

REDWOOD TRUST INC  
Form 10-Q  
August 04, 2010

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

**FORM 10-Q**

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

**For the Quarterly Period Ended: June 30, 2010**

**OR**

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

**For the Transition Period from to**

**Commission File Number 1-13759**

**REDWOOD TRUST, INC.**

(Exact Name of Registrant as Specified in Its Charter)

Maryland  
(State or Other Jurisdiction of  
Incorporation or Organization)

68-0329422  
(I.R.S. Employer  
Identification No.)

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

94941  
(Zip Code)

**(415) 389-7373**

(Registrant's Telephone Number, Including Area Code)

**Not Applicable**

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  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

77,979,850 shares outstanding as of August 3, 2010

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2010 FORM 10-Q REPORT  
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TABLE OF CONTENTS**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****REDWOOD TRUST, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

(In Thousands, Except Share Data) (Unaudited)	June 30, 2010	December 31, 2009
<b>ASSETS</b>		
Real estate loans	\$3,810,155	\$3,739,254
Real estate securities, at fair value:		
Trading securities	275,994	277,274
Available-for-sale securities	740,963	810,471
Total real estate securities	1,016,957	1,087,745
Other investments	3,654	20,371
Cash and cash equivalents	288,376	242,818
Total earning assets	5,119,142	5,090,188
Restricted cash	26,814	94,306
Accrued interest receivable	14,085	18,193
Derivative assets	4,735	12,372
Deferred tax asset	2,452	4,810
Deferred asset-backed securities issuance costs	7,045	6,639
Other assets	45,312	26,142
Total Assets <sup>(1)</sup>	\$5,219,585	\$5,252,650
<b>LIABILITIES AND EQUITY</b>		
Liabilities		
Short-term debt	\$	\$
Accrued interest payable	6,315	5,968
Derivative liabilities	106,355	83,800
Accrued expenses and other liabilities	10,184	71,828
Dividends payable	19,477	19,434
Asset-backed securities issued Sequoia	3,681,622	3,644,933
Asset-backed securities issued Acacia	253,104	297,596
Long-term debt	140,000	140,000
Total liabilities <sup>(2)</sup>	4,217,057	4,263,559
Equity		
Common stock, par value \$0.01 per share, 100,000,000 shares authorized; 77,908,439 and 77,737,130 issued and outstanding	779	777
Additional paid-in capital	1,684,304	1,674,367
Accumulated other comprehensive income	38,199	64,860
Cumulative earnings	440,332	364,888

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Cumulative distributions to stockholders	(1,173,079)	(1,133,171)
Total stockholders' equity	990,535	971,721
Noncontrolling interest	11,993	17,370
Total equity	1,002,528	989,091
Total Liabilities and Equity	\$5,219,585	\$5,252,650

Our consolidated balance sheets include assets of consolidated variable interest entities (VIEs) that can only be (1) used to settle obligations of these VIEs. At June 30, 2010, these assets totaled \$4,139,970, net of noncontrolling interest.

(2) Our consolidated balance sheets include liabilities of consolidated VIEs for which creditors do not have recourse to the primary beneficiary (Redwood Trust, Inc.). At June 30, 2010, these liabilities totaled \$4,023,219.

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

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TABLE OF CONTENTS**REDWOOD TRUST, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME (LOSS)**

(In Thousands, Except Share Data) (Unaudited)	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Interest Income				
Real estate loans	\$ 16,015	\$ 30,614	\$ 30,808	\$ 64,583
Real estate securities	40,458	43,475	84,357	90,737
Other investments	4	55	13	131
Cash and cash equivalents	93	117	110	247
Total interest income	56,570	74,261	115,288	155,698
Interest Expense				
Short-term debt	(36 )		(36 )	
Asset-backed securities issued	(18,988 )	(37,499 )	(36,054 )	(83,332 )
Long-term debt	(2,140 )	(1,502 )	(3,256 )	(3,310 )
Total interest expense	(21,164 )	(39,001 )	(39,346 )	(86,642 )
Net Interest Income	35,406	35,260	75,942	69,056
Provision for loan losses	(4,321 )	(14,545 )	(13,797 )	(30,577 )
Market valuation adjustments on trading instruments	(2,909 )	4,102	(12,200 )	(10,107 )
Other-than-temporary impairments <sup>(1)</sup>	(4,216 )	(33,237 )	(6,162 )	(62,272 )
Market valuation adjustments, net	(7,125 )	(29,135 )	(18,362 )	(72,379 )
Net Interest Income (Loss) After Provision and Market Valuation Adjustments	23,960	(8,420 )	43,783	(33,900 )
Operating expenses	(11,227 )	(10,769 )	(28,533 )	(21,308 )
Realized gains, net	16,080	25,525	60,417	25,988
Net income (loss) before provision for income taxes	28,813	6,336	75,667	(29,220 )
(Provision for) benefit from income taxes	(26 )	514	(52 )	409
Net income (loss)	28,787	6,850	75,615	(28,811 )
Less: Net income (loss) attributable to noncontrolling interest	186	127	171	(589 )
Net Income (Loss) Attributable to Redwood Trust, Inc.	\$ 28,601	\$ 6,723	\$ 75,444	\$ (28,222 )
Basic earnings (loss) per common share:	\$ 0.36	\$ 0.10	\$ 0.94	\$ (0.48 )
Diluted earnings (loss) per common share:	\$ 0.35	\$ 0.10	\$ 0.94	\$ (0.48 )
Regular dividends declared per common share	\$ 0.25	\$ 0.25	\$ 0.50	\$ 0.50
Special dividends declared per common share				
Total dividends declared per common share	\$ 0.25	\$ 0.25	\$ 0.50	\$ 0.50
Basic weighted average shares outstanding	77,800,642	65,697,887	77,739,279	59,137,864
Diluted weighted average shares outstanding	78,852,259	66,362,723	78,661,642	59,137,864

(1)

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For the three months ended June 30, 2010, other-than-temporary impairments were \$7,086, of which \$2,870 were recognized in Accumulated Other Comprehensive Income (Loss). For the six months ended June 30, 2010, other-than-temporary impairments were \$10,701, of which \$4,539 were recognized in Accumulated Other Comprehensive Income (Loss).

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



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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF EQUITY AND  
COMPREHENSIVE INCOME (LOSS)**

**For the Six Months Ended June 30, 2010**

**For the Six Months Ended June 30, 2009**

*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, Except Share Data) (Unaudited)	Six Months Ended June 30,	
	2010	2009
<b>Cash Flows From Operating Activities:</b>		
Net income (loss) attributable to Redwood Trust, Inc.	\$75,444	\$(28,222 )
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:		
Amortization of premiums, discounts, and debt issuance costs, net	(16,409 )	3,493
Depreciation and amortization of non-financial assets	439	539
Provision for loan losses	13,797	30,577
Non-cash equity award compensation	8,208	4,156
Market valuation adjustments, net	18,362	72,379
Realized gains, net	(60,417 )	(25,988 )
Net change in:		
Accrued interest receivable	3,732	9,738
Deferred tax asset	2,358	1,325
Other assets	(13,079 )	30,193
Accrued interest payable	5,602	(11,549 )
Accrued expenses and other liabilities	(61,644 )	22,280
Net cash (used in) provided by operating activities	(23,607 )	108,921
<b>Cash Flows From Investing Activities:</b>		
Purchases of real estate loans held-for-investment	(238,076)	
Principal payments on real estate loans held-for-investment	148,647	199,516
Purchases of real estate securities available-for-sale	(186,057)	(438,669)
Proceeds from sales of real estate securities available-for-sale	247,528	57,898
Principal payments on real estate securities available-for-sale	71,083	52,372
Purchases of real estate securities trading	(17,137 )	
Proceeds from sales of real estate securities trading	6,119	
Principal payments on real estate securities trading	31,102	50,942
Principal payments on other investments	9,675	14,279
Net decrease (increase) in restricted cash	67,492	(12,616 )
Net cash provided by (used in) investing activities	140,376	(76,278 )
<b>Cash Flows From Financing Activities:</b>		
Proceeds from issuance of asset-backed securities	211,178	
Repurchase of asset-backed securities	(8,639 )	
Deferred asset-backed security issuance costs	(1,667 )	
Repayments on asset-backed securities	(200,214)	(271,626)
Net settlements of derivatives	(26,268 )	(24,702 )
Net proceeds from issuance of common stock	1,731	520,546
Dividends paid	(39,865 )	(42,147 )

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Change in noncontrolling interests	(7,467 )	(4,119 )
Net cash (used in) provided by financing activities	(71,211 )	177,952
Net increase in cash and cash equivalents	45,558	210,595
Cash and cash equivalents at beginning of period	\$242,818	\$126,480
Cash and cash equivalents at end of period	\$288,376	\$337,075
Supplemental Disclosures:		
Cash paid for interest	\$32,646	\$105,591
Cash paid for taxes	\$15	\$70
Dividends declared but not paid at end of period	\$19,477	\$19,376

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

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# REDWOOD TRUST, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS June 30, 2010 (Unaudited)

### Note 1. Redwood Trust

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

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

### Note 2. Basis of Presentation

The consolidated financial statements presented herein are at June 30, 2010 and December 31, 2009, and for the three and six months ended June 30, 2010 and 2009. These consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) in the United States for interim financial information and with the Securities and Exchange Commission's (SEC) instructions to Form 10-Q and Article 10 of Regulation S-X. Results for the three and six months ended June 30, 2010, may not necessarily be indicative of the results for the year ending December 31, 2010. These unaudited interim consolidated financial statements should be read in conjunction with our audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2009. All amounts presented herein, except per share data, are shown in thousands.

We recognize the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* as a replacement of FASB Statement No. 162 (FAS 168), which establishes the Accounting Standards Codification (ASC) as the single source of authoritative GAAP in the United States.

### Organization

Our consolidated financial statements include the accounts of Redwood, its direct and indirect wholly-owned subsidiaries, and other entities in which we have a controlling financial interest. All significant intercompany balances and transactions have been eliminated. A number of Redwood's consolidated subsidiaries are qualifying REIT subsidiaries and the remainder are taxable subsidiaries. References to the Redwood REIT include Redwood and its qualifying REIT subsidiaries, excluding taxable subsidiaries.

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

We do not service any assets, including assets owned by the Fund, Sequoia, or Acacia.

## **Principles of Consolidation**

We apply ASC 860 and ASC 810-10 to determine whether we must consolidate transferred financial assets and variable interest entities (VIEs) for financial reporting purposes. These standards became effective for our interests in all VIEs as of January 1, 2010, except for the Fund, as a result of the FASB's decision to delay the applicability of ASC 810-10 for private equity funds. Our determination of whether we must consolidate the Fund was made in accordance with FASB Interpretation No. 46 (revised), *Consolidation of Variable Interest Entities* (FIN 46(R)), at the time we acquired our interests in the Fund.

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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**(Unaudited)**

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

We currently consolidate the assets, liabilities, and noncontrolling interests of the Fund, as well as the assets and liabilities of the Sequoia and the Acacia securitization entities where we maintain continuing involvement. For financial reporting purposes, the real estate securities owned at the Fund are shown on our consolidated balance sheets under real estate securities and the portion of the Fund owned by third parties is shown under noncontrolling interest. In our consolidated statements of income (loss), we record interest income on the securities owned at the Fund. Since the Fund is currently funded with equity, there is no associated interest expense. The underlying loans and securities owned at Sequoia and Acacia entities are shown on our consolidated balance sheets under real estate loans and real estate securities and the asset-back securities (ABS) issued to third parties by these entities are shown under ABS issued. In our consolidated statements of income (loss), we record interest income on the loans and securities owned by consolidated Sequoia and Acacia entities and interest expense on the ABS issued by these entities.

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

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

**Use of Estimates**

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

**Fair Value 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 the consolidated statements of income (loss).

Our decision to apply the fair value option for new financial instruments is generally based upon our funding strategy for the specific financial asset acquired. For example, securities that we anticipate funding with equity will generally

be accounted for as available-for-sale (AFS) securities. Securities that we anticipate funding with a combination of debt and equity or those financed through the issuance of asset-backed liabilities will generally be accounted for in a consistent manner. Additionally, we may elect to apply the fair value option for financial instruments that may not perform similarly to our traditional real estate investments or are particularly volatile or complex.

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

## **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;

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2010**  
**(Unaudited)**

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

Relevant reports issued by analysts and rating agencies;

The current level of interest rates and any directional movements in relevant indices, such as credit risk indices; Information about the performance of the underlying mortgage loans, such as delinquency and foreclosure rates, loss experience, and prepayment rates;

Indicative prices or yields from broker/dealers; and,

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

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

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

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

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

**Real Estate Loans**

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

Residential and commercial real estate loans at fair value are loans where we have elected the fair value option. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Changes in fair value are recurring and are reported through our consolidated statements of income



(loss) in market valuation adjustments, net.

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

Residential and commercial real estate loans held-for-sale are loans that we are marketing for sale to third parties. These loans are carried at the lower of their cost or fair value, as measured on an individual basis. If the fair value of a loan held-for-sale is lower than its amortized cost basis, this difference is reported as a negative market valuation adjustment through our consolidated statements of income (loss). Coupon interest for loans held-for-sale is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Gains or losses on the sale of real estate loans are based on the specific identification method.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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**(Unaudited)**

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

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

Real estate loans held-for-investment include residential real estate loans owned and securitized at Sequoia entities and commercial real estate loans owned at Redwood. These loans are carried at their unpaid principal balances adjusted for net unamortized premiums or discounts and net of any allowance for loan losses. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Interest previously accrued for loans that have become greater than 90 days past due is reserved for in the allowance for loan losses. Cash principal and interest that is advanced from servicers subsequent to a loan becoming greater than 90 days past due is used to reduce the outstanding loan principal balance.

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 loans acquired after July 1, 2004, we use the initial coupon interest rate of the loans (without regard to future changes in the underlying indices) and anticipated principal payments to determine periodic amortization.

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

See *Note 6* for further discussion on real estate loans.

**Real Estate Loans 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, the timing of defaults, and loss severities upon defaults) that can be specifically applied to each of the consolidated loans or pool of loans.

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

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

Historical loss rates and past performance of similar loans;

Relevant environmental factors;  
Relevant market research and publicly available third-party reference loss rates;  
Trends in delinquencies and charge-offs;  
Effects and changes in credit concentrations;  
Information supporting a borrower's ability to meet obligations;  
Ongoing evaluations of fair values of collateral using current appraisals and other valuations; and,  
Discounted cash flow analyses.

Once we determine the amount of defaults, the timing of the defaults, and severity of losses upon the defaults, we estimate expected losses for each individual loan or pool of loans over its expected life. We then estimate the timing of these losses and the losses probable to occur over an appropriate loss confirmation period. This period is defined as the range of time between the occurrence of a credit loss (such as the initial

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2010**  
**(Unaudited)**

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

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 as of the reported date of the financial statements. We re-evaluate the adequacy of our allowance for loan losses at least quarterly.

As part of the loss mitigation efforts undertaken by servicers of residential loans owned by Sequoia securitization entities, a growing number of loan modifications have been completed to help make mortgage loans more affordable for certain borrowers. Loan modifications may include, but are not limited to: (i) conversion of a floating rate mortgage loan into a fixed rate mortgage loan; (ii) reduction in the contractual interest rate of a mortgage loan; (iii) forgiveness of a portion of the contractual interest and/or principal amounts owed on a mortgage loan; and, (iv) extension of the contractual maturity of a mortgage loan. We evaluate all loan modifications performed by servicers to determine if they constitute troubled debt restructurings according to GAAP. If a loan is determined to be a troubled debt restructuring, 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 the consolidated statements of income (loss).

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

We do not currently maintain a loan repurchase reserve. We do not originate real estate loans and we believe that risk of loss due to loan repurchases (i.e., due to breach of representations and warranties) would generally be a contingency to the companies from whom we acquired the loans and therefore would be covered by our recourse to those companies. In addition, management is not aware of any outstanding repurchase claims against Redwood that would require the establishment of a loan repurchase reserve.

**Real Estate Securities, at Fair Value**

**Trading Securities**

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

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

### **Available-for-Sale Securities**

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

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2010**  
**(Unaudited)**

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

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

If we conclude through our analysis that there has been no significant adverse change in our cash flow assumptions for the security, then the impairment is deemed temporary in nature and the associated difference between the security's fair value and its amortized cost basis is recorded as an unrealized loss through accumulated other comprehensive income (loss), a component of stockholders' equity. Alternatively, if we conclude that there has been a significant adverse change in our cash flow assumptions for the security, then the impairment is deemed an OTTI and we perform an additional analysis to determine what portion of OTTI, if any, should be recorded through our consolidated statements of income (loss). This analysis entails discounting the security's cash flows to a present value using the prior period yield for the security to determine an expected recoverable value. The difference between this expected recoverable value and the amortized cost basis of the security is deemed to be the credit component of the OTTI that is recorded in our consolidated statements of income (loss). The amortized cost of the security is then adjusted to the expected recoverable value, and the difference between this expected recoverable value and the fair value is deemed to be the non-credit component of the OTTI that is recorded to accumulated other comprehensive income (loss). Future amortization and accretion for the security is computed based upon the new amortized cost basis.

In the second quarter of 2009, as part of our adoption of new authoritative GAAP that we currently use to evaluate impairments on AFS securities, we evaluated \$450 million of previously recorded OTTI on securities still held at April 1, 2009. We determined that \$224 million of these OTTI related to securities where we either had the intent to sell or the OTTI did not include a non-credit component. The remaining \$226 million of these OTTI related to securities that included a \$165 million aggregate credit component and a \$61 million aggregate non-credit component (of which \$60 million related to Redwood's interest and \$1 million related to noncontrolling interest at the Fund). In accordance with the adoption guidance, we recorded a \$61 million one-time cumulative-effect adjustment, net of any related tax effects, to reclassify the non-credit component of these OTTI previously recorded through our consolidated statements of income (loss), as was prescribed under previous GAAP. This reclassification increased retained earnings and decreased other comprehensive income (OCI), resulting in zero net impact to reported stockholders' equity and

noncontrolling interest.

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

## **Other Investments**

Other investments include a guaranteed investment contract (GIC) entered into by an Acacia securitization entity that we consolidate for financial statement purposes. We account for this investment under the fair value option. Changes in fair value are reported through our consolidated statements of income (loss) through market valuation adjustments, net. Interest income is reported through our consolidated statements of income (loss) through interest income, other investments.

See *Note 9* for further discussion on other investments.

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

**Cash and Cash Equivalents**

Cash and cash equivalents include non-restricted cash and highly liquid investments with original maturities of three months or less. At June 30, 2010, we had minimal concentrations of credit risk arising from cash deposits as more than 97% of our cash and cash equivalents were invested in U.S. Government Treasury Bills or FDIC-insured bank products.

**Restricted Cash**

Restricted cash primarily includes principal and interest payments that are collateral for, or payable to, owners of ABS issued by consolidated securitization entities, and cash pledged as collateral on interest rate agreements. Restricted cash may also include cash retained in Acacia or Sequoia securitization entities or in the Fund prior to the purchase of loans or securities, payments on or redemption of outstanding ABS issued, or distributions to limited partners. At June 30, 2010, we did not have any significant concentrations of credit risk arising from restricted cash deposits as more than 98% of our restricted cash was held in custodial accounts, invested in U.S. Government Treasury Bills, or held in FDIC-insured bank products.

**Accrued Interest Receivable**

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

**Derivative Financial Instruments**

Derivative financial instruments include contractual interest rate agreements, other hedging instruments, and credit derivatives. All derivative financial instruments are recorded at fair value in our consolidated balance sheets. Derivatives with a positive fair value to us are reported as an asset and derivatives with a negative fair value to us are reported as a liability. We classify each of our derivative financial instruments as either (i) a trading instrument (no hedging designation); or, (ii) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge).



Changes in fair value of derivatives accounted for as trading instruments, including any associated interest income or expense, are recorded in our consolidated statements of income (loss) through market valuation adjustments, net.

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

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

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**Interest Rate Agreements**

Interest rate agreements we currently utilize include interest rate swaps and caps. Interest rate swaps used at Redwood or Acacia are derivative contracts in which (i) one party exchanges a stream of fixed interest payments for another party's stream of variable interest cash flows; or (ii) each party exchanges variable interest cash flows that are referenced to different indices. Interest rate caps are derivative contracts in which the buyer receives payments at the end of each period in which the interest rate exceeds an agreed upon strike price. We enter into interest rate swaps and caps primarily to reduce significant changes in our income or stockholders' equity caused by interest rate volatility.

**Other Hedging Instruments**

Other hedging instruments we currently utilize include To Be Announced (TBA) contracts, which are forward commitments to purchase agency mortgage-backed securities to be issued in the future. We enter into TBA commitments to offset to varying degrees changes in the value of mortgage products in which we have exposure.

**Credit Derivatives**

Credit derivatives we currently utilize include credit default swaps (CDS), which are agreements to provide (receive) credit event protection based on a financial index or specific security in exchange for receiving (paying) a fixed-rate fee or premium over the term of the contract. These instruments enable us, or our consolidated securitization entities, to synthetically assume the credit risk of a reference security or index of securities. The estimated fair values of these contracts fluctuate for a variety of reasons, such as the likelihood or occurrence of a qualifying credit event (e.g., an interest shortfall, a failure to pay principal, or a distressed rating downgrade), the market perception of default risk and counterparty risk, and supply and demand changes.

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

**Deferred Tax Assets**

Our deferred tax assets are generated by differences in GAAP and taxable income at our taxable subsidiaries. These differences generally reflect differing accounting treatments for tax and GAAP, such as accounting for discount and premium amortization, credit losses, equity awards, asset impairments, and certain valuation estimates. As a result of these differences, we may recognize taxable income in periods prior to when we recognize income for GAAP. When

this occurs, we pay the tax liability and establish a deferred tax asset for GAAP. As the income is subsequently realized in future periods under GAAP, the deferred tax asset is reduced.

### **Deferred Asset-Backed Securities Issuance Costs**

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

### **Other Assets**

Other assets include real estate owned (REO), fixed assets, principal receivable, and other prepaid expenses. REO is reported at the lower of cost or fair value. Subsequent declines in the value of an REO property are recorded in our consolidated statements of income (loss) as a component of market valuation adjustments, net. All other assets are reported at cost.

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

**Short-Term Debt**

Short-term debt can include master repurchase agreements, bank borrowings, and other forms of collateralized borrowings with various commercial banks and investment banks that expire within one year. These facilities may be unsecured or collateralized by loans or securities. In the second quarter of 2010, we incurred short-term debt and intend to use short-term debt as we accumulate loans in the future. We had no short-term debt outstanding at June 30, 2010.

**Accrued Interest Payable**

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

**Asset Backed Securities Issued    Sequoia and Acacia**

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

**Sequoia ABS Issued**

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

## **Acacia ABS Issued**

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

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

## **Long-Term Debt**

Long-term debt includes trust preferred securities and subordinated notes at Redwood and is carried at its unpaid principal balance. Our long-term debt is unsecured with quarterly interest payments at a floating rate equal to the three-month London Interbank Offered Rate (LIBOR) plus a margin until it is redeemed in whole or matures at a future date.

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

## **Equity**

### **Earnings (Loss) Per Common Share**

Basic earnings per share (EPS) is computed by dividing net income allocated to common shareholders by the weighted average common shares outstanding. Net income allocated to common shareholders represents net income applicable to common shareholders, less income allocated to participating securities (as described below). Diluted earnings per common share is computed by dividing income allocated to common shareholders by the weighted average common shares outstanding plus amounts representing the dilutive effect of equity awards.

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**Note 3. Summary of Significant Accounting Policies**  
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On January 1, 2009, we adopted new accounting guidance on EPS that defines unvested share-based payment awards that contain nonforfeitable rights to dividends as participating securities that are included in computing EPS using the two-class method. The two-class method is an earnings allocation formula under which EPS is calculated for common stock and participating securities according to dividends declared and participating rights in undistributed earnings. Under this method, all earnings (distributed and undistributed) are allocated to participating securities and common shares based on their respective rights to receive dividends. Our adoption of this guidance required us to recast previously reported EPS and did not have a significant impact on EPS.

**Other Comprehensive Income (Loss)**

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

**Noncontrolling Interest**

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

**Equity Compensation Plans**

**Incentive Plan**

In May 2010, our shareholders approved an amendment to our previously amended 2002 Redwood Trust, Inc. Incentive Plan (Incentive Plan) for executive officers, employees, and non-employee directors. The amendment provided for an increase in the number of shares available for distribution under the plan. The Incentive Plan authorizes our Board of Directors (or a committee appointed by our Board of Directors) to grant incentive stock

options (ISOs), non-qualifying stock options (NQSOs), deferred stock units (DSUs), restricted stock, performance shares, performance units (including cash), stock appreciation rights, limited stock appreciation rights (awards), and dividend equivalent rights (DERs) to eligible recipients other than non-employee directors. These awards generally vest over a four-year period. Non-employee directors are also provided annual awards under the Incentive Plan that generally vest immediately.

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

### **Employee Stock Purchase Plan**

In May 2009, our stockholders approved an amendment to our 2002 Redwood Trust, Inc. Employee Stock Purchase Plan (ESPP), to increase the number of shares available under the ESPP. The purpose of the ESPP is to give our employees an opportunity to acquire an equity interest in Redwood through the purchase of shares of common stock at a discount. The ESPP allows eligible employees to purchase common stock at

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**Note 3. Summary of Significant Accounting Policies**  
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85% of its fair value, subject to certain limits. Fair value as defined under the ESPP is the lesser of the closing market price of the common stock on the first day of the calendar year or the first day of the calendar quarter.

**Executive Deferred Compensation Plan**

In May 2002, our Board of Directors approved our 2002 Executive Deferred Compensation Plan (EDCP). The EDCP allows eligible employees and directors to defer portions of current salary and certain other forms of compensation. Redwood matches some deferrals. Compensation deferred under the EDCP is an asset of Redwood and subject to the claims of the general creditors of Redwood. The EDCP allows for the investment of deferrals in either an interest crediting account or DSUs.

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

**Taxes**

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

See *Note 18* for further discussion on taxes.

**Recent Accounting Pronouncements**

In April 2010, the FASB issued Accounting Standards Update (ASU) 2010-18, *Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset* a consensus of the FASB Emerging Issues Task Force, to clarify the accounting for loan modifications when the loan is part of a pool of loans that is accounted for as a single asset. The new guidance provides that modification of such loans that are accounted for within a pool does not result in the removal of those loans from the pool even if the modification of those loans would otherwise be



considered a troubled debt restructuring. The entity would continue to consider whether such pool of assets is impaired if the expected cash flows for the pool change. The amended guidance does not affect the accounting for loans that are not accounted for within pools. Loans accounted for individually continue to be accounted for under the troubled debt restructuring guidance. In addition, the amended guidance allows entities to make a one-time election to terminate accounting for loans in a pool. The amended guidance is effective for a modification of a loan(s) accounted for within a pool occurring in the first interim or annual period ending on or after July 15, 2010. The amended guidance must be applied prospectively, and early application is permitted. We are currently evaluating the impact of ASU 2010-18 on our consolidated financial statements.

In July 2010, the FASB issued Accounting Standards Update (ASU) 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, which amends ASC 310 by requiring more robust and disaggregated disclosures about the credit quality of an entity's financing receivables and its allowance for credit losses. The objective of enhancing these disclosures is to improve financial statement users' understanding of (1) the nature of an entity's credit risk associated with its financing receivables and (2) the entity's assessment of that risk in estimating its allowance for credit losses as well as changes in the allowance and the reasons for those changes. ASU 2010-20 requires disclosures of the portfolio

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

segment and class of financing receivable levels, and focuses on the following: nonaccrual and past due financing receivables, allowance for credit losses related to financing receivables, impaired loans (individually evaluated for impairment), credit quality information, and modification. The amended guidance is effective for public companies in the first interim or annual period ending on or after December 31, 2010. ASU 2010-20 will increase our loan and allowance for loan loss disclosures, but will not have an effect on our consolidated financial statements.

**Note 4. Principles of Consolidation**

We apply ASC 860 and ASC 810-10 to determine whether we must consolidate transferred financial assets and variable interest entities (VIEs) for financial reporting purposes. ASC 860 considers whether securitizations and other transfers of financial assets are treated as sales or financings. Additionally, ASC 810-10 addresses whether VIEs (e.g., certain legal entities often used in securitization and other structured finance transactions) should be included in the consolidated financial statements of any particular interested party. These standards became effective for our interests in all VIEs as of January 1, 2010, except for the Fund as a result of the FASB's decision to delay the applicability of ASC 810-10 for private equity funds. Our determination of whether we must consolidate the Fund was performed in accordance with FASB Interpretation No. 46 (revised), *Consolidation of Variable Interest Entities* (FIN 46(R)), at the time we acquired our interests in the Fund.

**Analysis of Consolidated VIEs**

The VIEs we are required to consolidate include the Fund, certain Sequoia securitization entities, and the Acacia entities. The following table presents a summary of the assets and liabilities of these VIEs.

**Assets and Liabilities of Consolidated VIEs at June 30, 2010**

(Dollars in thousands)	The Fund	Sequoia Entities	Acacia Entities	Total
Real estate loans	\$	\$ 3,788,024	\$ 19,485	\$ 3,807,509
Real estate securities	25,080		257,530	282,610
Other investments			3,654	3,654
Other assets	2,428	23,882	32,993	59,303

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Total Assets	\$ 27,508	\$ 3,811,906	\$ 313,662	\$ 4,153,076
Asset-backed securities	\$	\$ 3,708,395	\$ 253,104	\$ 3,961,499
Other liabilities	806	2,892	84,491	88,189
Total Liabilities	\$ 806	\$ 3,711,287	\$ 337,595	\$ 4,049,688
Noncontrolling Interest	\$ 11,993	\$	\$	\$ 11,993
Number of VIEs	1	37	10	48

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

We consolidate the assets and liabilities of certain Sequoia securitization entities issued prior to 2010, as we did not meet the sale criteria at the time we transferred financial assets to these entities. Had we not been the transferor and depositor of these securitizations, we would likely not have consolidated them as we determined that we are not the primary beneficiary of these entities in accordance with ASC 810-10.

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

In April 2010, we sponsored a \$238 million residential prime jumbo mortgage securitization through our Sequoia program and recorded the assets and liabilities of this entity on our consolidated balance sheet, as we did not meet the sale criteria at the time we transferred financial assets to this entity. We determined that we are the primary beneficiary of this Sequoia entity as our ongoing loss mitigation and resolution responsibilities provide us with the power to direct the activities that most significantly impact the economic performance of the entity and our significant investment interests provide us with the obligation to absorb losses or the right to receive benefits that are significant.

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

**Analysis of Non-Consolidated VIEs**

Third party VIEs are securitization entities that Redwood did not sponsor. We may own several securities from a third party VIE, and in those cases, the analysis is done in consideration of all of our interests in that VIE. We determined that we are not the primary beneficiary of any third-party residential, commercial, re-REMIC, or CDO entities in any third party VIEs, 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 VIEs we only account for our specific interests in each.

The following table presents a summary of Redwood's interest in third party VIEs at June 30, 2010, grouped by collateral type and ownership interest.

**VIE Summary**

June 30, 2010 (Dollars in Thousands)	Fair Value	Number of VIEs
Real estate securities at Redwood		
Residential		
Senior	\$ 630,099	99

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Re-REMIC	69,070	10
Subordinate	26,436	203
Commercial	7,610	15
CDO	1,132	10
Total Third-party Real Estate Securities	\$ 734,347	337

Our future assessments of whether we are required to consolidate a VIE may change based upon the facts and circumstances pertaining to each VIE. Changes in accounting for any VIE could result in a material impact to our financial statements in subsequent reporting periods.

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(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 measure the fair value of the assets and liabilities in the table above. This hierarchy prioritizes relevant market inputs in order to determine an exit price, or the price at which an asset could be sold or a liability could be transferred in an orderly process that is not a forced liquidation or distressed sale at the date of measurement. Additionally, relevant market data, to the extent available and not internally generated or entity specific information should be used to determine fair value. Level 1 inputs are observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets. Level 2 inputs are observable inputs other than quoted prices for an asset or liability that are obtained through corroboration with observable market data. Level 3 inputs are unobservable inputs (e.g., our own data or assumptions) that are used when there is little, if any, relevant market activity for the asset or liability being measured at fair value.

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

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 as of June 30, 2010 and December 31, 2009.

(In Thousands)	June 30, 2010		December 31, 2009	
	Carrying Value	Fair Value	Carrying Value	Fair Value
<b>Assets</b>				
Real estate loans (held-for-investment)	\$ 3,788,266	\$ 3,112,660	\$ 3,724,791	\$ 3,000,496
Real estate loans (held-for-sale)	2,404	2,404	2,374	2,374
Real estate loans (fair value)	19,485	19,485	12,089	12,089
Trading securities	275,994	275,994	277,274	277,274
Available-for-sale securities	740,963	740,963	810,471	810,471
Other investments	3,654	3,654	20,371	20,371
Cash and equivalents	288,376	288,376	242,818	242,818
Derivative assets	4,735	4,735	12,372	12,372
Restricted cash	26,814	26,814	94,306	94,306
Accrued interest receivable	14,085	14,085	18,193	18,193
REO (included in other assets)	11,797	11,797	17,421	17,421

Liabilities				
Derivative liabilities	106,355	106,355	83,800	83,800
Accrued interest payable	6,315	6,315	5,968	5,968
ABS Issued				
ABS issued Sequoia	3,681,622	3,016,105	3,644,933	2,909,032
ABS issued Acacia	253,104	253,104	297,596	297,596
Total ABS issued	3,934,726	3,269,209	3,942,529	3,206,628
Long-term debt	140,000	61,600	140,000	68,600

We did not elect the fair value option for any residential securities that we acquired in the second quarter of 2010.

During the first quarter of 2010, we elected the fair value option for \$13 million of residential senior securities acquired during the quarter. During 2009, we elected the fair value option for certain ABS issued by Sequoia and acquired by Acacia as a result of the deconsolidation of certain Sequoia entities during the fourth quarter of 2008 and second quarter of 2009. These ABS issued had been previously eliminated as intercompany assets for financial reporting purposes.

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

During 2008, we elected the fair value option for all of the loans, securities, and ABS issued at Acacia. At June 30, 2010, the loans had an aggregate fair value of \$19 million and an unpaid principal balance of \$23 million, the securities had an aggregate fair value of \$258 million and an unpaid principal balance of \$1.9 billion, and the asset-backed securities issued had an aggregate fair value of \$253 million and an unpaid principal balance of \$3.0 billion.

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

**Assets and Liabilities Measured at Fair Value on a Recurring Basis as of June 30, 2010**

(In Thousands)	Carrying Value	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
<b>Assets</b>				
Real estate loans	\$ 19,485	\$	\$	\$ 19,485
Trading securities	275,994			275,994
Available-for-sale securities	740,963			740,963
Other investments	3,654		3,654	
Derivative assets	4,735		4,701	34
<b>Liabilities</b>				
ABS issued Acacia	253,104			253,104
Derivative liabilities	106,355	508	102,214	3,633

**Assets and Liabilities Measured at Fair Value on a Recurring Basis as of December 31, 2009**

(In Thousands)	Carrying Value	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
<b>Assets</b>				
Real estate loans	\$ 12,089	\$	\$	\$ 12,089
Trading securities	277,274			277,274



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Available-for-sale securities	810,471		810,471
Other investments	20,371	20,371	
Derivative assets	12,372	12,326	46
Liabilities			
ABS issued Acacia	297,596		297,596
Derivative liabilities	83,800	63,499	20,301

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TABLE OF CONTENTS**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2010  
(Unaudited)****Note 5. Fair Value of Financial Instruments (continued)**

The following table presents additional information about Level 3 assets and liabilities during the six months ended June 30, 2010.

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

(In Thousands)		Assets			Liabilities		
		Real Estate Loans	Trading Securities	AFS Securities	Derivative Assets	ABS Issued Acacia	Derivative Liabilities
Beginning balance	December 31, 2009	\$12,089	\$277,274	\$810,471	\$ 46	\$297,596	\$20,301
Principal paydowns		52	(31,102 )	(71,083 )		(43,743 )	
Gains (losses) in net income, net		7,344	18,479	15,290	(5 )	(6,004 )	(262 )
Gains (losses) in OCI, net				(5,485 )			
Acquisitions			17,137	186,057			
Sales			(6,119 )	(194,337)			
Other settlements, net			325	50	(7 )	5,255	(16,406)
Ending Balance	June 30, 2010	\$19,485	\$275,994	\$740,963	\$ 34	\$253,104	\$3,633

The following table presents the portion of gains or losses included in our consolidated statement of income (loss) that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and still held at June 30, 2010 and 2009. Gains or losses incurred on assets or liabilities sold or otherwise disposed of during the three and six months ended June 30, 2010 and 2009 are not included in this presentation.

**Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at June 30, 2010 and 2009 Included in Net Income (Loss)**

(In Thousands)	Included in Net Income (Loss)			
	Three Months Ended June 30, 2010	2009	Six Months Ended June 30, 2010	2009
Assets				

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Real estate loans	\$ 2,978	\$ (1,720 )	\$ 7,344	\$ (3,967 )
Trading securities	5,042	11,368	17,364	(34,408 )
Available-for-sale securities	(4,216 )	(33,237 )	(6,134 )	(62,121 )
Derivative assets	15	71	(5 )	231
Liabilities				
ABS issued Acacia	11,257	(28,792 )	6,004	2,897
Derivative liabilities	49	(401 )	109	(672 )

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TABLE OF CONTENTS**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2010  
(Unaudited)****Note 5. Fair Value of Financial Instruments (continued)**

The following table presents information on assets and liabilities recorded at fair value on a non-recurring basis at June 30, 2010 and December 31, 2009.

**Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis as of  
June 30, 2010**

(In Thousands)	Carrying Value	Fair Value Measurements Using			Gain (Loss)	
		Level 1	Level 2	Level 3	Three Months Ended June 30, 2010	Six Months Ended June 30, 2010
Assets						
Real estate loans (held-for-sale)	\$ 2,404	\$	\$	\$ 2,404	\$ 296	\$ 176
REO	11,797			11,797	(1,285 )	(1,359 )

**Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis as of  
December 31, 2009**

(In Thousands)	Carrying Value	Fair Value Measurements Using			Gain (Loss)	
		Level 1	Level 2	Level 3	Three Months Ended June 30, 2009	Six Months Ended June 30, 2009
Assets						
Real estate loans (held-for-sale)	\$ 2,374	\$	\$	\$ 2,374	\$ (56 )	\$ (77 )
REO	17,421			17,421	(1,159 )	(1,923 )

The following table presents the components of market valuation adjustments, net, recorded in our consolidated statements of income (loss) for the three and six months ended June 30, 2010 and 2009.

**Market Valuation Adjustments, Net**

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
<b>Assets</b>				
Real estate loans (fair value)	\$ 2,978	\$ (1,720 )	\$ 7,344	\$ (3,967 )
Real estate loans (held-for-sale)	296	(56 )	176	(77 )
REO	(1,285 )	(1,159 )	(1,359 )	(1,923 )
Trading securities	6,330	11,240	18,479	(35,185 )
Impairments on AFS securities	(4,216 )	(33,237 )	(6,162 )	(62,272 )
<b>Liabilities</b>				
ABS issued Acacia	11,257	(28,792 )	6,004	2,897
Derivative instruments, net	(22,485 )	24,589	(42,844 )	28,148
Market Valuation Adjustments, Net	\$ (7,125 )	\$ (29,135 )	\$ (18,362 )	\$ (72,379 )

A description of the instruments measured at fair value as well as the general classification of such instruments pursuant to the Level 1, Level 2, and Level 3 valuation hierarchy is listed below.

**Real estate loans**

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

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

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2010**  
**(Unaudited)**

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

Real estate securities

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

We request and consider indications of value (marks) from third-party dealers to assist us in our valuation process. The availability of third-party marks continues to decline, in part because some dealers no longer exist and others have ceased providing client valuation services. For June 30, 2010, we received dealer marks on 78% of our securities. In the aggregate, our internal valuations of the securities on which we received dealer marks were 3% lower (i.e., more conservative) than the aggregate dealer marks.

Other investments

Other investments currently include a GIC. Management considers the GIC's fair value to approximate its contract value, as the GIC earns a variable interest rate of LIBOR less 5 basis points and resets on a monthly basis (Level 2).

Derivative assets and liabilities

Our derivative instruments include interest rate agreements, TBAs, and credit default swaps. Fair values of derivative instruments are determined using quoted prices from active markets when available or valuation models and are verified by valuations provided by dealers active in derivative markets. TBA fair values are generally obtained using quoted prices from active markets (Level 1). Valuation models require a variety of inputs, including contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates, and correlations of such inputs. Model inputs for interest rate agreements can generally be verified and model selection does not involve significant management judgment (Level 2). For other derivatives, such as certain CDS, valuations are based on various factors such as liquidity, bid/offer spreads, and credit considerations for which we rely on available market evidence. In the absence of such evidence, management's best estimate is used (Level 3).

Cash and cash equivalents

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

Restricted cash

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

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.

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**REDWOOD TRUST, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**June 30, 2010**  
**(Unaudited)**

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

Short-term debt

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

ABS issued

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

We request and consider indications of value (marks) from third-party dealers to assist us in our valuation process. The availability of third-party marks continues to decline, in part because some dealers no longer exist and others have ceased providing client valuation services. For June 30, 2010, we received dealer marks on 88% of our ABS issued. Our internal valuations of our ABS issued on which we received dealer marks were 7% higher (i.e., more conservative) than the aggregate dealer marks.

Long-term debt

Long-term debt includes our subordinated notes and trust preferred securities. Fair values are determined using comparable market indicators of current pricing. Significant inputs in the valuation analysis are predominantly Level 3 due to the nature of these instruments and the lack of readily available market quotes. Estimated fair values are based on applying the market indicators to generate discounted cash flows (Level 3).

Real Estate Owned (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).



TABLE OF CONTENTS**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2010  
(Unaudited)****Note 6. Real Estate Loans**

We invest in residential and commercial real estate loans that we acquire from third party originators. We finance these loans through the Sequoia and Acacia entities that we sponsor or with equity or long-term debt.

The following table summarizes the classifications and carrying value of the residential and commercial real estate loans recorded on our consolidated balance sheets at June 30, 2010 and December 31, 2009.

(In Thousands)	June 30, 2010	December 31, 2009
Residential real estate loans (held-for-sale)	\$ 2,404	\$ 2,374
Residential real estate loans (held-for-investment)	3,788,024	3,724,546
Commercial real estate loans (fair value)	19,485	12,089
Commercial real estate loans (held-for-investment)	242	245
Total Real Estate Loans	\$ 3,810,155	\$ 3,739,254

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

Residential real estate loans held-for-sale are owned at Redwood and financed with equity. At June 30, 2010, there were 13 residential loans held-for-sale with \$4 million in outstanding principal value and a lower of cost or fair value of \$2 million. At December 31, 2009, there were 14 residential loans held-for-sale with \$4 million in outstanding principal value and a lower of cost or fair value of \$2 million.

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

Residential real estate loans held-for-investment are owned at the consolidated Sequoia securitization entities.

The following table provides additional information on residential real estate loans held-for-investment at June 30, 2010 and December 31, 2009.

(In Thousands)	June 30, 2010	December 31, 2009
Principal value	\$ 3,803,592	\$ 3,728,738
Unamortized premium, net	45,910	50,028

Allowance for loan losses	(61,478 )	(54,220 )
Carrying Value	\$3,788,024	\$3,724,546

In April 2010, we sponsored a residential prime jumbo mortgage securitization through our Sequoia program. At June 30, 2010 the loans owned by this Sequoia entity had an outstanding principal value of \$226 million.

Of the \$3.8 billion of principal and \$46 million of unamortized premium on loans held-for-investment at June 30, 2010, \$1.8 billion of principal and \$30 million of unamortized premium relates to residential loans acquired prior to July 1, 2004. During the first half of 2010, 4% of these residential loans prepaid and we amortized 9% of the premium based upon the accounting elections we apply. For residential loans acquired after July 1, 2004, the principal was \$2 billion and the unamortized premium was \$16 million. During the first half of 2010, 4% of these loans prepaid and we amortized 8% of the premium.

Of the \$3.7 billion of principal and \$50 million of unamortized premium on these loans at December 31, 2009, \$1.8 billion of principal and \$33 million of unamortized premium relates to residential loans acquired prior to July 1, 2004. For residential loans acquired after July 1, 2004, the principal face was \$1.9 billion and the unamortized premium was \$17 million. During the fourth quarter of 2009, 2% of these loans prepaid and we amortized 4% of the premium.

TABLE OF CONTENTS**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2010  
(Unaudited)****Note 6. Real Estate Loans (continued)****Commercial Real Estate Loans at Fair Value**

Commercial real estate loans at fair value are owned at the consolidated Acacia securitization entities. At June 30, 2010, there were four commercial loans at fair value with an aggregate outstanding principal value of \$23 million and an aggregate fair value of \$19 million, one of which has been delinquent since May 2009 with an outstanding principal balance of \$4 million and a fair value of \$3 million. At December 31, 2009, there were four commercial loans at fair value, with an outstanding principal of \$23 million and a fair value of \$12 million.

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

At June 30, 2010, there was one commercial loan held-for-investment with \$0.5 million in outstanding principal value and a carrying value of \$0.2 million. During the first half of 2010, we charged off a \$10 million commercial mezzanine loan with no impact to our consolidated statements of income (loss), as we had fully reserved for this loan in 2007. At December 31, 2009, there were two commercial loans held-for-investment with \$11 million in outstanding principal value and a carrying value of \$0.2 million.

**Note 7. Allowance for Loan Losses**

We establish an allowance for loan losses on our residential and commercial loans held-for-investment based on our estimate of losses incurred in these loan portfolios.

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

At June 30, 2010 and June 30, 2009, all residential loans classified as held-for-investment were owned by Sequoia entities. The following table summarizes the activity in the allowance for loan losses on residential loans for the three and six months ended June 30, 2010 and 2009.

(In Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Balance at Beginning of Period	\$ 61,169	\$ 47,947	\$ 54,220	\$ 35,713
Charge-offs, net	(4,012 )	(1,820 )	(6,539 )	(5,618 )
Provision for loan losses	4,321	14,545	13,797	30,577

Deconsolidation adjustment		(14,795 )		(14,795 )
Balance at End of Period	\$ 61,478	\$ 45,877	\$ 61,478	\$ 45,877

Serious delinquencies on consolidated Sequoia loans were \$144 million and \$137 million as of June 30, 2010 and 2009, respectively. Serious delinquencies include loans delinquent more than 90 days and in foreclosure. As a percentage of outstanding loan balances, serious delinquencies were 3.80% and 3.48% at June 30, 2010 and 2009, respectively.

When we pursue foreclosure in full satisfaction for a defaulted loan, we estimate the specific loan loss, if any, based on estimated net proceeds from the sale of the property (including accrued but unpaid interest and other costs), and charge this specific estimated loss against the allowance for loan losses. During the first half of 2010, there were \$7 million of charge-offs that reduced our allowance for loan losses. These charge-offs arose from \$21 million of defaulted loan principal. Foreclosed property is subsequently recorded as REO, a component of other assets.

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June 30, 2010  
(Unaudited)****Note 8. Real Estate Securities**

We invest in third party residential, commercial, and CDO securities. The following table presents the fair values of our real estate securities by collateral type and entity as of June 30, 2010 and December 31, 2009.

June 30, 2010 (In Thousands)	Redwood	The Fund	Acacia	Total Securities
Residential	\$ 725,605	\$ 21,135	\$ 197,167	\$ 943,907
Commercial	7,610		48,979	56,589
CDO	1,132	3,945	11,384	16,461
Total Real Estate Securities	\$ 734,347	\$ 25,080	\$ 257,530	\$ 1,016,957

December 31, 2009 (In Thousands)	Redwood	The Fund	Acacia	Total Securities
Residential	\$ 770,916	\$ 32,884	\$ 201,367	\$ 1,005,167
Commercial	9,200		54,206	63,406
CDO	1,247	4,067	13,858	19,172
Total Real Estate Securities	\$ 781,363	\$ 36,951	\$ 269,431	\$ 1,087,745

The following table presents our securities by trading and AFS, collateral type, and entity as of June 30, 2010 and December 31, 2009.

June 30, 2010 (In Thousands)	Trading			AFS		
	Redwood	Acacia	Total	Redwood	The Fund	Total
Senior Securities						
Residential prime	\$	\$ 4,653	\$ 4,653	\$ 309,702	\$	\$ 309,702
Residential non-prime	16,763	100,832	117,595	303,634	15,451	319,085
Commercial		10,832	10,832			
Total Senior Securities	16,763	116,317	133,080	613,336	15,451	628,787
Re-REMIC Securities				69,070		69,070
Subordinate Securities						
Residential prime	381	23,415	23,796	16,025		16,025
Residential non-prime	188	68,267	68,455	9,842	5,684	15,526
Commercial		38,147	38,147	7,610		7,610
CDO	1,132	11,384	12,516		3,945	3,945

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Total Subordinate Securities	1,701	141,213	142,914	33,477	9,629	43,106
Total Real Estate Securities	\$ 18,464	\$ 257,530	\$ 275,994	\$ 715,883	\$ 25,080	\$ 740,963

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June 30, 2010  
(Unaudited)****Note 8. Real Estate Securities (continued)**

December 31, 2009 (In Thousands)	Trading			AFS		
	Redwood	Acacia	Total	Redwood	The Fund	Total
Senior Securities						
Residential prime	\$	\$ 4,826	\$ 4,826	\$ 329,208	\$	\$ 329,208
Residential non-prime	6,084	100,397	106,481	308,868	26,735	335,603
Commercial		9,508	9,508			
Total Senior Securities	6,084	114,731	120,815	638,076	26,735	664,811
Re-REMIC Securities						