REDWOOD TRUST INC
Form 10-Q
August 08, 2018

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

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended: June 30, 2018

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	68-0329422
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

One Belvedere Place, Suite 300 Mill Valley, California	94941
(Address of Principal Executive Offices)	(Zip Code)

(415) 389-7373
(Registrant’s Telephone Number, Including Area Code)
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, smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer x	Accelerated filer o

Non-accelerated filer	o (Do not check if a smaller reporting company)	Smaller reporting company o
		Emerging growth company o

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. 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 82,929,990 shares outstanding as of August 6, 2018

REDWOOD TRUST, INC.
2018 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)	June 30, 2018	December 31, 2017
ASSETS [1]		
Residential loans, held-for-sale, at fair value	$1,104,660	$1,427,945
Residential loans, held-for-investment, at fair value	4,386,510	3,687,265
Real estate securities, at fair value	1,453,936	1,476,510
Cash and cash equivalents	184,779	144,663
Restricted cash	15,285	2,144
Accrued interest receivable	29,066	27,013
Derivative assets	65,645	15,718
Other assets	272,670	258,564
Total Assets	$7,512,551	$7,039,822
LIABILITIES AND EQUITY [1]		
Liabilities		
Short-term debt [2]	$1,426,288	$1,938,682
Accrued interest payable	21,925	18,435
Derivative liabilities	55,929	63,081
Accrued expenses and other liabilities	79,571	67,729
Asset-backed securities issued, at fair value	1,929,662	1,164,585
Long-term debt, net	2,770,221	2,575,023
Total liabilities	6,283,596	5,827,535
Equity		
Common stock, par value $0.01 per share, 180,000,000 shares authorized; 75,742,719 and 76,599,972 issued and outstanding	757	766
Additional paid-in capital	1,665,749	1,673,845
Accumulated other comprehensive income	75,620	85,248
Cumulative earnings	1,369,933	1,290,341
Cumulative distributions to stockholders	(1,883,104)	(1,837,913)
Total equity	1,228,955	1,212,287
Total Liabilities and Equity	$7,512,551	$7,039,822

(1) Our consolidated balance sheets include assets of consolidated variable interest entities ("VIEs") that can only be used to settle obligations of these VIEs and liabilities of consolidated VIEs for which creditors do not have recourse to Redwood Trust, Inc. or its affiliates. At June 30, 2018 and December 31, 2017, assets of consolidated VIEs totaled $2,082,771 and $1,259,774, respectively. At June 30, 2018 and December 31, 2017, liabilities of consolidated VIEs totaled $1,935,299 and $1,167,157, respectively. See Note 4 for further discussion.

(2) At December 31, 2017, balance includes $250 million of convertible notes, which were reclassified from Long-term debt, net to Short-term debt as the notes matured in April 2018. See Note 10 for further discussion.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

(In Thousands, except Share Data)	Three Months Ended June 30,		Six Months Ended June 30,	
(Unaudited)	2018	2017	2018	2017
Interest Income				
Residential loans	$55,514	$ 36,635	$105,745	$ 70,997
Real estate securities	26,296	21,826	51,991	41,643
Other interest income	1,166	763	1,859	1,212
Total interest income	82,976	59,224	159,595	113,852
Interest Expense				
Short-term debt	(13,175)	(9,350)	(26,610)	(13,803)
Asset-backed securities issued	(16,349)	(3,705)	(27,750)	(7,235)
Long-term debt	(18,689)	(11,179)	(35,367)	(24,227)
Total interest expense	(48,213)	(24,234)	(89,727)	(45,265)
Net Interest Income	34,763	34,990	69,868	68,587
Non-interest Income				
Mortgage banking activities, net	10,596	12,046	37,172	29,650
Investment fair value changes, net	889	8,115	2,498	9,666
Other income, net	3,322	3,764	5,440	6,661
Realized gains, net	4,714	1,372	14,077	7,075
Total non-interest income, net	19,521	25,297	59,187	53,052
Operating expenses	(19,009)	(18,641)	(42,039)	(36,867)
Net Income before Provision for Income Taxes	35,275	41,646	87,016	84,772
Provision for income taxes	(2,528)	(5,322)	(7,424)	(11,479)
Net Income	$32,747	$ 36,324	$79,592	$ 73,293
Basic earnings per common share	$0.42	$ 0.46	$1.02	$ 0.93
Diluted earnings per common share	$0.38	$ 0.43	$0.88	$ 0.85
Regular dividends declared per common share	$0.30	$ 0.28	$0.58	$ 0.56
Basic weighted average shares outstanding	75,380,715	76,819,703	75,388,638	76,779,178
Diluted weighted average shares outstanding	100,431,993	97,494,144	104,291,180	97,718,550

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

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

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
(Unaudited)	2018	2017	2018	2017
Net Income	$32,747	$36,324	$79,592	$73,293
Other comprehensive (loss) income:				
Net unrealized (loss) gain on available-for-sale securities [1]	(3,104)	1,811	(7,341)	4,741
Reclassification of unrealized gain on available-for-sale securities to net income	(4,748)	(2,322)	(14,135)	(6,250)
Net unrealized gain (loss) on interest rate agreements	3,417	(2,429)	11,848	(696)
Reclassification of unrealized loss on interest rate agreements to net income	—	14	—	28
Total other comprehensive (loss) income	(4,435)	(2,926)	(9,628)	(2,177)
Total Comprehensive Income	$28,312	$33,398	$69,964	$71,116

(1) Amounts are presented net of tax benefit (provision) of $0.2 million and $0.1 million for the three and six months ended June 30, 2018, respectively, and $0.1 million and $(0.1) million for the three and six months ended June 30, 2017, 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 CHANGES IN STOCKHOLDERS' EQUITY

For the Six Months Ended June 30, 2018

(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	Total
December 31, 2017	76,599,972	$ 766	$ 1,673,845	$ 85,248	$ 1,290,341	$ (1,837,913)	$ 1,212,287
Net income	—	—	—	—	79,592	—	79,592
Other comprehensive loss	—	—	—	(9,628)	—	—	(9,628)
Employee stock purchase and incentive plans	183,576	1	(195)	—	—	—	(194)
Non-cash equity award compensation	—	—	7,633	—	—	—	7,633
Share repurchases	(1,040,829)	(10)	(15,534)	—	—	—	(15,544)
Common dividends declared	—	—	—	—	—	(45,191)	(45,191)
June 30, 2018	75,742,719	$ 757	$ 1,665,749	$ 75,620	$ 1,369,933	$ (1,883,104)	$ 1,228,955

For the Six Months Ended June 30, 2017

(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	Total
December 31, 2016	76,834,663	$ 768	$ 1,676,486	$ 71,853	$ 1,149,935	$ (1,749,614)	$ 1,149,428
Net income	—	—	—	—	73,293	—	73,293
Other comprehensive loss	—	—	—	(2,177)	—	—	(2,177)
Employee stock purchase and incentive plans	282,212	3	(2,388)	—	—	—	(2,385)
Non-cash equity award compensation	—	—	5,377	—	—	—	5,377
Common dividends declared	—	—	—	—	—	(44,112)	(44,112)
June 30, 2017	77,116,875	$ 771	$ 1,679,475	$ 69,676	$ 1,223,228	$ (1,793,726)	$ 1,179,424

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

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

(In Thousands) (Unaudited)	Six Months Ended June 30, 2018	 2017
Cash Flows From Operating Activities:		
Net income	$79,592	$73,293
Adjustments to reconcile net income to net cash used in operating activities:		
Amortization of premiums, discounts, and securities issuance costs, net	(7,963)	(9,638)
Depreciation and amortization of non-financial assets	582	605
Purchases of held-for-sale loans	(3,772,494)	(2,309,856)
Proceeds from sales of held-for-sale loans	2,966,508	2,031,326
Principal payments on held-for-sale loans	30,656	22,093
Net settlements of derivatives	40,426	776
Non-cash equity award compensation expense	7,633	5,377
Market valuation adjustments	(34,136)	(30,743)
Realized gains, net	(14,077)	(7,075)
Net change in:		
Accrued interest receivable and other assets	32,478	(26,226)
Accrued interest payable and accrued expenses and other liabilities	(3,582)	(16,840)
Net cash used in operating activities	(674,377)	(266,908)
Cash Flows From Investing Activities:		
Principal payments on loans held-for-investment	335,720	258,267
Purchases of real estate securities	(319,975)	(236,036)
Proceeds from sales of real estate securities	352,563	99,121
Principal payments on real estate securities	33,974	34,752
Sales (purchases) of mortgage servicing rights, net	6,064	42,861
(Funding) payments of participation in loan warehouse facility, net	(34,333)	—
Other investing activities, net	(9,999)	—
Net cash provided by investing activities	364,014	198,965
Cash Flows From Financing Activities:		
Proceeds from borrowings on short-term debt	3,219,350	2,070,873
Repayments on short-term debt	(3,731,917)	(1,855,233)
Proceeds from issuance of asset-backed securities	925,845	—
Repayments on asset-backed securities issued	(181,781)	(103,371)
Proceeds from issuance of long-term debt	199,000	—
Deferred long-term debt issuance costs paid	(4,940)	—
Net settlements of derivatives	(237)	(72)
Net proceeds from issuance of common stock	177	145
Net payments on repurchase of common stock	(16,315)	—
Taxes paid on equity award distributions	(371)	(2,530)
Dividends paid	(45,191)	(44,112)
Net cash provided by financing activities	363,620	65,700
Net increase (decrease) in cash, cash equivalents and restricted cash	53,257	(2,243)
Cash, cash equivalents and restricted cash at beginning of period (1)	146,807	221,467
Cash, cash equivalents, and restricted cash at end of period (1)	$200,064	$219,224
Supplemental Cash Flow Information:		
Cash paid during the period for:		
Interest	$83,781	$44,274
Taxes	3,722	1,040

Supplemental Noncash Information:		
Real estate securities retained from loan securitizations	$43,513	$38,051
Retention of mortgage servicing rights from loan securitizations and sales	—	7,387
Transfers from loans held-for-sale to loans held-for-investment	1,069,326	247,377
Transfers from loans held-for-investment to loans held-for-sale	—	459
Transfers from residential loans to real estate owned	1,835	2,044
Transfers from long-term debt to short-term debt	—	285,900

(1) Cash, cash equivalents, and restricted cash at June 30, 2018 includes cash and cash equivalents of $185 million and restricted cash of $15 million, and at December 31, 2017 includes cash and cash equivalents of $145 million and restricted cash of $2 million.

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2018
(Unaudited)

Note 1. Organization

Redwood Trust, Inc., together with its subsidiaries, is a specialty finance company focused on making credit-sensitive investments in residential mortgages and related assets and engaging in mortgage banking activities. Our goal is to provide attractive returns to shareholders through a stable and growing stream of earnings and dividends, as well as through capital appreciation. We operate our business in two segments: Investment Portfolio and Residential Mortgage Banking.

Our primary sources of income are net interest income from our investment portfolios and non-interest income from our mortgage banking activities. Net interest income consists of the interest income we earn on investments less the interest expense we incur on borrowed funds and other liabilities. Income from mortgage banking activities is generated through the acquisition of loans and their subsequent sale or securitization.

Redwood Trust, Inc. has elected to be taxed as a real estate investment trust (“REIT”) under the Internal Revenue Code of 1986, as amended (the “Internal Revenue Code”), beginning with its taxable year ended December 31, 1994. We generally refer, collectively, to Redwood Trust, Inc. and those of its subsidiaries that are not subject to subsidiary-level corporate income tax as “the REIT” or “our REIT.” We generally refer to subsidiaries of Redwood Trust, Inc. that are subject to subsidiary-level corporate income tax as “our operating subsidiaries” or “our taxable REIT subsidiaries” or “TRS.”

Redwood was incorporated in the State of Maryland on April 11, 1994, and commenced operations on August 19, 1994. References herein to “Redwood,” the “company,” “we,” “us,” and “our” include Redwood Trust, Inc. and its consolidate subsidiaries, unless the context otherwise requires.

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at June 30, 2018 and December 31, 2017, and for the three and six months ended June 30, 2018 and 2017. These interim unaudited consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and note disclosures normally included in our annual financial statements prepared in accordance with U.S. generally accepted accounting principles ("GAAP") — as prescribed by the Financial Accounting Standards Board’s (“FASB”) Accounting Standards Codification (“ASC”) — have been condensed or omitted in these interim financial statements according to these SEC rules and regulations. Management believes that the disclosures included in these interim financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the company's Annual Report on Form 10-K for the year ended December 31, 2017. In the opinion of management, all normal and recurring adjustments to present fairly the financial condition of the company at June 30, 2018 and results of operations for all periods presented have been made. The results of operations for the three and six months ended June 30, 2018 should not be construed as indicative of the results to be expected for the full year.

Principles of Consolidation

In accordance with GAAP, we determine whether we must consolidate transferred financial assets and variable interest entities (“VIEs”) for financial reporting purposes. We currently consolidate the assets and liabilities of certain Sequoia securitization entities issued prior to 2012 where we maintain an ongoing involvement ("Legacy Sequoia"), as well as entities formed in connection with the securitization of Redwood Choice expanded-prime loans beginning in the third quarter of 2017 ("Sequoia Choice"). Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of Redwood Trust, Inc. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, servicing administrator, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities.

For financial reporting purposes, the underlying loans owned at the consolidated Sequoia entities are shown under Residential loans, held-for-investment, at fair value on our consolidated balance sheets. The asset-backed securities (“ABS”) issued to third parties by these entities are shown under ABS issued. In our consolidated statements of income, we recorded interest income on the loans owned at these entities and interest expense on the ABS issued by these entities as well as other income and expenses associated with these entities' activities. See Note 11 for further discussion on ABS issued.
See Note 4 for further discussion on principles of consolidation.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2018
(Unaudited)
Note 2. Basis of Presentation - (continued)

Use of Estimates
The preparation of financial statements requires us to make a number of significant estimates. These include estimates of fair value of certain assets and liabilities, amounts and timing of credit losses, prepayment rates, and other estimates that affect the reported amounts of certain assets and liabilities as of the date of the consolidated financial statements and the reported amounts of certain revenues and expenses during the reported periods. 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.
Note 3. Summary of Significant Accounting Policies

Significant Accounting Policies
Included in Note 3 to the Consolidated Financial Statements of our 2017 Annual Report on Form 10-K is a summary of our significant accounting policies. Provided below is a summary of additional accounting policies that are significant to the company’s consolidated financial position and results of operations for the three and six months ended June 30, 2018.
Recent Accounting Pronouncements
Newly Adopted Accounting Standards Updates ("ASUs")
In May 2017, the FASB issued ASU 2017-09, "Compensation - Stock Compensation (Topic 718)." This new guidance provides guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting in Topic 718. This new guidance is effective for fiscal years beginning after December 15, 2017, and should be applied prospectively to an award modified on or after the adoption date. We adopted this guidance, as required, in the first quarter of 2018, which did not have a material impact on our consolidated financial statements.
In November 2016, the FASB issued ASU 2016-18, "Statement of Cash Flows (Topic 230): Restricted Cash." This new guidance amends previous guidance on how to classify and present changes in restricted cash on the statement of cash flows. This new guidance is effective for fiscal years beginning after December 15, 2017. We adopted this guidance, as required, in the first quarter of 2018, which did not have a material impact on our results of operations but impacted the presentation of the statements of cash flows and related footnote disclosures.
In October 2016, the FASB issued ASU 2016-16, "Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory." This new guidance allows an entity to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. It also eliminates the exceptions for an intra-entity transfer of assets other than inventory. This new guidance is effective for fiscal years beginning after December 15, 2017. We adopted this guidance, as required, in the first quarter of 2018, which did not have a material impact on our consolidated financial statements.
In August 2016, the FASB issued ASU 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments." This new guidance provides guidance on how to present and classify certain cash receipts and cash payments in the statement of cash flows. This new guidance is effective for fiscal years beginning after December 15, 2017. We adopted this guidance, as required, in the first quarter of 2018, which did not have a material impact on our consolidated financial statements.
In January 2016, the FASB issued ASU 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities." This new guidance amends accounting related to the classification and measurement of investments in equity securities and the presentation of certain fair value changes for financial liabilities measured at fair value. This new guidance also amends certain disclosure requirements associated with the fair value of financial instruments and it is effective for fiscal years beginning after December 15, 2017. In February 2018, the FASB issued ASU 2018-03,

"Technical Corrections and Improvements to Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities," which clarified certain aspects of the guidance issued in ASU 2016-01. We adopted this guidance, as required, in the first quarter of 2018. This did not have a material impact on our consolidated financial statements as our investments in debt securities and loans were not subject to the amendments in this ASU. In accordance with this guidance, we amended certain fair value disclosures related to financial instruments that are carried at amortized cost on the consolidated balance sheets.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2018
(Unaudited)

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

In May 2014, the FASB issued ASU 2014-09, “Revenue from Contracts with Customers.” The update modifies the guidance companies use to recognize revenue from contracts with customers for transfers of goods or services and transfers of nonfinancial assets, unless those contracts are within the scope of other standards. The guidance also requires new qualitative and quantitative disclosures, including information about contract balances and performance obligations. In July 2015, the FASB approved a one-year deferral of the effective date. Accordingly, the update is effective for us in the first quarter of 2018 with retrospective application to prior periods presented or as a cumulative effect adjustment in the period of adoption. In March 2016, the FASB issued ASU 2016-08, "Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)." This new guidance provides additional implementation guidance on how an entity should identify the unit of accounting for the principal versus agent evaluations. In May 2016, the FASB issued ASU 2016-12, "Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients," and in December 2016, the FASB issued ASU 2016-20, "Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers." These new ASUs provide more specific guidance on certain aspects of Topic 606. In September 2017, the FASB issued ASU 2017-13, "Revenue Recognition (Topic 605), Revenue from Contracts with Customers (Topic 606), Leases (Topic 840), and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to the Staff Announcement at the July 20, 2017 EITF Meeting and Rescission of Prior SEC Staff Announcements and Observer Comments (SEC Update)." This new ASU allows certain public business entities to use the nonpublic business entity effective dates for adoption of the new revenue standard. In November 2017, the FASB issued ASU 2017-14, "Income Statement - Reporting Comprehensive Income (Topic 220), Revenue Recognition (Topic 605), and Revenue from Contracts with Customers (Topic 606): Amendments to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 116 and SEC Release No. 33-10403." This new ASU amends various paragraphs that contain SEC guidance. We adopted this guidance, as required, in the first quarter of 2018. This did not have a material impact on our consolidated financial statements as nearly all of our income is generated from financial instruments, which are explicitly scoped out of these standards.

Other Recent Accounting Pronouncements

In February 2018, the FASB issued ASU 2018-02, "Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income." This new guidance allows a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act of 2017 (the "Tax Act"). This new guidance is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. We plan to adopt this new guidance by the required date and do not anticipate that this update will have a material impact on our consolidated financial statements.

In August 2017, the FASB issued ASU 2017-12, "Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities." This new guidance amends previous guidance to better align an entity's risk management activities and financial reporting for hedging relationships through changes to both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. This new guidance is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. We plan to adopt this new guidance by the required date and do not anticipate that this update will have a material impact on our consolidated financial statements.

In July 2017, the FASB issued ASU 2017-11, "Earnings Per Share (Topic 260); Distinguishing Liabilities from Equity (Topic 480); Derivatives and Hedging (Topic 815): (Part I) Accounting for Certain Financial Instruments with Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception." This new guidance changes the classification analysis of certain equity-linked financial instruments (or embedded conversion options) with down round features. This new guidance is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. We plan to adopt this new guidance by the required date and do not anticipate that this update will have a material impact on our consolidated financial statements.

In March 2017, the FASB issued ASU 2017-08, "Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20)." This new guidance shortens the amortization period for certain callable debt securities purchased at a premium by requiring the premium to be amortized to the earliest call date. This new guidance is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. We plan to adopt this new guidance by the required date and do not anticipate that this update will have a material impact on our consolidated financial statements.

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

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments - Credit Losses." This new guidance provides a new impairment model that is based on expected losses rather than incurred losses to determine the allowance for credit losses. This new guidance is effective for fiscal years beginning after December 15, 2019. Early adoption is permitted for fiscal years beginning December 15, 2018. We currently have only a small balance of loans receivable that are not carried at fair value and would be subject to this new guidance for allowance for credit losses. Separately, we account for our available-for-sale securities under the other-than-temporary impairment ("OTTI") model for debt securities. This new guidance requires that credit impairments on our available-for-sale securities be recorded in earnings using an allowance for credit losses, with the allowance limited to the amount by which the security's fair value is less than its amortized cost basis. Subsequent reversals in credit loss estimates are recognized in income. We plan to adopt this new guidance by the required date and continue to evaluate the impact that this update will have on our consolidated financial statements.
In February 2016, the FASB issued ASU 2016-02, "Leases." This new guidance requires lessees to recognize most leases on their balance sheet as a right-of-use asset and a lease liability. This new guidance retains a dual lease accounting model, which requires leases to be classified as either operating or capital leases for lessees, for purposes of income statement recognition. This new guidance is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. In July 2018, the FASB issued ASU 2018-10, "Codification Improvements to Topic 842, Leases," which provides more specific guidance on certain aspects of Topic 842. Additionally, in July 2018, the FASB issued ASU 2018-11, "Leases (Topic 842): Targeted Improvements." This new ASU introduces an additional transition method which allows entities to apply the new standard at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. As discussed in Note 13, our only material leases are those related to our leased office space, for which future payments under these leases totaled $17 million at June 30, 2018. Upon adoption of this standard in the first quarter of 2019, we will record a right-of-use asset and lease liability equal to the present value of these future lease payments discounted at our incremental borrowing rate. Based on our initial evaluation of this new guidance, and taking into consideration our current in-place leases, we do not expect that its adoption will have a material impact on our consolidated financial statements. We will continue evaluating this new standard and caution that any changes in our business or additional leases we may enter into could change our initial assessment.

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

Balance Sheet Netting
Certain of our derivatives and short-term debt are subject to master netting arrangements or similar agreements. Under GAAP, in certain circumstances we may elect to present certain financial assets, liabilities and related collateral subject to master netting arrangements in a net position on our consolidated balance sheets. However, we do not report any of these financial assets or liabilities on a net basis, and instead present them on a gross basis on our consolidated balance sheets.
The table below presents financial assets and liabilities that are subject to master netting arrangements or similar agreements categorized by financial instrument, together with corresponding financial instruments and corresponding collateral received or pledged at June 30, 2018 and December 31, 2017.
Table 3.1 – Offsetting of Financial Assets, Liabilities, and Collateral

June 30, 2018 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet (1)		Net Amount
				Financial Instruments	Cash Collateral (Received) Pledged	
Assets (2)						
Interest rate agreements	$59,468	$ —	$59,468	$(12,372)	$ (6,803)	$40,293
TBAs	3,186	—	3,186	(2,568)	(481)	137
Total Assets	$62,654	$ —	$62,654	$(14,940)	$ (7,284)	$40,430
Liabilities (2)						
Interest rate agreements	$(44,730)	$ —	$(44,730)	$12,372	$ 32,358	$—
TBAs	(6,372)	—	(6,372)	2,568	3,804	—
Futures	(126)	—	(126)	—	126	—
Loan warehouse debt	(719,394)	—	(719,394)	719,394	—	—
Security repurchase agreements	(706,894)	—	(706,894)	706,894	—	—
Total Liabilities	$(1,477,516)	$ —	$(1,477,516)	$1,441,228	$ 36,288	$—

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

December 31, 2017 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet [1] Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
Assets [2]						
Interest rate agreements	$10,164	$ —	$10,164	$(6,196)	$(42)	$3,926
TBAs	133	—	133	(133)	—	—
Futures	1	—	1	—	—	1
Total Assets	$10,298	$ —	$10,298	$(6,329)	$(42)	$3,927
Liabilities [2]						
Interest rate agreements	$(55,567)	$ —	$(55,567)	$6,196	$49,371	$—
TBAs	(3,808)	—	(3,808)	133	1,376	(2,299)
Loan warehouse debt	(1,039,666)	—	(1,039,666)	1,039,666	—	—
Security repurchase agreements	(648,746)	—	(648,746)	648,746	—	—
Total Liabilities	$(1,747,787)	$ —	$(1,747,787)	$1,694,741	$50,747	$(2,299)

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

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

For each category of financial instrument set forth in the table above, the assets and liabilities resulting from individual transactions within that category between us and a counterparty are subject to a master netting arrangement or similar agreement with that counterparty that provides for individual transactions to be aggregated and treated as a single transaction. For certain categories of these instruments, some of our transactions are cleared and settled through one or more clearinghouses that are substituted as our counterparty. References herein to master netting arrangements or similar agreements include the arrangements and agreements governing the clearing and settlement of these transactions through the clearinghouses. In the event of the termination and close-out of any of those transactions, the corresponding master netting agreement or similar agreement provides for settlement on a net basis. Any such settlement would include the proceeds of the liquidation of any corresponding collateral, subject to certain limitations on termination, settlement, and liquidation of collateral that may apply in the event of the bankruptcy or insolvency of a party. Such limitations should not inhibit the eventual practical realization of the principal benefits of those transactions or the corresponding master netting arrangement or similar agreement and any corresponding collateral.

REDWOOD TRUST, INC. AND SUBSIDIARIES
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Note 4. Principles of Consolidation

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

Analysis of Consolidated VIEs

At June 30, 2018, we consolidated certain of our Legacy Sequoia and Sequoia Choice securitization entities that we determined were VIEs and for which we determined we were the primary beneficiary. Each of these entities is independent of Redwood and of each other and the assets and liabilities of these entities are not owned by and are not legal obligations of ours. Our exposure to these entities is primarily through the financial interests we have retained, although we are exposed to certain financial risks associated with our role as a sponsor, servicing administrator, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities. At June 30, 2018, the estimated fair value of our investments in the consolidated Legacy Sequoia and Sequoia Choice entities was $13 million and $135 million, respectively. The following table presents a summary of the assets and liabilities of these VIEs.

Table 4.1 – Assets and Liabilities of Consolidated VIEs

June 30, 2018 (Dollars in Thousands)	Legacy Sequoia	Sequoia Choice	Total Consolidated VIEs
Residential loans, held-for-investment	$592,029	$1,481,145	$ 2,073,174
Restricted cash	147	10	157
Accrued interest receivable	835	5,956	6,791
REO	2,649	—	2,649
Total Assets	$595,660	$1,487,111	$ 2,082,771
Accrued interest payable	$589	$5,038	$ 5,627
Accrued expenses and other liabilities	—	10	10
Asset-backed securities issued	582,235	1,347,427	1,929,662
Total Liabilities	$582,824	$1,352,475	$ 1,935,299
Number of VIEs	20	4	24

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Note 4. Principles of Consolidation - (continued)

December 31, 2017 (Dollars in Thousands)	Legacy Sequoia	Sequoia Choice	Total Consolidated VIEs
Residential loans, held-for-investment	$632,817	$620,062	$ 1,252,879
Restricted cash	147	4	151
Accrued interest receivable	867	2,524	3,391
REO	3,353	—	3,353
Total Assets	$637,184	$622,590	$ 1,259,774
Accrued interest payable	$537	$2,031	$ 2,568
Accrued expenses and other liabilities	—	4	4
Asset-backed securities issued	622,445	542,140	1,164,585
Total Liabilities	$622,982	$544,175	$ 1,167,157