REDWOOD TRUST INC
Form 10-Q
November 02, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**
**Washington, D.C. 20549**
**Form 10-Q**

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

**For the quarterly period ended: September 30, 2006**

**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)*

Indicate by check mark whether the Registrant (1) has filed all documents and 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 þ No o

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

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

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

| | |
|---|---|
| Common Stock ($0.01 par value per share) | 26,155,375 as of November 1, 2006 |

**REDWOOD TRUST, INC.**
**FORM 10-Q**
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## PART I. FINANCIAL INFORMATION

**ITEM 1. *FINANCIAL STATEMENTS***
**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**CONSOLIDATED BALANCE SHEETS**
**(In thousands, except share data)**
**(Unaudited)**

| | September 30, 2006 | December 31, 2005 |
|---|---|---|
| **ASSETS** | | |
| Real estate loans | $ 9,874,964 | $ 13,934,484 |
| Real estate securities | 2,912,365 | 2,418,917 |
| Cash and cash equivalents | 112,926 | 175,885 |
| Total earning assets | 12,900,255 | 16,529,286 |
| Restricted cash | 139,441 | 72,421 |
| Accrued interest receivable | 67,304 | 76,469 |
| Interest rate agreements | 29,692 | 31,220 |
| Principal receivable | 1,075 | 225 |
| Deferred tax asset | 3,205 | 5,384 |
| Deferred asset-backed security issuance costs | 46,945 | 54,125 |
| Other assets | 11,885 | 7,830 |
| **Total Assets** | $ 13,199,802 | $ 16,776,960 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| LIABILITIES | | |
| Redwood debt | $ 509,994 | $ 169,707 |
| Asset-backed securities issued | 11,554,259 | 15,585,277 |
| Accrued interest payable | 51,304 | 41,027 |
| Interest rate agreements | 6,080 | 507 |
| Accrued expenses and other liabilities | 17,267 | 27,889 |
| Dividends payable | 18,237 | 17,593 |
| Total liabilities | 12,157,141 | 15,842,000 |
| Commitments and contingencies *(Note 11)* | | |
| STOCKHOLDERS EQUITY | | |
| Common stock, par value $0.01 per share, 50,000,000 shares authorized; 26,053,016 and 25,132,625 issued and outstanding | 261 | 251 |
| Additional paid-in capital | 874,847 | 824,365 |
| Accumulated other comprehensive income | 94,780 | 73,731 |
| Cumulative earnings | 773,320 | 681,479 |
| Cumulative distributions to stockholders | (700,547) | (644,866) |
| Total stockholders equity | 1,042,661 | 934,960 |

| | | | | |
|---|---|---|---|---|
| **Total Liabilities and Stockholders Equity** | $ | 13,199,802 | $ | 16,776,960 |

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 September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| **Interest income** | | | | |
| Real estate loans | $ 149,483 | $ 194,025 | $ 469,028 | $ 600,282 |
| Real estate securities | 72,759 | 48,811 | 189,656 | 127,095 |
| Cash and cash equivalents | 1,872 | 990 | 7,220 | 2,374 |
| Interest income before provision for credit reserve | 224,114 | 243,826 | 665,904 | 729,751 |
| (Provision for) reversal of credit reserve | (465) | 805 | 1,865 | 1,307 |
| Total interest income | 223,649 | 244,631 | 667,769 | 731,058 |
| **Interest expense** | | | | |
| Redwood debt | (9,422) | (3,789) | (13,316) | (8,272) |
| Asset-backed securities issued | (165,251) | (192,802) | (515,531) | (559,341) |
| Total interest expense | (174,673) | (196,591) | (528,847) | (567,613) |
| **Net interest income** | 48,976 | 48,040 | 138,922 | 163,445 |
| Operating expenses | (13,455) | (12,364) | (42,074) | (35,618) |
| Net recognized gains and valuation adjustments | 433 | 24,916 | 4,556 | 42,973 |
| Net income before provision for income taxes | 35,954 | 60,592 | 101,404 | 170,800 |
| Provision for income taxes | (3,538) | (4,693) | (9,563) | (13,424) |
| **Net income** | $ 32,416 | $ 55,899 | $ 91,841 | $ 157,376 |
| Basic earnings per share: | $ 1.25 | $ 2.26 | $ 3.60 | $ 6.41 |
| Diluted earnings per share: | $ 1.22 | $ 2.21 | $ 3.51 | $ 6.26 |
| Regular dividends declared per common share | $ 0.70 | $ 0.70 | $ 2.10 | $ 2.10 |
| Special dividends declared per common share | | | | |
| Total dividends declared per common share | $ 0.70 | $ 0.70 | $ 2.10 | $ 2.10 |
| Basic weighted average shares outstanding | 25,869,743 | 24,712,536 | 25,525,054 | 24,554,475 |
| | 26,624,532 | 25,314,315 | 26,132,000 | 25,159,619 |

Diluted weighted average shares outstanding

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

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**
**(In thousands)**
**(Unaudited)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| **Net income** | $ 32,416 | $ 55,899 | $ 91,841 | $ 157,376 |
| **Other comprehensive income:** | | | | |
| Net unrealized gains (losses) on available-for-sale securities | 31,342 | (16,200) | 29,962 | 34,578 |
| Reclassification adjustment for net (gains) losses included in net income | 30 | (18,137) | 686 | (31,100) |
| Net unrealized gains (losses) on cash flow hedges | (27,576) | 13,891 | (3,261) | 7,901 |
| Reclassification of net realized cash flow hedge (gains) losses to interest expense on asset-backed securities issued and net recognized gains and valuation adjustments | 47 | 109 | (6,338) | 307 |
| **Total other comprehensive income** | 3,843 | (20,337) | 21,049 | 11,686 |
| **Comprehensive income** | $ 36,259 | $ 35,562 | $ 112,890 | $ 169,062 |

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

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**
**For the Nine Months Ended September 30, 2006:**
**(In thousands, except share data)**
**(Unaudited)**

| | Common Stock Shares | Common Stock Amount | Additional Paid-In Capital | Other Comprehensive Income | Cumulative Earnings | Cumulative Distributions to Stockholders | Total |
|---|---|---|---|---|---|---|---|
| ***December 31, 2005*** | 25,132,625 | $ 251 | $ 824,365 | $ 73,731 | $ 681,479 | $ (644,866) | $ 934,960 |
| Net income | | | | | 91,841 | | 91,841 |
| Net unrealized (gain) reclassification on assets AFS | | | | 30,648 | | | 30,648 |
| Net unrealized gain/ reclassification on interest rate agreements | | | | (9,599) | | | (9,599) |
| Issuance of common stock: | | | | | | | |
| Dividend Reinvestment & Stock Purchase Plans | 862,733 | 9 | 38,563 | | | | 38,572 |
| Employee Option & Stock Purchase Plans | 60,524 | 1 | 663 | | | | 664 |
| Restricted Stock & Stock DERs | (2,866) | | 11,256 | | | | 11,256 |
| Dividends declared: | | | | | | | |
| Common | | | | | | (55,681) | (55,681) |
| ***September 30, 2006*** | 26,053,016 | $ 261 | $ 874,847 | $ 94,780 | $ 773,320 | $ (700,547) | $ 1,042,661 |

**For the Nine Months Ended September 30, 2005:**
**(In thousands, except share data)**
**(Unaudited)**

| Common Stock | Additional Paid-In | Other Comprehensive | Cumulative | Cumulative |
|---|---|---|---|---|

| | Shares | Amount | Capital | Income | Earnings | Distributions to Stockholders | Total |
|---|---|---|---|---|---|---|---|
| ***December 31, 2004*** | 24,153,576 | $ 242 | $ 773,222 | $ 105,357 | $ 481,607 | $ (496,272) | $ 864,156 |
| Comprehensive income: | | | | | | | |
| Net income | | | | | 157,376 | | 157,376 |
| Net unrealized gain on assets AFS | | | | 3,478 | | | 3,478 |
| Net unrealized gain on interest rate agreements | | | | 8,208 | | | 8,208 |
| Issuance of common stock: | | | | | | | |
| Secondary Offerings | | | | | | | |
| Dividend Reinvestment & Stock Purchase Plans | 582,250 | 5 | 31,294 | | | | 31,299 |
| Employee Option & Stock Plans | 19,969 | 1 | 739 | | | | 740 |
| Restricted Stock & Stock DERs | 8,609 | | 2,852 | | | | 2,852 |
| Dividends declared: | | | | | | | |
| Common | | | | | | (52,044) | (52,044) |
| ***September 30, 2005*** | 24,764,404 | $ 248 | $ 808,107 | $ 117,043 | $ 638,983 | $ (548,316) | $ 1,016,065 |

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

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(In thousands)**
**(Unaudited)**

| | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|---|---|---|
| **Cash Flows From Operating Activities:** | | |
| Net income | $ 91,841 | $ 157,376 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Net amortization of premiums, discounts, and debt issuance costs | (48,611) | (61,045) |
| Depreciation and amortization of non-financial assets | 836 | 622 |
| Reversal of credit loss provision | (1,865) | (1,307) |
| Non-cash stock compensation | 11,256 | 2,852 |
| Net recognized gains and valuation adjustments | (4,556) | (42,973) |
| Principal payments on real estate loans held-for-sale | | 885 |
| Net sales of real estate loans held-for-sale | | 95,841 |
| Purchases of real estate loans held-for-sale | | (81,804) |
| Net change in: | | |
| Accrued interest receivable | 9,165 | (7,499) |
| Principal receivable | (850) | 1,124 |
| Deferred income taxes | 212 | 2,893 |
| Other assets | 770 | 161 |
| Accrued interest payable | 10,277 | 7,141 |
| Accrued expenses and other liabilities | (10,622) | 2,387 |
| Net cash provided by operating activities | 57,853 | 76,654 |
| **Cash Flows From Investing Activities:** | | |
| Purchases of real estate loans held-for-investment | (1,291,989) | (1,530,510) |
| Proceeds from sales of real estate loans held-for-investment | 8,408 | 181,827 |
| Principal payments on real estate loans held-for-investment | 5,303,962 | 7,247,574 |
| Purchases of real estate securities available-for-sale | (818,219) | (757,870) |
| Proceeds from sales of real estate securities available-for-sale | 241,624 | 141,442 |
| Principal payments on real estate securities available-for-sale | 161,790 | 153,971 |
| Net increase in restricted cash | (67,020) | (22,758) |
| Net cash provided by investing activities | 3,538,556 | 5,413,676 |
| **Cash Flows From Financing Activities:** | | |
| Net borrowings (repayments) on Redwood debt | 340,287 | (41,542) |
| Proceeds from issuance of asset-backed securities | 1,460,572 | 1,998,008 |
| Deferred asset-backed security issuance costs | (10,591) | (11,259) |
| Repayments on asset-backed securities | (5,431,649) | (7,307,909) |
| Net (purchase) of interest rate agreements | (2,186) | (2,860) |

| | | | | |
|---|---|---|---|---|
| Net proceeds from issuance of common stock | | 39,236 | | 32,038 |
| Dividends paid | | (55,037) | | (50,892) |
| Net cash used in financing activities | | (3,659,368) | | (5,384,416) |
| Net (decrease) increase in cash and cash equivalents | | (62,959) | | 105,914 |
| Cash and cash equivalents at beginning of period | | 175,885 | | 57,246 |
| Cash and cash equivalents at end of period | $ | 112,926 | $ | 163,160 |
| **Supplemental disclosure of cash flow information:** | | | | |
| Cash paid for interest | $ | 518,570 | $ | 560,692 |
| Cash paid for taxes | $ | 7,999 | $ | 8,765 |
| **Non-cash financing activity:** | | | | |
| Dividends declared but not paid | $ | 18,237 | $ | 17,335 |

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

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS**
**September 30, 2006**
**(Unaudited)**

**NOTE 1. REDWOOD TRUST**

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

As a real estate investment trust (REIT), we are required to distribute to stockholders as dividends at least 90% of our REIT taxable income, which is our income as calculated for tax purposes, exclusive of income earned in taxable subsidiaries. In order to meet our dividend distribution requirements, we have been paying both a regular quarterly dividend and a year-end special dividend. We expect our special dividend amount to be highly variable and we may not pay a special dividend in every year. Our dividend policies and distribution practices are determined by our Board of Directors and may change over time.

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

**NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Basis of Presentation***

The consolidated financial statements presented herein are for September 30, 2006 and December 31, 2005 and for the three and nine month periods ended September 30, 2006 and 2005. The accompanying consolidated financial statements are unaudited. The unaudited interim consolidated financial statements have been prepared on the same basis as the annual consolidated financial statements and, in our opinion, reflect all adjustments necessary for a fair statement of our financial position, results of operations, and cash flows. These consolidated financial statements and notes thereto should be read in conjunction with our audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2005. The results for the three and nine months ended September 30, 2006 are not necessarily indicative of the expected results for the year ended December 31, 2006. Certain amounts for prior periods have been reclassified to conform to the September 30, 2006 presentation. The nine months ended September 30, 2005 comparable cash flow statement has been reclassified to conform with the 2005 Form 10-K cash flow presentation.

These consolidated financial statements include the accounts of Redwood and its wholly-owned subsidiaries, Sequoia Mortgage Funding Corporation, Redwood Mortgage Funding, Inc. (RMF), Redwood Asset Management, Inc. (RAM), Cypress Trust, Inc., Acacia CDO 1, Ltd. through Acacia CDO 10, Ltd., Acacia CDO CRE1, Ltd., RWT Holdings, Inc. (Holdings), and Holdings wholly-owned subsidiaries, including Sequoia Residential Funding, Inc. and Madrona Residential Funding LLC. References to Sequoia mean Sequoia Mortgage Funding Corporation and Sequoia Residential Funding, Inc. References to Acacia mean all the Acacia CDO entities. References to the Redwood REIT mean Redwood exclusive of its taxable subsidiaries. The taxable subsidiaries of Redwood are Holdings, Holdings wholly owned subsidiaries, RMF and RAM, and the Acacia entities. All inter-company balances and transactions have been eliminated in consolidation.

Due diligence expenses are costs for services related to re-underwriting and analyzing the loans we acquire or the loans we credit-enhance through the purchase of certain securities. In previous financial statements we recognized these expenses as a reduction in interest income. After reviewing again the nature of these costs it was determined that they did not directly relate to the specific creation of a securitization and were dependent on specific asset acquisition analysis (which may or may not result in our acquiring assets). Therefore, beginning in the second quarter of 2006, we are recognizing these due diligence costs as an operating expense, and these amounts for prior periods have been reclassified to conform to this presentation.

**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**

***Use of Estimates***

The preparation of financial statements in conformity with Generally Accepted Accounting Principles in the United States of America (GAAP) requires us to make a significant number of estimates in the preparation of financial statements. These include fair value of certain assets, amount and timing of credit losses, prepayment assumptions, and other items that affect the reported amounts of certain assets and liabilities as of the date of the consolidated financial statements and the reported amounts of certain revenues and expenses during the reported period. It is likely that changes in these estimates (e.g., market values due to changes in supply and demand, credit performance, prepayments, interest rates, or other reasons; yields due to changes in credit outlook and loan prepayments) will occur in the near term. Our estimates are inherently subjective in nature and actual results could differ from our estimates and the differences may be material.

***Sequoia and Acacia Securitizations***

We treat the securitizations we sponsor as financings under the provisions of Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140), as under these provisions we have retained effective control over these loans and securities. Control is maintained through our active management of the assets in the securitization entities, our retained asset transfer discretion, our ability to direct certain servicing decisions, or a combination of the foregoing. These securitization entities issue asset-backed securities (ABS) to fund their acquisitions of loans and securities. Accordingly, the underlying loans owned by the Sequoia entities are shown on our Consolidated Balance Sheets under real estate loans and the Sequoia ABS issued to third parties are shown on our Consolidated Balance Sheets under ABS issued. Assets owned by the Acacia entities are shown on our Consolidated Balance Sheets in our real estate securities portfolio. ABS issued by the Acacia entities are shown on our Consolidated Balance Sheets as ABS issued. In our Consolidated Statements of Income, we record interest income on the loans and securities and interest expense on the ABS issued. Any Sequoia ABS (CES, investment grade, or interest-only security (IO)) acquired by Redwood or Acacia from Sequoia entities and any Acacia ABS acquired by Redwood for its own portfolio are eliminated in consolidation and thus are not shown separately on our Consolidated Balance Sheets.

***Earning Assets***

Earning assets (as consolidated for GAAP purposes) consist primarily of real estate loans and securities. Coupon interest is recognized as revenue when earned according to the terms of the loans and securities and when, in our opinion, it is collectible. Purchase discounts and premiums related to earning assets are amortized into interest income over their estimated lives to generate an effective yield, considering the actual and future estimated prepayments of the assets. Gains or losses on the sale of earning assets are based on the specific identification method.

Real estate loans combine our consolidated residential and commercial real estate loans. Real estate securities combine our consolidated residential and commercial real estate securities including those securities we define as credit-enhancement securities (CES). CES includes below-investment grade securities. Also included in our securities portfolio are residential sub-prime, collateral debt obligation (CDO), home equity lines of credit (HELOCs), and REIT corporate debt securities.

*Real Estate Loans: Held-for-Investment*

Our consolidated real estate loans are classified as held-for-investment because the consolidated securitization entities that own these assets have the ability and intent to hold these loans to maturity. Real estate loans held-for-investment are carried at their unpaid principal balances adjusted for net unamortized premiums or discounts and net of any allowance for credit losses.

Pursuant to Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Cost of Leases* (FAS 91), we

**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**

use the interest method to determine an effective yield and amortize the premium or discount on loans. For loans acquired prior to July 1, 2004, we use coupon interest rates as they change over time and anticipated principal payments to determine an effective yield to amortize the premium or discount. For loans acquired after July 1, 2004, we use the initial coupon interest rate of the loans (without regard to future changes in the underlying indices) and anticipated principal payments to calculate an effective yield to amortize the premium or discount.

*Real Estate Securities: Available-for-Sale*

Real estate securities are classified as available-for-sale (AFS) and are carried at their estimated fair values. Cumulative unrealized gains and losses are reported as a component of accumulated other comprehensive income in our Consolidated Statements of Stockholders Equity.

When recognizing revenue on AFS securities, we employ the interest method to account for purchase premiums, discounts, and fees associated with these securities. For securities rated AAA or AA, we use the interest method as prescribed under FAS 91, while for securities rated A or lower we use the interest method as prescribed under the Emerging Issues Task Force of the Financial Accounting Standards Board 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets* (EITF 99-20). The use of these methods requires us to project cash flows over the remaining life of each asset. These projections include assumptions about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. We review and make adjustments to our cash flow projections on an ongoing basis and monitor these projections based on input and analyses received from external sources, internal models, and our own judgment and experience. There can be no assurance that our assumptions used to estimate future cash flows or the current period s yield for each asset would not change in the near term.

For determining other-than-temporary impairment on our real estate securities, we use the guidelines prescribed under EITF 99-20, Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115), and Staff Accounting Bulletin No. 5(m), *Other-Than-Temporary Impairment for Certain Investments in Debt and Equity Securities* (SAB 5(m)). Any other-than-temporary impairments are reported under net recognized gains (losses) and valuation adjustments in our Consolidated Statements of Income.

***Credit Reserves***

For consolidated real estate loans held-for-investment, we establish and maintain credit reserves based on estimates of credit losses inherent in these loan portfolios as of the reporting date. To calculate the credit reserve, we assess inherent losses by determining loss factors (defaults, the timing of defaults, and loss severities upon defaults) that can be specifically applied to each of the consolidated loans, loan pools, or individual loans. We follow the guidelines of Staff Accounting Bulletin No. 102, *Selected Loan Loss Allowance Methodology and Documentation* (SAB 102), Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5), and Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114), in setting credit reserves for our real estate loans.

The following factors are considered and applied in such determinations:

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

Historical loss rates and past performance of similar loans;

Relevant environmental factors;

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

Trends in delinquencies and charge-offs;

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**

- Effects and changes in credit concentrations;
- Information supporting the borrowers ability to meet obligations;
- Ongoing evaluations of fair values of collateral using current appraisals and other valuations; and
- Discounted cash flow analyses.

Once we determine applicable default amounts, the timing of the defaults, and severity of losses upon the defaults, we estimate expected losses for each pool of loans over its expected life. We then estimate the timing of these losses and the losses probable to occur over an effective loss confirmation period. This period is defined as the range of time between the probable occurrence of a credit loss (such as the initial deterioration of the borrower s financial condition) and the confirmation of that loss (the actual impairment or charge-off of the loan). The losses expected to occur within the estimated loss confirmation period are the basis of our credit reserves because we believe those losses exist as of the reported date of the financial statements. We re-evaluate the level of our credit reserves on at least a quarterly basis, and we record provision, charge-offs, and recoveries monthly.

Additionally, if a loan becomes real estate owned (REO) or is reclassified as held-for-sale, valuations specific to that loan also include analyses of the underlying collateral.

***Cash and Cash Equivalents***

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

***Other Assets***

*Restricted Cash*

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

*Deferred Tax Assets*

Net deferred tax assets represent the net benefit of net operating loss (NOL) carry forwards, real estate asset basis differences, recognized tax gains on whole loan securitizations, interest rate agreement basis differences, and other temporary GAAP and tax timing differences. These temporary timing differences will be recognized in different periods for GAAP and tax purposes. Net unrealized gains and losses on securities and interest rate agreements in our taxable subsidiaries that are reported in other comprehensive income are adjusted for the effects of tax, thus creating deferred tax assets (liabilities).

*Deferred Asset-Backed Securities Issuance Costs*

Deferred ABS issuance costs are costs associated with the issuance of ABS from securitization entities we sponsor. These costs typically include underwriting, rating agency, legal, accounting, and other fees. Deferred ABS issuance costs are reported on our Consolidated Balance Sheets as deferred charges and are amortized as an adjustment to consolidated interest expense using the interest method based on the actual and estimated repayment schedules of the related ABS issued under the principles prescribed in Accounting Practice Bulletin 21, *Interest on Receivables and Payables* (APB 21).

*Other Assets*

Other assets on our Consolidated Balance Sheets include REO, fixed assets, purchased interest, and other prepaid expenses. REO is reported at the lower of cost or market value.

**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**

*Accrued Interest Receivable and Principal Receivable*

Accrued interest receivable and principal receivable represent principal and interest that is due and payable to us. These are generally received within the next month.

***Interest Rate Agreements and Purchase Commitments***

We enter into interest rate agreements to help manage some of our interest rate risks. We report our interest rate agreements at fair value. Those with a positive value to us are reported as an asset and those with a negative value to us are reported as a liability. We may elect hedge accounting treatment under Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133), or we may account for these as trading instruments. See *Note 5* for a further discussion on interest rate agreements.

We enter into commitments to purchase loans. These commitments are accounted for as derivatives under Statement of Financial Accounting Standards No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (FAS 149), when applicable. These are classified as trading instruments on our Consolidated Balance Sheets until the date of settlement and changes in fair value of the commitments are recorded through Net Recognized Gains and Valuation Adjustments in the Consolidated Statements of Income.

***Redwood Debt***

Redwood debt is short-term debt collateralized by loans and securities. We report this debt at its unpaid principal balance. We may use Redwood debt to fund assets temporarily as we accumulate them for future sale to securitization entities. Increasingly, we will use Redwood debt to fund loans and securities that do not have significant credit risk and that we believe can generate an attractive return on the capital employed.

***Asset-Backed Securities Issued***

The majority of the liabilities reported on our Consolidated Balance Sheets represents ABS issued by bankruptcy-remote securitization entities sponsored by Redwood. These ABS issued are carried at their unpaid principal balances net of any unamortized discount or premium. Our exposure to loss from consolidated securitization entities (such as Sequoia and Acacia) is limited (except, in some circumstances, for limited loan repurchase obligations) to our net investment in securities we have acquired from these entities. As required by the governing documents related to each series of ABS, Sequoia and Acacia assets are held in the custody of trustees. Trustees collect principal and interest payments (less servicing and related fees) from the assets and make corresponding principal and interest payments to the issued ABS. ABS obligations are payable solely from the assets of these entities and are non-recourse to Redwood.

***Other Liabilities***

*Accrued Interest Payable*

Accrued interest payable represents interest due and payable on Redwood debt and ABS issued. It is generally paid within the next month with the exception of interest due on Acacia ABS which is generally settled quarterly.

*Accrued Expenses and Other Liabilities*

Accrued expenses and other liabilities on our Consolidated Balance Sheets include cash held back from borrowers, derivatives margin liability, accrued employee bonuses, executive deferred compensation, dividend equivalent rights (DERs) payable, excise and income taxes, and accrued legal, accounting, consulting, and other miscellaneous expenses.

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**

*Dividends Payable*

Dividends payable reflect any dividend declared by us but not yet distributed to our stockholders as of the financial statement date.

***Income Taxes***

We have elected to be taxed as a REIT under the Internal Revenue Code and the corresponding provisions of state law. In order to qualify as a REIT, we must distribute at least 90% of our annual REIT taxable income (this does not include taxable income retained in our taxable subsidiaries) to stockholders within the time frame set forth in the tax rules and we must meet certain other requirements. If these requirements are met, we generally will not be subject to Federal or state income taxation at the corporate level with respect to the REIT taxable income we distribute to our stockholders. We may retain up to 10% of our REIT taxable income and pay corporate income taxes on this retained income while continuing to maintain our REIT status.

We have recorded a provision for income taxes in our Consolidated Statements of Income based upon our estimated liability for Federal and state income tax purposes. These tax liabilities arise from estimated taxable earnings in taxable subsidiaries and from the planned retention of a portion of our estimated REIT taxable income. See *Note 8* for a further discussion on income taxes.

***Net Income per Share***

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average number of common shares and potential common shares outstanding during the period. Potential common shares outstanding are calculated using the treasury stock method, which assumes that all dilutive common stock equivalents are exercised and the funds generated by the exercises are used to buy back outstanding common stock at the average market price of the common stock during the reporting period.

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**

The following table provides reconciliation of denominators of the basic and diluted net income per share computations.

***Basic and Diluted Net Income Per Share***
**(In thousands, except share data)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| **Denominator:** | | | | |
| Denominator for basic earnings per share: | | | | |
| Weighted average number of common shares outstanding during the period | 25,869,743 | 24,712,536 | 25,525,054 | 24,554,475 |
| Net effect of dilutive stock options | 754,789 | 601,779 | 606,946 | 605,144 |
| Denominator for diluted earnings per share | 26,624,532 | 25,314,315 | 26,132,000 | 25,159,619 |
| **Basic Earnings Per Share:** | | | | |
| Net income per share | $ 1.25 | $ 2.26 | $ 3.60 | $ 6.41 |
| **Diluted Earnings Per Share:** | | | | |
| Net income per share | $ 1.22 | $ 2.21 | $ 3.51 | $ 6.26 |

Pursuant to EITF 03-6, *Participating Securities and the Two Class Method* under *FASB No. 128* (EITF 03-6), we determined that there was no allocation of income for our outstanding stock options as they were antidilutive during the three and nine months ended September 30, 2006 and 2005. There were no other participating securities, as defined by EITF 03-6, during the three and nine months ended September 30, 2006 and 2005. For the three and nine months ended September 30, 2006, the number of outstanding stock options that were antidilutive totaled 369,343 and 384,399, respectively. For the three and nine months ended September 30, 2005, the number of outstanding stock options that were antidilutive totaled 368,522 and 167,622, respectively.

***Other Comprehensive Income***

Current period net unrealized gains and losses on real estate loan CES, real estate securities available-for-sale, and interest rate agreements classified as cash flow hedges are reported as components of other comprehensive income on our Consolidated Statements of Comprehensive Income. Net unrealized gains and losses on securities and interest rate agreements held by our taxable REIT subsidiaries that are reported in other comprehensive income are adjusted for the effects of tax, thus creating deferred tax assets (liabilities).

***Stock-Based Compensation***

As of September 30, 2006 and December 31, 2005, we had one stock-based employee compensation plan and one employee stock purchase plan. These plans, and associated stock options and other equity awards, are described more fully in *Note 10.*

We adopted Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* (FAS 123R), on January 1, 2006. With the adoption of FAS 123R, the grant date fair value of all remaining unvested stock compensation awards (stock options, deferred stock units, and restricted stock) are expensed on the Consolidated Statements of Income over the remaining vesting period. At January 1, 2006, upon adoption of FAS 123R, we had $19.3 million of unamortized costs related to non-

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**

vested equity awards (stock options, restricted stock, and deferred stock units). At September 30, 2006, the unamortized costs totaled $11.4 million and will be expensed over the next four years, over half of which will be recognized over the next twelve months.

Beginning in 2003, in accordance with the guidance of Statement of Financial Accounting Standards No. 148, *Accounting for Stock Based Compensation Transition and Disclosure, an amendment for FASB Statement No. 123* (FAS 148), we elected to prospectively apply the fair value method of accounting for stock-based awards issued after December 31, 2002. We accounted for all stock-based compensation awards issued prior to December 31, 2002 under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and related interpretations. Under APB 25, when we granted option awards we did not include any stock-based employee compensation cost in net income, as all option awards granted had an exercise price equal to the fair market value of the underlying common stock on the date of grant. All other equity awards (deferred stock units and restricted stock), were valued at the grant date and expensed over the vesting period (regardless of when they were granted). Had we also applied Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (FAS 123), to option awards granted prior to 2003, net income and net income per share would have been the pro-forma amounts indicated in the table below for the three and nine months ended September 30, 2005. Since we adopted FAS 123R as of January 1, 2006, there is no pro-forma presentation for the three and nine months ended September 30, 2006.

***Pro-Forma Net Income Under FAS 123***
**(In thousands, except share data)**

| | Three Months Ended September 30, 2005 | | Nine Months Ended September 30, 2005 | |
|---|---|---|---|---|
| Net income, as reported | $ | 55,899 | $ | 157,376 |
| Add: Dividend equivalent right operating expenses under APB 25 | | 2,029 | | 5,587 |
| Deduct: Stock option operating (expense) income under APB 25 | | (16) | | (98) |
| Deduct: Stock-based employee compensation expense determined under fair value based method for awards granted prior to January 1, 2003 | | (201) | | (671) |
| Pro forma net income | $ | 57,711 | $ | 162,194 |
| Earnings per share: | | | | |
| Basic as reported | $ | 2.26 | $ | 6.41 |
| Basic pro forma | $ | 2.34 | $ | 6.61 |
| Diluted as reported | $ | 2.21 | $ | 6.26 |
| Diluted pro forma | $ | 2.28 | $ | 6.45 |

The Black-Scholes option-pricing model was used in determining fair values of option grants accounted for under FAS 123R and FAS 123. The model requires the use of assumptions such as strike price, expected life, risk free rate of return, and stock price volatility. Options are generally granted over the course of the calendar year. Certain options have dividend equivalent rights (DERs) and, accordingly, the assumed dividend yield was zero for these options. Other options granted have no DERs and the assumed dividend yield was 10%. There were no options granted during the three months ended September 30, 2006 and 2005. The following table describes the weighted average of assumptions used for calculating the value of options granted during the nine months ended September 30, 2006 and

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**

2005. Similar assumptions were used to calculate the pro forma information presented in the table above.

***Weighted Average Assumptions used for Valuation of Options Under FAS 123R and FAS 123 Granted during period***

| | Nine Months Ended September 30, | |
|---|---|---|
| | **2006** | **2005** |
| Stock price volatility | 25.7% | 26.41% |
| Risk free rate of return (Treasury Rate) | 4.75% | 4.07% |
| Average life | 5 years | 5 years |
| Dividend yield assumptions | 10.00% | 4.45% |

***Recent Accounting Pronouncements***

In February 2006, the FASB issued Statement 155, *Accounting for Certain Hybrid Financial Instruments,* (FAS 155), to amend FAS 133 and FAS 140. This Statement simplifies the accounting for certain financial instruments by allowing an entity to make an irrevocable election on a specific instrument basis for certain financial assets and liabilities that contain embedded derivatives that would otherwise require bifurcation and to recognize and re-measure at fair value these instruments so elected. Thus, under this election, an entity would measure the entire hybrid financial instrument at fair value with changes in fair value recognized in earnings. FAS 155 will become effective for us as of January 1, 2007. We are currently assessing the impact on our financial statements.

In March 2006, the FASB issued Statement 156, *Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140* (FAS 156). This Statement amends FAS 140 with respect to the accounting for separately recognized servicing assets and servicing liabilities. FAS 156 requires an entity to either (i) recognize servicing assets or servicing liabilities initially at fair value and amortize this value over the period of servicing, or (ii) measure servicing assets or liabilities at fair value at each reporting date with changes in fair value reported in earnings. FAS 156 will become effective for us as of January 1, 2007. We believe FAS 156 will not have a material impact on our financial statements.

In July 2006, the FASB released *Accounting for Uncertainty In Income Taxes* (FIN 48). FIN 48 addresses the recognition and measurement of uncertain income tax positions using a more-likely-than-not threshold and introduces a number of new disclosure requirements. The differences between current practice and the requirements of FIN 48 are significant, and a substantial effort will be required by most companies to properly assess all material uncertain positions. Further, the impact of FIN 48 is not just technical; the interpretation may cause companies to modify their tax-related strategies. The new guidance will become effective for us January 1, 2007. We are currently assessing the impact on our financial statements.

In September 2006, the FASB issued Statement 157, *Fair Value Measurements,* (FAS 157). This statement clarifies the definition of fair value, the methods used to measure fair value, and requires expanded financial statement disclosures about fair value measurements for assets and liabilities. FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The new guidance will be effective for us January 1, 2008 and we are currently assessing the impact on our financial statements.

In September 2006, the SEC s Office of the Chief Accountant and Divisions of Corporation Finance and Investment Management released Staff Accounting Bulletin No. 108 (SAB 108), which provides interpretive guidance on how registrants should quantify financial-statement misstatements. Currently, the two methods most commonly used by preparers and auditors to quantify misstatements are the rollover method (which focuses primarily on the income statement impact of misstatements) and the iron curtain method (which focuses primarily on the balance sheet impact of misstatements). Under SAB 108, registrants will be required to consider both the rollover and iron curtain methods (i.e., a dual

**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**

approach) when evaluating the materiality of financial statement errors. Registrants will need to revisit their prior materiality assessments and consider them using both the rollover and iron curtain methods.

SAB 108 is effective for annual financial statements in the first fiscal year ending after November 15, 2006, therefore for us, the year ended December 31, 2006. The SAB provides transition accounting and disclosure guidance for situations in which a registrant concludes that a material error(s) existed in prior-period financial statements under the dual approach. Specifically, registrants will be permitted to restate prior period financial statements or recognize the cumulative effect of initially applying SAB 108 through an adjustment to beginning retained earnings in the year of adoption. We believe SAB 108 will not have a material impact on our annual financial statements.

In the first quarter of 2006, we became aware of a potential technical interpretation of GAAP that differs from our current accounting presentations. This issue relates to the accounting for transactions where assets are purchased from a counterparty and simultaneously financed through a repurchase agreement with that same counterparty and whether these transactions create derivatives instead of the acquisition of assets with related financing (which is how we currently present these transactions). This potential technical interpretation of GAAP does not affect the economics of the transactions but may affect how the transactions would be reported in our financial statements. Our cash flows, our liquidity, and our ability to pay a dividend would be unchanged, and we do not believe our taxable income would be affected. We have not changed our accounting treatment for this potential issue. However, if we were to change our current accounting presentations based on this interpretation, we do not believe there would be a material impact on our consolidated financial statements.

## NOTE 3. EARNING ASSETS

As of September 30, 2006 and December 31, 2005 our reported earning assets (owned by us or by consolidated securitization entities) consisted of investments in adjustable-rate, hybrid, and fixed-rate real estate loans and securities. Adjustable-rate loans have coupons that reset at least annually. Hybrid loans have an initial fixed coupon rate for three to ten years followed by periodic (usually annual or semi-annual) adjustments. The original maturity of the majority of our residential real estate loans and residential real estate securities is usually twenty-five to thirty years. The original maturity of our HELOCs is generally ten years. The original maturity of our commercial real estate loans and commercial real estate securities is generally ten years. The actual maturity is subject to change based on the prepayments of the underlying loans.

For the three months ended September 30, 2006 and 2005, the average consolidated balance of earning assets was $12.9 billion and $20.1 billion, respectively. For the nine months ended September 30, 2006 and 2005, the average consolidated balance of earning assets was $13.9 billion and $22.2 billion, respectively.

***Real Estate Loans***

We acquire real estate loans from third party originators for sale to securitization entities sponsored by us under our Sequoia program which, in turn, issue ABS (that are shown as liabilities on our Consolidated Balance Sheets). The following tables summarize the carrying value of real estate loans, which

**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**

include residential real estate loans, HELOCs, and commercial real estate loans as reported on our Consolidated Balance Sheets at September 30, 2006 and December 31, 2005.

***Real Estate Loans Composition***
**(In thousands)**

| | September 30, 2006 | December 31, 2005 |
|---|---|---|
| Residential real estate loans | $ 9,725,153 | $ 13,693,833 |
| HELOCs | 117,641 | 180,959 |
| Commercial real estate loans | 32,170 | 59,692 |
| Carrying value | $ 9,874,964 | $ 13,934,484 |

***Real Estate Loans Carrying Value***
**(In thousands)**

| | September 30, 2006 Held for Investment | December 31, 2005 Held for Investment |
|---|---|---|
| Current face | $ 9,761,369 | $ 13,789,333 |
| Unamortized premium | 141,062 | 175,948 |
| Discount designated as credit protection | (8,141) | (8,141) |
| Amortized cost | 9,894,290 | 13,957,140 |
| Reserve for credit losses | (19,326) | (22,656) |
| Carrying value | $ 9,874,964 | $ 13,934,484 |

Of the $9.8 billion of face and $141 million of unamortized premium on our real estate loans at September 30, 2006, $6.0 billion of face and $114 million of unamortized premium relates to loans acquired prior to July 1, 2004. The loans acquired prior to July 1, 2004 had face and unamortized premium balances of $9.7 billion and $138 million, respectively, at December 31, 2005. During the first nine months of 2006, 39% of these loans prepaid and we amortized 17% of the premium over the first nine months of 2006. For these loans acquired prior to July 2004, we use coupon interest rates as they change over time and anticipated principal payments to determine an effective yield to amortize the premium or discount. For real estate loans acquired after July 1, 2004, the face and unamortized premium was $3.8 billion and $27 million at September 30, 2006 and $4.1 billion and $38 million at December 31, 2005, respectively. For these loans acquired after July 1, 2004, we use the initial coupon interest rate of the loans (without regard to future changes in the underlying indices) and anticipated principal payments to calculate an effective yield to amortize the premium or discount.

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**

The following table provides detail of the activity of reported real estate loans for the three and nine months ended September 30, 2006 and 2005.

***Real Estate Loans Activity***

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Balance at beginning of period | $ 10,491,014 | $ 19,672,359 | $ 13,934,484 | $ 22,559,244 |
| Acquisitions | 966,673 | 346,268 | 1,291,989 | 1,612,316 |
| Settled commitment deducted from loan basis | (133) | | (133) | |
| Sales (other than to consolidated ABS trusts) | | (263,096) | (8,408) | (277,666) |
| Principal repayments | (1,570,389) | (3,127,329) | (5,303,962) | (7,248,463) |
| Transfers to REO | (1,093) | (2,005) | (7,026) | (3,334) |
| Net premium amortization | (11,232) | (14,507) | (35,261) | (32,038) |
| Reversal of credit loss provision, net of charge-offs | 124 | 930 | 3,295 | 1,552 |
| Net recognized gains (losses) and valuation adjustments | | (201) | (14) | 808 |
| Balance at end of period | $ 9,874,964 | $ 16,612,419 | $ 9,874,964 | $ 16,612,419 |

Some of the real estate loans we acquire from third party originators, we sell to securitization entities that finance their purchases of loans from us through the issuance of ABS. During the period that we accumulate loans for securitization, we fund these loans with equity and with short-term debt sourced through various whole loan-financing facilities available to us. Our Consolidated Statements of Cash Flows record the proceeds from any principal payments or sales in the same category as our original acquisition was recorded. The table below presents information regarding real estate loans pledged under our borrowing agreements and owned by securitization entities.

***Real Estate Loans Pledged and Unpledged***
**(In thousands)**

| | September 30, 2006 | | December 31, 2005 | |
|---|---|---|---|---|
| | Face Value | Carrying Value | Face Value | Carrying Value |
| Unpledged | $ 155,599 | $ 147,548 | $ 60,259 | $ 51,924 |
| Pledged for Redwood debt | 373,318 | 375,192 | | |
| Owned by securitization entities, financed through the issuance of ABS | 9,232,452 | 9,352,224 | 13,729,074 | 13,882,560 |
| Carrying value | $ 9,761,369 | $ 9,874,964 | $ 13,789,333 | $ 13,934,484 |

***Real Estate Securities***

The real estate securities shown on our Consolidated Balance Sheets include residential and commercial real estate securities acquired from securitizations sponsored by others and certain other securities.

Our real estate securities portfolio includes residential CES (BB, B, and unrated residential real estate securities), commercial first-loss CES (unrated commercial real estates securities), and various other securities, as reported on our Consolidated Balance Sheets at September 30, 2006 and December 31, 2005.

**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**

The table below presents the carrying value on the types of securities that are included in our Consolidated Balance Sheets as of September 30, 2006 and December 31, 2005, and their current credit ratings.

***Real Estate Securities Underlying Collateral Characteristics***
**At September 30, 2006**
**(In millions)**

| | | | | | Rating | | | |
|---|---|---|---|---|---|---|---|---|
| | **Total** | **AAA** | **AA** | **A** | **BBB** | **BB** | **B** | **Unrated** |
| Commercial real estate | $ 513 | $ 5 | $ 2 | $ 18 | $ 105 | $ 195 | $ 71 | $ 117 |
| Residential prime real estate | 1,378 | 20 | 201 | 265 | 294 | 339 | 131 | 128 |
| Residential Alt-A real estate | 283 | 81 | 39 | 8 | 16 | 86 | 20 | 33 |
| Residential HELOCs | 101 | 3 | 50 | 37 | 7 | 4 | | |
| Residential sub-prime real estate | 429 | 5 | 90 | 227 | 102 | 2 | | 3 |
| REIT corporate debt | 9 | | | | 1 | 8 | | |
| Real estate CDOs | 199 | 44 | 28 | 37 | 72 | 14 | | 4 |
| Total securities | $ 2,912 | $ 158 | $ 410 | $ 592 | $ 597 | $ 648 | $ 222 | $ 285 |

**At December 31, 2005**
**(In millions)**

| | | | | | Rating | | | |
|---|---|---|---|---|---|---|---|---|
| | **Total** | **AAA** | **AA** | **A** | **BBB** | **BB** | **B** | **Unrated** |
| Commercial real estate | $ 380 | $ 11 | $ 2 | $ 20 | $ 129 | $ 130 | $ 30 | $ 58 |
| Residential prime real estate | 1,185 | 29 | 197 | 195 | 232 | 281 | 113 | 138 |
| Residential Alt-A real estate | 117 | | 46 | 1 | | 50 | 3 | 17 |
| Residential HELOCs | 108 | | 49 | 54 | 5 | | | |
| Residential sub-prime real estate | 442 | 5 | 86 | 292 | 59 | | | |
| REIT corporate debt | 32 | | | | 24 | 8 | | |
| Real estate CDOs | 155 | 37 | 25 | 37 | 44 | 11 | | 1 |
| Total securities | $ 2,419 | $ 82 | $ 405 | $ 599 | $ 493 | $ 480 | $ 146 | $ 214 |

The table below presents the face value, unamortized discount, the portion of the discount designated as credit protection, the unrealized gains and losses, and the carrying value of real estate securities reported on our Consolidated Balance Sheets.

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**
***Real Estate Securities September 30, 2006***
**(In millions)**

| | Total Real Estate Securities Available-for-Sale | Residential CES and Commercial First-Loss CES Available-for-Sale | Other Securities Available-for-Sale |
|---|---|---|---|
| Current face | $ 3,679,693 | $ 1,533,697 | $ 2,145,996 |
| Unamortized premium interest-only certificates | 8,764 | | 8,764 |
| Unamortized discount, net | (222,256) | (111,412) | (110,844) |
| Discount designated as credit protection | (642,779) | (642,779) | |
| Amortized cost | 2,823,422 | 779,506 | 2,043,916 |
| Gross unrealized gains | 112,919 | 91,228 | 21,691 |
| Gross unrealized losses | (23,976) | (11,612) | (12,364) |
| Carrying value | $ 2,912,365 | $ 859,122 | $ 2,053,243 |

***Real Estate Securities December 31, 2005***
**(In thousands)**

| | Total Real Estate Securities Available-for-Sale | Residential CES and Commercial First-Loss CES Available-for-Sale | Other Securities Available-for-Sale |
|---|---|---|---|
| Current face | $ 3,021,363 | $ 1,211,217 | $ 1,810,146 |
| Unamortized premium interest-only certificates | 14,866 | | 14,866 |
| Unamortized discount, net | (177,438) | (107,337) | (70,101) |
| Discount designated as credit protection | (496,416) | (496,416) | |
| Amortized cost | 2,362,375 | 607,464 | $ 1,754,911 |
| Gross unrealized gains | 93,322 | 80,122 | 13,200 |
| Gross unrealized losses | (36,780) | (17,250) | (19,530) |
| Carrying value | $ 2,418,917 | $ 670,336 | $ 1,748,581 |

At September 30, 2006, our residential CES provided credit-enhancement on $225 billion of residential real estate loans, and our commercial first-loss CES provided credit-enhancement on $36 billion of commercial real estate loans. At December 31, 2005, our residential CES provided credit-enhancement on $170 billion of residential real estate loans, and our commercial first-loss CES provided credit-enhancement on $26 billion of commercial real estate loans.

The amount of designated credit protection equals the amount of credit losses within the underlying loan pool that we expect to incur over the life of the loans. This estimate is determined based upon various factors affecting these assets, including economic conditions, characteristics of the underlying loans, delinquency status, past performance of similar loans, and external credit protection. We use a variety of internal and external credit risk cash flow modeling and portfolio analytical tools to assist in our assessments. Quarterly, we complete our assessments on each individual underlying loan pool and determine the appropriate level of credit protection required for each security we own. The designated credit protection is specific to each security. The following table presents the changes in our unamortized discount and the portion of the discount designated as credit protection for the three and nine months ended September 30, 2006 and 2005.

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**
***Changes In Unamortized Discount and Designated Credit Protection on Residential CES and Commercial First-Loss CES***
**(In thousands)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| Beginning balance of net unamortized discount | $ 90,925 | $ 71,641 | $ 107,337 | $ 97,841 |
| Amortization | (14,946) | (10,291) | (38,144) | (26,038) |
| Calls, sales, and other | (3,177) | (14,153) | (2,759) | (29,544) |
| Re-designation of credit protection to discount | 33,277 | 19,242 | 50,481 | 41,432 |
| Acquisitions | 5,333 | (18,137) | (5,503) | (35,389) |
| Ending balance of net unamortized discount | $ 111,412 | $ 48,302 | $ 111,412 | $ 48,302 |
| Beginning balance of designated credit protection | $ 617,712 | $ 491,390 | $ 496,416 | $ 385,762 |
| Realized credit losses | (2,476) | (1,505) | (5,958) | (4,736) |
| Calls, sales, and other | (35,883) | (33,420) | (40,922) | (44,799) |
| Re-designation of credit protection to discount | (33,277) | (19,242) | (50,481) | (41,432) |
| Acquisitions | 96,703 | 84,169 | 243,724 | 226,597 |
| Ending balance of designated credit protection | $ 642,779 | $ 521,392 | $ 642,779 | $ 521,392 |

The net unamortized discount balance at September 30, 2006 of $111 million consists of $147 million of net unamortized discount on the residential CES and an effective premium of $36 million on the commercial first-loss CES. Yields recognized for GAAP for each security vary as a function of credit results, prepayment rates, and, for our securities with variable rate coupons, interest rates. If estimated future credit losses are less than our prior estimate, credit losses occur later than expected, or prepayment rates are faster than expected (meaning the present value of projected cash flows is greater then previously expected), the yield over the remaining life of the security may be adjusted upwards over time. If estimated future credit losses exceed our prior expectations, credit losses occur more quickly than expected, or prepayments occur more slowly than expected (meaning the present value of projected cash flows is less than previously expected), the yield over the remaining life of the security may be adjusted downward or we may have an other-than-temporary impairment. For the three and nine months ended September 30, 2006, we recognized other-than-temporary impairments of $0.5 million and $6.0 million, respectively. For the three and nine months ended September 30, 2005, we recognized other-than-temporary impairments of $1.2 million and $3.3 million, respectively. These impairments are included in net recognized gains and valuation adjustments in our Consolidated Statements of Income.

Gross unrealized gains and losses represent the difference between the net amortized cost and the fair value of individual securities. Gross unrealized losses represent a decline in market value for securities not deemed impaired for GAAP. The following table shows the gross unrealized losses, fair value, and length of time that any real estate securities have been in a continuous unrealized loss position as of September 30, 2006. These unrealized losses are not considered to be other-than-temporary impairments because these losses are not due to adverse changes in cash flows and we have the intent and ability to hold these securities for a period sufficient for these securities to potentially recover their values.

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**
***Real Estate Securities with Unrealized Losses as of September 30, 2006***
**(In thousands)**

| | Less Than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized (Losses) | Fair Value | Unrealized (Losses) | Fair Value | Unrealized (Losses) |
| Real estate securities | $ 548,959 | $ (13,112) | $ 341,343 | $ (10,864) | $ 890,302 | $ (23,976) |

The following table provides detail of the activity in our real estate securities portfolio for the three and nine months ended September 30, 2006 and 2005.

***Real Estate Securities Activity***
**(In thousands)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Balance at beginning of period | $ 2,661,250 | $ 2,384,429 | $ 2,418,917 | $ 1,956,232 |
| Acquisitions | 321,397 | 264,823 | 818,219 | 757,870 |
| Sales (other than to consolidated ABS trusts) | (65,192) | (98,775) | (241,624) | (141,442) |
| Principal repayments (including calls) | (59,987) | (60,236) | (161,790) | (153,971) |
| Discount amortization | 17,400 | 10,857 | 42,719 | 26,870 |
| Net unrealized gains (losses) | 32,291 | (34,338) | 32,402 | 3,478 |
| Net recognized gains and valuation adjustments | 5,206 | 25,010 | 3,522 | 42,733 |
| Balance at end of period | $ 2,912,365 | $ 2,491,770 | $ 2,912,365 | $ 2,491,770 |

Of the $60 million and $162 million of principal pay downs in the three and nine months ended September 30, 2006, $6 million and $12 million, respectively, represented calls of the securities in accordance with the original issue provisions of individual securitization entities. Of the $60 million and $154 million of principal pay downs in the three and nine months ended September 30, 2005, $19 million and $46 million, respectively, represented calls of the securities.

**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**

The following tables provide the activity for the components of the securities portfolios; residential CES, commercial CES, and other securities.

***Residential Credit-Enhancement Securities Activity***
**(In thousands)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| Balance at beginning of period | $ 715,360 | $ 706,195 | $ 612,649 | $ 561,658 |
| Acquisitions | 78,887 | 57,481 | 220,926 | 213,139 |
| Sales (other than to consolidated ABS trusts) | (47,585) | (98,775) | (67,552) | (126,068) |
| Principal repayments (including calls) | (32,338) | (18,403) | (77,909) | (62,735) |
| Discount amortization | 16,616 | 11,193 | 42,181 | 27,695 |
| Net unrealized gains (losses) | 6,404 | (18,848) | 3,983 | 5,545 |
| Net recognized gains and valuation adjustments | 5,037 | 25,958 | 8,103 | 45,567 |
| Balance at end of period | $ 742,381 | $ 664,801 | $ 742,381 | $ 664,801 |

***Commercial First-Loss Credit-Enhancement Securities Activity***
**(In thousands)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| Balance at beginning of period | $ 75,889 | $ 29,397 | $ 57,687 | $ 14,498 |
| Acquisitions | 36,858 | 17,182 | 51,894 | 30,052 |
| Sales (other than to consolidated ABS trusts) | | | | |
| Principal repayments (including calls) | | | | |
| Premium amortization | (1,670) | (902) | (4,037) | (1,657) |
| Net unrealized gains (losses) | 5,939 | (2,137) | 12,761 | 798 |
| Net recognized losses and valuation adjustments | (275) | | (1,564) | (151) |
| Balance at end of period | $ 116,741 | $ 43,540 | $ 116,741 | $ 43,540 |

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**
***Other Securities Activity***
**(In thousands)**

| | Three Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|---|---|---|---|---|
| Balance at beginning of period | $ 1,870,001 | $ 1,648,837 | $ 1,748,581 | $ 1,380,077 |
| Acquisitions | 205,652 | 190,160 | 545,399 | 514,679 |
| Sales (other than to consolidated ABS trusts) | (17,607) | | (174,072) | (15,374) |
| Principal repayments (including calls) | (27,649) | (41,833) | (83,881) | (91,236) |
| Discount amortization | 2,454 | 566 | 4,575 | 832 |
| Net unrealized gains (losses) | 19,948 | (13,353) | 15,658 | (2,866) |
| Net recognized gains (losses) and valuation adjustments | 444 | (948) | (3,017) | (2,683) |
| Balance at end of period | $ 2,053,243 | $ 1,783,429 | $ 2,053,243 | $ 1,783,429 |

We generally fund the first-loss and second-loss interests of residential securities and first-loss commercial securities with equity capital. We sell the other interests we acquire to securitization entities (generally, Acacia) that re-securitize these assets by issuing ABS. Prior to sale to these securitization entities, we may fund some of the securities acquired on a temporary basis with short-term borrowings through various financing facilities available to us. The table below presents information regarding our securities pledged under borrowing agreements and owned by securitization entities as of September 30, 2006 and December 31, 2005.

***Real Estate Securities Pledged and Unpledged***
**(In thousands)**

| | September 30, 2006 | December 31, 2005 |
|---|---|---|
| Unpledged | $ 413,107 | $ 371,225 |
| Pledged for Redwood debt | 150,584 | 164,426 |
| Owned by securitization entities, financed through issuance of ABS | 2,348,674 | 1,883,266 |
| Carrying value | $ 2,912,365 | $ 2,418,917 |

***Net Recognized Gains (Losses) and Valuation Adjustments***

Fluctuations in the market value of certain of our real estate loan and security assets and interest rate agreements may also affect our net income. The table below describes the various components of our net recognized gains (losses) and valuation adjustments reported in income for the three and nine months ended September 30, 2006 and 2005.

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**
***Net Recognized Gains and Valuation Adjustments***
**(In thousands)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Realized gains on calls: | | | | |
| Real estate securities | $ 723 | $ 2,914 | $ 1,470 | $ 14,883 |
| Realized gains (losses) on sales: | | | | |
| Real estate loans | | (201) | (14) | 808 |
| Real estate securities | 4,967 | 23,254 | 8,067 | 31,108 |
| Valuation adjustments impairments: | | | | |
| Real estate securities | (484) | (1,158) | (6,015) | (3,259) |
| Gains (losses) on interest rate agreements | (8,475) | 107 | 982 | (567) |
| Purchase commitments | 3,702 | | 66 | |
| Net recognized gains and valuation adjustments | $ 433 | $ 24,916 | $ 4,556 | $ 42,973 |

During the course of preparing the financial statements for the period ended June 30, 2006, we discovered two errors and under the provisions of Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3 (FAS 154), we analyzed the errors for each period affected. The accrual rate for interest income on certain securities and interest expense on certain ABS issued had been incorrectly applied and not correctly adjusted. The impact of this error was that on a cumulative basis we had overstated interest income by $1.3 million and understated interest expense by $0.2 million. Additionally, due diligence expenses for certain securities purchased had been incorrectly capitalized and amortized. The impact of this error was that on a cumulative basis we had understated operating expenses by $0.6 million and overstated mortgages securities on the Consolidated Balance Sheets.

After carefully assessing the effect of these errors on previously reported earnings and the effect of recording a total cumulative correcting adjustment of $2.1 million in the second quarter of 2006, we determined that the errors were not material to the financial statements for the six months ended June 30, 2006 and the year ended December 31, 2006. Accordingly, cumulative correcting adjustments for these errors were recorded in the second quarter of 2006.

## NOTE 4. RESERVES FOR CREDIT LOSSES

We establish and maintain credit reserves that we believe represent probable credit losses in our consolidated real estate loans held-for-investment as of the date of the financial statements. The reserves for credit losses are reflected as a component of real estate loans on our Consolidated Balance Sheets.

Our loan servicers advance payment on delinquent loans to the extent they deem them recoverable. We generally accrue interest on delinquent loans to the extent cash is received; any potential loss is included in our credit reserve. When a loan becomes REO, we estimate the specific loss, based on estimated net proceeds from the sale of the property (including accrued but unpaid interest), and charge this specific estimated loss against the reserve for credit losses. A majority of the residential loans consolidated on our balance sheet have interest-only payments for an initial term. Any increased credit risk that these loans may contain is reflected in our analysis and determination of the appropriate credit reserves.

**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**

The following table summarizes the activity in reserves for credit losses for our consolidated real estate loans for the three and nine months ended September 30, 2006 and 2005.

***Real Estate Loans***
**(In thousands)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| Balance at beginning of period | $ 19,450 | $ 22,959 | $ 22,656 | $ 23,896 |
| Provision for (reversal of) credit reserve | 465 | (805) | (1,865) | (1,307) |
| Charge-offs | (589) | (125) | (1,465) | (560) |
| Balance at end of period | $ 19,326 | $ 22,029 | $ 19,326 | $ 22,029 |

Delinquencies in our consolidated residential real estate loans were $61 million and $37 million as of September 30, 2006 and December 31, 2005, respectively. Delinquencies include loans delinquent more than 90 days, in bankruptcy, in foreclosure, and REO. As a percentage of our residential real estate loans, delinquencies stood at 0.63% and 0.27% of our current loan balances as of September 30, 2006 and December 31, 2005, respectively. We had no delinquent commercial real estate loans as of September 30, 2006 and December 31, 2005.

***Reserve for Deferred Interest***

For first and second loss securities owned, backed by negatively amortizing loans, we intend to recognize interest income when we receive the cash either currently, or at a later date, according to the terms of the loan.

To the extent we own any first- or second-loss securities with underlying loans that do not make the fully indexed payment, we do not recognize any unpaid interest as income. That is, we only recognize the actual interest paid by establishing a reserve for the amounts the loans negatively amortize. These reserves are netted against our accrued interest receivable. During the three and nine months ended September 30, 2006, we increased our reserve for deferred interest by $1.1 million and $2.9 million, respectively, against interest income on these securities. During both the three and nine months ended September 30, 2005, we increased our reserve for deferred interest by $0.3 million. At September 30, 2006, the outstanding reserve for deferred interest was $3.7 million.

One commercial loan that we own, in accordance with the contractual arrangements, began deferring interest payments in 2006, though we may receive these amounts at a later date. Consistent with our accounting practice on negatively amortizing loans, we did not recognize the $0.1 million and $0.5 million of interest accrued and not paid on this loan, during the three and nine months ended September 30, 2006, respectively.

**NOTE 5. INTEREST RATE AGREEMENTS AND PURCHASE COMMITMENTS**

We maintain an overall interest rate risk management strategy that incorporates the use of derivative interest rate agreements for a variety of reasons, including reducing significant fluctuations in earnings or market values on certain assets or liabilities that may be caused by interest rate volatility. Currently, the majority of our interest rate agreements are used to match the duration of liabilities to assets. Interest rate agreements we use as part of our interest rate risk management strategy may include interest rate options, swaps, options on swaps, futures contracts, options on futures contracts, and options on forward purchase commitments.

We may designate the interest rate agreement as (1) a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge), (2) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability

**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**

(cash flow hedge), or (3) held for trading (trading instrument). We currently have elected cash flow hedging treatment for certain interest rate agreements and treat other interest rate agreements as trading instruments.

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

We incur credit risk to the extent that the counterparties to the interest rate agreements do not perform their obligations under the interest rate agreements. If one of the counterparties does not perform, we may not receive the cash to which we would otherwise be entitled under the interest rate agreement. In order to mitigate this risk, we only enter into interest rate agreements that are either (a) transacted on a national exchange or (b) transacted with counterparties that are either (i) designated by the U.S. Department of Treasury as a primary government dealer, (ii) affiliates of primary government dealers, or (iii) rated AA or higher. Furthermore, we generally enter into interest rate agreements with several different counterparties in order to diversify our credit risk exposure and maintain margin accounts with them.

We report our interest rate agreements at fair value as determined using third-party models and confirmed by Wall Street dealers. As of September 30, 2006 and December 31, 2005, the net fair value of interest rate agreements was $23.6 million and $30.7 million, respectively, and are summarized in the table below. See *Note 10* for the impact of these fair value changes on Accumulated Other Comprehensive Income.

***Interest Rate Agreements***
**(In thousands)**

| | September 30, 2006 | | | December 31, 2005 | | |
|---|---|---|---|---|---|---|
| | **Fair Value** | **Notional Amount** | **Credit Exposure** | **Fair Value** | **Notional Amount** | **Credit Exposure** |
| **Trading Instruments** | | | | | | |
| Interest rate caps purchased | $ 1,535 | $ 91,400 | $ | $ 1,913 | $ 116,400 | $ |
| Interest rate caps sold | (175) | (25,000) | | (239) | (65,000) | |
| Interest rate corridors purchased | | 876,815 | | | 1,059,851 | |
| Interest rate swaps | 320 | 131,234 | | 148 | 80,400 | |
| Purchase commitments | 200 | 93,250 | | | | |
| **Cash Flow Hedges** | | | | | | |
| Interest rate swaps | 21,732 | 3,475,569 | 4,029 | 28,891 | 5,399,653 | (2,672) |
| **Total Interest Rate Agreements** | $ 23,612 | $ 4,643,268 | $ 4,029 | $ 30,713 | $ 6,591,304 | $ (2,672) |

We have elected cash flow hedging treatment for many of our existing interest rate agreements. For these interest rate agreements, the ineffective portion of the hedging derivative is recognized immediately in earnings. We anticipate having some ineffectiveness in our hedging program, as not all terms of our hedges and not all terms of our hedged items match perfectly. We use the dollar-offset method to determine the amount of ineffectiveness. For the three and nine months ended September 30, 2006, the amount of ineffectiveness was $0.3 million and $0.5 million of income, respectively. For both the three and nine months ended September 30, 2005, the amount of ineffectiveness was $0.1 million of expense.

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**

During the course of preparing the financial statements for the period ended September 30, 2006 we discovered an error in the valuation of certain interest rate agreements for the purpose of measuring the amount of hedge ineffectiveness under FAS 133. Under the provisions of Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3 (FAS 154), we analyzed the errors for each period affected. The impact of this error was that on a cumulative basis we had understated interest expense (negative ineffectiveness) by $1.0 million and overstated other comprehensive income by $1.0 million.

After carefully assessing the effect of this error on previously reported earnings and the effect of recording a total cumulative correcting adjustment in the third quarter of 2006, we determined that the errors were not material to the financial statements for the nine-months ended September 30, 2006 and the year ended December 31, 2006. Accordingly, a cumulative correcting adjustment for this error was recorded in the third quarter of 2006.

Should we choose to terminate a cash flow hedge, the value of that hedge is reclassified from accumulated other comprehensive income into earnings over time. The timing of the reclassification depends on the status of the hedged or forecasted transaction. If the hedged transaction no longer exists, or the forecasted transaction is no longer expected to occur, then the reclassification occurs immediately. If the hedged transaction still exists, or the forecasted transaction is still expected to occur, then the reclassification occurs over the original period of such transaction. We have terminated cash flow hedges where the hedged transaction still existed or is still expected to occur. For the three and nine months ended September 30, 2006, the amount reclassified from other comprehensive income to interest expense totaled negative $0.1 million and positive $0.4 million, respectively. For the three and nine months ended September 30, 2005, the amount reclassified from other comprehensive income to interest expense totaled negative $0.1 million and negative $0.3 million, respectively.

Also included in our interest expense in our Consolidated Statements of Income is the net cash receipts (payments) on interest rate agreements designated as cash flow hedges. For the three and nine months ended September 30, 2006, the net cash receipts credited to interest expense totaled $3.0 million and $9.1 million, respectively. For the three and nine months ended September 30, 2005, the net cash receipts credited to interest expense totaled $0.8 million and $3.4 million, respectively.

We do not elect hedge accounting treatment for some of our interest rate agreements and these are accounted for as trading instruments. Thus, changes in the market value of these interest rate agreements and associated income and expenses are reported through our earnings and appear in net recognized gains (losses) and valuation adjustments in our Consolidated Statements of Income.

We also enter into commitments to purchase loans. These commitments are accounted for as derivatives under Statement of Financial Accounting Standards No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (FAS 149), where applicable and are accounted for as trading instruments. During the three months ended September 30, 2006 we entered into commitments to purchase $93 million of residential hybrid loans that will settle in the fourth quarter of 2006.

For the three months ended September 30, 2006, the amount of market value changes associated with interest rate agreements accounted for as trading instruments totaled negative $8.5 million and the fair value change on loan purchase commitments was positive $3.7 million. For the nine months ended September 30, 2006, the amount of market value changes associated with interest rate agreements accounted for as trading instruments was positive $1.0 million and the fair value change related to loan purchase commitments was positive $0.1 million. For the three and nine months ended September 30, 2005, the amount of market value changes associated with interest rate agreements accounted for as trading instruments totaled positive $0.1 million and negative $0.6 million, respectively.

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**
**NOTES TO FINANCIAL STATEMENTS (Continued)**

The following table depicts the amounts included in interest expense and net recognized gains (losses) and valuation adjustments activity for the three and nine months ended September 30, 2006 and 2005 for our interest rate agreements.