

REDWOOD TRUST INC
Form 10-Q
November 07, 2014
Table of Contents

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

FORM 10-Q

x

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended: September 30, 2014
OR

..

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

REDWOOD TRUST, INC.

(Exact Name of Registrant as Specified in Its Charter)

Maryland

68-0329422

(State or Other Jurisdiction of
Incorporation or Organization)

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

One Belvedere Place, Suite 300

Mill Valley, California
(Address of Principal Executive Offices)
(415) 389-7373

94941
(Zip Code)

(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 No

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

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

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

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

83,283,922 shares outstanding as of November 3,
2014

Table of Contents

REDWOOD TRUST, INC.
2014 FORM 10-Q REPORT
TABLE OF CONTENTS

| | | Page |
|-----------------------|--|-------------|
| <u>PART I</u> | | |
| Item 1. | <u>Financial Statements</u> | 2 |
| | <u>Consolidated Balance Sheets at September 30, 2014 (Unaudited) and December 31, 2013</u> | 2 |
| | <u>Consolidated Statements of Income for the Three and Nine Months Ended September 30, 2014 and 2013 (Unaudited)</u> | 3 |
| | <u>Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2014 and 2013 (Unaudited)</u> | 4 |
| | <u>Consolidated Statements of Changes in Equity for the Nine Months Ended September 30, 2014 and 2013 (Unaudited)</u> | 5 |
| | <u>Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2014 and 2013 (Unaudited)</u> | 6 |
| | <u>Notes to Consolidated Financial Statements</u> | 7 |
| Item 2. | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 75 |
| Item 3. | <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 124 |
| Item 4. | <u>Controls and Procedures</u> | 124 |
| <u>PART II</u> | | |
| Item 1. | <u>Legal Proceedings</u> | 126 |
| Item 1A. | <u>Risk Factors</u> | 127 |
| Item 2. | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 128 |
| Item 3. | <u>Defaults Upon Senior Securities</u> | 128 |
| Item 4. | <u>Mine Safety Disclosures (Not Applicable)</u> | 128 |
| Item 5. | <u>Other Information</u> | 128 |

| | | |
|---------|-------------------|-----|
| Item 6. | <u>Exhibits</u> | 129 |
| | <u>Signatures</u> | 130 |

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

| | September 30, 2014 | December 31, 2013 |
|---|---------------------|---------------------|
| ASSETS | | |
| Residential loans, held-for-sale, at fair value | \$ 1,502,429 | \$ 404,267 |
| Residential loans, held-for-investment, at fair value | 238,651 | - |
| Residential loans, held-for-investment | 1,546,507 | 1,762,167 |
| Commercial loans, held-for-sale, at fair value | 104,709 | 89,111 |
| Commercial loans, held-for-investment (includes \$70,712 and \$0 at fair value) | 393,288 | 343,344 |
| Real estate securities, at fair value | 1,394,985 | 1,682,861 |
| Mortgage servicing rights, at fair value | 135,152 | 64,824 |
| Cash and cash equivalents | 149,617 | 173,201 |
| Total earning assets | 5,465,338 | 4,519,775 |
| Restricted cash | 455 | 398 |
| Accrued interest receivable | 15,261 | 13,475 |
| Derivative assets | 7,756 | 7,787 |
| Deferred securities issuance costs | 10,190 | 13,453 |
| Other assets | 112,768 | 53,640 |
| Total Assets ⁽¹⁾ | \$ 5,611,768 | \$ 4,608,528 |

LIABILITIES AND EQUITY**Liabilities**

| | | |
|--|------------------|------------------|
| Short-term debt | \$ 1,887,688 | \$ 862,763 |
| Accrued interest payable | 10,480 | 6,366 |
| Derivative liabilities | 38,263 | 18,167 |
| Accrued expenses and other liabilities | 48,239 | 48,704 |
| Deferred tax liability | 7,316 | 7,316 |
| Asset-backed securities issued | 1,656,202 | 1,942,962 |
| Long-term debt (includes \$66,146 and \$0 at fair value) | 696,902 | 476,467 |
| Total liabilities ⁽¹⁾ | 4,345,090 | 3,362,745 |

| Equity | | | |
|---|----|------------------|---------------------|
| Common stock, par value \$0.01 per share, 180,000,000 shares authorized; 83,284,392 and 82,504,801 issued and outstanding | | 833 | 825 |
| Additional paid-in capital | | 1,768,612 | 1,760,899 |
| Accumulated other comprehensive income | | 159,771 | 148,766 |
| Cumulative earnings | | 879,745 | 806,298 |
| Cumulative distributions to stockholders | | (1,542,283) | (1,471,005) |
| Total equity | | 1,266,678 | 1,245,783 |
| Total Liabilities and Equity | \$ | 5,611,768 | \$ 4,608,528 |

- (1) Our consolidated balance sheets include assets of consolidated variable interest entities (VIEs) that can only be used to settle obligations of these VIEs and liabilities of consolidated VIEs for which creditors do not have recourse to the primary beneficiary (Redwood Trust, Inc.). At September 30, 2014 and December 31, 2013, assets of consolidated VIEs totaled \$2,013,807 and \$2,299,576, respectively, and liabilities of consolidated VIEs totaled \$1,657,782 and \$1,944,911, respectively. See *Note 4* for further discussion.

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

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

| (In Thousands, Except Share Data) (Unaudited) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|----------------------------------|------------------|---------------------------------|-------------------|
| | 2014 | 2013 | 2014 | 2013 |
| Interest Income | | | | |
| Residential loans | \$ 19,280 | \$ 17,027 | \$ 45,539 | \$ 53,497 |
| Commercial loans | 12,603 | 10,740 | 34,204 | 30,534 |
| Real estate securities | 31,461 | 29,649 | 97,062 | 84,480 |
| Cash and cash equivalents | 7 | 4 | 15 | 153 |
| Total interest income | 63,351 | 57,420 | 176,820 | 168,664 |
| Interest Expense | | | | |
| Short-term debt | (8,441) | (5,227) | (17,409) | (13,721) |
| Asset-backed securities issued | (7,838) | (9,604) | (24,462) | (30,815) |
| Long-term debt | (7,071) | (6,894) | (21,689) | (16,908) |
| Total interest expense | (23,350) | (21,725) | (63,560) | (61,444) |
| Net Interest Income | 40,001 | 35,695 | 113,260 | 107,220 |
| Reversal of provision (provision) for loan losses | 1,596 | (1,727) | 629 | (493) |
| Net Interest Income After Provision | 41,597 | 33,968 | 113,889 | 106,727 |
| Noninterest Income | | | | |
| Mortgage banking activities, net | 17,872 | (8,698) | 23,950 | 85,562 |
| Mortgage servicing rights income, net | 5,821 | 3,113 | 4,650 | 14,681 |
| Other market valuation adjustments, net ⁽¹⁾ | (3,706) | 462 | (13,966) | (6,099) |
| Realized gains, net | 8,532 | 10,469 | 10,687 | 23,291 |
| Total noninterest income, net | 28,519 | 5,346 | 25,321 | 117,435 |
| Operating expenses | (21,406) | (22,320) | (63,660) | (66,937) |
| Other income | 1,600 | - | 1,600 | - |
| Net income before provision for income taxes | 50,310 | 16,994 | 77,150 | 157,225 |
| (Provision for) benefit from income taxes | (5,213) | 4,935 | (3,703) | (9,113) |
| Net Income | \$ 45,097 | \$ 21,929 | \$ 73,447 | \$ 148,112 |
| Basic earnings per common share | \$ 0.53 | \$ 0.26 | \$ 0.87 | \$ 1.76 |
| Diluted earnings per common share | \$ 0.50 | \$ 0.25 | \$ 0.84 | \$ 1.65 |
| | \$ 0.28 | \$ 0.28 | \$ 0.84 | \$ 0.84 |

Regular dividends declared per common share

| | | | | |
|---|------------|------------|------------|------------|
| Basic weighted average shares outstanding | 83,017,534 | 82,201,473 | 82,722,079 | 81,888,231 |
| Diluted weighted average shares outstanding | 96,956,232 | 84,422,039 | 85,031,130 | 93,233,865 |

- (1) For the three months ended September 30, 2014, other-than-temporary impairments were \$188, all of which was recognized through the income statement. For the three months ended September 30, 2013, there were no other-than-temporary impairments. For the nine months ended September 30, 2014, other-than-temporary impairments were \$4,774, of which \$565 were recognized through the Income Statement and \$4,209 were recognized in Accumulated Other Comprehensive Income. For the nine months ended September 30, 2013, other-than-temporary impairments were \$1,666, all of which was recognized through the income statement.

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

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

| (In Thousands) (Unaudited) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|------------------|--|-------------------|
| | 2014 | 2013 | 2014 | 2013 |
| Net Income | \$ 45,097 | \$ 21,929 | \$ 73,447 | \$ 148,112 |
| Other comprehensive income (loss): | | | | |
| Net unrealized gain (loss) on available-for-sale securities | 1,849 | (633) | 35,078 | (29,615) |
| Reclassification of unrealized (gain) loss on available-for-sale securities to net income | (6,409) | (6,962) | (6,750) | (19,211) |
| Net unrealized (loss) gain on interest rate agreements | (3,258) | 4,018 | (17,454) | 25,043 |
| Reclassification of unrealized loss on interest rate agreements to net income | 32 | 62 | 131 | 219 |
| Total other comprehensive income (loss) | (7,786) | (3,515) | 11,005 | (23,564) |
| Total Comprehensive Income | \$ 37,311 | \$ 18,414 | \$ 84,452 | \$ 124,548 |

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

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF EQUITY

For the Nine Months Ended September 30, 2014

| (Thousands, Except Share Data) (in thousands) | Common Stock | | Additional Paid-In Capital | Accumulated Other Comprehensive Income | Cumulative Earnings | Cumulative Distributions to Stockholders | Total |
|--|--------------|--------|----------------------------------|---|------------------------|--|--------------|
| | Shares | Amount | | | | | |
| September 30, 2013 | 82,504,801 | \$ 825 | \$ 1,760,899 | \$ 148,766 | \$ 806,298 | \$ (1,471,005) | \$ 1,244,755 |
| Income | - | - | - | - | 73,447 | - | 73,447 |
| Comprehensive income | - | - | - | 11,005 | - | - | 11,005 |
| Change of common stock: | | | | | | | |
| Dividend reinvestment & stock repurchase plans | 336,810 | 4 | 6,051 | - | - | - | 6,051 |
| Free stock purchase and repurchase plans | 442,781 | 4 | (7,272) | - | - | - | (7,272) |
| Share equity award compensation | - | - | 8,934 | - | - | - | 8,934 |
| Share dividends declared | - | - | - | - | - | (71,278) | (71,278) |
| September 30, 2014 | 83,284,392 | \$ 833 | \$ 1,768,612 | \$ 159,771 | \$ 879,745 | \$ (1,542,283) | \$ 1,266,897 |

For the Nine Months Ended September 30, 2013

| (Thousands, Except Share Data) (in thousands) | Common Stock | | Additional Paid-In Capital | Accumulated Other Comprehensive Income | Cumulative Earnings | Cumulative Distributions to Stockholders | Total |
|--|--------------|--------|----------------------------------|---|------------------------|--|--------------|
| | Shares | Amount | | | | | |
| September 30, 2012 | 81,716,416 | \$ 817 | \$ 1,744,554 | \$ 138,332 | \$ 633,052 | \$ (1,376,591) | \$ 1,140,158 |
| Income | - | - | - | - | 148,112 | - | 148,112 |
| Comprehensive income (loss) | - | - | - | (23,564) | - | - | (23,564) |
| Change of common stock: | | | | | | | |
| Dividend reinvestment & stock repurchase plans | 374,371 | 4 | 7,073 | - | - | - | 7,073 |
| Free stock purchase and repurchase plans | 297,715 | 3 | (5,390) | - | - | - | (5,390) |
| Share equity award compensation | - | - | 11,443 | - | - | - | 11,443 |
| Share dividends declared | - | - | - | - | - | (70,675) | (70,675) |
| September 30, 2013 | 82,388,502 | \$ 824 | \$ 1,757,680 | \$ 114,768 | \$ 781,164 | \$ (1,447,266) | \$ 1,207,966 |

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

Table of Contents

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

| (In Thousands) | Nine Months Ended September 30, | |
|--|--|------------------|
| (Unaudited) | 2014 | 2013 |
| Cash Flows From Operating Activities: | | |
| Net income | \$ 73,447 | \$ 148,112 |
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Amortization of premiums, discounts, and securities issuance costs, net | (26,248) | (18,060) |
| Depreciation and amortization of non-financial assets | 369 | 310 |
| Purchases of held-for-sale loans | (6,844,403) | (6,864,921) |
| Proceeds from sales of held-for-sale loans | 5,328,901 | 6,263,058 |
| Principal payments on held-for-sale loans | 19,648 | 9,467 |
| Net settlements of derivatives | (22,776) | 55,694 |
| Provision (reversal of provision) for loan losses | (629) | 493 |
| Non-cash equity award compensation expense | 8,934 | 11,443 |
| Market valuation adjustments, net | (1,787) | (76,425) |
| Realized gains, net | (10,687) | (34,322) |
| Net change in: | | |
| Accrued interest receivable and other assets | (57,806) | 2,374 |
| Accrued interest payable, deferred tax liabilities, and accrued expenses and other liabilities | (266) | 17,378 |
| Net cash used in operating activities | (1,533,303) | (485,399) |
| Cash Flows From Investing Activities: | | |
| Purchases of loans held-for-investment | (65,584) | (63,071) |
| Proceeds from sales of held-for-investment loans | - | 440 |
| Principal payments on held-for-investment loans | 267,425 | 415,576 |
| Purchases of real estate securities | (132,393) | (142,628) |
| Proceeds from sales of real estate securities | 457,131 | 204,462 |
| Principal payments on real estate securities | 144,598 | 124,030 |
| Purchase of mortgage servicing rights | (41,834) | (3,106) |
| Net change in restricted cash | (57) | (34) |
| Net cash provided by investing activities | 629,286 | 535,669 |
| Cash Flows From Financing Activities: | | |
| Proceeds from borrowings on short-term debt | 5,615,317 | 5,745,892 |
| Repayments on short-term debt | (4,643,308) | (5,459,511) |
| Repayments on asset-backed securities issued | (286,248) | (465,986) |
| Deferred securities issuance costs | - | (9,184) |
| Proceeds from issuance of long-term debt | 272,937 | 332,119 |

Edgar Filing: REDWOOD TRUST INC - Form 10-Q

| | | |
|--|----------------|---------------|
| Repayments on long-term debt | (685) | (14) |
| Net settlements of derivatives | (2,507) | (9) |
| Net proceeds from issuance of common stock | 3,840 | 6,452 |
| Taxes paid on equity award distributions | (7,635) | (5,789) |
| Dividends paid | (71,278) | (70,675) |
| Net cash provided by financing activities | 880,433 | 73,295 |
| Net (decrease) increase in cash and cash equivalents | (23,584) | 123,566 |
| Cash and cash equivalents at beginning of period | 173,201 | 81,080 |
| Cash and cash equivalents at end of period | \$ 149,617 | \$ 204,646 |

Supplemental Cash Flow Information:

Cash paid during the period for:

| | | |
|----------|-----------|-----------|
| Interest | \$ 57,047 | \$ 60,394 |
| Taxes | 1,399 | 3,397 |

Supplemental Noncash Information:

| | | |
|--|------------|------------|
| Real estate securities retained from loan securitizations | \$ 126,009 | \$ 370,498 |
| Retention of mortgage servicing rights from loan securitizations and sales | 30,962 | 41,128 |
| Transfers from loans held-for-sale to loans held-for-investment | 278,913 | - |
| Transfers from residential loans to real estate owned | 4,753 | 3,448 |

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

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 1. Redwood Trust

Redwood Trust, Inc., together with its subsidiaries, focuses on investing in mortgage- and other real estate-related assets and engaging in residential and commercial mortgage banking activities. We seek to invest in real estate-related assets that have the potential to generate attractive cash flow returns over time and to generate income through our residential and commercial mortgage banking activities.

Our primary sources of income are net interest income from our investment portfolios and noninterest 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 consists of the profit we seek to generate through the acquisition or origination of loans and their subsequent sale or securitization. References herein to Redwood, the company, we, us, and our include Redwood Trust, Inc. consolidated subsidiaries, unless the context otherwise requires.

We operate our business in three segments: residential mortgage banking, residential investments, and commercial mortgage banking and investments.

Our residential mortgage banking segment primarily consists of operating a mortgage loan conduit that acquires residential loans from third-party originators for subsequent sale through securitization or as whole loans. Jumbo loans we acquire are typically sold through private-label securitization through our Sequoia securitization program or to institutions that acquire pools of whole loans. Conforming loans we acquire are generally sold to Fannie Mae and Freddie Mac (the Agencies). Our residential loan acquisitions are usually made on a flow basis, after origination by banks or mortgage companies, and are periodically augmented by bulk acquisitions. Our acquisition and accumulation of residential loans is generally funded with equity and short-term debt. This segment also includes various derivative financial instruments and IO securities retained from our Sequoia securitizations that we utilize to manage certain risks associated with residential loans we acquire. Our residential mortgage banking segment's main source of revenue is mortgage banking income, which includes valuation increases (or gains) on the loans we acquire for sale or securitization as well as valuation changes in associated derivatives and IO securities that are used in part to manage risks associated with our mortgage banking activities. Additionally, this segment may generate interest income on loans held for future sale or securitization and interest income from IO securities. Interest expense on short-term debt used to fund the purchase of residential loans, direct operating expenses and tax provisions associated with these activities are also included in the residential mortgage banking segment.

Our residential investments segment includes a portfolio of investments in residential mortgage-backed securities retained from our Sequoia securitizations, as well as residential mortgage-backed securities issued by third parties. This segment also includes mortgage servicing rights (MSRs) associated with residential loans securitized through our Sequoia program or sold to third parties and MSRs purchased from third parties as well as residential loans acquired and held-for-investment. The residential investment segment's main sources of revenue are interest income from investment portfolio securities and residential loans held-for-investment, as well as the realized gains recognized upon sales of these securities and income from MSRs. This segment also includes derivative financial instruments that we

utilize to manage certain risks associated with our residential investment portfolio. Also included in this segment is interest expense on the short-term debt and asset-backed securities (ABS) used to partially finance certain of these securities, as well as direct operating expenses and tax provisions associated with these activities.

Our commercial mortgage banking and investments segment consists of our commercial mortgage banking operations as well as our portfolio of held-for-investment commercial real estate loans. We operate as a commercial real estate lender by originating mortgage loans and providing other forms of commercial real estate financing. This may include senior or subordinate mortgage loans, mezzanine loans, and other forms of financing, such as preferred equity interests in special purpose entities that own commercial real estate. We typically sell the senior loans we originate to third parties for securitization and the mezzanine and subordinate loans we originate are generally held for investment. This segment also includes derivative financial instruments that we utilize to manage certain risks associated with our commercial loan origination activity. Our commercial mortgage banking and investments segment's main sources of revenue are interest income from our commercial loan investments as well as income from mortgage banking activities, which includes valuation increases (or gains) on the senior commercial loans we originate for sale as well as valuation changes in associated derivatives that are used to manage risks associated with our mortgage banking activities. Interest expense from a commercial securitization we engaged in during 2012 (Commercial Securitization) and from short-term and long-term debt used to fund the purchase of commercial loans as well as operating expenses and tax provisions associated with these activities are also included in the commercial mortgage banking and investments segment.

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 1. Redwood Trust (continued)

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

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at September 30, 2014 and December 31, 2013, and for the three and nine months ended September 30, 2014 and 2013. These consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) in the United States of America as prescribed by the Financial Accounting Standards Board s (FASB) Accounting Standards Codification (ASC) and using the Securities and Exchange Commission s (SEC) instructions to Form 10-Q.

Organization

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. Our mortgage banking activities and investments in MSRs are generally carried out through our taxable REIT subsidiaries, while our portfolio of mortgage- and other real estate-related investments is primarily held at our REIT. We generally intend to retain profits generated and taxed at our taxable REIT subsidiaries, and to distribute as dividends at least 90% of the taxable income we generate at our REIT.

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

Principles of Consolidation

We apply FASB guidance to determine whether we must consolidate transferred financial assets and variable interest entities (VIEs) for financial reporting purposes. We currently consolidate the assets and liabilities of certain Sequoia securitization entities where we maintain an ongoing involvement, as well as an entity formed in connection with a resecuritization transaction we engaged in during 2011 (Residential Resecuritization), and an entity formed in

connection with a commercial securitization we engaged in during 2012 (Commercial Securitization). Each securitization entity is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of Redwood Trust, Inc. Our exposure to these entities is primarily through the financial interests we have retained in them, although we are also exposed to certain financial risks associated with our role as a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities.

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

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

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies

Use of Estimates

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

Fair Value Measurements

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

Quoted prices for the same or similar securities;

Relevant reports issued by analysts and rating agencies;

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

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

Indicative prices or yields from broker/dealers (including prices from counterparties under securities repurchase and whole-loan warehouse agreements); and,

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

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

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

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

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

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Fair Value Option

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

We elect the fair value option for certain residential and commercial loans, Sequoia IO securities, and MSR. We generally elect the fair value option for residential and commercial loans that are held-for-sale, due to our intent to sell or securitize the loans in the near-term. We generally elect the fair value option for Sequoia IO securities as we use these in part to hedge certain risks associated with our residential loans held-for-sale. We elect the fair value option for our MSR in order to reflect the current value of these investments in our financial position and results each period. We also elect the fair value option for certain secured borrowings we may recognize when the sale of commercial loans do not meet the sale criteria in ASC 860.

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

Real Estate Loans

Residential and Commercial Loans Held-for-Sale at Fair Value

Residential and commercial loans held-for-sale include loans that we are marketing for sale to third parties, including transfers to securitization entities that we plan to sponsor and expect to be accounted for as sales for financial reporting purposes. We generally elect the fair value option for residential and commercial loans that we purchase with the intent to sell to third parties or transfer to Sequoia securitizations. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Changes in fair value are recurring and are reported through our consolidated statements of income in mortgage banking activities, net.

Residential and Commercial Loans Held-for-Investment

Residential Loans At Fair Value

Certain loans that were originally purchased with the intent to sell as part of our residential mortgage banking operations, and for which we elected the fair value option at acquisition, were subsequently reclassified to

held-for-investment when the loans were pledged as collateral for borrowings made from the Federal Home Loan Bank of Chicago (FHLBC). As of September 30, 2014, our current intention is to hold these loans for longer-term investment while they are financed by the FHLBC. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Changes in fair value are recurring and are reported through our consolidated statements of income in other market valuation adjustments, net.

Commercial Loans At Fair Value

We may elect the fair value option for senior commercial mortgage loans that we originate or acquire that are bifurcated into a senior portion that is sold to a third party and a junior portion that we retain as an investment. When the transfer of the senior portion does not meet the criteria for sale treatment under GAAP, the entire loan (the senior and junior portions) remains on our consolidated balance sheet, and we account for the transfer of the senior portion as a secured borrowing liability. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Changes in fair value are recurring and are reported through our consolidated statements of income in mortgage banking activities, net.

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Residential and Commercial Loans At Amortized Cost

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

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

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

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

Residential Loans Allowance for Loan Losses

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

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

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

Historical loss rates and past performance of similar loans;

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

Trends in delinquencies and charge-offs;

Effects and changes in credit concentrations;

Information supporting a borrower's ability to meet obligations;

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

Discounted cash flow analyses.

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

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

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

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

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

Commercial Loans Allowance for Loan Losses

For commercial loans classified as held-for-investment, we establish and maintain a general allowance for loan losses inherent in our portfolio at the reporting date and, where appropriate, a specific allowance for loan losses for loans we have determined to be impaired at the reporting date. An individual loan is considered impaired when it is deemed

probable that we will not be able to collect all amounts due according to the contractual terms of the loan.

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

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

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

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

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

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

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

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

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

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

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

Trends in delinquencies and charge-offs in our own portfolio and among industry participants.

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

Repurchase Reserves

We sell residential mortgage loans to various parties, including (1) securitization trusts, (2) the Agencies, and (3) banks and other financial institutions that purchase mortgage loans. We also purchase mortgage servicing rights. We may be required to repurchase residential mortgage loans we have sold, or loans associated with MSRs we own, in the event of a breach of specified contractual representations and warranties made in connection with these sales and purchases. We do not originate residential mortgage loans and believe the initial risk of loss due to loan repurchases (i.e., due to a breach of representations and warranties) would generally be a contingency to the companies from whom we acquired the loans. However, in some cases, such as where loans were acquired from companies that have since become insolvent, we may be required to repurchase loans.

We establish reserves for mortgage repurchase liabilities related to various representations and warranties that reflect management's estimate of losses for loans for which we could have a repurchase obligation, based on a combination of factors. Such factors can include estimated future defaults and loan repurchase rates, the potential severity of loss in the event of defaults, and the probability of our being liable for a repurchase obligation. We establish a reserve at the time loans are sold and continually update our reserve estimate during its life. The reserve for mortgage loan repurchase losses is included in other liabilities on our consolidated balance sheets and the related expense is included as a component of mortgage banking activities, net on our consolidated statements of income.

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

See *Note 15* for further discussion on the residential repurchase reserve.

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Real Estate Securities, at Fair Value

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

Trading Securities

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

Available-for-Sale Securities

AFS securities primarily consist of non-agency residential mortgage backed securities (RMBS) and may include other residential and commercial securities. Non-Agency RMBS are not issued or guaranteed by a federally chartered corporation, such as Fannie Mae or Freddie Mac, or any agency of the U.S. Government. AFS securities are carried at their estimated fair value with unrealized gains and losses excluded from earnings (except when an other-than-temporary impairment (OTTI) is recognized, as discussed below) and reported in accumulated other comprehensive income (AOCI), a component of stockholders' equity.

Interest income on AFS securities is accrued based on their outstanding principal balance and contractual terms and interest income is recognized based on the security's effective interest rate. In order to calculate the effective interest rate, we must project cash flows over the remaining life of each security and make assumptions with regards to interest rates, prepayment rates, the timing and amount of credit losses, and other factors. On at least a quarterly basis,

we review and, if appropriate, make adjustments to our cash flow projections based on input and analysis received from external sources, internal models, and our own judgments about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the yield and interest income recognized on these securities or in the recognition of OTTI as discussed below.

For AFS securities purchased and held at a discount, a portion of the discount may be designated as non-accretable purchase discount (credit reserve), based on the cash flows we have projected for the security. The amount designated as credit reserve may be adjusted over time, based on our periodic evaluation of projected cash flows. If the performance of a security with a credit reserve is more favorable than previously forecasted, a portion of the credit reserve may be reallocated to accretable discount and recognized into interest income over time. Conversely, if the performance of a security with a credit reserve is less favorable than forecasted, the amount designated as credit reserve may be increased, or impairment charges and write-downs of such securities to a new cost basis could result.

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

When the fair value of an AFS security is less than its amortized cost at the reporting date, the security is considered impaired. We assess our impaired securities at least quarterly to determine if the impairment is temporary or other-than-temporary (resulting in an OTTI). If we either (i) intend to sell the impaired security; (ii) will more likely than not be required to sell the impaired security before it recovers in value; or (iii) if there has been an adverse change in cash flows the impairment is deemed an OTTI. In the case of criteria (i) and (ii), we record the entire difference between the security's estimated fair value and its amortized cost at the reporting date in our consolidated statements of income. If there has been an adverse change in cash flows, only the portion of the OTTI related to credit losses is recognized through other market valuation adjustments, net on our consolidated statements of income, with the remaining non-credit portion recognized through AOCI on our consolidated balance sheet. If the first two criteria are not met and there has not been an adverse change in cash flows, the impairment is considered temporary and the entire unrealized loss is recognized through AOCI on our consolidated balance sheets.

For impaired AFS securities, to determine if there has been an adverse change in cash flows and if any portion of a resulting OTTI is related to credit losses, we compare the present value of the cash flows expected to be collected as of the current financial reporting date to the amortized cost basis of the security. The discount rate used to calculate the present value of expected future cash flows is the current yield used for income recognition purposes. If the present value of the current expected cash flows is less than the amortized cost basis, there has been an adverse change and the security is considered OTTI with the difference between these two amounts representing the credit loss. The determination as to whether an OTTI exists and, if so, the amount of credit impairment recognized in earnings is subjective, and based on information available at the time of the assessment as well as our estimates of future performance and cash flows. As a result, the timing and amount of OTTI constitute a material estimate that is susceptible to significant change.

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

MSRs

We recognize MSRs through the retention of servicing rights associated with residential mortgage loans that we have acquired and subsequently transferred to third parties (including the Agencies) or through the direct acquisition of MSRs sold by third parties. Typically, our MSRs are created through the transfer of loans to a third party or to a Sequoia residential mortgage securitization sponsored by us that meets the GAAP criteria for sale accounting.

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

servicing functions for loans associated with our MSR. We have elected the fair value option for all of our MSRs, and they are initially recognized and carried at their estimated fair values. Income from MSRs and changes in the estimated fair value of MSRs are reported in MSR income, net, a component of our consolidated statements of income.

See *Note 9* for further discussion on MSRs.

Cash and Cash Equivalents

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

Restricted Cash

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

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Accrued Interest Receivable

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

Derivative Financial Instruments

Derivative financial instruments we typically utilize include swaps, swaptions, financial futures contracts, CMBX credit default index swaps, and To Be Announced (TBA) contracts. These derivatives are primarily used to manage interest rate risk associated with our operations. In addition, we enter into certain residential loan purchase commitments (LPCs) and residential loan forward sale commitments (FSCs) that are treated as derivatives for financial reporting purposes. All derivative financial instruments are recorded at their estimated fair values on our consolidated balance sheets. Derivatives with positive fair values to us are reported as assets and derivatives with negative fair values to us are reported as liabilities. We classify each derivative as either (i) a trading instrument (no specific hedging designation for financial reporting purposes) or (ii) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge).

Changes in the fair values of derivatives accounted for as trading instruments, including any associated interest income or expense, are recorded in our consolidated statements of income through other market valuation adjustments, net, to the extent they are used to manage risks associated with our residential investment portfolio. Derivatives used to manage certain risks associated with our residential and commercial mortgage banking activities, including valuation changes related to residential LPCs and FSCs, are included in mortgage banking activities, net, on our consolidated statements of income.

Changes in the fair values of derivatives accounted for as cash flow hedges, to the extent they are effective, are recorded in accumulated other comprehensive income, a component of equity on our consolidated balance sheets. Interest income or expense, and any ineffectiveness associated with these derivatives, are recorded as a component of net interest income in our consolidated statements of income. We measure the effective portion of cash flow hedges by comparing the change in fair value of the expected future variable cash flows of the derivative hedging instruments with the change in fair value of the expected future variable cash flows of the hedged item.

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

Swaps and Swaptions

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

Table of Contents

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

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Eurodollar Futures and Financial Futures

Eurodollar futures are futures contracts on time deposits denominated in U.S. dollars at banks outside the United States. Eurodollar futures, unlike our other derivatives, have maturities of only three months. Therefore, in order to achieve the desired interest rate offset necessary to manage our risk, consecutively maturing contracts are required, resulting in a stated notional amount that is typically higher than our other derivatives. Financial futures are futures contracts on benchmark U.S. Treasury rates.

TBA Contracts

TBA contracts are forward contracts to purchase mortgage-backed securities that will be issued by a U.S. government sponsored enterprise in the future. We purchase or sell these derivatives to offset to varying degrees changes in the values of mortgage products for which we have exposure to interest rate volatility.

CMBX Credit Default Index Swaps

CMBX credit default index swaps are derivative instruments that reference an index reflecting the performance of specified tranches from selected commercial mortgage-backed securities (CMBS) transactions. Transacting in CMBX credit default index swaps enables us to hedge certain financial risks we are exposed to as we originate senior commercial mortgage loans in anticipation of the sale of these loans into CMBS transactions.

Loan Purchase and Forward Sale Commitments

We use the term LPCs to refer to agreements with third-party residential loan originators to purchase residential loans at a future date that qualify as a derivative under GAAP and we use the term FSCs to refer to agreements with third-parties to sell residential loans at a future date that also qualify as derivatives under GAAP. LPCs and FSCs are recorded at their estimated fair values on our consolidated balance sheets and changes in fair value are recurring and are reported through our consolidated statements of income in mortgage banking activities, net.

See *Note 10* for further discussion on derivative financial instruments.

Deferred Tax Assets and Liabilities

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

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

Table of Contents

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

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Deferred Securities Issuance Costs

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

Other Assets

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

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

See *Note 11* for further discussion on other assets.

Short-Term Debt

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

See *Note 12* for further discussion on short-term debt.

Accrued Interest Payable

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

Asset-Backed Securities Issued

ABS issued represents asset-backed securities issued by bankruptcy-remote entities sponsored and consolidated by Redwood. These entities include certain Sequoia entities, the Residential Resecuritization, and the Commercial Securitization. Assets at these entities are held in the custody of securitization trustees and are not owned by Redwood. These trustees collect principal and interest payments (less servicing and related fees) from the assets and make corresponding principal and interest payments to the ABS investors.

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

See *Note 13* for further discussion on ABS issued.

Table of Contents

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

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Long-Term Debt

FHLBC Borrowings

FHLBC borrowings include amounts borrowed, also referred to as advances, from the Federal Home Loan Bank of Chicago that are secured by eligible collateral, including, but not limited to, residential mortgage loans and residential mortgage-backed securities. FHLBC borrowings are carried at their unpaid principal balance and interest on advances is paid every 13 weeks from when each respective advance is made. If the value (as determined by the FHLBC) of the collateral securing those borrowings decreases, we may be subject to margin calls during the period the borrowings are outstanding. In instances where we do not satisfy the margin calls within the required time frame, the FHLBC may foreclose upon the collateral and pursue any outstanding debt amount from us. Individual advances can be made with maturities ranging from one day to 30 years.

Commercial Long-term Debt

Commercial long-term debt includes borrowings under a master repurchase agreement that, as of the date reported, expires in more than one year with a financial institution counterparty. Beginning in the third quarter of 2014, amounts previously classified as commercial long-term debt were reclassified to short-term debt due to the associated agreement expiring in less than one year as of September 30, 2014.

Commercial Secured Borrowings

Commercial secured borrowings represent liabilities recognized in association with cash received from transfers of portions of senior commercial mortgage loans to third parties that did not meet the criteria for sale treatment under ASC 860 and were accounted for as financings. We elect the fair value option for these secured borrowings and they are held at their estimated fair value on our consolidated balance sheets. These amounts do not represent legal obligations of Redwood and we are not required to make interest payments on these borrowings.

Convertible Notes

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

Trust Preferred Securities and Subordinated Notes

Trust preferred securities and subordinated notes are carried at their unpaid principal balance. This long-term debt is unsecured and interest is paid quarterly until it is redeemed in whole or matures at a future date.

See *Note 14* for further discussion on long-term debt.

Equity

Accumulated Other Comprehensive Income

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

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Earnings Per Common Share

Basic earnings per common share (EPS) is computed by dividing net income allocated to common shareholders by the weighted average common shares outstanding. Net income allocated to common shareholders represents net income less income allocated to participating securities (as described herein). Diluted EPS is computed by dividing income allocated to common shareholders by the weighted average common shares outstanding plus amounts representing the dilutive effect of share-based payment awards. In addition, if the assumed conversion of convertible notes to common shares is dilutive, diluted EPS is adjusted by adding back the periodic interest expense associated with dilutive convertible debt to net income and adding the shares issued in an assumed conversion to the diluted share count.

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

See *Note 16* for further discussion on equity.

Incentive Plans

In May 2014, our shareholders approved the 2014 Redwood Trust, Inc. Incentive Plan (Incentive Plan) for executive officers, employees, and non-employee directors, which replaced the 2002 Redwood Trust, Inc. Incentive Plan. The Incentive Plan provides for the grant of restricted stock, deferred stock, deferred stock units, performance-based awards (including performance stock units), dividend equivalents, stock payments, restricted stock units, and other types of awards to eligible participants. Long-term incentive awards granted under the Incentive Plan generally vest over a three- or four-year period. Awards made under the Incentive Plan to officers and other employees in lieu of the payment in cash of a portion of annual bonuses earned generally vest immediately, but are subject to a three-year mandatory holding period. Non-employee directors are also provided annual awards under the Incentive Plan that generally vest immediately. The cost of the awards is amortized over the vesting period on a straight-line basis.

Employee Stock Purchase Plan

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

Executive Deferred Compensation Plan

In November 2013, our Board of Directors approved an amendment to our 2002 Executive Deferred Compensation Plan (EDCP) to allow non-employee directors to defer certain cash payments and dividends into Deferred Stock Units (DSUs). The EDCP allows eligible employees and directors to defer portions of current salary and certain other forms of compensation. The Company matches some deferrals. Compensation deferred under the EDCP is recorded as a liability on our consolidated balance sheets. The EDCP allows for the investment of deferrals in either an interest crediting account or DSUs.

Table of Contents

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

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

401(k) Plan

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

See *Note 17* for further discussion on equity compensation plans.

Taxes

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

See *Note 20* for further discussion on taxes.

Recent Accounting Pronouncements

In May 2014, the FASB issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers. ASU 2014-09 supersedes the revenue recognition requirements in Topic 605, Revenue Recognition and requires entities to recognize revenue in a way that depicts the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 is effective retrospectively for annual or interim reporting periods beginning after December 15, 2016, with early application not permitted. We are currently evaluating the new standard.

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.

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

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 September 30, 2014 and December 31, 2013.

Offsetting of Financial Assets, Liabilities, and Collateral

| September 30, 2014 (In Thousands) | Gross Amounts of Recognized Assets (Liabilities) | Gross Amounts Offset in Consolidated Balance Sheet | Net Amounts of Gross Amounts Not Offset in Consolidated Balance Sheet ⁽¹⁾ | | | | Net Amount |
|--------------------------------------|--|---|--|--------------------------|---|-----------------|------------|
| | | | Assets (Liabilities) Presented in Consolidated Balance Sheet | Financial Instruments | Cash Collateral (Received) Pledged | | |
| Assets ⁽²⁾ | | | | | | | |
| Interest rate agreements | \$ 2,892 | \$ - | \$ 2,892 | \$ (1,033) | \$ (1,150) | \$ 709 | |
| Credit default index swaps | 2,372 | - | 2,372 | - | (375) | 1,997 | |
| TBA's | 1,496 | - | 1,496 | (1,484) | - | 12 | |
| Total Assets | \$ 6,760 | \$ - | \$ 6,760 | \$ (2,517) | \$ (1,525) | \$ 2,718 | |
| Liabilities ⁽²⁾ | | | | | | | |
| Interest rate agreements | \$ (34,449) | \$ - | \$ (34,449) | \$ 1,033 | \$ 33,416 | \$ - | |
| TBA's | (3,298) | - | (3,298) | 1,484 | 1,267 | (547) | |
| Futures | (411) | - | (411) | - | 411 | - | |
| Loan warehouse debt | (1,241,074) | - | (1,241,074) | 1,241,074 | - | - | |
| Security repurchase agreements | (646,614) | - | (646,614) | 646,614 | - | - | |
| Total Liabilities | \$ (1,925,846) | \$ - | \$ (1,925,846) | \$ 1,890,205 | \$ 35,094 | \$ (547) | |

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

| December 31, 2013 (In Thousands) | Net Amounts of Gross Amounts Not Offset in Consolidated Balance Sheet ⁽¹⁾ | | | | | | Net Amount |
|-------------------------------------|---|---|--|--------------------------|---|-----------------|------------|
| | Gross Amounts of Recognized Assets (Liabilities) | Gross Amounts Offset in Consolidated Balance Sheet | Assets (Liabilities) Presented in Consolidated Balance Sheet | Financial Instruments | Cash Collateral (Received) Pledged | | |
| Assets ⁽²⁾ | | | | | | | |
| Interest rate agreements | \$ 6,566 | \$ - | \$ 6,566 | \$ (5,402) | \$ - | \$ 1,164 | |
| TBAs | 1,138 | - | 1,138 | (656) | (482) | - | |
| Total Assets | \$ 7,704 | \$ - | \$ 7,704 | \$ (6,058) | \$ (482) | \$ 1,164 | |
| Liabilities ⁽²⁾ | | | | | | | |
| Interest rate agreements | \$ (16,599) | \$ - | \$ (16,599) | \$ 5,402 | \$ 11,197 | \$ - | |
| TBAs | (661) | - | (661) | 656 | 5 | - | |
| Futures | (528) | - | (528) | - | 528 | - | |
| Loan warehouse debt | (184,789) | - | (184,789) | 184,789 | - | - | |
| Security repurchase agreements | (677,974) | - | (677,974) | 677,974 | - | - | |
| Commercial borrowings | (49,467) | - | (49,467) | 49,467 | - | - | |
| Total Liabilities | \$ (930,018) | \$ - | \$ (930,018) | \$ 918,288 | \$ 11,730 | \$ - | |

(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 balances sheets. Loan warehouse debt, which is secured by residential and commercial 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 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 and 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 arrangement or similar agreement provides for settlement on a net basis and for settlement to 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 that 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.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****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

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

Assets and Liabilities of Consolidated VIEs at September 30, 2014**September 30, 2014**

| (Dollars in Thousands) | Sequoia Entities | Residential Resecuritization | Commercial Securitization | Total |
|--|-----------------------------|---|--------------------------------------|---------------------|
| Residential loans, held-for-investment | \$ 1,546,507 | \$ - | \$ - | \$ 1,546,507 |
| Commercial loans, held-for-investment | - | - | 204,741 | 204,741 |
| Real estate securities, at fair value | - | 233,311 | - | 233,311 |
| Restricted cash | 147 | - | 138 | 285 |
| Accrued interest receivable | 1,882 | 506 | 1,527 | 3,915 |
| Other assets | 3,349 | - | 21,699 | 25,048 |
| Total Assets | \$ 1,551,885 | \$ 233,817 | \$ 228,105 | \$ 2,013,807 |
| Accrued interest payable | \$ 1,034 | \$ 7 | \$ 539 | \$ 1,580 |
| Asset-backed securities issued | 1,484,751 | 56,508 | 114,943 | 1,656,202 |
| Total Liabilities | \$ 1,485,785 | \$ 56,515 | \$ 115,482 | \$ 1,657,782 |

| | | | | |
|-----------------------|----|---|---|----|
| Number of VIEs | 24 | 1 | 1 | 26 |
|-----------------------|----|---|---|----|

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

We consolidate the assets and liabilities of the Residential Resecuritization entity as we did not meet the GAAP sale criteria at the time the financial assets were transferred to this entity based on our role in the entity's inception and design. We transferred senior residential securities to Credit Suisse First Boston Mortgage Securities Corp., which subsequently sold them to CSMC 2011-9R, the Residential Resecuritization entity. In connection with this transaction, we acquired certain senior and subordinate securities that we continue to hold. We engaged in the Residential Resecuritization primarily for the purpose of obtaining permanent non-recourse financing on a portion of our senior residential securities portfolio. Our credit risk exposure is largely unchanged as a result of engaging in the transaction, as we remain economically exposed to the financed securities through our senior and subordinate investment in the Residential Resecuritization.

Table of Contents

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

September 30, 2014

(Unaudited)

Note 4. Principles of Consolidation (continued)

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

Analysis of Unconsolidated VIEs with Continuing Involvement

Since 2012, we have transferred residential loans to 21 Sequoia securitization entities sponsored by us and accounted for these transfers as sales for financial reporting purposes. We also determined we were not the primary beneficiary of these VIEs as we lacked the power to direct the activities that will have the most significant economic impact on the entities. For the transferred loans where we held the servicing rights prior to the transfer and continue to hold the servicing rights, we recorded MSR's on our consolidated balance sheets, and classified those MSR's as Level 3 assets. We also retained senior and subordinate securities in these securitizations that we classified as Level 3 assets.

The following table presents information related to securitization transactions that occurred during the three and nine months ended September 30, 2014 and 2013.

Securitization Activity Related to Unconsolidated VIEs Sponsored by Redwood

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|---|--------------|--|--------------|
| | 2014 | 2013 | 2014 | 2013 |
| Principal balance of loans transferred | \$ 635,608 | \$ 1,210,604 | \$ 982,913 | \$ 5,253,314 |
| Trading securities retained, at fair value | 1,680 | 8,702 | 71,243 | 100,552 |
| AFS securities retained, at fair value | 39,330 | 71,527 | 59,757 | 278,622 |
| MSR's recognized | 4,356 | 12,514 | 6,542 | 41,128 |

Our continuing involvement in these securitizations is limited to customary servicing obligations associated with retaining residential MSR's (which we retain a third-party servicer to perform) and the receipt of interest income associated with the securities we retained. The following table summarizes the cash flows between us and the

unconsolidated VIEs sponsored by us during the three and nine months ended September 30, 2014 and 2013.

Cash Flows Related to Unconsolidated VIEs Sponsored by Redwood

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|----------------------------------|------------|---------------------------------|--------------|
| | 2014 | 2013 | 2014 | 2013 |
| Cash proceeds | \$ 610,167 | \$ 507,202 | \$ 877,943 | \$ 4,366,556 |
| MSR fees received | 3,571 | 3,160 | 10,618 | 6,235 |
| Funding of compensating interest | (68) | (152) | (144) | (415) |
| Cash flows received on retained securities | 16,190 | 15,656 | 44,417 | 30,606 |

Table of Contents

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

September 30, 2014

(Unaudited)

Note 4. Principles of Consolidation (continued)

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

MSR Assumptions Related to Unconsolidated VIEs Sponsored by Redwood

| At Date of Securitization | Issued During | | | |
|---------------------------|---------------------------------------|---------|--------------------------------------|----------|
| | Three Months Ended September 30, 2014 | | Nine Months Ended September 30, 2013 | |
| | 2014 | 2013 | 2014 | 2013 |
| Prepayment speeds | 5 - 16 % | 5 - 8 % | 5 - 16 % | 5 - 13 % |
| Discount rates | 11 % | 12 % | 11 % | 12 % |

The following table presents additional information at September 30, 2014 and December 31, 2013, related to unconsolidated securitizations accounted for as sales since 2012.

Unconsolidated VIEs Sponsored by Redwood

| (In Thousands) | September 30, 2014 | December 31, 2013 |
|--|--------------------|-------------------|
| On-balance sheet assets, at fair value: | | |
| Interest-only and senior securities, classified as trading | \$ 100,613 | \$ 110,505 |
| Senior and subordinate securities, classified as AFS | 441,835 | 405,415 |
| Maximum loss exposure ⁽¹⁾ | 542,448 | 515,920 |
| Assets transferred: | | |
| Principal balance of loans outstanding | 7,173,303 | 6,627,874 |
| Principal balance of delinquent loans 30+ days delinquent | 16,482 | 14,587 |

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

Table of Contents

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

September 30, 2014

(Unaudited)

Note 4. Principles of Consolidation (continued)

The following table presents key economic assumptions for assets retained from unconsolidated VIEs and the sensitivity of their fair values to immediate adverse changes in those assumptions at September 30, 2014 and December 31, 2013.

Key Assumptions and Sensitivity Analysis for Assets Retained from Unconsolidated VIEs Sponsored by Redwood**September 30, 2014**

| (Dollars in Thousands) | MSRs | Senior Securities | Subordinate Securities |
|---|-------------|--------------------------|-------------------------------|
| Fair value at June 30, 2014 | \$ 59,890 | \$ 100,613 | \$ 441,835 |
| Expected life (in years) ⁽¹⁾ | 7 | 6 | 10 |
| Prepayment speed assumption (annual CPR) ⁽¹⁾ | 12 % | 9 % | 10 % |
| Decrease in fair value from: | | | |
| 10% adverse change | \$ 2,454 | \$ 4,552 | \$ 404 |
| 25% adverse change | 5,589 | 10,470 | 2,058 |
| Discount rate assumption ⁽¹⁾ | 11 % | 7 % | 9 % |
| Decrease in fair value from: | | | |
| 100 basis point increase | \$ 2,381 | \$ 4,444 | \$ 33,310 |
| 200 basis point increase | 4,568 | 8,528 | 62,862 |
| Credit loss assumption ⁽¹⁾ | N/A | 0.25 % | 0.25 % |
| Decrease in fair value from: | | | |
| 10% higher losses | N/A | \$ 144 | \$ 3,132 |
| 25% higher losses | N/A | 349 | 7,779 |

December 31, 2013

| (Dollars in Thousands) | MSRs | Senior Securities | Subordinate Securities |
|-------------------------------|-------------|--------------------------|-------------------------------|
|-------------------------------|-------------|--------------------------|-------------------------------|

Edgar Filing: REDWOOD TRUST INC - Form 10-Q

| | | | |
|---|-----------|------------|------------|
| Fair value at December 31, 2013 | \$ 60,318 | \$ 110,505 | \$ 405,415 |
| Expected life (in years) ⁽¹⁾ | 8 | 7 | 11 |
| Prepayment speed assumption (annual CPR) ⁽¹⁾ | 8 % | 10 % | 11 % |
| Decrease in fair value from: | | | |
| 10% adverse change | \$ 1,649 | \$ 5,773 | \$ 1,658 |
| 25% adverse change | 4,218 | 13,555 | 4,354 |
| Discount rate assumption ⁽¹⁾ | 11 % | 5 % | 6 % |
| Decrease in fair value from: | | | |
| 100 basis point increase | \$ 2,468 | \$ 5,632 | \$ 30,644 |
| 200 basis point increase | 4,828 | 10,757 | 57,836 |
| Credit loss assumption ⁽¹⁾ | N/A | 0.23 % | 0.23 % |
| Decrease in fair value from: | | | |
| 10% higher losses | N/A | \$ 70 | \$ 1,369 |
| 25% higher losses | N/A | 175 | 3,420 |

- (1) Expected life, prepayment speed assumption, discount rate assumption, and credit loss assumption presented in the tables above represent weighted averages.

Table of Contents

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

September 30, 2014

(Unaudited)

Note 4. Principles of Consolidation (continued)*Analysis of Third-Party VIEs*

Third-party VIEs are securitization entities in which we maintain an economic interest, but do not sponsor. Our economic interest may include several securities from the same third-party VIE, and in those cases, the analysis is performed in consideration of all of our interests. The following table presents a summary of our interests in third-party VIEs at September 30, 2014, grouped by collateral type.

Third-Party Sponsored VIE Summary

| (In Thousands) | September 30, 2014 |
|--|---------------------------|
| Residential real estate securities at Redwood | |
| Senior | \$ 552,793 |
| Re-REMIC | 176,117 |
| Subordinate | 123,626 |
| Total Investments in Third-Party Real Estate Securities | \$ 852,536 |

We determined that we are not the primary beneficiary of any third-party residential, commercial, or collateralized debt obligation entities, as we do not have the required power to direct the activities that most significantly impact the economic performance of these entities. Specifically, we do not service or manage these entities or otherwise hold decision making powers that are significant. As a result of this assessment, we do not consolidate any of the underlying assets and liabilities of these third-party VIEs we only account for our specific interests in them.

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

Other Transfers of Financial Assets

Certain of our senior commercial mortgage loans were bifurcated into a senior portion that was sold to a third party and a junior portion that we retained as an investment. When the transfer of the senior portion did not meet the criteria for sale treatment under GAAP, the entire loan (the senior and junior portions) remains on our consolidated balance

sheet classified as a held-for-investment loan and we account for the transfer of the senior portion as a secured borrowing.

The following table presents commercial loan transfers accounted for as secured borrowings for the three and nine months ended September 30, 2014.

Loan Transfers Accounted for as Secured Borrowings

| (In Thousands) | Three Months Ended September 30, 2014 | Nine Months Ended September 30, 2014 |
|-----------------------|--|---|
| Principal balance | \$ - | \$ 63,375 |
| Cash proceeds | - | 65,048 |

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 5. Fair Value of Financial Instruments**

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

In certain cases, inputs used to measure fair value fall into different levels of the fair value hierarchy. In such cases, the level at which the fair value measurement falls is determined based on the lowest level input that is significant to the fair value measurement. Our assessment of the significance of a particular input requires judgment and considers factors specific to the asset or liability being measured.

The following table presents the carrying values and estimated fair values of assets and liabilities that are required to be recorded or disclosed at fair value at September 30, 2014 and December 31, 2013.

| (In Thousands) | September 30, 2014 | | December 31, 2013 | |
|---|---------------------------|-------------------|--------------------------|-------------------|
| | Carrying Value | Fair Value | Carrying Value | Fair Value |
| Assets | | | | |
| Residential loans, held-for-sale | | | | |
| At fair value | \$ 1,501,252 | \$ 1,501,252 | \$ 402,602 | \$ 402,602 |
| At lower of cost or fair value | 1,502 | 1,662 | 1,665 | 1,817 |
| Residential loans, held-for-investment, at fair value | 238,326 | 238,326 | - | - |
| Residential loans, held-for-investment | 1,546,507 | 1,447,463 | 1,762,167 | 1,610,024 |
| Commercial loans, held-for-sale | 175,421 | 175,421 | 89,111 | 89,111 |
| Commercial loans, held-for-investment | | | | |
| At fair value | 70,712 | 70,712 | - | - |
| At amortized cost | 322,576 | 328,076 | 343,344 | 348,305 |
| Trading securities | 108,750 | 108,750 | 124,555 | 124,555 |
| Available-for-sale securities | 1,286,235 | 1,286,235 | 1,558,306 | 1,558,306 |

Edgar Filing: REDWOOD TRUST INC - Form 10-Q

| | | | | |
|--|--------------|--------------|------------|------------|
| MSRs | 135,152 | 135,152 | 64,824 | 64,824 |
| Cash and cash equivalents | 149,617 | 149,617 | 173,201 | 173,201 |
| Restricted cash | 455 | 455 | 398 | 398 |
| Accrued interest receivable | 15,261 | 15,261 | 13,475 | 13,475 |
| Derivative assets | 7,756 | 7,756 | 7,787 | 7,787 |
| REO ⁽¹⁾ | 3,349 | 3,407 | 3,661 | 4,084 |
| Margin receivable ⁽¹⁾ | 56,217 | 56,217 | 31,149 | 31,149 |
| Other collateral posted ⁽¹⁾ | 5,000 | 5,000 | 5,000 | 5,000 |
| Liabilities | | | | |
| Short-term debt | \$ 1,887,688 | \$ 1,887,688 | \$ 862,763 | \$ 862,763 |
| Accrued interest payable | 10,480 | 10,480 | 6,366 | 6,366 |
| Derivative liabilities | 38,263 | 38,263 | 18,167 | 18,167 |
| ABS issued | 1,656,202 | 1,548,795 | 1,942,962 | 1,746,906 |
| FHLBC Borrowings | 203,756 | 203,756 | - | - |
| Commercial long-term debt | - | - | 49,467 | 49,467 |
| Commercial secured borrowings | 66,146 | 66,146 | - | - |
| Convertible notes | 287,500 | 285,344 | 287,500 | 299,719 |
| Other long-term debt | 139,500 | 101,835 | 139,500 | 111,600 |

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

Table of Contents

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

September 30, 2014

(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

We elected the fair value option for \$3.31 billion and \$6.12 billion of residential loans (principal balance) and \$340 million and \$609 million of commercial loans (principal balance) we acquired during the three and nine months ended September 30, 2014, respectively. We also elected the fair value option for \$65 million of commercial secured borrowings we recorded during the nine months ended September 30, 2014. We anticipate electing the fair value option for all future purchases of residential loans and commercial senior loans that we intend to sell to third parties or transfer to securitizations.

The following table presents the assets and liabilities that are reported at fair value on our consolidated balance sheets on a recurring basis at September 30, 2014, as well as the fair value hierarchy of the valuation inputs used to measure fair value.

Assets and Liabilities Measured at Fair Value on a Recurring Basis at September 30, 2014

| September 30, 2014 (In Thousands) | Carrying Value | Fair Value Measurements Using | | |
|--|---------------------------|--------------------------------------|----------------|----------------|
| | | Level 1 | Level 2 | Level 3 |
| Assets | | | | |
| Residential loans, at fair value | \$ 1,739,578 | \$ - | \$ 399,145 | \$ 1,340,433 |
| Commercial loans, at fair value | 175,421 | - | - | 175,421 |
| Trading securities | 108,750 | - | - | 108,750 |
| Available-for-sale securities | 1,286,235 | - | - | 1,286,235 |
| MSRs | 135,152 | - | - | 135,152 |
| Derivative assets | 7,756 | 1,496 | 5,327 | 933 |
| Liabilities | | | | |
| Derivative liabilities | 38,263 | 3,709 | 34,472 | 82 |
| Commercial secured borrowings | 66,146 | - | - | 66,146 |

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

The following table presents additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the nine months ended September 30, 2014.

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

| (In Thousands) | Assets | | | | | Liabilities | |
|--|----------------------|---------------------|-----------------------|---------------------|-------------------|----------------------------|-------------------------------------|
| | Residential Loans | Commercial Loans | Trading Securities | AFS Securities | MSRs | Derivatives ⁽¹⁾ | Commercial Secured Borrowings |
| Beginning balance - December 31, 2013 | \$ 391,100 | \$ 89,111 | \$ 124,555 | \$ 1,558,306 | \$ 64,824 | \$ (379) | \$ - |
| Principal paydowns | (20,728) | (3,684) | (5,848) | (138,751) | - | - | (1,081) |
| Discount accretion | - | - | - | 32,774 | - | - | - |
| Gains (losses) in net income, net | 35,971 | 14,986 | (15,041) | 9,389 | (5,944) | 6,434 | 2,179 |
| Unrealized gains in OCI, net | - | - | - | 28,328 | - | - | - |
| Acquisitions | 3,557,753 | 611,624 | 66,253 | 192,151 | 76,272 | - | 65,048 |
| Sales | (2,621,349) | (536,671) | (61,169) | (395,962) | - | - | - |
| Other settlements, net | (2,314) | 55 | - | - | - | (5,204) | - |
| Ending balance - September 30, 2014 | \$ 1,340,433 | \$ 175,421 | \$ 108,750 | \$ 1,286,235 | \$ 135,152 | \$ 851 | \$ 66,146 |

(1) For the purpose of this presentation, derivative assets and liabilities, which consist of loan purchase commitments, are presented net.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 5. Fair Value of Financial Instruments (continued)**

The following table presents the portion of gains or losses included in our consolidated statements of income that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and held at September 30, 2014 and 2013. Gains or losses incurred on assets or liabilities sold, matured, called, or fully written down during the three and nine months ended September 30, 2014 and 2013 are not included in this presentation.

Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at September 30, 2014 and 2013 Included in Net Income

| (In Thousands) | Included in Net Income | | | |
|----------------------------------|--|--|---|---|
| | Three Months Ended September 30, 2014 | Three Months Ended September 30, 2013 | Nine Months Ended September 30, 2014 | Nine Months Ended September 30, 2013 |
| Assets | | | | |
| Residential loans, at fair value | \$ 7,280 | \$ (1,864) | \$ 8,524 | \$ (3,088) |
| Commercial loans, at fair value | 2,009 | 831 | 2,009 | 831 |
| Trading securities | (1,882) | (1,525) | (16,033) | 28,491 |
| Available-for-sale securities | (188) | - | (434) | 940 |
| MSRs | 3,509 | 1,344 | (3,184) | 12,561 |
| Liabilities | | | | |
| Loan purchase commitments | 932 | - | 932 | - |
| Commercial secured borrowing | (420) | - | 1,339 | - |

The following table presents information on assets recorded at fair value on a non-recurring basis at September 30, 2014. This table does not include the carrying value and gains or losses associated with the asset types below that were not recorded at fair value on our balance sheet at September 30, 2014.

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis at September 30, 2014

| September 30, 2014 (In Thousands) | Carrying Value | Fair Value Measurements Using | | | Gain (Loss) for the Month Ended September 30, 2014 |
|--|-----------------------|--------------------------------------|----------------|----------------|---|
| | | Level 1 | Level 2 | Level 3 | |
| | | | | | Gain (Loss) for the Month Ended September 30, 2014 |

Assets

| | | | | | | |
|---|----------|------|------|----------|------|--------|
| Residential loans, at lower of cost or fair value | \$ 1,106 | \$ - | \$ - | \$ 1,106 | \$ 1 | \$ (1) |
| REO | 1,944 | - | - | 1,994 | 0 | (133) |

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 5. Fair Value of Financial Instruments (continued)**

The following table presents the components of market valuation adjustments, net, recorded in our consolidated statements of income for the three and nine months ended September 30, 2014 and 2013.

Market Valuation Adjustments, Net

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|---|-------------------|--|------------------|
| | 2014 | 2013 | 2014 | 2013 |
| Mortgage banking activities | | | | |
| Residential loans, at fair value | \$ 13,446 | \$ (10,804) | \$ 34,554 | \$ (17,339) |
| Commercial loans, at fair value | 4,305 | 3,171 | 13,644 | 2,826 |
| Trading securities | (1,332) | (1,866) | (14,419) | 36,399 |
| Derivative instruments, net | (2,404) | 442 | (18,159) | 51,009 |
| Loan purchase and forward sale commitments | 2,487 | - | 6,077 | - |
| Total mortgage banking activities⁽¹⁾ | 16,502 | (9,057) | 21,697 | 72,895 |
| MSRs | 2,321 | 460 | (5,944) | 9,628 |
| Other | | | | |
| Residential loans, at lower of cost or fair value | 43 | (11) | 54 | 68 |
| Held-for-investment loans at fair value | (991) | - | (991) | - |
| Trading securities | (577) | 540 | (653) | (4,168) |
| Impairments on AFS securities | (188) | - | (565) | (1,666) |
| REO | (361) | (76) | (825) | (407) |
| Other derivative instruments, net | (1,632) | 9 | (10,986) | 74 |
| Total other | (3,706) | 462 | (13,966) | (6,099) |
| Total Market Valuation Adjustments, Net | \$ 15,117 | \$ (8,135) | \$ 1,787 | \$ 76,425 |

- (1) Income from mortgage banking activities presented above does not include fee income or provisions for repurchases that is a component of mortgage banking income presented on our consolidated statements of income as these amounts do not represent a market valuation adjustment.

Valuation Policy

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

Table of Contents

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

September 30, 2014

(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

Valuation Process

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

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 5. Fair Value of Financial Instruments (continued)**

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

Fair Value Methodology for Level 3 Financial Instruments**September 30, 2014**

| (Dollars in Thousands) | Fair Value | Unobservable Input | Range | Weighted Average |
|---|-------------------|---------------------------|-------------------|-------------------------|
| Assets | | | | |
| Residential loans, at fair value: | | | | |
| Loans priced to securitization or priced to whole loan market and uncommitted to sell | \$ 758,501 | Discount rate | 4 - 5 % | 4 % |
| | | Prepayment rate | 8 - 8 % | 8 % |
| | | Default rate | 1 - 1 % | 1 % |
| | | Loss severity | 20 - 20 % | 20 % |
| | | Credit support | 8 - 8 % | 8 % |
| | | Spread to securitization | 38 - 38 bps | 38 bps |
| | | Credit spread | 118 - 173 bps | 129 bps |
| Loans priced to whole loan market, committed to sell | 581,932 | Pool fallout assumption | 10 bps - 10 bps | 10 bps |
| Residential loans, at lower of cost or fair value | 1,106 | Loss severity | 15-28 % | 21 % |
| Commercial loans, at fair value | 175,421 | Credit spread | 152 bps - 152 bps | 152 bps |
| | | Credit support | 24 - 24 % | 24 % |

Edgar Filing: REDWOOD TRUST INC - Form 10-Q

| | | | | |
|--|-----------|------------------|-------------------|---------|
| Trading and AFS securities | 1,394,985 | Discount rate | 4 - 12 % | 6 % |
| | | Prepayment speed | 1 - 35 % | 12 % |
| | | Default rate | 0 - 35 % | 8 % |
| | | Loss severity | 20 - 64 % | 35 % |
| | | Credit support | 0 - 88 % | 6 % |
| MSRs | 135,152 | Discount rate | 8 - 11 % | 10 % |
| | | Prepayment rate | 4 - 60 % | 10 % |
| REO | 1,994 | Loss severity | 13 - 96 % | 34 % |
| Loan purchase commitments, net ⁽¹⁾ | 851 | MSR Multiple | 1 - 5x | 4x |
| | | Pullthrough rate | 58 - 99 % | 82 % |
| Liabilities | | | | |
| Commercial secured financing | 66,146 | Credit spread | 152 bps - 152 bps | 152 bps |
| | | Credit support | 24 - 24 % | 24 % |

(1) For the purpose of this presentation loan purchase commitment assets and liabilities are presented net.

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

Determination of Fair Value

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

Residential loans

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

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

Estimated fair values for conforming loans are determined based upon quoted market prices (Level 2). Conforming loans are mortgage loans that conform to Agency guidelines. As necessary, these values are adjusted for servicing value, market conditions and liquidity.

Commercial loans

Estimated fair values for senior commercial loans are determined by an exit price to securitization. Certain significant inputs in the valuation analysis are Level 3 in nature. Relevant market indicators that are factored into the analyses

include third-party Commercial Mortgage-Backed Securities (CMBS) sales, pricing points for secondary sales of CMBS, yields for synthetic instruments that use CMBS bonds as an underlying index, indexed swap yields, credit rating agency guidance on expected credit enhancement levels for newly issued CMBS transactions, and interest rates (Level 3). In certain cases, commercial senior mortgage loans are valued based on third-party offers for the securities for purchase into securitization (Level 2).

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

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

Real estate securities

Real estate securities primarily include residential mortgage-backed securities that are generally illiquid in nature and trade infrequently. Significant inputs in the valuation analysis are predominantly Level 3 in nature, due to the lack of readily available market quotes and related inputs. For real estate securities, we utilize both market comparable pricing and discounted cash flow analysis valuation techniques. Relevant market indicators that are factored into the analyses include bid/ask spreads, the amount and timing of credit losses, interest rates, and prepayment speeds. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3). These cash flow models use significant unobservable inputs such as a discount rate, prepayment rate, default rate, loss severity and credit support. The estimated fair value of our securities would generally decrease based upon an increase in serious delinquencies or loss severities, or a decrease in prepayment speeds or credit support.

As part of our securities valuation process, we request and consider indications of value from third-party securities dealers. For purposes of pricing our securities at September 30, 2014, we received dealer price indications on 81% of our securities, representing 94% of our carrying value. In the aggregate, our internal valuations of the securities for which we received dealer price indications were within 2% of the aggregate dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis. In circumstances where relevant market inputs cannot be obtained, increased reliance on discounted cash flow analysis and management judgment are required to estimate fair value.

Derivative assets and liabilities

Our derivative instruments include swaps, swaptions, TBAs, financial futures, CMBX credit default index swaps, LPCs, and FSCs. Fair values of derivative instruments are determined using quoted prices from active markets, when available, or from valuation models and are supported by valuations provided by dealers active in derivative markets. TBA and financial futures fair values are generally obtained using quoted prices from active markets (Level 1). Our derivative valuation models for swaps and swaptions require a variety of inputs, including contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates, and correlations of certain inputs. Model inputs can generally be verified and model selection does not involve significant management judgment (Level 2). CMBX credit default index swaps are generally obtained using quoted prices; however, they are not always actively traded (Level 2). LPC fair values are estimated based on quoted Agency MBS prices, estimates of the fair value of the MSRs we expect to retain in the sale of the loans, and the probability that the mortgage loan will be purchased (Level 3). FSC fair values are obtained using quoted Agency prices. Model inputs can generally be verified and model

selection does not involve significant management judgment (Level 2).

For other derivatives, valuations are based on various factors such as liquidity, bid/ask spreads, and credit considerations for which we rely on available market inputs. In the absence of such inputs, management's best estimate is used (Level 3).

MSRs

MSRs represent the rights to service jumbo and conforming residential mortgage loans. Significant inputs in the valuation analysis are predominantly Level 3, due to the nature of these instruments and the lack of readily available market quotes. These inputs include market discount rates, prepayment speeds of serviced loans, and the market cost of servicing. Changes in the fair value of MSRs occur primarily due to the collection/realization of expected cash flows, as well as changes in valuation inputs and assumptions. Estimated fair values are based on applying the inputs to generate the net present value of estimated MSR income, which is what we believe market participants would use to estimate fair value (Level 3). These discounted cash flow models utilize certain significant unobservable inputs including prepayment rate and discount rate assumptions. An increase in these unobservable inputs will reduce the estimated fair value of the MSRs.

As part of our MSR valuation process, we received a valuation estimate from a third-party valuations group. In the aggregate, our internal valuation of the MSRs was less than 1% lower than the third-party valuation at September 30, 2014.

Table of Contents

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

September 30, 2014

(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

Cash and cash equivalents

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

Restricted cash

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

Accrued interest receivable and payable

Accrued interest receivable and payable includes interest due on our assets and payable on our liabilities. Due to the short-term nature of when these interest payments will be received or paid, fair values approximate carrying values (Level 1).

REO

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

Margin receivable

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

Short-term debt

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

ABS issued

ABS issued includes asset-backed securities issued through the Sequoia, Residential Resecuritization, and Commercial Securitization entities. These instruments are illiquid in nature and trade infrequently, if at all. For ABS issued, we utilize both market comparable pricing and discounted cash flow analysis valuation techniques. Significant inputs in the valuation analysis are predominantly Level 3, due to the nature of these instruments and the lack of readily available market quotes. Relevant market indicators factored into the analyses include bid/ask spreads, external spreads, collateral credit losses, interest rates, default rates, loss severities, and collateral prepayment speeds. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3). These liabilities would generally increase in value based upon a decrease in default rates and would generally decrease in value if the prepayment rate or credit support input were to decrease.

As part of our ABS issued valuation process, we also request and consider indications of value from third-party securities dealers. For purposes of pricing our ABS issued at September 30, 2014, we received dealer price indications on 42% of our ABS issued. In the aggregate, our internal valuations of the ABS issued for which we received dealer price indications were within 1% of the aggregate dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis.

Table of Contents

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

September 30, 2014

(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

FHLBC Borrowings

FHLBC borrowings include amounts borrowed from the Federal Home Loan Bank of Chicago that are secured by residential mortgage loans or residential mortgage-backed securities. As these borrowings are secured and subject to margin calls and as the rates on these borrowings reset frequently to market rates, we believe that carrying values approximate fair values (Level 1).

Commercial secured borrowings

Commercial secured borrowings represent liabilities recognized as a result of transfers of portions of senior commercial mortgage loans to third parties that do not meet the criteria for sale treatment under GAAP and are accounted for as secured borrowings. Fair values for commercial secured borrowings are based on the fair values of the senior commercial loans associated with the borrowings (Level 3).

Convertible notes

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

Trust preferred securities and subordinated notes

Estimated fair values of trust preferred securities and subordinated notes are determined using discounted cash flow analysis valuation techniques. Significant inputs in the valuation analysis are predominantly Level 3, due to the nature of these instruments and the lack of readily available market quotes. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3).

Note 6. Residential Loans

We acquire residential loans from third-party originators. The following table summarizes the classifications and carrying value of the residential loans owned at Redwood and at consolidated Sequoia Entities at September 30, 2014 and December 31, 2013.

September 30, 2014

| (In Thousands) | Redwood | Sequoia | Total |
|--------------------------------|---------------------|---------------------|---------------------|
| Held-for-sale | | | |
| Fair value - Conforming | \$ 399,145 | \$ - | \$ 399,145 |
| Fair value - Jumbo | 1,101,782 | - | 1,101,782 |
| Lower of cost or fair value | 1,502 | - | 1,502 |
| Held-for-investment | | | |
| Fair value - Jumbo | 238,651 | - | 238,651 |
| At amortized cost | - | 1,546,507 | 1,546,507 |
| Total Residential Loans | \$ 1,741,080 | \$ 1,546,507 | \$ 3,287,587 |

December 31, 2013

| (In Thousands) | Redwood | Sequoia | Total |
|---|-------------------|---------------------|---------------------|
| Held-for-sale | | | |
| Fair value - Conforming | \$ 11,502 | \$ - | \$ 11,502 |
| Fair value - Jumbo | 391,100 | - | 391,100 |
| Lower of cost or fair value | 1,665 | - | 1,665 |
| Held-for-investment, at amortized cost | | | |
| | - | 1,762,167 | 1,762,167 |
| Total Residential Loans | \$ 404,267 | \$ 1,762,167 | \$ 2,166,434 |

Table of Contents

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

September 30, 2014

(Unaudited)

Note 6. Residential Loans (continued)

As of September 30, 2014, we owned mortgage servicing rights associated with \$1.61 billion of consolidated residential loans purchased from third-party originators. The value of these MSR is included in the carrying value of the associated loans on our balance sheet. We contract with a licensed sub-servicer that performs servicing functions for these loans.

Residential Loans Held-for-Sale

Residential Loans at Fair Value

At September 30, 2014, we held 2,862 residential loans at fair value, with an aggregate outstanding principal balance of \$1.46 billion and an aggregate fair value of \$1.50 billion. During the three and nine months ended September 30, 2014, we purchased \$3.31 billion and \$6.12 billion (principal balance) of residential loans, respectively, for which we elected the fair value option. During the three and nine months ended September 30, 2014, we recorded \$13 million and \$35 million of positive valuation adjustments, respectively, on fair value residential loans through mortgage banking activities, net, a component of our consolidated income statement. At December 31, 2013, we held 537 residential loans at fair value, with an aggregate outstanding principal balance of \$399 million and an aggregate fair value of \$403 million.

Residential Loans at Lower of Cost or Fair Value

At September 30, 2014, we held nine residential loans at lower of cost or fair value with \$2 million in outstanding principal balance and a carrying value of \$2 million. At December 31, 2013, we held 10 residential loans at lower of cost or fair value with \$2 million in outstanding principal balance and a carrying value of \$2 million. During the three and nine months ended September 30, 2014, we recorded valuation adjustments for residential loans held-for-sale of positive \$43 thousand and \$54 thousand, respectively.

Residential Loans Held-for-Investment

Residential Loans at Fair Value

During the three months ended September 30, 2014, we transferred loans with a principal balance of \$235 million and a fair value of \$241 million from held-for-sale at fair value to held-for-investment at fair value. As of September 30, 2014, these loans were pledged as collateral under the FHLBC borrowing agreement and our current intention is to hold these loans for investment.

Residential Loans at Amortized Cost

The following table details the carrying value for residential loans held-for-investment at amortized cost at September 30, 2014 and December 31, 2013. These loans are owned at Sequoia securitization entities that we consolidate for financial reporting purposes.

| (In Thousands) | September 30, 2014 | December 31, 2013 |
|---------------------------|---------------------------|--------------------------|
| Principal balance | \$ 1,554,876 | \$ 1,770,803 |
| Unamortized premium, net | 13,540 | 16,791 |
| Recorded investment | 1,568,416 | 1,787,594 |
| Allowance for loan losses | (21,909) | (25,427) |
| Carrying Value | \$ 1,546,507 | \$ 1,762,167 |

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 6. Residential Loans (continued)**

Of the \$1.55 billion of principal balance and \$14 million of unamortized premium on loans held-for-investment at September 30, 2014, \$629 million of principal balance and \$8 million of unamortized premium relate to residential loans acquired prior to July 1, 2004. During the nine months ended September 30, 2014, 14% of these residential loans prepaid and we amortized 23% of the premium based upon the accounting elections we apply. For residential loans acquired after July 1, 2004, the principal balance was \$929 million and the unamortized premium was \$5 million. During the nine months ended September 30, 2014, 11% of these loans prepaid and we amortized 13% of the premium.

Of the \$1.77 billion of principal balance and \$17 million of unamortized premium on loans held-for-investment at December 31, 2013, \$731 million of principal balance and \$11 million of unamortized premium relate to residential loans acquired prior to July 1, 2004. For residential loans acquired after July 1, 2004, the principal balance was \$1 billion and the unamortized premium was \$6 million.

Credit Characteristics of Residential Loans Held-for-Investment

As a percentage of our recorded investment, 99% of residential loans held-for-investment at September 30, 2014, were first lien, predominately prime-quality loans at the time of origination. The remaining 1% of loans were second lien, home equity lines of credit. The weighted average original LTV ratio for our residential loans held-for-investment outstanding at September 30, 2014, was 66%. The weighted average FICO score for the borrowers of these loans was 733 at the time the loans were originated.

We consider the year of origination of our residential loans held-for-investment to be a general indicator of credit performance as loans originated in specific years have often possessed similar product and credit characteristics. The following table displays our recorded investment in residential loans held-for-investment at September 30, 2014 and December 31, 2013, organized by year of origination.

| (In Thousands) | September 30, 2014 | December 31, 2013 |
|-----------------------|---------------------------|--------------------------|
| 2003 & Earlier | \$ 758,768 | \$ 881,364 |
| 2004 | 459,050 | 513,458 |
| 2005 | 59,946 | 62,675 |
| 2006 | 138,263 | 149,776 |
| 2007 | - | - |

| | | |
|----------------------------------|--------------|--------------|
| 2008 | - | - |
| 2009 | 19,273 | 25,860 |
| 2010 | 80,209 | 92,728 |
| 2011 | 52,907 | 61,733 |
| Total Recorded Investment | \$ 1,568,416 | \$ 1,787,594 |

Allowance for Loan Losses on Residential Loans

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

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 6. Residential Loans (continued)*****Activity in the Allowance for Loan Losses on Residential Loans***

The following table summarizes the activity in the allowance for loan losses for the three and nine months ended September 30, 2014 and 2013.

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|------------------|--|------------------|
| | 2014 | 2013 | 2014 | 2013 |
| Balance at beginning of period | \$ 23,972 | \$ 23,150 | \$ 25,427 | \$ 28,504 |
| Charge-offs, net | (1,355) | (818) | (2,833) | (3,363) |
| (Reversal of provision) provision for loan losses | (708) | 883 | (685) | (1,926) |
| Balance at End of Period | \$ 21,909 | \$ 23,215 | \$ 21,909 | \$ 23,215 |

During each of the three months ended September 30, 2014 and 2013, there were \$1 million of charge-offs of residential loans that reduced our allowance for loan losses. These charge-offs were from \$6 million and \$3 million of defaulted loan principal, respectively. During each of the nine months ended September 30, 2014 and 2013, there were \$3 million of charge-offs of residential loans that reduced our allowance for loan losses. These charge-offs arose from \$14 million and \$10 million of defaulted loan principal, respectively.

Residential Loans Collectively Evaluated for Impairment

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

The following table summarizes the balances for loans collectively evaluated for impairment at September 30, 2014 and December 31, 2013.

| (In Thousands) | September 30, 2014 | December 31, 2013 |
|-----------------------|---------------------------|--------------------------|
| Principal balance | \$ 1,539,330 | \$ 1,762,165 |
| Recorded investment | 1,553,147 | 1,779,161 |
| Related allowance | 20,580 | 24,762 |

The following table summarizes the recorded investment and past due status of residential loans collectively evaluated for impairment at September 30, 2014 and December 31, 2013.

| (In Thousands) | 30-59 Days Past Due | 60-89 Days Past Due | 90+ Days Past Due | Current | Total Loans |
|-----------------------|--------------------------------|--------------------------------|------------------------------|----------------|--------------------|
| September 30, 2014 | \$ 25,885 | \$ 10,046 | \$ 73,355 | \$ 1,443,861 | \$ 1,553,147 |
| December 31, 2013 | 34,187 | 13,248 | 79,010 | 1,652,716 | 1,779,161 |

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 6. Residential Loans (continued)*****Residential Loans Individually Evaluated for Impairment***

As part of the loss mitigation efforts undertaken by servicers of residential loans owned at Sequoia securitization entities, a number of loan modifications have been completed to help make mortgage loans more affordable for qualifying borrowers and potentially reduce a future impairment. For the nine months ended September 30, 2014 and 2013, all of the loan modifications determined to be TDRs were either: (i) conversions of a floating rate mortgage loan into a fixed rate mortgage loan; (ii) reductions in the contractual interest rates of a mortgage loan paired with capitalization of accrued interest; or (iii) principal forgiveness paired with interest rate reductions.

The following table presents the details of the loan modifications determined to be TDRs for the three and nine months ended September 30, 2014 and 2013.

| (Dollars in Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|-------------|--|-------------|
| | 2014 | 2013 | 2014 | 2013 |
| TDRs | | | | |
| Number of modifications | 8 | 5 | 22 | 12 |
| Pre-modification outstanding recorded investment | \$ 2,041 | \$ 1,144 | \$ 7,008 | \$ 2,939 |
| Post-modification outstanding recorded investment | 2,081 | 898 | 7,245 | 2,838 |
| Loan modification effect on net interest income after provision and other MVA | (494) | (555) | (1,714) | (863) |

TDRs that Subsequently Defaulted

| | | | | |
|-------------------------|--------|--------|----------|--------|
| Number of modifications | 3 | 1 | 9 | 4 |
| Recorded investment | \$ 672 | \$ 201 | \$ 3,165 | \$ 788 |

If we determine that a restructured loan is a TDR, we remove it from the general loan pools used for determining the allowance for residential loan losses and assess it for impairment on an individual basis. This assessment is based primarily on whether an adverse change in the expected future cash flows resulted from the restructuring. The average recorded investment of loans for the three months ended September 30, 2014 and 2013 was \$15 million and \$8 million, respectively. The average recorded investment of loans individually evaluated for impairment for the nine months ended September 30, 2014 and 2013 was \$12 million and \$7 million, respectively. For the three months ended September 30, 2014 and 2013, we recorded interest income of \$32 thousand and \$81 thousand, respectively, on

individually impaired loans. For the nine months ended September 30, 2014 and 2013, we recorded interest income of \$99 thousand and \$102 thousand, respectively, on individually impaired loans.

The following table summarizes the balances for loans individually evaluated for impairment, all of which had an allowance, at September 30, 2014 and December 31, 2013.

| (In Thousands) | September 30, 2014 | December 31, 2013 |
|-----------------------|---------------------------|--------------------------|
| Principal balance | \$ 15,546 | \$ 8,638 |
| Recorded investment | 15,269 | 8,433 |
| Related allowance | 1,329 | 665 |

The following table summarizes the recorded investment and past due status of residential loans individually evaluated for impairment at September 30, 2014 and December 31, 2013.

| (In Thousands) | 30-59 Days Past Due | 60-89 Days Past Due | 90+ Days Past Due | Current | Total Loans |
|-----------------------|--------------------------------|--------------------------------|------------------------------|----------------|--------------------|
| September 30, 2014 | \$ 1,842 | \$ 1,538 | \$ 544 | \$ 11,345 | \$ 15,269 |
| December 31, 2013 | 1,560 | - | 567 | 6,306 | 8,433 |

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 7. Commercial Loans**

We invest in commercial loans that we originate and service as well as loans that we acquire from third-party originators. The following table summarizes the classifications and carrying value of commercial loans at September 30, 2014 and December 31, 2013.

| (In Thousands) | September 30, 2014 | December 31, 2013 |
|-------------------------------|---------------------------|--------------------------|
| Held-for-sale, at fair value | \$ 104,709 | \$ 89,111 |
| Held-for-investment | | |
| At fair value | 70,712 | - |
| At amortized cost | 322,576 | 343,344 |
| Total Commercial Loans | \$ 497,997 | \$ 432,455 |

Of the held-for-investment commercial loans at amortized cost shown above at September 30, 2014 and December 31, 2013, \$205 million and \$258 million, respectively, were financed through the Commercial Securitization entity, as discussed in *Note 4*.

Commercial Loans Held-for-Sale

Commercial loans held-for-sale include loans we originate and intend to sell to third parties. At September 30, 2014, we held seven commercial loans at fair value, with an aggregate outstanding principal balance of \$103 million and an aggregate fair value of \$105 million. During the three and nine months ended September 30, 2014, we originated and funded senior commercial loans for \$340 million and \$578 million, respectively, and recorded \$4 million and \$14 million, respectively, of positive valuation adjustments on commercial loans held-for-sale through mortgage banking activities, net, a component of our consolidated income statement. At December 31, 2013, we held seven senior commercial loans at fair value, with an aggregate outstanding principal balance of \$88 million and an aggregate fair value of \$89 million.

Commercial Loans Held-for-Investment***Commercial Loans Held-for-Investment, at Fair Value***

Commercial loans held-for-investment at fair value include certain loans we hold for investment for which we have elected the fair value option. At September 30, 2014, we held three of these commercial loans, with an aggregate outstanding principal balance of \$68 million and an aggregate fair value of \$71 million. During the three months

ended September 30, 2014, we did not originate any commercial loans held-for-investment at fair value and recorded \$420 thousand of negative valuation adjustments on our existing portfolio. During the nine months ended September 30, 2014, we originated and funded commercial loans for \$31 million and recorded \$2 million of positive valuation adjustments on commercial loans held-for-investment at fair value through mortgage banking activities, net, a component of our consolidated income statement. We did not have any commercial loans held-for-investment at fair value at December 31, 2013.

Table of Contents

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

September 30, 2014

(Unaudited)

Note 7. Commercial Loans (continued)*Commercial Loans Held-for-Investment, at Amortized Cost*

Commercial loans held-for-investment at amortized cost include loans we originate and preferred equity investments we make or, in either case, acquire from third parties. Through September 30, 2014, these loans have typically been mezzanine loans that are secured by a borrower's ownership interest in a single purpose entity that owns commercial property, rather than a lien on the commercial property. The preferred equity investments are typically preferred equity interests in a single purpose entity that owns commercial property and are included within, and referred to herein, as commercial loans held-for-investment due to the fact that their risks and payment characteristics are nearly equivalent to commercial mezzanine loans.

The following table provides additional information for our commercial loans held-for-investment at amortized cost at September 30, 2014 and December 31, 2013.

| (In Thousands) | September 30, 2014 | December 31, 2013 |
|---------------------------|---------------------------|--------------------------|
| Principal balance | \$ 332,258 | \$ 353,331 |
| Unamortized discount, net | (2,253) | (2,614) |
| Recorded investment | 330,005 | 350,717 |
| Allowance for loan losses | (7,429) | (7,373) |
| Carrying Value | \$ 322,576 | \$ 343,344 |

At September 30, 2014, we held 55 commercial loans held-for-investment at amortized cost with an outstanding principal balance of \$332 million and a carrying value of \$323 million. During the three and nine months ended September 30, 2014, we originated or acquired \$26 million and \$34 million, respectively, of commercial loans held-for-investment at amortized cost. Of the \$330 million of recorded investment in commercial loans held-for-investment at September 30, 2014, 10% was originated in 2014, 20% was originated in 2013, 37% was originated in 2012, 29% was originated in 2011, and 4% was originated in 2010.

At December 31, 2013, we held 50 commercial loans held-for-investment at amortized cost with an outstanding principal balance of \$353 million and a carrying value of \$343 million. Of the \$351 million of recorded investment in commercial loans held-for-investment at December 31, 2013, 19% was originated in 2013, 43% was originated in

2012, 34% was originated in 2011, and 4% was originated in 2010.

Allowance for Loan Losses on Commercial Loans

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

Our methodology for assessing the adequacy of the allowance for loan losses includes a formal review of each commercial loan in the portfolio and the assignment of an internal impairment status. Based on the assigned impairment status, a loan is categorized as Pass, Watch List, or Workout. The following table presents the principal balance of commercial loans held-for-investment by risk category.

| (In Thousands) | September 30, 2014 | December 31, 2013 |
|---|---------------------------|--------------------------|
| Pass | \$ 306,575 | \$ 309,792 |
| Watch list | 25,683 | 43,539 |
| Total Commercial Loans Held-for-Investment | \$ 332,258 | \$ 353,331 |

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 7. Commercial Loans (continued)***Activity in the Allowance for Loan Losses on Commercial Loans*

The following table summarizes the activity in the allowance for commercial loan losses for the three and nine months ended September 30, 2014 and 2013.

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|-----------------|--|-----------------|
| | 2014 | 2013 | 2014 | 2013 |
| Balance at beginning of period | \$ 8,317 | \$ 5,660 | \$ 7,373 | \$ 4,084 |
| Charge-offs, net | - | - | - | - |
| Reversal of provision (provision) for loan losses | (888) | 844 | 56 | 2,420 |
| Balance at End of Period | \$ 7,429 | \$ 6,504 | \$ 7,429 | \$ 6,504 |

Commercial Loans Collectively Evaluated for Impairment

At September 30, 2014 and December 31, 2013, all of our commercial loans collectively evaluated for impairment were current. The following table summarizes the balances for loans collectively evaluated for impairment at September 30, 2014 and December 31, 2013.

| (In Thousands) | September 30, 2014 | December 31, 2013 |
|-----------------------|---------------------------|--------------------------|
| Principal balance | \$ 332,258 | \$ 353,331 |
| Recorded investment | 330,005 | 350,717 |
| Related allowance | 7,429 | 7,373 |

Commercial Loans Individually Evaluated for Impairment

We did not have any commercial loans individually evaluated for impairment at either September 30, 2014 or December 31, 2013.

Note 8. Real Estate Securities

We invest in residential mortgage-backed securities. The following table presents the fair values of our real estate securities by type at September 30, 2014 and December 31, 2013.

| (In Thousands) | September 30, 2014 | December 31, 2013 |
|-------------------------------------|---------------------------|--------------------------|
| Trading | \$ 108,750 | \$ 124,555 |
| Available-for-sale | 1,286,235 | 1,558,306 |
| Total Real Estate Securities | \$ 1,394,985 | \$ 1,682,861 |

Our real estate securities herein are presented in accordance with their general position within a securitization structure based on their rights to cash flows. Senior securities are those interests in a securitization that generally have the first right to cash flows and are last in line to absorb losses. Re-REMIC securities, as presented herein, were created through the resecuritization of certain senior interests to provide additional credit support to those interests. These re-REMIC securities are therefore subordinate to the remaining senior interest, but senior to any subordinate tranches of the securitization from which they were created. Subordinate securities are all interests below senior and re-REMIC interests.

Table of Contents

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

September 30, 2014

(Unaudited)

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

We elected the fair value option for certain securities and classify them as trading securities. At September 30, 2014, our trading securities included \$105 million of interest-only securities, for which there is no principal balance, \$3 million of senior securities and less than \$1 million of residential subordinate securities. The unpaid principal balance of residential senior and subordinate securities classified as trading was \$3 million and \$11 million, respectively, at September 30, 2014. The following table presents trading securities by collateral type at September 30, 2014 and December 31, 2013.

| (In Thousands) | September 30, 2014 | December 31, 2013 |
|-------------------------------------|---------------------------|--------------------------|
| Senior Securities | | |
| Prime | \$ 100,612 | \$ 110,505 |
| Non-prime | 7,758 | 9,070 |
| Total Senior Securities | 108,370 | 119,575 |
| Subordinate Securities | | |
| Prime | 380 | 4,980 |
| Total Subordinate Securities | 380 | 4,980 |
| Total Trading Securities | \$ 108,750 | \$ 124,555 |

AFS Securities

The following table presents the fair value of our available-for-sale securities held at Redwood by collateral type at September 30, 2014 and December 31, 2013.

| (In Thousands) | September 30, 2014 | December 31, 2013 |
|-----------------------|---------------------------|--------------------------|
|-----------------------|---------------------------|--------------------------|

| | | | |
|-------------------------------------|----|-----------|--------------|
| Senior Securities | | | |
| Prime | \$ | 358,813 | \$ 662,306 |
| Non-prime | | 186,223 | 193,386 |
| Total Senior Securities | | 545,036 | 855,692 |
| Re-REMIC Securities | | 176,117 | 176,376 |
| Subordinate Securities | | | |
| Prime | | 564,932 | 526,095 |
| Non-prime | | 150 | 143 |
| Total Subordinate Securities | | 565,082 | 526,238 |
| Total AFS Securities | \$ | 1,286,235 | \$ 1,558,306 |

The senior securities shown above at September 30, 2014 and December 31, 2013, included \$111 million and \$131 million, respectively, of prime securities, and \$122 million and \$132 million, respectively, of non-prime securities that were financed through the Residential Resecuritization entity, as discussed in *Note 4*.

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

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 8. Real Estate Securities (continued)**

At September 30, 2014, there were \$9 million of AFS residential securities with contractual maturities less than five years, \$2 million of AFS residential securities with contractual maturities greater than five years but less than 10 years, and the remainder of our real estate securities had contractual maturities greater than 10 years.

The following table presents the components of carrying value (which equals fair value) of residential AFS securities at September 30, 2014 and December 31, 2013.

Carrying Value of Residential AFS Securities

| September 30, 2014 | Senior | | | | Total |
|---------------------------|-------------------|-------------------|-------------------|--------------------|---------------------|
| (In Thousands) | Prime | Non-prime | Re-REMIC | Subordinate | |
| Principal balance | \$ 362,902 | \$ 202,812 | \$ 206,212 | \$ 694,308 | \$ 1,466,234 |
| Credit reserve | (4,082) | (9,894) | (16,553) | (43,346) | (73,875) |
| Unamortized discount, net | (41,314) | (33,676) | (80,986) | (143,129) | (299,105) |
| Amortized cost | 317,506 | 159,242 | 108,673 | 507,833 | 1,093,254 |
| Gross unrealized gains | 42,113 | 27,004 | 67,444 | 59,427 | 195,988 |
| Gross unrealized losses | (805) | (24) | - | (2,178) | (3,007) |
| Carrying Value | \$ 358,814 | \$ 186,222 | \$ 176,117 | \$ 565,082 | \$ 1,286,235 |

| December 31, 2013 | Senior | | | | Total |
|---------------------------|---------------|------------------|-----------------|--------------------|--------------|
| (In Thousands) | Prime | Non-prime | Re-REMIC | Subordinate | |
| Principal balance | \$ 670,051 | \$ 218,603 | \$ 214,046 | \$ 706,292 | \$ 1,808,992 |
| Credit reserve | (10,144) | (13,840) | (30,429) | (62,457) | (116,870) |
| Unamortized discount, net | (44,133) | (36,882) | (80,188) | (137,266) | (298,469) |
| Amortized cost | 615,774 | 167,881 | 103,429 | 506,569 | 1,393,653 |
| Gross unrealized gains | 47,980 | 25,654 | 72,947 | 41,205 | 187,786 |
| Gross unrealized losses | (1,448) | (149) | - | (21,536) | (23,133) |

| | | | | | |
|-----------------------|------------|------------|------------|------------|--------------|
| Carrying Value | \$ 662,306 | \$ 193,386 | \$ 176,376 | \$ 526,238 | \$ 1,558,306 |
|-----------------------|------------|------------|------------|------------|--------------|

The following table presents the changes for the three and nine months ended September 30, 2014, in unamortized discount and designated credit reserves on residential AFS securities.

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

| (In Thousands) | Three Months Ended September 30, 2014 | |
|--|--|--------------------------------------|
| | Credit Reserve | Unamortized Discount, Net |
| Beginning balance | \$ 83,276 | \$ 304,293 |
| Amortization of net discount | - | (10,890) |
| Realized credit losses | (1,692) | - |
| Acquisitions | 1,589 | 4,404 |
| Sales, calls, other | (1,013) | (7,175) |
| Impairments | 188 | - |
| Transfers to (release of) credit reserves, net | (8,473) | 8,473 |
| Ending Balance | \$ 73,875 | \$ 299,105 |

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 8. Real Estate Securities (continued)

| (In Thousands) | Nine Months Ended September 30, 2014 | |
|--|--------------------------------------|---------------------------|
| | Credit Reserve | Unamortized Discount, Net |
| Beginning balance | \$ 116,870 | \$ 298,469 |
| Amortization of net discount | - | (32,774) |
| Realized credit losses | (9,002) | - |
| Acquisitions | 1,846 | 7,241 |
| Sales, calls, other | (2,425) | (7,810) |
| Impairments | 565 | - |
| Transfers to (release of) credit reserves, net | (33,979) | 33,979 |
| Ending Balance | \$ 73,875 | \$ 299,105 |

Residential AFS Securities with Unrealized Losses

The following table presents the components comprising the total carrying value of residential AFS securities that were in a gross unrealized loss position at September 30, 2014 and December 31, 2013.

| (In Thousands) | Less Than 12 Consecutive Months | | | 12 Consecutive Months or Longer | | |
|--------------------|---------------------------------|-------------------|------------|---------------------------------|-------------------|------------|
| | Amortized Cost | Unrealized Losses | Fair Value | Amortized Cost | Unrealized Losses | Fair Value |
| September 30, 2014 | \$ 104,118 | \$ (1,097) | \$ 103,021 | \$ 75,582 | \$ (1,910) | \$ 73,672 |
| December 31, 2013 | 607,030 | (21,195) | 585,835 | 19,828 | (1,938) | 17,890 |

At September 30, 2014, after giving effect to purchases, sales, and extinguishments due to credit losses, our consolidated balance sheet included 294 AFS securities, of which 30 were in an unrealized loss position and 12 were in a continuous unrealized loss position for 12 consecutive months or longer. At December 31, 2013, our consolidated balance sheet included 303 AFS securities, of which 76 were in an unrealized loss position and five were in a continuous unrealized loss position for 12 consecutive months or longer.

Evaluating AFS Securities for Other-than-Temporary Impairments

Gross unrealized losses on our AFS securities were \$3 million at September 30, 2014. We evaluate all securities in an unrealized loss position to determine if the impairment is temporary or other-than-temporary (resulting in an OTTI). At September 30, 2014, we did not intend to sell any of our AFS securities that were in an unrealized loss position, and it is more likely than not that we will not be required to sell these securities before recovery of their amortized cost basis, which may be at their maturity. We review our AFS securities that are in an unrealized loss position to identify those securities with losses that are other-than-temporary based on an assessment of changes in expected cash flows for such securities, which considers recent security performance and expected future performance of the underlying collateral.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 8. Real Estate Securities (continued)**

During the three months ended September 30, 2014, we determined that unrealized losses of less than \$1 million related to our AFS securities were OTTI, of which less than \$1 million was determined to be credit related and recorded in Other market valuation adjustments in our consolidated statements of income and none was determined to be non-credit related and recorded through AOCI on our consolidated balance sheets. AFS securities on which OTTI is recognized have experienced, or are expected to experience, credit-related adverse cash flow changes. In determining our estimate of cash flows for AFS securities we may consider factors such as structural credit enhancement, past and expected future performance of underlying mortgage loans, including timing of expected future cash flows, which are informed by prepayment rates, default rates, loss severities, delinquency rates, percentage of non-performing loans, FICO scores at loan origination, year of origination, loan-to-value ratios, and geographic concentrations, as well as general market assessments. Changes in our evaluation of these factors impacted the cash flows expected to be collected at the OTTI assessment date and were used to determine if there were credit-related adverse cash flows and if so, the amount of credit related losses. Significant judgment is used in both our analysis of the expected cash flows for our AFS securities and any determination of the credit loss component of OTTI.

The table below summarizes the significant valuation assumptions we used for our OTTI AFS securities at September 30, 2014.

Significant Valuation Assumptions

| September 30, 2014 | Range for Securities | |
|---------------------------|-----------------------------|------------------|
| | Prime Securities | Non-prime |
| Prepayment rates | 15 - 20 % | 10 - 10 % |
| Loss severity | 20 - 52 % | 35 - 35 % |
| Projected default rate | 1 - 22 % | 15 - 15 % |

The following table details the activity related to the credit loss component of OTTI (i.e., OTTI recognized through earnings) for AFS securities held at September 30, 2014 and 2013, for which a portion of an OTTI was recognized in other comprehensive income.

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

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|----------------------------------|------------------|---------------------------------|------------------|
| | 2014 | 2013 | 2014 | 2013 |
| Balance at beginning of period | \$ 34,256 | \$ 42,674 | \$ 37,149 | \$ 50,852 |
| Additions | | | | |
| Initial credit impairments | - | - | 261 | - |
| Subsequent credit impairments | - | - | 70 | - |
| Reductions | | | | |
| Securities sold, or expected to sell | (18) | (3,288) | (922) | (5,479) |
| Securities with no outstanding principal at period end | - | (764) | (2,320) | (6,751) |
| Balance at End of Period | \$ 34,238 | \$ 38,622 | \$ 34,238 | \$ 38,622 |

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 8. Real Estate Securities (continued)*Gross Realized Gains and Losses on AFS Securities*

Gains and losses from the sale of AFS securities are recorded as realized gains, net, in our consolidated statements of income. The following table presents the gross realized gains and losses on sales and calls of AFS securities for the three and nine months ended September 30, 2014 and 2013.

| (In Thousands) | Three Months Ended September 30, 2014 | | Three Months Ended September 30, 2013 | |
|---|---------------------------------------|------------------|---------------------------------------|------------------|
| | 2014 | 2013 | 2014 | 2013 |
| Gross realized gains - sales | \$ 10,227 | \$ 10,532 | \$ 11,219 | \$ 22,762 |
| Gross realized gains - calls | 462 | - | 1,449 | 333 |
| Gross realized losses - sales | (2,713) | (214) | (2,713) | (214) |
| Gross realized losses - calls | - | - | - | - |
| Total Realized Gains on Sales and Calls of AFS Securities, net | \$ 7,976 | \$ 10,318 | \$ 9,955 | \$ 22,881 |

Note 9. Mortgage Servicing Rights

We invest in mortgage servicing rights associated with residential mortgage loans and contract with a licensed sub-servicer to perform all servicing functions for these loans. The following table presents the fair value of MSRs and the aggregate principal amounts of associated loans as of September 30, 2014 and December 31, 2013.

| (In Thousands) | September 30, 2014 | | December 31, 2013 | |
|--|--------------------|----------------------|-------------------|----------------------|
| | MSR Fair Value | Associated Principal | MSR Fair Value | Associated Principal |
| Mortgage Servicing Rights | | | | |
| Conforming Loans | \$ 73,953 | \$ 6,254,058 | \$ 3,331 | \$ 308,258 |
| Jumbo Loans | 61,199 | 5,962,758 | 61,493 | 5,483,500 |
| Total Mortgage Servicing Rights | \$ 135,152 | \$ 12,216,816 | \$ 64,824 | \$ 5,791,758 |

The following table presents activity for MSR for the three and nine months ended September 30, 2014 and 2013.

MSR Activity

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---------------------------------------|---|------------------|--|------------------|
| | 2014 | 2013 | 2014 | 2013 |
| Balance at beginning of period | \$ 71,225 | \$ 43,098 | \$ 64,824 | \$ 5,315 |
| Additions | 61,606 | 16,676 | 76,272 | 45,291 |
| Changes in fair value due to: | | | | |
| Changes in assumptions ⁽¹⁾ | 4,323 | 1,444 | (318) | 11,764 |
| Other changes ⁽²⁾ | (2,002) | (984) | (5,626) | (2,136) |
| Balance at End of Period | \$ 135,152 | \$ 60,234 | \$ 135,152 | \$ 60,234 |

(1) Primarily reflects changes in prepayment assumptions due to changes in market interest rates.

(2) Represents changes due to realization of expected cash flows.

Table of Contents

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

September 30, 2014

(Unaudited)

Note 9. Mortgage Servicing Rights (continued)

We make investments in MSR's through the retention of servicing rights associated with the residential mortgage loans that we have acquired and subsequently transfer to third parties or through the direct acquisition of MSR's sold by third parties. The following table details the retention and purchase of MSR's during the three and nine months ended September 30, 2014.

MSR Additions

| (In Thousands) | Three Months Ended September 30, 2014 | | Nine Months Ended September 30, 2014 | |
|---------------------------------------|--|-------------------------|---|-------------------------|
| | MSR Fair Value | Associated Principal | MSR Fair Value | Associated Principal |
| Jumbo MSR additions: | | | | |
| From securitization | \$ 4,356 | \$ 516,004 | \$ 6,542 | \$ 773,205 |
| From loan sales | - | - | 488 | 58,793 |
| Total jumbo MSR additions | 4,356 | 516,004 | 7,030 | 831,998 |
| Conforming MSR additions: | | | | |
| From loan sales | \$ 14,630 | \$ 1,352,122 | \$ 23,933 | \$ 2,232,559 |
| From purchases | 42,620 | 3,497,224 | 45,309 | 3,770,566 |
| Total conforming MSR additions | 57,250 | 4,849,346 | 69,242 | 6,003,125 |
| Total MSR additions | \$ 61,606 | \$ 5,365,350 | \$ 76,272 | \$ 6,835,123 |

MSR Income

The following table presents the components of our MSR income.

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|----------------|----------------------------------|------|---------------------------------|------|
| | 2014 | 2013 | 2014 | 2013 |

Edgar Filing: REDWOOD TRUST INC - Form 10-Q

| | | | | |
|-------------------------------|-----------------|-----------------|-----------------|------------------|
| Servicing income, net: | | | | |
| Income | \$ 4,590 | \$ 3,008 | \$ 12,287 | \$ 5,820 |
| Cost of sub-servicer | (437) | (355) | (1,040) | (767) |
| Net servicing income | 4,153 | 2,653 | 11,247 | 5,053 |
| Market valuation adjustments | 2,321 | 460 | (5,944) | 9,628 |
| MSR provision for repurchases | (653) | - | (653) | - |
| Income from MSRs, Net | \$ 5,821 | \$ 3,113 | \$ 4,650 | \$ 14,681 |

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 10. Derivative Financial Instruments**

The following table presents the fair value and notional amount of derivative financial instruments held by us at September 30, 2014 and December 31, 2013.

| (In Thousands) | September 30, 2014 | | December 31, 2013 | |
|--|--------------------|---------------------|--------------------|---------------------|
| | Fair Value | Notional Amount | Fair Value | Notional Amount |
| Assets - Risk Management Derivatives | | | | |
| Interest rate swaps | \$ 148 | \$ 60,500 | \$ 5,972 | \$ 268,000 |
| TBAs | 1,496 | 671,000 | 1,138 | 241,000 |
| Swaptions | 2,744 | 420,000 | 596 | 340,000 |
| Credit default index swaps | 2,372 | 75,000 | - | - |
| Assets - Other Derivatives | | | | |
| Loan purchase commitments | 933 | 273,781 | - | 360 |
| Loan forward sale commitments | 63 | 128,232 | 81 | 10,000 |
| Total Assets | \$ 7,756 | \$ 1,628,513 | \$ 7,787 | \$ 859,360 |
| Liabilities - Cash Flow Hedges | | | | |
| Interest rate swaps | \$ (33,973) | \$ 139,500 | \$ (16,519) | \$ 139,500 |
| Liabilities - Risk Management Derivatives | | | | |
| Interest rate swaps | (476) | 154,500 | (80) | 50,500 |
| TBAs | (3,298) | 1,274,500 | (661) | 235,000 |
| Futures | (411) | 108,000 | (528) | 162,000 |
| Liabilities - Other Derivatives | | | | |
| Loan purchase commitments | (82) | 50,439 | (379) | 42,562 |
| Loan forward sale commitments | (23) | 200,000 | - | - |
| Total Liabilities | \$ (38,263) | \$ 1,926,939 | \$ (18,167) | \$ 629,562 |
| Total Derivative Financial Instruments, Net | \$ (30,507) | \$ 3,555,452 | \$ (10,380) | \$ 1,488,922 |

Risk Management Derivatives

To manage, to varying degrees, risks associated with certain assets and liabilities on our consolidated balance sheet, we may enter into derivative contracts. In order to manage certain risks associated with residential loans, residential securities, and commercial loans we own or plan to acquire, at September 30, 2014, we were party to swaps and swaptions with an aggregate notional amount of \$635 million, TBA contracts sold with an aggregate notional amount of \$1.9 billion, credit default index swaps with an aggregated notional amount of \$75 million, and financial futures contracts with an aggregate notional amount of \$108 million. Net market valuation adjustments on risk management derivatives were negative \$4 million and negative \$29 million for the three and nine months ended September 30, 2014, respectively, and positive less than \$1 million and \$51 million for the three and nine months ended September 30, 2013, respectively.

Loan Purchase and Forward Sale Commitments

LPCs and FSCs that qualify as derivatives are recorded at their estimated fair values. Net valuation adjustments on LPCs and FSCs were positive \$2 million and \$6 million for the three and nine months ended September 30, 2014, respectively, and are reported through our consolidated statements of income in mortgage banking activities, net.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 10. Derivative Financial Instruments (continued)***Derivatives Designated as Cash Flow Hedges*

To manage the variability in interest expense related to our long-term debt and certain adjustable-rate securitization entity liabilities that are included in our consolidated balance sheets for financial reporting purposes, we designated certain interest rate swaps as cash flow hedges with an aggregate notional balance of \$140 million.

For the three months ended September 30, 2014 and 2013, designated cash flow hedges decreased in value by \$3 million and increased in value by \$4 million, respectively, which was recorded in accumulated other comprehensive income, a component of equity. For the nine months ended September 30, 2014 and 2013, these cash flow hedges decreased in value by \$17 million and increased in value by \$25 million, respectively. For interest rate agreements currently or previously designated as cash flow hedges, our total unrealized loss reported in accumulated other comprehensive income was \$33 million and \$16 million at September 30, 2014 and December 31, 2013, respectively. For both of the three months ended September 30, 2014 and 2013, we reclassified less than \$100 thousand of unrealized losses on derivatives to interest expense. For the nine months ended September 30, 2014 and 2013, we reclassified \$131 thousand and \$219 thousand, respectively, of unrealized losses on derivatives to interest expense. Accumulated other comprehensive loss of less than \$1 million will be amortized into interest expense, a component of our consolidated income statements, over the remaining life of the hedge liabilities.

The following table illustrates the impact on interest expense of our interest rate agreements accounted for as cash flow hedges for the three and nine months ended September 30, 2014 and 2013.

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

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|----------------------------------|------------|---------------------------------|------------|
| | 2014 | 2013 | 2014 | 2013 |
| Net interest expense on cash flow interest rate agreements | \$ (1,487) | \$ (1,474) | \$ (4,465) | \$ (4,406) |
| Realized income (expense) due to ineffective portion of hedges | - | - | - | - |
| Realized net losses reclassified from other comprehensive income | (32) | (62) | (131) | (219) |

| | | | | |
|-------------------------------|------------|------------|------------|------------|
| Total Interest Expense | \$ (1,519) | \$ (1,536) | \$ (4,596) | \$ (4,625) |
|-------------------------------|------------|------------|------------|------------|

Derivative Counterparty Credit Risk

We incur credit risk to the extent that counterparties to our derivative financial instruments do not perform their obligations under specified contractual agreements. If a derivative counterparty does not perform, we may not receive the proceeds to which we may be entitled under these agreements. Each of our derivative counterparties that is not a clearinghouse must maintain compliance with International Swaps and Derivatives Association (ISDA) agreements or other similar agreements (or receive a waiver of non-compliance after a specific assessment) in order to conduct derivative transactions with us. Additionally, we review non-clearinghouse derivative counterparty credit standings, and in the case of a deterioration of creditworthiness, appropriate remedial action is taken. To further mitigate counterparty risk, we exit derivatives contracts with counterparties that (i) do not maintain compliance with (or obtain a waiver from) the terms of their ISDA or other agreements with us; or (ii) do not meet internally established guidelines regarding creditworthiness. Our ISDA and similar agreements currently require full bilateral collateralization of unrealized loss exposures with our derivative counterparties. Through a margin posting process, our positions are revalued with counterparties each business day and cash margin is generally transferred to either us or our derivative counterparties as collateral based upon the directional changes in fair value of the positions. We also attempt to transact with several different counterparties in order to reduce our specific counterparty exposure. With respect to certain of our derivatives, clearing and settlement is through one or more clearinghouses, which may be substituted as a counterparty. Clearing and settlement of derivative transactions through a clearinghouse is also intended to reduce specific counterparty exposure. We consider counterparty risk as part of our fair value assessments of all derivative financial instruments.

Table of Contents

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

September 30, 2014

(Unaudited)

Note 10. Derivative Financial Instruments (continued)

At September 30, 2014, we were in compliance with ISDA and similar agreements governing our open derivative positions. We assessed the risk associated with these counterparties as remote and did not record a specific valuation adjustment.

Note 11. Other Assets and Liabilities

Other assets at September 30, 2014 and December 31, 2013, are summarized in the following table.

Other Assets

| (In Thousands) | September 30, 2014 | December 31, 2013 |
|---|---------------------------|--------------------------|
| Margin receivable | \$ 56,217 | \$ 31,149 |
| Investment receivable | 24,814 | 8,923 |
| Restricted investments | 11,319 | - |
| Other pledged collateral | 5,000 | 5,000 |
| FHLBC stock | 4,846 | - |
| REO | 3,349 | 3,661 |
| Prepaid expenses | 2,350 | 1,850 |
| Fixed assets and leasehold improvements | 2,273 | 1,232 |
| Other | 2,600 | 1,825 |
| Total Other Assets | \$ 112,768 | \$ 53,640 |

Margin receivable resulted from margin calls from our swap, master repurchase agreements, and warehouse facilities counterparties that required us to post collateral. Investment receivable represents amounts due to us related to a commercial loan included in our Commercial Securitization that repaid prior to September 30, 2014, but for which we received the cash proceeds subsequent to quarter-end.

During the three months ended September 30, 2014, we transferred \$11 million of U.S. Treasury securities to a custodial account related to a risk sharing arrangement we entered into during the same period.

The carrying value of REO at September 30, 2014, was \$3 million, which includes the net effect of \$5 million related to transfers into REO during the first nine months of 2014, offset by \$5 million of REO liquidations. At September 30, 2014 and December 31, 2013, there were 16 and 20 REO properties, respectively, recorded on our consolidated balance sheets, all of which were owned at consolidated Sequoia Entities.

Our fixed assets included in the table above have a basis of \$4 million and accumulated depreciation of \$2 million.

Table of Contents

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

September 30, 2014

(Unaudited)

Note 11. Other Assets and Liabilities (continued)***Accrued Expenses and Other Liabilities***

Accrued expenses and other liabilities at September 30, 2014 and December 31, 2013 are summarized in the following table.

| (In Thousands) | September 30, 2014 | December 31, 2013 |
|--------------------------------|---------------------------|--------------------------|
| Accrued compensation | \$ 12,562 | \$ 22,160 |
| Legal reserve | 10,400 | 12,000 |
| MSR holdbacks payable | 4,049 | - |
| Residential repurchase reserve | 3,771 | 1,771 |
| Income tax payable | 3,560 | 1,337 |
| Derivative margin payable | 2,873 | 4,700 |
| Accrued operating expenses | 2,170 | 4,291 |
| Other | 8,854 | 2,445 |
| Total Other Liabilities | \$ 48,239 | \$ 48,704 |

See *Note 15* for additional information on the legal and residential repurchase reserves.

Note 12. Short-Term Debt

We enter into repurchase agreements, bank warehouse agreements, and other forms of collateralized (and generally uncommitted) short-term borrowings with several banks and major investment banking firms. At September 30, 2014, we had outstanding agreements with 17 counterparties and we were in compliance with all of the related covenants. Further information about these financial covenants is set forth in Part I, Item 2 *Management's Discussion and Analysis of Financial Condition and Results of Operations* of this Quarterly Report on Form 10-Q.

The table below summarizes the facilities that are available to us and the balances of short-term debt at September 30, 2014 and December 31, 2013 by the type of collateral securing the debt.

September 30, 2014

| (Dollars in Thousands) | Number of | | Limit | Maturity |
|------------------------|------------|---------------------|--------------|-----------------|
| Collateral Type | Facilities | Outstanding | | |
| Residential loans | 5 | \$ 1,188,179 | \$ 1,550,000 | 12/2014-8/2015 |
| Commercial loans | 2 | 52,895 | 340,000 | 4/2015-9/2015 |
| Real estate securities | 10 | 646,614 | - | 10/2014-12/2014 |
| Total | 17 | \$ 1,887,688 | | |

December 31, 2013

| (Dollars in Thousands) | Number of | | Limit | Maturity |
|------------------------|------------|-------------------|--------------|------------------|
| Collateral Type | Facilities | Outstanding | | |
| Residential loans | 5 | \$ 184,789 | \$ 1,400,000 | 1/2014 - 12/2014 |
| Commercial loans | 1 | - | 100,000 | 4/2014 |
| Real estate securities | 7 | 677,974 | - | 1/2014 - 2/2014 |
| Total | 13 | \$ 862,763 | | |

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 12. Short-Term Debt (continued)**

Borrowings under these facilities are generally charged interest based on a specified margin over the one-month LIBOR interest rate. At September 30, 2014, all of these borrowings were under uncommitted facilities except for \$100 million that is committed under one commercial facility and were due within 364 days (or less) of the borrowing date. During the quarter, we transferred one commercial loan repurchase facility from long-term to short-term debt, due to its expiration falling within one year as of September 30, 2014.

The fair value of residential loans, commercial loans, and real estate securities pledged as collateral was \$1.32 billion, \$85 million, and \$812 million, respectively, at September 30, 2014. For the three and nine months ended September 30, 2014, the average balance of short-term debt was \$1.87 billion and \$1.40 billion, respectively. At September 30, 2014 and December 31, 2013, accrued interest payable on short-term debt was \$1.61 million and less than \$1 million, respectively.

We also maintain a \$10 million committed line of credit with one financial institution, which is secured by our pledge of certain mortgage-backed securities we own. At both September 30, 2014 and December 31, 2013, we had no outstanding borrowings on this facility.

Characteristics of Short-Term Debt

The table below summarizes short-term debt by weighted average interest rates and by collateral type at September 30, 2014 and December 31, 2013.

| | September 30, 2014 | | | December 31, 2013 | | |
|-----------------------------------|---------------------------|---------------------------------------|---|--------------------------|---------------------------------------|---|
| | Amount Borrowed | Weighted Average Interest Rate | Weighted Average Days Until Maturity | Amount Borrowed | Weighted Average Interest Rate | Weighted Average Days Until Maturity |
| (Dollars in Thousands) | | | | | | |
| Collateral Type | | | | | | |
| Residential loan collateral | \$ 1,188,179 | 1.71% | 216 | \$ 184,789 | 1.71% | 228 |
| Commercial loan collateral | 52,895 | 5.15% | 359 | - | - | - |
| Real estate securities collateral | 646,614 | 1.37% | 23 | 677,974 | 1.34% | 15 |
| Total Short-Term Debt | \$ 1,887,688 | 1.69% | 154 | \$ 862,763 | 1.42% | 61 |

Remaining Maturities of Short-Term Debt

The following table presents the remaining maturities of short-term debt at September 30, 2014 and December 31, 2013.

| (In Thousands) | September 30, 2014 | December 31, 2013 |
|------------------------------|---------------------------|--------------------------|
| Within 30 days | \$ 548,890 | \$ 659,262 |
| 31 to 90 days | 213,330 | 54,434 |
| Over 90 days | 1,125,468 | 149,067 |
| Total Short-Term Debt | \$ 1,887,688 | \$ 862,763 |

Note 13. Asset-Backed Securities Issued

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

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 13. Asset-Backed Securities Issued (continued)**

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

The carrying values of ABS issued by consolidated securitization entities we sponsored at September 30, 2014 and December 31, 2013, along with other selected information, are summarized in the following table.

Asset-Backed Securities Issued

| (Dollars in Thousands) | September 30, 2014 | | | |
|---|---------------------------|---|--------------------------------------|--------------|
| | Sequoia | Residential Resecuritization | Commercial Securitization | Total |
| Certificates with principal balance | \$ 1,495,988 | \$ 56,508 | \$ 114,943 | \$ 1,667,439 |
| Interest-only certificates | 2,318 | - | - | 2,318 |
| Unamortized discount | (13,555) | - | - | (13,555) |
| Total ABS Issued | \$ 1,484,751 | \$ 56,508 | \$ 114,943 | \$ 1,656,202 |
| Range of weighted average interest rates, by series | 0.08% to 4.26% | 2.16% | 5.62% | |
| Stated maturities | 2014 - 2047 | 2046 | 2018 | |
| Number of series | 24 | 1 | 1 | |

| (Dollars in Thousands) | December 31, 2013 | | | |
|-------------------------------------|--------------------------|---|--------------------------------------|--------------|
| | Sequoia | Residential Resecuritization | Commercial Securitization | Total |
| Certificates with principal balance | \$ 1,708,324 | \$ 94,934 | \$ 153,693 | \$ 1,956,951 |
| Interest-only certificates | 3,400 | - | - | 3,400 |

| | | | | |
|---|----------------|-----------|------------|--------------|
| Unamortized discount | (17,389) | - | - | (17,389) |
| Total ABS Issued | \$ 1,694,335 | \$ 94,934 | \$ 153,693 | \$ 1,942,962 |
| Range of weighted average interest rates, by series | 0.24% to 4.23% | 2.21% | 5.62% | |
| Stated maturities | 2014 - 2047 | 2046 | 2018 | |
| Number of series | 24 | 1 | 1 | |

The actual maturity of each class of ABS issued is primarily determined by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption prior to the stated maturity according to the terms of the respective governing documents of each ABS issuing entity. As a result, the actual maturity of ABS issued may occur earlier than its contractual maturity. At September 30, 2014, \$1.64 billion of ABS issued (\$1.65 billion principal balance) had contractual maturities beyond five years and \$18 million of ABS issued (\$18 million principal balance) had contractual maturities of less than one year. Amortization of Sequoia, Commercial Securitization, and Residential Resecuritization deferred ABS issuance costs was \$2 million and \$3 million for the nine months ended September 30, 2014 and 2013, respectively. The following table summarizes the accrued interest payable on ABS issued at September 30, 2014 and December 31, 2013. Interest due on consolidated ABS issued is payable monthly.

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 13. Asset-Backed Securities Issued (continued)

Accrued Interest Payable on Asset-Backed Securities Issued

| (In Thousands) | September 30, 2014 | December 31, 2013 |
|---|--------------------|-------------------|
| Sequoia | \$ 1,034 | \$ 1,218 |
| Residential Resecuritization | 7 | 11 |
| Commercial Securitization | 539 | 720 |
| Total Accrued Interest Payable on ABS Issued | \$ 1,580 | \$ 1,949 |

The following table summarizes the carrying value components of the collateral for ABS issued and outstanding at September 30, 2014 and December 31, 2013.

Collateral for Asset-Backed Securities Issued

| (In Thousands) | September 30, 2014 | | | Total |
|--|---------------------|---------------------------------|------------------------------|---------------------|
| | Sequoia | Residential Resecuritization | Commercial Securitization | |
| Residential loans | \$ 1,546,507 | \$ - | \$ - | \$ 1,546,507 |
| Commercial loans | - | - | 204,741 | 204,741 |
| Real estate securities | - | 233,311 | - | 233,311 |
| Restricted cash | 147 | - | 138 | 285 |
| Accrued interest receivable | 1,882 | 506 | 1,527 | 3,915 |
| Other assets | 3,349 | - | 21,699 | 25,048 |
| Total Collateral for ABS Issued | \$ 1,551,885 | \$ 233,817 | \$ 228,105 | \$ 2,013,807 |

| (In Thousands) | December 31, 2013 | | | Total |
|----------------|-------------------|---------------------------------|------------------------------|-------|
| | Sequoia | Residential Resecuritization | Commercial Securitization | |

| | | | | |
|--|---------------------|-------------------|-------------------|---------------------|
| Residential loans | \$ 1,762,167 | \$ - | \$ - | \$ 1,762,167 |
| Commercial loans | - | - | 257,741 | 257,741 |
| Real estate securities | - | 263,204 | - | 263,204 |
| Restricted cash | 152 | - | 137 | 289 |
| Accrued interest receivable | 2,714 | 627 | 1,975 | 5,316 |
| REO | 3,661 | - | - | 3,661 |
| Total Collateral for ABS Issued | \$ 1,768,694 | \$ 263,831 | \$ 259,853 | \$ 2,292,378 |

Note 14. Long-Term Debt

FHLBC Borrowings

In July 2014, we entered into a borrowing agreement with the Federal Home Loan Bank of Chicago. Under this agreement, we may incur borrowings, also referred to as advances, from time to time from the FHLBC secured by eligible collateral, including, but not limited to residential mortgage loans and residential mortgage-backed securities. As of September 30, 2014, \$204 million of advances were outstanding under this agreement with a weighted average interest rate of 0.2524% and a weighted average maturity of 8.9 years. Advances under this agreement are charged interest based on a specified margin over the FHLBC's 13-week discount note rate, which resets every 13 weeks. These advances were secured by residential mortgage loans with a fair value of \$238 million as of September 30, 2014. This agreement also requires us to purchase and hold stock in the FHLBC in an amount equal to a specified percentage of our advances. As of September 30, 2014, we held \$5 million of FHLBC stock that is included in other assets in our consolidated balance sheets.

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 14. Long-Term Debt (continued)

Commercial Long-Term Debt

Commercial long-term debt reported in periods prior to the third quarter of 2014 includes borrowings under a master repurchase agreement that, as of the date reported, expired in more than one year with a financial institution counterparty. Beginning in the third quarter of 2014, amounts previously classified as commercial long-term debt were reclassified to short-term debt due to the associated agreement expiring in less than one year as of September 30, 2014.

Commercial Secured Borrowing

At September 30, 2014, we had commercial secured borrowings of \$66 million resulting from transfers of portions of senior commercial mortgage loans to third parties that did not meet the criteria for sale treatment under GAAP and were accounted for as financings. We bifurcated certain of our senior commercial mortgage loans into a senior portion that was sold to a third party and a junior portion that we retained as an investment. Although GAAP requires us to record a secured borrowing liability when we receive cash from selling the senior portion of the loan, the liability has no economic substance to us in that it does not require periodic interest payments and has no maturity. For each commercial secured borrowing, at such time that the associated senior portion of the loan is repaid or we sell our retained junior portion, the secured borrowing liability and associated senior portion of the loan would be derecognized from our balance sheet.

Convertible Notes

In March 2013, we issued \$287.5 million principal amount of 4.625% convertible senior notes due 2018. These convertible notes require semi-annual interest distributions at a fixed coupon rate of 4.625% until maturity or conversion, which will be no later than April 15, 2018. Including amortization of deferred securities issuance costs, the interest expense yield on our convertible notes was 5.49% and 5.44% for the three and nine months ended September 30, 2014, respectively. At September 30, 2014, the accrued interest payable balance on this debt was \$6 million.

At September 30, 2014, our convertible senior notes were convertible at the option of the holder at a conversion rate of 41.1320 common shares per \$1,000 principal amount of convertible senior notes (equivalent to a conversion price of \$24.31 per common share). Upon conversion of these convertible senior notes by a holder, the holder will receive shares of our common stock.

Trust Preferred Securities and Subordinated Notes

At September 30, 2014, we had trust preferred securities and subordinated notes outstanding of \$100 million and \$40 million, respectively. The interest expense yield on both our trust preferred securities and subordinated notes was 2.58% and 2.65% for the nine months ended September 30, 2014 and 2013, respectively. Including hedging costs and amortization of deferred securities issuance costs, the interest expense yield on both our trust preferred securities and subordinated notes was 6.88% and 6.90% for the nine months ended September 30, 2014 and 2013, respectively.

At both September 30, 2014 and December 31, 2013, the accrued interest payable balance on our trust preferred securities and subordinated notes was less than \$1 million. Under the terms of this long-term debt, we covenant, among other things, to use our best efforts to continue to qualify as a REIT. If an event of default were to occur in respect of this long-term debt, we would generally be restricted under its terms (subject to certain exceptions) from making dividend distributions to stockholders, from repurchasing common stock or repurchasing or redeeming any other then-outstanding equity securities, and from making any other payments in respect of any equity interests in us or in respect of any then-outstanding debt that is *pari passu* or subordinate to this long-term debt.

Table of Contents

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

September 30, 2014

(Unaudited)

Note 15. Commitments and Contingencies*Lease Commitments*

At September 30, 2014, we were obligated under eight non-cancelable operating leases with expiration dates through 2021 for \$14 million. Operating lease expense was \$2 million and \$1 million for the nine months ended September 30, 2014 and 2013, respectively.

The following table presents our future lease commitments at September 30, 2014.

Future Lease Commitments by Year

| (In Thousands) | September 30, 2014 |
|-----------------------|---------------------------|
| 2014 (3 months) | \$ 751 |
| 2015 | 3,061 |
| 2016 | 2,832 |
| 2017 | 2,879 |
| 2018 | 1,827 |
| 2019 and thereafter | 2,683 |
| Total | \$ 14,033 |

Loss Contingencies Residential Repurchase Reserve

We maintain a repurchase reserve for potential obligations arising from representation and warranty violations related to the residential loans we have sold to securitization trusts or third parties and for conforming residential loans associated with MSR's that we have purchased from third parties. We do not originate residential loans and we believe the initial risk of loss due to loan repurchases (i.e., due to a breach of representations and warranties) would generally be a contingency to the companies from whom we acquired the loans. However, in some cases, for example, where loans were acquired from companies that have since become insolvent, repurchase claims may result in our being liable for a repurchase obligation.

At September 30, 2014 and December 31, 2013, our repurchase reserve associated with our residential loans and MSR's was \$4 million and \$1.8 million, respectively. This liability is recorded in accrued expenses and other liabilities in our consolidated balance sheets and the provision for repurchase expense is included in mortgage banking activities, net and MSR income, net in our consolidated statements of income.

Loss Contingencies Litigation

On or about December 23, 2009, the Federal Home Loan Bank of Seattle (the FHLB-Seattle) filed a complaint in the Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. (SRF), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the FHLB-Seattle Defendants) alleging that the FHLB-Seattle Defendants made false or misleading statements in offering materials for a mortgage pass-through certificate (the Seattle Certificate) issued in the Sequoia Mortgage Trust 2005-4 securitization transaction (the 2005-4 RMBS) and purchased by the FHLB-Seattle. Specifically, the complaint alleges that the alleged misstatements concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Seattle Certificate. The FHLB-Seattle alleges claims under the Securities Act of Washington (Section 21.20.005, et seq.) and seeks to rescind the purchase of the Seattle Certificate and to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received) as well as attorneys fees and costs. The Seattle Certificate was issued with an original principal amount of approximately \$133 million, and, as of September 30, 2014, the FHLB-Seattle has received approximately \$115.4 million of principal and \$11.1 million of interest payments in respect of the Seattle Certificate. The claims were subsequently dismissed for lack of personal jurisdiction as to Redwood Trust and SRF. Redwood agreed to indemnify the underwriters of the 2005-4 RMBS for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. The FHLB-Seattle s claims against the underwriters of this RMBS were not dismissed and remain pending. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 15. Commitments and Contingencies (continued)

On or about July 15, 2010, The Charles Schwab Corporation (Schwab) filed a complaint in the Superior Court for the State of California in San Francisco (case number CGC-10-501610) against SRF and 26 other defendants (collectively, the Schwab Defendants) alleging that the Schwab Defendants made false or misleading statements in offering materials for various residential mortgage-backed securities sold or issued by the Schwab Defendants. With respect to SRF, Schwab alleges that SRF made false or misleading statements in offering materials for a mortgage pass-through certificate (the Schwab Certificate) issued in the 2005-4 RMBS and purchased by Schwab. Specifically, the complaint alleges that the misstatements for the 2005-4 RMBS concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Schwab Certificate. Schwab alleges a claim for negligent misrepresentation under California state law and seeks unspecified damages and attorneys fees and costs. The Schwab Certificate was issued with an original principal amount of approximately \$14.8 million, and, as of September 30, 2014, Schwab has received approximately \$12.8 million of principal and \$1.3 million of interest payments in respect of the Schwab Certificate. SRF has denied Schwab s allegations. This case is in discovery, and no trial date has been set. We intend to defend the action vigorously. Redwood agreed to indemnify the underwriters of the 2005-4 RMBS, which underwriters were also named as defendants in this action, for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

In October 2010, a complaint was filed in Illinois state court against SRF and more than 45 other named defendants alleging that the defendants made false or misleading statements in offering materials for various RMBS sold or issued by the defendants or entities controlled by them. The plaintiff subsequently amended the complaint to name Redwood Trust, Inc. and another one of our subsidiaries, RWT Holdings, Inc., as defendants. With respect to Redwood Trust, Inc., RWT Holdings, Inc., and SRF (the Redwood Defendants), the plaintiff alleged that there were false or misleading statements in the offering materials for two mortgage pass-through certificates issued in the Sequoia Mortgage Trust 2006-1 securitization transaction. In October 2014, the plaintiff and the Redwood Defendants agreed to settle the complaint on mutually satisfactory terms. The terms of the agreed-upon settlement remain confidential.

In accordance with GAAP, we review the need for any loss contingency reserves and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability and the amount of loss, if any, can be reasonably estimated. Additionally, we record receivables for insurance recoveries relating to litigation-related losses and expenses if and when such amounts are covered by insurance and recovery of such losses or expenses are due. At September 30, 2014, the aggregate amount of loss contingency reserves established in respect of the three

above-referenced litigation matters was \$10.4 million. Included within this aggregate reserve is the amount the Redwood Defendants agreed to pay pursuant to the confidential settlement reached in October 2014, which amount was paid subsequent to September 30, 2014. We review our litigation matters each quarter to assess these loss contingency reserves and make adjustments in these reserves, upwards or downwards, as appropriate, in accordance with GAAP based on our review.

In the ordinary course of any litigation matter, including certain of the above-referenced matters, we have engaged and may continue to engage in formal or informal settlement communications with the plaintiffs. Settlement communications we have engaged in relating to certain of the above-referenced litigation matters are one of the factors that have resulted in our determination to establish the loss contingency reserves described above. We cannot be certain that any of these matters will be resolved through a settlement prior to trial and we cannot be certain that the resolution of these matters, whether through trial or settlement, will not have a material adverse effect on our financial condition or results of operations in any future period.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 15. Commitments and Contingencies (continued)**

Future developments (including resolution of substantive pre-trial motions relating to these matters, receipt of additional information and documents relating to these matters (such as through pre-trial discovery), new or additional settlement communications with plaintiffs relating to these matters, or resolutions of similar claims against other defendants in these matters) could result in our concluding in the future to establish additional loss contingency reserves or to disclose an estimate of reasonably possible losses in excess of our established reserves with respect to these matters. Our actual losses with respect to the above-referenced litigation matters may be materially higher than the aggregate amount of loss contingency reserves we have established in respect of these litigation matters, including in the event that any of these matters proceeds to trial and the plaintiff prevails. Other factors that could result in our concluding to establish additional loss contingency reserves or estimate additional reasonably possible losses, or could result in our actual losses with respect to the above-referenced litigation matters being materially higher than the aggregate amount of loss contingency reserves we have established in respect of these litigation matters include that: there are significant factual and legal issues to be resolved; information obtained or rulings made during the lawsuits could affect the methodology for calculation of the available remedies; and we may have additional obligations pursuant to indemnity agreements, representations and warranties, and other contractual provisions with other parties relating to these litigation matters that could increase our potential losses.

Note 16. Equity

The following table provides a summary of changes to accumulated other comprehensive income by component for the three and nine months ended September 30, 2014 and 2013.

Changes in Accumulated Other Comprehensive Income by Component

| | Three Months Ended September 30, 2014 | | Three Months Ended September 30, 2013 | |
|--------------------------------|--|--|--|--|
| | Net unrealized losses on interest rate agreements accounted for as cash flow hedges | | Net unrealized losses on interest rate agreements accounted for as cash flow hedges | |
| (In Thousands) | securities available-for-sale | securities available-for-sale | securities available-for-sale | securities available-for-sale |
| Balance at beginning of period | \$ 197,542 | \$ (29,985) | \$ 145,349 | \$ (27,066) |

Edgar Filing: REDWOOD TRUST INC - Form 10-Q

| | | | | |
|--|-------------------|--------------------|-------------------|--------------------|
| Other comprehensive income (loss) before reclassifications | 1,849 | (3,258) | (633) | 4,018 |
| Amounts reclassified from other accumulated comprehensive income | (6,409) | 32 | (6,962) | 62 |
| Net current-period other comprehensive (loss) income | (4,560) | (3,226) | (7,595) | 4,080 |
| Balance at End of Period | \$ 192,982 | \$ (33,211) | \$ 137,754 | \$ (22,986) |

| | Nine Months Ended September 30, 2014 | | Nine Months Ended September 30, 2013 | |
|--|---|---|---|---|
| | Net unrealized gains on available-for-sale securities | Net unrealized losses on interest rate agreements accounted for as cash flow hedges | Net unrealized gains on available-for-sale securities | Net unrealized losses on interest rate agreements accounted for as cash flow hedges |
| (In Thousands) | | | | |
| Balance at beginning of period | \$ 164,654 | \$ (15,888) | \$ 186,580 | \$ (48,248) |
| Other comprehensive income (loss) before reclassifications | 35,078 | (17,454) | (29,615) | 25,043 |
| Amounts reclassified from other accumulated comprehensive income | (6,750) | 131 | (19,211) | 219 |
| Net current-period other comprehensive (loss) income | 28,328 | (17,323) | (48,826) | 25,262 |
| Balance at End of Period | \$ 192,982 | \$ (33,211) | \$ 137,754 | \$ (22,986) |

Table of Contents

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

September 30, 2014

(Unaudited)

Note 16. Equity (continued)

The following table provides a summary of reclassifications out of accumulated other comprehensive income for three and nine months ended September 30, 2014 and 2013.

Reclassifications Out of Accumulated Other Comprehensive Income

| (In Thousands) | Affected Line Item in the Income Statement | Amount reclassified from accumulated other comprehensive income Three Months Ended September 30, | |
|--|---|---|------------|
| | | 2014 | 2013 |
| Net realized gains (losses) on AFS securities | | | |
| Other than temporary impairment | Other market valuations, net | \$ 188 | \$ - |
| Gain on sale of AFS securities | Realized gains, net | (6,597) | (6,962) |
| | | \$ (6,409) | \$ (6,962) |
| Net realized gains on interest rate agreements designated as cash flow hedges | | | |
| Amortization of deferred loss | Interest expense | \$ 32 | \$ 62 |
| | | \$ 32 | \$ 62 |

| (In Thousands) | Affected Line Item in the Income Statement | Amount reclassified from accumulated other comprehensive income Nine Months Ended September 30, | |
|--|---|---|----------|
| | | 2014 | 2013 |
| Net realized gains (losses) on AFS securities | | | |
| Other than temporary impairment | Other market valuations, net | \$ 565 | \$ (124) |
| Gain on sale of AFS securities | Realized gains, net | (7,315) | (19,087) |

\$ (6,750) \$ (19,211)

**Net realized gains on interest rate agreements
designated as cash flow hedges**

| | | | |
|-------------------------------|------------------|--------|--------|
| Amortization of deferred loss | Interest expense | \$ 131 | \$ 219 |
| | | \$ 131 | \$ 219 |

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 16. Equity (continued)*****Earnings Per Common Share***

The following table provides the basic and diluted earnings per common share computations for the three and nine months ended September 30, 2014 and 2013.

Basic and Diluted Earnings Per Common Share

| (In Thousands, Except Share Data) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|---|-------------|--|-------------|
| | 2014 | 2013 | 2014 | 2013 |
| Basic Earnings Per Common Share: | | | | |
| Net income attributable to Redwood | \$ 45,097 | \$ 21,929 | \$ 73,447 | \$ 148,112 |
| Less: Dividends and undistributed earnings allocated to participating securities | (1,054) | (565) | (1,819) | (4,209) |
| Net income allocated to common shareholders | \$ 44,043 | \$ 21,364 | \$ 71,628 | \$ 143,903 |
| Basic weighted average common shares outstanding | 83,017,534 | 82,201,473 | 82,722,079 | 81,888,231 |
| Basic Earnings Per Common Share | \$ 0.53 | \$ 0.26 | \$ 0.87 | \$ 1.76 |
| Diluted Earnings Per Common Share: | | | | |
| Net income attributable to Redwood | \$ 45,097 | \$ 21,929 | \$ 73,447 | \$ 148,112 |
| Less: Dividends and undistributed earnings allocated to participating securities | (756) | (565) | (1,784) | (3,030) |
| Add back: Interest expense on convertible notes | 3,855 | - | - | 8,790 |
| Net income allocated to common shareholders | \$ 48,196 | \$ 21,364 | \$ 71,663 | \$ 153,872 |
| Weighted average common shares outstanding | 83,017,534 | 82,201,473 | 82,722,079 | 81,888,231 |
| Net effect of dilutive equity awards | 2,113,248 | 2,220,566 | 2,309,051 | 2,292,451 |

| | | | | |
|---|------------|------------|------------|------------|
| Net effect of assumed convertible notes conversion to common shares | 11,825,450 | - | - | 9,053,183 |
| Diluted weighted average common shares outstanding | 96,956,232 | 84,422,039 | 85,031,130 | 93,233,865 |
| Diluted Earnings Per Common Share | \$ 0.50 | \$ 0.25 | \$ 0.84 | \$ 1.65 |

For the three and nine months ended September 30, 2014, there were 2,113,248 and 2,309,051 of dilutive equity awards, respectively, determined under the two-class method. For the three and nine months ended September 30, 2013, there were 2,220,566 and 2,292,451 of dilutive equity awards, respectively, determined under the two-class method. We included participating securities in the calculation of diluted earnings per common share as we determined that the two-class method was more dilutive than the alternative treasury stock method. Dividends and undistributed earnings allocated to participating securities under the basic and diluted earnings per share calculations require specific shares to be included that may differ in certain circumstances. For the three and nine months ended September 30, 2014, common shares related to the assumed conversion of the convertible notes, totaling 11,825,450 and zero, respectively, were included in the calculation of diluted earnings per share. For the three and nine months ended September 30, 2013, common shares related to the assumed conversion of the convertible notes, totaling zero and 9,053,183, respectively, were included in the calculation of the diluted earnings per share.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 16. Equity (continued)**

For the nine months ended September 30, 2014, as well as for the three months ended September 30, 2013, 11,825,450 common shares related to the assumed conversion of the convertible notes were antidilutive and were excluded in the calculation of diluted earnings per share. For the three months ended September 30, 2014 and 2013, the number of outstanding equity awards that were antidilutive totaled 57,514 and 190,627, respectively. For the nine months ended September 30, 2014 and 2013, the number of outstanding equity awards that were antidilutive totaled 66,129 and 244,174 respectively, under the two-class method. There were no other participating securities during these periods.

Stock Repurchases

We announced a stock repurchase authorization in November 2007 for the repurchase of up to 5,000,000 common shares. This plan replaced all previous share repurchase plans and has no expiration date. During the nine months ended September 30, 2014, there were no shares acquired under the plan. At September 30, 2014, there remained 4,005,985 shares available for repurchase under this plan.

Note 17. Equity Compensation Plans

At September 30, 2014 and December 31, 2013, 2,603,630 and 1,683,956 shares of common stock, respectively, were available for grant under our Incentive Plan. The unamortized compensation cost of awards issued under the Incentive Plan and purchases under the Employee Stock Purchase Plan totaled \$14 million at September 30, 2014, as shown in the following table.

| (In Thousands) | Nine Months Ended September 30, 2014 | | | | | |
|---|--------------------------------------|------------------|----------------------|-------------------------|------------------------------|-----------|
| | Stock Options | Restricted Stock | Deferred Stock Units | Performance Stock Units | Employee Stock Purchase Plan | Total |
| Unrecognized compensation cost at beginning of period | \$ - | \$ 1,869 | \$ 13,044 | \$ 5,817 | \$ - | \$ 20,730 |
| Equity grants | - | 94 | 1,187 | - | 215 | 1,496 |
| Equity grant forfeitures | - | (213) | (150) | - | - | (363) |
| Equity compensation expense | - | (509) | (4,549) | (2,196) | (161) | (7,415) |

| | | | | | | |
|--|------|----------|----------|----------|-------|-----------|
| Unrecognized Compensation Cost at End of Period | \$ - | \$ 1,241 | \$ 9,532 | \$ 3,621 | \$ 54 | \$ 14,448 |
|--|------|----------|----------|----------|-------|-----------|

At September 30, 2014, the weighted average amortization period remaining for all of our equity awards was less than two years.

Stock Options

At September 30, 2014 and December 31, 2013, there were 57,514 and 79,535 fully vested stock options outstanding, respectively. There was no aggregate intrinsic value for the options outstanding and exercisable at September 30, 2014. For both the nine months ended September 30, 2014 and 2013, there were no stock options exercised. For the nine months ended September 30, 2014, 22,021 stock options expired.

Restricted Stock

At September 30, 2014 and December 31, 2013, there were 110,948 and 166,941 shares, respectively, of restricted stock awards outstanding. Restrictions on these shares lapse through 2018. During the nine months ended September 30, 2014, there were 2,574 restricted stock awards granted, 42,725 restricted stock awards that vested and were distributed, and 15,842 restricted stock awards forfeited.

Table of Contents

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

September 30, 2014

(Unaudited)

Note 17. Equity Compensation Plans (continued)

Deferred Stock Units (DSUs)

At September 30, 2014 and December 31, 2013, there were 1,961,038 and 2,266,473 DSUs, respectively, outstanding of which 1,218,012 and 1,263,420, respectively, had vested. There were 142,983 DSUs granted and 7,870 DSUs forfeited related to employee departures during the nine months ended September 30, 2014. During the nine months ended September 30, 2014, there were 440,548 of DSU distributions and cash distributions of less than \$1 million to participants in the EDCP. Unvested DSUs at September 30, 2014 vest through 2018.

Performance Stock Units (PSUs)

At both September 30, 2014 and December 31, 2013, the target number of PSUs that were unvested was 779,871. PSUs do not vest until the third anniversary of their grant date, with the level of vesting at that time contingent on total stockholder return (defined as the change in our common stock price plus dividends paid on our common stock relative to the per share price of our common stock on the date of the PSU grant) over the three-year vesting period (Three-Year TSR). The number of underlying shares of our common stock that will vest during 2014 and in future years will vary between 0% (if Three-Year TSR is negative) and 200% (if Three-Year TSR is greater than or equal to 125%) of the target number of PSUs originally granted, adjusted upward (if vesting is greater than 0%) to reflect the value of dividends paid during the three-year vesting period. During the nine months ended September 30, 2014, 351,640 shares of common stock underlying vested PSUs were distributed.

Employee Stock Purchase Plan

The ESPP allows a maximum of 450,000 shares of common stock to be purchased in aggregate for all employees. At September 30, 2014 and December 31, 2013, 266,463 and 243,020 shares had been purchased, respectively, and there remained a negligible amount of uninvested employee contributions in the ESPP.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 18. Mortgage Banking Activities**

The following table presents the components of mortgage banking activities, net, recorded in our consolidated income statements for the three and nine months ended September 30, 2014 and 2013.

Components of Mortgage Banking Activities, Net

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|----------------------------------|-------------------|---------------------------------|------------------|
| | 2014 | 2013 | 2014 | 2013 |
| Residential mortgage banking activities: | | | | |
| Changes in fair value of: | | | | |
| Residential loans, at fair value | \$ 13,446 | \$ (10,804) | \$ 34,554 | \$ (17,339) |
| Sequoia IO securities | (1,332) | (1,866) | (14,419) | 36,399 |
| Risk management derivatives ⁽¹⁾ | (4,297) | 75 | (16,433) | 48,583 |
| Loan purchase and forward sale commitments | 2,487 | - | 6,077 | - |
| Other ⁽²⁾ | 1,082 | 359 | 1,871 | 1,635 |
| Total residential mortgage banking activities: | 11,386 | (12,236) | 11,650 | 69,278 |
| Commercial mortgage banking activities: | | | | |
| Changes in fair value of: | | | | |
| Commercial loans, at fair value | 4,305 | 3,171 | 13,644 | 2,826 |
| Risk management derivatives ⁽¹⁾ | 1,892 | 367 | (1,726) | 2,426 |
| Other ⁽²⁾ | 289 | - | 382 | 1 |
| Net gains on commercial loan originations and sales | - | - | - | 11,031 |
| Total commercial mortgage banking activities: | 6,486 | 3,538 | 12,300 | 16,284 |
| Mortgage Banking Activities, Net | \$ 17,872 | \$ (8,698) | \$ 23,950 | \$ 85,562 |

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

(2) Amounts in this line item include other fee income and the provision for repurchase expenses, presented net.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 19. Operating Expenses**

Components of our operating expenses for the three and nine months ended September 30, 2014 and 2013 are presented in the following table.

Operating Expenses

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-----------------------------------|---|------------------|--|------------------|
| | 2014 | 2013 | 2014 | 2013 |
| Fixed compensation expense | \$ 7,445 | \$ 5,808 | \$ 21,109 | \$ 17,524 |
| Variable compensation expense | 2,418 | 5,621 | 8,170 | 14,418 |
| Equity compensation expense | 2,261 | 1,997 | 7,415 | 7,880 |
| Severance expense | 4 | 445 | 226 | 3,879 |
| Total compensation expense | 12,128 | 13,871 | 36,920 | 43,701 |
| Systems and consulting | 3,463 | 2,780 | 10,906 | 6,840 |
| Accounting and legal | 1,223 | 2,066 | 4,039 | 5,118 |
| Office costs | 1,282 | 829 | 3,437 | 2,444 |
| Corporate costs | 569 | 508 | 1,679 | 1,545 |
| Other operating expenses | 2,741 | 2,266 | 6,679 | 7,289 |
| Total Operating Expenses | \$ 21,406 | \$ 22,320 | \$ 63,660 | \$ 66,937 |

Note 20. Taxes

For the nine months ended September 30, 2014 and 2013, we recognized a provision for income taxes of \$4 million and \$9 million, respectively. The following is a reconciliation of the statutory federal and state tax rates to our projected annual effective rate at September 30, 2014 and 2013.

Reconciliation of Statutory Tax Rate to Effective Tax Rate

| | September 30, 2014 | September 30, 2013 |
|---|---------------------------|---------------------------|
| Federal statutory rate | 34.0 % | 34.0 % |
| State statutory rate, net of Federal tax effect | 7.2 % | 7.2 % |

| | | |
|---|---------|---------|
| Differences in taxable (loss) income from GAAP income | (10.0)% | (2.1)% |
| Change in valuation allowance | (1.0)% | (18.5)% |
| Dividends paid deduction | (25.4)% | (14.8)% |
| Effective Tax Rate | 4.8 % | 5.8 % |

We assessed our tax positions for all open tax years (Federal years 2011 to 2014, State years 2010 to 2014) and, at September 30, 2014 and December 31, 2013, concluded that we had no uncertain tax positions that resulted in material unrecognized tax benefits.

Note 21. Segment Information

Redwood operates in three segments: residential mortgage banking, residential investments, and commercial mortgage banking and investments. Our segments are based on our organizational and management structure, which aligns with how our results are monitored and performance is assessed. The accounting policies of the reportable segments are the same as those described in *Note 3* Summary of Significant Accounting Policies. For a full description of our segments, see *Note 1* Redwood Trust.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2014****(Unaudited)****Note 21. Segment Information (continued)**

Segment contribution represents the measure of profit that management uses to assess the performance of our business segments and make resource allocation and operating decisions. Certain expenses not directly assigned or allocated to one of the three primary segments, as well as activity from certain legacy Sequoia entities consolidated for GAAP financial reporting purposes, are included in the Corporate/Other column as reconciling items to our consolidated financial statements. These unallocated expenses primarily include interest expense associated with certain long-term debt, indirect operating expenses, and other expense.

The following tables present financial information by segment for the three and nine months ended September 30, 2014 and 2013.

Business Segment Financial Information

| (In Thousands) | Three Months Ended September 30, 2014 | | | | |
|---|--|--------------------|--------------------|-------------------|--------------|
| | Residential | Residential | Commercial | Corporate/ | Total |
| | Mortgage | Investments | Mortgage | Other | |
| | Banking | Investments | Banking and | Other | |
| | | | Investments | | |
| Interest income | \$ 16,911 | \$ 27,600 | \$ 12,603 | \$ 6,237 | \$ 63,351 |
| Interest expense | (4,192) | (3,142) | (4,526) | (11,490) | (23,350) |
| Net interest income (loss) | 12,719 | 24,458 | 8,077 | (5,253) | 40,001 |
| Reversal of provision (provision) for loan losses | - | - | 888 | 708 | 1,596 |
| Mortgage banking activities, net | 11,386 | - | 6,486 | - | 17,872 |
| MSR income (loss), net | - | 5,821 | - | - | 5,821 |
| Other market valuation adjustments, net | 43 | (3,371) | - | (378) | (3,706) |
| Realized gains, net | - | 7,836 | - | 696 | 8,532 |
| Operating expenses | (9,982) | (802) | (2,279) | (8,343) | (21,406) |
| Other income | - | - | - | 1,600 | 1,600 |
| (Provision for) benefit from income taxes | (3,352) | 150 | (1,764) | (247) | (5,213) |
| Segment Contribution | \$ 10,814 | \$ 34,092 | \$ 11,408 | \$ (11,217) | |

| | | | | | |
|-------------------|--|--|--|--|------------------|
| Net Income | | | | | \$ 45,097 |
|-------------------|--|--|--|--|------------------|

| | | | | | |
|--|------|--------|-------|---------|-------|
| Non-cash amortization income (expense) | (43) | 10,890 | (191) | (2,049) | 8,607 |
|--|------|--------|-------|---------|-------|

70

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 21. Segment Information (continued)

| (In Thousands) | Three Months Ended September 30, 2013 | | | | | Total |
|---|---------------------------------------|----------------------------|--|---------------------|-----------|-------|
| | Residential Mortgage Banking | Residential Investments | Commercial Mortgage Banking and Investments | Corporate/ Other | | |
| Interest income | \$ 15,954 | \$ 22,887 | \$ 10,740 | \$ 7,839 | \$ 57,420 | |
| Interest expense | (3,501) | (2,229) | (3,560) | (12,435) | (21,725) | |
| Net interest income (loss) | 12,453 | 20,658 | 7,180 | (4,596) | 35,695 | |
| Reversal of provision (provision) for loan losses | - | - | (844) | (883) | (1,727) | |
| Mortgage banking activities, net | (12,236) | - | 3,538 | - | (8,698) | |
| MSR income (loss), net | - | 3,113 | - | - | 3,113 | |
| Other market valuation adjustments, net | (11) | 549 | - | (76) | 462 | |
| Realized gains, net | - | 10,469 | - | - | 10,469 | |
| Operating expenses | (7,874) | (229) | (2,176) | (12,041) | (22,320) | |
| (Provision for) benefit from income taxes | 4,867 | 377 | 29 | (338) | 4,935 | |
| Segment Contribution | \$ (2,801) | \$ 34,937 | \$ 7,727 | \$ (17,934) | | |
| Net Income | | | | | \$ 21,929 | |
| Non-cash amortization income (expense) | (13) | 8,702 | (228) | (2,256) | 6,205 | |

| (In Thousands) | Nine Months Ended September 30, 2014 | | | | | Total |
|------------------|--------------------------------------|----------------------------|--|---------------------|------------|-------|
| | Residential Mortgage Banking | Residential Investments | Commercial Mortgage Banking and Investments | Corporate/ Other | | |
| Interest income | \$ 40,015 | \$ 83,120 | \$ 34,204 | \$ 19,481 | \$ 176,820 | |
| Interest expense | (7,674) | (9,106) | (12,234) | (34,546) | (63,560) | |

Edgar Filing: REDWOOD TRUST INC - Form 10-Q

| | | | | | |
|--|---------------|---------------|---------------|-----------------|------------------|
| Net interest income (loss) | 32,341 | 74,014 | 21,970 | (15,065) | 113,260 |
| Provision for loan losses | - | - | (56) | 685 | 629 |
| Mortgage banking activities, net | 11,650 | - | 12,300 | - | 23,950 |
| MSR income (loss), net | - | 4,650 | - | - | 4,650 |
| Other market valuation adjustments, net | 54 | (13,117) | - | (903) | (13,966) |
| Realized gains, net | - | 9,815 | - | 872 | 10,687 |
| Operating expenses | (26,577) | (2,667) | (7,085) | (27,330) | (63,660) |
| Other income | - | - | - | 1,600 | 1,600 |
| (Provision for) benefit from income taxes | (3,258) | 1,826 | (2,159) | (112) | (3,703) |
| Segment Contribution | \$ 14,210 | \$ 74,521 | \$ 24,970 | \$ (40,253) | |
| Net Income | | | | | \$ 73,447 |
| Non-cash amortization income (expense) | (131) | 32,724 | (579) | (6,068) | 25,946 |

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 21. Segment Information (continued)

| (In Thousands) | Nine Months Ended September 30, 2013 | | | | Total |
|---|--------------------------------------|----------------------------|--|---------------------|-------------------|
| | Residential Mortgage Banking | Residential Investments | Commercial Mortgage Banking and Investments | Corporate/ Other | |
| Interest income | \$ 40,869 | \$ 70,420 | \$ 30,534 | \$ 26,841 | \$ 168,664 |
| Interest expense | (8,631) | (7,448) | (8,928) | (36,437) | (61,444) |
| Net interest income (loss) | 32,238 | 62,972 | 21,606 | (9,596) | 107,220 |
| Reversal of provision (provision) for loan losses | - | - | (2,419) | 1,926 | (493) |
| Mortgage banking activities, net | 69,278 | - | 16,284 | - | 85,562 |
| MSR income (loss), net | - | 14,681 | - | - | 14,681 |
| Other market valuation adjustments, net | 67 | (5,759) | - | (407) | (6,099) |
| Realized gains, net | - | 23,032 | 210 | 49 | 23,291 |
| Operating expenses | (18,565) | (3,768) | (8,026) | (36,578) | (66,937) |
| (Provision for) benefit from income taxes | (6,447) | (1,284) | (1,689) | 307 | (9,113) |
| Segment Contribution | \$ 76,571 | \$ 89,874 | \$ 25,966 | \$ (44,299) | |
| Net Income | | | | | \$ 148,112 |
| Non-cash amortization income (expense) | (132) | 24,348 | (639) | (5,637) | 17,940 |

The following tables present the components of Corporate/Other for the three and nine months ended September 30, 2014 and 2013.

| (In Thousands) | Three Months Ended September 30, 2014 | | | Three Months Ended September 30, 2013 | | |
|----------------|---------------------------------------|-------|-------|---------------------------------------|-------|-------|
| | Legacy Consolidated VIEs | Other | Total | Legacy Consolidated VIEs | Other | Total |

Edgar Filing: REDWOOD TRUST INC - Form 10-Q

| | | | | | | |
|---|-----------------|--------------------|--------------------|---------------|--------------------|--------------------|
| Interest income | \$ 6,233 | \$ 4 | \$ 6,237 | \$ 7,835 | \$ 4 | \$ 7,839 |
| Interest expense | (5,250) | (6,240) | (11,490) | (6,190) | (6,245) | (12,435) |
| Net interest income (loss) | 983 | (6,236) | (5,253) | 1,645 | (6,241) | (4,596) |
| Reversal of provision for loan losses | 708 | - | 708 | (883) | - | (883) |
| Mortgage banking activities, net | - | - | - | - | - | - |
| MSR income, net | - | - | - | - | - | - |
| Other market valuation adjustments, net | (361) | (17) | (378) | (76) | - | (76) |
| Realized gains, net | 696 | - | 696 | - | - | - |
| Operating expenses | (26) | (8,317) | (8,343) | (51) | (11,990) | (12,041) |
| Other income | - | 1,600 | 1,600 | - | - | - |
| (Provision for) benefit from income taxes | - | (247) | (247) | - | (338) | (338) |
| Total | \$ 2,000 | \$ (13,217) | \$ (11,217) | \$ 635 | \$ (18,569) | \$ (17,934) |
| Non-cash amortization expense | (1,412) | (637) | (2,049) | (1,724) | (532) | (2,256) |

Table of Contents

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2014

(Unaudited)

Note 21. Segment Information (continued)

| (In Thousands) | 2014 | | | 2013 | | |
|---|--------------------------|--------------------|--------------------|--------------------------|--------------------|--------------------|
| | Legacy Consolidated VIEs | Other | Total | Legacy Consolidated VIEs | Other | Total |
| Interest income | \$ 19,473 | \$ 8 | \$ 19,481 | \$ 26,688 | \$ 153 | \$ 26,841 |
| Interest expense | (15,950) | (18,596) | (34,546) | (20,188) | (16,249) | (36,437) |
| Net interest income (loss) | 3,523 | (18,588) | (15,065) | 6,500 | (16,096) | (9,596) |
| Reversal of provision (provision) for loan losses | 685 | - | 685 | 1,926 | - | 1,926 |
| Mortgage banking activities, net | - | - | - | - | - | - |
| MSR income, net | - | - | - | - | - | - |
| Other market valuation adjustments, net | (825) | (78) | (903) | (407) | - | (407) |
| Realized gains, net | 872 | - | 872 | 49 | - | 49 |
| Operating expenses | (120) | (27,210) | (27,330) | (158) | (36,420) | (36,578) |
| Other income | - | 1,600 | 1,600 | - | - | - |
| (Provision for) benefit from income taxes | - | (112) | (112) | - | 307 | 307 |
| Total | \$ 4,135 | \$ (44,388) | \$ (40,253) | \$ 7,910 | \$ (52,209) | \$ (44,299) |
| Non-cash amortization expense | (4,207) | (1,861) | (6,068) | (4,388) | (1,249) | (5,637) |

The following table presents supplemental information by segment at September 30, 2014 and December 31, 2013.

Supplemental Disclosures

| (In Thousands) | Residential Mortgage Banking | Residential Investments | Commercial Mortgage Banking and | Corporate/ Other | Total |
|----------------|------------------------------|-------------------------|---------------------------------|------------------|-------|
|----------------|------------------------------|-------------------------|---------------------------------|------------------|-------|

Investments**September 30, 2014**

| | | | | | |
|--|--------------|-----------|---------|-----------|--------------|
| Residential loans, held-for-sale | \$ 1,502,429 | \$ - | \$ - | \$ - | \$ 1,502,429 |
| Residential loans, held-for-investment | - | 238,651 | - | 1,546,507 | 1,785,158 |
| Commercial loans | - | - | 497,997 | - | 497,997 |
| Real estate securities | 100,613 | 1,294,372 | - | - | 1,394,985 |
| Mortgage servicing rights | - | 135,152 | - | - | 135,152 |
| Total assets | 1,635,463 | 1,696,343 | 527,094 | 1,752,868 | 5,611,768 |

December 31, 2013

| | | | | | |
|--|------------|-----------|---------|-----------|------------|
| Residential loans, held-for-sale | \$ 404,267 | \$ - | \$ - | \$ - | \$ 404,267 |
| Residential loans, held-for-investment | - | - | - | 1,762,167 | 1,762,167 |
| Commercial loans | - | - | 432,455 | - | 432,455 |
| Real estate securities | 110,505 | 1,572,356 | - | - | 1,682,861 |
| Mortgage servicing rights | - | 64,824 | - | - | 64,824 |
| Total assets | 531,092 | 1,655,209 | 439,139 | 1,983,088 | 4,608,528 |

Table of Contents

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

September 30, 2014

(Unaudited)

Note 22. Subsequent Events

At September 30, 2014, we had identified for purchase \$1.3 billion of jumbo residential mortgage loans that were in various stages of the origination process with third-party originators. Some of these loans may not ultimately close and, therefore, would not be available for purchase. Since September 30, 2014, and through November 2, 2014, \$597 million of these loans closed and were purchased by us. We expect the purchase of an additional amount of these loans to occur during the fourth quarter of 2014, subject to loan availability and delivery.

Table of Contents

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

INTRODUCTION

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) is intended to provide a reader of our financial statements with a narrative from the perspective of our management on our financial condition, results of operations, liquidity and certain other factors that may affect our future results. Our MD&A is presented in six main sections:

Overview

Results of Operations

Liquidity and Capital Resources

Off Balance Sheet Arrangements and Contractual Obligations

Critical Accounting Policies and Estimates

New Accounting Standards

Our MD&A should be read in conjunction with the Consolidated Financial Statements and related Notes included in Item 1, Financial Statements of this Quarterly Report on Form 10-Q and in Item 8, Financial Statements in our most recent Annual Report on Form 10-K, as well as the sections entitled "Risk Factors" in Item 1A of our most recent Annual Report on Form 10-K and Part II, Item 1A of this Quarterly Report on Form 10-Q, as well as other cautionary statements and risks described elsewhere in this report and our most recent Annual Report on Form 10-K. The discussion in this financial review contains forward-looking statements that involve substantial risks and uncertainties. Our actual results could differ materially from those anticipated in these forward looking statements as a result of various factors, such as those discussed in the Cautionary Statement below.

References herein to Redwood, the company, we, us, and our include Redwood Trust, Inc. and its consolidated subsidiaries, unless the context otherwise requires. Financial information concerning our business is set forth in this

Management's Discussion and Analysis of Financial Condition and Results of Operations, our consolidated financial statements and notes thereto, which are included in Part I, Items 1 and 2 of this Quarterly Report on Form 10-Q.

Our website can be found at www.redwoodtrust.com. We make available, free of charge through the investor information section of our website, access to our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the U.S. Securities Exchange Act of 1934, as well as proxy statements, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the U.S. Securities and Exchange Commission (SEC). We also make available, free of charge, access to our charters for our Audit Committee, Compensation Committee, and Governance and Nominating Committee, our Corporate Governance Standards, and our Code of Ethics governing our

directors, officers, and employees. Within the time period required by the SEC and the New York Stock Exchange, we will post on our website any amendment to the Code of Ethics and any waiver applicable to any executive officer, director, or senior officer (as defined in the Code). In addition, our website includes information concerning purchases and sales of our equity securities by our executive officers and directors, as well as disclosure relating to certain non-GAAP financial measures (as defined in the SEC's Regulation G) that we may make public orally, telephonically, by webcast, by broadcast, or by similar means from time to time. Through the commercial section of our website, we also disclose information about our origination or acquisition of new commercial loans and other commercial investments, generally within five business days of origination or acquisition. We believe that this information may be of interest to investors in Redwood, although we may not always disclose on our website each new commercial loan or other new commercial investment we originate or acquire (or we may not disclose them on our website within the five business day period described above) due to, among other reasons, confidentiality obligations to the borrowers of those loans or counterparties to those investments. The information on our website is not part of this Quarterly Report on Form 10-Q.

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

Our Business

Redwood Trust, Inc., together with its subsidiaries, focuses on investing in mortgage- and other real estate-related assets and engaging in residential and commercial mortgage banking activities. We seek to invest in real estate-related assets that have the potential to generate attractive cash flow returns over time and to generate income through our residential

Table of Contents

and commercial mortgage banking activities. We operate our business in three segments: residential mortgage banking, residential investments, and commercial mortgage banking and investments. A description of these segments can be found in *Notes 1 and 21* in Part I, Item 1 of this Quarterly Report on Form 10-Q.

Our primary sources of income are net interest income from our investment portfolios and income from our mortgage banking activities. Net interest income consists of the interest income we earn less the interest expense we incur on borrowed funds and other liabilities. Income from mortgage banking activities consists of the profit we seek to generate through the acquisition or origination 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. Our mortgage banking activities and investments in MSRs are generally carried out through our taxable REIT subsidiaries, while our portfolio of mortgage- and other real estate-related investments is primarily held at our REIT. We generally intend to retain profits generated and taxed at our taxable REIT subsidiaries, and to distribute as dividends at least 90% of the taxable income we generate at our REIT.

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

Consolidated Securitization Entities

We sponsor our Sequoia securitization program, which we use for the securitization of residential mortgage loans. We are required under Generally Accepted Accounting Principles in the United States (GAAP) to consolidate the assets and liabilities of certain Sequoia securitization entities we have sponsored for financial reporting purposes. However, each of these entities is independent of Redwood and of each other, and the assets and liabilities of these entities are not owned by us or legal obligations of ours, respectively, although we are exposed to certain financial risks associated with our role as the sponsor or manager of these entities and, to the extent we hold securities issued by, or other investments in, these entities, we are exposed to the performance of these entities and the assets they hold. We refer to certain of these securitization entities as Legacy Consolidated Entities, and where applicable, in analyzing our results of operations we distinguish results from current operations at Redwood and, from Legacy Consolidated Entities.

During the third quarter of 2011, we engaged in a transaction in which we resecuritized a pool of senior residential securities (the Residential Resecuritization) primarily for the purpose of obtaining permanent non-recourse financing on a portion the residential securities we hold in our investment portfolio at the REIT. Similarly, during the fourth quarter of 2012, we engaged in a transaction in which we securitized a pool of commercial loans (the Commercial Securitization) primarily for the purpose of obtaining permanent non-recourse financing on a portion of the commercial loans we hold in our investment portfolio at the REIT. In analyzing our results of operations, the Commercial Securitization and Residential Resecuritization are included in our results at Redwood as we view these transactions as a form of financing.

Cautionary Statement

This Quarterly Report on Form 10-Q and the documents incorporated by reference herein contain forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995.

Forward-looking statements involve numerous risks and uncertainties. Our actual results may differ from our beliefs, expectations, estimates, and projections and, consequently, you should not rely on these forward-looking statements as predictions of future events. Forward-looking statements are not historical in nature and can be identified by words such as anticipate, estimate, will, should, expect, believe, intend, seek, plan and similar expressions, or by references to strategy, plans, or intentions. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013 and this Quarterly Report on Form 10-Q, in each case under the caption Risk Factors. Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected may be described from time to time in reports we file with the SEC, including reports on Forms 10-Q and 8-K. We undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

Table of Contents

Statements regarding the following subjects, among others, are forward-looking by their nature: (i) statements we make regarding Redwood's business strategy and strategic focus, including statements relating to our confidence in our overall market position, strategy and long-term prospects, and our belief in the long-term efficiency of private label securitization as a form of mortgage financing; (ii) statements we make regarding our new risk-sharing arrangement with Fannie Mae, including our belief that, under this arrangement, we can enhance the profitability of transacting in conforming loans that we plan to sell to Fannie Mae during the fourth quarter of 2014, as well as our expectations of reducing taxpayer risk through an upfront credit risk transfer and by increasing the role of private capital in the mortgage market; (iii) statements we make regarding our new business relationships with the Federal Home Loan Bank of Chicago (FHLBC), including our plan to acquire eligible residential loans from up to approximately 750 Federal Home Loan Bank members and our expectations regarding the timing for commencing and expanding the acquisition program, and our statements relating to quantifying the acquisition opportunity; (iv) statements we make regarding the FHFA's notice of proposed rulemaking (NPR) relating to FHLB membership requirements, including the potential implications for our captive insurance subsidiary's membership in the FHLB; (v) statements we make regarding the outlook for our commercial business, including our positioning to benefit from a substantial wave of refinance opportunities set to begin in 2015, industry estimates relating to maturing CMBS loans, our pipeline of loans under application for the fourth quarter of 2014, and our projected total origination volume for 2014; (vi) statements we make regarding the outlook for the residential mortgage market, including expectations relating to residential loan originations in 2014; (vii) statements related to our residential mortgage banking activities, including our long-term loan sale profit margin target of 25-to-50 basis points, our expectation to complete at least one more Sequoia securitization in the fourth quarter of 2014, our expectation for whole loan sales to remain our most active distribution channel for the remainder of 2014, statements we make relating to the risk retention rules applicable to residential securitization transactions and our expectation of their impact on our business and our expectations regarding the impact of timing differences related to loans identified for purchase at September 30, 2014 on our reported income in the fourth quarter of 2014; (viii) statements relating to acquiring residential mortgage loans in the future that we have identified for purchase or plan to purchase, including the amount of such loans that we identified for purchase during the third quarter of 2014 and at September 30, 2014, and statements relating to expected fallout and the corresponding volume of residential mortgage loans expected to be available for purchase; (ix) statements relating to our estimate of our investment capacity (including that we estimate our investment capacity at September 30, 2014 to be approximately \$145 million), our statements related to sourcing additional capital prior to the end of 2014, our belief that our remaining investment capacity is sufficient to fund our near-term investment activities, the likelihood of needing additional capital to make sustained long-term investments over the coming quarters, and our consideration of raising capital from outside sources, such as through a convertible debt offering or other medium- or long-term debt issuance; (x) statements we make regarding our dividend policy and our process for determining dividends; and (xi) statements regarding our expectations and estimates relating to the characterization for income tax purposes of our dividend distributions, our expectations and estimates relating to tax accounting, tax liabilities and tax savings, and GAAP tax provisions, our estimates of REIT taxable income and TRS taxable income, and our anticipation of additional credit losses for tax purposes in future periods (and, in particular, our statement that, for tax purposes, we expect an additional \$36 million of credit losses for tax on securities we currently own).

Important factors, among others, that may affect our actual results include: general economic trends, Federal Reserve monetary policy, the performance of the housing, commercial real estate, mortgage, credit, and broader financial markets, and their effects on the prices of earning assets and the credit status of borrowers; federal and state legislative and regulatory developments, and the actions of governmental authorities, including those affecting the mortgage industry or our business; our exposure to credit risk and the timing of credit losses within our portfolio; the concentration of the credit risks we are exposed to, including due to the structure of assets we hold and the geographical concentration of real estate underlying assets we own; the efficacy and expense of our efforts to manage or hedge credit risk, interest rate risk, and other financial and operational risks; changes in credit ratings on assets we own and changes in the rating agencies' credit rating methodologies; changes in interest rates; changes in mortgage

prepayment rates; the availability of assets for purchase at attractive prices and our ability to reinvest cash we hold; changes in the values of assets we own; changes in liquidity in the market for real estate securities and loans; our ability to finance the acquisition of real estate-related assets with short-term debt; the ability of counterparties to satisfy their obligations to us; our involvement in securitization transactions, the timing and profitability of those transactions, and the risks we are exposed to in engaging in securitization transactions; exposure to claims and litigation, including litigation arising from our involvement in securitization transactions; whether we have sufficient liquid assets to meet short-term needs; our ability to successfully compete and retain or attract key personnel; our ability to adapt our business model and strategies to changing circumstances; changes in our investment, financing, and hedging strategies and new risks we may be exposed to if we expand our business activities; exposure to environmental liabilities and the effects of global climate change; failure to comply with applicable laws and regulations; our failure to maintain appropriate internal controls over financial reporting and disclosure controls and procedures; the impact on our reputation that could result from our actions or omissions or from those of others; changes in accounting principles and tax rules; our ability to maintain our status as a REIT for tax purposes; limitations imposed on our business due to our REIT status and our status as exempt from registration under the Investment Company Act of 1940; decisions about raising, managing, and distributing capital; and other factors not presently identified.

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

Table of Contents

OVERVIEW

Business Update

During the third quarter of 2014, we made solid financial and operating progress as we continued to leverage our residential and commercial loan platforms by expanding the types of loan products we acquire, our group of loan sellers, and our distribution capabilities. Our loan platforms are multidimensional and competitively strong. They provide us with the means to create proprietary investments, generate fees, and build franchise value for shareholders.

Our residential mortgage-banking business had a positive third quarter, especially in light of the challenging market conditions for loan originations. Loan acquisitions were \$3.4 billion, an 89% increase over the prior quarter, with our new initiative of acquiring conforming loans generating 46% of that total. Also of note, our gross margin on conforming loan sales turned positive this quarter following our early focus on building market share and establishing a meaningful competitive presence with our sellers. In our traditional business of acquiring jumbo loans, gross margins remained strong and in excess of our long-term target range of 25-to-50 basis points. Overall, the results of this quarter indicate to us that we have moved beyond the start-up phase of platform building and into a more efficient operational phase.

We have said many times that one of our strategic goals is to develop multiple ways to invest in newly originated prime residential mortgage credit, particularly loans that were underwritten and acquired through our mortgage-banking platform. This meant expanding beyond our Sequoia jumbo securitization program, which has remained the industry leader in terms of post-crisis RMBS issuance activity. Since 2010, our Sequoia program has created nearly \$600 million of credit investments for our portfolio, as well as more than \$200 million of investments in interest-only securities and mortgage-servicing rights.

In September, we further expanded our entry into the conforming loan business by entering into our first risk-sharing arrangement with Fannie Mae. Under this arrangement, Redwood can enhance the profitability of transacting in conforming loan products by committing to absorb the first one percent of credit losses on \$1.1 billion of new conforming loans that we plan to sell to Fannie Mae during the fourth quarter of 2014. This risk-sharing arrangement provides a strong, direct alignment of interests between Redwood and Fannie Mae for the acquisition and sale of high-quality mortgage loans. Additionally, this transaction is expected to reduce taxpayer risk through an upfront credit risk transfer and by increasing the role of private capital in the mortgage market, which is one of the goals set forth in the 2014 FHFA Scorecard issued by the FHFA (Fannie Mae's regulator). We hope that it is the first of many such transactions for Redwood.

The Fannie Mae risk-sharing arrangement follows our recent joint announcement with the Federal Home Loan Bank of Chicago (FHLBC) that we plan to acquire eligible high-balance residential loans from up to approximately 750 participating Federal Home Loan Bank (FHLB) members. We have started a pilot roll out of this program to a small set of FHLB member banks and plan to expand it further in the fourth quarter of 2014 and in 2015. We also announced that one of our wholly-owned subsidiaries, a captive insurance company, had become a member of the FHLBC, providing it with access to attractive financing for well-underwritten residential loans that it may acquire from other Redwood subsidiaries or other sources.

Our insurance subsidiary's membership in the FHLBC may be limited to five years under a proposed rule that was issued by the FHFA in September 2014. The Notice of Proposed Rulemaking (NPR) seeks comments on a range of membership issues, including whether the FHFA should move forward with its proposed ban on captive insurance company membership and a five-year phase out of current captive insurance members. We plan to file a comment letter that will clearly state how the business of our captive insurance subsidiary is closely aligned with the mission of

the FHLB system and meets the high safety and soundness standards of the FHLB System. Notably, the outcome of the NPR will not affect our separate loan purchase program with the FHLBC. While the likelihood of this proposed rule change going into effect remains uncertain, the initial public comment responses we have reviewed have been opposed to the proposed rule changes applicable to captive insurance company members of the FHLB System.

In our commercial business, we continued to grow our platform as a provider of both senior and mezzanine financing for stabilized commercial properties. In the third quarter of 2014, we originated \$340 million of senior loans, a 128% increase over the prior quarter and our largest quarterly origination volume to date. While gross margins declined modestly, they remain well above historical industry averages and continue to exceed our long-term expectations. We continued to add experienced staff in this business line during the third quarter as we prepare to capitalize on the wave of refinance opportunities we expect to begin in 2015. The refinancing wave is the product of the record \$635 billion of CMBS issuance between 2005 and 2007. Industry estimates suggest that the maturing

Table of Contents

CMBS loans represent about one quarter of the maturing commercial real estate loans over that time, which should result in an opportunity for us to provide commercial financing over the next few years.

Financial and Operational Overview Third Quarter of 2014

Our businesses generated strong operating and financial results in the third quarter of 2014, despite persistent market volatility that may continue to impact our near-term quarterly results. Our GAAP earnings more than covered our dividend payment to shareholders in the third quarter of 2014, and we generated significant increases in our residential and commercial loan purchase and origination volumes. We also achieved another strategic milestone in the third quarter of 2014 by implementing a risk-sharing arrangement with Fannie Mae for conforming residential loans. Our jumbo loan purchase program with the FHLBC continues to move forward through its implementation phase, while our FHLB member subsidiary has been actively financing jumbo loans at attractive terms. Finally, our commercial team completed a record quarter of senior loan originations. Given the progress we are making in our businesses, our rate of capital deployment increased during the third quarter and remained elevated through October 2014.

Before we get into any further details, here is a summary of Redwood's third quarter 2014 results:

Earnings per share were \$0.50 for the third quarter of 2014, up from \$0.18 per share in the second quarter of 2014. The increase in earnings was largely attributable to higher mortgage banking income, particularly from our residential mortgage banking activities and a favorable timing difference, combined with a steady contribution of net interest income from our investment portfolio.

Our GAAP book value per share was \$15.21 at September 30, 2014, an increase from \$15.03 per share at June 30, 2014. The increase was primarily driven by GAAP earnings that more than covered our third quarter dividend of \$0.28 per share.

Our residential loan acquisition volume was \$3.4 billion in the third quarter of 2014, up 89% from the second quarter of 2014. At September 30, 2014, our pipeline of loans identified for purchase was \$1.6 billion and included \$1.3 billion of jumbo loans and \$0.3 billion of conforming loans, unadjusted for fallout expectations.

We originated \$340 million of senior commercial loans and \$26 million of mezzanine commercial loans in the third quarter of 2014. Our senior commercial loan pipeline, defined as loans under application, totaled \$199 million at September 30, 2014.

We sold \$456 million of securities in the third quarter of 2014 that were not part of our long-term core holdings in order to generate capital for reinvestment. As a result, our residential securities portfolio declined to \$1.4 billion at September 30, 2014.

We also reached an agreement in October 2014 to settle with the plaintiff, on mutually satisfactory terms, the legacy Sequoia RMBS-related case that had been brought in 2010 relating to our Sequoia Mortgage Trust 2006-1 securitization transaction. The terms of the settlement remain confidential.

Table of Contents

At September 30, 2014, our GAAP book value was \$1.3 billion, or \$15.21 per share, an increase from \$15.03 per share at June 30, 2014. The following table sets forth the changes in our GAAP book value per share for the third and second quarters of 2014.

Table 1 Changes in Book Value per Share

| (In Dollars, per share basis) | Three Months Ended | |
|--|---------------------------|----------------------|
| | September 30, 2014 | June 30, 2014 |
| Beginning book value | \$ 15.03 | \$ 15.14 |
| Net income | 0.50 | 0.18 |
| Change in unrealized gains (losses), net | (0.09) | 0.09 |
| Equity award distributions | (0.02) | (0.14) |
| Other, net | 0.07 | 0.04 |
| Dividends | (0.28) | (0.28) |
| Ending Book Value per Share | \$ 15.21 | \$ 15.03 |

The increase in GAAP book value per share during the third quarter of 2014 was primarily driven by earnings that more than covered our third quarter dividend of \$0.28 per share. While in aggregate prices increased on our securities portfolio, the realization of gains on sales of securities combined with a reduction in the value of cash flow hedges on our long-term debt contributed to an overall reduction in unrealized gains in the third quarter.

Residential Update

Our residential mortgage banking business had positive third quarter 2014 results. Jumbo loan acquisitions doubled to \$1.8 billion compared to the second quarter of 2014, while our conforming loan acquisitions increased 78% to \$1.5 billion over the same period. Higher loan purchase volumes contributed positively to our mortgage banking results for the third quarter, and also contributed to an increase in our investment in mortgage servicing rights (MSRs) which has roughly doubled over the past three quarters to a total of \$135 million at September 30, 2014. For the first nine months of 2014, total residential loan acquisitions (jumbo and conforming) were \$6.3 billion, down less than 3% from the same period in 2013. Our business continues to benefit from the expansion of our group of loan sellers, which increased by a net 12 to 152 sellers at September 30, 2014.

Despite stronger macroeconomic data, including second quarter 2014 revised GDP growth of 4.6%, interest rates were relatively steady in the third quarter as the 10-year Treasury Note yield ended unchanged from the beginning of the quarter. While broader economic growth appears to be moving forward, the housing market is now lagging the recovery. Mortgage rates are up meaningfully from 2013 lows (the 30-year fixed mortgage rate averaged 3.50% for the first five months of 2013), averaging 4.24% for the first nine months of 2014. The resulting reduction in refinancing activity has impacted the industry, with the Mortgage Bankers Association further reducing their annual forecast for industry originations to \$1 trillion for 2014, down 43% from 2013 originations.

We executed our second and third Sequoia securitizations of 2014 in July and September, and we expect to complete at least one more in the fourth quarter of 2014. These securitizations created \$39 million of subordinate investment securities for our portfolio. Although the difference has narrowed, our whole loan sale execution for most jumbo loans continues to be better than our securitization execution as a result of strong loan demand from banks. We expect whole loan sales to remain our most active distribution channel for the remainder of 2014. However, our subsidiary s

recently established FHLB financing capabilities provide an alternative to selling or securitizing jumbo loans that we also plan to utilize. During the third quarter of 2014, our FHLB member subsidiary financed \$236 million of jumbo loans with the FHLBC, investing approximately \$37 million of our own capital at attractive levels.

Risk Retention Rules

In October 2014, Federal regulators released the final risk retention rules applicable to residential securitization transactions. Of note, these rules require risk retention by a sponsor in the event that non-QM loans are included in a securitization transaction. Although we have recently included non-QM loans in our Sequoia securitizations, we do not expect these rules to have any adverse impact on our business. As a long-time investor in mortgage credit risk, our residential business model is built to create and retain first-loss credit risk through the retention of the subordinate securities issued through our Sequoia securitization platform regardless of whether they include QM or non-QM loans. We continue to explore alternative ways to source more high-quality non-QM loans made to borrowers of the type we have traditionally financed in the past.

Table of Contents***MPF Direct***

We are making steady progress on our initiative to acquire jumbo loans through the FHLBC's MPF Direct™ product. In the third quarter, we launched a pilot program with certain MPF participating member banks to begin the process of making purchases of jumbo loans through MPF Direct™. To date, we are moving forward with 10 banks and we expect to begin acquiring loans late in the fourth quarter of 2014. After this initial test phase, we plan to do a further roll out to all interested MPF participants in 2015. It is too early to provide any metrics around the potential size of this opportunity. For now, we think it has the potential to be a meaningful source of residential loan acquisitions over time.

Commercial Update

Our commercial mortgage-banking and investments business had a very strong third quarter of 2014. During the third quarter, we originated 24 senior commercial loans totaling \$340 million, as compared to 15 loans totaling \$149 million in the second quarter of 2014. Through the first three quarters of 2014, we originated \$608 million of senior commercial loans, as compared to \$563 million for the first three quarters of 2013. We entered the fourth quarter with a pipeline of loans under application of \$199 million, and when combined with the applications received in October, we project our total origination volume will likely exceed \$900 million for 2014, as compared to \$805 million in 2013.

During the third quarter, we added a senior originator in the Los Angeles area. Together with other recent hiring in the New York area, this should position us well for 2015, which we expect to be the first year of a wave of commercial refinancing activity resulting from the record volumes of 10-year CMBS loans originated between 2005 and 2007.

Quarterly Investment Activity

Our deployment of capital increased significantly in the third quarter of 2014 compared to the prior quarter. The following table details our capital invested for the third and second quarters of 2014.

Table 2 Investment Activity

| (In Millions) ⁽¹⁾ | Three Months Ended | |
|---|---------------------------|----------------------|
| | September 30, 2014 | June 30, 2014 |
| Residential | | |
| Sequoia RMBS | \$ 41 | \$ 85 |
| Third-party RMBS | 2 | 56 |
| Less: Short-term debt/Other liabilities | (25) | (121) |
| Total RMBS | 18 | 20 |
| Agency risk sharing transaction | 11 | - |
| Loans, net - FHLBC ⁽²⁾ | 37 | - |
| MSR investments | 62 | 12 |
| Total residential | 128 | 32 |

Commercial

| | | |
|-------------------------|--------|-------|
| Mezzanine loans | 26 | 6 |
| Less: Borrowings | - | (2) |
| Total commercial | 26 | 4 |
| Capital Invested | \$ 154 | \$ 36 |

(1) Certain totals may not foot, due to rounding.

(2) Includes loans pledged to FHLBC and FHLBC stock acquired, less FHLBC borrowings.

Table of Contents

Net of financing, we deployed \$154 million of capital in third quarter, up substantially from \$36 million in the second quarter of 2014. The increase in investment activity reflects a combination of strong growth in our loan purchase volume and growing opportunities to invest capital. Notable investments in the third quarter included \$39 million in retained subordinate securities and \$2 million of IOs created from our two Sequoia securitizations, \$37 million of capital invested in \$236 million of loans financed through our FHLB member subsidiary, and \$62 million of investments in MSRs. Following the end of the third quarter of 2014 and through October 31, 2014, we invested net capital of \$21 million in loans financed through our FHLB member subsidiary, \$8 million in MSRs, and \$3 million in commercial mezzanine loans.

Following the end of the third quarter of 2014 and through October 31, 2014, we invested net capital of \$21 million in loans financed through our FHLB member subsidiary, \$8 million in MSRs, and \$3 million in commercial mezzanine loans.

Capital and Liquidity

We maintained capital of \$1.7 billion at September 30, 2014. This included \$1.3 billion of equity capital, \$140 million of long-term debt due in 2037, and \$288 million of medium-term convertible debt due in 2018. It did not include \$1.2 billion of residential loan warehouse debt, which we primarily use to finance our inventory of residential loans awaiting sale, securitization, or long-term financing by one of our subsidiaries through the utilization of FHLB advances. It also did not include \$647 million of financing through repurchase facilities for securities that we believe offer an attractive levered return profile but do not otherwise meet our internal capital return targets.

At September 30, 2014, we held \$150 million in cash, and our investment capacity (defined as the approximate amount of capital we had readily available for long-term investments) was estimated to be approximately \$145 million. Our rate of capital deployment in the second half of 2014 is requiring us to source additional capital prior to the end of the year to support the growth in our investment opportunities. During the third quarter of 2014, we generated approximately \$49 million of internal capital through the sale of \$456 million of residential securities. The securities we sold included lower yielding mezzanine securities and other senior securities financed with short-term repurchase debt and capital. These sales resulted in \$7 million of realized gains and reduced our short-term repurchase debt to \$647 million at September 30, 2014, from \$854 million at June 30, 2014. We also generated capital by more efficiently financing our accumulation of residential and commercial loans held for sale, utilizing warehouse financing facilities where we deemed it appropriate. While we believe our remaining investment capacity is sufficient to fund our near-term investment activities, we will likely need additional capital to make sustained long-term investments over the coming quarters. As a result, we are considering raising capital from outside sources, such as through a convertible debt offering or other medium- or long-term debt issuance.

Table of Contents**RESULTS OF OPERATIONS**

The following table presents the components of our GAAP net income for the three and nine months ended September 30, 2014 and 2013.

Table 3 Net Income

| (In Millions, Except per Share Data) ⁽¹⁾ | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|----------------------------------|---------|---------------------------------|---------|
| | 2014 | 2013 | 2014 | 2013 |
| Interest income | \$ 63 | \$ 57 | \$ 177 | \$ 169 |
| Interest expense | (23) | (22) | (64) | (61) |
| Net Interest Income | 40 | 36 | 113 | 107 |
| Reversal of provision (provision) for loan losses | 2 | (2) | 1 | - |
| Net Interest Income After Provision | 42 | 34 | 114 | 107 |
| Noninterest Income | | | | |
| Mortgage banking activities, net | 18 | (9) | 24 | 86 |
| MSR income, net | 6 | 3 | 5 | 15 |
| Other market valuation adjustments, net | (4) | - | (14) | (6) |
| Realized gains, net | 9 | 10 | 11 | 23 |
| Total noninterest income (loss), net | 29 | 5 | 25 | 117 |
| Operating expenses | (21) | (22) | (64) | (67) |
| Other income | 2 | - | 2 | - |
| Net income before provision for income taxes | 50 | 17 | 77 | 157 |
| (Provision for) benefit from income taxes | (5) | 5 | (4) | (9) |
| Net Income | \$ 45 | \$ 22 | \$ 73 | \$ 148 |
| Diluted earnings per common share | \$ 0.50 | \$ 0.25 | \$ 0.84 | \$ 1.65 |

(1) Certain totals may not foot, due to rounding.

Net Interest Income

Net interest income increased by \$4 million to \$40 million in the third quarter of 2014, and increased by \$6 million to \$113 million during the first nine months of 2014, each as compared to the respective periods in 2013. The increase in net interest income in both the three and nine month periods was primarily due to an increase in the average balance of investments we retained from Sequoia securitizations and third party investments we acquired during the past year.

Additional detail on changes in net interest income is provided in the *Net Interest Income* section of this MD&A.

Provision for Loan Losses

We maintain an allowance for loan losses for both our commercial loan investment portfolio and for residential loans held-for-investment in consolidated Sequoia entities. During the three and nine months ended September 30, 2014, we recorded reversals of provision for loan losses that primarily resulted from \$51 million of commercial loan repayments in the third quarter of 2014 and lower loss severities on residential loans largely due to home price appreciation impacting these loans over the last two years.

Additional information on the allowance for loan losses on our consolidated Sequoia entities is provided in the *Results of Legacy Consolidated Entities* section of this MD&A.

Table of Contents

Mortgage Banking Activities, Net

Income from mortgage banking activities, net, includes results from both our residential and commercial mortgage banking operations.

Income from residential mortgage banking activities increased by \$24 million to \$11 million in the third quarter of 2014, and decreased \$58 million to \$12 million in the first nine months of 2014, each as compared to the respective periods in 2013. Higher residential loan acquisition volumes in the third quarter of 2014 contributed to higher mortgage banking income in that period. The loss we recorded in the third quarter of 2013 was primarily attributable to timing differences related to our jumbo mortgage pipeline (defined as those loans we have identified for purchase) and the hedging derivatives associated with those loans. This timing difference affected the second and third quarters of 2013, impacting the third quarter results, but not the year-to-date results. The overall decrease in mortgage banking income in the first nine months of 2014 was primarily due to a combination of slightly lower residential loan acquisition volumes, resulting from higher mortgage rates and lower industry origination volumes during that period, and lower loan sale profit margins, particularly for conforming loans, which have become a larger portion of our overall loan acquisitions during 2014.

Income from commercial mortgage banking activities increased \$3 million to \$6 million in the third quarter of 2014, and decreased \$4 million to \$12 million in the first nine months of 2014, each as compared to the respective periods in 2013. The increase in income in the third quarter of 2014 primarily resulted from higher origination volume compared to the third quarter of 2013. The decrease in income during the first nine months of 2014 primarily resulted from lower profit margins on commercial originations from increased competition, which were only partially offset by higher origination volumes in that period.

Additional detail on our residential and commercial mortgage banking results are included in the Residential Mortgage Banking and Commercial Mortgage Banking and Investment portions of the *Segment Results* section of this MD&A.

MSR Income, Net

MSR income is comprised of both the net fee income earned from MSRs and their market value changes. MSR income increased \$3 million to \$6 million during the third quarter of 2014, and decreased \$10 million to \$5 million during the first nine months of 2014, each as compared to the respective periods in 2013. The net cash we received from our MSRs has steadily increased over the past several quarters due to additional MSR investments recognized through the sale of jumbo loans we securitized as well as an increasing amount recognized through the sale of conforming loans to the Agencies. During the third quarter and first nine months of 2014, we received \$4 million and \$11 million in net servicing fees, respectively, as compared to \$3 million and \$5 million during the third quarter and first nine months of 2013, respectively.

During the third quarter and first nine months of 2014, market valuation adjustments on MSRs were \$2 million and negative \$6 million, respectively, as compared to less than \$1 million and \$10 million during the respective periods of 2013. Mortgage rates have generally declined in 2014, adversely affecting the valuation of our MSRs during that period. During the first nine months of 2013, mortgage rates generally increased, benefitting the valuation of our MSRs.

Additional detail on our investment in MSRs is included in the Residential Investments portion of the *Segment Results* section of this MD&A.

Other Market Valuation Adjustments, Net

For the three and nine months ended September 30, 2014, other market valuation adjustments, net, included an expense of \$2 million and \$11 million, respectively, attributable to declines in the value of derivatives used to manage risks associated with certain of our residential investment securities. These derivatives declined in value as a result of declining interest rates during the first nine months of 2014. Changes in the value of the securities being hedged by these derivatives were recorded in other comprehensive income on our balance sheet and were not recognized in net income. Additional expenses of \$2 million and \$3 million in the three and nine months ended September 30, 2014, respectively, relate to a combination of impairments on certain AFS securities, changes in the fair value of residential loans that were retained for investment purposes and financed with the FHLBC, and valuation adjustments of certain securities carried at fair value on our financial statements. For the three and nine months ended September 30, 2013, other market valuation adjustments, net, included impairments on AFS securities of zero and \$2 million, respectively, and income less than \$1 million and an expense of \$4 million, respectively, due to valuation adjustments of certain fair value securities.

Realized Gains, Net

Realized gains, net, were \$9 million and \$11 million, respectively, for the three and nine months ended September 30, 2014 and primarily resulted from the sale of \$395 million of available-for-sale securities in the third quarter of 2014. The amount of the gains or losses in a period depends on several factors including the amount of sales and the unrealized gain or loss on the securities prior to sale.

For additional detail on realized gains, see the Residential Investments portion of the Segment Results section of this MD&A.

Operating Expense

During the third quarter of 2014, operating expenses decreased to \$21 million, as compared to \$22 million in the third quarter of 2013. During the first nine months of 2014, operating expenses decreased to \$64 million, as compared to \$67 million in the first nine

Table of Contents

months of 2013. The decreases over both periods are primarily due to a decline in both severance-related expenses and variable compensation accruals. During the first nine months of 2014, we recorded less than \$1 million of severance-related expenses, as compared to expenses of \$4 million during the first nine months of 2013. These reductions in expenses were partially offset by increases in fixed compensation and systems and consulting expenses that increased over the last year as we expanded our residential and commercial mortgage banking operations.

Other Income

Other income of \$2 million reflects a reduction in our aggregate litigation reserve relating to three legacy Sequoia RMBS-related cases we reserved for in the fourth quarter of 2013. Additional information on our legal proceedings and litigation reserve can be found in *Note 15* in *Part I, Item 1* of this Quarterly Report on Form 10-Q.

Provision for Income Taxes

We recorded a tax provision of \$5 million in the third quarter of 2014, as compared to a benefit from income taxes of \$5 million in the third quarter of 2013. We recorded a tax provision of \$4 million in the first nine months of 2014, as compared to a tax provision of \$9 million during the first nine months of 2013. Our provision for income taxes is primarily driven by activity at our taxable REIT subsidiaries, including our residential and commercial mortgage banking activities and MSR investments. The lower tax provision during the first nine months of 2014 was primarily the result of lower income from our mortgage banking activities during that period, as compared to the first nine months of 2013. The benefit from income taxes in the third quarter of 2013 primarily resulted from a reduction of our annual estimated effective tax rate during that period.

For additional detail on income taxes, see the *Taxable Income* section of this MD&A.

Net Interest Income

The following tables present the components of net interest income for the three and nine months ended September 30, 2014 and 2013.

Table 4 Net Interest Income⁽¹⁾

| (Dollars in Millions) | Three Months Ended September 30, 2014 | | | Three Months Ended September 30, 2013 | | |
|--|--|-----------------------------------|---------|--|-----------------------------------|---------|
| | Interest Income/ (Expense) | Average Balance ⁽²⁾ | Yield | Interest Income/ (Expense) | Average Balance ⁽²⁾ | Yield |
| Interest Income | | | | | | |
| Residential loans, at fair value | \$ 13 | \$ 1,369 | 3.81 % | \$ 9 | \$ 861 | 4.27 % |
| Residential loans - HFI ⁽³⁾ | 6 | 1,570 | 1.59 % | 8 | 1,911 | 1.64 % |
| Commercial loans - HFS | 2 | 170 | 4.80 % | 1 | 68 | 6.21 % |
| Commercial loans - HFI | 11 | 420 | 10.05 % | 10 | 348 | 11.14 % |
| Trading securities | 6 | 133 | 17.13 % | 8 | 204 | 15.31 % |
| Available-for-sale securities | 26 | 1,295 | 7.96 % | 22 | 968 | 9.03 % |
| Cash and cash equivalents | - | 151 | - % | - | 275 | - % |

Edgar Filing: REDWOOD TRUST INC - Form 10-Q

| | | | | | | |
|-------------------------------------|-------|-------|----------|-------|-------|----------|
| Total interest income | 63 | 5,109 | 4.96 % | 57 | 4,634 | 4.96 % |
| Interest Expense | | | | | | |
| Short-term debt | (8) | 1,874 | (1.80) % | (5) | 1,151 | (1.82) % |
| ABS issued - Redwood | (3) | 184 | (5.63) % | (3) | 274 | (4.98) % |
| ABS issued - Sequoia ⁽³⁾ | (5) | 1,508 | (1.39) % | (6) | 1,835 | (1.35) % |
| Long-term debt | (7) | 568 | (4.98) % | (7) | 450 | (6.12) % |
| Total interest expense | (23) | 4,133 | (2.26) % | (22) | 3,711 | (2.34) % |
| Net Interest Income | \$ 40 | | | \$ 36 | | |

Table of Contents

| (Dollars in Millions) | Nine Months Ended September 30, 2014 | | | Nine Months Ended September 30, 2013 | | |
|--|---|-----------------------------------|-----------------|---|-----------------------------------|-----------------|
| | Interest Income/ (Expense) | Average Balance ⁽²⁾ | Yield | Interest Income/ (Expense) | Average Balance ⁽²⁾ | Yield |
| Interest Income | | | | | | |
| Residential loans, at fair value | \$ 26 | \$ 879 | 3.95 % | \$ 27 | \$ 914 | 3.91 % |
| Residential loans - HFI ⁽³⁾ | 19 | 1,641 | 1.58 % | 27 | 2,043 | 1.74 % |
| Commercial loans - HFS | 4 | 105 | 4.92 % | 2 | 56 | 5.50 % |
| Commercial loans - HFI | 30 | 400 | 10.11 % | 28 | 333 | 11.29 % |
| Trading securities | 18 | 146 | 16.02 % | 19 | 118 | 21.07 % |
| Available-for-sale securities | 80 | 1,387 | 7.64 % | 66 | 966 | 9.09 % |
| Cash and cash equivalents | - | 147 | - % | - | 151 | - % |
| Total interest income | 177 | 4,705 | 5.01 % | 169 | 4,580 | 4.91 % |
| Interest Expense | | | | | | |
| Short-term debt | (17) | 1,406 | (1.65) % | (14) | 1,021 | (1.79) % |
| ABS issued - Redwood | (9) | 210 | (5.41) % | (11) | 295 | (4.80) % |
| ABS issued - Sequoia ⁽³⁾ | (16) | 1,576 | (1.35) % | (20) | 1,966 | (1.37) % |
| Long-term debt | (22) | 527 | (5.49) % | (17) | 370 | (6.09) % |
| Total interest expense | (64) | 3,719 | (2.28) % | (61) | 3,652 | (2.24) % |
| Net Interest Income | \$ 113 | | | \$ 107 | | |

(1) Certain totals may not foot, due to rounding.

(2) Average balances for residential and commercial loans held-for-sale and trading securities are calculated based upon carrying values, which represent estimated fair values. Average balances for available-for-sale securities and debt are calculated based upon amortized historical cost.

(3) The interest income from residential loans held-for-investment and the interest expense from ABS issued - Sequoia represent activity from our Legacy Consolidated Entities.

The following table presents the components of net interest income by segment for the three and nine months ended September 30, 2014 and 2013.

Table 4A Net Interest Income by Segment⁽¹⁾

| (In Millions) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|----------------------------------|-------|---------------------------------|-------|
| | 2014 | 2013 | 2014 | 2013 |
| Net interest income by segment | | | | |
| Residential Mortgage Banking | \$ 13 | \$ 12 | \$ 32 | \$ 32 |
| Residential Investments | 24 | 21 | 74 | 63 |
| Commercial Mortgage Banking and Investments | 8 | 7 | 22 | 22 |
| Corporate/Other | (5) | (5) | (15) | (10) |

\$ 40 \$ 36 \$ 113 \$ 107

(1) Certain totals may not foot, due to rounding.

86

Table of Contents*Analysis of Changes in Net Interest Income*

Net interest income increased by \$4 million to \$40 million in the third quarter of 2014 and increased by \$6 million to \$113 million in the first nine months of 2014, as compared to the respective periods in 2013. The increases in net interest income in the third quarter and first nine months of 2014 were mostly attributable to \$4 million and \$11 million increases, respectively, from our residential investments segment that primarily resulted from higher average balances of securities we retained from Sequoia securitizations we sponsored and third-party securities we acquired during the past year. In addition, in each of the periods, \$1 million of the increase in the residential investments segment was attributable to residential loans held-for-investment and financed through the FHLBC that were transferred into the segment in the third quarter of 2014. Additional details regarding the activities impacting net interest income at each segment are included in the *Segment Results* section of this MD&A.

The corporate/other line item includes net interest income from Legacy Consolidated Entities and interest expense related to long-term debt not directly allocated to our segments. Interest expense from long-term debt not directly allocated to our segments remained consistent at \$6 million in the third quarter of 2014 and increased \$3 million to \$19 million in first nine months of 2014, as compared to the respective periods in 2013. The increase in the first nine months of 2014 primarily resulted from the issuance of convertible debt at the end of the first quarter of 2013. Contributions to net interest income from Legacy Consolidated Entities were \$1 million and \$2 million in the third quarter of 2014 and 2013, respectively, and \$4 million and \$7 million in the first nine months of 2014 and 2013, respectively. Additional details regarding Legacy Consolidated Entities are included in the *Results from Legacy Consolidated Entities* section of this MD&A.

The following table presents the net interest rate spread between the yield on unsecuritized loans and securities and their specific debt financing costs at September 30, 2014.

Table 5 Interest Expense Specific Borrowing Costs

| September 30, 2014 | Residential Loans | Commercial Loans | Residential Securities |
|---------------------------|------------------------------|-----------------------------|-----------------------------------|
| Asset yield | 3.81% | 10.65% | 6.37% |
| Short-term debt yield | 1.71% | 5.15% | 1.37% |
| Net spread | 2.10% | 5.50% | 5.00% |

For additional discussion on short-term debt, including information regarding margin requirements and financial covenants, see *Risks Relating to Debt Incurred Under Short- and Long-Term Borrowing Facilities* in the *Liquidity and Capital Resources* section below.

Table of Contents**Segment Results**

The following is a discussion of the results of operations for our three business segments for the three and nine months ended September 30, 2014 and 2013. For additional information on our segments, refer to *Note 1* and *Note 21* in Part I, Item I of this Quarterly Report on Form 10-Q.

Residential Mortgage Banking

The following table presents the components of segment contribution for the residential mortgage banking segment for the three and nine months ended September 30, 2014 and 2013.

Table 6 Residential Mortgage Banking Segment Contribution

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|-------------|--|-------------|
| | 2014 | 2013 | 2014 | 2013 |
| Interest income | \$ 16,911 | \$ 15,954 | \$ 40,015 | \$ 40,869 |
| Interest expense | (4,192) | (3,501) | (7,674) | (8,631) |
| Net interest income | 12,719 | 12,453 | 32,341 | 32,238 |
| Mortgage banking activities, net | 11,386 | (12,236) | 11,650 | 69,278 |
| Other market valuation adjustments, net | 43 | (11) | 54 | 67 |
| Direct operating expenses | (9,982) | (7,874) | (26,577) | (18,565) |
| Provision for income taxes | (3,352) | 4,867 | (3,258) | (6,447) |
| Segment Contribution | \$ 10,814 | \$ (2,801) | \$ 14,210 | \$ 76,571 |

The following table provides the activity of unsecuritized residential loans during the three and nine months ended September 30, 2014 and 2013.

Table 7 Unsecuritized Residential Loans Activity

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|--------------|--|-------------|
| | 2014 | 2013 | 2014 | 2013 |
| Balance at beginning of period | \$ 1,107,877 | \$ 1,221,097 | \$ 404,267 | \$ 562,658 |
| Acquisitions | 3,387,875 | 1,294,372 | 6,271,755 | 6,448,697 |
| Sales | (2,757,954) | (1,771,727) | (4,947,313) | (6,255,982) |
| Transfers between portfolios ⁽¹⁾ | (241,282) | - | (241,282) | - |
| Principal repayments | (7,687) | (4,188) | (19,718) | (9,243) |
| Changes in fair value, net | 13,600 | (11,675) | 34,720 | (18,251) |
| Balance at End of Period | \$ 1,502,429 | \$ 727,879 | \$ 1,502,429 | \$ 727,879 |

- (1) During the three months ended September 30, 2014, we transferred loans with a principal balance of \$235 million and a fair value of \$241 million from held-for-sale at fair value to held-for-investment at fair value. As of September 30, 2014, these loans were financed through the FHLBC borrowing agreement and our current intention is to hold these loans for investment. As such, the loans were transferred to our residential investments segment in the third quarter of 2014.

Table of Contents

The following table provides the activity of our retained Sequoia IO securities for the three and nine months ended September 30, 2014 and 2013.

Table 8 Sequoia IO Securities Activity

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---------------------------|----------------------------------|-------------------|---------------------------------|-------------------|
| | 2014 | 2013 | 2014 | 2013 |
| Beginning fair value | \$ 96,894 | \$ 123,591 | \$ 110,505 | \$ 10,409 |
| Acquisitions | 1,680 | 8,702 | 1,680 | 100,552 |
| Sales | - | (13,942) | - | (30,876) |
| Change in fair value, net | (1,253) | (908) | (14,864) | 37,358 |
| Ending Fair Value | \$ 97,321 | \$ 117,443 | \$ 97,321 | \$ 117,443 |

During the third quarter of 2014, we identified \$3.7 billion of loans for purchase, and we purchased \$3.4 billion of prime residential loans, which included \$1.5 billion of conforming loans and \$1.8 billion of jumbo loans. We sold \$1.4 billion of conforming loans to the Agencies and \$699 million of jumbo loans to third parties. In addition, we securitized \$653 million of jumbo loans as part of two Sequoia securitizations that settled during the third quarter. In association with these sales and securitizations, during the third quarter of 2014, we retained \$2 million of Sequoia IO securities, \$39 million of Sequoia subordinate securities and \$18 million of MSR investments. At September 30, 2014, we owned \$1.5 billion of prime residential loans, including \$1.1 billion of jumbo loans and \$399 million of conforming loans. Our pipeline of loans identified for purchase at September 30, 2014, included \$1.3 billion of jumbo loans and \$324 million of conforming loans (unadjusted for expected fallout).

Net Interest Income

Net interest income from residential mortgage banking is primarily comprised of interest income earned on residential loans from the time we purchase the loans to when we sell or securitize them, offset by interest expense incurred on short-term warehouse debt used in part to finance the loans while we hold them on balance sheet. Net interest income also includes interest income from Sequoia IO securities that are used to mitigate certain risks related to interest rate movements on our residential loan pipeline.

During the third quarter of 2014, net interest income from loans held-for-sale increased to \$8 million from \$6 million in the third quarter of 2013, primarily due to a higher average balance of loans outstanding during the current quarter, which was only partially offset by lower yields. Interest income from Sequoia IO and senior securities declined to \$5 million in the third quarter of 2014 from \$7 million during the third quarter of 2013, mostly due to lower average balances as sales and paydowns outpaced acquisitions of these securities during 2014.

During the first nine months of 2014, net interest income from loans held-for-sale decreased to \$17 million from \$18 million in the first nine months of 2013, primarily due to a lower average loan balance in the first nine months of 2014. Interest income from Sequoia IO securities increased to \$15 million in the first nine months of 2014 from \$14 million in the first nine months of 2013. The increase in interest income from Sequoia IO securities resulted from higher average balances of IO securities during the first nine months of 2014, which we retained from Sequoia securitizations we completed during 2013 and 2014.

The amount of net interest income we earn on loans held-for-sale is dependent on many variables, including the amount of loans and the time they are outstanding on our balance sheet and their interest rates, as well as the amount of leverage we employ through the use of short-term debt to finance the loans and the interest rates on that debt. These factors will impact interest income in future periods.

Mortgage Banking Activities, Net

Mortgage banking activities, net, include the changes in market value associated with both the loans we hold on balance sheet prior to sale, as well as the derivative instruments and Sequoia IO securities we use to manage risks associated with our loans held-for-sale and loans identified for purchase. Our loan sale profit margins are measured over the period from which we identify a loan for purchase and subsequently sell or securitize the loan and may be realized over the course of one or more quarters for financial reporting purposes.

The following table presents the components of residential mortgage banking activities, net. Amounts presented include both the changes in market values for loans that were sold and associated derivative positions that were

Table of Contents

settled during the periods presented as well as changes in market values of loans, derivatives and Sequoia IO securities we owned as of the period end.

Table 9 Components of Residential Mortgage Banking Activities, Net

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|----------------------------------|--------------------|---------------------------------|------------------|
| | 2014 | 2013 | 2014 | 2013 |
| Changes in fair value of: | | | | |
| Residential loans, at fair value | \$ 13,446 | \$ (10,804) | \$ 34,554 | \$ (17,339) |
| Sequoia securities | (1,332) | (1,866) | (14,419) | 36,399 |
| Risk management derivatives | (4,297) | 75 | (16,433) | 48,583 |
| Purchase and forward sale commitments | 2,487 | - | 6,077 | - |
| Other ⁽¹⁾ | 1,082 | 359 | 1,871 | 1,635 |
| Total Residential Mortgage Banking Activities, Net | \$ 11,386 | \$ (12,236) | \$ 11,650 | \$ 69,278 |

(1) Amounts in this line item include other fee income and the provision for repurchase expenses, presented net.

Our income from residential mortgage banking activities can experience volatility between quarters resulting from timing differences related to our jumbo mortgage pipeline (defined as those loans we have identified for purchase), and the hedging for those loans. We record changes in the value of hedges associated with our jumbo mortgage pipeline in earnings in the period they occur. However, the corresponding changes in value of the jumbo mortgage loan pipeline outstanding at any quarter-end are not reflected in earnings until the loans are purchased, which is typically in the following quarter. These timing differences are most pronounced when there is interest rate volatility during a quarter.

Income from residential mortgage banking activities, net, increased \$24 million to \$11 million in the third quarter of 2014 and decreased \$58 million to \$12 million in the first nine months of 2014, each as compared to the respective periods in 2013. Higher loan acquisition volumes in the third quarter of 2014 contributed to higher mortgage banking income in that period as compared to the third quarter of 2013. In addition, mortgage banking income in the third quarter of 2014 benefited from a timing difference that affected the second and third quarters of 2014. We do not expect the timing difference related to the loans we identified for purchase at September 30, 2014 to have a significant impact on our recorded income in the fourth quarter of 2014. Income from mortgage banking activities in the third quarter of 2013 was significantly impacted by timing differences that affected the second and third quarters of 2013. At June 30, 2013, we estimated that the net market valuation adjustment associated with loans identified for purchase was approximately negative \$34 million, which was not recognized in earnings until the third quarter of 2013, whereas the gains from derivatives associated with those loans were included in earnings in the second quarter of 2013.

The decline in the first nine months of 2014 was primarily attributable to a combination of reduced residential loan acquisition volumes, resulting from higher mortgage rates and lower industry origination volumes during that period, and lower loan sale profit margins in the current year. The reduced margins resulted from increased competition, particularly for conforming loans, which have become a larger portion of our overall loan acquisitions during 2014 and have lower margins than our jumbo loans.

At September 30, 2014, we had a repurchase reserve of \$3 million related to residential loans sold through this segment. During the third quarter of 2014, we recorded a \$702 thousand provision for repurchases that was included in income from mortgage banking activities, net, in this segment. We review our loan repurchase reserves each quarter and adjust them as necessary based on current information available at each reporting date. As our business continues to grow we expect that our repurchase reserve will continue to grow to reflect our increased potential obligations arising from representation and warranty violations related to the residential loans we have sold to securitization trusts or third parties, as well as from residential loans associated with MSR's we acquire.

The following table details outstanding principal balances for residential loans held-for-sale by product type at September 30, 2014.

Table 10 Characteristics of Unsecuritized Residential Loans

| September 30, 2014 (Dollars In Thousands) | Principal Value | Weighted Average Coupon |
|--|------------------------|------------------------------------|
| First Lien Prime | | |
| Fixed - 30 year | \$ 1,206,638 | 4.21% |
| Fixed - 15, 20, & 25 year | 97,803 | 3.60% |
| Hybrid | 160,987 | 3.32% |
| ARM | 1,273 | 2.18% |
| Total Outstanding Principal | \$ 1,466,701 | 4.07% |

Table of Contents*Operating Expenses and Provision for Income Taxes*

Direct operating expenses attributable to this segment increased \$2 million to \$10 million during the third quarter of 2014, and increased \$8 million to \$27 million during the first nine months of 2014, each as compared to the respective periods in 2013. The increase in expenses in both periods was attributable to the expansion of our residential mortgage banking operations.

Our residential mortgage banking activities are conducted in a taxable REIT subsidiary and our provision for income taxes is generally correlated to our segment contribution income. In certain periods, the relationship between these two amounts can change as a result of updates to our estimated annual effective tax rate.

Residential Investments

Our residential investments segment is comprised of our residential securities portfolio, MSR investment portfolio, and residential loans held-for-investment that are financed through the FHLBC. Sequoia IOs that are included as a component of trading securities in our consolidated financial statements are included in our Residential Mortgage Banking segment for reporting purposes. As such, they are excluded from any amounts and tables in this section and such amounts and tables will not conform to amounts presented in our consolidated financial statements for securities.

The following table presents the components of segment contribution for the residential investments segment for the three and nine months ended September 30, 2014 and 2013.

Table 11 Residential Investments Segment Contribution**Direct segment profit**

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|-------------|--|-------------|
| | 2014 | 2013 | 2014 | 2013 |
| Interest income | \$ 27,600 | \$ 22,887 | \$ 83,120 | \$ 70,420 |
| Interest expense | (3,142) | (2,229) | (9,106) | (7,448) |
| Net interest income | 24,458 | 20,658 | 74,014 | 62,972 |
| MSR income, net | 5,821 | 3,113 | 4,650 | 14,681 |
| Other market valuation adjustments, net | (3,371) | 549 | (13,117) | (5,759) |
| Realized gains, net | 7,836 | 10,469 | 9,815 | 23,032 |
| Direct operating expenses | (802) | (229) | (2,667) | (3,768) |
| Benefit from income taxes | 150 | 377 | 1,826 | (1,284) |
| Total Segment Contribution | \$ 34,092 | \$ 34,937 | \$ 74,521 | \$ 89,874 |

Table of Contents

The following table provides real estate securities activity in our residential investments segment for the three and nine months ended September 30, 2014 and 2013.

Table 12 Real Estate Securities Activity

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|----------------------------------|---------------------|---------------------------------|---------------------|
| | 2014 | 2013 | 2014 | 2013 |
| Beginning fair value | \$ 1,685,756 | \$ 1,190,714 | \$ 1,572,356 | \$ 1,098,344 |
| Acquisitions | | | | |
| Sequoia securities | 39,330 | 71,526 | 59,758 | 278,622 |
| Third-party securities | 1,811 | 142,629 | 132,393 | 142,629 |
| Sales | | | | |
| Sequoia securities | (57,422) | - | (57,422) | - |
| Third-party securities | (342,482) | (168,092) | (343,795) | (182,353) |
| Gains on sales and calls, net | 7,975 | 10,317 | 9,954 | 22,881 |
| Effect of principal payments ⁽¹⁾ | (46,455) | (37,624) | (136,732) | (110,954) |
| Change in fair value, net | 5,859 | (2,236) | 57,860 | (41,935) |
| Ending Fair Value | \$ 1,294,372 | \$ 1,207,234 | \$ 1,294,372 | \$ 1,207,234 |

(1) The effect of principal payments reflects the change in fair value due to principal payments, which is calculated as the cash principal received on a given security during the period multiplied by the prior quarter ending price or acquisition price for that security.

The following table provides MSR activity in our residential investments segment for the three and nine months ended September 30, 2014 and 2013.

Table 13 MSR Activity

| (In Thousands) | Three Months Ended September 30, | | | |
|---------------------------|----------------------------------|------------------|------------------|-----------------|
| | 2014 | | 2013 | |
| | Jumbo | Conforming | Jumbo | Conforming |
| Beginning fair value | \$ 56,038 | \$ 15,187 | \$ 43,098 | \$ - |
| Additions | 4,356 | 57,250 | 13,226 | 3,451 |
| Change in fair value, net | 805 | 1,516 | 647 | (187) |
| Ending Fair Value | \$ 61,199 | \$ 73,953 | \$ 56,971 | \$ 3,264 |

| (In Thousands) | Nine Months Ended September 30, | | | |
|----------------|---------------------------------|------------|-------|------------|
| | 2014 | | 2013 | |
| | Jumbo | Conforming | Jumbo | Conforming |

| | | | | |
|---------------------------|------------------|------------------|------------------|-----------------|
| Beginning fair value | \$ 61,493 | \$ 3,331 | \$ 5,315 | \$ - |
| Additions | 7,030 | 69,242 | 41,840 | 3,451 |
| Change in fair value, net | (7,324) | 1,380 | 9,815 | (187) |
| Ending Fair Value | \$ 61,199 | \$ 73,953 | \$ 56,971 | \$ 3,264 |

Residential Securities

During the third quarter of 2014, our residential securities portfolio declined \$391 million to \$1.29 billion, primarily resulting from \$400 million of sales and the effect of \$46 million of principal payments, partially offset by \$39 million of subordinate securities acquired from the Sequoia securitizations we completed during the quarter. The third-party securities acquired during the quarter included \$2 million of senior securities.

Net interest income from our residential securities increased \$3 million to \$24 million in the third quarter of 2014, and increased \$10 million to \$73 million in the first nine months of 2014, each as compared to the respective periods in 2013. These amounts exclude net interest income from FHLBC financed loans that are discussed below. The increases in net interest income over both the three and nine month periods was primarily due to higher average balances of assets, which increased \$325 million to \$1.3 billion in the third quarter of

Table of Contents

2014. The increase in interest income from higher average balances was partially offset by a decline in interest income from lower asset yields, which in the aggregate declined to a yield of 8.0% in the third quarter of 2014 from a yield of 9.0% in the third quarter of 2013. This decrease in yield is primarily attributable to the changing composition of our portfolio as higher yielding legacy senior and subordinate securities purchased in past years pay down and are replaced by new-issue Sequoia and third-party subordinate securities and seasoned third-party senior securities that have lower relative yields.

Interest expense in our residential investments segment increased by \$1 million and \$2 million during the three and nine months ended September 30, 2014, respectively. This increase was primarily due to an increase in average short-term debt balances used to finance the net growth in our investment portfolio. This increase was partially offset by a decline in interest expense on ABS issued as the Residential Resecuritization we completed in 2011 continues to pay down.

During the third quarter of 2014, we recognized \$6 million of net positive changes in fair value related to our available-for-sale residential securities portfolio, primarily resulting from improved pricing on our subordinate Sequoia securities. During the third quarter of 2014, other market valuation adjustments, net, included negative \$2 million attributable to declines in the value of interest-rate hedging derivatives caused by declining interest rates, negative \$1 million from a decline in value of residential loans held-for-investment, and negative \$188 thousand related to other-than-temporary impairments on securities in an unrealized loss position.

We use derivatives to manage risks associated with the net interest rate exposure at this segment, which includes fixed-rate securities and loans that generally increase in value as rates decline, and MSRs that generally decrease in value as rates decline. During the third quarter of 2014, the \$2 million decline in the value of derivatives, the \$1 million decline in value of loans, and the \$2 million increase in value of MSRs, were each recognized through earnings, while the \$6 million increase in value of securities was recognized through accumulated comprehensive income on our balance sheet.

During the first nine months of 2014, we realized \$10 million of gains on sold and called securities, as compared to \$23 million of securities sold during the first nine months of 2013. Although we generally intend to hold our investment securities as long-term investments, we may sell certain of these securities to meet operating objectives and to adapt to market conditions. Sales of \$400 million of securities from this segment in the third quarter of 2014 were made to generate capital for reinvestment.

The following table provides the activity of our real estate securities by collateral type in our residential investments segment for the three and nine months ended September 30, 2014 and 2013.

Table 14 Real Estate Securities Activity by Collateral Type

Three Months Ended September 30, 2014

| (In Thousands) | Senior | Re-REMIC ⁽¹⁾ | Subordinate | Total |
|------------------------|------------|-------------------------|-------------|--------------|
| Beginning fair value | \$ 912,345 | \$ 192,596 | \$ 580,815 | \$ 1,685,756 |
| Acquisitions | | | | |
| Sequoia securities | - | - | 39,330 | 39,330 |
| Third-party securities | 1,811 | - | - | 1,811 |
| Sales | | | | |

Edgar Filing: REDWOOD TRUST INC - Form 10-Q

| | | | | |
|---|-------------------|-------------------|-------------------|---------------------|
| Sequoia securities | (3,074) | - | (54,348) | (57,422) |
| Third-party securities | (318,926) | (15,538) | (8,018) | (342,482) |
| Gains (losses) on sales and calls, net | (2,198) | 6,080 | 4,093 | 7,975 |
| Effect of principal payments ⁽²⁾ | (41,373) | - | (5,082) | (46,455) |
| Change in fair value, net | 4,209 | (7,021) | 8,671 | 5,859 |
| Ending Fair Value | \$ 552,794 | \$ 176,117 | \$ 565,461 | \$ 1,294,372 |

Table of Contents**Nine Months Ended September 30, 2014**

| (In Thousands) | Senior | Re-REMIC ⁽¹⁾ | Subordinate | Total |
|---|-------------------|--------------------------------|--------------------|---------------------|
| Beginning fair value | \$ 864,762 | \$ 176,376 | \$ 531,218 | \$ 1,572,356 |
| Acquisitions | | | | |
| Sequoia securities | - | - | 59,758 | 59,758 |
| Third-party securities | 116,260 | 10,200 | 5,933 | 132,393 |
| Sales | | | | |
| Sequoia securities | (3,074) | - | (54,348) | (57,422) |
| Third-party securities | (320,239) | (15,538) | (8,018) | (343,795) |
| Gains (losses) on sales and calls, net | (1,206) | 6,080 | 5,080 | 9,954 |
| Effect of principal payments ⁽²⁾ | (122,711) | - | (14,021) | (136,732) |
| Change in fair value, net | 19,002 | (1,001) | 39,859 | 57,860 |
| Ending Fair Value | \$ 552,794 | \$ 176,117 | \$ 565,461 | \$ 1,294,372 |

- (1) Re-REMIC securities, as presented herein, were created by third parties through the resecuritization of certain senior interests to provide additional credit support to those interests.
- (2) The effect of principal payments reflects the change in fair value due to principal payments, which is calculated as the cash principal received on a given security during the period multiplied by the prior quarter ending price or acquisition price for that security.

At September 30, 2014, our residential securities (as a percentage of current market value) consisted of fixed-rate assets (52%), adjustable-rate assets (18%), hybrid assets that reset within the next year (29%), and hybrid assets that reset between 12 and 36 months (1%).

The following table presents real estate securities at September 30, 2014, categorized by portfolio vintage (the years the securities were issued), by priority of cash flows (senior, re-REMIC, and subordinate), and by quality of underlying loans (prime and non-prime).

Table 15 Securities by Vintage and as a Percentage of Total Securities^{(1) (2)}

| September 30, 2014 | Sequoia | Third-party Securities | | | Total | % of Total Securities |
|-------------------------------|-----------------------------|-------------------------------|--------------------|--------------------|--------------|------------------------------|
| | Securities 2012-2014 | 2005 & Earlier | 2006 - 2008 | 2012 - 2014 | | |
| (Dollars In Thousands) | | | | | | |
| Senior | | | | | | |
| Prime | \$ - | \$ 277,795 | \$ 81,018 | \$ - | \$ 358,813 | 28 % |
| Non-prime | - | 189,512 | 4,469 | - | 193,981 | 15 % |
| Total Senior | - | 467,307 | 85,487 | - | 552,794 | 43 % |
| Re-REMIC | - | 60,196 | 115,921 | - | 176,117 | 13 % |
| Subordinate | | | | | | |
| Mezzanine ⁽³⁾ | 356,847 | - | - | 54,938 | 411,785 | 32 % |
| Subordinate | 84,988 | 53,935 | 1,220 | 13,533 | 153,676 | 12 % |

| | | | | | | |
|-------------------------|------------|------------|------------|-----------|--------------|-------|
| Total Subordinate | 441,835 | 53,935 | 1,220 | 68,471 | 565,461 | 44 % |
| Total Securities | \$ 441,835 | \$ 581,438 | \$ 202,628 | \$ 68,471 | \$ 1,294,372 | 100 % |

- (1) Certain totals may not foot, due to rounding.
- (2) The securities and interests that we acquired from the Residential Resecuritization entity (which are eliminated for consolidation purposes) were \$167 million at September 30, 2014. As a result, to adjust at September 30, 2014, for the legal and economic interests that resulted from the Residential Resecuritization, total residential senior securities would be decreased by \$233 million to \$320 million, total re-REMIC residential securities would be increased by \$167 million to \$343 million, and total residential securities would be reduced by \$66 million to \$1.23 billion.
- (3) Mezzanine includes securities initially rated AA, A, and BBB- and issued in 2012 or later.

Table of Contents

The following tables present the components of the interest income we earned on AFS securities for the three and nine months ended September 30, 2014 and 2013.

Table 16 Interest Income AFS Securities

| Three Months Ended September 30, 2014 | | | | | Yield as a Result of | | |
|--|------------------------|--|------------------------------|-------------------------------|-----------------------------|--|------------------------------|
| (Dollars in Thousands) | Interest Income | Discount (Premium) Amortization | Total Interest Income | Average Amortized Cost | Interest Income | Discount (Premium) Amortization | Total Interest Income |
| Residential | | | | | | | |
| Senior | \$ 5,470 | \$ 6,610 | \$ 12,080 | \$ 649,179 | 3.37 % | 4.07 % | 7.44 % |
| Re-REMIC | 2,659 | 1,619 | 4,278 | 114,433 | 9.29 % | 5.66 % | 14.95 % |
| Mezzanine ⁽¹⁾ | 4,363 | 945 | 5,308 | 421,111 | 4.14 % | 0.90 % | 5.04 % |
| Subordinate | 2,377 | 1,717 | 4,094 | 110,494 | 8.61 % | 6.22 % | 14.82 % |
| Total AFS Securities | \$ 14,869 | \$ 10,891 | \$ 25,760 | \$ 1,295,217 | 4.59 % | 3.36 % | 7.96 % |

| Three Months Ended September 30, 2013 | | | | | Yield as a Result of | | |
|--|------------------------|--|------------------------------|-------------------------------|-----------------------------|--|------------------------------|
| (Dollars in Thousands) | Interest Income | Discount (Premium) Amortization | Total Interest Income | Average Amortized Cost | Interest Income | Discount (Premium) Amortization | Total Interest Income |
| Residential | | | | | | | |
| Senior | \$ 4,198 | \$ 5,190 | \$ 9,388 | \$ 428,080 | 3.92 % | 4.85 % | 8.77 % |
| Re-REMIC | 2,709 | 865 | 3,574 | 101,808 | 10.64 % | 3.40 % | 14.04 % |
| Mezzanine ⁽¹⁾ | 3,400 | 759 | 4,159 | 336,781 | 4.04 % | 0.90 % | 4.94 % |
| Subordinate | 2,759 | 1,971 | 4,730 | 101,194 | 10.91 % | 7.79 % | 18.70 % |
| Total AFS Securities | \$ 13,066 | \$ 8,785 | \$ 21,851 | \$ 967,864 | 5.40 % | 3.63 % | 9.03 % |

| Nine Months Ended September 30, 2014 | | | | | Yield as a Result of | | |
|---|------------------------|--|------------------------------|-------------------------------|-----------------------------|--|------------------------------|
| (Dollars in Thousands) | Interest Income | Discount (Premium) Amortization | Total Interest Income | Average Amortized Cost | Interest Income | Discount (Premium) Amortization | Total Interest Income |
| Residential | | | | | | | |
| Senior | \$ 18,841 | \$ 20,107 | \$ 38,948 | \$ 753,488 | 3.33 % | 3.56 % | 6.89 % |
| Re-REMIC | 8,103 | 4,502 | 12,605 | 113,328 | 9.53 % | 5.30 % | 14.83 % |
| Mezzanine ⁽¹⁾ | 12,781 | 2,979 | 15,760 | 411,968 | 4.14 % | 0.96 % | 5.10 % |
| Subordinate | 7,006 | 5,186 | 12,192 | 108,580 | 8.60 % | 6.37 % | 14.97 % |
| Total AFS Securities | \$ 46,731 | \$ 32,774 | \$ 79,505 | \$ 1,387,364 | 4.49 % | 3.15 % | 7.64 % |

Nine Months Ended September 30, 2013

| (Dollars in Thousands) | Nine Months Ended September 30, 2013 | | | Average Amortized Cost | Yield as a Result of | | | |
|-----------------------------|--------------------------------------|---------------------------------------|-----------------------------|------------------------------|----------------------|---------------------------------------|-----------------------------|--|
| | Interest Income | Discount (Premium) Amortization | Total Interest Income | | Interest Income | Discount (Premium) Amortization | Total Interest Income | |
| Residential | | | | | | | | |
| Senior | \$ 17,922 | \$ 14,636 | \$ 32,558 | \$ 537,486 | 4.45 % | 3.63 % | 8.08 % | |
| Re-REMIC | 8,234 | 2,933 | 11,167 | 100,808 | 10.89 % | 3.88 % | 14.77 % | |
| Mezzanine ⁽¹⁾ | 7,444 | 1,605 | 9,049 | 241,244 | 4.11 % | 0.89 % | 5.00 % | |
| Subordinate | 7,666 | 5,436 | 13,102 | 86,193 | 11.86 % | 8.41 % | 20.27 % | |
| Total AFS Securities | \$ 41,266 | \$ 24,610 | \$ 65,876 | \$ 965,730 | 5.70 % | 3.40 % | 9.10 % | |

(1) Mezzanine includes securities initially rated AA, A, and BBB- and issued in 2012 or later.

Table of Contents

The following tables present the components of carrying value at September 30, 2014 and December 31, 2013 for our AFS residential securities.

Table 17 Carrying Value of AFS Securities**September 30, 2014**

| (In Thousands) | Senior | Re-REMIC | Subordinate | Total |
|---------------------------|-------------------|-------------------|--------------------|---------------------|
| Principal balance | \$ 565,714 | \$ 206,212 | \$ 694,308 | \$ 1,466,234 |
| Credit reserve | (13,976) | (16,553) | (43,346) | (73,875) |
| Unamortized discount, net | (74,990) | (80,986) | (143,129) | (299,105) |
| Amortized cost | 476,748 | 108,673 | 507,833 | 1,093,254 |
| Gross unrealized gains | 69,117 | 67,444 | 59,427 | 195,988 |
| Gross unrealized losses | (829) | - | (2,178) | (3,007) |
| Carrying Value | \$ 545,036 | \$ 176,117 | \$ 565,082 | \$ 1,286,235 |

December 31, 2013

| (In Thousands) | Senior | Re-REMIC | Subordinate | Total |
|---------------------------|-------------------|-------------------|--------------------|---------------------|
| Principal balance | \$ 888,654 | \$ 214,046 | \$ 706,292 | \$ 1,808,992 |
| Credit reserve | (23,984) | (30,429) | (62,457) | (116,870) |
| Unamortized discount, net | (81,015) | (80,188) | (137,266) | (298,469) |
| Amortized cost | 783,655 | 103,429 | 506,569 | 1,393,653 |
| Gross unrealized gains | 73,634 | 72,947 | 41,205 | 187,786 |
| Gross unrealized losses | (1,597) | - | (21,536) | (23,133) |
| Carrying Value | \$ 855,692 | \$ 176,376 | \$ 526,238 | \$ 1,558,306 |

At September 30, 2014, credit reserves for our AFS securities totaled \$74 million, or 5.0% of the principal balance of our residential securities, down from \$117 million, or 6.5%, at December 31, 2013. The decrease in the credit reserve primarily resulted from a transfer of credit reserves to accretable unamortized discount during the first nine months of 2014, based on sustained improvements in the overall credit performance of loans underlying our securities that reduced our estimate of future losses on these loans. Accretable unamortized discounts are recognized into income prospectively over the remaining life of the associated loans. During the three and nine months ended September 30, 2014, realized credit losses on our residential securities totaled \$2 million and \$9 million, respectively. Volatility in income recognition for these securities is generally due to changes in prepayment rates and, to varying degrees, credit performance and interest rates.

Senior Securities

The fair value of our senior AFS securities was equal to 96% of their principal balance at September 30, 2014, and the amortized cost was equal to 84% of the principal balance. The fair value of our senior securities accounted for as trading securities in this segment was \$8 million. We expect future losses will extinguish a portion of the outstanding principal of these AFS securities, as reflected by the \$14 million of credit reserves we have provided for on the \$566 million principal balance of those securities.

Re-REMIC Securities

Our re-REMIC portfolio consists primarily of prime residential senior securities that were pooled and re-securitized in 2009 and 2010 by third parties to create two-tranche structures. We own support (or subordinate) securities within those structures. The fair value of our re-REMIC AFS securities was equal to 85% of the principal balance of the portfolio at September 30, 2014, while our amortized cost was equal to 53% of the principal balance. We expect future losses will extinguish a portion of the outstanding principal of these securities, as reflected by the \$17 million of credit reserves we have provided for on the \$206 million principal balance of those securities.

Subordinate Securities

The fair value of our subordinate AFS securities was equal to 81% of the principal balance at September 30, 2014, and the amortized cost was equal to 73% of the principal balance. Credit losses totaled \$1 million in our residential subordinate portfolio

Table of Contents

during the third quarter of 2014, as compared to \$4 million of losses during the third quarter of 2013. We expect future losses will extinguish a portion of the outstanding principal of these securities, as reflected by the \$43 million of credit reserves we have provided for on the \$694 million principal balance of those securities.

Mortgage Servicing Rights

Our MSR's are held and managed at a taxable REIT subsidiary of ours and, typically, are directly acquired from loan originators and recognized through the transfer of loans to a third party or a Sequoia residential securitization sponsored by us that meets the GAAP criteria for sale. Although we retain the rights to service certain loans we securitize or sell, we employ a sub-servicer to perform these activities. Our receipt of MSR income is not subject to any covenants other than customary performance obligations associated with servicing residential loans. For loans that we have transferred into securitizations while maintaining the associated servicing rights, the sub-servicer we contract with to perform servicing activities may be terminated if it fails to perform under the applicable contractual terms. If the sub-servicer is terminated for a breach of contract, a new sub-servicer would need to be approved by the securitization's master servicer and assume the servicing responsibilities in accordance with the applicable pooling and servicing agreement. If a sub-servicer we contract with was to default, we would evaluate our MSR asset for impairment at that time.

The following table provides the activity for MSR's by portfolio for the three and nine months ended September 30, 2014.

Table 18 MSR Activity by Portfolio**Three Months Ended September 30, 2014**

| (In Thousands) | Jumbo | Conforming | Total MSR's |
|---|------------------|------------------|-------------------|
| Balance at beginning of period | \$ 56,038 | \$ 15,187 | \$ 71,225 |
| MSR's retained from Sequoia securitizations | 4,356 | - | 4,356 |
| MSR's retained from third-party loan sales | - | 14,630 | 14,630 |
| Purchased MSR's | - | 42,620 | 42,620 |
| Market valuation adjustments due to: | | | |
| Changes in assumptions | 2,582 | 1,741 | 4,323 |
| Other changes ⁽¹⁾ | (1,777) | (225) | (2,002) |
| Balance at End of Period | \$ 61,199 | \$ 73,953 | \$ 135,152 |
| Loans associated with MSR's ⁽²⁾ | 5,962,758 | 6,254,058 | 12,216,816 |
| MSR values as percent of loans ⁽³⁾ | 1.03% | 1.18% | 1.11% |

Nine Months Ended September 30, 2014

| (In Thousands) | Jumbo | Conforming | Total MSR's |
|---|-----------|------------|-------------|
| Balance at beginning of period | \$ 61,493 | \$ 3,331 | \$ 64,824 |
| MSR's retained from Sequoia securitizations | 6,542 | - | 6,542 |

Edgar Filing: REDWOOD TRUST INC - Form 10-Q

| | | | |
|---|-----------|-----------|------------|
| MSRs retained from third-party loan sales | 488 | 23,933 | 24,421 |
| Purchased MSRs | - | 45,309 | 45,309 |
| Market valuation adjustments due to: | | | |
| Changes in assumptions | (2,114) | 1,796 | (318) |
| Other changes ⁽¹⁾ | (5,210) | (416) | (5,626) |
| Balance at End of Period | \$ 61,199 | \$ 73,952 | \$ 135,151 |
| Loans associated with MSRs ⁽²⁾ | 5,962,758 | 6,254,058 | 12,216,816 |
| MSR values as percent of loans ⁽³⁾ | 1.03% | 1.18% | 1.11% |

(1) Represents changes due to realization of expected cash flows.

(2) Amounts represent the aggregate principal balance of loans associated with MSRs outstanding at September 30, 2014.

(3) Amounts represent the carrying value of MSRs at September 30, 2014 divided by the outstanding balance of the loans associated with these MSRs.

Table of Contents

The following table presents the components of MSR income for the three and nine months ended September 30, 2014 and 2013.

Table 19 MSR Income, Net

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|------------------------------|----------------------------------|-----------------|---------------------------------|------------------|
| | 2014 | 2013 | 2014 | 2013 |
| Servicing income | \$ 4,590 | \$ 3,008 | \$ 12,287 | \$ 5,820 |
| Cost of sub-servicer | (437) | (355) | (1,040) | (767) |
| Net servicing income | 4,153 | 2,653 | 11,247 | 5,053 |
| Market valuation adjustments | 2,321 | 460 | (5,944) | 9,628 |
| Provision for repurchases | (653) | - | (653) | - |
| Income from MSRs, Net | \$ 5,821 | \$ 3,113 | \$ 4,650 | \$ 14,681 |

The increase in MSR net servicing income in both the third quarter and the first nine months of 2014, compared to the same periods in 2013, was primarily attributable to higher balances of MSRs in 2014 resulting from MSR additions during the past year. The market value increases in the third quarter of 2014 as well as the three and nine months ending September 30, 2013, were primarily due to increases in mortgage interest rates during those periods. The market value declines in the first nine months of 2014 were primarily due to a decrease in mortgage interest rates during the first six months of 2014. Changes in interest rates generally result in changes to the expected prepayment speeds for the loans associated with our MSRs, which impact the MSRs fair value. At September 30, 2014 the 60-day plus delinquency rate was 0.01% and there were no loans greater than 90 days delinquent.

Residential Loans Held-for-Investment

During the third quarter of 2014, we transferred \$236 million of held-for-sale residential loans from our Residential Mortgage Banking segment and reclassified the loans to held-for-investment based on our intention to hold these loans for longer-term investment while they are financed through the FHLBC. At September 30, 2014, our investment in these loans was partially financed with \$204 million of long-term debt from our FHLB financing arrangement. During the third quarter of 2014, we recorded \$1 million of net interest income associated with these loans.

Direct Operating Expenses and Provision for Income Taxes

In the third quarter of 2014, the benefit for income taxes of less than \$1 million in our residential investments segment resulted from GAAP loss recorded at our taxable REIT subsidiaries associated with this segment. As the amount of GAAP income or loss changes at the taxable REIT subsidiary in future periods, the corresponding provision/benefit for income taxes will generally increase or decrease accordingly. However, this change may not always be evident as a significant portion of the GAAP income earned at this segment is recorded at the REIT, for which no tax provision is recorded.

Commercial Mortgage Banking and Investments

The following table presents the components of segment contribution for the commercial mortgage banking and investments segment for the three and nine months ended September 30, 2014 and 2013.

Table 20 Commercial Mortgage Banking and Investments Segment Contribution

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|-------------|--|-------------|
| | 2014 | 2013 | 2014 | 2013 |
| Interest income | \$ 12,603 | \$ 10,740 | \$ 34,204 | \$ 30,534 |
| Interest expense | (4,526) | (3,560) | (12,234) | (8,928) |
| Net interest income | 8,077 | 7,180 | 21,970 | 21,606 |
| Reversal of provision (provision for) loan losses | 888 | (844) | (56) | (2,419) |
| Mortgage banking activities, net | 6,486 | 3,538 | 12,300 | 16,284 |
| Realized gains, net | - | - | - | 210 |
| Direct operating expenses | (2,279) | (2,176) | (7,085) | (8,026) |
| Benefit from (provision for) income taxes | (1,764) | 29 | (2,159) | (1,689) |
| Total Segment Contribution | \$ 11,408 | \$ 7,727 | \$ 24,970 | \$ 25,966 |

Table of Contents

The following table provides the activity of commercial loans during the three and nine months ended September 30, 2014 and 2013.

Table 21 Commercial Loans Activity

| (In Thousands) | Three Months Ended September 30, | | | |
|---|----------------------------------|-------------------------|----------------------|-------------------------|
| | 2014 | | 2013 | |
| | Held-for-Sale (1) | Held-for- Investment | Held-for-Sale (1) | Held-for- Investment |
| Balance at beginning of period | \$ 50,848 | \$ 417,918 | \$ 149,470 | \$ 345,353 |
| Originations/acquisitions | 340,200 | 26,140 | 112,991 | 8,532 |
| Sales | (290,563) | - | (238,102) | - |
| Transfers between portfolios ⁽²⁾ | - | - | - | - |
| Principal repayments | (83) | (51,422) | (109) | (739) |
| Discount amortization | - | 184 | - | 138 |
| Reversal of provision (provision for) loan losses | - | 888 | - | (844) |
| Changes in fair value, net | 4,307 | (420) | 3,163 | - |
| Balance at End of Period | \$ 104,709 | \$ 393,288 | \$ 27,413 | \$ 352,440 |

| (In Thousands) | Nine Months Ended September 30, | | | |
|---|---------------------------------|-------------------------|----------------------|-------------------------|
| | 2014 | | 2013 | |
| | Held-for-Sale (1) | Held-for- Investment | Held-for-Sale (1) | Held-for- Investment |
| Balance at beginning of period | \$ 89,111 | \$ 343,344 | \$ 8,500 | \$ 304,510 |
| Originations/acquisitions | 577,530 | 65,131 | 416,224 | 63,071 |
| Sales | (536,549) | - | (399,865) | (230) |
| Transfers between portfolios ⁽²⁾ | (37,631) | 37,631 | - | - |
| Principal repayments | (253) | (55,723) | (264) | (12,955) |
| Discount amortization | - | 481 | - | 464 |
| Provision for loan losses | - | (56) | - | (2,420) |
| Changes in fair value, net | 12,501 | 2,480 | 2,818 | - |
| Balance at End of Period | \$ 104,709 | \$ 393,288 | \$ 27,413 | \$ 352,440 |

- (1) Beginning in the second quarter of 2013 and through the current period, we elected the fair value option for all of senior commercial loans we originated and we anticipate electing the fair value option for all future senior commercial loans that we originate and intend to sell to third parties.
- (2) During the first nine months of 2014, we sold three senior A-note commercial mortgages to third parties that did not qualify as sales under GAAP, and were not derecognized from our balance sheet. During the first quarter of 2014, these loans and the associated B-note mortgage loans we retained were transferred from held-for-sale to

held-for-investment classification and are carried at fair value on our consolidated balance sheets. At September 30, 2014, we held commercial loans with a total outstanding carrying value of \$498 million, consisting of our \$393 million held-for-investment portfolio of mostly mezzanine loans as well as \$105 million of senior mortgage loans held-for-sale through our mortgage banking operations.

The segment contribution from commercial mortgage banking and investments increased to \$11 million during the third quarter of 2014, as compared to \$8 million in the third quarter of 2013, and decreased to \$25 million in the first nine months of 2014, as compared to \$26 million in the first nine months of 2013. The year-over-year changes were primarily driven by changes in income from mortgage banking activities as described below.

Table of Contents*Mortgage Banking Activities, Net*

During the third quarter and first nine months of 2014, we originated 24 and 46 senior commercial mortgage loans, respectively, as compared to 12 and 33 senior commercial mortgage loans originated in the third quarter and first nine months of 2013, respectively. At September 30, 2014, there were seven senior loans held-for-sale with a carrying value of \$105 million.

Income from mortgage banking activities, net, increased to \$6 million in the third quarter of 2014 from \$4 million in the third quarter of 2013 and decreased to \$12 million in the first nine months of 2014 from \$16 million during the first nine months of 2013. The increase in mortgage banking income during the third quarter of 2014 was primarily due to increased origination volume, which was only partially offset by a decline in gain on sale margins. The decrease in mortgage banking income during the first nine months of 2014 was primarily due to a decline in gain on sale margins due to increased competition. The following table presents the components of commercial mortgage banking activities, net, for the three and nine months ended September 30, 2014 and 2013.

Table 22 *Components of Commercial Mortgage Banking Activities, Net⁽¹⁾*

| (In Thousands) | Three Months Ended September | | Nine Months Ended September | |
|---|------------------------------|-----------------|-----------------------------|------------------|
| | 2014 | 2013 | 2014 | 2013 |
| Changes in fair value of: | | | | |
| Commercial loans, at fair value | \$ 4,305 | \$ 3,171 | \$ 13,644 | \$ 2,826 |
| Risk management derivatives | 1,892 | 367 | (1,726) | 2,426 |
| Other fees | 289 | - | 382 | 1 |
| Net gains on commercial loan sales and originations | - | - | - | 11,031 |
| Total Mortgage Banking Activities, Net | \$ 6,486 | \$ 3,538 | \$ 12,300 | \$ 16,284 |

(1) Amounts reported as net gains on commercial loan sales and originations for 2013 relate to the sale of loans held at the lower of cost or fair value that were purchased or originated prior to when we began electing the fair value option for commercial loans held-for-sale and represent the net benefit of the gross proceeds from the sale of the loans, less the carrying value of the loans and any related issuance costs. As a result the majority of our income during the first nine months of 2014 was from loan sales and not from loans that were on our balance sheet at the end of the reporting period.

Our commercial mortgage banking activities are conducted in a taxable REIT subsidiary and our provision for income taxes is generally correlated to our income from mortgage banking activities. In certain periods, the relationship between these two amounts can change as a result of updates to our estimated annual effective tax rate. This was the case in the third quarter of 2013, which resulted in a benefit from income taxes during that period.

Commercial Investments

Our commercial investments portfolio is comprised almost entirely of mezzanine loans and at September 30, 2014, included 55 loans held-for-investment with an outstanding principal balance of \$332 million, an unamortized discount of \$2 million, an allowance for loan losses of \$7 million, and a carrying value of \$323 million. In addition, our held-for-investment portfolio also includes three senior commercial mortgage loans totaling \$71 million that were

each bifurcated into senior (A-note) and junior (B-note) portions. The A-notes were sold during the first nine months of 2014, but were not derecognized from our balance sheet as they did not qualify as sales in accordance with GAAP, and rather were treated as secured borrowings. A-notes that are sold and their associated secured debt are each held at fair value on our consolidated balance sheets and interest income, interest expense and fair value changes associated with these instruments offset each other and have no net impact to our operating results. Our credit exposure related to these investments resides in the associated B-notes that we retained, which totaled \$5 million as of September 30, 2014.

During the third quarter of 2014, we originated five mezzanine loans for \$26 million, as compared to two loans for \$9 million in the third quarter of 2013. At September 30, 2014, this portfolio included 31 non-securitized loans with a carrying value of \$118 million and 24 loans with a carrying value of \$205 million that are included in our Commercial Securitization with \$115 million of associated ABS issued long-term debt.

Net interest income related to our commercial investments increased \$1 million to \$8 million in the third quarter of 2014, and was unchanged at \$22 million for the first nine months of 2014, each as compared to the respective periods in 2013. Net interest income

Table of Contents

for the first nine months of 2013 included \$1 million of prepayment penalties related to a \$12 million mezzanine loan that prepaid during that period.

At September 30, 2014, we had one loan with a carrying value of \$26 million (net of allowance for loan losses) on watch list status. This loan is current on all payments and we continue to believe we will receive all amounts due in accordance with the contractual terms of the loan. However, in our judgment, certain conditions with this loan warrant closer management attention. Improvements in these conditions would result in the asset being removed from our watch list, whereas deterioration could warrant further downgrades and potential evaluation for impairment. At September 30, 2014, we had no loans designated as impaired and did not have any charge-offs during 2014. Our allowance for loan losses on our held-for-investment portfolio was \$7 million at both September 30, 2014 and December 31, 2013, representing 2.3% and 2.1%, respectively, of outstanding loans.

On average, our commercial loans held-for-investment have a maturity of more than four years, an unlevered yield in excess of 10% per annum before credit costs, a loan-to-value ratio of 73% at origination, and a debt service coverage ratio at origination of 1.31x based on our underwritten cash flows. The following table details principal balances and other characteristics for these loans by product type at September 30, 2014.

Table 23 Characteristics of Commercial Loans Held-for-Investment at Amortized Cost

| September 30, 2014 (Dollars In Thousands) | Number of Loans | Average Loan Size | Principal Balance | Percent of Total Principal | Weighted Average DSCR (1) | Weighted Average LTV (2) |
|--|--------------------|----------------------|----------------------|----------------------------------|------------------------------------|--------------------------------|
| Multi-family | 27 | \$ 8,497 | \$ 59,478 | 34% | 1.33 | 79% |
| Hospitality | 10 | 4,199 | 113,379 | 25% | 1.41 | 63% |
| Office | 7 | 8,546 | 51,277 | 19% | 1.23 | 76% |
| Retail | 6 | 6,333 | 19,000 | 15% | 1.16 | 76% |
| Self storage | 3 | 2,293 | 4,587 | 6% | 1.39 | 75% |
| Industrial | 2 | 8,454 | 84,537 | 1% | 1.37 | 70% |
| Total | 55 | \$ 6,041 | \$ 332,258 | 100% | 1.31 | 73% |

(1) The debt service coverage ratio (DSCR) is defined as the property's annual net operating income divided by the annual principal and interest payments. The weighted average DSCRs in this table are based on the ratios at the time the loans were originated and are not based on subsequent time periods during which there may have been increases or decreases in each property's operating income.

(2) The loan-to-value (LTV) calculation is defined as the sum of the senior and all subordinate loan amounts divided by the value of the property at the time the loan was originated.

The following table details principal balances for these loans by geographic concentration at September 30, 2014.

Table 24 Geographic Concentration of Commercial Loans Held-for-Investment at Amortized Cost

| Geographic Concentration (by Principal) | September 30, 2014 |
|--|---------------------------|
| California | 21% |
| New York | 20% |
| Florida | 11% |
| Michigan | 9% |
| Texas | 8% |
| Tennessee | 4% |
| Washington | 4% |
| Delaware | 3% |
| Other states (none greater than 3%) | 20% |
| Total | <u>100%</u> |

Table of Contents

Results of Legacy Consolidated Entities

During 2013 and 2014, Legacy Consolidated Entities include certain Sequoia securitization entities issued prior to 2012 that we consolidate for financial reporting purposes. The estimated carrying value of our investments in Legacy Consolidated Entities was \$67 million, or 5% of our equity capital base, at September 30, 2014. The carrying value reflects the estimated book value of our retained investments in these entities based on the difference between the consolidated assets and liabilities of the entities in the aggregate according to their GAAP carrying amounts. For the three months ended September 30, 2014, cash flow generated by our investments in these entities totaled \$4 million.

To show the impact of the Legacy Consolidated Entities to our consolidated financial results, we have included the following tables that present our consolidated GAAP income statements and balance sheets distributed between Legacy Consolidated Entities and the remainder of our operations, which we refer to as at Redwood. Results at Redwood include all activities from our three business segments and results from assets associated with our Residential Resecuritization completed in 2011 and our Commercial Securitization completed in 2012.

Table of Contents**Table 25 Consolidating Income Statement⁽¹⁾**

| (In Millions) | At Redwood | | Legacy Consolidated Entities Redwood Consolidated | | | |
|---|----------------------------------|-------|--|------|-------|-------|
| | Three Months Ended September 30, | | | | | |
| | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 |
| Interest income | \$ 57 | \$ 50 | \$ 6 | \$ 8 | \$ 63 | \$ 57 |
| Interest expense | (18) | (16) | (5) | (6) | (23) | (22) |
| Net interest income | 39 | 34 | 1 | 2 | 40 | 36 |
| Reversal of provision (provision) for loan losses | 1 | (1) | 1 | (1) | 2 | (2) |
| Net interest income after provision | 40 | 33 | 2 | 1 | 42 | 34 |
| Noninterest income | | | | | | |
| Mortgage banking activities, net | 18 | (9) | - | - | 18 | (9) |
| MSR income, net | 6 | 3 | - | - | 6 | 3 |
| Other market valuation adjustments, net | (3) | 1 | - | - | (4) | - |
| Realized gains, net | 8 | 10 | 1 | - | 9 | 10 |
| Total noninterest income (loss), net | 28 | 5 | 1 | - | 29 | 5 |
| Operating expenses | (21) | (22) | - | - | (21) | (22) |
| Other income | 2 | - | - | - | 2 | - |
| Net income before provision for taxes | 48 | 16 | 2 | 1 | 50 | 17 |
| Benefit from (provision for) income taxes | (5) | 5 | - | - | (5) | 5 |
| Net Income | \$ 43 | \$ 21 | \$ 2 | \$ 1 | \$ 45 | \$ 22 |

| (In Millions) | At Redwood | | Legacy Consolidated Entities Redwood Consolidated | | | |
|---|---------------------------------|--------|--|-------|--------|--------|
| | Nine Months Ended September 30, | | | | | |
| | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 |
| Interest income | \$ 157 | \$ 142 | \$ 19 | \$ 27 | \$ 177 | \$ 169 |
| Interest expense | (48) | (41) | (16) | (20) | (64) | (61) |
| Net interest income | 110 | 101 | 4 | 6 | 113 | 107 |
| Reversal of provision (provision) for loan losses | - | (2) | 1 | 2 | 1 | - |
| Net interest income after provision | 110 | 98 | 4 | 8 | 114 | 107 |
| Noninterest income | | | | | | |
| Mortgage banking activities, net | 24 | 86 | - | - | 24 | 86 |
| MSR income, net | 5 | 15 | - | - | 5 | 15 |
| Other market valuation adjustments, net | (13) | (6) | (1) | - | (14) | (6) |

Edgar Filing: REDWOOD TRUST INC - Form 10-Q

| | | | | | | |
|---------------------------------------|--------------|---------------|-------------|-------------|--------------|---------------|
| Realized gains, net | 10 | 23 | 1 | - | 11 | 23 |
| Total noninterest income (loss), net | 25 | 118 | - | - | 25 | 117 |
| Operating expenses | (64) | (67) | - | - | (64) | (67) |
| Other income | 2 | - | - | - | 2 | - |
| Net income before provision for taxes | 73 | 149 | 4 | 8 | 77 | 157 |
| Provision for income taxes | (4) | (9) | - | - | (4) | (9) |
| Net Income | \$ 69 | \$ 140 | \$ 4 | \$ 8 | \$ 73 | \$ 148 |

(1) Certain totals may not foot, due to rounding.

Table of Contents**Table 26 Consolidating Balance Sheet^{(1) (2)}**

| (In Millions) | At Redwood ⁽³⁾ | | Legacy Consolidated Entities ⁽⁴⁾ | | Redwood Consolidated | |
|---------------------------------------|---------------------------|-----------------|---|-----------------|----------------------|-----------------|
| | September 30, | December 31, | September 30, | December 31, | September 30, | December 31, |
| | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 |
| Residential loans | \$ 1,741 | \$ 404 | \$ 1,547 | \$ 1,762 | \$ 3,288 | \$ 2,166 |
| Commercial loans | 498 | 432 | - | - | 498 | 432 |
| Real estate securities, at fair value | 1,395 | 1,683 | - | - | 1,394 | 1,683 |
| MSRs, at fair value | 135 | 65 | - | - | 135 | 65 |
| Cash and cash equivalents | 150 | 173 | - | - | 150 | 173 |
| Total earning assets | 3,919 | 2,758 | 1,547 | 1,762 | 5,465 | 4,520 |
| Other assets | 140 | 81 | 6 | 8 | 146 | 89 |
| Total Assets | \$ 4,059 | \$ 2,838 | \$ 1,553 | \$ 1,770 | \$ 5,612 | \$ 4,609 |
| Short-term debt | \$ 1,888 | \$ 863 | \$ - | \$ - | \$ 1,888 | \$ 863 |
| Other liabilities | 103 | 79 | 1 | 1 | 104 | 81 |
| Asset-backed securities issued | 171 | 249 | 1,485 | 1,694 | 1,656 | 1,943 |
| Long-term debt | 697 | 476 | - | - | 697 | 476 |
| Total liabilities | 2,859 | 1,667 | 1,486 | 1,696 | 4,345 | 3,363 |
| Stockholders' equity | 1,200 | 1,171 | 67 | 75 | 1,267 | 1,246 |
| Total Liabilities and Equity | \$ 4,059 | \$ 2,838 | \$ 1,553 | \$ 1,770 | \$ 5,613 | \$ 4,609 |

(1) Certain totals may not foot, due to rounding.

(2) We are required under GAAP to consolidate the assets and liabilities of certain securitization entities we have sponsored for financial reporting purposes. However, the securitized assets of these entities are not legally ours and we own only the securities and interests that we acquired from these securitization entities. Similarly, the liabilities of these entities are obligations payable only from the cash flow generated by their securitized assets and are not obligations of Redwood.

(3) Included in the At Redwood column are the assets and liabilities of the Residential Resecuritization and Commercial Securitization transactions we completed in 2011 and 2012, respectively. These transactions are treated as secured borrowings under GAAP. At September 30, 2014, the Residential Resecuritization accounted for \$234 million of assets (\$233 million of available-for-sale securities and \$1 million of other assets) and \$57 million of asset-backed securities issued. Our \$177 million investment in this resecuritization, as estimated for

GAAP, equals the difference between these assets and liabilities. At September 30, 2014, the Commercial Securitization accounted for \$230 million of assets (\$205 million of commercial loans at historical cost and \$25 million of other assets) and \$115 million of asset-backed securities issued (at amortized cost). Our \$115 million investment in this securitization, as estimated for GAAP, equals the difference between these assets and liabilities.

- (4) Legacy Consolidated Entities includes certain Sequoia securitizations completed prior to 2012 that we are required to consolidate under GAAP. Our estimated GAAP investment in these entities was \$67 million at September 30, 2014, representing the difference between the aggregate carrying value of assets and liabilities of these entities.

Net Interest Income at Legacy Consolidated Entities

Net interest income from Legacy Consolidated Entities decreased \$1 million to \$1 million in the third quarter of 2014 and decreased \$2 million to \$4 million in the first nine months of 2014, each as compared to the respective periods in 2013. The decreases year-over-year were primarily attributable to continued principal paydowns of assets at these entities. Net interest income at Legacy Consolidated Entities will vary from period to period and depend primarily on the rate of principal repayments on loans and changes in the levels of delinquencies associated with consolidated loans. As the loans and associated liabilities pay down, net interest income will decline over time.

Table of Contents***Loan Loss Provision at Legacy Consolidated Entities***

Each quarter we utilize a loan loss reserving methodology that has been established to provide management with a reasonable and adequate estimate of loan loss reserving needs. This methodology is disclosed in *Note 3* and *Note 6* to the financial statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q.

The reversal of provision for loan losses at Legacy Consolidated Entities was less than \$1 million during the third quarter of 2014, as compared to provision expense of less than \$1 million in the third quarter of 2013. The reversal of provision for loan losses was less than the net charge-offs of \$1 million (or 0.09% of outstanding loan balances) for the third quarter of 2014, and the provision for loan losses was greater than the net charge-offs of \$1 million (or 0.04% of outstanding loan balances) for the third quarter of 2013. This resulted in a decrease of \$2 million and an increase of less than \$1 million in our allowance for loan losses for the three months ended September 30, 2014 and 2013, respectively. Charge-offs resulted from \$6 million and \$3 million of defaulted loan principal for the third quarters of 2014 and 2013, for average implied loss severities of 21% and 31%, respectively.

The allowance for loan losses decreased to \$22 million (or 1.41% of outstanding residential loans held-for-investment balances) at September 30, 2014, from \$23 million (or 1.24% of outstanding residential loans held-for-investment balances) at September 30, 2013. Serious delinquencies on loans held at Consolidated Sequoia Entities (90+ days delinquent) increased to \$73 million (or 4.70% of outstanding loan balances) at September 30, 2014, from \$69 million (or 3.70% of outstanding loan balances) at September 30, 2013. The increase in the allowance as a percentage of total outstanding loan balances during the past year is due to an increase in the balance of loans 90+ days delinquent. The reserve as a percentage of loans 90+ days delinquent decreased primarily due to lower loss severities on loans resulting from home price appreciation over the last two years. Loans originated in Florida, New Jersey, North Carolina, and Nevada accounted for 22% of total loans and 41% of the serious delinquent loan balance held by Sequoia entities at September 30, 2014.

At September 30, 2014, we estimate that there were four consolidated Sequoia entities for which the carrying value of the entity's liabilities exceeded the corresponding carrying value of the entity's assets. This is primarily attributable to the continued building of loan loss allowances in accordance with GAAP, resulting in lower asset carrying values. The aggregate estimated net assets (or equity) at these consolidated entities were less than negative \$2 million at September 30, 2014, an amount we expect to reverse through positive adjustments to earnings in future periods as the entities are retired or deconsolidated for financial reporting purposes.

Real Estate Loans at Legacy Consolidated Entities

The following table provides details of residential loan activity at Legacy Consolidated Entities for the three and nine months ended September 30, 2014 and 2013.

Table 27 Residential Loans at Legacy Consolidated Entities Activity

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--------------------------------|----------------------------------|--------------|---------------------------------|--------------|
| | 2014 | 2013 | 2014 | 2013 |
| Balance at beginning of period | \$ 1,616,505 | \$ 1,998,178 | \$ 1,762,168 | \$ 2,272,812 |
| Principal repayments | (67,026) | (130,766) | (209,578) | (402,920) |
| Charge-offs, net | 1,354 | 818 | 2,832 | 3,363 |
| Premium amortization | (1,046) | (1,642) | (3,251) | (5,105) |

Edgar Filing: REDWOOD TRUST INC - Form 10-Q

| | | | | |
|---|---------------------|---------------------|---------------------|---------------------|
| Transfers to REO | (3,988) | (1,052) | (6,349) | (5,424) |
| Reversal of provision (provision) for loan losses | 708 | (883) | 685 | 1,927 |
| Balance at End of Period | \$ 1,546,507 | \$ 1,864,653 | \$ 1,546,507 | \$ 1,864,653 |

Table of Contents***Loan Characteristics***

The following table highlights unpaid principal balances for loans at legacy Consolidated Sequoia Entities by product type at September 30, 2014. First lien adjustable rate mortgage (ARM) and hybrid loans comprise 91% of the consolidated portfolio and were primarily originated in 2005 or prior. Fixed-rate loans, which make up 8% of the portfolio, were primarily originated in 2009 or later. Of the \$48 million of hybrid loans held at legacy consolidated Sequoia securitization entities at September 30, 2014, \$28 million (or 59%) had reset as of September 30, 2014, and now act as ARM loans.

Table 28 *Loan Characteristics at Legacy Consolidated Entities***September 30, 2014**

| (Dollars In Thousands) | Principal Balance | Percent of Total |
|------------------------------------|--------------------------|-------------------------|
| First Lien | | |
| ARM | \$ 1,363,479 | 87.69% |
| Fixed | 130,412 | 8.39% |
| Hybrid (years to reset) | | |
| Reset ⁽¹⁾ | 28,519 | 1.83% |
| 0-4 | 6,097 | 0.39% |
| 5-8 | 13,742 | 0.89% |
| Second Lien | | |
| ARM | 12,627 | 0.81% |
| Total Outstanding Principal | \$ 1,554,876 | 100.00% |

(1) These loans represent hybrid loans that have reached the initial interest rate reset date and are currently adjustable rate mortgages.

For outstanding loans at legacy Consolidated Sequoia Entities at September 30, 2014, the weighted average FICO score (at origination) of borrowers backing these loans was 733 and the weighted average original LTV ratio was 66%.

The majority of hybrid loans and all of the fixed rate loans at the legacy consolidated Sequoia entities were securitized during 2010 and 2011. At September 30, 2014, fixed-rate loans had a weighted average coupon of 4.62%, ARM loans had a weighted average coupon of 1.56%, and hybrid loans had a weighted average coupon of 3.30%.

Taxable Income

The following table summarizes our taxable income and distributions to shareholders for the three and nine months ended September 30, 2014 and 2013. For each of these periods, we had no undistributed REIT taxable income.

Table 29 *Taxable Income*

| (In Thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---------------------------------------|----------------------------------|------------------|---------------------------------|------------------|
| | 2014 est. ⁽¹⁾ | 2013 | 2014 est. ⁽¹⁾ | 2013 |
| REIT taxable income | \$ 17,832 | \$ 19,990 | \$ 47,497 | \$ 56,299 |
| Taxable REIT subsidiary (loss) income | (1,988) | 26,415 | (5,734) | 19,016 |
| Total Taxable Income | \$ 15,844 | \$ 46,405 | \$ 41,763 | \$ 75,315 |
| Distributions to shareholders | \$ 23,274 | \$ 23,052 | \$ 69,616 | \$ 68,922 |

(1) Our tax results for 2014 are estimates until we file tax returns for this year.

Our estimated total taxable income for the three months ended September 30, 2014, was \$16 million (\$0.19 per share) and included \$1 million in realized credit losses on investments. This compared to taxable income for the three months ended September 30, 2013, of \$46 million (\$0.56 per share) that included \$3 million in realized credit losses. For the three months ended September 30, 2014, we realized net capital gains of \$14 million at the REIT for tax purposes.

Our estimated total taxable income for the nine months ended September 30, 2014, was \$42 million (\$0.50 per share) and included \$5 million in realized credit losses on investments. This compared to taxable income for the nine months ended September 30,

Table of Contents

2013, of \$75 million (\$0.92 per share) that included \$9 million in realized credit losses. For the nine months ended September 30, 2014, we realized net capital gains of \$15 million at the REIT for tax purposes.

For the three and nine months ended September 30, 2014, we recorded a tax provision of \$5 million and \$4 million, respectively. Our tax provisions relate to GAAP income earned at our TRS. We are currently benefiting from favorable timing differences between when income associated with our mortgage banking activities is recognized for GAAP purposes versus when it is recognized for tax purposes, thus deferring a significant portion of the tax liability on that income. The mortgage banking income is not expected to be excess inclusion income, was not earned at the REIT, and will not affect the tax characterization of our 2014 dividends. We did not record a material tax provision associated with taxable income generated at our REIT.

Differences between Estimated Total Taxable Income and GAAP Income

Differences between estimated taxable income and GAAP income are largely due to the following: (i) we cannot establish loss reserves for future anticipated events for tax but can for GAAP as realized credit losses are expensed when incurred for tax and these losses are anticipated through lower yields on assets or through loss provisions for GAAP; (ii) the timing, and possibly the amount, of some expenses (e.g., compensation expenses) are different for tax than for GAAP; (iii) since amortization and impairments differ for tax and GAAP, the tax and GAAP gains and losses on sales may differ, resulting in differences in realized gains on sale; (iv) at the REIT and certain TRS entities, unrealized gains and losses on market valuation adjustments of securities and derivatives are not recognized for tax until the instrument is sold or extinguished; (v) for tax, basis may not be assigned to mortgage servicing rights retained when whole loans are sold resulting in lower tax gain on sale; and, (vi) for tax, we do not consolidate securitization entities as we do under GAAP. As a result of these differences in accounting, our estimated taxable income can vary significantly from our GAAP income during certain reporting periods.

The tables below reconcile our estimated total taxable income to our GAAP income for the three and nine months ended September 30, 2014 and 2013.

Table 30 Differences between Estimated Total Taxable Income and GAAP Net Income

| (In Thousands, Except per Share Data) | Three Months Ended September 30, 2014 | | |
|--|--|-------------|--------------------|
| | Tax (Est.) | GAAP | Differences |
| Interest income | \$ 54,243 | \$ 63,351 | \$ (9,108) |
| Interest expense | (19,602) | (23,350) | 3,748 |
| Net interest income | 34,641 | 40,001 | (5,360) |
| Reversal of provision for loan losses | - | 1,596 | (1,596) |
| Realized credit losses | (1,083) | - | (1,083) |
| Mortgage banking activities, net | 759 | 17,872 | (17,113) |
| MSR income, net | 3,981 | 5,821 | (1,840) |
| Other market valuation adjustments, net | - | (3,706) | 3,706 |
| Operating expenses | (22,422) | (21,406) | (1,016) |
| Other income | - | 1,600 | (1,600) |
| Realized gains, net | - | 8,532 | (8,532) |
| Benefit from (provision for) income taxes | (32) | (5,213) | 5,181 |

| | | | |
|-------------------|-----------|-----------|-------------|
| Net Income | \$ 15,844 | \$ 45,097 | \$ (29,253) |
| Income per share | \$ 0.19 | \$ 0.50 | \$ (0.31) |

Table of Contents

| (In Thousands, Except per Share Data) | Three Months Ended September 30, 2013 | | |
|--|--|------------------|--------------------|
| | Tax | GAAP | Differences |
| Interest income | \$ 56,791 | \$ 57,420 | \$ (629) |
| Interest expense | (15,855) | (21,725) | 5,870 |
| Net interest income | 40,936 | 35,695 | 5,241 |
| Reversal of provision for loan losses | - | (1,727) | 1,727 |
| Realized credit losses | (2,757) | - | (2,757) |
| Mortgage banking activities, net | 26,214 | (8,698) | 34,912 |
| MSR income, net | 2,653 | 3,113 | (460) |
| Other market valuation adjustments, net | - | 462 | (462) |
| Operating expenses | (20,636) | (22,320) | 1,684 |
| Realized gains, net | - | 10,469 | (10,469) |
| Benefit from (provision for) income taxes | (5) | 4,935 | (4,940) |
| Net Income | \$ 46,405 | \$ 21,929 | \$ 24,476 |
| Income per share | \$ 0.56 | \$ 0.25 | \$ 0.31 |

| (In Thousands, Except per Share Data) | Nine Months Ended September 30, 2014 | | |
|--|---|------------------|--------------------|
| | Tax (Est.) | GAAP | Differences |
| Interest income | \$ 149,538 | \$ 176,820 | \$ (27,282) |
| Interest expense | (58,014) | (63,560) | 5,546 |
| Net interest income | 91,524 | 113,260 | (21,736) |
| Provision for loan losses | - | 629 | (629) |
| Realized credit losses | (5,186) | - | (5,186) |
| Mortgage banking activities, net | 8,925 | 23,950 | (15,025) |
| MSR income, net | 10,855 | 4,650 | 6,205 |
| Other market valuation adjustments, net | - | (13,966) | 13,966 |
| Operating expenses | (64,258) | (63,660) | (598) |
| Other income | - | 1,600 | (1,600) |
| Realized gains, net | - | 10,687 | (10,687) |
| Benefit from (provision for) income taxes | (97) | (3,703) | 3,606 |
| Net Income | \$ 41,763 | \$ 73,447 | \$ (31,684) |
| Income per share | \$ 0.50 | \$ 0.84 | \$ (0.34) |

| (In Thousands, Except per Share Data) | Nine Months Ended September 30, 2013 | | |
|--|---|-------------|--------------------|
| | Tax | GAAP | Differences |
| Interest income | \$ 158,456 | \$ 168,664 | \$ (10,208) |

Edgar Filing: REDWOOD TRUST INC - Form 10-Q

| | | | |
|---|-----------|------------|-------------|
| Interest expense | (41,922) | (61,444) | 19,522 |
| Net interest income | 116,534 | 107,220 | 9,314 |
| Reversal of provision for loan losses | - | (493) | 493 |
| Realized credit losses | (9,452) | - | (9,452) |
| Mortgage banking activities, net | 21,787 | 85,562 | (63,775) |
| MSR income, net | 5,053 | 14,681 | (9,628) |
| Other market valuation adjustments, net | - | (6,099) | 6,099 |
| Operating expenses | (58,363) | (66,937) | 8,574 |
| Realized gains, net | - | 23,291 | (23,291) |
| Benefit from (provision for) income taxes | (244) | (9,113) | 8,869 |
| Net Income | \$ 75,315 | \$ 148,112 | \$ (72,797) |
| Income per share | \$ 0.92 | \$ 1.65 | \$ (0.73) |

Table of Contents**Potential Taxable Income Volatility**

We expect period-to-period estimated taxable income volatility for a variety of reasons, including those described below.

Credit Losses on Securities and Loans

To determine estimated taxable income, we are generally not permitted to anticipate, or reserve for, credit losses on investments which are generally purchased at a discount. For tax purposes, we accrue the entire purchase discount on a security into taxable income over the expected life of the security. Estimated taxable income is reduced when actual credit losses occur. For GAAP purposes, we establish a credit reserve and only accrete a portion of the purchase discount, if any, into income and write-down securities that become impaired. Our income recognition is therefore faster for tax as compared to GAAP, especially in the early years of owning a security (when there are generally few credit losses). At September 30, 2014, the cumulative difference between the GAAP and tax amortized cost basis of our residential securities (excluding our investments in our consolidated securitization entities and IO securities) was \$30 million.

As we have no credit reserves or allowances for tax, any future credit losses on securities or loans will have a more significant impact on tax earnings than on GAAP earnings and may create significant taxable income volatility to the extent the level of credit losses fluctuates during reporting periods. We anticipate that credit losses will continue to be a significant, but declining, factor for determining taxable income. Credit losses are based on our tax basis, which differs materially from our basis for GAAP purposes. We anticipate an additional \$36 million of credit losses for tax on securities, based on our projection of principal balance losses and assuming a similar tax basis as we have recently experienced, although the timing of actual losses is difficult to accurately project. At September 30, 2014, for GAAP we had a designated credit reserve of \$74 million on our securities, and an allowance for loan losses of \$29 million for our consolidated residential and commercial loans.

Recognition of Gains and Losses on Sale

Since the computation of amortization and impairments on assets may differ for tax and GAAP, the tax and GAAP basis on assets sold or called may differ, resulting in differences in gains and losses on sale or call. In addition, gains realized for tax may be offset by prior capital losses and, thus, not affect taxable income. At September 30, 2014, the REIT had an estimated \$280 million in federal capital loss carryforwards (\$3.36 per share) that can be used to offset future capital gains over the next one to four years. Since our intention is to generally make long-term investments, it is difficult to anticipate when sales may occur and, thus, when or whether we might exhaust these capital loss carryforwards. At September 30, 2014, we had an estimated \$23 million in federal capital loss carryforwards at the TRS level. We anticipate selling most of our portfolio of appreciated IO securities within the capital loss carryforward period. Consequently, it is likely that the TRS will benefit from the use of the capital loss carryforwards.

Prepayments on Securities

We have retained certain IO securities at the time they were issued from Sequoia securitizations we sponsored. Our tax basis in these securities was \$79 million at September 30, 2014, which includes a tax basis of \$67 million for IOs retained from securitizations completed in 2010 and later. The return on IOs is sensitive to prepayments and, to the extent prepayments vary period to period, income from these IOs will vary. Typically, fast prepayments reduce yields and slow prepayments increase yields. We are not permitted to recognize a negative yield under tax accounting rules, so during periods of fast prepayments our periodic premium expense for tax purposes can be relatively low and the tax cost basis for these securities may not be significantly reduced. In periods prior to 2008, we experienced fast

prepayments on the loans underlying our IOs. More recently, prepayments on loans owned at Consolidated Sequoia Entities issued prior to 2010 have been slow, and our tax basis is now below the fair values for these IOs in the aggregate. If a Sequoia securitization is called, the remaining tax basis in the IO is expensed, creating an ordinary loss at the call date.

Prepayments also affect the taxable income recognition on other securities we own. We are required to use particular prepayment assumptions for the remaining lives of each security. As actual prepayment speeds vary, the yield we recognize for tax purposes will be adjusted accordingly. Thus, to the extent prepayments differ from our long-term assumptions or vary from period to period, the yield recognized will also vary and this difference could be material for a specific security.

Compensation Expense

The total tax expense for equity award compensation is dependent upon varying factors such as the timing of payments of dividend equivalent rights, the exercise of stock options, the distribution of deferred stock units and preferred stock units, and the cash deferrals to and withdrawals from our Executive Deferred Compensation Plan. For GAAP purposes, the total expense associated with

Table of Contents

an equity award is determined at the award date and is recognized over the vesting period. For tax, the total expense is recognized at the date of distribution or exercise, not the award date. In addition, some compensation may not be deductible for tax if it exceeds certain levels and is not performance-based. Thus, the total amount of compensation expense, as well as the timing, could be significantly different for tax than for GAAP.

As an example, for GAAP we expense the grant date fair value of performance stock units (PSUs) granted over the vesting term of those PSUs (regardless of the degree to which the performance conditions for vesting are ultimately satisfied, if at all), whereas for tax the value of the PSUs that actually vest in accordance with the performance conditions of those awards and are subsequently distributed to the award recipient is recorded as an expense on the date of distribution. For example, if no PSUs under a particular grant ultimately vest, due to the failure to satisfy the performance conditions, no tax expense will be recorded for those PSUs, even though we would have already recorded expense for GAAP equal to the grant date fair value of the PSU awards. Conversely, for example, if performance is such that a number of shares of common stock equal to 200% of the PSU award ultimately vest and are delivered to the award recipient, expense for tax will equal the common stock value on the date of distribution of 200% of the number of PSUs originally granted. This expense for tax could significantly exceed the recorded expense for GAAP.

In addition, since the decision to exercise options or distribute deferred stock units, performance stock units, or cash out of the Executive Deferred Compensation Plan is an employee s, it can be difficult to project when the tax expense will occur.

Mortgage Servicing Rights

For GAAP purposes, we recognize MSR assets through the acquisition of servicing rights from third parties or through the retention of MSR assets associated with residential loans that we have acquired and subsequently transferred to non-consolidated securitization entities or to third parties. For tax purposes, basis in our MSR assets is recognized through the acquisition of servicing rights from third parties, or to the extent that the MSR entitles us to receive a servicing fee that is in excess of a safe harbor amount prescribed by the Internal Revenue Service. Tax basis in our MSR assets is not recognized when MSR assets are retained from transfers of loans to non-consolidated securitization entities or to third parties thereby creating a temporary GAAP to tax difference on the gain from sale. For the nine months ended September 30, 2014, we purchased \$46 million of MSR assets on conforming loans that were recognized for tax purposes. No other tax basis in our MSR assets has been recognized to date.

For GAAP purposes, mortgage servicing fee income, net of servicing expense and changes in the estimated fair value of our MSR assets, is recognized on our consolidated income statement over the life of the MSR asset. For tax purposes, only mortgage servicing fee income, net of servicing expense is recognized as taxable income. Any MSR where basis is recognized for tax purposes through acquisition is amortized as a tax expense over a finite life.

LIQUIDITY AND CAPITAL RESOURCES**Summary**

Our principal sources of cash consist of borrowings under mortgage loan warehouse facilities, securities repurchase agreements, and our FHLB member subsidiary s borrowing facility with the FHLBC, payments of principal and interest we receive on our securities portfolio and commercial investments portfolio and cash generated from our operating activities. Our most significant uses of cash are to purchase mortgage loans for our residential and commercial mortgage banking operations, to fund investments in residential and commercial loans, to repay principal and interest on our warehouse facilities, repurchase agreements, and long-term debt, to purchase investment securities,

to make dividend payments on our capital stock, and to fund our operations.

Our rate of capital deployment in the second half of 2014 has required us to source additional capital to support the growth in our investment opportunities. During the third quarter of 2014, we generated approximately \$49 million of internal capital through the sale of \$456 million of residential securities. The securities we sold included lower yielding mezzanine securities and other senior securities financed with short-term repurchase debt and capital. These sales resulted in \$7 million of realized gains and reduced our short-term repurchase debt to \$647 million at September 30, 2014, from \$854 million at June 30, 2014. We also generated capital by more efficiently financing our accumulation of residential and commercial loans held for sale, utilizing warehouse financing facilities where we deemed it appropriate. While we believe our remaining investment capacity is sufficient to fund our near-term investment activities, we will likely need additional capital to make sustained long-term investments over the coming quarters. As a result, we are considering raising capital from outside sources, such as through a convertible debt offering or other medium- or long-term debt issuance.

Table of Contents

At September 30, 2014, we held \$150 million in cash, and our investment capacity (defined as the approximate amount of capital we had readily available for long-term investments) was estimated to be approximately \$145 million. Total capital of \$1.7 billion at September 30, 2014, included \$1.27 billion of equity capital, \$140 million of long-term debt, and \$288 million of long-term convertible debt.

In the ordinary course of our business, we use recourse debt through several different types of borrowing facilities and use cash borrowings under these facilities to, among other things, fund the acquisition of residential loans and the origination of commercial loans (including those we acquire and originate in anticipation of securitization), finance investments in securities and other investments, and otherwise fund our business and operations. At September 30, 2014, we had five short-term residential loan warehouse facilities with a total outstanding debt balance of \$1.19 billion (secured by residential loans with an aggregate fair value of \$1.32 billion) and a total borrowing limit of \$1.55 billion. At September 30, 2014, we also had short-term commercial loan warehouse facilities with a total outstanding debt balance of \$53 million (secured by commercial loans with an aggregate fair value of \$85 million). In addition, at September 30, 2014, we had an aggregate outstanding short-term debt balance of \$647 million under 10 securities repurchase facilities, which were secured by securities with a fair market value of \$812 million. We also had a secured line of credit with no outstanding debt balance and a total borrowing limit of \$10 million (secured by securities with a fair market value in excess of \$14 million) at September 30, 2014. At September 30, 2014, we also had a debt balance of \$204 million (secured by residential mortgage loans with a fair value of \$238 million) under our FHLB member subsidiary's borrowing facility with the FHLBC.

At September 30, 2014, we had \$1.89 billion of short-term debt outstanding. For the third quarter of 2014, the highest balance of our short-term debt outstanding was \$2.24 billion.

We are subject to risks relating to our liquidity and capital resources, including risks relating to incurring short-term debt under residential and commercial loan warehouse facilities, securities repurchase facilities, and other short- and long-term debt facilities and other risks relating to our use of derivatives. A further discussion of these risks is set forth below under the heading *Risks Relating to Debt Incurred Under Short- and Long-Term Borrowing Facilities* below in this Quarterly Report on Form 10-Q.

Cash Flows and Liquidity for the Nine Months Ended September 30, 2014

Cash flows from residential and commercial mortgage banking activities and other investments can be volatile from period to period depending on many factors, including the timing and amount of loan and securities acquisitions and sales, the profitability of mortgage banking activities, as well as changes in credit losses, prepayments, and interest rates. Therefore, cash flows generated in the current period is not necessarily reflective of the long-term cash flows we will receive from these investments or activities.

Cash Flows from Operating Activities

Cash flows from operating activities were negative \$1.53 billion in the first nine months of 2014. This amount was negative primarily due to the inclusion of the net cash utilized during the period from the purchase and sale of residential and commercial mortgage loans associated with our mortgage banking activities. Purchases of loans are financed to a large extent with short-term debt, for which changes in cash are included as a component of financing activities. Excluding cash flows from the purchase and sale of loans, cash flows from operating activities were close to zero in the first nine months of 2014.

Cash Flows from Investing Activities

Although we generally intend to hold our investment securities as long-term investments, we may sell certain of these securities in order to manage our interest rate risk and liquidity needs, to meet other operating objectives, and to adapt to market conditions. We cannot predict the timing and impact of future sales of investment securities, if any. Because many of our investment securities are financed through repurchase agreements, a significant portion of the proceeds from any sales of our investment securities would generally be used to repay balances under these financing sources. Similarly, all or a significant portion of cash flows from prepayments and scheduled amortization in respect of our investment securities would also generally be used to repay balances under these financing sources.

Cash Flows from Financing Activities

During the nine months ended September 30, 2014, we paid \$71 million of cash dividends on our common stock, representing a dividend of \$0.28 per share per quarter. In accordance with the terms of outstanding deferred stock units, which are stock-based

Table of Contents

compensation awards, each time we declare and pay a dividend on our common stock, we are required to make a dividend equivalent payment in that same per share amount on each outstanding deferred stock unit and restricted share.

In November 2013, our Board of Directors announced its intention to pay a regular dividend of \$0.28 per share per quarter in 2014. Our regular quarterly dividend rate is determined by our Board of Directors. Our Board's practice has been to announce its intention with respect to the regular quarterly dividend for the upcoming calendar year towards the end of the fourth quarter of each year. The consistency and sustainability of the dividend over time has always been an important consideration and priority. In recent years, the quarterly dividend rate has not been directly tied to GAAP or REIT taxable earnings for any particular quarter. In addition, in deliberating about dividends, the Board has generally considered numerous factors, including management's projections for the company's GAAP and REIT taxable earnings, and also projections of cash flows, capital, and liquidity. For example, in 2011, no change to the dividend rate was made, even though our earnings were lower than the quarterly dividend, as we invested in building our residential and commercial platforms.

During 2013, we issued \$287.5 million of convertible senior notes, as described in the long-term debt section that follows.

Long-Term Debt

FHLBC Borrowings

FHLBC borrowings include amounts, also referred to as advances, borrowed from the Federal Home Loan Bank of Chicago that are secured by eligible collateral, including, but not limited to, residential mortgage loans and residential mortgage-backed securities. FHLBC borrowings are carried at their unpaid principal balance and interest on these borrowings is paid (accrued). If the value (as determined by the FHLBC) of the collateral securing those borrowings decreases, we may be subject to margin calls during the period the borrowings are outstanding. In instances where we do not satisfy the margin calls within the required time frame, the FHLBC may foreclose upon the collateral and pursue any outstanding debt amount from us. Individual advances can be made with maturities ranging from one day to 30 years.

Commercial Long-term Debt

Commercial long-term debt reported in periods prior to the third quarter of 2014 includes borrowings under a master repurchase agreement that, as of the date reported, expired in more than one year with a financial institution counterparty. Beginning in the third quarter of 2014, amounts previously classified as commercial long-term debt were reclassified to short-term debt due to the associated agreement expiring in less than one year as of September 30, 2014.

Commercial Secured Borrowings

At September 30, 2014, we had commercial secured borrowings of \$66 million resulting from transfers of portions of senior commercial mortgage loans to third parties that did not meet the criteria for sale treatment under GAAP and were accounted for as financings. We structured certain of our senior commercial mortgage loans into a senior portion that was sold to a third party and a junior portion that we retained as an investment. Although GAAP requires us to record a secured borrowing liability when we receive cash from selling the senior portion of the loan, the liability has no economic substance to us in that it does not require periodic interest payments and has no maturity. For each commercial secured borrowing, at such time that the associated senior portion of the loan is repaid or we sell our

retained junior portion, the secured borrowing liability and associated senior portion of the loan would be derecognized from our balance sheet.

Convertible Notes

In March 2013, we issued \$287.5 million principal amount of 4.625% convertible senior notes that are convertible into 41.1320 shares of common stock per \$1,000 principal amount (equivalent to a conversion price of \$24.31 per common share and subject to certain adjustments) on or before their maturity in April 2018. After deducting the underwriting discount and issuance costs, we received approximately \$279 million of net proceeds. Including amortization of deferred issuance costs, the interest expense yield on our convertibles notes was 5.49% and 5.44% for the three and nine months ended September 30, 2014, respectively. At September 30, 2014, the accrued interest payable balance on this debt was \$6 million.

Table of Contents***Trust Preferred Securities and Subordinated Notes***

At September 30, 2014, we had trust preferred securities and subordinated notes of \$100 million and \$40 million, respectively issued by us in 2006 and 2007. This debt requires quarterly distributions at a floating rate equal to three-month LIBOR plus 2.25% until the notes are redeemed in whole. Beginning in the first quarter of 2011, we entered into interest rate swaps with aggregate notional values currently totaling \$140 million to hedge the variability in this long-term debt interest expense, fixing our gross interest expense yield at 6.75%. These swaps are accounted for as cash flow hedges with all interest income recorded as a component of net interest income and other valuation changes recorded as a component of equity.

Asset-Backed Securities

In July 2011, Redwood transferred \$365 million of residential securities into the Residential Resecuritization in connection with the issuance of \$245 million of ABS by the Residential Resecuritization to third parties. At September 30, 2014, there were \$233 million of securities owned at the Residential Resecuritization, which were funded with \$57 million of ABS issued.

In November 2012, Redwood transferred \$291 million (principal balance) of commercial loans into the Commercial Securitization in connection with the issuance of \$172 million of ABS by the Commercial Securitization to third parties. At September 30, 2014, there were \$205 million (carrying value) of commercial loans owned at the Commercial Securitization, which were funded with \$115 million of ABS issued.

At September 30, 2014, there were \$1.55 billion of loans owned at Sequoia securitization entities (Legacy Consolidated Entities), which were funded with \$1.48 billion of ABS issued at these entities. The loans and ABS issued from these entities are reported at their unpaid principal balances net of any unamortized premium or discount.

Risks Relating to Debt Incurred Under Short- and Long-Term Borrowing Facilities.

As described above under the heading *Results of Operations*, in the ordinary course of our business, we use debt financing obtained through several different types of borrowing facilities to, among other things, finance the acquisition of residential mortgage loans we acquire (including those we acquire in anticipation of sale or securitization), finance commercial mortgage loans we originate (including those we originate in anticipation of sale or securitization), finance the other commercial debt investments we originate and acquire, and finance investments in securities and other investments. We may also use short- and long-term borrowings to fund other aspects of our business and operations. Debt incurred under these facilities is either the direct obligation of Redwood Trust, Inc., or the direct obligation of subsidiaries of Redwood Trust, Inc. and guaranteed by Redwood Trust, Inc.

Residential Loan Warehouse Facilities. One source of our short-term debt financing is secured borrowings under residential loan warehouse facilities that are in place with five different financial institution counterparties. Under these five warehouse facilities, we had an aggregate borrowing limit of \$1.55 billion at September 30, 2014; however, these facilities are uncommitted, which means that any request we make to borrow funds under these facilities may be declined for any reason, even if at the time of the borrowing request we have then-outstanding borrowings that are less than the borrowing limits under these facilities. Short-term financing for residential mortgage loans is obtained under these facilities by our transfer of mortgage loans to the counterparty in exchange for cash proceeds (in an amount less than 100% of the principal amount of the transferred mortgage loans), and our covenant to reacquire those loans from the counterparty for the same amount plus a financing charge.

In order to obtain financing for a residential loan under these facilities, the loan must initially (and continuously while the financing remains outstanding) meet certain eligibility criteria, including, without limitation, that the loan is not in a delinquent status. In addition, under these warehouse facilities, residential loans can only be financed for a maximum period, which period would not generally exceed 364 days. We generally intend to repay the short-term financing of a loan under one of these facilities at or prior to the expiration of that financing with the proceeds of a securitization or other sale of that loan, through the proceeds of other short-term borrowings, or with other equity or long-term debt capital. While a residential loan is financed under a warehouse facility, to the extent the market value of the loan declines (which market value is generally determined by the counterparty under the facility), we are required to either immediately reacquire the loan or meet a margin requirement to pledge additional collateral, such as cash or additional residential loans, in an amount at least equal to the decline in value. See further discussion below under the heading *Margin Call Provisions Associated with Short-Term Debt and Other Debt Financing*.

Because these warehouse facilities are uncommitted, at any given time we may not be able to obtain additional financing under

Table of Contents

them when we need it, exposing us to, among other things, liquidity risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading *Risk Factors*, and below under the heading *Market Risks*. In addition, with respect to residential loans that at any given time are already being financed through these warehouse facilities, we are exposed to market, credit, liquidity, and other risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading *Risk Factors*, and below under the heading *Market Risks*, if and when those loans become ineligible to be financed, decline in value, or have been financed for the maximum term permitted under the applicable facility.

Under our residential loan warehouse facilities, we also make various representations and warranties and have agreed to certain covenants, events of default, and other terms that if breached or triggered can result in our being required to immediately repay all outstanding amounts borrowed under these facilities and these facilities being unavailable to use for future financing needs. In particular, the terms of these facilities include financial covenants, cross-default provisions, judgment default provisions, and other events of default (such as, for example, events of default triggered by one of the following: a change in control over Redwood, regulatory investigation or enforcement action against Redwood, Redwood's failure to continue to qualify as a REIT for tax purposes, or Redwood's failure to maintain the listing of its common stock on the New York Stock Exchange). Under a cross-default provision, an event of default is triggered (and the warehouse facility becomes unavailable and outstanding amounts borrowed thereunder become due and payable) if an event of default or similar event occurs under another borrowing or credit facility we maintain in excess of a specified amount. Under a judgment default provision, an event of default is triggered (and the warehouse facility becomes unavailable and outstanding amounts borrowed thereunder become due and payable) if a judgment for damages in excess of a specified amount is entered against us in any litigation and we are unable to promptly satisfy the judgment. Financial covenants included in these warehouse facilities are further described below under the heading *Financial Covenants Associated with Short-Term Debt and Other Debt Financing*.

These residential loan warehouse facilities could also become unavailable and outstanding amounts borrowed thereunder could become immediately due and payable if there is a material adverse change in our business. If we breach or trigger the representations and warranties, covenants, events of default, or other terms of our warehouse facilities, we are exposed to liquidity and other risks, including of the type described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading *Risk Factors*, and below under the heading *Market Risks*.

In addition to the five residential loan warehouse facilities described above, in the ordinary course of business we may seek to establish additional warehouse facilities that may be of a similar or greater size and may have similar or more restrictive terms. In the event a counterparty to one or more of our warehouse facilities becomes insolvent or unable or unwilling to perform its obligations under the facility, we may be unable to access short-term financing we need or fail to recover the full value of our residential mortgage loans financed.

Securities Repurchase Facilities. Another source of short-term debt financing is through securities repurchase facilities we have established with various different financial institution counterparties. Under these facilities we do not have an aggregate borrowing limit; however, these facilities are uncommitted, which means that any request we make to borrow funds under these facilities may be declined for any reason. Short-term financing for securities is obtained under these facilities by our transfer of securities to the counterparty in exchange for cash proceeds (in an amount less than 100% of the fair value of the transferred securities), and our covenant to reacquire those securities from the counterparty for the same amount plus a financing charge.

Under these securities repurchase facilities, securities are financed for a fixed period, which would not generally exceed 90 days. We generally intend to repay the short-term financing of a security under one of these facilities through a renewal of that financing with the same counterparty, through a sale of the security, or with other equity or

long-term debt capital. While a security is financed under a securities repurchase facility, to the extent the value of the security declines (which value is generally determined by the counterparty under the facility), we are required to either immediately reacquire the security or meet a margin requirement to pledge additional collateral, such as cash or U.S. Treasury securities, in an amount at least equal to the decline in value. See further discussion below under the heading *Margin Call Provisions Associated with Short-Term Debt and Other Debt Financing*.

At the end of the fixed period applicable to the financing of a security under a securities repurchase facility, if we intend to continue to obtain financing for that security we would typically request the same counterparty to renew the financing for an additional fixed period. If the same counterparty does not renew the financing, it may be difficult for us to obtain financing for that security under one of our other securities repurchase facilities, due to the fact that the financial institution counterparties to our securities repurchase facilities generally only provide financing for securities that we purchased from them or one of their affiliates.

Table of Contents

Because our securities repurchase facilities are uncommitted, at any given time we may not be able to obtain additional financing under them when we need it, exposing us to, among other things, liquidity risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading *Risk Factors*, and below under the heading *Market Risks*. In addition, with respect to securities that at any given time are already being financed through our securities repurchase facilities, we are exposed to market, credit, liquidity, and other risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading *Risk Factors*, below under the heading *Market Risks*, if and when those securities decline in value, or have been financed for the maximum term permitted under the applicable facility.

Under our securities repurchase facilities, we also make various representations and warranties and have agreed to certain covenants, events of default, and other terms (including of the type described above under the heading *Residential Loan Warehouse Facilities*) that if breached or triggered can result in our being required to immediately repay all outstanding amounts borrowed under these facilities and these facilities being unavailable to use for future financing needs. In particular, the terms of these facilities include financial covenants, cross-default provisions, judgment default provisions, and other events of default (including of the type described above under the heading *Residential Loan Warehouse Facilities*). Financial covenants included in our repurchase facilities are further described below under the heading *Financial Covenants Associated with Short-Term Debt and Other Debt Financing*.

Our securities repurchase facilities could also become unavailable and outstanding amounts borrowed thereunder could become immediately due and payable if there is a material adverse change in our business. If we breach or trigger the representations and warranties, covenants, events of default, or other terms of our securities repurchase facilities, we are exposed to liquidity and other risks, including of the type described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading *Risk Factors*, and below under the heading *Market Risks*.

In the ordinary course of business we may seek to establish additional securities repurchase facilities that may have similar or more restrictive terms. In the event a counterparty to one or more of our securities repurchase facilities becomes insolvent or unable or unwilling to perform its obligations under the facility, we may be unable to access the short-term financing we need or fail to recover the full value of our securities financed.

Commercial Mortgage Loan Warehouse Facility. Another source of short-term debt financing is secured borrowings under a commercial mortgage loan warehouse facility that is in place with a financial institution counterparty. Under this warehouse facility, we had an aggregate borrowing limit of \$190 million at September 30, 2014; however, this facility is uncommitted, which means that any request we make to borrow funds under this facility may be declined for any reason, even if at the time of the borrowing request we have then-outstanding borrowings that are less than the borrowing limits under this facility. Short-term financing for commercial mortgage loans is obtained under this facility by our transfer of commercial mortgage loans to a special purpose entity which transfers them to the counterparty in exchange for cash proceeds (in an amount less than 100% of the principal amount of the transferred commercial mortgage loans), and our covenant to reacquire those commercial mortgage loans from the counterparty for the same amount plus a financing charge. Other periodic payments are also due under the facility.

In order to obtain financing for a commercial mortgage loan under this facility, the commercial mortgage loan must initially (and continuously while the financing remains outstanding) meet certain eligibility criteria, including, without limitation, that the commercial mortgage loan is not in a delinquent status. In addition, under this facility, a commercial mortgage loan can only be financed for a maximum period, which period would not generally exceed 180 days. We generally intend to repay the short-term financing of a commercial mortgage loan under this facility at or prior to the expiration of the financing term with the proceeds of a sale or securitization of that commercial mortgage loan, through the proceeds of other short-term borrowings, or with other equity or long-term debt capital. While a

commercial mortgage loan is financed under this facility, to the extent the market value of the commercial mortgage loan declines (which market value is generally determined by the counterparty under the facility), we are required to either immediately reacquire the commercial mortgage loan or meet a margin requirement to pledge additional collateral, such as cash or additional commercial mortgage loans, in an amount at least equal to the decline in value. See further discussion below under the heading *Margin Call Provisions Associated with Short-Term Debt and Other Debt Financing*.

Because this warehouse facility is uncommitted, at any given time we may not be able to obtain additional financing under this facility when we need it, exposing us to, among other things, liquidity risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading *Risk Factors*, and below under the heading *Market Risks*. In addition, with respect to commercial mortgage loans that at any given time are already being financed through this facility, we are exposed to market, credit, liquidity, and other risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading *Risk Factors*, and below under the heading *Market Risks*, if and when

Table of Contents

those commercial mortgage loans become ineligible to be financed, decline in value, or have been financed for the maximum term permitted under the facility.

Under our commercial mortgage loan warehouse facility, we also make various representations and warranties and have agreed to certain covenants, events of default, and other terms that if breached or triggered can result in our being required to immediately repay all outstanding amounts borrowed under this facility and this facility being unavailable to use for future financing needs. In particular, the terms of this facility include financial covenants, cross-default provisions, judgment default provisions, and other events of default (including of the type described above under the heading *Residential Loan Warehouse Facilities*). Financial covenants included in this warehouse facility are further described below under the heading *Financial Covenants Associated with Short-Term Debt and Other Debt Financing*.

Our commercial mortgage loan warehouse facility could also become unavailable and outstanding amounts borrowed thereunder could become immediately due and payable if there is a material adverse change in our business. If we breach or trigger the representations and warranties, covenants, events of default, or other terms of this facility, we are exposed to liquidity and other risks, including of the type described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading *Risk Factors*, and below under the heading *Market Risks*.

In addition to the commercial mortgage loan warehouse facility described above, in the ordinary course of business we may seek to establish additional facilities that may be of a similar or greater size and may have similar or more restrictive terms. In the event a counterparty to one or more of our facilities becomes insolvent or unable or unwilling to perform its obligations under a facility, we may be unable to access the financing we need or we may fail to recover the full value of our commercial mortgage loans financed under the applicable facility.

Other Short-Term Debt Facilities. We also maintain a \$10 million committed line of short-term credit from a bank, which is secured by our pledge of certain mortgage-backed securities we own. This bank line of credit is an additional source of short-term financing for us. Similar to the uncommitted warehouse and securities repurchase facilities described herein, under this committed line we make various representations and warranties and have agreed to certain covenants, events of default, and other terms that if breached or triggered can result in our being required to immediately repay all outstanding amounts borrowed under this facility and this facility being unavailable to use for future financing needs. The margin call provisions and financial covenants included in this committed line are further described below under the headings *Margin Call Provisions Associated with Short-Term Debt and Other Debt Financing* and *Financial Covenants Associated with Short-Term Debt and Other Debt Financing*. When we use this committed line to incur short-term debt we are exposed to the market, credit, liquidity, and other types of risks described above with respect to residential loan warehouse and securities repurchase facilities.

Commercial Debt Investment Repurchase Facility. Another source of debt financing is secured borrowings through a commercial debt investment repurchase facility that is in place with a financial institution counterparty. Under this repurchase facility, we have an aggregate borrowing limit of \$150 million; however, any request we make to borrow funds under this facility secured by a particular commercial debt investment may be declined for any reason, even if at the time of the borrowing request we have then-outstanding borrowings that are less than the borrowing limits under this facility. Financing for commercial debt investments is obtained under this facility by our transfer of commercial debt investments to a special purpose entity which is beneficially owned by the counterparty in exchange for cash proceeds (in an amount less than 100% of the principal amount of the transferred commercial debt investments), and our covenant to reacquire those commercial debt investments for the same amount plus a financing charge. Other periodic payments are also due under the facility.

In order to obtain financing for a commercial debt investment under this facility, the commercial debt investment must initially (and continuously while the financing remains outstanding) meet certain eligibility criteria, including, without limitation, that the commercial debt investment is not in a delinquent status. This facility has an original three-year term. We generally intend to repay the financing of a commercial debt investment under this facility at or prior to the expiration of the financing term with the proceeds of a securitization or other sale of that commercial debt investment, or with other equity or long-term debt capital. While a commercial debt investment is financed under this facility, to the extent the value of the commercial debt investment declines (which value is generally determined by the counterparty under the facility), we are required to either immediately reacquire the commercial debt investment or meet a margin requirement to pledge additional collateral, such as cash or additional commercial debt investments, in an amount at least equal to the decline in value. See further discussion below under the heading *Margin Call Provisions Associated with Short-Term Debt and Other Debt Financing*.

Because the counterparty under this facility retains discretion to accept or reject a financing with respect to any particular

Table of Contents

commercial debt investment, at any given time we may not be able to obtain additional financing under this facility when we need it, exposing us to, among other things, liquidity risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading *Risk Factors*, and below under the heading *Market Risks*. In addition, with respect to commercial debt investments that at any given time are already being financed through this facility, we are exposed to market, credit, liquidity, and other risks of the types described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading *Risk Factors*, and below under the heading *Market Risks*, if and when those commercial debt investments become ineligible to be financed, decline in value, or have been financed for the maximum term permitted under the facility.

Under our commercial debt investment repurchase facility, we also make various representations and warranties and have agreed to certain covenants, events of default, and other terms that if breached or triggered can result in our being required to immediately repay all outstanding amounts borrowed under this facility and this facility being unavailable to use for future financing needs. In particular, the terms of this facility include financial covenants, cross-default provisions, judgment default provisions, and other events of default (including of the type described above under the heading *Residential Loan Warehouse Facilities*). Financial covenants included in our repurchase facilities are further described below under the heading *Financial Covenants Associated with Short-Term Debt and Other Debt Financing*.

Our commercial debt investment repurchase facility could also become unavailable and outstanding amounts borrowed thereunder could become immediately due and payable if there is a material adverse change in our business. If we breach or trigger the representations and warranties, covenants, events of default, or other terms of this facility, we are exposed to liquidity and other risks, including of the type described in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013, under the heading *Risk Factors*, and below under the heading *Market Risks*.

In addition to the commercial debt investment repurchase facility described above, in the ordinary course of business we may seek to establish additional facilities that may be of a similar or greater size and may have similar or more restrictive terms. In the event a counterparty to one or more of our facilities becomes insolvent or unable or unwilling to perform its obligations under a facility, we may be unable to access the financing we need or we may fail to recover the full value of our commercial debt investments financed under the applicable facility.

FHLB Borrowing Facility. Another source of debt financing is secured borrowings by our wholly-owned subsidiary, RWT Financial, LLC, through a borrowing facility with the Federal Home Loan Bank of Chicago (FHLBC) that was put into place in July 2014. This facility is uncommitted, which means that any request we make to borrow funds under this facility may be declined for any reason. Borrowings under this facility, also referred to as advances, are required to be secured by eligible collateral including, but not limited to, residential mortgage loans and residential mortgage-backed securities. Individual advances can be made with maturities ranging from one day to 30 years. Similar to the uncommitted warehouse and securities repurchase facilities described herein, under this facility we make various representations and warranties and have agreed to certain covenants, events of default, and other terms that if breached or triggered can result in our being required to immediately repay all outstanding amounts borrowed under this facility and this facility being unavailable to use for future financing needs. The margin call provisions and financial covenants included in this facility are further described below under the headings *Margin Call Provisions Associated With Short-Term Debt and Other Debt Financing* and *Financial Covenants Associated With Short-Term Debt and Other Debt Financing*. When we use this facility to incur debt we are exposed to the market, credit, liquidity, and other types of risks described above with respect to residential loan warehouse and securities repurchase facilities.

Financial Covenants Associated With Short-Term Debt and Other Debt Financing

Set forth below is a summary of the financial covenants associated with our short-term debt and other debt financing facilities.

Residential Loan Warehouse Facilities. As noted above, one source of our short-term debt financing is secured borrowings under residential loan warehouse facilities we have established with five different financial institution counterparties. Financial covenants included in these warehouse facilities are as follows and at September 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we were in compliance with each of these financial covenants:

- i Maintenance of a minimum dollar amount of stockholders' equity/tangible net worth at Redwood.

- i Maintenance of a minimum dollar amount of cash and cash equivalents at Redwood or maintenance of an amount of cash and cash equivalents in excess of a specified percentage of outstanding short-term recourse indebtedness.

Table of Contents

- i Maintenance of a minimum ratio of consolidated recourse indebtedness to stockholders' equity and tangible net worth at Redwood.
- i Maintenance of uncommitted residential loan warehouse facilities with a specified level of unused borrowing capacity.

Securities Repurchase Facilities. As noted above, another source of our short-term debt financing is through secured borrowings under securities repurchase facilities we have established with various financial institution counterparties. Financial covenants included in these securities repurchase facilities are as follows and at September 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we were in compliance with each of these financial covenants:

- i Maintenance of a minimum dollar amount of stockholders' equity/tangible net worth at Redwood.
- i Maintenance of a minimum dollar amount of cash and cash equivalents at Redwood.
- i Maintenance of a minimum ratio of consolidated recourse indebtedness to consolidated adjusted tangible net worth at Redwood.

Commercial Mortgage Loan Warehouse Facility. As noted above, another source of our short-term debt financing is secured borrowings under a commercial mortgage loan warehouse facility that we have in place with a financial institution counterparty. Financial covenants included in this facility are as follows and at September 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we were in compliance with each of these financial covenants:

- i Maintenance of a minimum dollar amount of stockholders' equity/tangible net worth at Redwood.
- i Maintenance of a minimum dollar amount of cash and cash equivalents at Redwood.
- i Maintenance of a minimum ratio of consolidated recourse indebtedness to stockholders' equity at Redwood, including a separate minimum ratio for commercial assets which is applicable under certain specified circumstances.

Committed Line of Credit. As noted above, we also maintain a \$10 million committed line of short-term credit from a bank, which is secured by our pledge of certain mortgage-backed securities we own. The types of financial covenants included in this bank line of credit are a subset of the covenants summarized above.

Commercial Debt Investment Repurchase Facility. As noted above, one source of our debt financing is secured borrowings under a commercial debt investment repurchase facility we have established with a financial institution counterparty. Financial covenants included in this facility are as follows and at September 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we were in compliance with each of these financial covenants:

- i Maintenance of a minimum dollar amount of stockholders' equity/tangible net worth at Redwood.
- i Maintenance of a minimum dollar amount of cash and cash equivalents at Redwood.
- i Maintenance of a minimum ratio of consolidated recourse indebtedness to stockholders' equity at Redwood.

FHLB Borrowing Facility. As noted above, a wholly-owned subsidiary of ours, RWT Financial, also maintains a borrowing facility with the FHLBC, borrowings under which are required to be secured by eligible collateral including, but not limited to, residential mortgage loans and residential mortgage-backed securities. Financial covenants included in this facility are as follows and at September 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we were in compliance with each of these financial covenants:

- i Maintenance by RWT Financial of a minimum ratio of total liabilities (excluding debt subordinated to the FHLBC and non-recourse debt) to stockholders' equity and debt subordinated to the FHLBC.
- i Maintenance by RWT Financial of a minimum level of unencumbered assets based on the level of indebtedness to the FHLBC.
- i Maintenance of a minimum ratio of total liabilities (excluding non-recourse debt) to stockholders' equity at Redwood.
- i Maintenance of a minimum dollar amount of cash and cash equivalents at Redwood.

As noted above, at September 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we were in compliance with the financial covenants associated with our short-term debt and other debt financing facilities. In particular, with respect to: (i) financial covenants that require us to maintain a minimum dollar amount of stockholders' equity or tangible net worth, at September 30, 2014 our level of stockholders' equity and tangible net worth resulted in our being in compliance with these covenants.

Table of Contents

by more than \$200 million; and (ii) financial covenants that require us to maintain recourse indebtedness below a specified ratio, at September 30, 2014 our level of recourse indebtedness resulted in our being in compliance with these covenants at a level such that we could incur at least \$600 million in additional recourse indebtedness.

Margin Call Provisions Associated With Short-Term Debt and Other Debt Financing

Residential Loan Warehouse Facilities. As noted above, one source of our short-term debt financing is secured borrowings under residential loan warehouse facilities we have established with five different financial institution counterparties. These warehouse facilities include the margin call provisions described below and during the three months ended September 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we complied with any margin calls received from creditors under these warehouse facilities:

- i If at any time the market value (as determined by the creditor) of any residential mortgage loan financed under a facility declines, then the creditor may demand that we transfer additional collateral to the creditor (in the form of cash, U.S. Treasury obligations (in certain cases), or additional residential mortgage loans) with a value equal to the amount of the decline. If we receive any such demand, (i) under three of our residential loan warehouse facilities, we would generally be required to transfer the additional collateral on the same day (although demands received after a certain time would only require the transfer of additional collateral on the following business day) and (ii) under two of our residential loan warehouse facilities, we would generally be required to transfer the additional collateral on the following business day. The value of additional residential mortgage loans transferred as additional collateral is determined by the creditor

Securities Repurchase Facilities. Another source of our short-term debt financing is through secured borrowings under securities repurchase facilities we have established with various financial institution counterparties. These repurchase facilities include the margin call provisions described below and during the three months ended September 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we complied with any margin calls received from creditors under these repurchase facilities

- i If at any time the market value (as determined by the creditor) of any securities financed under a facility declines, then the creditor may demand that we transfer additional collateral to the creditor (in the form of cash, U.S. Treasury obligations, or additional securities) with a value equal to the amount of the decline. If we receive any such demand, we would generally be required to transfer the additional collateral on the same day. The value of additional securities transferred as additional collateral is determined by the creditor.

Commercial Mortgage Loan Warehouse Facility. As noted above, another source of our short-term debt financing is secured borrowings under a commercial mortgage loan warehouse facility we have in place with a financial institution counterparty. This facility includes the margin call provisions described below and during the three months ended September 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we complied with any margin calls received from the creditor under this facility:

- i If at any time the market value (as determined by the creditor) of any commercial mortgage loan financed under the facility declines, then the creditor may demand that we transfer additional collateral to the creditor (in the form of cash or additional commercial mortgage loans) with a value equal to the amount of the decline. If we receive any such demand, we would generally be required to transfer the additional collateral on the following business day. The value of additional commercial mortgage loans transferred as additional collateral is determined by the creditor.

Committed Line of Credit. As noted above, we also maintain a \$10 million committed line of short-term credit from a bank, which is secured by our pledge of certain mortgage-backed securities we own. Margin call provisions included in this bank line of credit are as follows and during the three months ended September 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we complied with any margin calls received from this creditor under this line of credit:

- i If at any time the total market value (as determined by two broker-dealers) of the securities that are pledged as collateral under this facility declines to a value less than the outstanding amount of borrowings under this facility, then the creditor may demand that we transfer additional collateral to the creditor (in the form of cash, U.S. Treasury obligations, or additional securities) with a value equal to the amount of the difference. If we receive any such demand, we would generally be required to transfer the additional collateral within two business days. The value of additional collateral pledged is determined by the creditor.

Commercial Debt Investment Repurchase Facility. As noted above, one source of our debt financing is secured borrowings under a commercial debt investment repurchase facility we have established with a financial institution counterparty. This

Table of Contents

facility includes the margin call provisions described below during the three months ended September 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we complied with any margin calls received from the creditor under this facility:

- i If at any time the asset value (as determined by the creditor) of any commercial debt investment financed under the facility declines, then the creditor may demand that we transfer additional collateral to the creditor (in the form of cash or additional commercial debt investments) with a value equal to the amount of the decline. If we receive any such demand, we would generally be required to transfer the additional collateral on the second business day thereafter (although demands received after a certain time would allow an additional business day for the transfer of additional collateral to occur). The value of additional commercial debt investments transferred as additional collateral is determined by the creditor.

FHLB Borrowing Facility. As noted above, a wholly-owned subsidiary of ours, RWT Financial, also maintains a borrowing facility with the FHLBC, borrowings under which are required to be secured by eligible collateral including, but not limited to, residential mortgage loans and residential mortgage-backed securities. This facility includes the margin call provisions described below during the three months ended September 30, 2014, and through the date of this Quarterly Report on Form 10-Q, we complied with any margin calls received from the creditor under this facility.

- i If we become aware or have reason to believe that the collateral value of our qualifying collateral has fallen below the required collateral maintenance level (based on information, including but not limited to, updated appraisals, revised model valuations and information obtained in connection with our evaluation of our loan loss reserves), or that a contingency exists which with the lapse of time would result in our failing to meet the collateral maintenance level, or if any collateral ceases to be qualifying collateral, we must deliver additional qualifying collateral sufficient to maintain the required collateral maintenance level.

OFF BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS

Off Balance Sheet Arrangements

We do not have any material off balance sheet arrangements.

Table of Contents**Contractual Obligations**

The following table presents our contractual obligations and commitments at September 30, 2014, as well as the obligations of the securitization entities that we sponsor and consolidate for financial reporting purposes.

Table 31 Contractual Obligations and Commitments

| September 30, 2014 (In Millions) | Payments Due or Commitment Expiration by Period | | | | Total |
|--|---|-----------------|-----------------|------------------|-----------------|
| | Less Than 1 Year | 1 to 3 Years | 3 to 5 Years | After 5 Years | |
| Obligations of Redwood | | | | | |
| Short-term debt | \$ 1,888 | \$ - | \$ - | \$ - | \$ 1,888 |
| Convertible notes | - | - | 288 | - | 288 |
| Anticipated interest payments on convertible notes | 13 | 27 | 13 | - | 53 |
| FHLBC borrowings | - | 26 | - | 178 | 204 |
| Anticipated interest payments on FHLBC borrowings | 1 | 8 | 11 | 30 | 50 |
| Other long-term debt | - | - | - | 140 | 140 |
| Anticipated interest payments on other long-term debt ⁽¹⁾ | 9 | 19 | 19 | 164 | 211 |
| Accrued interest payable | 9 | - | - | - | 9 |
| Operating leases | 3 | 6 | 2 | 3 | 14 |
| Total Redwood Obligations and Commitments | \$ 1,923 | \$ 86 | \$ 333 | \$ 515 | \$ 2,857 |

Obligations of Consolidated Entities for Financial Reporting Purposes

| | | | | | |
|--|-----------------|---------------|---------------|-----------------|-----------------|
| Consolidated ABS ⁽²⁾ | \$ - | \$ 18 | \$ - | \$ 1,649 | \$ 1,667 |
| Anticipated interest payments on ABS ⁽³⁾ | 26 | 74 | 90 | 328 | 518 |
| Accrued interest payable | 2 | - | - | - | 2 |
| Total Obligations of Entities Consolidated for Financial Reporting Purposes | 28 | 92 | 90 | 1,977 | 2,187 |
| Total Consolidated Obligations and Commitments | \$ 1,951 | \$ 178 | \$ 423 | \$ 2,492 | \$ 5,044 |

(1) Includes anticipated interest payments related to hedges.

(2) All consolidated ABS issued are collateralized by real estate loans and securities. Although the stated maturity is as shown, the ABS obligations will pay down as the principal balances of these real estate loans or securities pay down. The amount shown is the principal balance of the ABS issued and not necessarily the value reported in our consolidated financial statements.

- (3) The anticipated interest payments on consolidated ABS issued is calculated based on the contractual maturity of the ABS and therefore assumes no prepayments of the principal outstanding at September 30, 2014.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates. A discussion of critical accounting policies and the possible effects of changes in estimates on our financial statements is included in *Note 3 Summary of Significant Accounting Policies* included in Part I, Item 1 of this Quarterly Report on Form 10-Q. Management discusses the ongoing development and selection of these critical accounting policies with the audit committee of the board of directors.

We expect quarter-to-quarter GAAP earnings volatility from our business activities. This volatility can occur for a variety of reasons, including the timing and amount of purchases, sales, calls, and repayment of consolidated assets, changes in the fair values of consolidated assets and liabilities, increases or decreases in earnings from mortgage banking activities, and certain non-recurring

Table of Contents

events. In addition, the amount or timing of our reported earnings may be impacted by technical accounting issues and estimates, some of which are described below.

Changes in Premium Amortization for Loans

The net unamortized premium for loans owned at Redwood, Consolidated Sequoia Entities, and the Commercial Securitization, was \$11 million at September 30, 2014. The amount of periodic premium amortization expense we recognize is volatile and dependent on a number of factors, including credit performance of the underlying loans, changes in prepayment speeds, and changes in short-term interest rates. Loan premium amortization was \$3 million and \$5 million for the nine months ended September 30, 2014 and 2013, respectively.

Changes in Allowance for Loan Losses

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

Changes in actual defaults or our expectations on loss severities and default timing can have a significant effect on periodic income.

Changes in the Fair Value of Residential and Commercial Loans Held at Fair Value

Our residential and commercial loans held-for-sale on our consolidated balance sheet at September 30, 2014, were being held for future securitizations or sales and expected to be sold to non-consolidated securitization entities or third parties. At the time of purchase, we typically elect the fair value option for these loans. For residential and commercial loans for which we have elected the fair value option, changes in fair values are recorded in mortgage banking activities, net, through the consolidated statements of income in the period in which the valuation change occurs. Periodic fluctuations in the values of these investments are inherently volatile and thus can lead to significant period-to-period GAAP earnings volatility.

The fair value of loans is affected by, among other things, changes in interest rates, credit performance, prepayments, and market liquidity. To the extent interest rates change or market liquidity and or credit conditions materially change, the value of these loans could decline below their cost basis, which could have a material effect on reported earnings.

Changes in Mortgage Banking Income

The amount of income that can be earned from mortgage banking activities is primarily dependent on the volume of loans we are able to acquire or originate and any potential profit we earn upon the sale or securitization of these loans. Our ability to acquire or originate residential and commercial loans and the volume of loans we acquire or originate is dependent on many factors that are beyond our control, including general economic conditions and changes in interest rates, loan origination volumes industry-wide and at the sellers we purchase our loans from, increased regulation, and competition from other financial institutions. Our profitability from mortgage banking activities is also dependent on many factors, including our ability to effectively hedge certain risks related to changes in interest rates and other factors that are beyond our control, including changes in market credit risk pricing. Additionally, our income from mortgage banking activities is generally generated over the period from when we originate or identify a loan for purchase until we subsequently sell or securitize the loan. This income may encompass positive or negative market valuation adjustments on loans, hedging gains or losses associated with related risk management activities, and any

other related transaction expenses, and may be realized unevenly over the course of one or more quarters for financial reporting purposes. Examples of additional factors that could impact our profitability include those discussed in Part I, Item 1A Risk Factors of our Annual Report on Form 10-K for the fiscal year ending December 31, 2013, and under the headings *Changes in the Fair Value of Residential and Commercial Loans Held at Fair Value* and *Changes in Fair Values of Derivative Financial Instruments*. Changes in the volumes of loans acquired or originated in connection with our mortgage banking activities and our profitability on these activities can have a significant effect on periodic income.

Changes in Yields for Securities

The yields we project on real estate securities can have a significant effect on the periodic interest income we recognize for financial reporting purposes. Yields can vary as a function of credit results, prepayment rates, and interest rates. If estimated future

Table of Contents

credit losses are less than our prior estimate, credit losses occur later than expected, or prepayment rates are faster than expected (meaning the present value of projected cash flows is greater than previously expected for assets acquired at a discount to principal balance), the yield over the remaining life of the security may be adjusted upwards. If estimated future credit losses exceed our prior expectations, credit losses occur more quickly than expected, or prepayments occur more slowly than expected (meaning the present value of projected cash flows is less than previously expected for assets acquired at a discount to principal balance), the yield over the remaining life of the security may be adjusted downward.

Changes in the actual maturities of real estate securities may also affect their yields to maturity. Actual maturities are affected by the contractual lives of the associated mortgage collateral, periodic payments of principal, and prepayments of principal. Therefore, actual maturities of AFS securities are generally shorter than stated contractual maturities. Stated contractual maturities are generally greater than 10 years. There is no assurance that our assumptions used to estimate future cash flows or the current period's yield for each asset will not change in the near term, and any change could be material.

Changes in Fair Values of Securities

All securities owned at Redwood and Legacy Consolidated Entities are classified as either trading or AFS securities, and in both cases are carried on our consolidated balance sheets at their estimated fair values. For trading securities, changes in fair values are recorded in the consolidated statements of income. Periodic fluctuations in the values of these investments are inherently volatile and thus can lead to significant GAAP earnings volatility each quarter.

For AFS securities, cumulative unrealized gains and losses are recorded as a component of accumulated other comprehensive income in our consolidated balance sheets. Unrealized gains are not credited to current earnings and unrealized losses are not charged against current earnings to the extent they are temporary in nature. Certain factors may require us, however, to recognize declines in the values of AFS securities as other-than-temporary impairments and record them through our current earnings. Factors that determine other-than-temporary-impairment include a change in our ability or intent to hold AFS securities, adverse changes to projected cash flows of assets, or the likelihood that declines in the fair values of assets would not return to their previous levels within a reasonable time. Impairments on AFS securities can lead to significant GAAP earnings volatility each quarter. In addition, sales of securities in large unrealized gain or loss positions that are not impaired can lead to significant GAAP earnings volatility each year.

Changes in Fair Values of Mortgage Servicing Rights

Mortgage servicing rights are carried on our consolidated balance sheets at their estimated fair values, with changes in fair values recorded in the consolidated statements of income as a component of MSR income (loss), net. Periodic fluctuations in the values of these investments are inherently volatile and can lead to significant GAAP earnings volatility each quarter. Periodic fluctuations in the values of our mortgage servicing rights can be caused by actual prepayments on the underlying loans, changes in assumptions regarding future projected prepayments on the underlying loans, or changes in the discount rate assumptions used to value mortgage servicing rights.

Changes in Fair Values of Derivative Financial Instruments

We can experience significant earnings volatility from our use of derivatives. We generally use derivatives as part of our mortgage banking activities (e.g., to manage risks associated with loans we plan to acquire and subsequently sell or securitize), and to manage variability in debt interest expense indexed to adjustable rates, and cash flows on assets and liabilities that have different coupon rates (fixed rates versus floating rates, or floating rates based on different

indices). The nature of the instruments we use and the accounting treatment for the specific assets, liabilities, and derivatives may therefore lead to volatility in our periodic earnings, even when we are meeting our hedging objectives.

Some of our derivatives are accounted for as trading instruments with all associated changes in value recorded through our consolidated statements of income. Changes in value of the assets and liabilities we manage by using derivatives may not be accounted for similarly. This could lead to reported income and book values in specific periods that do not necessarily reflect the economics of our risk management strategy. Even when the assets and liabilities are similarly accounted for as trading instruments, periodic changes in their values may not coincide as other market factors (e.g., supply and demand) may affect certain instruments and not others at any given time.

Table of Contents***Changes in Loss Contingency Reserves***

We may be exposed to various loss contingencies, including, without limitation, those described in *Note 14* to the financial statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q. In accordance with FASB guidance on accounting for contingencies, we review the need for any loss contingency reserves and establish them when, in the opinion of management, it is probable that a matter would result in a liability, and the amount of loss, if any, can be reasonably estimated. The establishment of a loss contingency reserve, the subsequent increase in a reserve or release of reserves previously established, or the recognition of a loss in excess of previously established reserves, can occur as a result of various factors and events that affect management's opinion of whether the standard for establishing, increasing, or continuing to maintain, a reserve has been met. Changes in the loss contingency reserves can lead to significant GAAP earnings volatility each quarter.

Changes in Provision for Taxes

Our quarterly tax provision is determined by multiplying actual year-to-date GAAP earnings by our estimated annual effective tax rate (ETR) and subtracting any tax expense recorded in prior quarters of the current year. The ETR is calculated by dividing the estimated annual tax expense by the estimated annual GAAP pre-tax earnings for the current year. Our estimated annual tax expense includes estimates for GAAP earnings, permanent and temporary book-to-tax differences, valuation allowances, and taxable income. Changes in our estimates and fluctuations in quarterly GAAP earnings can cause volatility in the quarterly tax provision. It is possible that a change in estimates could cause us to have a tax provision in one quarter and a tax benefit in a later quarter. Changes in the tax provision can lead to significant GAAP earnings volatility each quarter.

Market Risks

We seek to manage risks inherent in our business including but not limited to credit risk, interest rate risk, prepayment risk, liquidity risk, and fair value risk in a prudent manner designed to enhance our earnings and dividends and preserve our capital. In general, we seek to assume risks that can be quantified from historical experience, to actively manage such risks, and to maintain capital levels consistent with these risks. Information concerning the risks we are managing, how these risks are changing over time, and potential GAAP earnings and taxable income volatility we may experience as a result of these risks is discussed in Part II, Item 7A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

Other Risks

In addition to the market and other risks described above, our business and results of operations are subject to a variety of types of risks and uncertainties, including, among other things, those described under the caption *Risk Factors* in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

NEW ACCOUNTING STANDARDS

If applicable, a discussion of new accounting standards and the possible effects of these standards on our financial statements is included in *Note 3 Summary of Significant Accounting Policies* included in Part I, Item 1 of this Quarterly Report on Form 10-Q.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Information concerning market risk is incorporated herein by reference to Part II, Item 7A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2013, as supplemented by the information under *Management's Discussion and Analysis of Financial Condition and Results of Operations* and *Market Risks* within Item 2 above. Other than the developments described thereunder, including changes in the fair values of our assets, there have been no other material changes in our quantitative or qualitative exposure to market risk since December 31, 2013.

Item 4. Controls and Procedures

We have adopted and maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed on our reports under the Securities Exchange Act of 1934, as amended (the Exchange Act), is recorded, processed, summarized, and reported within the time periods specified in the U.S. Securities and Exchange Commission's rules and forms and that the information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide

Table of Contents

only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Rule 13a-15(b) of the Exchange Act, we have carried out an evaluation, under the supervision and with the participation of management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the quarter covered by this report. Based on the foregoing, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective at a reasonable assurance level.

There have been no changes in our internal control over financial reporting during the third quarter of 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents**PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

On or about December 23, 2009, the Federal Home Loan Bank of Seattle (the FHLB-Seattle) filed a complaint in the Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. (SRF), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the FHLB-Seattle Defendants) alleging that the FHLB-Seattle Defendants made false or misleading statements in offering materials for a mortgage pass-through certificate (the Seattle Certificate) issued in the Sequoia Mortgage Trust 2005-4 securitization transaction (the 2005-4 RMBS) and purchased by the FHLB-Seattle. Specifically, the complaint alleges that the alleged misstatements concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Seattle Certificate. The FHLB-Seattle alleges claims under the Securities Act of Washington (Section 21.20.005, et seq.) and seeks to rescind the purchase of the Seattle Certificate and to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received) as well as attorneys' fees and costs. The Seattle Certificate was issued with an original principal amount of approximately \$133 million, and, as of September 30, 2014, the FHLB-Seattle has received approximately \$115.4 million of principal and \$11.1 million of interest payments in respect of the Seattle Certificate. As of September 30, 2014, the Seattle Certificate had a remaining outstanding principal amount of approximately \$17.9 million. The claims were subsequently dismissed for lack of personal jurisdiction as to Redwood Trust and SRF. Redwood agreed to indemnify the underwriters of the 2005-4 RMBS for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. The FHLB-Seattle's claims against the underwriters of this RMBS were not dismissed and remain pending. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

On or about July 15, 2010, The Charles Schwab Corporation (Schwab) filed a complaint in the Superior Court for the State of California in San Francisco (case number CGC-10-501610) against SRF and 26 other defendants (collectively, the Schwab Defendants) alleging that the Schwab Defendants made false or misleading statements in offering materials for various residential mortgage-backed securities sold or issued by the Schwab Defendants. With respect to SRF, Schwab alleges that SRF made false or misleading statements in offering materials for a mortgage pass-through certificate (the Schwab Certificate) issued in the 2005-4 RMBS and purchased by Schwab. Specifically, the complaint alleges that the misstatements for the 2005-4 RMBS concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Schwab Certificate. Schwab alleges a claim for negligent misrepresentation under California state law and seeks unspecified damages and attorneys' fees and costs. The Schwab Certificate was issued with an original principal amount of approximately \$14.8 million, and, as of September 30, 2014, Schwab has received approximately \$12.8 million of principal and \$1.3 million of interest payments in respect of the Schwab Certificate. As of September 30, 2014, the Schwab Certificate had a remaining outstanding principal amount of approximately \$2.0 million. SRF has denied Schwab's allegations. This case is in discovery, and no trial date has been set. We intend to defend the action vigorously. Redwood agreed to indemnify the underwriters of the 2005-4 RMBS, which underwriters were also named as defendants in this action, for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

In October 2010, a complaint was filed in Illinois state court against SRF and more than 45 other named defendants alleging that the defendants made false or misleading statements in offering materials for various RMBS sold or

issued by the defendants or entities controlled by them. The plaintiff subsequently amended the complaint to name Redwood Trust, Inc. and another one of our subsidiaries, RWT Holdings, Inc., as defendants. With respect to Redwood Trust, Inc., RWT Holdings, Inc., and SRF (the Redwood Defendants), the plaintiff alleged that there were false or misleading statements in the offering materials for two mortgage pass-through certificates issued in the Sequoia Mortgage Trust 2006-1 securitization transaction. In October 2014, the plaintiff and the Redwood Defendants agreed to settle the complaint on mutually satisfactory terms. The terms of the agreed-upon settlement remain confidential.

In accordance with GAAP, we review the need for any loss contingency reserves and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability and the amount of loss, if any, can be reasonably estimated. Additionally, we record receivables for insurance recoveries relating to litigation-related losses and expenses if and when such amounts are covered by insurance and recovery of such losses or expenses are due. At September 30, 2014, the aggregate amount of

Table of Contents

loss contingency reserves established in respect of the three above-referenced litigation matters was \$10.4 million. Included within this aggregate reserve is the amount the Redwood Defendants agreed to pay pursuant to the confidential settlement reached in October 2014, which amount was paid subsequent to September 30, 2014. We review our litigation matters each quarter to assess these loss contingency reserves and make adjustments in these reserves, upwards or downwards, as appropriate, in accordance with GAAP based on our review.

In the ordinary course of any litigation matter, including certain of the above-referenced matters, we have engaged and may continue to engage in formal or informal settlement communications with the plaintiffs. Settlement communications we have engaged in relating to certain of the above-referenced litigation matters are one of the factors that have resulted in our determination to establish the loss contingency reserves described above. We cannot be certain that any of these matters will be resolved through a settlement prior to trial and we cannot be certain that the resolution of these matters, whether through trial or settlement, will not have a material adverse effect on our financial condition or results of operations in any future period.

Future developments (including resolution of substantive pre-trial motions relating to these matters, receipt of additional information and documents relating to these matters (such as through pre-trial discovery), new or additional settlement communications with plaintiffs relating to these matters, or resolutions of similar claims against other defendants in these matters) could result in our concluding in the future to establish additional loss contingency reserves or to disclose an estimate of reasonably possible losses in excess of our established reserves with respect to these matters. Our actual losses with respect to the above-referenced litigation matters may be materially higher than the aggregate amount of loss contingency reserves we have established in respect of these litigation matters, including in the event that any of these matters proceeds to trial and the plaintiff prevails. Other factors that could result in our concluding to establish additional loss contingency reserves or estimate additional reasonably possible losses, or could result in our actual losses with respect to the above-referenced litigation matters being materially higher than the aggregate amount of loss contingency reserves we have established in respect of these litigation matters include that: there are significant factual and legal issues to be resolved; information obtained or rulings made during the lawsuits could affect the methodology for calculation of the available remedies; and we may have additional obligations pursuant to indemnity agreements, representations and warranties, and other contractual provisions with other parties relating to these litigation matters that could increase our potential losses.

Item 1A. Risk Factors

Our risk factors are discussed under Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013. In addition, the following risk factor reflects recent developments.

Proposed Federal regulations may limit, eliminate, or reduce the attractiveness of our subsidiary's ability to use borrowings from the Federal Home Loan Bank of Chicago to finance the mortgage loans and securities it holds and acquires, which could negatively impact our business and operating results.

In June 2014, we announced that our wholly-owned captive insurance company subsidiary, RWT Financial, LLC, was approved as a member of the Federal Home Loan Bank of Chicago (FHLBC). This membership provides RWT Financial with access to attractive long-term and short-term collateralized financing for mortgage loans and securities it holds and acquires. RWT Financial is currently using long-term borrowings from the FHLBC to finance certain jumbo residential mortgage loans. At September 30, 2014, RWT Financial had \$204 million of long-term borrowings outstanding from the FHLBC, which were collateralized by residential mortgage loans. RWT Financial currently intends to increase its borrowings from FHLBC, including borrowings to finance holdings of residential mortgage loans it acquires that may not be eligible for long-term financing from other sources of debt financing available to Redwood.

The Federal Housing Finance Agency (FHFA) is the Federal agency that regulates the FHLBC and the other Federal Home Loan Banks (FHLBs) that comprise the Federal Home Loan Banking System, including through regulations relating to membership in each of the FHLBs (FHLB Membership Regulations). On September 12, 2014, the FHFA published a notice of proposed rulemaking and request for comments (NPR) proposing to revise the FHLB Membership Regulations. Among other things, the NPR includes a proposal to amend the FHLB Membership Regulations to exclude additional captive insurance companies from membership in an FHLB. The NPR also proposes to address existing captive insurance company members in FHLBs, like our wholly-owned subsidiary RWT Financial, by allowing them to remain members for five years following the effective date of the amended regulations with certain restrictions on their ability to obtain and renew borrowings from FHLBs during that five-year period.

Table of Contents

As a practical matter, if the NPR is adopted as proposed, the FHLB Membership Regulations would be amended in a manner that would prevent RWT Financial from obtaining additional borrowings from the FHLBC (or renewing existing borrowings) with a term that extended beyond the five year membership grace period and would prevent RWT Financial from obtaining additional borrowings or renewing existing borrowings from the FHLBC if after doing so the total advances to RWT Financial would exceed 40% of its total assets. In addition, amendments to the FHLB Membership Regulations could also be made that are not set forth in the NPR that could further limit or increase the cost of RWT Financial's borrowings from the FHLBC. If the NPR is adopted as proposed, RWT Financial would lose access (in the manner and over the time periods set forth in the amended FHLB Membership Regulations) to a source of attractive long-term and short-term collateralized financing for mortgage loans and securities it holds and acquires. The loss of this source of financing could also negatively impact us in a number of other different ways, including, without limitation, by limiting our ability to acquire (or the attractiveness of acquiring) residential mortgage loans to hold as long-term investments, or by exposing us to risks of the type described below in Management's Discussion and Analysis of Financial Condition and Results of Operations under the heading Risks Relating to Debt Incurred Under Short- and Long-Term Borrowing Facilities. To the extent the NPR is adopted or the FHLB Membership Regulations are otherwise amended in a manner that would limit, eliminate, or reduce the attractiveness of RWT Financial's ability to use borrowings from the FHLBC to finance the mortgage loans and securities it holds and acquires, it could negatively impact our business and operating results.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

During the nine months ended September 30, 2014, we did not sell any equity securities that were not registered under the Securities Act of 1933, as amended. We announced a stock repurchase plan on November 5, 2007, for the repurchase of up to a total of 5,000,000 shares. This plan replaced all previous share repurchase plans and has no expiration date. We did not repurchase any shares under this plan during the nine months ended September 30, 2014. At September 30, 2014, 4,005,985 shares remained available for repurchase under our stock repurchase plan.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Not Applicable**Item 5. Other Information**

None.

Table of Contents**Item 6. Exhibits**

| Exhibit Number | Exhibit |
|---------------------------|--|
| 3.1 | Articles of Amendment and Restatement of the Registrant, effective July 6, 1994 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1, filed on August 6, 2008) |
| 3.1.1 | Articles Supplementary of the Registrant, effective August 10, 1994 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.1, filed on August 6, 2008) |
| 3.1.2 | Articles Supplementary of the Registrant, effective August 11, 1995 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.2, filed on August 6, 2008) |
| 3.1.3 | Articles Supplementary of the Registrant, effective August 9, 1996 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.3, filed on August 6, 2008) |
| 3.1.4 | Certificate of Amendment of the Registrant, effective June 30, 1998 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.4, filed on August 6, 2008) |
| 3.1.5 | Articles Supplementary of the Registrant, effective April 7, 2003 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.5, filed on August 6, 2008) |
| 3.1.6 | Articles of Amendment of the Registrant, effective June 12, 2008 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.6, filed on August 6, 2008) |
| 3.1.7 | Articles of Amendment of the Registrant, effective May 19, 2009 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2009) |
| 3.1.8 | Articles of Amendment of the Registrant, effective May 24, 2011 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 20, 2011) |
| 3.1.9 | Articles of Amendment of the Registrant, effective May 18, 2012 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2012) |
| 3.1.10 | Articles of Amendment of the Registrant, effective May 16, 2013 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2013) |
| 3.2.1 | Amended and Restated Bylaws of the Registrant, as adopted on March 5, 2008 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on March 11, 2008) |
| 3.2.2 | First Amendment to Amended and Restated Bylaws of the Registrant, as adopted on May 17, 2012 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.2, filed on May 21, 2012) |
| 31.1 | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101 | Pursuant to Rule 405 of Regulation S-T, the following financial information from the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2014, is filed in XBRL-formatted interactive data files: |

(i) Consolidated Balance Sheets at September 30, 2014 and December 31, 2013;

(ii) Consolidated Statements of Income for the three and nine months ended September 30, 2014 and 2013;

(iii) Statements of Consolidated Comprehensive Income for the three and nine months ended September 30, 2014 and 2013;

(iv) Consolidated Statements of Changes in Equity for the nine months ended September 30, 2014 and 2013;

(v) Consolidated Statements of Cash Flows for the nine months ended September 30, 2014 and 2013; and

(vi) Notes to Consolidated Financial Statements.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

REDWOOD TRUST, INC.

Date: November 7, 2014

By: /s/ MARTIN S. HUGHES
Martin S. Hughes
Chief Executive Officer
(Principal Executive Officer)

Date: November 7, 2014

By: /s/ CHRISTOPHER J. ABATE
Christopher J. Abate
Chief Financial Officer
(Principal Financial Officer)

Date: November 7, 2014

By: /s/ COLLIN L. COCHRANE
Collin L. Cochrane
Controller
(Principal Accounting Officer)

Table of Contents**EXHIBIT INDEX**

| Exhibit | |
|----------------|--|
| Number | Exhibit |
| 3.1 | Articles of Amendment and Restatement of the Registrant, effective July 6, 1994 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1, filed on August 6, 2008) |
| 3.1.1 | Articles Supplementary of the Registrant, effective August 10, 1994 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.1, filed on August 6, 2008) |
| 3.1.2 | Articles Supplementary of the Registrant, effective August 11, 1995 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.2, filed on August 6, 2008) |
| 3.1.3 | Articles Supplementary of the Registrant, effective August 9, 1996 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.3, filed on August 6, 2008) |
| 3.1.4 | Certificate of Amendment of the Registrant, effective June 30, 1998 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.4, filed on August 6, 2008) |
| 3.1.5 | Articles Supplementary of the Registrant, effective April 7, 2003 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.5, filed on August 6, 2008) |
| 3.1.6 | Articles of Amendment of the Registrant, effective June 12, 2008 (incorporated by reference to the Registrant's Quarterly Report on Form 10-Q, Exhibit 3.1.6, filed on August 6, 2008) |
| 3.1.7 | Articles of Amendment of the Registrant, effective May 19, 2009 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2009) |
| 3.1.8 | Articles of Amendment of the Registrant, effective May 24, 2011 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 20, 2011) |
| 3.1.9 | Articles of Amendment of the Registrant, effective May 18, 2012 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2012) |
| 3.1.10 | Articles of Amendment of the Registrant, effective May 16, 2013 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on May 21, 2013) |
| 3.2.1 | Amended and Restated Bylaws of the Registrant, as adopted on March 5, 2008 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.1, filed on March 11, 2008) |
| 3.2.2 | First Amendment to Amended and Restated Bylaws of the Registrant, as adopted on May 17, 2012 (incorporated by reference to the Registrant's Current Report on Form 8-K, Exhibit 3.2, filed on May 21, 2012) |
| 31.1 | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101 | Pursuant to Rule 405 of Regulation S-T, the following financial information from the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2014, is filed in XBRL-formatted interactive data files: |
| | (i) Consolidated Balance Sheets at September 30, 2014 and December 31, 2013; |

Edgar Filing: REDWOOD TRUST INC - Form 10-Q

(ii) Consolidated Statements of Income for the three and nine months ended September 30, 2014 and 2013;

(iii) Statements of Consolidated Comprehensive Income for the three and nine months ended September 30, 2014 and 2013;

(iv) Consolidated Statements of Changes in Equity for the nine months ended September 30, 2014 and 2013;

(v) Consolidated Statements of Cash Flows for the nine months ended September 30, 2014 and 2013; and

(vi) Notes to Consolidated Financial Statements.