warehouse facility at December 31, 2012.

At June 30, 2013, we were in compliance with all of the covenants related to our commercial loan repurchase facility. Further information about the financial covenants under this facility is set forth in Part I, Item 2 *Management's Discussion and Analysis of Financial Condition and Results of Operations* of this Quarterly Report on Form 10-Q.

**Convertible Notes**

In March 2013, we issued in a public offering \$287.5 million principal amount of 4.625% convertible senior notes due 2018. These convertibles notes require semi-annual interest distributions at a fixed coupon rate of 4.625% until maturity or conversion, which will be no later than April 15, 2018. After deducting the underwriting discount and offering costs, we received approximately \$279 million of net proceeds. Including amortization of deferred securities issuance costs, the interest expense yield on our convertibles notes was 5.53% and 5.48%, respectively, for the three and six months ended June 30, 2013. At June 30, 2013, the accrued interest payable balance on this debt was \$4 million.

Our convertible senior notes are convertible at the option of the holder at a conversion rate of 41.1320 common shares per \$1,000 principal amount of convertible senior notes at June 30, 2013 (equivalent to a conversion price of \$24.31 per common share). Upon conversion of these convertible senior notes by a holder, the holder will receive shares our common stock.

***Trust Preferred Securities and Subordinated Notes***

In 2006, we issued \$100 million of trust preferred securities through Redwood Capital Trust I, a Delaware statutory trust, in a private placement transaction. These trust preferred securities require quarterly distributions at a floating coupon rate equal to three-month LIBOR plus 2.25% until the securities are redeemed, which will be no later than January 30, 2037. The interest expense yield on our trust preferred securities was 2.65% and 2.91% for the six months ended June 30, 2013 and 2012, respectively. Including hedging costs and amortization of deferred securities issuance costs, the interest expense yield on our trust preferred securities was 6.89% and 6.88% for the six months ended June 30, 2013 and 2012, respectively. The earliest optional redemption date without penalty was January 30, 2012. In December 2010, we repurchased \$500 thousand principal amount of these trust preferred securities.

In 2007, we issued an additional \$50 million of subordinated notes. These subordinated notes require quarterly distributions at a floating interest rate equal to six-month LIBOR plus 2.25% until the notes are redeemed, which will be no later than July 30, 2037. The interest expense yield on our subordinated notes was 2.65% and 2.91% for the six months ended June 30, 2013 and 2012, respectively. Including hedging costs and amortization of deferred securities issuance costs, the interest expense yield on our subordinated notes was 6.89% and 6.88% for the six months ended June 30, 2013 and 2012, respectively. The earliest optional redemption date without a penalty was July 30, 2012. In July 2009, we repurchased \$10 million principal amount of this subordinated debt.

At both June 30, 2013 and December 31, 2012, the accrued interest payable balance on this long-term debt was less than \$1 million. Under the terms of this long-term debt, we covenant, among other things, to use our best efforts to continue to qualify as a REIT. If an event of default were to occur in respect of this long-term debt, we would generally be restricted under its terms (subject to certain exceptions) from making dividend distributions to stockholders, from repurchasing common stock or repurchasing or redeeming any other then-outstanding equity securities, and from making any other payments in respect of any equity interests in us or in respect of any then-outstanding debt that is *pari passu* or subordinate to this long-term debt.

#### **Note 14. Commitments and Contingencies**

##### ***Lease Commitments***

At June 30, 2013, we were obligated under four non-cancelable operating leases with expiration dates through 2021 for \$12 million. In the second quarter of 2013, a new lease for our Denver-based operations became effective. We do not have a 2013 rent obligation for this lease due to an abatement period through the first quarter of 2014. The total rent obligation through 2020 is \$1.9 million. During the second quarter of 2013, we also entered into an amendment to this lease to expand the original premises. The 2013

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 14. Commitments and Contingencies (continued)**

rent obligation related to this amendment is \$88 thousand, and the total rent obligation through 2021 is \$2 million. Operating lease expense was less than \$1 million for both the six months ended June 30, 2013 and 2012.

The following table presents our future lease commitments at June 30, 2013.

***Future Lease Commitments by Year***

<b>(In Thousands)</b>	<b>June 30, 2013</b>	
2013 (six months)	\$	975
2014		2,294
2015		2,302
2016		2,056
2017		2,111
2018 and thereafter		2,384
<b>Total</b>	<b>\$</b>	<b>12,122</b>

Leasehold improvements for our offices are amortized into expense over the lease term. There were \$12 thousand of unamortized leasehold improvements at June 30, 2013. For the six months ended June 30, 2013 and 2012, we recognized a negligible amount of leasehold amortization.

***Loss Contingencies    Litigation***

On or about December 23, 2009, the Federal Home Loan Bank of Seattle (the "FHLB-Seattle") filed a complaint in the Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. ("SRF"), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the "FHLB-Seattle Defendants") alleging that the FHLB-Seattle Defendants made false or misleading statements in offering materials for a mortgage pass-through certificate (the "Seattle Certificate") issued in the Sequoia Mortgage Trust 2005-4 securitization transaction (the "2005-4 RMBS") and purchased by the FHLB-Seattle. Specifically, the complaint alleges that the alleged misstatements concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the

properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Seattle Certificate. The FHLB-Seattle alleges claims under the Securities Act of Washington (Section 21.20.005, et seq.) and seeks to rescind the purchase of the Seattle Certificate and to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received) as well as attorneys' fees and costs. The Seattle Certificate was issued with an original principal amount of approximately \$133 million, and, as of June 30, 2013, the FHLB-Seattle has received approximately \$113.0 million of principal and \$11.0 million of interest payments in respect of the Seattle Certificate. The claims were subsequently dismissed for lack of personal jurisdiction as to Redwood Trust and SRF. Redwood agreed to indemnify the underwriters of the 2005-4 RMBS for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. The FHLB-Seattle's claims against the underwriters of this RMBS were not dismissed and remain pending. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

On or about July 15, 2010, The Charles Schwab Corporation ( Schwab ) filed a complaint in the Superior Court for the State of California in San Francisco (case number CGC-10-501610) against SRF and 26 other defendants (collectively, the Schwab Defendants ) alleging that the Schwab Defendants made false or misleading statements in offering materials for various residential mortgage-backed securities sold or issued by the Schwab Defendants. With respect to SRF, Schwab alleges that SRF made false or misleading statements in offering materials for a mortgage pass-through certificate (the Schwab Certificate ) issued in the 2005-4 RMBS and purchased by Schwab. Specifically, the complaint alleges that the misstatements for the 2005-4 RMBS concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Schwab Certificate. Schwab alleges a claim for negligent misrepresentation under California state law and seeks unspecified damages and attorneys' fees and costs. The Schwab Certificate was issued with an original principal amount of approximately \$14.8 million, and, as of June 30, 2013, Schwab has received approximately \$12.6 million of principal and \$1.3 million of interest payments in respect of the Schwab

Table of Contents

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 14. Commitments and Contingencies (continued)**

Certificate. SRF has denied Schwab's allegations. This case is in early stages of discovery, and no trial date has been set. We believe that this case is without merit, and we intend to defend the action vigorously. Redwood agreed to indemnify the underwriters of the 2005-4 RMBS, which underwriters are also named defendants in this action, for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

On or about October 15, 2010, the Federal Home Loan Bank of Chicago ( FHLB-Chicago ) filed a complaint in the Circuit Court of Cook County, Illinois (case number 10-CH-45033) against SRF and more than 45 other named defendants (collectively, the FHLB-Chicago Defendants ) alleging that the FHLB-Chicago Defendants made false or misleading statements in offering materials for various RMBS sold or issued by the FHLB-Chicago Defendants or entities controlled by them. FHLB-Chicago subsequently amended the complaint to name Redwood Trust, Inc. and another one of our subsidiaries, RWT Holdings, Inc., as defendants. With respect to Redwood Trust, Inc., RWT Holdings, Inc., and SRF, the FHLB-Chicago alleges that SRF, Redwood Trust, Inc., and RWT Holdings, Inc. made false or misleading statements in the offering materials for two mortgage pass-through certificates (the Chicago Certificates ) issued in the Sequoia Mortgage Trust 2006-1 securitization transaction (the 2006-1 RMBS ) and purchased by the FHLB-Chicago. The complaint alleges that the alleged misstatements concern, among other things, the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2006-1 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, (4) ratings assigned to the Chicago Certificates, and (5) due diligence performed on these mortgage loans. The FHLB-Chicago alleges claims under Illinois Securities Law (815 ILCS Sections 5/12(F)-(H)) and North Carolina Securities Law (N.C.G.S.A. §78A-8(2) & §78A-56(a)) as well as a claim for negligent misrepresentation under Illinois common law. On some of the causes of action, the FHLB-Chicago seeks to rescind the purchase of the Chicago Certificates and to collect interest on the original purchase prices at the statutory interest rate of 10% per annum from the dates of original purchase (net of interest received). On one cause of action, the FHLB-Chicago seeks unspecified damages. The FHLB-Chicago also seeks attorneys' fees and costs. The first of the Chicago Certificates was issued with an original principal amount of approximately \$105 million and, at June 30, 2013, the FHLB Chicago has received approximately \$70.3 million of principal and \$23.8 million of interest payments in respect of this Chicago Certificate. The second of the Chicago Certificates was issued with an original principal amount of approximately \$379 million and, at June 30, 2013, the FHLB Chicago has received approximately \$251.8 million of principal and \$79.9 million of interest payments in respect of this Chicago Certificate. SRF, Redwood Trust, Inc., and RWT Holdings, Inc. have denied FHLB-Chicago's allegations. This case is in early stages of discovery, and no trial date has been set. We believe that this case is without merit, and we intend to defend the action vigorously. Redwood agreed to indemnify the underwriters of the 2006-1 RMBS, which underwriters are also named defendants in this action, for certain losses and

expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

We cannot determine the outcome of any of the above-referenced litigation matters at this time or predict the results with certainty. We cannot be certain that any of these matters will not have a material adverse effect on our results of operations in any future period, and any loss or expense related to any of this litigation could have a material adverse impact on our consolidated financial statements.

In accordance with FASB guidance on accounting for contingencies, we review the need for any loss contingency reserves and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability, and the amount of loss, if any, can be reasonably estimated. Additionally, we record receivables for insurance recoveries relating to litigation-related losses and expenses if and when such amounts are covered by insurance and recovery of such losses or expenses are due. If, with respect to a matter, it is not both probable to result in liability and the amount of loss cannot be reasonably estimated (as is the case for each of the above-referenced litigation matters), FASB guidance on accounting for contingencies provides that an estimate of possible loss or range of loss be disclosed unless such an estimate cannot be made. There are numerous factors that make it difficult to meaningfully estimate possible loss or range of loss at this stage of these litigation matters, including that: we are no longer a party to the FHLB-Seattle matter, the proceedings to which we are a party are in relatively early stages with no trial dates set, there are significant factual and legal issues to be resolved, information obtained or rulings made during the lawsuits could affect the methodology for calculation of the available remedies, our belief that these litigations are without merit, and our intent to defend these actions vigorously. In addition, with respect to claims where damages are the requested relief, no amount of loss or damages has been specified. We also may have additional rights and/or obligations pursuant to indemnity agreements, representations and warranties, and other contractual



Table of Contents

**REDWOOD TRUST, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 14. Commitments and Contingencies (continued)**

provisions with other parties relating to these litigation matters. These rights and obligations could offset or increase our potential losses. We are unable at this time to estimate the potential amount of any such offset or loss.

Although we believe the above-referenced litigation matters are without merit and we intend to defend vigorously the actions to which we are a party, in the ordinary course of any litigation matter, including the above-referenced matters, we may engage in formal or informal settlement communications. While we have not had any settlement discussions in the above-referenced matters that cause us to determine that a material loss is probable or be able to estimate an amount or range of material loss liability, future settlement discussions relating to these matters could result in our concluding to establish loss contingency reserves or make additional disclosures regarding an estimate of possible loss or range of loss with respect to one or more of these matters. Any settlement agreements could have a material impact on our consolidated financial statements.

**Note 15. Equity**

The following table provides a summary of changes to accumulated other comprehensive income by component for the three and six months ended June 30, 2013.

*Changes in Accumulated Other Comprehensive Income by Component*

<b>Three Months Ended June 30, 2013</b>	<b>Net unrealized gains on available-for-sale securities</b>	<b>Net unrealized losses on interest rate agreements accounted for as cash flow hedges</b>
<b>(In Thousands)</b>		
Balance at beginning of period	\$ 183,603	\$ (40,720)
Other comprehensive (loss) income before reclassifications	(38,012)	13,585
Amounts reclassified from other accumulated comprehensive income	(242)	69
Net current-period other comprehensive (loss) income	(38,254)	13,654
<b>Balance at End of Period</b>	<b>\$ 145,349</b>	<b>\$ (27,066)</b>

<b>Six Months Ended June 30, 2013</b>	<b>Net unrealized gains on available-for-sale securities</b>	<b>Net unrealized losses on interest rate agreements accounted for as cash flow hedges</b>
<b>(In Thousands)</b>		
Balance at beginning of period	\$ 186,580	\$ (48,248)
Other comprehensive (loss) income before reclassifications	(28,982)	21,025
Amounts reclassified from other accumulated comprehensive income	(12,249)	157
Net current-period other comprehensive (loss) income	(41,231)	21,182
<b>Balance at End of Period</b>	<b>\$ 145,349</b>	<b>\$ (27,066)</b>

Table of Contents

**REDWOOD TRUST, INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 15. Equity (continued)**

The following table provides a summary of reclassifications out of accumulated other comprehensive income for three and six months ended June 30, 2013.

***Reclassifications out of Accumulated Other Comprehensive Income***

(In Thousands)	Affected line item in the statement where net income is presented	Amount reclassified from accumulated other comprehensive income Three Months Ended June 30, 2013	Six Months Ended June 30, 2013
<b>Net realized gains (losses) on AFS securities</b>			
Other than temporary impairment	Other market valuations, net	\$ (133)	\$ (124)
Gain on sale of AFS securities	Realized gains, net	(109)	(12,125)
Loss on sale of AFS securities	Realized gains, net	-	-
		\$ (242)	\$ (12,249)
<b>Net realized gains on interest rate agreements designated as cash flow hedges</b>			
Amortization of deferred gain	Interest expense	\$ -	\$ -
Hedge ineffectiveness	Interest expense	69	157
		\$ 69	\$ 157

Table of Contents

## REDWOOD TRUST, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(Unaudited)

## Note 15. Equity (continued)

*Earnings Per Common Share*

The following table provides the basic and diluted earnings per common share computations for the three and six months ended June 30, 2013 and 2012.

*Basic and Diluted Earnings Per Common Share*

(In Thousands, Except Share Data)	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
<b>Basic Earnings Per Common Share:</b>				
Net income attributable to Redwood	\$ 65,573	\$ 19,527	\$ 126,183	\$ 49,990
Less: Dividends and undistributed earnings allocated to participating securities	(1,830)	(538)	(3,819)	(1,491)
Net income allocated to common shareholders	\$ 63,743	\$ 18,989	\$ 122,364	\$ 48,499
Basic weighted average common shares outstanding	82,123,823	78,815,313	81,729,014	78,606,336
<b>Basic Earnings Per Common Share</b>	<b>\$ 0.78</b>	<b>\$ 0.24</b>	<b>\$ 1.50</b>	<b>\$ 0.62</b>
<b>Diluted Earnings Per Common Share:</b>				
Net income attributable to Redwood	\$ 65,573	\$ 19,527	\$ 126,183	\$ 49,990
Less: Dividends and undistributed earnings allocated to participating securities	(1,175)	(538)	(2,527)	(1,336)
Add back: Interest expense on convertible notes	3,856	-	4,933	-

Net income allocated to common shareholders	\$	68,254	\$	18,989	\$	128,589	\$	48,654
Weighted average common shares outstanding		82,123,823		78,815,313		81,729,014		78,606,336
Net effect of dilutive equity awards		2,222,440		-		2,274,311		1,359,070
Net effect of assumed convertible notes conversion to common shares		11,825,450		-		7,644,075		-
Diluted weighted average common shares outstanding		96,171,713		78,815,313		91,647,400		79,965,406

**Diluted Earnings Per Common**

<b>Share</b>	\$	0.71	\$	0.24	\$	1.40	\$	0.61
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For the three and six months ended June 30, 2013, there were 2,222,440 and 2,274,311 of dilutive equity awards, respectively, determined under the two-class method. For the three and six months ended June 30, 2012, there were no dilutive equity awards determined under the two-class method as dividend distributions were greater than net income for these periods. We included participating securities in the calculation of diluted earnings per common share as we determined that the two-class method was more dilutive than the alternative treasury stock method. Dividends and undistributed earnings allocated to participating securities under the basic and diluted earnings per share calculations require specific shares to be included that may differ in certain circumstances. For the three and six months ended June 30, 2013, common shares related to the assumed conversion of the convertible notes, totaling 11,825,450 and 7,644,075, respectively, were included in the calculation of diluted earnings per share.

For the three months ended June 30, 2013 and 2012, the number of outstanding equity awards that were antidilutive totaled 255,529 and 1,877,664, respectively, under the two-class method. For the six months ended June 30, 2013 and 2012, the number of outstanding equity awards that were antidilutive totaled 271,392 and 531,072, respectively, under the two-class method. There were no other participating securities during these periods.

***Stock Repurchases***

We announced a stock repurchase authorization in November 2007 for the repurchase of up to 5,000,000 common shares. This plan replaced all previous share repurchase plans and has no expiration date. During the six months ended June 30, 2013, there were no shares acquired under the plan. At June 30, 2013, there remained 4,005,985 shares available for repurchase under this plan.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 16. Equity Compensation Plans**

At June 30, 2013 and December 31, 2012, 1,831,109 and 666,610 shares of common stock, respectively, were available for grant under our Incentive Plan. The unamortized compensation cost of awards issued under the Incentive Plan and purchases under the Employee Stock Purchase Plan totaled \$15 million at June 30, 2013, as shown in the following table.

**Six Months Ended June 30, 2013**

<b>(In Thousands)</b>	<b>Stock Options</b>	<b>Restricted Stock</b>	<b>Deferred Stock Units</b>	<b>Performance Stock Units</b>	<b>Employee Stock Purchase Plan</b>	<b>Total</b>
Unrecognized compensation cost at beginning of period	\$ -	\$ 1,822	\$ 13,378	\$ 6,484	\$ -	\$ 21,684
Equity grants	-	59	973	-	217	1,249
Equity grant forfeitures	-	(116)	(631)	(876)	-	(1,623)
Equity compensation expense	-	(361)	(3,836)	(1,578)	(108)	(5,883)
<b>Unrecognized Compensation Cost at End of Period</b>	<b>\$ -</b>	<b>\$ 1,404</b>	<b>\$ 9,884</b>	<b>\$ 4,030</b>	<b>\$ 109</b>	<b>\$ 15,427</b>

At June 30, 2013, the weighted average amortization period remaining for all of our equity awards was less than two years.

***Stock Options***

At June 30, 2013 and December 31, 2012, there were 190,801 and 287,516 fully vested stock options outstanding, respectively. There was no aggregate intrinsic value for the options outstanding and exercisable at June 30, 2013. For both the six months ended June 30, 2013 and 2012, there were no stock options exercised. For the six months ended June 30, 2013, 96,715 stock options expired.

***Restricted Stock***

At June 30, 2013 and December 31, 2012, there were 132,802 and 190,088 shares, respectively, of restricted stock awards outstanding. Restrictions on these shares lapse through 2017. There were 1,096 restricted stock awards granted during the three months ended June 30, 2013.

**Table of Contents**

**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2013**

**(Unaudited)**

**Note 16. Equity Compensation Plans (continued)**

***Deferred Stock Units***

At June 30, 2013 and December 31, 2012, there were 2,024,446 and 2,361,285 DSUs outstanding, respectively, of which 1,088,569 and 1,119,753, respectively, had vested. There were 31,011 and 232,794 DSUs granted, respectively, during the three and six months ended June 30, 2013. During the three and six months ended June 30, 2013, there were 30,384 DSUs forfeited related to employee departures. During the six months ended June 30, 2013, there were 539,250 DSU distributions and cash distributions of less than \$1 million to participants in the EDCP. Unvested DSUs at June 30, 2013 vest through 2017.

***Performance Stock Units***

At June 30, 2013 and December 31, 2012, there were 762,375 and 837,737 PSUs outstanding, respectively, none of which had vested. During the three and six months ended June 30, 2013, there were 75,362 PSUs forfeited related to employee departures. PSUs cliff vest on the third anniversary of their grant date, with vesting contingent on total stockholder return (defined as the change in our common stock price plus dividends paid on our common stock relative to the per share price of our common stock on the date of the PSU grant) over the three-year vesting period ( Three-Year TSR ). The number of underlying shares of our common stock that will vest during 2013 and in future years will vary between 0% (if Three-Year TSR is negative) and 200% (if Three-Year TSR is greater than or equal to 125%) of the number of PSUs originally granted, adjusted upward (if vesting is greater than 0%) to reflect the value of dividends paid during the three-year vesting period.

***Employee Stock Purchase Plan***

The ESPP allows a maximum of 450,000 shares of common stock to be purchased in aggregate for all employees. At June 30, 2013 and December 31, 2012, 227,043 and 207,031 shares had been purchased, respectively, and there remained a negligible amount of uninvested employee contributions in the ESPP.

**Note 17. Mortgage Banking Activities**

The following table presents the components of mortgage banking activities, net, recorded in our consolidated income statement for the three and six months ended June 30, 2013 and 2012.

***Components of Mortgage Banking Activities, Net***



(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
<b>Income from MSR, net:</b>				
Income	\$ 1,943	\$ 123	\$ 2,794	\$ 137
Late charges	11	1	18	1
Cost of sub-servicer	(234)	(30)	(412)	(34)
<b>Income from MSR, net:</b>	<b>1,720</b>	<b>94</b>	<b>2,400</b>	<b>104</b>
<b>Changes in fair value of:</b>				
Residential loans, at fair value	(41,405)	-	(6,535)	-
Commercial loans, at fair value	(345)	-	(345)	-
MSRs	8,827	(527)	9,169	(544)
Sequoia IO securities	36,336	(5,363)	38,265	(4,674)
Risk management derivatives <sup>(1)</sup>	49,544	(3,282)	50,567	(6,398)
<b>Net market valuation adjustments</b>	<b>52,957</b>	<b>(9,172)</b>	<b>91,121</b>	<b>(11,616)</b>
Net gains on residential loan sales	-	5,471	-	12,836
Net gains on commercial loan originations	-	-	40	-
Net gains on commercial loan sales	3,854	-	10,991	-
<b>Mortgage Banking Activities, Net</b>	<b>\$ 58,531</b>	<b>\$ (3,607)</b>	<b>\$ 104,552</b>	<b>\$ 1,324</b>

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 17. Mortgage Banking Activities (continued)**

(1) Represents market valuations of derivatives that are used to manage risks associated with our accumulation of residential and commercial loans.

***Mortgage Servicing Rights***

During the three and six months ended June 30, 2013, we transferred an aggregate \$1.80 billion and \$4.04 billion (principal balance), respectively, of residential loans to eight Sequoia securitization entities and accounted for the transfers as sales in accordance with GAAP. As a result of these sales, during the three and six months ended June 30, 2013, we recorded MSR's of \$16 million and \$29 million, respectively, at a taxable REIT subsidiary of ours. These MSR's represent rights we had acquired and retained to service \$1.78 billion and \$3.34 billion of loans transferred (original principal balance), to these securitizations or sold to third parties during the three and six months ended June 30, 2013, respectively. At June 30, 2013, the principal balance of the loans underlying our MSR's was \$4.13 billion.

We contract with a licensed sub-servicer to perform all servicing functions for loans underlying our MSR's. The following table presents activity for MSR's for the three and six months ended June 30, 2013 and 2012.

***MSR Activity***

<b>(In Thousands)</b>	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Balance at beginning of period	\$ 18,123	\$ 1,562	\$ 5,315	\$ -
Additions	16,148	1,029	28,614	2,608
Changes in fair value due to:				
Changes in assumptions <sup>(1)</sup>	9,506	(481)	10,312	(481)
Other changes <sup>(2)</sup>	(679)	(46)	(1,143)	(63)
<b>Balance at End of Period</b>	<b>\$ 43,098</b>	<b>\$ 2,064</b>	<b>\$ 43,098</b>	<b>\$ 2,064</b>

- (1) Primarily reflects changes in discount rates and prepayment assumptions due to changes in interest rates.  
(2) Reflects the impact of MSR-related cash flows received during the period.

**Note 18. Operating Expenses**

Components of our operating expenses for the three and six months ended June 30, 2013 and 2012 are presented in the following table.

*Operating Expenses*

<b>(In Thousands)</b>	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Fixed compensation expense	\$ 6,067	\$ 4,373	\$ 11,690	\$ 9,208
Variable compensation expense	3,960	3,024	8,797	5,617
Equity compensation expense	3,396	2,958	5,883	5,134
Severance expense	3,366	-	3,434	200
<b>Total compensation expense</b>	<b>16,789</b>	<b>10,355</b>	<b>29,804</b>	<b>20,159</b>
Accounting and legal	805	1,048	3,052	2,166
Systems and consulting	2,318	1,303	4,060	2,484
Office costs	1,355	1,682	2,652	3,423
Other operating expenses	2,377	777	3,673	1,567
<b>Total Operating Expenses</b>	<b>\$ 23,644</b>	<b>\$ 15,165</b>	<b>\$ 43,241</b>	<b>\$ 29,799</b>

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****June 30, 2013****(Unaudited)****Note 19. Taxes**

For the six months ended June 30, 2013 and 2012, we recognized a provision for income taxes of \$14 million and less than \$1 million, respectively. The following is a reconciliation of the statutory federal and state tax rates to our projected annual effective rate at June 30, 2013 and 2012.

***Reconciliation of Statutory Tax Rate to Effective Tax Rate***

	<b>2013</b>	<b>June 30,</b>	<b>2012</b>
Federal statutory rate	34.0 %		34.0 %
State statutory rate, net of Federal tax effect	7.2 %		7.2 %
Differences in taxable (loss) income from GAAP income	(20.5) %		(17.4) %
Dividends paid deduction	(10.7) %		(22.6) %
<b>Effective Tax Rate</b>	<b>10.0 %</b>		<b>1.2 %</b>

We assessed our tax positions for all open tax years (Federal years 2009 to 2012, State years 2008 to 2012) and, at June 30, 2013 and December 31, 2012, concluded that we had no uncertain tax positions that resulted in material unrecognized tax benefits.

**Note 20. Subsequent Events**

At June 30, 2013, we had identified for purchase \$1.39 billion of residential mortgage loans that were in various stages of the origination process with third-party originators. Some of these loans may not ultimately close and, therefore, would not be available for purchase. Since June 30, 2013, and through August 5, 2013, \$753 million of these loans closed and were purchased by us. We expect the purchase of an additional amount of these loans to occur during the third quarter of 2013, subject to loan availability and delivery.

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**Table of Contents**

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

**Introduction**

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

Redwood Trust, Inc. was incorporated in the State of Maryland on April 11, 1994, and commenced operations on August 19, 1994. Our executive offices are located at One Belvedere Place, Suite 300, Mill Valley, California 94941.

References herein to Redwood, the company, we, us, and our include Redwood Trust, Inc. and its consolidated subsidiaries, unless the context otherwise requires. Financial information concerning our business is set forth in this Management's Discussion and Analysis of Financial Condition and Results of Operations, our consolidated financial statements and notes thereto, and the supplemental financial information, which are included in Part I, Items 1 and 2 of this Quarterly Report on Form 10-Q.

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

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

**Cautionary Statement**

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

expectations, estimates, and projections and, consequently, you should not rely on these forward-looking statements as predictions of future events. Forward-looking statements are not historical in nature and can be identified by words such as anticipate, estimate, will, should, expect, believe, intend, seek, plan and similar expressions, or by references to strategy, plans, or intentions. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012 and this Quarterly Report on Form 10-Q, in each case under the caption Risk Factors. Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected may be described from time to time in reports we file with the SEC, including reports on Forms 10-Q and 8-K. We undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

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**Table of Contents**

Statements regarding the following subjects, among others, are forward-looking by their nature:

(i) statements we make regarding Redwood's future business strategy and strategic focus, including statements relating to our confidence in our business model and our belief that private capital will be necessary to finance residential mortgages if the government is going to successfully reduce its role as the primary capital provider to the mortgage market; (ii) statements we make regarding future conditions in the market for Agency and non-Agency residential mortgage-backed securities (RMBS), including our statement that these markets appear to be starting to firm; (iii) statements we make regarding yield spreads (or premiums) relating to triple-A rated residential mortgage-backed securities (RMBS), including our statement that spread premiums on triple-A rated RMBS are beginning to stabilize and could tighten (i.e., decrease) further; (iv) statements we make regarding our expectations and outlook for residential loan sale profit margins, including our statement that we intend to earn residential loan sale margins, net of hedging, roughly in line with our previous forecast for long-term average margins of 25 to 50 basis points; (v) statements describing and relating to our goals for 2013, including that we are on track to reach our goal for 2013 to originate and sell \$1 billion of senior commercial loans and statements regarding our ability to achieve our goal to acquire up to \$8 billion of jumbo residential loans in 2013; (vi) statements relating to acquiring residential mortgage loans in the future that we have identified for purchase or plan to purchase, including the amount of such loans that we identified for purchase during the second quarter of 2013 and at June 30, 2013, and statements relating to the impact of rising interest rates on the volume of residential mortgage loans available for purchase; (vii) statements relating to our estimate of the amount of negative market valuation adjustments we expect to realize during the third quarter of 2013 relating to our pipeline of residential mortgage loans owned and identified for purchase at June 30, 2013 and our statements that we expect to complete additional transactions to sell or securitize the remainder of this pipeline in the third quarter of 2013 and our estimate that we will achieve, overall, a small economic profit on these transactions after factoring in our hedges (and our expectation to create approximately \$90 million to \$120 million in proprietary investments to retain for our portfolio as a result of these transactions); (viii) statements regarding our residential mortgage pipeline, which includes loans on our balance sheet and loans identified for purchase, including statements related to our ability to hedge our pipeline and the effectiveness of those hedges; (ix) statements we make regarding the future profitability of our residential conduit, including our statements relating to our expectations regarding future interest rate changes and statements regarding future home purchase activity; (x) statements regarding our expectations of reported GAAP book value at September 30, 2013; (xi) statements relating to our future investment strategy and future investment activity, including, without limitation, that over time we expect that investments created through our Sequoia program or other mortgage banking activities, as well as through the acquisition of newly issued subordinate securities from third-party securitization sponsors, will replace the senior residential securities in our investment portfolio; (xii) statements relating to our estimate of our investment capacity (including that we estimate our investment capacity at June 30, 2013 to be approximately \$130 million) and our statement that we believe that our available capital and liquidity is sufficient to fund our business and investment objectives for the remainder of 2013; (xiii) statements relating to the amount of equity capital we are targeting to allocate to fund commercial investments; (xiv) statements relating to our competitive position and our ability to compete in the future; (xv) statements relating to future market and economic conditions and the future volume of transactions in those markets, including, without limitation, future conditions in the residential and commercial real estate markets and related financing markets, and the related potential opportunities for our residential and commercial business activity; (xvi) statements relating to our expectations regarding future interest income and net interest income, future earnings, future gains, future earnings volatility, and future trends in operating expenses and the factors that may affect those trends; (xvii) statements regarding credit reserves, credit losses, the adequacy of credit support, and impairments and their impact on our investments (including as compared to our original expectations and credit reserve levels) and the timing of losses and impairments, and statements that the amount of credit reserves we designate are adequate or may require changes in the future; (xviii) statements relating to our expectation that we will start acquiring Agency conforming residential mortgage loans by the fourth quarter of 2013 and our expectation that this will result in higher overall loan acquisition volumes from new and existing sellers; (xix) statements relating to our expectations regarding

opportunities to invest in conforming mortgage servicing rights (MSRs) and to participate in risk-sharing transactions with Fannie Mae and Freddie Mac; and (xx) statements regarding our expectations and estimates relating to the characterization for income tax purposes of our dividend distributions, our expectations and estimates relating to tax accounting, tax liabilities, and GAAP tax provisions, our estimates of REIT taxable income and TRS taxable income, and our anticipation of additional credit losses for tax purposes in future periods (and, in particular, our statement that, for tax purposes, we expect an additional \$107 million of credit losses for tax on securities, based on our projection of principal balance losses and assuming a similar tax basis as we have recently experienced).

Important factors, among others, that may affect our actual results include: general economic trends, the performance of the housing, commercial real estate, mortgage, credit, and broader financial markets, and their effects on the prices of earning assets and



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**Table of Contents**

the credit status of borrowers; federal and state legislative and regulatory developments, and the actions of governmental authorities, including those affecting the mortgage industry or our business; developments related to the fixed income and mortgage finance markets and the Federal Reserve's statements regarding its future open market activity and monetary policy; our exposure to credit risk and the timing of credit losses within our portfolio; the concentration of the credit risks we are exposed to, including due to the structure of assets we hold and the geographical concentration of real estate underlying assets we own; our exposure to adjustable-rate and negative amortization mortgage loans; the efficacy and expense of our efforts to manage or hedge credit risk, interest rate risk, and other financial and operational risks; changes in credit ratings on assets we own and changes in the rating agencies credit rating methodologies; changes in interest rates; changes in mortgage prepayment rates; the availability of assets for purchase at attractive prices and our ability to reinvest cash we hold; changes in the values of assets we own; changes in liquidity in the market for real estate securities and loans; our ability to finance the acquisition of real estate-related assets with short-term debt; the ability of counterparties to satisfy their obligations to us; our involvement in securitization transactions, the profitability of those transactions, and the risks we are exposed to in engaging in securitization transactions; exposure to claims and litigation, including litigation arising from our involvement in securitization transactions; whether we have sufficient liquid assets to meet short-term needs; our ability to successfully compete and retain or attract key personnel; our ability to adapt our business model and strategies to changing circumstances; changes in our investment, financing, and hedging strategies and new risks we may be exposed to if we expand our business activities; exposure to environmental liabilities and the effects of global climate change; failure to comply with applicable laws and regulations; our failure to maintain appropriate internal controls over financial reporting and disclosure controls and procedures; the impact on our reputation that could result from our actions or omissions or from those of others; changes in accounting principles and tax rules; our ability to maintain our status as a REIT for tax purposes; limitations imposed on our business due to our REIT status and our status as exempt from registration under the Investment Company Act of 1940; decisions about raising, managing, and distributing capital; and other factors not presently identified.

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

**Our Business**

Redwood is an internally-managed operating company focused on engaging in residential and commercial mortgage banking activities and investing in mortgage- and other real estate-related assets. We seek to generate fee and gain on sale income through our mortgage banking activities and to invest in real estate-related assets that have the potential to generate attractive cash flow returns over time. For tax purposes, Redwood Trust, Inc. is structured as a real estate investment trust ( REIT ) and we generally refer, collectively, to Redwood Trust, Inc. and those of its subsidiaries that are not subject to subsidiary-level corporate income tax as the REIT or our REIT. We generally refer to subsidiaries of Redwood Trust, Inc. that are subject to subsidiary-level corporate income tax as our operating subsidiaries or our taxable REIT subsidiaries. Our mortgage banking activities are generally carried out through our operating subsidiaries, while our portfolio of mortgage- and other real estate-related investments is primarily held at our REIT. We generally intend to retain profits generated and taxed at our operating subsidiaries, and to distribute as dividends at least 90% of the income we generate from the investment portfolio at our REIT.

Our residential mortgage banking activities primarily consist of operating a residential mortgage loan conduit i.e., the acquisition of residential mortgage loans, which we also refer to as residential loans, from third-party originators and the subsequent sale or securitization of those loans. Most of the residential loans we acquire are securitized through our Sequoia securitization program. The process of sponsoring a Sequoia securitization begins with the acquisition, on a loan-by-loan basis (or flow basis), of residential loans originated by banks and mortgage companies located throughout the U.S., periodically augmented by our acquisition of larger pools of residential loans (or bulk

acquisitions) that may be available for purchase from other participants in the capital markets for residential loan finance. Our acquisition and accumulation of these loans for securitization is generally funded with equity and short-term debt. Once a sufficient amount of residential loans has been accumulated for securitization, we pool and transfer those loans to a Sequoia securitization entity, establish a financial structure for the securitization, and the Sequoia securitization entity then issues senior and subordinate residential mortgage-backed securities ( RMBS or residential securities ) collateralized by that pool of loans. Senior securities issued by Sequoia securitization entities, or those interests that generally have the first right to cash flows and are generally last to absorb losses, are generally issued to third parties we refer to as senior investors or triple-A investors, while some or all of the remaining subordinate securities, or those interests that generally have the last right to cash flows and are generally first in line to absorb losses, are generally retained by us and held for investment at our REIT. From time to time, we may also invest in senior interest-only ( IO ) securities issued by a Sequoia securitization entity. These IO securities receive interest payments (but no principal payments) related to securitized residential mortgage loans. We may also retain mortgage servicing rights ( MSRs ) associated with residential loans transferred to a Sequoia securitization entity and invest in other MSRs associated with residential loans. The owner of an MSR is entitled to receive a portion of the interest payments from the associated residential loan and is obligated to directly service, or retain a sub-servicer to directly service, the associated loan. The MSR owner may also be

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**Table of Contents**

obligated to fund advances of principal and interest payments due to a third party owner of the loan (including, for example, a securitization trust), but not received on schedule from the loan borrower. We do not originate or directly service residential loans. Residential loans for which we own the MSR are directly serviced by a sub-servicer we retain.

Our commercial mortgage banking activities primarily consist of operating as a commercial real estate lender by originating mortgage loans and providing other forms of commercial real estate financing (which we also refer to generally as commercial loans) directly to borrowers and through a correspondent network of third-party brokers. We may structure commercial loans as senior or subordinate mortgage loans, as mezzanine loans, or as other forms of financing, such as preferred equity interests in special purpose entities that own commercial real estate. We typically sell the senior loans we originate to other participants in the capital markets for commercial real estate finance, primarily to third-party sponsors of commercial loan securitization entities that issue commercial mortgage-backed securities (CMBS or commercial securities). The mezzanine and subordinate commercial loans we originate are generally transferred to, and held for investment at, our REIT.

Our investment portfolio is primarily held at our REIT, and includes investments in residential securities issued in our Sequoia securitization transactions, as well as residential securities issued by third parties. Some of the securities we invest in are residential re-REMIC support securities or similar securities, which are securities that are generally created through the resecuritization of senior RMBS. Re-REMIC support securities are subordinate to, and provide credit support for, the senior re-REMIC securities issued in a resecuritization. We may also invest in other assets, securities, and instruments that are related to residential real estate. For example, in addition to investing in MSRs associated with residential loans transferred to Sequoia securitization entities, we may also invest in MSRs acquired directly from third parties. Our investment portfolio includes investments in commercial loans that are originated through our commercial mortgage banking activities and may also include investments in CMBS or other forms of commercial real estate financing originated by others. We assume a range of risks in our investments and the level of risk is influenced by, among other factors, the manner in which we finance our purchases of, and derive income from, our investments.

Our primary sources of income are net interest income from our investment portfolio and income from our mortgage banking activities. Net interest income consists of the interest income we earn less the interest expenses we incur on borrowed funds and other liabilities. Mortgage banking income consists of, among other things, the fee and gain on sale income we generate through our residential and commercial mortgage banking activities, offset by hedging costs directly associated with engaging in these activities.

Throughout our history we have sponsored or managed other investment entities, including a private limited partnership fund that we managed, the Redwood Opportunity Fund, LP (the Fund), as well as Acacia securitization entities, certain of which we continue to manage. The Fund was primarily invested in residential securities and the Acacia entities are primarily invested in a variety of real estate-related assets. We are not currently seeking to sponsor or manage other entities like the Fund or the Acacia securitization entities.

During the third quarter of 2011, we engaged in a transaction in which we resecuritized a pool of senior residential securities (the Residential Resecuritization) primarily for the purpose of obtaining permanent non-recourse financing on a portion the residential securities we hold in our investment portfolio at the REIT. Similarly, during the fourth quarter of 2012, we engaged in a transaction in which we securitized a pool of commercial loans (the Commercial Securitization) primarily for the purpose of obtaining permanent non-recourse financing on a portion of the commercial loans we hold in our investment portfolio at the REIT.

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

### **Business Update Second Quarter 2013**

We continued to make progress on our business objectives during the second quarter of 2013, achieving several key milestones along the way. We added the 100th third-party originator (which we refer to as sellers ) to our residential conduit platform and completed the process of becoming an approved seller/servicer with both Fannie Mae and Freddie Mac. The build-out of our Denver residential conduit operations center progressed on schedule, and should position us to begin buying Agency conforming mortgages from our sellers by the fourth quarter of 2013. Through our commercial platform, we continued to execute on our strategy of originating and selling senior commercial loans and we remain on track to reach our goal of \$1 billion of commercial originations for the year.

## **Table of Contents**

The second quarter of 2013 can be characterized by the sharp increases observed in long-term interest rates and the resulting adverse impact on yield spreads for triple-A rated RMBS. We expected these margins, which include the effect of our associated hedges, to narrow from the extraordinarily high levels observed in recent quarters to levels more in line with our long-term expectation of 25 to 50 basis points. This move, however, happened quickly and was more severe than many market participants anticipated. Our observations have shown that the mortgage market is highly cyclical and that changes in the market are generally rapid and disruptive, and market participants that are not prepared can incur significant adverse consequences. We believe that a mortgage finance company such as ours should maintain a well managed loan pipeline, remain focused in steering through market changes, and not lose sight of its long-term strategy and the opportunities ahead.

In respect to the second quarter of 2013, we believe our residential mortgage pipeline was well hedged. Our total pipeline was \$2.61 billion at June 30, 2013, and consisted of an inventory of loans on our balance sheet of \$1.22 billion and loans we had identified for purchase of \$1.39 billion. From July 1 to August 1, 2013, after adjusting for expected fallout and completed and contracted for sales and securitizations, approximately 60% of this \$2.61 billion pipeline exposure has been eliminated. Based on the pace and pricing of these transactions, we expect to complete additional transactions to sell or securitize the remainder of this pipeline by the end of the third quarter of 2013 and we currently estimate we will achieve, overall, a small economic profit on these transactions after factoring in our hedges. During this process, we also expect to create approximately \$90 million to \$120 million in proprietary investments to retain for our portfolio.

All told, given the extreme market conditions we have faced recently, we are proud of how the Redwood team has executed. Our risk management efforts have not only helped us to maintain GAAP book value and earnings, but have also enabled us to continue the expansion of our residential conduit and investment opportunities.

Subsequent to the second quarter of 2013, we are pricing residential loans we have identified for purchase with the intention of earning loan sale profit margins, net of our hedges, roughly in line with the 25 to 50 basis point long-term average margins we have previously forecast. We are not certain whether the worst of the recent market disruptions has occurred, but it does appear that the Agency and non-Agency RMBS markets are starting to firm. We are beginning to see spread premiums on triple-A rated RMBS stabilize, supporting this outlook for our loan sale profit margins. We believe that Agency and non-Agency RMBS spreads could tighten further as investors (including the Federal Reserve) bid for the diminished supply of new-issue RMBS that has resulted from slowing refinance activity among mortgage borrowers.

Recent changes in the interest rate environment may also impact our future jumbo loan acquisition volumes. Our current premise is that mortgage rates may have temporarily stabilized but will move higher over time albeit with significant volatility related to the impact of headline news on market participants' desire to own mortgage-related investments. Refinancing activity has naturally slowed as mortgage rates have risen, but home purchase activity should remain robust if mortgage rates do not spike significantly higher. Based on our year-to-date acquisition volume, residential loan pipeline, and current pace for loan acquisitions, we still see a path to achieving our goal of acquiring \$8 billion of jumbo residential loans during 2013. We believe this goal will be challenging to meet, however.

In terms of future acquisition volumes for our new Agency conforming loan initiative, it is too early to offer a meaningful estimate based on the data we have today. We hope to provide a more detailed outlook on this topic in our next Quarterly Report on Form 10-Q for the period ending September 30, 2013.

We remain confident about the future and the business model we have built to capitalize on our belief that private capital will be necessary if the government is going to successfully reduce its role as the primary capital provider to

the mortgage market. We believe that the government cannot continue to guarantee nine out of every 10 mortgage loans originated in the U.S. We have made excellent progress to date building our residential loan conduit and through August 1, 2013, maintained an approximate 50% market share of all jumbo residential loan securitizations completed in the post-crisis period, which has contributed to our growing portfolio of subordinate RMBS investments. We continue to add loan sellers and we are expecting to broaden the menu of mortgage products we acquire through our conduit once we enter the Agency conforming loan market. We expect this to result in higher overall acquisition volumes from both new and existing sellers, as well as provide us with an opportunity to invest in conforming MSRs and to participate in risk-sharing transactions with Fannie Mae and Freddie Mac.

**Table of Contents****Financial Results Second Quarter 2013**

We managed well through the downturn in the mortgage capital markets during the second quarter of 2013. Our operating results remained positive and were bolstered by our risk management efforts during the second quarter in particular our management of interest rate exposure associated with our residential loan pipeline. Quarterly highlights include the following:

We earned \$0.71 per share for the second quarter of 2013. This amount does not reflect our estimate, as of August 1, 2013, of approximately \$0.22 per share of net negative market valuation adjustments we expect will be realized for GAAP purposes in the third quarter of 2013 related to loans we owned and loans we had identified but not purchased at June 30, 2013.

Our GAAP book value at June 30, 2013 was \$14.69 per share, up \$0.15 per share from March 31, 2013.

At June 30, 2013, we owned \$1.22 billion of residential loans and had identified an additional \$1.39 billion for purchase. We currently expect our overall risk management and hedging activities to offset market value declines on these loans as they are securitized or sold in whole loan form.

We completed four residential securitizations totaling \$1.80 billion, and created a net \$124 million of securities for our investment portfolio and \$16 million of investments in mortgage servicing rights.

We added 24 residential loan sellers to our platform, increasing the total to 104 at June 30, 2013, as compared to 37 sellers a year ago.

We originated and funded 10 senior commercial loans totaling \$150 million and sold six senior commercial loans totaling \$75 million. We also originated six mezzanine commercial loans totaling \$19 million.

We declared and distributed a \$0.28 per share dividend to shareholders for the second quarter of 2013.

***Portfolio Investment Activity***

We deployed \$159 million of capital into new investments in the second quarter of 2013, down from \$202 million in the first quarter of 2013. The following table summarizes our investment activity for the three months ended June 30, 2013 and March 31, 2013.

***Table 1 Quarterly Investment Activity***

(In Millions)	Three Months Ended	
	June 30, 2013	March 31, 2013

Residential investments				
Sequoia RMBS		\$	124	\$ 166
Third-Party RMBS			-	-
Less: Short-term debt			-	-
Net residential investments			124	166
Commercial investments			19	36
Less: Borrowings			-	(12)
Net commercial investments			19	24
MSR Investments			16	12
<b>Equity Capital Invested</b>		\$	159	\$ 202

We retained a net \$124 million (\$133 million initially retained less \$9 million of sales) of residential securities from the \$1.8 billion of Sequoia securitizations we completed during the second quarter. These retained securities included \$92 million of subordinate securities (AA, A, BBB, BB and non-rated securities) and \$32 million of interest-only securities.

In July 2013, we deployed \$33 million of capital into newly issued third-party subordinate securities backed by prime jumbo mortgage loans. We expect to have more opportunities to invest in third-party issued securities in addition to the subordinate securities that we create through our Sequoia program.



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**Table of Contents*****Residential Securities Portfolio***

At June 30, 2013, our residential securities portfolio had a market value of \$1.31 billion, as compared to \$1.23 billion at March 31, 2013. The increase resulted from the addition of a net \$124 million of securities retained from our second quarter Sequoia securitizations (\$133 million retained less \$9 million of securities sold during the quarter). This increase was partially offset by portfolio principal repayments. We did not acquire any third-party securities during the second quarter of 2013. Prices for legacy RMBS were generally down in the second quarter of 2013 due to market expectations of higher benchmark interest rates and a general increase in the incremental yields investors demand for these types of investments. Over time, we expect that investments created through our Sequoia program and the acquisition of newly issued subordinate securities from third-party securitization sponsors will replace the senior residential securities in our investment portfolio. Senior securities in our portfolio continue to pay down or be sold and represented 59% of the portfolio at June 30, 2013, as compared to 73% at June 30, 2012. Subordinate securities in our portfolio represented 29% of the portfolio at June 30, 2013, as compared to 12% at June 30, 2012.

***Residential Mortgage Banking Activities******Recent Market Conditions***

In the second quarter of 2013, the fixed income markets experienced a significant dislocation. Many market participants were concerned the Federal Reserve would begin to end its Quantitative Easing program, which largely consists of the Federal Reserve acquiring Agency RMBS and Treasury securities in an effort to lower long-term interest rates. Heavy selling by investors looking to reposition their portfolios, or in some cases meet redemptions or margin requirements, soon followed. As a result, interest rates on 10-year Treasury notes rapidly increased by nearly 100 basis points during the quarter, with yields for both Agency and non-Agency RMBS rising at an even faster rate.

The market continued to weaken into early July 2013, with the yield on the 10-year Treasury note closing at a recent high of 2.71% on July 5, 2013. This coincided with significantly higher non-Agency RMBS spreads (i.e., the yield premium over comparable Agency RMBS or alternative benchmark interest rates required by investors to participate in the less liquid, non-Agency market). Later in July, the yield on the 10-year Treasury note settled into an approximate range of 2.50% to 2.60%, and RMBS spreads began to stabilize. This facilitated the issuance of four prime non-Agency RMBS transactions totaling \$1.6 billion in July, including two Sequoia securitizations sponsored by Redwood. In addition, Freddie Mac completed a \$500 million STACRs risk-sharing transaction in July 2013.

***Quarterly Update***

Income from mortgage banking activities was \$59 million in the second quarter of 2013. This included income from residential mortgage banking activities of \$52 million, which was primarily attributable to positive market valuation adjustments on risk management derivatives, MSRs, and IO securities used to hedge our loan pipeline. Partially offsetting these gains were negative market valuation adjustments on residential loans as a result of declines in the value of triple-A rated Sequoia RMBS.

We completed four Sequoia securitizations totaling \$1.80 billion in the second quarter, as compared to four securitizations totaling \$2.24 billion in the first quarter of 2013. In early July 2013, we closed our ninth securitization of 2013, a \$463 million securitization we refer to as SEMT 2013-9, and in late July we closed a \$401 million securitization we refer to as SEMT 2013-10.

The volume of loans we identified for purchase from our sellers decreased to \$2.49 billion in the second quarter of 2013, from \$3.06 billion in the first quarter of 2013. The decrease resulted from an approximate 100 basis point rise in

the interest rate for 30-year fixed-rate jumbo mortgages since mid-May. This sharp increase reduced the number of refinance-related loans available for acquisition. Of the loans we identified for purchase in the second quarter, \$1.33 billion, or 53% of the loans, were refinance-related, down from \$2.10 billion, or 69%, in the first quarter of 2013. Partially offsetting the decline was an increase in purchase-related loans to \$1.16 billion in the second quarter, as compared to \$957 million in the first quarter. For the month of July, purchase-related loans represented 54% of the \$308 million of loans we identified for purchase.

At June 30, 2013, we had \$1.22 billion of residential loans held for future sale or securitization on our balance sheet, as compared to \$832 million at March 31, 2013, and our pipeline of loans identified for purchase totaled \$1.39 billion.

At June 30, 2013, our 104 sellers consisted of 48 regional banks (or their subsidiaries) and 56 mortgage companies, located throughout the U.S.

At the end of the second quarter of 2013, we owned MSRMs associated with \$4.13 billion of residential loans acquired through our Sequoia platform, as compared to \$2.47 billion at the end of the first quarter of 2013. At June 30, 2013, the market value of these MSRMs was \$43 million, or 1.04% of the principal amount of the associated mortgage loans. We earn fees from these MSRMs, but outsource the actual servicing of these loans to a nationally recognized third-party servicer. In the second and first quarters of 2013, our net servicing fees earned were \$2 million.

**Table of Contents*****Commercial Mortgage Banking Activities***

Income from commercial mortgage banking activities was \$6 million in the second quarter of 2013. Included in this amount was \$3 million related to gains on our risk management derivatives, \$2 million related to gains on sales of senior loans, and \$2 million related to gains recognized on loans originated by us and table-funded by third-parties, offset by less than \$1 million related to changes in the value of senior loans held on our balance sheet.

During second quarter 2013, we funded 10 senior commercial loans totaling \$150 million, as compared to the first quarter of 2013 when we funded 11 loans totaling \$153 million and originated another four loans totaling \$146 million that were table-funded by third-parties. We sold six senior loans totaling \$74 million in the second quarter of 2013, as compared to six senior loans totaling \$88 million in the first quarter of 2013. Our commercial mortgage banking activities generated income of \$6 million for both the second and first quarters of 2013. At June 30, 2013, we had \$150 million of senior commercial loans held for sale, all of which were sold in July. For the first six months ended June 30, 2013, we originated \$449 million of senior commercial loans, including those that were table-funded by third parties. We believe we are still on track to meet our goal of originating \$1 billion of senior commercial loans in 2013.

Commercial mezzanine loan originations in the second quarter totaled six loans for \$19 million, as compared to nine loans for \$36 million in the first quarter. This brought our portfolio of non-securitized mezzanine loans to 19 for \$75 million at June 30, 2013. Our securitized mezzanine portfolio totaled \$270 million at June 30, 2013, down from \$271 million at March 31, 2013, as a result of general loan loss provisioning. Redwood's investment in this securitized portfolio totaled \$116 million at the end of the second quarter.

**Summary of Results of Operations*****Net Income***

Our reported GAAP net income was \$66 million (\$0.71 per share) and \$126 million (\$1.40 per share), respectively, for the three and six months ended June 30, 2013, as compared to \$20 million (\$0.24 per share) and \$50 million (\$0.61 per share), respectively, for the three and six months ended June 30, 2012. The following table presents the components of our GAAP net income for the three and six months ended June 30, 2013 and 2012.

***Table 2 Net Income***

<b>(In Thousands, Except Share Data)</b>	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Interest income	\$ 57,719	\$ 59,523	\$ 111,243	\$ 118,264
Interest expense	(21,463)	(28,881)	(39,817)	(59,536)
Net interest income	36,256	30,642	71,426	58,728
Reversal of provision for loan losses	3,272	1,340	1,233	1,065
Other market valuation adjustments, net	(6,258)	(86)	(6,561)	(1,343)
<b>Net interest income after provision and other market valuation</b>	<b>33,270</b>	<b>31,896</b>	<b>66,098</b>	<b>58,450</b>

**adjustments**

Mortgage banking activities, net	58,531	(3,607)	104,552	1,324
Operating expenses	(23,644)	(15,165)	(43,241)	(29,799)
Realized gains, net	556	6,995	12,823	20,615
Provision for income taxes	(3,140)	(592)	(14,049)	(600)
<b>Net Income</b>	<b>\$ 65,573</b>	<b>\$ 19,527</b>	<b>\$ 126,183</b>	<b>\$ 49,990</b>

Diluted weighted average common

shares outstanding	96,171,713	78,815,313	91,647,400	79,965,406
Net earnings per share	\$ 0.71	\$ 0.24	\$ 1.40	\$ 0.61

The *Results of Operations and Financial Condition* section of this *Management's Discussion and Analysis of Financial Condition and Results of Operations* contains a detailed analysis of the components of our GAAP net income.

***Net Interest Income after Provision and Other Market Valuation Adjustments***

Net interest income after provision and other MVA was \$33 million for the second quarter for 2013, as compared to \$32 million for the second quarter of 2012, an increase of \$1 million. This increase was primarily due to higher net interest income, as increasing asset yields more than offset the decline in average earning assets. In addition, we recognized a reversal of our provision for loan losses of \$3 million in the second quarter of 2013, as compared to \$1 million in the second quarter of 2012,

**Table of Contents**

predominately driven by continued improvement in the credit performance of residential loans at consolidated Sequoia entities. These amounts were partially offset by a \$6 million decrease in other MVA as valuations on certain of our fair value securities declined during the second quarter of 2013, primarily as a result of rising long-term interest rates.

The following table details the components of other MVA for the three and six months ended June 30, 2013 and 2012.

**Table 3 Components of Other MVA**

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Residential loans, at lower of cost or fair value	\$ 38	\$ 405	\$ 78	\$ 498
Commercial loans, at fair value	-	111	-	122
Trading securities	(4,140)	16,349	(4,707)	49,824
Impairments on AFS securities	(1,642)	(303)	(1,665)	(635)
REO	(558)	(162)	(331)	(144)
Other derivative instruments, net	44	(3,513)	64	(5,982)
ABS issued - Acacia	-	(12,973)	-	(45,026)
<b>Total Other MVA, Net</b>	<b>\$ (6,258)</b>	<b>\$ (86)</b>	<b>\$ (6,561)</b>	<b>\$ (1,343)</b>

**Mortgage Banking Activities, Net**

Mortgage banking activities, net, include valuation changes of residential and commercial loans and MSR, valuation changes related to derivatives and Sequoia IO securities associated with our mortgage banking activities, gains from mortgage loan sales and securitizations, and net income from MSR. Beginning in the second quarter of 2013, we are presenting market valuation changes for our retained Sequoia IO securities in mortgage banking activities and have conformed the presentation of prior period results for consistency of comparison. We believe this change helps better align the presentation of our reported results with the economics underlying our residential mortgage banking activities, as we utilize our retained Sequoia IO securities as an economic hedge to manage certain interest rate risks associated with our residential mortgage loan pipeline. In general, the change in fair value of our IO securities is inversely related to the change in fair value of mortgage loans we hold in respect to movement in interest rates. The following table presents the components of mortgage banking activities, net, for the three and six months ended June 30, 2013 and 2012.

**Table 4 Components of Mortgage Banking Activities, Net**

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012

Net market valuation adjustments on:								
Residential loans	\$	(41,405)	\$	-	\$	(6,535)	\$	-
Commercial loans		(345)		-		(345)		-
MSRs		8,827		(527)		9,169		(544)
Sequoia IO securities		36,336		(5,363)		38,265		(4,674)
Risk management derivatives		49,544		(3,282)		50,567		(6,398)
Net gains on residential loan sales and securitizations		-		5,471		-		12,836
Net gains on commercial loan sales and originations		3,854		-		11,031		-
Income from MSRs, net		1,720		94		2,400		104
<b>Total Mortgage Banking Activities, Net</b>	\$	58,531	\$	(3,607)	\$	104,552	\$	1,324

Our second quarter income from mortgage banking activities, net, of \$59 million does not reflect net negative market valuation adjustments we expect to recognize under GAAP in the third quarter of 2013 related to loans we had identified for purchase at June 30, 2013. We estimate that the net market valuation adjustment associated with these loans was approximately negative \$34 million, or \$0.35 per share, at June 30, 2013. As of August 1, 2013, we estimate the market valuation adjustment on loans we owned and loans we had identified but not yet purchased at June 30, 2013, has decreased to negative \$21 million, or \$0.22 per share. The exact amount of this net market valuation adjustment as of the end

**Table of Contents**

of the third quarter of 2013 will generally be impacted by: the amount of loans we ultimately purchase that were identified at June 30, 2013; the market value of these purchased loans at the time they are subsequently sold or securitized; and the market value of loans we already owned at June 30, 2013, at the time they are subsequently sold or securitized. Setting aside the timing of the GAAP recognition of negative valuation adjustments on these loans and of offsetting gains on associated hedges, we currently expect to earn a small economic profit on these loans as they are sold or securitized. The amount of overall net market valuation adjustments on residential loans we report for the third quarter of 2013 will be impacted not only by market valuation adjustments relating to these loans, but will also be impacted by the purchase and valuation of additional loans identified for purchase after June 30, 2013.

Income from mortgage banking activities in the second quarter of 2013 also included \$4 million in gains from the sale of \$74 million of senior commercial loans and origination of table-funded loans, as compared to \$7 million of gains on \$88 million of sales in the first quarter of 2013. We also recognized market valuation adjustments of positive \$3 million on risk management derivatives, and less than negative \$1 million on senior commercial loans in the second quarter of 2013, as compared to negative \$1 million on risk management derivatives in the first quarter of 2013.

**Realized Gains, Net**

The following table details the components of realized gains, net, for the three and six months ended June 30, 2013 and 2012.

**Table 5 Realized Gains, Net**

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net gains on sales of real estate securities	\$ 193	\$ 6,989	\$ 12,231	\$ 13,174
Net gains on calls of real estate securities	333	-	333	113
Net gains on sales of commercial mortgage loans	-	-	210	-
Net gains on extinguishment of debt	30	6	49	318
Gain on deconsolidation	-	-	-	7,010
<b>Total Realized Gains, Net</b>	<b>\$ 556</b>	<b>\$ 6,995</b>	<b>\$ 12,823</b>	<b>\$ 20,615</b>

Realized gains, net, were less than \$1 million for the second quarter of 2013, a \$6 million decrease from the second quarter of 2012. During the second quarter of 2013, we sold less than \$1 million of residential available-for-sale ( AFS ) securities for a minimal gain.

**Operating Expenses**

Operating expenses were \$24 million during the second quarter of 2013, an increase of \$8 million from the second quarter of 2012. The increase was primarily due to severance charges recorded in the second quarter. In addition, we continued to add to our employee headcount to support our expanding residential and commercial mortgage operations.

***Tax Provision***

Our tax provision was \$3 million for the second quarter of 2013, a \$2 million increase from the second quarter of 2012. The increase relates primarily to GAAP net income earned from mortgage banking activities at our taxable REIT subsidiaries ( TRS ) in 2013 versus a loss in 2012.

***Estimated Taxable Income for Federal Tax Purposes***

Our estimated total taxable loss was \$30 million (\$0.36 per share) for the second quarter of 2013, as compared to taxable income of \$17 million (\$0.22 per share) for the second quarter of 2012. Our estimated REIT taxable income was \$20 million (\$0.25 per share) for the second quarter of 2013, as compared to REIT taxable income of \$17 million (\$0.22 per share) for the second quarter of 2012. Total realized credit losses on our investments for the second quarters of 2013 and 2012 were \$2 million (\$0.02 per share) and \$5 million (\$0.07 per share), respectively, for tax purposes. The *Results of Operations Taxable Income* section of this *Management's Discussion and Analysis of Financial Condition and Results of Operations* contains a detailed analysis of our tax results and distributions to shareholders.



**Table of Contents*****Summary of Financial Condition, Capital Resources, and Liquidity***

At June 30, 2013, our total capital was \$1.6 billion, including \$1.2 billion of shareholders' equity and \$428 million of long-term debt. We use our capital to invest in earning assets, meet lender capital requirements, and fund our operations and working capital needs. At June 30, 2013, our cash amounted to \$208 million and our current investment capacity (defined as the approximate amount of capital we have readily available for long-term investments) was estimated to be approximately \$130 million. We ended the second quarter with short-term warehouse debt of \$1.08 billion, which was used to finance residential loans, and had additional uncommitted borrowing capacity of \$267 million under existing warehouse lines of credit to finance additional residential loans. Subsequent to the end of the second quarter, and through August 1, 2013, we sold \$166 million of senior securities previously funded with short-term debt and equity. These sales freed up approximately \$49 million of equity capital and resulted in realized gains of \$8 million that will be recognized in the third quarter of 2013. At August 1, 2013, our cash balance was \$267 million, our short-term debt financing residential loans was \$838 million, and we had additional uncommitted borrowing capacity of \$612 million under existing warehouse lines of credit to finance additional residential loans.

We had \$324 million of capital invested in commercial loan assets at June 30, 2013, which included \$150 million of senior loans held for sale that were subsequently sold in July. As we have noted previously, we are targeting to allocate up to \$300 million of equity capital to fund commercial investments, although our allocation could exceed that amount from time to time in anticipation of asset sales or other transactions.

We currently believe that our available capital and liquidity is sufficient to fund our business and investment objectives for the remainder of 2013. To the extent we need additional incremental capital to fund our operations and investment activities, our approach to raising capital will continue to be based on what we believe to be in the best long-term interests of our shareholders. Any future capital raising transaction could include the issuance of debt or equity securities under the shelf registration statement we currently have on file with the SEC or the issuance of similar or other types of securities in public or private offerings. The issuance of any securities will depend on future market conditions, funding needs and other factors and there can be no assurance that any such issuance will occur or be successful.

***Changes in Book Value***

During the second quarter of 2013, our GAAP book value increased by \$0.15 per share to \$14.69 per share. Our second quarter 2013 GAAP book value benefited from hedging gains noted previously that we expect will offset market value declines with respect to residential loans we had identified but not yet purchased as of June 30, 2013. Consequently, we expect reported GAAP book value at September 30, 2013 to reflect these market value declines. The following table presents the changes in GAAP book value per share for the three months ended June 30, 2013 and March 31, 2013.

***Table 6 Changes in GAAP Book Value per Share***

<b>(In Dollars, per share basis)</b>	<b>Three Months Ended</b>	
	<b>June 30, 2013</b>	<b>March 31, 2013</b>
Beginning book value per share	\$ 14.54	\$ 13.95
Net income	0.71	0.69
Unrealized losses gains on securities, net <sup>(1)</sup>	(0.46)	(0.04)

Unrealized gains on hedges, net		0.17		0.10
Equity issuance		0.06		0.05
Other, net		(0.05)		0.07
Dividends		(0.28)		(0.28)
<b>Ending Book Value per Share</b>	<b>\$</b>	<b>14.69</b>	<b>\$</b>	<b>14.54</b>

(1) Unrealized losses on securities, net for the three months ended March 31, 2013, included positive \$0.11 from valuation increases on residential securities, offset by the reclassification of \$0.15 of unrealized gains to net income relating to the disposition of our remaining commercial securities.

***Investments in Consolidated Entities***

The estimated carrying value of our investments in the Sequoia securitization entities totaled \$86 million, or 7% of our equity capital, at June 30, 2013. The carrying value reflects the estimated book value of our retained investments in these entities, based on

**Table of Contents**

the difference between the consolidated assets and liabilities of the entities in the aggregate according to their GAAP carrying amounts. During the second quarter of 2013, cash flow generated by our investments in these entities totaled \$6 million.

We recognized net income of \$6 million in the second quarter of 2013 from our investments in consolidated Sequoia entities, as compared to net income of \$4 million in the first quarter of 2013. This increase is primarily attributable to the reversal of provision for loan losses at Sequoia entities in the second quarter of 2013.

**Real Estate Securities at Redwood**

At June 30, 2013, the fair value of the residential securities we own totaled \$1.31 billion, consisting of \$534 million in prime senior securities, \$242 million in non-prime senior securities, \$154 million of re-REMIC securities, and \$384 million in subordinate securities. The following table presents the components of fair value (which equals GAAP carrying value) for real estate securities at Redwood at June 30, 2013. We categorize our securities by portfolio vintage (the years the securities were issued), by priority of cash flows – senior, re-REMIC, and subordinate – and by quality of underlying loans – prime and non-prime.

**Table 7 Securities at Redwood by Vintage and as a Percentage of Total Securities <sup>(1)</sup>**

<b>June 30, 2013</b>							
<b>(In Millions)</b>	<b>2004 &amp; Earlier</b>	<b>2005</b>	<b>2006 - 2008</b>	<b>2012 - 2013</b>	<b>Total</b>	<b>% of Total Securities</b>	
<b>Senior</b>							
Prime	\$ 20	\$ 174	\$ 216	\$ 124	\$ 534	41	%
Non-prime	90	147	5	-	242	18	%
<b>Total Senior</b>	<b>110</b>	<b>321</b>	<b>222</b>	<b>124</b>	<b>776</b>	<b>59</b>	<b>%</b>
Re-REMIC	-	63	91	-	154	12	%
<b>Subordinate</b>							
Prime	47	15	1	319	382	29	%
Non-prime	2	-	-	-	2	-	%
<b>Total Subordinate</b>	<b>49</b>	<b>15</b>	<b>1</b>	<b>319</b>	<b>384</b>	<b>29</b>	<b>%</b>
<b>Total Securities at Redwood</b>	<b>\$ 159</b>	<b>\$ 399</b>	<b>\$ 314</b>	<b>\$ 442</b>	<b>\$ 1,314</b>	<b>100</b>	<b>%</b>

(1) Table may not foot due to rounding.

During the second quarter of 2013, our securities portfolio increased \$84 million to \$1.31 billion. This increase was attributable to \$133 million of acquisitions of Sequoia-related securities partially offset by a \$4 million decrease in the value of our entire securities portfolio, \$8 million of sales and \$37 million from the effect of principal repayments. Our second quarter of 2013 acquisitions included \$41 million of prime senior securities and \$92 million of prime

subordinate securities.

We financed our holdings of residential securities with a combination of short-term debt secured by securities, through the Residential Resecuritization, and with long-term debt and equity capital. During the second quarter of 2013, average short-term debt secured by securities was \$370 million and the average asset-backed securities in the Residential Resecuritization was \$139 million. The securities and interests that we acquired from the Residential Resecuritization entity (which are eliminated for consolidation purposes) was \$148 million at June 30, 2013. As a result, to adjust at June 30, 2013 for the legal and economic interests that resulted from the Residential Resecuritization, total residential senior securities would be decreased by \$295 million to \$481 million, total re-REMIC residential securities would be increased by \$148 million to \$302 million, and total residential securities would be reduced by \$147 million to \$1.17 billion.

**Table of Contents*****Derivatives at Redwood***

At June 30, 2013, we had net derivative assets of \$14 million, as compared with net derivative liabilities of \$48 million at December 31, 2012. We are party to interest rate swaps, interest rate swaptions, TBA contracts sold, net, and financial futures that we generally utilize to (i) manage risks associated with loans we own or plan to acquire and securitize or sell; (ii) manage risks associated with commercial loans we invest in; and, (iii) fix the interest expense related to our long-term debt and other liabilities. The following table presents the aggregate fair value of derivative financial instruments held at Redwood at June 30, 2013 and December 31, 2012.

***Table 8 Derivatives at Redwood***

<b>(In Thousands)</b>	<b>June 30, 2013</b>		<b>December 31, 2012</b>	
<b>Assets - Risk Management Derivatives</b>				
Interest rate swaps	\$	32,742	\$	739
TBAs		8,655		-
Futures		328		-
Swaptions		1,616		2,233
<b>Total Derivative Assets</b>		<b>43,341</b>		<b>2,972</b>
<b>Liabilities - Cash Flow Hedges</b>				
Interest rate swaps		(27,566)		(48,581)
<b>Liabilities - Risk Management Derivatives</b>				
Interest rate swaps		(219)		(1,893)
TBAs		(1,139)		-
Futures		(647)		(607)
<b>Total Derivative Liabilities</b>		<b>(29,571)</b>		<b>(51,081)</b>
<b>Total Derivative Financial Instruments, Net</b>	<b>\$</b>	<b>13,770</b>	<b>\$</b>	<b>(48,109)</b>

Rising benchmark interest rates resulted in significant increases in the fair value of our risk management derivatives during the second quarter of 2013. These derivatives were primarily used to hedge our \$1.2 billion of residential loans owned at June 30, 2013, and the portion of our \$1.4 billion of loans identified for purchase at June 30, 2013, that we expect to purchase in the third quarter. Net increases in fair value of \$50 million associated with risk management derivatives were reflected in the income statement in Mortgage Banking Activities, net, during the three months ended June 30, 2013.

Rising benchmark interest rates also resulted in a \$14 million reduction to our derivative liability related to our cash flow hedges on our long-term debt. Changes in the fair value of our cash flow hedges are recorded in shareholders equity through accumulated other comprehensive income. Therefore, the decrease in the cash flow hedge liability during the second quarter of 2013 resulted in a corresponding increase to shareholders equity.

**Table of Contents*****Unrealized Gains and Losses on Real Estate Securities and Derivatives***

At June 30, 2013, we had net unrealized gains of \$118 million recorded to accumulated other comprehensive income, a component of stockholders' equity, a \$20 million decrease from the net unrealized gains of \$138 million at December 31, 2012. The following table presents the activity related to unrealized gains and losses on securities and derivatives for the six months ended June 30, 2013.

**Table 9 Accumulated Other Comprehensive Income Recognized in Stockholders' Equity**

(In Millions)	Senior	Residential Re-REMIC	Subordinate	Commercial	Derivatives	Total
Beginning balance - December 31, 2012	\$ 89	\$ 64	\$ 21	\$ 12	\$ (48)	\$ 138
OTTI recognized in OCI	-	-	-	-	-	-
Net unrealized loss on real estate securities	(18)	(11)	-	(12)	-	(41)
Net unrealized gain on interest rate agreements	-	-	-	-	21	21
Reclassification:						
OTTI to net income	-	-	-	-	-	-
Unrealized loss on interest rate agreements to net income	-	-	-	-	-	-
<b>Ending balance - June 30, 2013</b>	<b>\$ 71</b>	<b>\$ 53</b>	<b>\$ 21</b>	<b>\$ -</b>	<b>\$ (27)</b>	<b>\$ 118</b>

A significant aspect of our ongoing risk management activities entails managing the interest-rate exposure on a portion of our long-term debt. Changes in the values of derivatives designated as cash flow hedges used to offset changes in future payment obligations are currently recorded - to the extent effective - through our consolidated balance sheet and not our consolidated income statement. The increase in benchmark interest rates during the second quarter of 2013 caused a \$14 million increase in the value of these derivatives.

**Table of Contents****Results of Operations and Financial Condition**

The following tables present the results of Redwood (Parent) and other Consolidated Entities in order to supplement our consolidated GAAP results for the three and six months ended June 30, 2013 and 2012. These tables do not represent separate business segments, as we manage and evaluate our business as one reportable unit. Rather, they are intended to separate the accounts of certain independent securitization entities that are bankruptcy-remote from us and from each other but for which we are still required to consolidate for financial reporting purposes. They have been structured such that Redwood's obligations are not liabilities of the consolidated entities and the liabilities of the consolidated entities are not legal obligations of Redwood.

**Table 10 Consolidating Income Statements**

(In Thousands)	Three Months Ended June 30, 2013		
	Redwood (Parent) <sup>(1)</sup>	Consolidated Entities	Redwood Consolidated
Interest income	\$ 48,933	\$ 8,786	\$ 57,719
Interest expense	(14,721)	(6,742)	(21,463)
<b>Net interest income</b>	34,212	2,044	36,256
(Provision for) reversal of loan losses	(891)	4,163	3,272
Other market valuation adjustments, net	(5,700)	(558)	(6,258)
<b>Net interest income after provision and other market valuation adjustments</b>	27,621	5,649	33,270
Mortgage banking activities, net	58,531	-	58,531
Operating expenses	(23,571)	(73)	(23,644)
Realized gains, net	526	30	556
Net income before provision for taxes	63,107	5,606	68,713
Provision for income taxes	(3,140)	-	(3,140)
<b>Net Income</b>	\$ 59,967	\$ 5,606	\$ 65,573

(In Thousands)	Three Months Ended June 30, 2012		
	Redwood (Parent) <sup>(1)</sup>	Consolidated Entities	Redwood Consolidated
Interest income	\$ 34,862	\$ 24,661	\$ 59,523
Interest expense	(5,929)	(22,952)	(28,881)
<b>Net interest income</b>	28,933	1,709	30,642
(Provision for) reversal of loan losses	(376)	1,716	1,340
Other market valuation adjustments, net	(943)	857	(86)

<b>Net interest income after provision and market valuation adjustments</b>	27,614	4,282	31,896
Mortgage banking activities, net	(3,607)	-	(3,607)
Operating expenses	(15,105)	(60)	(15,165)
Realized gains, net	6,989	6	6,995
Net income before provision for taxes	15,891	4,228	20,119
Provision for income taxes	(592)	-	(592)
<b>Net Income</b>	\$ 15,299	\$ 4,228	\$ 19,527



**Table of Contents**

(In Thousands)	Six Months Ended June 30, 2013		
	Redwood (Parent) <sup>(1)</sup>	Consolidated Entities	Redwood Consolidated
Interest income	\$ 92,390	\$ 18,853	\$ 111,243
Interest expense	(25,795)	(14,022)	(39,817)
<b>Net interest income</b>	66,595	4,831	71,426
(Provision for) reversal of loan losses	(1,576)	2,809	1,233
Other market valuation adjustments, net	(6,230)	(331)	(6,561)
<b>Net interest income after provision and other market valuation adjustments</b>	58,789	7,309	66,098
Mortgage banking activities, net	104,552	-	104,552
Operating expenses	(43,135)	(106)	(43,241)
Realized gains, net	12,774	49	12,823
Net income before provision for taxes	132,980	7,252	140,232
Provision for income taxes	(14,049)	-	(14,049)
<b>Net Income</b>	\$ 118,931	\$ 7,252	\$ 126,183

(In Thousands)	Six Months Ended June 30, 2012		
	Redwood (Parent) <sup>(1)</sup>	Consolidated Entities	Redwood Consolidated
Interest income	\$ 66,631	\$ 51,633	\$ 118,264
Interest expense	(11,478)	(48,058)	(59,536)
<b>Net interest income</b>	55,153	3,575	58,728
(Provision for) reversal of loan losses	(650)	1,715	1,065
Other market valuation adjustments, net	(1,950)	607	(1,343)
<b>Net interest income after provision and market valuation adjustments</b>	52,553	5,897	58,450
Mortgage banking activities, net	1,324	-	1,324
Operating expenses	(29,697)	(102)	(29,799)
Realized gains, net	13,287	7,328	20,615
Net income before provision for taxes	37,467	13,123	50,590
Provision for income taxes	(600)	-	(600)
<b>Net Income</b>	\$ 36,867	\$ 13,123	\$ 49,990

(1)

For the three and six months ended June 30, 2013 and 2012, the consolidating income statement presents the income generated and expense incurred by the Residential Resecuritization and Commercial Securitization entities under Redwood (Parent).

**Table of Contents**

At June 30, 2013, 37% of our consolidated assets and 45% of our consolidated liabilities were owned at consolidated Sequoia entities. The following table presents the components of our consolidating balance sheet at June 30, 2013.

**Table 11 Consolidating Balance Sheet****June 30, 2013**

(In Thousands)	Redwood (Parent) <sup>(1)</sup>	Consolidated Sequoia Entities	Redwood Consolidated
Residential loans	\$ 1,221,098	\$ 1,998,178	\$ 3,219,276
Commercial loans	494,823	-	494,823
Real estate securities, at fair value:			
Trading securities	141,615	-	141,615
Available-for-sale securities	1,172,690	-	1,172,690
Mortgage servicing rights	43,098	-	43,098
Cash and cash equivalents	207,694	-	207,694
<b>Total earning assets</b>	<b>3,281,018</b>	<b>1,998,178</b>	<b>5,279,196</b>
Other assets	146,590	9,626	156,216
<b>Total Assets</b>	<b>\$ 3,427,608</b>	<b>\$ 2,007,804</b>	<b>\$ 5,435,412</b>
<b>Short-term debt</b>			
Mortgage loan warehouse debt	\$ 1,082,726	\$ -	\$ 1,082,726
Security repurchase facilities	363,235	-	363,235
Other liabilities	120,742	1,509	122,251
Asset-backed securities issued	293,682	1,920,614	2,214,296
Long-term debt	443,591	-	443,591
<b>Total liabilities</b>	<b>2,303,976</b>	<b>1,922,123</b>	<b>4,226,099</b>
Stockholders equity	1,123,632	85,681	1,209,313
<b>Total Liabilities and Equity</b>	<b>\$ 3,427,608</b>	<b>\$ 2,007,804</b>	<b>\$ 5,435,412</b>

(1) The consolidating balance sheet presents the assets and liabilities of the Residential Resecuritization and Commercial Securitization under Redwood (Parent), although these assets and liabilities are owned by their respective entities and are legally not ours and we own only the securities and interests that we acquired from these entities. At June 30, 2013, the Residential Resecuritization accounted for \$296 million of available-for-sale real estate securities and other assets and \$134 million of asset-backed securities issued and other liabilities. At June 30, 2013, the Commercial Securitization accounted for \$276 million of commercial loans held-for-investment and other assets and \$160 million of asset-backed securities issued and other liabilities.



**Table of Contents****Results of Operations Redwood (Parent)****Net Interest Income after Provision and Other MVA at Redwood (Parent)**

Net interest income after provision and other MVA at Redwood was \$28 million for both the three months ended June 30, 2013 and 2012. Net interest income after provision and other MVA at Redwood was \$59 million for the six months ended June 30, 2013, as compared to \$53 million for the six months ended June 30, 2012. The following tables present the components of net interest income after provision and other MVA at Redwood for the three and six months ended June 30, 2013 and 2012.

**Table 12 Net Interest Income after Other MVA at Redwood (Parent)**

Dollars in Thousands)	Three Months Ended June 30,					
	Interest Income/ (Expense)	2013 Average Amortized Cost	Yield	Interest Income/ (Expense)	2012 Average Amortized Cost	Yield
<b>Interest Income</b>						
Residential loans	\$ 10,059	\$ 1,060,347	3.79 %	\$ 3,690	\$ 363,882	4.06 %
Commercial loans	9,623	382,479	10.06 %	5,341	199,440	10.71 %
Trading securities	6,834	101,724	26.87 %	3,099	38,171	32.47 %
Available-for-sale securities	22,280	1,002,167	8.89 %	22,721	903,140	10.06 %
Cash and cash equivalents	137	96,302	0.57 %	11	78,339	0.06 %
<b>Total interest income</b>	<b>48,933</b>	<b>2,643,019</b>	<b>7.41 %</b>	<b>34,862</b>	<b>1,582,972</b>	<b>8.81 %</b>
<b>Interest Expense</b>						
Short-term debt	(4,686)	1,053,610	(1.78) %	(2,299)	474,053	(1.94) %
ABS issued	(3,555)	294,629	(4.83) %	(1,251)	197,808	(2.53) %
Long-term debt <sup>(1)</sup>	(5,010)	433,691	(4.62) %	(983)	138,227	(2.84) %
Interest rate agreements	(1,470)	138,323	(4.25) %	(1,396)	138,227	(4.04) %
<b>Total interest expense</b>	<b>(14,721)</b>	<b>1,781,930</b>	<b>(3.30) %</b>	<b>(5,929)</b>	<b>810,138</b>	<b>(2.93) %</b>
<b>Net Interest Income</b>	<b>34,212</b>			<b>28,933</b>		
Provision for loan losses	(891)			(376)		
Other MVA, net	(5,700)			(943)		
<b>Net Interest Income after Provision and Other MVA</b>	<b>\$ 27,621</b>			<b>\$ 27,614</b>		

- (1) Interest rate agreement expense relates to cash-flow hedges on a portion of our long-term debt. The combined expense yield on our hedged long-term debt was 6.93% and 6.88% for the three months ended June 30, 2013 and 2012, respectively.

**Table of Contents**

	Six Months Ended June 30,					
	Interest Income/ (Expense)	2013 Average Amortized Cost	Yield	Interest Income/ (Expense)	2012 Average Amortized Cost	Yield
(Dollars in Thousands)						
<b>Interest Income</b>						
Residential loans	\$ 17,616	\$ 940,315	3.75 %	\$ 7,108	\$ 341,618	4.16 %
Commercial loans	19,794	375,687	10.54 %	10,494	184,436	11.38 %
Trading securities	10,806	73,995	29.21 %	5,633	34,472	32.68 %
Available-for-sale securities	44,025	965,027	9.12 %	43,367	830,820	10.44 %
Cash and cash equivalents	149	86,993	0.34 %	29	137,480	0.04 %
<b>Total interest income</b>	<b>92,390</b>	<b>2,442,017</b>	<b>7.57 %</b>	<b>66,631</b>	<b>1,528,826</b>	<b>8.72 %</b>
<b>Interest Expense</b>						
Short-term debt	(8,494)	954,475	(1.78) %	(4,126)	418,080	(1.97) %
ABS issued	(7,287)	305,701	(4.77) %	(2,597)	204,624	(2.54) %
Long-term debt <sup>(1)</sup>	(7,080)	329,670	(4.30) %	(2,013)	138,271	(2.91) %
Interest rate agreements	(2,934)	138,318	(4.24) %	(2,742)	138,271	(3.97) %
<b>Total interest expense</b>	<b>(25,795)</b>	<b>1,589,846</b>	<b>(3.24) %</b>	<b>(11,478)</b>	<b>760,974</b>	<b>(3.02) %</b>
<b>Net Interest Income</b>	<b>66,595</b>			<b>55,153</b>		
Provision for loan losses	(1,576)			(650)		
Other MVA, net	(6,230)			(1,950)		
<b>Net Interest Income after Provision and Other MVA</b>	<b>\$ 58,789</b>			<b>\$ 52,553</b>		

(1) Interest rate agreements expense relates to cash-flow hedges on a portion of our long-term debt. The combined expense yield on our hedged long-term debt was 6.89% and 6.88% for the six months ended June 30, 2013 and 2012, respectively.

Net interest income in the second quarter of 2013 increased \$5 million from the second quarter of 2012 primarily due to a \$14 million increase in interest income attributable to higher average earning assets. This increase was partially offset by a \$9 million increase in interest expense, as we funded our investments with a greater portion of debt in the second quarter of 2013 than in prior quarters. The increase in net interest income was offset by higher other MVA expenses as certain of our fair value securities declined in value during the quarter.

Net interest income increased \$11 million during the six months ended June 30, 2013 compared to the same period in 2012, primarily due to a \$26 million increase in interest income attributable to higher average earning assets. This increase was partially offset by a \$14 million increase in interest expense, as we funded our investments with a greater portion of debt in 2013 than in prior years. The increase in net interest income was offset by higher other MVA

expenses as certain of our fair value securities declined in value during the first half of 2013.



**Table of Contents****Net Interest Income at Redwood (Parent)**

Interest income on AFS securities at Redwood was \$22 million and \$23 million for the three months ended June 30, 2013 and 2012, respectively. Interest income on AFS securities at Redwood was \$44 million and \$43 million for the six months ended June 30, 2013 and 2012, respectively. The following tables present the components of the interest income we earned on AFS securities for the three and six months ended June 30, 2013 and 2012.

**Table 13 Interest Income AFS Securities at Redwood (Parent)****Three Months Ended June 30, 2013**

(Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Yield as a Result of <sup>(1)</sup>		
					Interest Income	Discount (Premium) Amortization	Total Interest Income
<b>Residential</b>							
Senior	\$ 6,689	\$ 4,673	\$ 11,362	\$ 579,333	4.62 %	3.23 %	7.84 %
Re-REMIC	2,731	1,104	3,835	100,824	10.83 %	4.38 %	15.21 %
Subordinate	4,707	2,376	7,083	322,010	5.85 %	2.95 %	8.80 %
<b>Total AFS Securities</b>	<b>\$ 14,127</b>	<b>\$ 8,153</b>	<b>\$ 22,280</b>	<b>\$ 1,002,167</b>	<b>5.64 %</b>	<b>3.25 %</b>	<b>8.89 %</b>

**Three Months Ended June 30, 2012**

(Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Yield as a Result of <sup>(1)</sup>		
					Interest Income	Discount (Premium) Amortization	Total Interest Income
<b>Residential</b>							
Senior	\$ 8,079	\$ 6,327	\$ 14,406	\$ 682,007	4.74 %	3.71 %	8.45 %
Re-REMIC	3,209	(24)	3,185	105,281	12.19 %	(0.09) %	12.10 %
Subordinate	2,630	1,895	4,525	111,872	9.40 %	6.78 %	16.18 %
<b>Total Residential</b>	<b>13,918</b>	<b>8,198</b>	<b>22,116</b>	<b>899,160</b>	<b>6.19 %</b>	<b>3.65 %</b>	<b>9.84 %</b>
Commercial	455	150	605	3,980	45.73 %	15.08 %	60.81 %
CDO	30	(30)	-	-	-	-	-
<b>Total AFS Securities</b>	<b>\$ 14,403</b>	<b>\$ 8,318</b>	<b>\$ 22,721</b>	<b>\$ 903,140</b>	<b>6.38 %</b>	<b>3.68 %</b>	<b>10.06 %</b>

**Six Months Ended June 30, 2013**

(Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Yield as a Result of <sup>(1)</sup>		
					Interest Income	Discount (Premium) Amortization	Total Interest Income
<b>Residential</b>							

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Senior	\$ 13,726	\$ 9,448	\$ 23,174	\$ 593,096	4.63 %	3.19 %	7.81 %
Re-REMIC	5,525	2,067	7,592	100,299	11.02 %	4.12 %	15.14 %
Subordinate	8,302	4,332	12,634	271,251	6.12 %	3.19 %	9.32 %
<b>Total Residential</b>	27,553	15,847	43,400	964,646	5.71 %	3.29 %	9.00 %
Commercial	647	(22)	625	381	339.67 %	(11.55) %	328.12 %
<b>Total AFS Securities</b>	\$ 28,200	\$ 15,825	\$ 44,025	\$ 965,027	6.07 %	3.28 %	9.12 %

**Table of Contents**

Six Months Ended June 30, 2012

(Dollars in Thousands)	Interest Income	Discount (Premium) Amortization	Total Interest Income	Average Amortized Cost	Yield as a Result of <sup>(1)</sup>		
					Interest Income	Discount (Premium) Amortization	Total Interest Income
<b>Residential</b>							
Senior	\$ 14,630	\$ 12,921	\$ 27,551	\$ 629,529	4.65 %	4.10 %	8.75 %
Re-REMIC	6,120	(112)	6,008	96,141	12.73 %	(0.23) %	12.50 %
Subordinate	5,134	3,589	8,723	101,187	10.15 %	7.09 %	17.24 %

&amp;