REDWOOD TRUST INC
Form 10-Q
May 05, 2011

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

# FORM 10-Q

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

## For the Quarterly Period Ended: March 31, 2011

## OR

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

## For the Transition Period from to .

## Commission File Number 1-13759

# REDWOOD TRUST, INC.

(Exact Name of Registrant as Specified in Its Charter)

| | |
|---|---|
| Maryland<br>(State or Other Jurisdiction of<br>Incorporation or Organization) | 68-0329422<br>(I.R.S. Employer<br>Identification No.) |
| One Belvedere Place, Suite 300<br>Mill Valley, California<br>(Address of Principal Executive Offices) | 94941<br>(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 o

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 o

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 o Non-accelerated filer o Smaller reporting company o

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

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

| | |
|---|---|
| Common Stock, $0.01 par value per share | 78,548,044 shares outstanding as of May 4, 2011 |

# REDWOOD TRUST, INC.
# 2011 FORM 10-Q REPORT

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# PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

# REDWOOD TRUST, INC. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS

| (In Thousands, Except Share Data) (Unaudited) | March 31, 2011 | December 31, 2010 |
|---|---|---|
| ASSETS | | |
| Residential real estate loans | $3,795,762 | $3,797,095 |
| Commercial real estate loans | 62,436 | 50,386 |
| Real estate securities, at fair value: | | |
| Trading securities | 321,820 | 329,717 |
| Available-for-sale securities | 781,992 | 825,119 |
| Total real estate securities | 1,103,812 | 1,154,836 |
| Other investments | | |
| Cash and cash equivalents | 220,276 | 46,937 |
| Total earning assets | 5,182,286 | 5,049,254 |
| Restricted cash | 34,983 | 24,524 |
| Accrued interest receivable | 13,569 | 13,782 |
| Derivative assets | 5,698 | 8,051 |
| Deferred tax asset | 3,487 | 3,487 |
| Deferred securities issuance costs | 7,052 | 5,928 |
| Other assets | 36,231 | 38,662 |
| Total Assets(1) | $5,283,306 | $5,143,688 |
| LIABILITIES AND EQUITY | | |
| Liabilities | | |
| Short-term debt | $ | $44,137 |
| Accrued interest payable | 6,611 | 5,930 |
| Derivative liabilities | 70,157 | 83,115 |
| Accrued expenses and other liabilities | 8,358 | 14,305 |
| Dividends payable | 19,535 | 19,531 |
| Asset-backed securities issued Sequoia | 3,646,342 | 3,458,501 |
| Asset-backed securities issued Acacia | 310,952 | 303,077 |
| Long-term debt | 139,500 | 139,500 |
| Total liabilities(2) | 4,201,455 | 4,068,096 |
| Equity | | |
| Common stock, par value $0.01 per share, 100,000,000 shares authorized; 78,138,724 and 78,124,668 issued and outstanding | 781 | 781 |
| Additional paid-in capital | 1,692,095 | 1,689,851 |
| Accumulated other comprehensive income | 122,112 | 112,339 |
| Cumulative earnings | 493,105 | 474,940 |
| Cumulative distributions to stockholders | (1,233,282) | (1,213,158 ) |

| | | |
|---|---|---|
| Total stockholders equity | 1,074,811 | 1,064,753 |
| Noncontrolling interest | 7,040 | 10,839 |
| Total equity | 1,081,851 | 1,075,592 |
| Total Liabilities and Equity | $5,283,306 | $5,143,688 |

(1) Our consolidated balance sheets include assets of consolidated variable interest entities (VIEs) that can only be used to settle obligations of these VIEs. At March 31, 2011 and December 31, 2010, these assets totaled $4,134,480 and $3,941,212, respectively.

(2) Our consolidated balance sheets include liabilities of consolidated VIEs for which creditors do not have recourse to the primary beneficiary (Redwood Trust, Inc.). At March 31, 2011 and December 31, 2010, these liabilities totaled $4,027,793 and $3,838,386, respectively.

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

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# REDWOOD TRUST, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF INCOME

| (In Thousands, Except Share Data) (Unaudited) | Three Months Ended March 31, 2011 | 2010 |
|---|---|---|
| Interest Income | | |
| Residential real estate loans | $18,469 | $14,488 |
| Commercial real estate loans | 1,225 | 303 |
| Real estate securities | 34,624 | 43,899 |
| Other investments | | 9 |
| Cash and cash equivalents | 15 | 17 |
| Total interest income | 54,333 | 58,716 |
| Interest Expense | | |
| Short-term debt | (182) | |
| Asset-backed securities issued | (19,423) | (17,066) |
| Long-term debt | (2,367) | (1,116) |
| Total interest expense | (21,972) | (18,182) |
| Net Interest Income | 32,361 | 40,534 |
| Provision for loan losses | (2,807) | (9,475) |
| Market valuation adjustments | (3,118) | (9,291) |
| Other-than-temporary impairments[1] | (2,622) | (1,946) |
| Market valuation adjustments, net | (5,740) | (11,237) |
| Net Interest Income After Provision and Market Valuation Adjustments | 23,814 | 19,822 |
| Operating expenses | (11,514) | (17,306) |
| Realized gains on sales and calls, net | 3,864 | 44,338 |
| Net income before provision for income taxes | 16,164 | 46,854 |
| Provision for income taxes | (14) | (26) |
| Net income | 16,150 | 46,828 |
| Less: Net loss attributable to noncontrolling interest | (2,015) | (15) |
| Net Income Attributable to Redwood Trust, Inc. | $18,165 | $46,843 |
| Basic earnings per common share | $0.23 | $0.59 |
| Diluted earnings per common share | $0.22 | $0.58 |
| Regular dividends declared per common share | $0.25 | $0.25 |
| Basic weighted average shares outstanding | 78,027,840 | 77,677,235 |
| Diluted weighted average shares outstanding | 79,371,776 | 78,542,299 |

(1) For the three months ended March 31, 2011, other-than-temporary impairments were $3,312, of which $690 were recognized in Accumulated Other Comprehensive Income. For the three months ended March 31, 2010, other-than-temporary impairments were $3,615, of which $1,669 were recognized in Accumulated Other Comprehensive Income.

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

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# REDWOOD TRUST, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF EQUITY AND COMPREHENSIVE INCOME

## For the Three Months Ended March 31, 2011

| (In Thousands, Except Share Data) (Unaudited) | Common Stock Shares | Common Stock Amount | Additional Paid-In Capital | Accumulated Other Comprehensive Income | Cumulative Earnings | Cumulative Distributions to Stockholders | Noncontrolling Interest | Total |
|---|---|---|---|---|---|---|---|---|
| December 31, 2010 | 78,124,668 | $781 | $1,689,851 | $112,339 | $474,940 | $(1,213,158) | $10,839 | $1,075,592 |
| Net income (loss) | | | | | 18,165 | | (2,015) | 16,150 |
| Net unrealized gain on available-for-sale securities | | | | 3,049 | | | 4,539 | 7,588 |
| Reclassification of other-than-temporary impairments to net income | | | | 1,770 | | | | 1,770 |
| Net unrealized gain on interest rate agreements | | | | 3,890 | | | | 3,890 |
| Reclassification of unrealized loss on interest rate agreements to net income | | | | 1,064 | | | | 1,064 |
| Total other comprehensive gain | | | | 9,773 | | | | |
| Total comprehensive income | | | | | | | | 30,462 |
| Issuance of common stock: | | | | | | | | |
| Dividend reinvestment & stock purchase plans | 13,304 | | 196 | | | | | 196 |
| Employee stock purchase and incentive plans | 752 | | (26) | | | | | (26) |
| Non-cash equity award compensation | | | 2,074 | | | | | 2,074 |
| Distributions to noncontrolling interest, net | | | | | | | (6,323) | (6,323) |
| Common dividends declared | | | | | | (20,124) | | (20,124) |
| March 31, 2011 | 78,138,724 | $781 | $1,692,095 | $122,112 | $493,105 | $(1,233,282) | $7,040 | $1,081,851 |

## For the Three Months Ended March 31, 2010

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

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

| (In Thousands, Except Share Data)<br>(Unaudited) | Three Months Ended March 31, 2011 | 2010 |
|---|---|---|
| Cash Flows From Operating Activities: | | |
| Net income attributable to Redwood Trust, Inc. | $18,165 | $46,843 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Amortization of premiums, discounts, and debt issuance costs, net | (9,520) | (8,220) |
| Depreciation and amortization of non-financial assets | 257 | 240 |
| Provision for loan losses | 2,807 | 9,475 |
| Non-cash equity award compensation | 2,074 | 6,086 |
| Market valuation adjustments, net | 5,740 | 11,237 |
| Realized gains on sales and calls, net | (3,864) | (44,338) |
| Net change in: | | |
| Accrued interest receivable | 76 | 3,349 |
| Deferred tax asset | | 1,179 |
| Other assets | 3,529 | 1,976 |
| Accrued interest payable | 3,892 | 2,026 |
| Accrued expenses and other liabilities | (5,947) | 31,789 |
| Net cash provided by operating activities | 17,209 | 61,642 |
| Cash Flows From Investing Activities: | | |
| Purchases of real estate loans held-for-investment | (112,742) | |
| Principal payments on real estate loans held-for-investment | 93,292 | 65,647 |
| Proceeds from sales of real estate loans held-for-sale | 1,857 | |
| Purchases of available-for-sale securities | (13,223) | (162,772) |
| Proceeds from sales of available-for-sale securities | 48,072 | 134,025 |
| Principal payments on available-for-sale securities | 31,234 | 33,458 |
| Purchases of real estate securities trading | | (17,137) |
| Proceeds from sales of trading securities | 12,841 | 3,603 |
| Principal payments on trading securities | 15,080 | 14,290 |
| Principal payments on other investments | | 3,766 |
| Net (increase) decrease in restricted cash | (10,459) | 6,706 |
| Net cash provided by investing activities | 65,952 | 81,586 |
| Cash Flows From Financing Activities: | | |
| Net repayments on short-term debt | (44,137) | |
| Proceeds from issuance of asset-backed securities | 280,111 | |
| Repurchase of asset-backed securities | | (8,639) |
| Deferred securities issuance costs | (1,695) | |
| Repayments on asset-backed securities | (110,896) | (96,568) |
| Net settlements of derivatives | (4,916) | (12,390) |
| Net proceeds from issuance of common stock | 170 | 113 |
| Dividends paid | (20,121) | (19,890) |

| | | |
|---|---|---|
| Change in noncontrolling interests | (8,338) | (6,919) |
| Net cash provided by (used in) financing activities | 90,178 | (144,293) |
| Net increase (decrease) in cash and cash equivalents | 173,339 | (1,065) |
| Cash and cash equivalents at beginning of period | $46,937 | $242,818 |
| Cash and cash equivalents at end of period | $220,276 | $241,753 |
| Supplemental Disclosures: | | |
| Cash paid for interest | $16,833 | $16,156 |
| Cash paid for taxes | $18 | $4 |
| Dividends declared but not paid at end of period | $19,535 | $19,438 |
| Transfers from real estate loans to real estate owned | $2,396 | $3,707 |

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

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 1. Redwood Trust

Redwood Trust, Inc., together with its subsidiaries (Redwood, we, or us), invests in, finances, and manages real estate assets. We invest in residential and commercial real estate loans and in asset-backed securities backed by real estate loans. We seek to invest in assets that have the potential to generate sufficient long-term cash flow returns to support our goal of distributing an attractive level of dividends per share to shareholders over time. For tax purposes, we are structured as a real estate investment trust (REIT).

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

## Note 2. Basis of Presentation

The consolidated financial statements presented herein are at March 31, 2011 and December 31, 2010, and for the three months ended March 31, 2011 and 2010. 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. All amounts presented herein, except share data, are shown in thousands.

### Organization

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. A number of Redwood s consolidated subsidiaries are qualifying REIT subsidiaries and the remainder are taxable subsidiaries. References to the Redwood REIT include Redwood and its qualifying REIT subsidiaries, excluding taxable subsidiaries.

We sponsor two securitization programs. Our Sequoia program is used for the securitization of residential mortgage loans. References to Sequoia refer collectively to all the consolidated Sequoia securitization entities. Our Acacia program was used for the securitization of mortgage-backed securities and other types of financial assets. References to Acacia refer collectively to all the consolidated Acacia securitization entities. We are also the asset manager for and an investor in the Redwood Opportunity Fund LP (the Fund) that we sponsor. The Fund primarily invests in mortgage-backed securities.

## 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, liabilities, and noncontrolling interests of the Fund, as well as the assets and liabilities of the Sequoia and the Acacia securitization entities where we maintain a continuing involvement.

For financial reporting purposes, the underlying loans and securities owned at Sequoia and Acacia entities are shown on our consolidated balance sheets under real estate loans and real estate securities and 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 by consolidated Sequoia and Acacia entities and interest expense on the ABS issued by these entities. The real estate securities owned at the Fund are shown on our consolidated balance sheets under real estate securities and the portion of the Fund owned by third-parties is shown under noncontrolling interest. In our consolidated statements of income, we record interest income on the securities owned at the Fund. Since the Fund is currently funded with equity, there is no associated interest expense.

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

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## 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,
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 real estate 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 the use of our 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.

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

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

### 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 financial instruments that may not perform similarly to our traditional real estate investments or are particularly volatile or complex.

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

### Real Estate Loans

#### Residential and Commercial Real Estate Loans  Fair Value

Residential and commercial real estate loans at fair value include loans where we have elected the fair value option. 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 market valuation adjustments, net.

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

Residential and commercial real estate loans held-for-sale include loans that we are marketing for sale to third-parties. These loans are carried at the lower of their cost or fair value, as measured on an individual basis. If the fair value of a loan held-for-sale is lower than its amortized cost basis, this difference is reported as a negative market valuation adjustment through our consolidated statements of income. 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. Gains or losses on the sale of real estate loans are based on the specific identification method.

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

Real estate loans held-for-investment include residential real estate loans owned and securitized at Sequoia entities and residential and commercial real estate loans owned at Redwood. These loans are carried at their unpaid principal balances adjusted for net unamortized premiums or discounts and 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 when a loan 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. Loans delinquent more than 90 days or in foreclosure are characterized as seriously delinquent. Cash principal and interest that is advanced from servicers subsequent to a loan becoming greater than 90 days past due or individually impaired is used to reduce 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. Loans that have been individually impaired are placed back on accrual status once the loan is considered reperforming.

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

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

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 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 to loans held-for-sale if we determine that these loans will be sold 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 real estate loans.

### Residential Real Estate Loans Allowance for Loan Losses

For residential real estate 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 of the consolidated loans or pools of loans.

We consider the following factors in setting 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 environmental factors;
Relevant market research and publicly available third-party reference loss rates;
Trends in delinquencies and charge-offs;
Effects and changes in credit concentrations;
Information supporting 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 by Sequoia securitization entities, a growing 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

# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

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

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 according to GAAP. If a loan is determined to be a troubled debt restructuring (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 specific loan loss, if any, based on estimated net proceeds from the sale of the property (including accrued but unpaid interest and other costs) and charge this specific estimated loss against the allowance for loan losses. 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.

### Commercial Real Estate Loans Allowance for Loan Losses

For commercial real estate loans classified as held-for-investment, we establish and maintain an allowance for loan losses on an individual basis for those loans we have determined to be impaired as of the reporting date. To calculate the allowance for loan losses, we assess each loan for indications of adverse credit conditions such as delinquencies or changes in expected future cash flows. Upon identification of an adverse credit conditions, the loans are evaluated for impairment and any resulting impairment is recorded in the provision for loan losses in our consolidated statements of income. We re-evaluate the adequacy of our allowance for loan losses for commercial loans held-for-investment at least quarterly.

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

### Repurchase Reserves

We do not currently maintain a loan repurchase reserve and management is not aware of any outstanding repurchase claims against Redwood that would require the establishment of such a reserve. We do not originate residential loans and believe that risk of loss due to loan repurchases (i.e., due to 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 matter would result in a liability and the amount of loss, if any, can be reasonably estimated.

## Real Estate Securities, at Fair Value

### Trading Securities

Trading securities include residential, commercial, and collateralized debt obligation (CDO) securities. Trading securities are carried at their estimated fair values. Coupon interest is recognized as interest income when earned and deemed collectible. All changes in fair value are reported through our consolidated statements of income in market valuation adjustments, net.

We primarily denote trading securities as those securities where we have adopted the fair value option. We currently account for certain securities at Redwood and all securities at Acacia entities as trading securities, at fair value.

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

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

### Available-for-Sale (AFS) Securities

AFS securities include certain residential, commercial, and CDO 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 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 fair value has declined 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 the 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, a component of 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 fair value is deemed to be the non-credit component of the OTTI that 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.

## Other Investments

Other investments included a guaranteed investment contract (GIC) entered into by an Acacia securitization entity that we consolidate for financial statement purposes. At December 31, 2010, the GIC had been drawn down completely to cover credit losses and principal reductions on the referenced securities. We accounted for this investment under the fair value option. Changes in fair value were reported through our consolidated statements of income through market valuation adjustments, net. Interest income was reported through our consolidated statements of income through interest income, other investments. This GIC represented a deposit certificate issued by a rated investment bank and serves as collateral to cover realized losses on credit default swaps (CDS) entered into by this same Acacia entity.

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

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

### Cash and Cash Equivalents

Cash and cash equivalents include non-restricted cash and highly liquid investments with original maturities of three months or less. At March 31, 2011, we did not have any significant concentrations of credit risk arising from cash deposits as all of our cash and cash equivalents were invested in FDIC-insured bank products.

### 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 Acacia or Sequoia securitization entities prior to the payments on or redemptions of outstanding ABS issued, or in the Fund prior to distributions to limited partners. At March 31, 2011, we did not have any significant concentrations of credit risk arising from restricted cash deposits as all of our restricted cash was held in custodial accounts or FDIC-insured bank products.

### Accrued Interest Receivable

Accrued interest receivable includes interest that is due and payable to us. 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 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 include risk management derivatives namely interest rate agreements and credit derivatives. All derivative financial instruments are recorded at fair value in our consolidated balance sheets. Derivatives with a positive fair value to us are reported as an asset and derivatives with a negative fair value to us are reported as a liability. We classify each of our derivative financial instruments as either (i) a trading instrument (no hedging designation) 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 fair value of derivatives accounted for as trading instruments, including any associated interest income or expense, are recorded in our consolidated statements of income through market valuation adjustments, net. Changes in the fair value 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 hedging 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 liabilities.

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 a cash flow hedging relationship but the associated hedged item continues to exist, the fair value 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 liability.

# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

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

### Risk Management Derivatives

Risk management derivatives that we currently utilize include interest rate swaps and caps. Interest rate swaps are derivative contracts in which (i) one party exchanges a stream of fixed interest payments for another party s stream of variable interest cash flows or (ii) each party exchanges variable interest cash flows that are referenced to different indices. Interest rate caps are derivative contracts in which the buyer receives payments at the end of each period in which the interest rate exceeds an agreed upon strike price. We enter into interest rate swaps and caps 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.

Other risk management derivatives we currently utilize include To Be Announced (TBA) contracts and financial futures contracts such as Eurodollar futures and Treasury futures. TBA contracts are forward commitments to purchase agency mortgage-backed securities to be issued in the future. Financial futures are futures contracts on short-term interest rates. We purchase or sell these hedging instruments to offset to varying degrees changes in the value of mortgage products in which we have exposure.

### Credit Derivatives

Credit derivatives that we have historically utilized include CDS, which are agreements to provide (receive) credit event protection based on a financial index or specific security in exchange for receiving (paying) a fixed-rate fee or premium over the term of the contract. These instruments enable us, or our consolidated securitization entities, to synthetically assume the credit risk of a reference security or index of securities. The estimated fair values of these contracts fluctuate for a variety of reasons, such as the likelihood or occurrence of a qualifying credit event (e.g., an interest shortfall, a failure to pay principal, or a distressed rating downgrade), the market perception of default risk and counterparty risk, and supply and demand changes. We do not designate any credit derivatives as cash flow hedges.

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

## Deferred Tax Assets

Our deferred tax assets are generated by differences in GAAP and taxable income at our taxable subsidiaries. These differences generally reflect differing accounting treatments for tax and GAAP, such as accounting for 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 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.

## Deferred Securities Issuance Costs

Securities issuance costs are expenses associated with the issuance of long-term debt and ABS from the Sequoia securitization entities we sponsor. 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 ABS 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 debt and ABS issued.

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

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

### Other Assets

Other assets include REO, derivative margin receivables, fixed assets, principal receivable and other prepaid expenses. REO property acquired through, or in lieu of, loan foreclosure is initially recorded at fair value, and subsequently reported at the lower of 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 market valuation adjustments, net. Derivative margin receivables reflect cash collateral Redwood has posted with our various hedge counterparties as required to satisfy the minimum margin requirements.

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

### Short-Term Debt

Short-term debt includes master repurchase agreements, bank borrowings, and other forms of collateralized borrowings that expire within one year with various commercial banks and investment banks. These facilities may be unsecured or collateralized by cash, loans, or securities. There was no short-term debt outstanding at March 31, 2011. At December 31, 2010, we had short-term debt outstanding of $44 million, which matured in the first quarter of 2011.

### 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. 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   Sequoia and Acacia

The majority of the liabilities reported on our consolidated balance sheets represent ABS issued by bankruptcy-remote entities sponsored by Redwood. Sequoia and Acacia assets are held in the custody of securitization trustees. 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

Acacia ABS issued are accounted for under the fair value option and carried at their estimated fair values. Changes in fair value (gains or losses) are reported in our consolidated statements of income through market valuation adjustments, net.

See *Note 11* for further discussion on ABS issued.

## Long-Term Debt

Long-term debt includes trust preferred securities and subordinated notes at Redwood and is carried at its unpaid principal balance. Our 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 12 for further discussion on long-term debt.

# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

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

### Equity

#### Accumulated Other Comprehensive Income

Net unrealized gains and losses on real estate securities available-for-sale and interest rate agreements previously designated as cash flow hedges are reported as components of accumulated other comprehensive income on our consolidated statements of equity and 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.

#### Noncontrolling Interest

Noncontrolling interest represents the aggregate limited partnership interests in the Fund held by third-parties. In accordance with GAAP, the noncontrolling interest of the Fund is shown as a component of equity on our consolidated balance sheets, and the portion of income allocable to third-parties is shown as net income (loss) attributable to noncontrolling interest in our consolidated statements of income. Equity attributable to noncontrolling interest is disclosed in our consolidated statements of equity and comprehensive income.

#### 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 applicable to common shareholders, less income allocated to participating securities (as described below). 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 equity awards.

Accounting guidance on EPS defines unvested share-based payment awards containing nonforfeitable rights to dividends as participating securities that are included in computing EPS using the two-class method. 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 to participating securities and common shares based on their respective rights to receive dividends.

See *Note 14* for further discussion on equity.

## Incentive Plans

In May 2010, our shareholders approved an amendment to our previously amended 2002 Redwood Trust, Inc. Incentive Plan (Incentive Plan) for executive officers, employees, and non-employee directors. The amendment provided 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 (including cash), stock appreciation rights, limited stock appreciation rights (awards), and dividend equivalent rights (DERs) to eligible recipients other than non-employee directors. These awards generally vest over a three- or four-year period. Non-employee directors are also provided annual awards under the Incentive Plan that generally vest immediately.

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

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

The cost of equity awards is determined in accordance with share-based payment accounting guidance and amortized over the vesting term using an accelerated method for equity awards granted prior to December 1, 2008. For equity awards granted after December 1, 2008, the cost of the awards is amortized over the vesting period on a straight-line basis. Timing differences between the accelerated and straight-line methods of amortization were determined to not be material to our financial statements.

### Employee Stock Purchase Plan

In May 2009, our stockholders approved an amendment to our 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 first 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 an asset on our consolidated balance sheet and subject to the claims of our general creditors. 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) contribution amount. 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 15* 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 determine whether we have any material unrecognized liabilities in accordance with FASB guidance on accounting for uncertainty in income taxes. We record these liabilities to the extent we deem them incurred. We classify interest and penalties on material uncertain tax positions as interest expense and operating expense, respectively, in our consolidated statements of income.

See *Note 17* for further discussion on taxes.

# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

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

### Recent Accounting Pronouncements

In April 2011, the FASB issued Accounting Standards Update (ASU) 2011-02, *A Creditor s Determination of Whether a Restructuring Is a Troubled Debt Restructuring*, which provides additional guidance to creditors for evaluating troubled debt restructurings. The amendments clarify the guidance in ASC 310-40, *Receivables: Troubled Debt Restructurings by Creditors*, which requires a creditor to classify a restructuring as a TDR if (1) the restructuring includes a concession by the creditor to the borrower and (2) the borrower is experiencing financial difficulties. The amended guidance requires a creditor to consider all aspects of the restructuring to determine whether it has granted a concession, and includes additional guidance to identify concessions, as well as indicators for determining whether the debtor is facing financial difficulties. The effective date of the amended guidance for public companies is the first interim or annual period beginning on or after June 15, 2011, and it requires companies to retrospectively evaluate all restructurings occurring on or after the beginning of the fiscal year of adoption to determine if the restructuring is a TDR.

In addition, ASU 2011-02 ended the public-entity deferral of TDR disclosures in ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses.* Public entities must begin providing TDR disclosures in the period they adopt ASU 2011-02. We are still evaluating the impact of ASU 2011-02 on our financial statements, but believe this will result in a larger percentage of our modified loans qualifying as TDRs. The increased disclosures required in ASU 2010-20 will not have an impact on our financial statements.

## Note 4. Principles of Consolidation

We apply FASB guidance to determine whether we must consolidate transferred financial assets and VIEs for financial reporting purposes. Specifically, 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 (e.g., certain legal entities often used in securitization and other structured finance transactions) should be included in our consolidated financial statements.

The tables below present our analysis of VIEs where we maintain an interest, as distinguished by those we have consolidated for financial reporting purposes and those we have not. The principles of consolidation 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 financial statements during subsequent reporting periods.

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2011
(Unaudited)

## Note 4. Principles of Consolidation (continued)

### Analysis of Consolidated VIEs

The VIEs we are required to consolidate include certain Sequoia securitization entities, the Acacia entities, and the Fund. 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 March 31, 2011

| (Dollars in thousands) | Sequoia Entities | Acacia Entities | The Fund | Total |
|---|---|---|---|---|
| Real estate loans | $ 3,740,892 | $ 19,953 | $ | $ 3,760,845 |
| Real estate securities | | 301,119 | 15,285 | 316,404 |
| Other investments | | | | |
| Other assets | 24,077 | 37,842 | 4,955 | 66,874 |
| Total Assets | $ 3,764,969 | $ 358,914 | $ 20,240 | $ 4,144,123 |
| Asset-backed securities | $ 3,646,342 | $ 310,952 | $ | $ 3,957,294 |
| Other liabilities | 3,605 | 64,477 | 2,417 | 70,499 |
| Total Liabilities | $ 3,649,947 | $ 375,429 | $ 2,417 | $ 4,027,793 |
| Noncontrolling interest | $ | $ | $ 7,040 | $ 7,040 |
| Number of VIEs | 38 | 10 | 1 | 49 |

We consolidate the assets and liabilities of certain Sequoia securitization entities issued prior to 2010, as we did not meet the sale criteria at the time we transferred financial assets to these entities. Had we not been the transferor and depositor of these securitizations, we would likely not have consolidated them as we determined that we are not the primary beneficiary of these entities in accordance with ASC 810-10. In April 2010 and March 2011, we sponsored residential prime jumbo mortgage securitizations through our Sequoia program of $238 million and $295 million, respectively. We recorded the assets and liabilities of these entities on our consolidated balance sheets, as we did not meet the sale criteria at the time we transferred financial assets to these entities. Additionally, we determined that we are the primary beneficiary of these VIEs as our ongoing loss mitigation and resolution responsibilities provide us with the power to direct the activities that most significantly impact the economic performance of these entities and our significant investment interests provide us with the obligation to absorb losses or the right to receive benefits that are significant.

We consolidate the assets and liabilities of the Acacia securitization entities, as we did not meet the sale criteria at the time we transferred financial assets to these entities and we are the primary beneficiary of these VIEs. Our ongoing asset management responsibilities and call options provide us with the power to direct the activities that most significantly impact the economic performance of these individual entities, and our equity investments in each entity provide us with the obligation to absorb losses or the right to receive benefits that are significant.

We consolidate the assets, liabilities, and noncontrolling interests of the Fund, as we determined that we are the primary beneficiary of this VIE. Our ongoing asset management responsibilities provide us with the power to direct the activities that most significantly impact the Fund s economic performance, and our general and limited partnership interests provide us with the obligation to absorb losses or the right to receive benefits that are significant.

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 4. Principles of Consolidation (continued)

### Analysis of Non-Consolidated VIEs

Third-party VIEs are securitization entities in 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 analysis is performed in consideration of all of our interests. The following table presents a summary of Redwood s interest in third-party VIEs at March 31, 2011, grouped by collateral type and ownership interest.

### Third-Party VIE Summary

| March 31, 2011<br>(Dollars in Thousands) | Fair<br>Value | Number<br>of VIEs |
|---|---|---|
| Real estate securities at Redwood | | |
| Residential | | |
| Senior | $ 622,818 | 93 |
| Re-REMIC | 85,497 | 7 |
| Subordinate | 71,435 | 185 |
| Commercial | 6,362 | 13 |
| CDO | 1,296 | 9 |
| Total Third-party Real Estate Securities | $ 787,408 | 307 |

We determined that we are not the primary beneficiary of any third-party residential, commercial, or CDO 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 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 each.

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 measure the fair value of the assets and liabilities. This hierarchy prioritizes relevant market inputs in order to determine an exit price , 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 at the date of measurement. Level 1 inputs are observable inputs that reflect quoted prices (unadjusted) 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 being 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 in which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement. Our assessment of the significance of a particular input requires judgment and considers factors specific to the asset or liability being measured.

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
# March 31, 2011
# (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 March 31, 2011 and December 31, 2010.

| (In Thousands) | March 31, 2011 Carrying Value | March 31, 2011 Fair Value | December 31, 2010 Carrying Value | December 31, 2010 Fair Value |
|---|---|---|---|---|
| Assets | | | | |
| Real estate loans (held-for-investment) | | | | |
| Unsecuritized loans | $ 95,508 | $ 95,627 | $ 283,618 | $ 283,939 |
| Securitized loans | 3,740,892 | 3,394,372 | 3,542,158 | 3,114,288 |
| Real estate loans (held-for-sale) | 1,845 | 1,845 | 1,855 | 1,855 |
| Commercial real estate loans (fair value) | 19,953 | 19,953 | 19,850 | 19,850 |
| Trading securities | 321,820 | 321,820 | 329,717 | 329,717 |
| Available-for-sale securities | 781,992 | 781,992 | 825,119 | 825,119 |
| Other investments | | | | |
| Cash and cash equivalents | 220,276 | 220,276 | 46,937 | 46,937 |
| Derivative assets | 5,698 | 5,698 | 8,051 | 8,051 |
| Restricted cash | 34,983 | 34,983 | 24,524 | 24,524 |
| Accrued interest receivable | 13,569 | 13,569 | 13,782 | 13,782 |
| REO (included in other assets) | 10,998 | 10,998 | 14,481 | 14,481 |
| Liabilities | | | | |
| Short-term debt | | | 44,137 | 44,137 |
| Accrued interest payable | 6,611 | 6,611 | 5,930 | 5,930 |
| Derivative liabilities | 70,157 | 70,157 | 83,115 | 83,115 |
| ABS issued | | | | |
| ABS issued Sequoia | 3,646,342 | 3,187,566 | 3,458,501 | 2,959,997 |
| ABS issued Acacia | 310,952 | 310,952 | 303,077 | 303,077 |
| Total ABS issued | 3,957,294 | 3,498,518 | 3,761,578 | 3,263,074 |
| Long-term debt | 139,500 | 80,910 | 139,500 | 75,330 |

We did not elect the fair value option for any financial instruments that we acquired in the first three months of 2011. We have elected the fair value option for all of the commercial loans, trading securities, and ABS issued at Acacia, as well as certain residential securities and CDOs at Redwood.

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

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

The following table presents assets and liabilities recorded at fair value on our consolidated balance sheet on a recurring basis and indicates the fair value hierarchy of the valuation techniques used to measure fair value.

### Assets and Liabilities Measured at Fair Value on a Recurring Basis at March 31, 2011

| March 31, 2011 (In Thousands) | Carrying Value | Fair Value Measurements Using Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| Assets | | | | |
| Commercial real estate loans | $ 19,953 | $ | $ | $ 19,953 |
| Trading securities | 321,820 | | | 321,820 |
| Available-for-sale securities | 781,992 | | | 781,992 |
| Derivative assets | 5,698 | 22 | 5,676 | |
| Liabilities | | | | |
| Derivative liabilities | 70,157 | 134 | 70,023 | |
| ABS issued Acacia | 310,952 | | | 310,952 |

The following table presents additional information about Level 3 assets and liabilities for the three months ended March 31, 2011.

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

| (In Thousands) | Assets Commercial Real Estate Loans | Trading Securities | AFS Securities | Derivative Assets | Liabilities ABS Issued Acacia |
|---|---|---|---|---|---|
| Beginning balance December 31, 2010 | $ 19,850 | $ 329,717 | $ 825,119 | $ 1 | $ 303,077 |
| Principal paydowns | (116 ) | (15,080 ) | (31,234 ) | | (19,473 ) |
| Gains in net income, net | 219 | 19,916 | 9,616 | | 24,137 |
| Gains in OCI, net | | | 9,358 | | |
| Acquisitions | | | 13,223 | | |

| | | | | | |
|---|---|---|---|---|---|
| Sales | | (12,841 ) | (44,116 ) | | |
| Other settlements, net | | 108 | 26 | (1 ) | 3,211 |
| Ending Balance March 31, 2011 | $ 19,953 | $ 321,820 | $ 781,992 | $ | $ 310,952 |

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (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 still held at March 31, 2011 and 2010. Gains or losses incurred on assets or liabilities sold, matured, called, or fully written down during the three months ended March 31, 2011 and 2010 are not included in this presentation.

### Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at March 31, 2011 and 2010 Included in Net Income

| | Included in Net Income Three Months Ended March 31, | |
|---|---|---|
| (In Thousands) | 2011 | 2010 |
| Assets | | |
| Real estate loans | $ 219 | $ 4,366 |
| Trading securities | 10,366 | 12,281 |
| Available-for-sale securities | (2,622 ) | (1,946 ) |
| Derivative assets | | (20 ) |
| Liabilities | | |
| Derivative liabilities | | 186 |
| ABS issued Acacia | (24,137 ) | (5,253 ) |

The following table presents information on assets and liabilities recorded at fair value on a non-recurring basis at March 31, 2011.

### Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis at March 31, 2011

| March 31, 2011 (In Thousands) | Carrying Value | Fair Value Measurements Using Level 1 | Level 2 | Level 3 | Gain (Loss) Three Months Ended March 31, 2011 |
|---|---|---|---|---|---|
| Assets | | | | | |
| Real estate loans (held-for-sale) | $ 1,845 | $ | $ | $ 1,845 | $ 31 |

| | | | |
|---|---|---|---|
| REO | 10,998 | 10,998 | (918 ) |

The following table presents the components of market valuation adjustments, net, recorded in our consolidated statements of income for the three months ended March 31, 2011 and 2010.

## Market Valuation Adjustments, Net

| | Three Months Ended March 31, | |
|---|---|---|
| (In Thousands) | 2011 | 2010 |
| Assets | | |
| Real estate loans (fair value) | $ 219 | $ 4,366 |
| Real estate loans (held-for-sale) | 3 | (120 ) |
| Trading securities | 19,916 | 12,149 |
| REO | (918 ) | (74 ) |
| Impairments on AFS securities | (2,622 ) | (1,946 ) |
| Liabilities | | |
| ABS issued Acacia | (24,137 ) | (5,253 ) |
| Derivative instruments, net | 1,799 | (20,359 ) |
| Market Valuation Adjustments, Net | $ (5,740 ) | $ (11,237 ) |

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

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

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 below.

Real estate loans

Residential real estate loan fair values are determined by available market quotes and discounted cash flow analyses (Level 3).

Commercial real estate loan fair values are determined by available market quotes and discounted cash flow analyses (Level 3). The availability of market quotes for all of our commercial loans is limited. Any changes in fair value are primarily a result of instrument specific credit risk.

Real estate securities

Real estate securities are residential, commercial, CDO, and other asset-backed securities that are illiquid in nature and trade infrequently. Fair values are determined by discounted cash flow analyses and other valuation techniques using market pricing assumptions that are confirmed by third-party dealer/pricing indications, to the extent available. 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 in the analyses include bid/ask spreads, credit losses, interest rates, and prepayment speeds. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3).

We request and consider indications of value (marks) from third-party dealers to assist us in our valuation process. For March 31, 2011, we received dealer marks on 80% of our securities. In the aggregate, our internal valuations of the securities on which we received dealer marks were 2% lower (i.e., more conservative) than the aggregate dealer marks.

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

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.

Restricted cash

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

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

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

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.

Short-term debt

Short-term debt includes our credit facilities that mature within one year. Short-term debt is generally at an adjustable rate. Fair values approximate carrying values.

ABS issued

ABS issued includes asset-backed securities issued through our Sequoia and Acacia programs. These instruments are illiquid in nature and trade infrequently, if at all. Fair values are determined by discounted cash flow analyses and other valuation techniques using market pricing assumptions that are confirmed by third-party dealer/pricing indications, to the extent available. Significant inputs in the valuation analysis are predominantly Level 3, due to the nature of these instruments and the lack of readily available market quotes. 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 and collateral prepayment speeds. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3).

We request and consider indications of value (marks) from third-party dealers to assist us in our valuation process. For March 31, 2011, we received dealer marks on 86% of our ABS issued. Our internal valuations of our ABS issued on which we received dealer marks were 7% higher (i.e., more conservative) than the aggregate dealer marks.

Long-term debt

Long-term debt includes our subordinated notes and trust preferred securities. Fair values are determined using comparable market indicators of current pricing. 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).

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).

## Note 6. Real Estate Loans

We invest in residential real estate loans that we acquire from third-party originators and commercial loans that we originate or acquire from third-party originators. These loans are financed through the Sequoia and Acacia entities that we sponsor or with equity and long-term debt. We do not service any residential loans. Commercial loans originated by our subsidiary, Redwood Commercial Mortgage Company, in 2010 and 2011 and held-for-investment are currently serviced by us.

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 6. Real Estate Loans (continued)

The following table summarizes the classifications and carrying value of the residential and commercial real estate loans recorded on our consolidated balance sheets at March 31, 2011 and December 31, 2010.

| March 31, 2011 (In Thousands) | Redwood | Sequoia | Acacia | Total Loans |
|---|---|---|---|---|
| Residential real estate loans | | | | |
| Held-for-sale | $ 1,845 | $ | $ | $ 1,845 |
| Held-for-investment | 53,025 | 3,740,892 | | 3,793,917 |
| Commercial real estate loans | | | | |
| Fair value | | | 19,953 | 19,953 |
| Held-for-investment | 42,483 | | | 42,483 |
| Total Real Estate Loans | $ 97,353 | $ 3,740,892 | $ 19,953 | $ 3,858,198 |

| December 31, 2010 (In Thousands) | Redwood | Sequoia | Acacia | Total Loans |
|---|---|---|---|---|
| Residential real estate loans | | | | |
| Held-for-sale | $ 1,855 | $ | $ | $ 1,855 |
| Held-for-investment | 253,081 | 3,542,159 | | 3,795,240 |
| Commercial real estate loans | | | | |
| Fair value | | | 19,850 | 19,850 |
| Held-for-investment | 30,536 | | | 30,536 |
| Total Real Estate Loans | $ 285,472 | $ 3,542,159 | $ 19,850 | $ 3,847,481 |

### Residential Real Estate Loans Held-for-Sale

Residential real estate loans held-for-sale are owned at Redwood and financed with equity and long-term debt. At both March 31, 2011 and December 31, 2010, there were eleven residential loans held-for-sale with $3 million in outstanding principal value and a lower of cost or fair value of $2 million.

### Residential Real Estate Loans Held-for-Investment

In March 2011, we sponsored a $295 million residential prime mortgage securitization through our Sequoia program. At March 31, 2011, the loans owned by this Sequoia entity had an outstanding principal value of $291 million. During the three months ended March 31, 2011, we purchased $101 million of prime quality residential loans in conjunction with our Sequoia securitization program.

The following table provides additional information on residential real estate loans held-for-investment at March 31, 2011 and December 31, 2010.

| (In Thousands) | March 31, 2011 | December 31, 2010 |
|---|---|---|
| Principal value | $3,816,321 | $3,815,273 |
| Unamortized premium, net | 40,518 | 42,399 |
| Recorded investment | 3,856,839 | 3,857,672 |
| Allowance for loan losses | (62,922 ) | (62,432 ) |
| Carrying Value | $3,793,917 | $3,795,240 |

Of the $3.8 billion of principal value and $41 million of unamortized premium on loans held-for-investment at March 31, 2011, $1.6 billion of principal value and $26 million of unamortized premium relates to residential loans acquired prior to July 1, 2004. During the first three months of 2011, 2% of these residential loans prepaid and we amortized 5% of the premium based upon the accounting elections

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 6. Real Estate Loans (continued)

we apply. For residential loans acquired after July 1, 2004, the principal value was $2.2 billion and the unamortized premium was $14 million. During the first three months of 2011, 3% of these loans prepaid and we amortized 3% of the premium.

Of the $3.8 billion of principal value and $42 million of unamortized premium on loans held-for-investment at December 31, 2010, $1.7 billion of principal value and $28 million of unamortized premium relates to residential loans acquired prior to July 1, 2004. For residential loans acquired after July 1, 2004, the principal value was $2.1 billion and the unamortized premium was $15 million.

### Commercial Real Estate Loans at Fair Value

Commercial real estate loans at fair value are owned at the consolidated Acacia securitization entities. At both March 31, 2011 and December 31, 2010, there were four commercial real estate loans at fair value with an aggregate outstanding principal value of $23 million and an aggregate fair value of $20 million.

### Commercial Real Estate Loans Held-for-Investment

During the three months ended March 31, 2011, we originated or acquired two commercial real estate loans with an outstanding principal balance of $12 million. At March 31, 2011, there were six commercial real estate loans held-for-investment (one of which was purchased prior to 2010) with an outstanding principal value of $43 million and a carrying value of $42 million. At December 31, 2010, there were four commercial real estate loans held-for-investment with an outstanding principal value and carrying value of $31 million.

## Note 7. Allowance for Loan Losses

We establish an allowance for loan losses on our residential and commercial loans held-for-investment based on our estimate of losses incurred in these portfolios. The allowance includes a component for loans collectively evaluated for impairment that includes pools of residential loans owned at Sequoia securitization entities, and a component for loans individually evaluated for impairment that includes modified residential loans where it has been determined a concession has been granted, and commercial loans.

We collectively evaluate most of our residential loans for impairment based on the characteristics of the loan pools underlying the securitization entities that own the loans. These characteristics, which include loan product types, credit characteristics, and origination years, are what management primarily uses to establish the allowance for loan losses for residential loans. 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.

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 7. Allowance for Loan Losses (continued)

### Activity in the Allowance for Losses on Residential Loans

The following table summarizes the activity in the allowance for loan losses for the three months ended March 31, 2011 and 2010.

| (In Thousands) | Three Months Ended March 31, 2011 | 2010 |
|---|---|---|
| Balance at beginning of period | $ 62,432 | $ 54,220 |
| Charge-offs, net | (2,317 ) | (2,526 ) |
| Provision for loan losses | 2,807 | 9,475 |
| Balance at End of Period | $ 62,922 | $ 61,169 |

During the three months ended March 31, 2011 and 2010, there were $2 million and $3 million of charge-offs, respectively, in our residential loan portfolio that reduced our allowance for loan losses. These charge-offs arose from $8 million and $9 million of defaulted loan principal, respectively. As of March 31, 2011 and December 31, 2010, we did not record any interest income on individually impaired loans.

### Loans Collectively Evaluated for Impairment

The following table summarizes the balances for loans collectively evaluated for impairment at March 31, 2011 and December 31, 2010.

| (In Thousands) | March 31, 2011 | December 31, 2010 |
|---|---|---|
| Unpaid principal balance | $ 3,803,837 | $ 3,801,921 |
| Recorded investment | 3,844,408 | 3,844,372 |
| Related allowance | 58,538 | 57,804 |

### Residential Loans Collectively Evaluated for Impairment Past Due

The following table shows the recorded investment in residential loans collectively evaluated for impairment past due at March 31, 2011 and December 31, 2010.

| (In Thousands) | 30 59 Days Past Due | 60 89 Days Past Due | 90+ Days Past Due | Total Past Due | Current Loans | Total Loans |
|---|---|---|---|---|---|---|
| March 31, 2011 | $ 70,777 | $ 21,382 | $ 136,067 | $ 228,226 | $ 3,616,182 | $ 3,844,408 |
| December 31, 2010 | 65,708 | 21,674 | 133,695 | 221,077 | 3,623,295 | 3,844,372 |

## Loans Individually Evaluated for Impairment

The following table summarizes the balances for loans individually evaluated for impairment at March 31, 2011 and December 31, 2010. Individually impaired loans include TDRs where we have determined a concession has been granted.

| (In Thousands) | March 31, 2011 | December 31, 2010 |
|---|---|---|
| Unpaid principal balance | $ 12,484 | $ 13,352 |
| Recorded investment | 12,431 | 13,300 |
| Related allowance | 4,384 | 4,628 |
| Average recorded investment for the three months ended | 12,634 | 13,014 |

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 7. Allowance for Loan Losses (continued)

### Residential Loans Individually Evaluated for Impairment Past Due

The following table shows the recorded investment in individually impaired loans past due at March 31, 2011 and December 31, 2010.

| (In Thousands) | 30 59 Days Past Due | 60 89 Days Past Due | 90+ Days Past Due | Total Past Due | Current Loans | Total Loans |
|---|---|---|---|---|---|---|
| March 31, 2011 | $ 2,278 | $ | $ 808 | $ 3,086 | $ 9,345 | $ 12,431 |
| December 31, 2010 | 2,604 | | 1,046 | 3,650 | 9,650 | 13,300 |

### Credit Quality of Residential Loans Held-for-Investment

We invest primarily in prime quality residential loans in conjunction with our Sequoia securitization program. As a percent of total recorded investment, 99% of residential loans held-for-investment on our balance sheet at March 31, 2011, were first lien, prime quality loans. The remaining 1% of loans at March 31, 2011 were second lien, prime quality, home equity lines of credit. The weighted average original loan-to-value (LTV) and weighted average original Fair Isaac Corporation (FICO) score for our residential loans held-for-investment outstanding at March 31, 2011, was 66% and 735, respectively. Due to the uniform product and credit characteristics of our residential loans, an indicator of credit performance is loan origination vintage.

The following table displays the recorded investment and year of origination for residential loans recorded on our consolidated balance sheets at March 31, 2011 and December 31, 2010.

| (In Thousands) | March 31, 2011 | December 31, 2010 |
|---|---|---|
| 2003 & Earlier | $ 1,897,768 | $ 1,939,618 |
| 2004 | 1,100,306 | 1,116,358 |
| 2005 | 135,928 | 136,481 |
| 2006 | 190,153 | 191,945 |
| 2007 | 71,331 | 75,136 |
| 2008 | | |
| 2009 | 182,690 | 189,355 |
| 2010 | 263,178 | 208,779 |

| | | |
|---|---|---|
| 2011 | 15,485 | |
| Total Principal | $ 3,856,839 | $ 3,857,672 |

## Allowance for Loan Losses on Commercial Loans

For commercial real estate loans classified as held-for-investment, we establish and maintain an allowance for loan losses on an individual basis for those loans we have determined to be impaired as of the reporting date. At March 31, 2011 and December 31, 2010, there were no commercial loans impaired.

Of the $42 million of recorded investment in commercial loans held-for-investment at March 31, 2011, 28% were originated during the first quarter of 2011, 71% were originated in the fourth quarter of 2010, and 1% were originated in 2004. Of the $31 million of recorded investment in commercial loans held-for-investment at December 31, 2010, 99% were originated in the fourth quarter of 2010 and 1% were originated in 2004.

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 8. Real Estate Securities

We invest in third-party residential, commercial, and CDO securities. The following table presents the fair values of our real estate securities by collateral type and entity at March 31, 2011 and December 31, 2010.

| March 31, 2011 (In Thousands) | Redwood | The Fund | Acacia | Total Securities |
|---|---|---|---|---|
| Residential | $ 779,750 | $ 14,648 | $ 240,124 | $ 1,034,522 |
| Commercial | 6,362 | | 44,557 | 50,919 |
| CDO | 1,296 | 637 | 16,438 | 18,371 |
| Total Real Estate Securities | $ 787,408 | $ 15,285 | $ 301,119 | $ 1,103,812 |

| December 31, 2010 (In Thousands) | Redwood | The Fund | Acacia | Total Securities |
|---|---|---|---|---|
| Residential | $ 814,683 | $ 19,011 | $ 248,494 | $ 1,082,188 |
| Commercial | 7,496 | | 43,828 | 51,324 |
| CDO | 1,038 | 4,245 | 16,041 | 21,324 |
| Total Real Estate Securities | $ 823,217 | $ 23,256 | $ 308,363 | $ 1,154,836 |

At March 31, 2011, there were $3 million of residential securities that had 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.

The following table presents our securities by accounting classification, collateral type, and ownership entity at March 31, 2011 and December 31, 2010.

| March 31, 2011 | Trading | | | AFS | | |
|---|---|---|---|---|---|---|
| (In Thousands) | Redwood | Acacia | Total | Redwood | The Fund | Total |
| Senior Securities | | | | | | |
| Residential prime | $ | $ 4,259 | $ 4,259 | $ 306,192 | $ | $ 306,192 |
| Residential non-prime | 18,868 | 115,427 | 134,295 | 297,758 | 11,683 | 309,441 |
| Commercial | | 11,234 | 11,234 | | | |
| Total Senior Securities | 18,868 | 130,920 | 149,788 | 603,950 | 11,683 | 615,633 |
| Re-REMIC Securities | | | | 85,497 | | 85,497 |
| Subordinate Securities | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Residential prime | 369 | 47,387 | 47,756 | 58,870 | | 58,870 |
| Residential non-prime | 168 | 73,051 | 73,219 | 12,028 | 2,965 | 14,993 |
| Commercial | | 33,323 | 33,323 | 6,362 | | 6,362 |
| CDO | 1,296 | 16,438 | 17,734 | | 637 | 637 |
| Total Subordinate Securities | 1,833 | 170,199 | 172,032 | 77,260 | 3,602 | 80,862 |
| Total Real Estate Securities | $ 20,701 | $ 301,119 | $ 321,820 | $ 766,707 | $ 15,285 | $ 781,992 |

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 8. Real Estate Securities (continued)

| December 31, 2010 | Trading | | | AFS | | |
|---|---|---|---|---|---|---|
| (In Thousands) | Redwood | Acacia | Total | Redwood | The Fund | Total |
| Senior Securities | | | | | | |
| Residential prime | $ | $ 4,412 | $ 4,412 | $ 315,891 | $ | $ 315,891 |
| Residential non-prime | 19,742 | 117,623 | 137,365 | 326,365 | 12,915 | 339,280 |
| Commercial | | 11,000 | 11,000 | | | |
| Total Senior Securities | 19,742 | 133,035 | 152,777 | 642,256 | 12,915 | 655,171 |
| Re-REMIC Securities | | | | 85,077 | | 85,077 |
| Subordinate Securities | | | | | | |
| Residential prime | 386 | 49,620 | 50,006 | 53,846 | | 53,846 |
| Residential non-prime | 188 | 76,839 | 77,027 | 13,188 | 6,096 | 19,284 |
| Commercial | | 32,828 | 32,828 | 7,496 | | 7,496 |
| CDO | 1,038 | 16,041 | 17,079 | | 4,245 | 4,245 |
| Total Subordinate Securities | 1,612 | 175,328 | 176,940 | 74,530 | 10,341 | 84,871 |
| Total Real Estate Securities | $ 21,354 | $ 308,363 | $ 329,717 | $ 801,863 | $ 23,256 | $ 825,119 |

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.

For purposes of the table above, the prime or non-prime designation used to categorize our residential securities is 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 LTV ratios, and are made to borrowers with higher FICO scores. Non-prime residential loans are generally characterized by higher LTV ratios and may have been made to borrowers with lower credit scores or impaired credit histories (while exhibiting the ability to repay their loans). Regardless of whether or not the loans backing a mortgage-backed 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.

We elected the fair value option for certain securities at Redwood and the Acacia entities, now classified as trading securities. The unpaid principal balance of these trading securities was $1.4 billion and $2.1 billion at March 31, 2011 and December 31, 2010, respectively.

## AFS Securities

We often purchase AFS securities at a discount to their par principal values. To the extent we purchase an AFS security that has a likelihood of incurring a loss, we generally 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 the amount of principal face that we do not expect to receive and will not amortize into income as a credit reserve on the security, with any remaining net unamortized discounts or premiums amortized into income over time using the interest method.

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 8. Real Estate Securities (continued)

The following table presents the components of carrying value (which equals fair value) of AFS securities at March 31, 2011 and December 31, 2010.

| March 31, 2011<br>(In Thousands) | Residential | Commercial | CDO | Total |
|---|---|---|---|---|
| Current face | $1,169,378 | $74,782 | $30,587 | $1,274,747 |
| Credit reserve | (280,478 ) | (64,717 ) | (29,505) | (374,700 ) |
| Net unamortized discount | (259,469 ) | (4,784 ) | (520 ) | (264,773 ) |
| Amortized cost | 629,431 | 5,281 | 562 | 635,274 |
| Gross unrealized gains | 152,535 | 1,765 | 75 | 154,375 |
| Gross unrealized losses | (6,973 ) | (684 ) | | (7,657 ) |
| Carrying Value | $774,993 | $6,362 | $637 | $781,992 |

| December 31, 2010<br>(In Thousands) | Residential | Commercial | CDO | Total |
|---|---|---|---|---|
| Current face | $1,257,601 | $89,103 | $89,476 | $1,436,180 |
| Credit reserve | (297,849 ) | (76,979 ) | (88,394) | (463,222 ) |
| Net unamortized (discount) premium | (291,093 ) | (5,591 ) | 11,485 | (285,199 ) |
| Amortized cost | 668,659 | 6,533 | 12,567 | 687,759 |
| Gross unrealized gains | 153,125 | 1,604 | | 154,729 |
| Gross unrealized losses | (8,406 ) | (641 ) | (8,322 ) | (17,369 ) |
| Carrying Value | $813,378 | $7,496 | $4,245 | $825,119 |

The following table presents the changes for the three months ended March 31, 2011, of the unamortized discount and designated credit reserves on AFS securities.

### Changes in Unamortized Discount and Designated Credit Reserves on AFS Securities

| | Residential | | Commercial | | CDO | |
|---|---|---|---|---|---|---|
| Three Months Ended March 31, 2011<br>(In Thousands) | Credit Reserve | Unamortized Discount Net | Credit Reserve | Unamortized Discount Net | Credit Reserve | Unamortized Discount Net |

| | | | | | | |
|---|---|---|---|---|---|---|
| Beginning balance December 31, 2010 | $297,849 | $291,093 | $76,979 | $5,591 | $88,394 | $(11,485) |
| Amortization of net discount | | (11,967) | | (36) | | (103) |
| Realized credit losses | (22,174) | | (9,297) | | (3,005) | |
| Acquisitions | 1,148 | 2,489 | | | | |
| Sales, calls, other | (8,645) | (11,553) | (2,653) | (1,439) | (55,911) | 11,575 |
| Impairments | 1,707 | | 356 | | 560 | |
| Transfers to (release of) credit reserves | 10,593 | (10,593) | (668) | 668 | (533) | 533 |
| Ending Balance March 31, 2011 | $280,478 | $259,469 | $64,717 | $4,784 | $29,505 | $520 |

The loans underlying our residential subordinate securities totaled $36 billion at March 31, 2011. These loans are located nationwide with a large concentration in California (44%). Serious delinquencies (90+ days, in foreclosure or REO) at March 31, 2011 were 7.12% of current principal balances. The loans underlying our commercial subordinate securities totaled $20 billion at March 31, 2011, and consist primarily of office (31%),

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 8. Real Estate Securities (continued)

retail (35%), and multifamily (12%) loans. These loans are located nationwide with the highest concentration in California (15%). Serious delinquencies (60+ days, in foreclosure or REO) at March 31, 2011 were 5.9% of current principal balances.

### AFS Securities with Unrealized Losses

The following table presents the components comprising the carrying value of AFS securities that were in an unrealized loss position at March 31, 2011 and December, 31 2010.

| March 31, 2011 (In Thousands) | Less Than 12 Consecutive Months | | | 12 Consecutive Months or Longer | | |
|---|---|---|---|---|---|---|
| | Total Amortized Cost | Gross Unrealized Losses | Total Fair Value | Total Amortized Cost | Gross Unrealized Losses | Total Fair Value |
| Residential | $ 29,454 | $ (197 ) | $ 29,257 | $ 64,760 | $ (6,776 ) | $ 57,984 |
| Commercial | 953 | (165 ) | 788 | 1,751 | (519 ) | 1,232 |
| CDO | | | | | | |
| Total Securities | $ 30,407 | $ (362 ) | $ 30,045 | $ 66,511 | $ (7,295 ) | $ 59,216 |

| December 31, 2010 (In Thousands) | Less Than 12 Consecutive Months | | | 12 Consecutive Months or Longer | | |
|---|---|---|---|---|---|---|
| | Total Amortized Cost | Gross Unrealized Losses | Total Fair Value | Total Amortized Cost | Gross Unrealized Losses | Total Fair Value |
| Residential | $ 104,154 | $ (1,628 ) | $ 102,526 | $ 26,374 | $ (6,778 ) | $ 19,596 |
| Commercial | 2,134 | (257 ) | 1,877 | 1,728 | (384 ) | 1,344 |
| CDO | | | | 12,567 | (8,322 ) | 4,245 |
| Total Securities | $ 106,288 | $ (1,885 ) | $ 104,403 | $ 40,669 | $ (15,484 ) | $ 25,185 |

At March 31, 2011, after giving effect to purchases, sales, and extinguishments due to credit losses, our consolidated balance sheet included 482 AFS securities, of which 48 were in an unrealized loss position and 29 were in a continuous unrealized loss position for twelve consecutive months or longer. At December 31, 2010, our consolidated balance sheet included 509 AFS securities, of which 80 were in a continuous unrealized loss position, of which 46 were in a continuous unrealized loss position for twelve consecutive months or longer.

Of the total unrealized losses at March 31, 2011, none related to securities owned at the Fund. At December 31, 2010, $10 million of unrealized losses related to securities owned at the Fund and the remaining unrealized losses related to securities owned at Redwood.

## 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 March 31, 2011.

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 8. Real Estate Securities (continued)

### Significant Valuation Assumptions

| | Range for Securities | | |
|---|---|---|---|
| March 31, 2011 | Prime | Non-prime | Commercial |
| Prepayment rates | 4 15 % | 1 15 % | N/A |
| Loss severity[(1)] | 12 61 % | 23 59 % | 33 50 % |
| Projected losses[(1)] | 0 25 % | 1 67 % | 2 14 % |

(1) Projected losses and severities are generally vintage specific, with the 2005 and later vintage securities having higher projected losses and severities and the 2004 and earlier vintages having lower projected losses and severities.

The following table details the components of OTTI for the three months ended March 31, 2011 and 2010.

### Components of Other-than-Temporary Impairments

| | Three Months Ended March 31, | |
|---|---|---|
| (In Thousands) | 2011 | 2010 |
| Securities with a non-credit component of OTTI | | |
| Initial credit impairment | $ 14 | $ 90 |
| Subsequent credit impairment | 181 | 1,296 |
| Securities without a non-credit component of OTTI | 2,427 | 560 |
| Total credit OTTI | 2,622 | 1,946 |
| Non-credit component of OTTI | 690 | 1,669 |
| Total OTTI | $ 3,312 | $ 3,615 |

The credit component of OTTI is recognized through our consolidated statement of income as a component of market valuation adjustments, net, while the non-credit component of OTTI is to 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 March 31, 2011 and 2010.

## Activity of Credit Component of Other-than-Temporary Impairments

| (In Thousands) | Three Months Ended March 31, 2011 | 2010 |
|---|---|---|
| Balance at beginning of period | $ 121,016 | $ 146,455 |
| Additions | | |
| Initial credit impairments | 14 | 90 |
| Subsequent credit impairments | 181 | 1,296 |
| Reductions | | |
| Securities sold, or intent to sell | (12,317 ) | |
| Securities matured, called, or fully written down | (7,946 ) | (4,724 ) |
| Balance at End of Period | $ 100,948 | $ 143,117 |

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 8. Real Estate Securities (continued)

The credit component is reduced if we sell, intend to sell, or believe we will be required to sell previously credit-impaired debt securities. Additionally, the credit loss component 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 is fully written down.

### Gross Realized Gains and Losses

Gains and losses from the sale of AFS securities are recorded as realized gains on sales and calls, 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 months ended March 31, 2011 and 2010.

| | Three Months Ended March 31, | |
|---|---|---|
| (In Thousands) | 2011 | 2010 |
| Gross realized gains sales | $ 7,313 | $ 38,854 |
| Gross realized gains calls | 132 | |
| Gross realized losses sales | (3,358 ) | (1,475 ) |
| Gross realized losses calls | (223 ) | |
| Total Realized Gains on Sales and Calls of AFS Securities, net | $ 3,864 | $ 37,379 |

## Note 9. Derivative Financial Instruments

The following table presents the aggregate fair value and notional amount of derivative financial instruments held by Redwood and the consolidated Acacia entities at March 31, 2011 and December 31, 2010. The derivatives held at Acacia entities are not obligations of Redwood.

| March 31, 2011<br>(In Thousands) | Redwood<br>Fair<br>Value | Notional<br>Amount | Acacia<br>Fair<br>Value | Notional<br>Amount | Total<br>Fair<br>Value | Notional<br>Amount |
|---|---|---|---|---|---|---|
| Assets Risk Management Derivatives | | | | | | |
| Interest rate swaps | $286 | $49,000 | $730 | $5,811 | $1,016 | $54,811 |
| TBAs | 22 | 14,000 | | | 22 | 14,000 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Interest rate caps purchased | | | 4,660 | 705,400 | 4,660 | 705,400 |
| Total Assets | 308 | 63,000 | 5,390 | 711,211 | 5,698 | 774,211 |
| Liabilities Cash Flow Hedges | | | | | | |
| Interest rate swaps | (7,640) | 155,500 | | | (7,640 ) | 155,500 |
| Liabilities Risk Management Derivatives | | | | | | |
| Interest rate swaps | (1,231) | 26,000 | (61,152) | 627,521 | (62,383) | 653,521 |
| TBAs | (134 ) | 45,000 | | | (134 ) | 45,000 |
| Total Liabilities | (9,005) | 226,500 | (61,152) | 627,521 | (70,157) | 854,021 |
| Total Derivative Financial Instruments, net | $(8,697) | $289,500 | $(55,762) | $1,338,732 | $(64,459) | $1,628,232 |

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 9. Derivative Financial Instruments (continued)

| December 31, 2010 (In Thousands) | Redwood Fair Value | Notional Amount | Acacia Fair Value | Notional Amount | Total Fair Value | Notional Amount |
|---|---|---|---|---|---|---|
| Assets Risk Management Derivatives | | | | | | |
| Interest rate swaps | $175 | $44,000 | $813 | $18,037 | $988 | $62,037 |
| TBAs | 348 | 35,000 | | | 348 | 35,000 |
| Futures | 703 | 433,000 | | | 703 | 433,000 |
| Interest rate caps purchased | | | 6,012 | 703,400 | 6,012 | 703,400 |
| Total Assets | 1,226 | 512,000 | 6,825 | 721,437 | 8,051 | 1,233,437 |
| Liabilities Cash Flow Hedges | | | | | | |
| Interest rate swaps | (11,449) | 155,500 | | | (11,449) | 155,500 |
| Liabilities Risk Management Derivatives | | | | | | |
| Interest rate swaps | (1,283) | 26,000 | (69,373) | 663,604 | (70,656) | 689,604 |
| TBAs | (951) | 124,000 | | | (951) | 124,000 |
| Futures | (59) | 225,000 | | | (59) | 225,000 |
| Total Liabilities | (13,742) | 530,500 | (69,373) | 663,604 | (83,115) | 1,194,104 |
| Total Derivative Financial Instruments, net | $(12,516) | $1,042,500 | $(62,548) | $1,385,041 | $(75,064) | $2,427,541 |

## Risk Management Derivatives

To offset to varying degrees the changes in the value of mortgage products to which we have exposure, we may enter into interest rate agreements, TBA contracts, and financial futures contracts. We account for our risk management derivatives as trading instruments, and record any changes in value (including any associated interest income or expense) in our consolidated statements of income through market valuation adjustments, net.

### Risks Related to Unsecuritized Loans at Redwood

In order to manage risks associated with residential loans we own or plan to acquire and securitize, at March 31, 2011, we were party to interest rate agreements with an aggregate notional amount of $75 million, and TBA contracts sold with a notional amount of $59 million. Net positive market valuation adjustments on these derivatives were $3 million for the three months ended March 31, 2011.

### Risks Related to Liabilities at Acacia Entities

Net valuation adjustments on interest rate agreements at Acacia were negative $1 million and negative $20 million for the three months ended March 31, 2011 and 2010, 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, we entered into interest rate swaps during 2010 with an aggregate notional balance of $156 million. We designated these derivatives as cash flow hedges. For the three months ended March 31, 2011, these hedges increased in value by $4 million, which was recorded as an increase to accumulated other comprehensive income, a component of equity.

# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2011
(Unaudited)

## Note 9. Derivative Financial Instruments (continued)

For interest rate agreements currently or previously designated as cash flow hedges, our total unrealized loss reported in accumulated other comprehensive income was negative $24 million at March 31, 2011, and negative $29 million at December 31, 2010. For the three months ended March 31, 2011 and 2010 we reclassified $1 million and less than $1 million, respectively, of unrealized losses on derivatives to interest expense.

The following table illustrates the impact on interest income (expense) of our interest rate agreements accounted for as cash flow hedges for the three months ended March 31, 2011 and 2010.

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

| | Three Months Ended March 31, | |
|---|---|---|
| (In Thousands) | 2011 | 2010 |
| Net interest expense on cash flow interest rate agreements | $ (1,538 ) | $ |
| Realized net expense due to net ineffective portion of hedges | (1 ) | |
| Realized net losses reclassified from other comprehensive loss | (1,064 ) | (495 ) |
| Total Interest Expense | $ (2,603 ) | $ (495 ) |

### Credit Derivatives

At March 31, 2011 and December 31, 2010, we had no outstanding CDS contracts or obligations. During the three months ended March 31, 2010, the reference securities underlying our CDS experienced principal losses, and corresponding obligations, of $10 million.

### 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. To mitigate this risk, we enter into agreements that are either a) transacted on a national exchange or b) transacted with counterparties that are either i) designated by the Federal Reserve Bank of New York as a primary government dealer, ii) affiliates of primary government dealers, or iii) rated A or higher. 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 March 31, 2011, Redwood had outstanding derivative agreements with seven bank counterparties and Acacia entities had outstanding derivative agreements with five bank counterparties. At March 31, 2011, Redwood and the Acacia entities were in compliance with International Swaps and Derivatives Association (ISDA) agreements governing these open derivative positions.

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 10. Other Assets

Other assets at March 31, 2011 and December 31, 2010, are summarized in the following table.

### Other Assets

| (In Thousands) | March 31, 2011 | December 31, 2010 |
|---|---|---|
| REO | $ 10,998 | $ 14,481 |
| Fixed assets and leasehold improvements | 3,434 | 3,692 |
| Derivative margin posted, net | 12,751 | 16,233 |
| Investment receivable | 6,227 | 883 |
| Income tax receivables | 1,243 | 1,243 |
| Prepaid expenses | 1,419 | 1,973 |
| Other | 159 | 157 |
| Total Other Assets | $ 36,231 | $ 38,662 |

REO consists of foreclosed properties received in full satisfaction of defaulted real estate loans. The carrying value of REO at March 31, 2011 was $11 million, which includes the net effect of $2 million related to transfers into REO during the first three months of 2011, offset by $5 million of REO liquidations and less than $1 million of negative market valuation adjustments. At March 31, 2011, there were 77 REO properties recorded on our balance sheet, of which 75 were owned at Sequoia and two were owned at Redwood. At December 31, 2010, there were 83 REO properties recorded on our balance sheet, of which 81 were owned at Sequoia and two were owned at Redwood. Properties located in Arizona, California, Colorado, Florida, and Georgia accounted for 52% of our REO properties at March 31, 2011.

Derivative margin posted, net, was $13 million at March 31, 2011, resulting from margin calls from our swap counterparties requiring Redwood to post collateral.

## Note 11. Asset-Backed Securities Issued

The Sequoia and Acacia securitization entities issue ABS to acquire assets from us and from third-parties. Each series of ABS issued consists of various classes 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 include 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.

In March 2011, Redwood securitized $295 million of loans through our Sequoia program, with $281 million of ABS issued to third-parties.

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 11. Asset-Backed Securities Issued (continued)

The components of ABS issued by consolidated securitization entities we sponsored at March 31, 2011 and December 31, 2010, along with other selected information, are summarized in the following table.

### Asset-Backed Securities Issued

| | March 31, 2011 | | | December 31, 2010 | | |
|---|---|---|---|---|---|---|
| (In Thousands) | Sequoia | Acacia | Total | Sequoia | Acacia | Total |
| Certificates with principal value | $3,635,125 | $2,939,248 | $6,574,373 | $3,445,882 | $2,956,657 | $6,402,539 |
| Interest-only certificates | 10,629 | | 10,629 | 15,587 | | 15,587 |
| Unamortized premium | 1,592 | | 1,592 | 1,726 | | 1,726 |
| Unamortized discount | (1,004) | | (1,004) | (4,694) | | (4,694) |
| Fair value adjustment, net | | (2,628,296) | (2,628,296) | | (2,653,580) | (2,653,580) |
| Total ABS Issued | $3,646,342 | $310,952 | $3,957,294 | $3,458,501 | $303,077 | $3,761,578 |
| Range of weighted average interest rates, by series | 0.45% to 4.17% | 0.76% to 1.89% | | 0.45% to 4.40% | 0.76% to 1.88% | |
| Stated maturities | 2014 2047 | 2039 2052 | | 2014 2047 | 2039 2052 | |
| Number of series | 38 | 10 | | 37 | 10 | |

The 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 (call) according to the specific terms of the respective governing documents. As a result, the actual maturity of ABS issued will often occur earlier than its stated maturity. At March 31, 2011, all of the $4.0 billion reported value of ABS issued ($6.6 billion principal value) had contractual maturities of over five years. Amortization of Sequoia deferred ABS issuance costs was less than $1 million for both the three months ended March 31, 2011 and 2010.

The following table summarizes the accrued interest payable on ABS issued at March 31, 2011 and December 31, 2010. Interest due on Sequoia ABS issued is settled monthly and interest due on Acacia ABS issued is settled quarterly.

## Accrued Interest Payable on Asset-Backed Securities Issued

| (In Thousands) | March 31, 2011 | December 31, 2010 |
|---|---|---|
| Sequoia | $ 3,140 | $ 2,356 |
| Acacia | 2,867 | 2,911 |
| Total Accrued Interest Payable on ABS Issued | $ 6,007 | $ 5,267 |

The following table summarizes the carrying value components of the collateral for ABS issued and outstanding at March 31, 2011 and December 31, 2010.

## Collateral for Asset-Backed Securities Issued

| | March 31, 2011 | | | December 31, 2010 | | |
|---|---|---|---|---|---|---|
| (In Thousands) | Sequoia | Acacia | Total | Sequoia | Acacia | Total |
| Real estate loans | $3,740,892 | $19,953 | $3,760,845 | $3,542,159 | $19,850 | $3,562,009 |
| Real estate securities | | 319,623 | 319,623 | | 327,919 | 327,919 |
| REO | 10,778 | | 10,778 | 14,241 | | 14,241 |
| Restricted cash | 285 | 29,771 | 30,056 | 331 | 21,790 | 22,121 |
| Accrued interest receivable | 7,205 | 2,484 | 9,689 | 6,264 | 2,735 | 8,999 |
| Total Collateral for ABS Issued | $3,759,160 | $371,831 | $4,130,991 | $3,562,995 | $372,294 | $3,935,289 |

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 12. Long-Term Debt

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 notes are redeemed, which will be no later than January 30, 2037. The interest expense yield on our trust preferred securities was 2.60% and 3.23% for the three months ended March 31, 2011 and 2010, respectively. Including hedging costs, and amortization of deferred ABS issuance costs, our trust preferred securities yielded 6.85% for the three months ended March 31, 2011. The earliest optional redemption date without penalty is 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, which require quarterly distributions at a floating interest rate equal to three-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 2.60% and 3.23% for the three months ended March 31, 2011 and 2010, respectively. Including hedging costs, and amortization of deferred ABS issuance costs, our subordinated notes yielded 6.85% for the three months ended March 31, 2011. The earliest optional redemption date without a penalty is July 30, 2012. In July 2009, we repurchased $10 million principal amount of this subordinated debt.

At both March 31, 2011 and December 31, 2010, the accrued interest payable balance on long-term Redwood debt was less than $1 million. There are no financial covenants associated with our long-term debt.

## Note 13. Commitments and Contingencies

### Lease Commitments

At March 31, 2011, we were obligated under non-cancelable operating leases with expiration dates through 2018 for $10 million. The majority of the future lease obligations relates to operating leases for our executive office that expire in 2013 and 2018. The total payments required under these leases are recognized as office rent expense on a straight-line basis over the lease terms. Operating lease expense was less than $1 million for both the three months ended March 31, 2011 and 2010.

The following table presents our future lease commitments at March 31, 2011.

## Future Lease Commitments by Year

| (In Thousands) | March 31, 2011 |
|---|---|
| 2011 (nine months) | $ 1,424 |
| 2012 | 1,882 |
| 2013 | 1,439 |
| 2014 | 1,132 |
| 2015 | 1,166 |
| 2016 and thereafter | 2,954 |
| Total | $ 9,997 |

Leasehold improvements for our offices are amortized into expense over the ten-year lease term, expiring in 2013. The unamortized leasehold improvement balance was $3 million at both March 31, 2011 and December 31, 2010.

# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 13. Commitments and Contingencies (continued)

### Loss Contingencies Litigation

On December 23, 2009, the Federal Home Loan Bank of Seattle (the FHLB-Seattle ) filed a claim in Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. ( SRF ), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the FHLB-Seattle Defendants ). The FHLB-Seattle alleges claims under the Securities Act of Washington (Section 21.20.005, *et seq.*) and seeks to rescind the purchase of a mortgage pass-through certificate (or, residential mortgage backed securities, RMBS ) issued through our Sequoia RMBS platform as part of the Sequoia Mortgage Trust 2005-4 securitization transaction and purchased by the FHLB-Seattle. The FHLB-Seattle seeks to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received), as well as attorneys fees and costs. The FHLB-Seattle alleges that the FHLB-Seattle Defendants offering materials for this RMBS contained materially untrue statements and omitted material facts about this RMBS and the credit quality of the mortgage loans that backed it. Among other things, the FHLB-Seattle alleges that the FHLB-Seattle Defendants made untrue statements or omissions regarding the (1) loan-to-value ratios of these mortgage loans and the appraisals of the properties that secured these mortgage loans, (2) occupancy status of those properties, (3) underwriting standards of the originators of these mortgage loans, and (4) ratings assigned to this RMBS. The Sequoia RMBS that is the subject of the FHLB-Seattle s claim was issued with an original principal amount of approximately $133 million and, as of March 31, 2011, had a remaining outstanding principal balance of approximately $30 million. On October 18, 2010, the FHLB-Seattle Defendants filed motions to dismiss the FHLB-Seattle s complaint, which motions are pending. We believe that this claim is without merit and we intend to defend the action vigorously. In connection with the issuance of the Sequoia RMBS that is the subject of the FHLB-Seattle s claim, Redwood indemnified the underwriters of this RMBS for certain losses and expenses they might incur in 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 August 18, 2010, Redwood Trust, Inc. s subsidiary, SRF, received service of process with respect to a case filed on July 15, 2010 in Superior Court for the State of California in San Francisco (case number CGC-10-501610) by The Charles Schwab Corporation ( Schwab ). In the claim, Schwab is suing SRF and 26 other named defendants (collectively, the Schwab Defendants ) in relation to RMBS sold or issued by the Schwab Defendants. With respect to SRF, Schwab alleges a cause of action of negligent misrepresentation under California state law and seeks unspecified damages and attorneys fees and costs with respect to a RMBS issued through the Sequoia RMBS platform as part of the Sequoia Mortgage Trust 2005-4 securitization transaction (which is the same securitization transaction at issue in the litigation initiated by the FHLB-Seattle described in the preceding paragraph). Among other things, Schwab alleges that the offering materials for this Sequoia RMBS contained materially untrue statements or omissions regarding this RMBS and the loans securitized in this securitization transaction, including untrue statements or omissions regarding the (1) loan-to-value ratios of these mortgage loans and the appraisals of the properties that secured these mortgage loans, (2) occupancy status of those properties, (3) underwriting standards of the originators of these mortgage loans, and (4) ratings assigned to this RMBS. The Sequoia RMBS that is the subject of Schwab s cause of action was issued with an original principal amount of approximately $14.8 million and, as of March 31, 2011, had a remaining outstanding principal balance of approximately $3.3 million. SRF has not yet responded to the complaint. We believe that this case is without merit and we intend to defend the action vigorously. In connection with the issuance of the Sequoia RMBS that is the subject of Schwab s claim, Redwood indemnified the underwriters of this RMBS for certain losses and expenses they might incur in as a

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 13. Commitments and Contingencies (continued)

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

On July 12, 2010, two notices of Election to Void Sale of Securities pursuant to Illinois Securities Law (815 ILCS Section 5/13(A)) were received from the Federal Home Loan Bank of Chicago (FHLB-Chicago). In the notices, the FHLB-Chicago sought to void its purchase of two RMBS that were issued in 2006 by a securitization trust with respect to which Redwood Trust, Inc. s subsidiary, SRF, was the depositor. Subsequently, on October 15, 2010, the FHLB-Chicago filed a case in the Circuit Court of Cook County, Illinois (case number 10-CH-45033) against SRF and more than 45 other named defendants (collectively, the FHLB-Chicago Defendants ) in relation to RMBS sold or issued by the FHLB-Chicago Defendants or by entities controlled by the FHLB-Chicago Defendants. In an amended complaint filed on March 16, 2011, FHLB-Chicago added as defendants Redwood Trust, Inc. and another one of our subsidiaries, RWT Holdings, Inc. With respect to Redwood Trust, Inc. and SRF, the FHLB-Chicago alleges that the offering materials for two RMBS issued through the Sequoia RMBS platform as part of the Sequoia Mortgage Trust 2006-1 securitization transaction contained untrue and misleading statements and material representations in violation of Illinois Securities Law (815 ILCS Sections 5/12(F)-(H)) and North Carolina Securities Law N.C.G.S.A. § 78A-8(2) & § 78A-56(a)). FHLB-Chicago also alleges a cause of action of negligent misrepresentation under Illinois common law against SRF and Redwood Trust, Inc. RWT Holdings, Inc. is a defendant in the North Carolina Securities Law cause of action. On some of the causes of action, the FHLB-Chicago seeks to rescind the purchase of these RMBS and to collect interest on the original purchase price at the statutory interest rate of 10% per annum from the date of original purchase (net of interest received). On one cause of action, the FHLB-Chicago seeks unspecified damages. The FHLB-Chicago also seeks attorneys fees and costs. Among other things, the FHLB-Chicago alleges that the offering materials for this RMBS contained materially untrue statements or omissions regarding this RMBS and the loans securitized in this securitization transaction, including untrue statements or omissions regarding the (1) loan-to-value ratios of these mortgage loans and the appraisals of the properties that secured these mortgage loans, (2) occupancy status of those properties, (3) underwriting standards of the originators of these mortgage loans, (4) ratings assigned to this RMBS, and (5) due diligence performed on these mortgage loans. The first of these two Sequoia RMBS was issued with an original principal amount of approximately $105 million and, as of March 31, 2011, had a remaining outstanding principal balance of approximately $47 million. The second of these two Sequoia RMBS was issued with an original principal amount of approximately $379 million and, as of March 31, 2011, had a remaining outstanding principal balance of approximately $170 million. The FHLB-Chicago Defendants have not yet responded to the amended complaint. We believe that this case is without merit, and we intend to defend the action vigorously. In connection with the issuance of the Sequoia RMBS that is the subject of the FHLB-Chicago s claim, Redwood indemnified the underwriters of this RMBS for certain losses and expenses they might incur in 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 and 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

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 13. Commitments and Contingencies (continued)

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 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: the proceedings are in relatively early stages, 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 rescission and the related statutory interest rate, 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 provisions with other parties relating to these litigation matters, which rights and obligations could offset or increase our losses. We are unable at this time to estimate the potential amount of any such offset or loss.

## Note 14. Equity

The following table provides a summary of changes to stockholders equity for the three months ended March 31, 2011 and 2010.

### Stockholders Equity

| | Three Months Ended March 31, | |
|---|---|---|
| (In Thousands) | 2011 | 2010 |
| Balance at beginning of period | $ 1,064,753 | $ 971,721 |
| New equity capital, net | 2,244 | 6,199 |
| Unrealized gains on securities and derivatives, net | 9,773 | (7,263 ) |
| Distributions to shareholders | (20,124 ) | (19,894 ) |
| Net income attributable to Redwood Trust, Inc. | 18,165 | 46,843 |
| Balance at End of Period | $ 1,074,811 | $ 997,606 |

## Accumulated Other Comprehensive Income

The following table provides a summary of the components of accumulated other comprehensive income at March 31, 2011 and December 31, 2010.

| (In Thousands) | March 31, 2011 | December 31, 2010 |
|---|---|---|
| Net unrealized gains on real estate securities | $ 146,718 | $ 137,360 |
| Less: Unrealized gains (losses) attributable to noncontrolling interest | 374 | (4,164 ) |
| Net unrealized gains on real estate securities recognized in equity | 146,344 | 141,524 |
| Net unrealized losses on interest rate agreements accounted for as cash flow hedges | (24,232 ) | (29,185 ) |
| Total Accumulated Other Comprehensive Income | $ 122,112 | $ 112,339 |

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 14. Equity (continued)

### Noncontrolling Interest

Of the total equity recorded on our consolidated balance sheet at March 31, 2011, and December 31, 2010, $7 million and $11 million, respectively, is noncontrolling interest. Noncontrolling interest represents the aggregate limited partnership (LP) interests in the Fund held by third-parties. Income allocated to the noncontrolling interest is based on the 48% third-party LP ownership percentage. The ownership percentage is determined by dividing the number of units held by third-party LP investors by the total units outstanding. Subsequent changes, if any, in our ownership percentage would be treated as equity transactions and result in a reallocation between shareholders equity and noncontrolling interest in our consolidated balance sheets.

### Earnings Per Common Share

The following table provides the basic and diluted earnings per common share computations for the three months ended March 31, 2011 and 2010.

### Basic and Diluted Earnings Per Common Share

| | Three Months Ended March 31, | |
|---|---|---|
| (In Thousands, Except Share Data) | 2011 | 2010 |
| Basic Earnings Per Common Share: | | |
| Net income attributable to Redwood | $18,165 | $46,843 |
| Less: Dividends and undistributed earnings allocated to participating securities | 551 | 1,298 |
| Net income allocated to common shareholders | $17,614 | $45,545 |
| Basic weighted average common shares outstanding | 78,027,840 | 77,677,235 |
| Basic Earnings Per Common Share | $0.23 | $0.59 |
| Diluted Earnings Per Common Share: | | |
| Net income attributable to Redwood | $18,165 | $46,843 |
| Less: Dividends and undistributed earnings allocated to participating securities | 584 | 1,012 |
| Net income allocated to common shareholders | $17,581 | $45,831 |
| Basic weighted average common shares outstanding | 78,027,840 | 77,677,235 |

| | | |
|---|---|---|
| Net effect of dilutive equity awards | 1,343,936 | 865,064 |
| Diluted weighted average common shares outstanding | 79,371,776 | 78,542,299 |
| Diluted Earnings Per Common Share | $0.22 | $0.58 |

For the three months ended March 31, 2011 and 2010, there were 1,343,936 and 865,064, respectively, of dilutive equity awards determined under the two-class method. 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. For the three months ended March 31, 2011, the number of outstanding equity awards that were antidilutive totaled 669,229 and 496,767, 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 three months ended March 31, 2011 and 2010, there were no shares acquired under the plan. At March 31, 2011, there remained 4,658,071 shares available for repurchase under this plan.

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 15. Equity Compensation Plans

At March 31, 2011 and December 31, 2010, 1,048,941 and 1,052,826 shares of common stock, respectively, were available for grant under Redwood s Incentive Plan. The unamortized compensation cost under the Incentive Plan and the Employee Stock Purchase Plan totaled $17 million at March 31, 2011, as shown in the following table.

| | Three Months Ended March 31, 2011 | | | | | |
|---|---|---|---|---|---|---|
| (In Thousands) | Stock Options | Restricted Stock | Deferred Stock Units | Performance Stock Units | Employee Stock Purchase Plan | Total |
| Unrecognized compensation cost at beginning of period | $ | $ 1,390 | $ 14,420 | $ 3,320 | $ | $ 19,130 |
| Equity grants | | 36 | 48 | | 120 | 204 |
| Equity compensation cost | | (128 ) | (1,618 ) | (284 ) | (30 ) | (2,060 ) |
| Unrecognized Compensation Cost at End of Period | $ | $ 1,298 | $ 12,850 | $ 3,036 | $ 90 | $ 17,274 |

At March 31, 2011, the weighted average amortization period remaining for all of our equity awards was less than two years.

### Stock Options

At both March 31, 2011 and December 31, 2010, there were 459,115 of fully vested stock options outstanding. There was no aggregate intrinsic value for the options outstanding and exercisable at March 31, 2011.

For both the three months ended March 31, 2011 and 2010, there were no stock options exercised.

### Restricted Stock

At March 31, 2011 and December 31, 2010, there were 102,116 and 119,071 shares, respectively, of restricted stock outstanding. Restrictions on these shares lapse through 2015. There were 1,647 restricted stock awards granted during the three months ended March 31, 2011.

## Deferred Stock Units

At March 31, 2011 and December 31, 2010, there were 2,356,767 and 2,351,804, respectively, DSUs outstanding, of which 1,169,727 and 1,042,341, respectively, had vested. There were 4,961 DSUs granted during the three months ended March 31, 2011. During the three months ended March 31, 2011, there were no DSUs distributed or cash distributions to participants in the Executive Deferred Compensation Plan (EDCP).

In March 2010, vesting of 376,564 DSUs previously awarded to Mr. George E. Bull, III, was accelerated to June 1, 2010, in connection with the announcement that he would retire from serving as Chief Executive Officer in the second quarter of 2010. We recorded a $4 million equity compensation expense during the three months ended March 31, 2010, related to the modification of these DSUs. No such equity award modifications occurred during the three months ended March 31, 2011.

## Performance Stock Units

At both March 31, 2011 and December 31, 2010, there were 243,754 PSUs outstanding, none of which had vested. These PSUs cliff vest, if at all, on November 30, 2013, the third anniversary of their grant date, with vesting contingent on total stockholder return (change in our common stock price plus dividends paid on our common stock) over the three-year vesting period (Three-Year TSR). The number of underlying shares of our common stock that will vest on November 30, 2013, will vary between 0% (if Three-Year TSR is

# REDWOOD TRUST, INC. AND SUBSIDIARIES

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS March 31, 2011 (Unaudited)

## Note 15. Equity Compensation Plans (continued)

negative) and 200% (if Three-Year TSR is greater than or equal to 125%) of the number of these PSUs originally granted on November 30, 2010, adjusted (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 200,000 shares of common stock to be purchased in aggregate for all employees. At March 31, 2011 and December 31, 2010, 127,518 and 121,643 shares have been purchased, respectively, and there remained a negligible amount of uninvested employee contributions in the ESPP.

## Note 16. Operating Expenses

Components of our operating expenses for the three months ended March 31, 2011 and 2010 are presented in the following table.

### Operating Expenses

| | Three Months Ended March 31, | |
|---|---|---|
| (In Thousands) | 2011 | 2010 |
| Fixed compensation expense | $ 4,144 | $ 4,109 |
| Variable compensation expense | 599 | 1,961 |
| Equity compensation expense | 2,060 | 6,059 |
| Total compensation expense | 6,803 | 12,129 |
| Systems | 1,939 | 1,577 |
| Office costs | 1,740 | 1,765 |
| Accounting and legal | 636 | 1,466 |
| Other operating expenses | 396 | 369 |
| Total Operating Expenses | $ 11,514 | $ 17,306 |

# Note 17. Taxes

For the three months ended March 31, 2011 and 2010, we recognized a provision for income taxes of less than $1 million. The following is a reconciliation of the statutory federal and state tax rates to our projected annual effective rate at March 31, 2011 and 2010.

## Reconciliation of Statutory Tax Rate to Effective Tax Rate

| | Three Months Ended March 31, 2011 | | 2010 | |
|---|---|---|---|---|
| Federal statutory rate | 34.0 | % | 34.0 | % |
| State statutory rate, net of Federal tax effect | 7.2 | % | 7.2 | % |
| Differences in taxable income from GAAP income | (41.1 | )% | (41.1 | )% |
| Dividends paid deduction | | | | |
| Effective Tax Rate | 0.1 | % | 0.1 | % |

We assessed our tax positions for all open tax years (Federal years 2007 to 2009, State years 2005 to 2009) and concluded at March 31, 2011 and December 31, 2010, that we have no material unrecognized tax liabilities.

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

## Introduction

Redwood Trust, Inc., together with its subsidiaries, is a financial institution that seeks to invest in real estate related assets that have the potential to provide attractive cash flows over a long period of time and support our goal of distributing attractive levels of dividends to our stockholders. For tax purposes, we are structured as a real estate investment trust (REIT). We are able to pass through substantially all of our earnings generated at our REIT to our stockholders without paying income tax at the corporate level. We pay income tax on the REIT taxable income we retain and on the income we earn at our taxable subsidiaries. Redwood was incorporated in the State of Maryland on April 11, 1994, and commenced operations on August 19, 1994. Our executive offices are located at One Belvedere Place, Suite 300, Mill Valley, California 94941.

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

Our website can be found at *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 Corporate Governance Standards, charters for our Audit Committee, Compensation Committee, and Corporate Governance and Nominating Committee, our Corporate Governance Standards, and our Code of Ethics governing our directors, officers, and employees. Within the time period required by the SEC and the New York Stock Exchange, we will post on our website any amendment to the Code of Ethics and any waiver applicable to any executive officer, director, or senior officer (as defined in the Code). In addition, our website includes information concerning purchases and sales of our equity securities by our executive officers and directors, as well as disclosure relating to certain non-GAAP and financial measures (as defined in the SEC s Regulation G) that we may make public orally, telephonically, by webcast, by broadcast, or by similar means from time to time. 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 expression forms, or by references to strategy, plans, or intentions. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010, 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.

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

(i) our competitive position and our ability to compete in the future, including our ability to effectively compete to acquire residential mortgage loans and our ability to compete to originate and acquire commercial real estate loans; (ii) our future investment strategy and our ability to find attractive investments and future trends relating to our pace of acquiring or selling assets, including, without limitation, statements relating to our efforts to acquire residential mortgage loans and make commercial real estate investments; (iii) our plan to acquire the $137 million of loans comprising the pipeline of residential mortgage loans that, as of the end of the first quarter of 2011, we planned to purchase through our conduit program and our plan to acquire additional loans that we have already added, or plan in the future to add, to our pipeline after the end of the first quarter of 2011; (iv) our statement that the systems and operational infrastructure we have in place for our loan conduit can be leveraged to handle a dramatic increase in the volume of securitization transactions we complete and our statement that if we could acquire a greater volume of loans to securitize it would likely lead to higher earnings from our loan conduit; (v) references to future securitization transactions, the timing of the completion of those future securitization transactions, and the number and size of such transactions we expect to complete in 2011 and future periods, which future securitizations may not be completed when planned or at all, and, more generally, statements regarding the likelihood and timing of, and our participation in, future securitization transactions and our ability to finance loan acquisitions through the execution of securitization transaction; (vi) our expectation that new Sequoia securitization entities will represent a larger portion of our balance sheet in the future; (vii) references to our expectations of future levels of our securities purchase and sale activity and our plan to invest much of our excess capital in 2011,

including, without limitation, our statement that our biggest planned investment of capital in 2011 will be in commercial real estate loans; (viii) that we do not anticipate a need to issue equity in the near term, our estimates of our short-term borrowing capacity and our short-term investment capacity, our statements regarding our ability to access additional short-term borrowings and to access capital through re-securitization transactions or other forms of debt financing, and our statements regarding future balances of outstanding short-term debt; (ix) future market and economic conditions, 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 businesses; (x) our statement that as we look ahead at the state of the residential mortgage markets we see positive trends, including, without limitation, residential mortgage products that are safer for borrowers, low loan loss rates for newly originated loans comparable to historic norms, and sources of private capital willingly funding residential mortgages through securitization and our statement that these trends could present a vast growth opportunity for us and offer us a competitive advantage; (xi) our beliefs about, and our outlook for, the future direction of housing market fundamentals, including, without limitation, home prices, demand for housing, delinquency rates, foreclosure rates, prepayment rates, inventory of homes for sale, and mortgage interest rates and their potential impact on our business and results of operations and our belief that the housing market is in the process of forming a bottom and our expectation that housing, in general, will not be a significantly appreciating asset class for years;

(xii) our beliefs about the future direction of commercial real estate fundamentals and that those fundamentals continue to show signs of improvement, including, without limitation, statements regarding commercial real estate vacancy rates, rental rates, and default rates, and statements regarding the competitive landscape for and availability of financing for commercial real estate, the number of future opportunities for us to provide mezzanine financing to borrowers, the pipeline of possible loans we are competing to make in the near future, our estimate that our commercial real estate loan originations are likely to be in the range of $25 million to $50 million per quarter over the next several quarters, and statements regarding the future of the CMBS market; (xiii) statements relating to the impact of recent and future legislative and regulatory changes that affect our business, the regulation of securitization transactions, and the mortgage finance markets, the manner in which the reform of the GSEs, including Fannie Mae and Freddie Mac, may take place and the timeline for that reform, and our statements that GSE reform could result in a substantially larger portion of the mortgage market being available to us; (xiv) our expectations regarding credit reserves, credit losses, the adequacy of credit support, and impairments and their impact on our investments (including as compared to our original expectations and credit reserve levels) and the timing of losses and impairments, and statements that the amount of credit reserves we designate may require changes in the future; (xv) our statement that we expect to reverse an aggregate of $5 million of loan loss reserves that relate to ten Sequoia securitization entities in future periods upon the payoff or deconsolidation of those entities; (xvi) expectations regarding future interest

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income, future earnings, future earnings volatility, and future trends in operating expenses and the factors that may affect those trends, as well as statements regarding the impact of future changes in interest rates and how the value of, and cash-flow produced by, the mix of adjustable-rate and fixed-rate instruments in our portfolio of assets would respond to future changes in interest rates; (xvii) our board of directors intention to pay a regular dividend of $0.25 per share per quarter in 2011; and (xviii) our expectations relating to tax accounting, including our estimated taxable income for the first quarter of 2011, our expectation that we will realize a taxable loss for the full year 2011, and our anticipation of additional credit losses for tax purposes in 2011 and future periods and the level of those losses.

Important factors, among others, that may affect our actual results include: general economic trends, the performance of the housing, commercial real estate, mortgage, credit, and broader financial markets, and their effects on the prices of earning assets and the credit status of borrowers; federal and state legislative and regulatory developments, and the actions of governmental authorities, including those affecting the mortgage industry or our business; our exposure to credit risk and the timing of credit losses within our portfolio; the concentration of the credit risks we are exposed to, including due to the structure of assets we hold and the geographical concentration of real estate underlying assets we own; our exposure to adjustable-rate and negative amortization mortgage loans; the efficacy and expense of our efforts to manage or hedge credit risk, interest rate risk, and other financial and operational risks; changes in credit ratings on assets we own and changes in the rating agencies credit rating methodologies; changes in interest rates; changes in mortgage prepayment rates; the availability of assets for purchase at attractive prices and our ability to reinvest cash we hold; changes in the values of assets we own; changes in liquidity in the market for real estate securities and loans; our ability to finance the acquisition of real estate-related assets with short-term debt; the ability of counterparties to satisfy their obligations to us; our involvement in securitization transactions and the risks we are exposed to in engaging in securitization transactions; exposure to 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 invests in, finances, and manages real estate assets. We invest in residential and commercial real estate loans and in asset-backed securities backed by real estate loans. We seek to invest in assets that have the potential to generate sufficient long-term cash flow returns to support our goal of distributing an attractive level of dividends per share to shareholders over time.

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

Our investments include residential and commercial real estate loans and securities backed by residential and commercial loans. The securities include both senior securities and subordinate securities. Senior securities are those interests in a securitization that have the first right to cash flows and are last to absorb losses. Subordinate securities are those interests in a securitization that have the last right to cash flows and are first in line to absorb losses. We may also invest in re-REMIC securities, or securities that were created

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through the resecuritization of certain senior interests in residential mortgage securitizations to provide additional credit support to those interests.

Residential securities we invest in are generally acquired by us from third-parties or by retaining mortgage-backed securities issued by Sequoia securitization trusts, which are securitization entities we sponsor. The process of sponsoring a Sequoia securitization includes the acquisition of residential loans, which we generally fund with equity and short-term debt during the accumulation period, the transfer of a pool of those loans to a Sequoia securitization entity, and the structuring and issuance by the Sequoia securitization entity of mortgage-backed securities collateralized by that pool of loans. Senior securities issued by Sequoia securitization entities are generally issued to third-parties, while the subordinate securities issued by these entities are generally retained by us.

Historically, we have also sponsored other entities: a private limited partnership fund that we manage, the Redwood Opportunity Fund, LP (the Fund), and Acacia securitization entities that we also manage. The Fund and the Acacia securitization entities generally invested in a variety of real estate related assets. Our investments in these entities are currently financed with equity and long-term debt. We are not currently seeking to sponsor other entities like the Fund and the 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 obligations of Redwood, although we are exposed to certain financial risks associated with our role as the sponsor or manager of these entities. For financial reporting purposes, we are required to consolidate the assets and liabilities of the Fund and the assets and liabilities of many of the Sequoia and Acacia securitization entities we have sponsored.

The commercial real estate loans we invest in are primarily originated by us and any commercial mortgage-backed securities we invest in are acquired from third-parties. Our commercial investments are currently financed with equity and long-term debt.

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

## Business Update    First Quarter 2011

We are off to a productive start to 2011. Our residential loan business continues to move forward, we completed our second securitization, our commercial efforts are beginning to produce results, and our investment portfolio continues to perform well.

### Residential Mortgage Loan Business

There are currently significant regulatory, political, social, and servicer-related issues that overhang today s housing and residential mortgage markets. As we look forward, we see a number of things emerging that could be positive for our business and industry: safer mortgages that borrowers can afford, the return of low loan loss rates to historic norms for newly originated prime loans, private capital willingly funding residential mortgages via responsible securitizations, and a housing market that is on firmer ground.

If these changes do emerge, there will be a vast growth opportunity for a residential credit investor like Redwood to act as a financial intermediary between borrowers, lenders, and triple-A investors. Our goal is to create our own credit investments during this process through our Sequoia securitization program. We are also positioned to acquire credit securities issued by major banks or other financial institutions if the securities meet our investment criteria.

We believe the business of buying and securitizing residential mortgage loans is and will continue to be fundamentally different than it was in 2006 and 2007. Securitization sponsors will be required to adhere to new, stricter regulations, and we believe lenders, triple-A investors, and rating agencies will be significantly more discerning and demanding when analyzing investments.

In our opinion, lenders will demand more than just competitive pricing from the securitization conduits they sell loans to, including our conduit. Lenders will likely want reliable and value-added relationships with fewer trusted conduits which will include competitiveness in products, consistency in pricing, timeliness in approvals, and efficiency in delivery. Triple-A investors will likely demand simpler, safer securitization

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structures that offer transparency, alignment of interests, and governance and representation and warranty mechanisms that deal effectively with loan collateral issues. And our recent experience working with credit ratings agencies has shown that the ratings process is now far more complex and extensive than it was a few years ago.

As a result of these changes, we believe that the securitization business will be a lot more difficult for sponsors and potentially offers us a competitive advantage. We believe we have the appropriate skill sets, relationships with lenders and triple-A investors, and balance sheet structure to be successful.

The biggest obstacle we face today is loan acquisition volume. We are only able to source loans from the small percentage of mortgage loans that are not directly or indirectly being financed by the government. At current levels, our loan conduit is operationally inefficient and is not accretive to our earnings. In effect, our loan conduit is similar to a start-up company. Looking forward, the systems and operations in place can be leveraged, likely leading to higher earnings from our conduit as loan volume increases. For example, we believe we could handle a dramatic increase in our securitization volume, with some but not a substantial increase in operating expenses.

We continue to gain traction in terms of the number of active originators who use our conduit and those in the implementation stage of preparing to do so. At the end of the first quarter of 2011, we held $53 million of residential loans for future securitization, plus we had a pipeline of an additional $137 million in residential mortgage loans we planned to purchase. At April 30, 2011, we held $87 million of residential loans for future securitization, and had a pipeline of $200 million. We are targeting our next residential mortgage securitization for the third quarter of 2011, assuming market conditions permit. In fact, we believe we are likely to close three securitizations this year (given current market conditions) for an estimated total of $800 million to $1.0 billion in loans securitized. This would be a significant increase from the one securitization of $238 million in loans we completed in 2010.

Furthermore, there are hopeful, encouraging signs out of Washington, D.C., as both political parties now acknowledge the need to reduce the government s outsized role in mortgage finance in favor of the private sector. The first step could come at the end of September, when the conforming loan limit is scheduled to come down from $729,750 to $625,000 in high cost areas.

## Residential Portfolio Business

On balance, in the first quarter of 2011, securities prices did not change much over the course of the quarter. While prices rose meaningfully in January and February for certain types of securities, we observed general weakness in pricing in March as buyers pulled back and the resulting spread between what prices buyers and sellers were willing to accept widened (bid-offer spread). By the end of the first quarter of 2011, on average, market prices were just slightly ahead of where they began the quarter. In April, prices have once again begun to rise. In our opinion, the catalyst for the improvement in prices was the orderly liquidation of portions of the Federal Reserve s Maiden Lane II portfolio. This portfolio contained $16 billion (in market value) of securities, and primarily included subprime, Alt-A, and Option ARM assets from 2006 2007. Such liquidation sales have recently been met with broad-based investor demand and larger portfolio liquidations have typically priced better in the secondary mortgage-backed securities market than smaller portfolio sales. We expect the entire Maiden Lane II portfolio to be liquidated over time and believe this supply will help to narrow bid-offer spreads and improve market liquidity.

The pace of our RMBS acquisitions has slowed significantly as credit risk spreads have contracted and prices have risen since 2009. Since our goal is to make long-term investments and appropriately manage our existing portfolio, we remain active in monitoring market activity and pricing even when the number of trades we execute is small. Gathering market intelligence is essential to managing our $780 million RMBS portfolio. We will selectively sell assets when we believe the market value is too optimistic relative to our assessment of future cash flows, including credit risk considerations. During the first quarter, we sold $33 million of RMBS (excluding sales from the Fund and Acacia) and invested $28 million in our residential business    $13 million in seasoned third-party securities and $15 million in newly issued Sequoia securities.

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## Commercial Loan Business

As we have commented previously, our balance sheet is well suited for retaining long-term credit risk. We provide reliability, flexibility, and other advantages to borrowers including the advantage of permanent funding of longer-term assets. In our commercial group, we are currently focused on financing the gap that exists between the amount of equity a borrower will put into a property and the amount of financing a senior lender will provide.

The recovery in financing for select commercial real estate properties continues, with significant funding available for stabilized commercial assets in select, highly desirable markets. The change in sentiment and increased liquidity can be seen in the commercial mortgage-backed securities (CMBS) market. For example, non-government agency CMBS issued in 2010 amounted to roughly $9 billion. CMBS issuance was about $8 billion in the first quarter of 2011 alone, with strong prospects for the remaining quarters of 2011, as reflected in the consensus estimate for 2011 issuance of around $40 billion.

This rapid return of capital to commercial real estate is accompanied by increased competition by lenders, tightening triple-A spreads, and easing underwriting standards. Borrowers are able to refinance at increasingly attractive rates with higher proceeds for high-quality properties in select markets. There are already signs of aggressive financing terms returning to commercial mortgage securitization i.e., lenders pushing proceeds and loan-to-value ratios higher on loans. This suggests that the available supply of mezzanine lending opportunities could be reduced as senior loans absorb additional risks.

We are an active originator and underwriter and continue to focus on high-quality loans. We have worked hard to develop a network of relationships to source good opportunities and our pipeline of possible loans is growing. We closed three loans year-to-date through April 30, 2011, totaling $19 million. The average yield on these loans has been between 10% and 11%. At April 30, 2011, we had a $49 million portfolio of six mezzanine loans. We anticipate continued competitive pressure on rates on mezzanine loans. We estimate originations are likely to be in the range of $25 million to $50 million per quarter over the next several quarters, based on current market conditions.

## Proposed Rules Relating to Securitization

On March 21, 2011, long-awaited proposed implementation rules related to securitization were released, as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The most impactful provisions relate to (1) the definition of a Qualified Residential Mortgage (QRM) the type of loan that requires no risk retention and (2) the amount and acceptable methods of risk retention for sponsors of securitizations of non-QRM loans. As currently written, the proposed rules are open to differing interpretations and have left many market participants, including us, confused about how various calculations would work, and trying to figure out what the proposed rules really intend.

While it is too early to draw definitive conclusions since the final rules are likely to change, we have made a few initial observations. First, the rules appear in general appear to be more restrictive than market participants had anticipated. In our opinion, if the proposed rules are adopted as written, prime borrowers will face unnecessarily higher mortgage rates. This is partially because regulators appear to have taken a one-size-fits-all approach to rule-making even though there are significant differences between prime and subprime borrowers, and the corresponding securitization structures typically used to finance loans backed by these borrowers. The proposed rules are effectively subprime-centric as they address and deter most abuses historically prevalent in subprime securitization structures. The rules apply to all securitizations, however, and appear overly and unnecessarily harsh when applied to prime securitization structures. Additionally, since the rules, as written, may result in unnecessary upward pressure on prime borrowers mortgage rates, this is incongruous with the Obama Administration s intention to reduce the government s current outsized role in mortgage finance and move towards a safer, more robust, and competitively priced private market for residential mortgages.

We note that these same issues apply to commercial mortgage-backed securitizations. The proposed rules appear to be overwhelmingly penal to commercial borrowers. In our opinion, the typical commercial mortgage-backed securitization will become uneconomic under the rules as currently written.

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We think it is likely the proposed rules will be revised. In any case, we will adapt to whatever the final rules are and do not believe we will end up disadvantaged compared to other private market participants.

### Interest Rates and Our Business

Our businesses have been able to be successful in both rising and falling interest rate environments. In conjunction with increased discourse over the direction of benchmark interest rates, we continue to review our investment philosophy and balance sheet sensitivity with respect to changing interest rates. Some believe that the expected end of the Federal Reserve s most recent attempt to lower long-term interest rates (QE2) will inevitably lead to a rise in interest rates as a consequence of the extraordinary monetary stimulus. Some also expect inflationary pressures emanating from rising food, energy, and commodity prices that will further pressure interest rates upward. Others believe that interest rates will stay at current levels or drift lower, citing worldwide de-leveraging, declining labor costs, rising productivity, and ongoing pressure on home values.

We do not know the direction interest rates will take in the future and we do not believe our shareholders expect us to make investments based on a strict interest rate view. Our approach has been to balance our business and portfolio investments to perform across a range of potential interest rate scenarios. This approach is consistent with our attempts to not become overly exposed to changes in any one of the variables that directly impact our returns, such as the level of interest rates and prepayment rates. Ideally, we would like to be agnostic in terms of interest rate changes, however, in our business that is difficult to achieve because mortgage values generally go down more when interest rates rise than they go up when interest rates fall, all else equal.

In reviewing the interest rate sensitivity of assets and liabilities at Redwood at March 31, 2011, we have invested in a relatively balanced mix of adjustable-rate and fixed-rate instruments. Such balance is important because if we have too many adjustable-rate securities, with short-term benchmark interest rates close to zero, we may not generate enough interest cash flow to fund our growth. If we had too many fixed-rate assets, we may satisfy our need for interest cash flow but would be subject to greater declines in book value if market rates moved higher.

In reviewing our liabilities, our company is principally funded with equity, asset-backed securities associated with securitizations that we have sponsored and consolidated for financial reporting purposes, and long-term debt. The rate on our roughly $140 million of long-term debt is effectively fixed at 6.75% via long-term hedges. We have used, and will likely continue to utilize, varying amounts of short-term borrowings to fund a portion of the loans we are accumulating for securitization. In aggregate, however, we typically have very few recourse liabilities that re-price when rates change, and have typically avoided significant weightings of short-term recourse borrowings as a core element of our management of liquidity risk. All else equal, avoiding this leverage has reduced current returns on equity but we have taken less risk on behalf of shareholders.

## Outlook

We are in the process of expanding our residential conduit and our commercial loan business. We believe these businesses play to our strengths and, if executed correctly, offer the best growth opportunity to grow and generate attractive, durable, long-term cash flows for shareholders. We are working to get ahead of the crowd and enhance our relationships with lenders and senior investors, but realize it could take until 2012 to gain significant traction in our residential loan business. While we continue to actively look for residential portfolio opportunities, our biggest plan for capital deployment in 2011 is by our commercial group.

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# Summary of Results of Operations

## Net Income

Our reported GAAP net income was $18 million ($0.22 per share) for the first quarter of 2011, as compared to $47 million ($0.58 per share) for the first quarter of 2010. We declared regular quarterly dividends of $0.25 per share for both the first quarter of 2011 and 2010.

The following table presents the components of our GAAP net income for the three months ended March 31, 2011 and 2010.

## Table 1 Net Income

| | Three Months Ended March 31, | |
|---|---|---|
| (In Thousands, Except Share Data) | 2011 | 2010 |
| Interest income | $ 54,333 | $ 58,716 |
| Interest expense | (21,972) | (18,182) |
| Net interest income | 32,361 | 40,534 |
| Provision for loan losses | (2,807) | (9,475) |
| Market valuation adjustments, net | (5,740) | (11,237) |
| Net interest income after provision and market valuation adjustments | 23,814 | 19,822 |
| Operating expenses | (11,514) | (17,306) |
| Realized gains on sales and calls, net | 3,864 | 44,338 |
| Provision for income taxes | (14) | (26) |
| Less: Net loss attributable to noncontrolling interest | (2,015) | (15) |
| Net Income | $ 18,165 | $ 46,843 |
| Diluted weighted average common shares outstanding | 79,371,776 | 78,542,299 |
| Net earnings per share | $ 0.22 | $ 0.58 |

## Net Interest Income after Provision and Market Valuation Adjustments (MVA)

Net interest income after provision and MVA was $24 million for the first quarter of 2011, as compared to $20 million for the first quarter of 2010, an increase of $4 million. This increase was primarily a result of a lower provision for loan losses due to a stabilization of observed loss securities on our loans originated in 2003 and prior, along with a reduction in negative market valuation adjustments. These increases were partially offset by a decline in net interest income due to lower balances of loans and securities held at consolidated entities.

The following table details the components of market valuation adjustments for the three months ended March 31, 2011 and 2010.

## Table 2 Components of MVA

| | Three Months Ended March 31, | |
|---|---|---|
| (In Thousands) | 2011 | 2010 |

| | | |
|---|---|---|
| Commercial real estate loans (fair value) | $ 219 | $ 4,366 |
| Residential real estate loans (held-for-sale) | 3 | (120 ) |
| Trading securities | 19,916 | 12,149 |
| Impairment on AFS securities | (2,622 ) | (1,946 ) |
| REO | (918 ) | (74 ) |
| Risk management derivatives | 1,799 | (20,359 ) |
| ABS issued Acacia | (24,137 ) | (5,253 ) |
| Total Market Valuation Adjustments, Net | $ (5,740 ) | $ (11,237 ) |

Market valuation adjustments, net, were negative $6 million for the first quarter of 2011, as compared to negative $11 million for the first quarter of 2010, a decrease of $5 million. This decrease was primarily a

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result of greater positive changes in fair values of risk management derivatives and trading securities, partially offset by more stable valuations of pre-2010 commercial loans and greater positive changes in fair values of ABS issued liabilities at consolidated entities.

## Operating Expenses

Operating expenses were $12 million and $17 million for the first quarters of 2011 and 2010, respectively. This decrease was primarily due to a $4 million non-recurring equity compensation expense in the first quarter of 2010 related to the retirement of our former Chief Executive Officer. Another contributing factor to this decrease was the decline in variable compensation expense.

## Realized Gains on Sales and Calls, Net

The following table details the components of realized gains on sales and calls, net, for the three months ended March 31, 2011 and 2010.

## Table 3 Realized Gains on Sales and Calls, Net

| | Three Months Ended March 31, | |
|---|---|---|
| (In Thousands) | 2011 | 2010 |
| Net gains on sales of real estate securities | $ 3,955 | $ 37,379 |
| Net gains on repurchase of Sequoia ABS | | 6,959 |
| Net losses on calls | (91 ) | |
| Total Realized Gains on Sales and Calls, Net | $ 3,864 | $ 44,338 |

Realized gains on sales and calls, net, were $4 million for the first quarter of 2011, as compared to $44 million for the first quarter of 2010, a decrease of $40 million. This decrease was primarily due to the significant gains realized during the first quarter of 2010 as liquidity returning to the market allowed us to sell securities at attractive prices relative to our carrying value. In addition, there were no gains on the repurchase of Sequoia ABS in the first quarter of 2011, as compared to $7 million in the first quarter of 2010.

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 net income.

## Estimated Taxable Income (Loss) for Federal Tax Purposes

Our estimated total taxable income was $5 million ($0.06 per share) for the first quarter of 2011, as compared to estimated taxable income of $1 million ($0.01 per share) for the first quarter of 2010. Our estimated REIT taxable income was $7 million ($0.09 per share) for the first quarter of 2011, as compared to estimated REIT taxable income of $10 million ($0.13 per share) for the first quarter of 2010. Total realized credit losses on subordinate securities for the first quarters of 2011 and 2010 were $15 million ($0.19 per share) and $24 million ($0.31 per share), respectively.

Our REIT taxable income is that portion of our total taxable income that we earn at Redwood and its qualifying REIT subsidiaries and determines the minimum amount of dividends we must distribute to shareholders in order to maintain our tax status as a REIT.

# Summary of Financial Condition, Capital Resources, and Liquidity

At March 31, 2011, our total capital was $1.2 billion, including $1.1 billion in stockholders equity and $140 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.

Our investment capacity, or the amount of capital we estimate that we have readily available to support long-term investments, was $249 million at March 31, 2011, up $25 million from $224 million at year-end 2010. Until recently, our cash balance was a good proxy for our investment capacity. Now that we are funding loans acquired for future securitization with a combination of cash and short-term borrowings, our cash balance alone is no longer a good indicator of investment capacity. We estimate our investment capacity as (1) cash on hand, plus (2) cash we could raise by increasing short-term borrowings to finance all our residential mortgage loans held for securitization, less (3) cash needed to cover short-term operations, working capital, and a liquidity cushion.

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We intend to more fully employ our capital in 2011, which will involve additional increases in borrowing activity. Our estimates of investment capacity presume that we are able to borrow on a secured basis. We continue to closely monitor our liquidity risk and manage our capital through our risk-adjusted capital policy that has served us well since the company was founded.

In the near term, we do not anticipate a need to issue additional equity. Although we plan to invest much of our excess capital in 2011, we are more likely to look to our residential securities portfolio as a source of liquidity for additional investment capacity. We also believe we could raise additional investment capital (in the range of $200 to $300 million) by permanently financing a portion of our residential securities portfolio either through a resecuritization or by other means. Similarly, over time, we believe we could raise additional investment capacity by permanently financing a portion of our commercial portfolio. We would most likely exhaust these or similar possibilities before seeking to raise equity, if we needed additional capital.

## GAAP and Economic Book Value

The following supplemental non-GAAP components of book value table presents our assets and liabilities at March 31, 2011, as estimated under GAAP and as estimated using fair values for our investments and long-term debt. We show our investments in the Sequoia and Acacia entities and the Fund as separate line items to highlight our specific ownership interests, as the underlying assets and liabilities of these entities are legally not ours even though we are required to consolidate them for financial reporting purposes. Accordingly, we determine the estimated economic value of these investments directly as opposed to deriving their reported GAAP values by netting their consolidated assets and liabilities. We also value our long-term debt at its estimated fair value rather than its amortized cost basis as reported for GAAP to determine our estimated economic book value.

## Table 4 GAAP and Economic Book Value at March 31, 2011

| (In Millions, Except per Share Data) | Components of GAAP Book Value | Adjustments | Estimate of Non-GAAP Economic Value |
|---|---|---|---|
| Cash and cash equivalents | $ 220 | $ | $ 220 |
| Real estate loans | | | |
| Residential | 55 | | 55 |
| Commercial | 42 | | 42 |
| Total real estate loans at Redwood | 97 | | 97 |
| Real estate securities at Redwood | | | |
| Residential | 780 | | 780 |
| Commercial | 7 | | 7 |
| CDO | 1 | | 1 |
| Total real estate securities at Redwood | 788 | | 788 |
| Investments in Sequoia | 97 | (4 ) | 93 |
| Investments in Acacia | 2 | (1 ) | 1 |
| Investments in the Fund | 11 | | 11 |
| Other assets | 34 | | 34 |
| Total assets | 1,249 | | |