

REDWOOD TRUST INC
Form 10-Q
May 08, 2012
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UNITED STATES OF AMERICA
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended: March 31, 2012

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
(State or Other Jurisdiction of

68-0329422
(I.R.S. Employer

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Incorporation or Organization)

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

79,055,468 shares outstanding as of May 4, 2012

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2012 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)	March 31, 2012	December 31, 2011
ASSETS		
Residential loans, held-for-sale	\$ 303,106	\$ 395,237
Residential loans, held-for-investment	3,347,952	3,799,648
Commercial loans (includes \$12,103 and \$12,129 at fair value)	190,518	169,855
Real estate securities, at fair value	1,262,156	981,837
Cash and cash equivalents	149,558	267,176
Total earning assets	5,253,290	5,613,753
Restricted cash	15,795	14,987
Accrued interest receivable	16,213	15,840
Derivative assets	3,185	2,373
Deferred securities issuance costs	7,459	8,083
Other assets	76,145	88,262
Total Assets ⁽¹⁾	\$ 5,372,087	\$ 5,743,298
LIABILITIES AND EQUITY		
Liabilities		
Short-term debt	\$ 440,965	\$ 428,056
Accrued interest payable	7,774	8,134
Derivative liabilities	103,826	127,564
Accrued expenses and other liabilities	13,983	8,105
Asset-backed securities issued (includes \$236,925 and \$209,381 at fair value)	3,703,782	4,139,355
Long-term debt	139,500	139,500
Total liabilities ⁽¹⁾	4,409,830	4,850,714
Equity		
Common stock, par value \$0.01 per share, 125,000,000 shares authorized; 78,756,319 and 78,555,908 issued and outstanding	788	786
Additional paid-in capital	1,702,412	1,697,979
Accumulated other comprehensive income	41,856	(13,151)
Cumulative earnings	531,746	501,283
Cumulative distributions to stockholders	(1,314,545)	(1,294,313)
Total stockholders' equity	962,257	892,584
Noncontrolling interest	-	-
Total equity	962,257	892,584

Total Liabilities and Equity	\$	5,372,087	\$	5,743,298
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- (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 March 31, 2012 and December 31, 2011, assets of consolidated VIEs totaled \$3,985,463 and \$4,408,350, respectively, and liabilities of consolidated VIEs totaled \$3,770,197 and \$4,209,124, 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 March 31,	
	2012	2011
Interest Income		
Residential loans	\$ 23,379	\$ 18,469
Commercial loans	5,346	1,225
Real estate securities	29,994	34,624
Cash and cash equivalents	21	15
Total interest income	58,740	54,333
Interest Expense		
Short-term debt	(1,827)	(182)
Asset-backed securities issued	(26,452)	(19,423)
Long-term debt	(2,376)	(2,367)
Total interest expense	(30,655)	(21,972)
Net Interest Income	28,085	32,361
Provision for loan losses	(274)	(2,807)
Other market valuation adjustments	(296)	(3,118)
Other-than-temporary impairments ⁽¹⁾	(332)	(2,622)
Other market valuation adjustments, net	(628)	(5,740)
Net Interest Income After Provision and Other Market Valuation Adjustments	27,183	23,814
Mortgage banking activities, net	4,302	-
Operating expenses	(14,634)	(11,514)
Realized gains, net	13,620	3,864
Net income before provision for income taxes	30,471	16,164
Provision for income taxes	(8)	(14)
Net income	30,463	16,150
Less: Net loss attributable to noncontrolling interest	-	(2,015)
Net Income Attributable to Redwood Trust, Inc.	\$ 30,463	\$ 18,165
Basic earnings per common share	\$ 0.38	\$ 0.23
Diluted earnings per common share	\$ 0.37	\$ 0.22
Regular dividends declared per common share	\$ 0.25	\$ 0.25
Basic weighted average shares outstanding	78,397,359	78,027,840
Diluted weighted average shares outstanding	79,892,013	79,371,776

- (1) For the three months ended March 31, 2012, other-than-temporary impairments were \$481 of which \$149 were recognized in Accumulated Other Comprehensive Income. For the three months ended March 31, 2011, other-than-temporary impairments were \$3,312, of which \$690 were recognized in Accumulated Other Comprehensive Income.

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 March 31,	
	2012	2011
Net Income	\$ 30,463	\$ 18,165
Other comprehensive income:		
Net unrealized gain on available-for-sale securities	40,701	7,588
Reclassification of other-than-temporary impairments to net income	77	1,770
Net unrealized gain on interest rate agreements	13,193	3,890
Reclassification of unrealized loss on interest rate agreements to net income	1,036	1,064
Total other comprehensive income	55,007	14,312
Total comprehensive income	85,470	32,477
Less: Comprehensive income attributable to noncontrolling interest	-	4,539
Comprehensive Income Attributable to Redwood Trust, Inc.	\$ 85,470	\$ 27,938

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

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY**

For the Three Months Ended March 31, 2012

(In Thousands, Except Share Data) (Unaudited)	Common Stock		Additional	Accumulated Other	Cumulative Earnings	Cumulative		Total
	Shares	Amount	Paid-In Capital	Comprehensive Income		Distributions to Stockholders	Noncontrolling Interest	
December 31, 2011	78,555,908	\$ 786	\$ 1,697,979	\$ (13,151)	\$ 501,283	\$ (1,294,313)	\$ -	\$ 892,584
Net income	-	-	-	-	30,463	-	-	30,463
Other comprehensive income	-	-	-	55,007	-	-	-	55,007
Issuance of common stock:								
Dividend reinvestment & stock purchase plans	201,186	2	2,201	-	-	-	-	2,203
Employee stock purchase and incentive plans	(775)	-	(24)	-	-	-	-	(24)
Non-cash equity award compensation	-	-	2,256	-	-	-	-	2,256
Distributions to noncontrolling interest, net	-	-	-	-	-	-	-	-
Common dividends declared	-	-	-	-	-	(20,232)	-	(20,232)
March 31, 2012	78,756,319	\$ 788	\$ 1,702,412	\$ 41,856	\$ 531,746	\$ (1,314,545)	\$ -	\$ 962,257

For the Three Months Ended March 31, 2011

(In Thousands, Except Share Data) (Unaudited)	Common Stock		Additional	Accumulated Other	Cumulative Earnings	Cumulative		Total
	Shares	Amount	Paid-In Capital	Comprehensive Income		Distributions to Stockholders	Noncontrolling Interest	
December 31, 2010	78,124,668	\$ 781	\$ 1,689,851	\$ 112,339	\$ 474,940	\$ (1,213,158)	\$ 10,839	\$ 1,075,592
Net income (loss)	-	-	-	-	18,165	-	(2,015)	16,150
Other comprehensive income	-	-	-	9,773	-	-	4,539	14,312
Issuance of common stock:								
Dividend reinvestment & stock purchase plans	13,304	-	196	-	-	-	-	196
Employee stock purchase and incentive plans	752	-	(26)	-	-	-	-	(26)
Non-cash equity award compensation	-	-	2,074	-	-	-	-	2,074
Distributions to noncontrolling interest, net	-	-	-	-	-	-	(6,323)	(6,323)
Common dividends declared	-	-	-	-	-	(20,124)	-	(20,124)
March 31, 2011	78,138,724	\$ 781	\$ 1,692,095	\$ 122,112	\$ 493,105	\$ (1,233,282)	\$ 7,040	\$ 1,081,851

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) (Unaudited)	Three Months Ended March 31,	
	2012	2011
Cash Flows From Operating Activities:		
Net income attributable to Redwood Trust, Inc.	\$ 30,463	\$ 18,165
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of premiums, discounts, and debt issuance costs, net	(6,622)	(9,520)
Depreciation and amortization of non-financial assets	944	257
Purchases of loans held-for-sale	(660,008)	-
Principal payments on loans held-for-sale	724	-
Proceeds from sales of loans held-for-sale	388,760	-
Provision for loan losses	274	2,807
Non-cash equity award compensation	2,256	2,074
Market valuation adjustments, net	3,701	5,740
Realized gains, net	(20,985)	(3,864)
Net change in:		
Accrued interest receivable	(1,062)	76
Other assets	20,073	3,529
Accrued interest payable	5,101	3,892
Accrued expenses and other liabilities	2,715	(5,947)
Net cash (used in) provided by operating activities	(233,666)	17,209
Cash Flows From Investing Activities:		
Purchases of loans held-for-investment	(26,888)	(112,742)
Principal payments on loans held-for-investment	155,301	93,292
Proceeds from sales of loans held-for-sale	364,536	1,857
Purchases of available-for-sale securities	(259,697)	(13,223)
Proceeds from sales of available-for-sale securities	49,511	48,072
Principal payments on available-for-sale securities	28,004	31,234
Purchases of trading securities	(21,176)	-
Proceeds from sales of trading securities	859	12,841
Principal payments on trading securities	12,199	15,080
Proceeds from deconsolidation	3,220	-
Net decrease in restricted cash	(849)	(10,459)
Net cash provided by investing activities	305,020	65,952
Cash Flows From Financing Activities:		
Proceeds from borrowings on short-term debt	477,389	-
Repayments on short-term debt	(464,480)	(44,137)
Proceeds from issuance of asset-backed securities	96	280,111
Repayments on asset-backed securities issued	(164,740)	(110,896)
Deferred securities issuance costs	-	(1,695)
Net settlements of derivatives	(16,981)	(4,916)
Net proceeds from issuance of common stock	(24)	170
Dividends paid	(20,232)	(20,121)
Change in noncontrolling interests	-	(8,338)
Net cash (used in) provided by financing activities	(188,972)	90,178

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Net (decrease) increase in cash and cash equivalents	(117,618)	173,339
Cash and cash equivalents at beginning of period	267,176	46,937
Cash and cash equivalents at end of period	\$ 149,558	\$ 220,276

Supplemental Disclosures:

Cash paid for interest	\$ 30,068	\$ 16,833
Cash paid for taxes	15	18
Dividends declared but not paid at end of period	-	19,535
Transfers from residential loans to real estate owned	2,606	2,396

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2012

(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 loans and in asset-backed securities backed by real estate loans. We seek to invest in assets that have the potential to generate sufficient long-term cash flow returns to support our goal of distributing an attractive level of dividends per share to shareholders over time. For tax purposes, we are structured as a real estate investment trust (REIT).

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

Note 2. Basis of Presentation

The consolidated financial statements presented herein are at March 31, 2012 and December 31, 2011, and for the three months ended March 31, 2012 and 2011. 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

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. Redwood's consolidated subsidiaries include both qualifying REIT subsidiaries and taxable subsidiaries. References to the Redwood REIT include Redwood and its qualifying REIT subsidiaries, excluding taxable subsidiaries.

We sponsor two securitization programs. Our Sequoia program is used for the securitization of residential mortgage loans. References to Sequoia refer collectively to all the consolidated Sequoia securitization entities. Our Acacia program was used for the securitization of mortgage-backed securities and other types of financial assets. References to Acacia refer collectively to all the consolidated Acacia securitization entities.

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 the Sequoia and the Acacia 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. Prior to the fourth quarter of 2011, we also consolidated the assets, liabilities, and noncontrolling interests of the Opportunity Fund (Fund) that we managed. 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, although we are exposed to certain financial risks associated with our role as the sponsor or manager of these entities.

For financial reporting purposes, the underlying loans and securities owned at the Sequoia, Acacia, and resecuritization entities are shown under residential and commercial loans and real estate securities on our consolidated balance sheets. The asset-backed securities (ABS) issued to third parties by these entities are shown under ABS issued. In our consolidated statements of income, we record interest income on the loans and securities owned by consolidated Sequoia, Acacia, and resecuritization entities and interest expense on the ABS issued by these entities. The real estate securities owned at the Fund were shown on our consolidated balance sheets under real estate securities and the portion of the Fund owned by third parties was shown under noncontrolling interest. In our consolidated statements of income, we recorded interest income on the securities owned at the Fund.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2012

(Unaudited)

Note 3. Summary of Significant Accounting Policies

Use of Estimates

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

Fair Value Measurements

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

Quoted prices for the same or similar securities;

Relevant reports issued by analysts and rating agencies;

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

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

Indicative prices or yields from broker/dealers; and,

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

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

The markets for many of the real estate securities that we invest in and issue are generally illiquid. Establishing fair values for illiquid assets and liabilities is inherently subjective and is often dependent upon our estimates and modeling assumptions. If we determine that either the volume and/or level of trading activity for an asset or liability has significantly decreased from normal market conditions, or price quotations or

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observable inputs are not associated with orderly transactions, the market inputs that we obtain might not be relevant. For example, broker or pricing service quotes might not be relevant if an active market does not exist for the financial asset or liability. The nature of the quote (for example, whether the quote is an indicative price or a binding offer) is also evaluated.

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

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2012

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Fair Value Option

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

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

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

Residential and Commercial Loans

Residential and Commercial Loans Fair Value

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

Residential and Commercial Loans Held-for-Sale

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. These loans are carried at the lower of their cost or fair value, as measured on an individual basis or, in the case of the loans we intend to pool for securitization based upon similar underwriting characteristics, on an aggregate basis. If the fair value of a loan, or pool of loans, held-for-sale is lower than its amortized cost basis, this difference is reported as a negative market valuation adjustment through our consolidated statements of income. Coupon interest for loans held-for-sale is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Gains or losses on the sale of residential or commercial loans are based on the specific identification method for loans measured on an individual basis or in aggregate for those loans measured on a pool basis.

Residential and Commercial Loans Held-for-Investment

Loans held-for-investment include residential loans owned at Sequoia entities and commercial loans owned at Redwood. These loans are carried at their unpaid principal balances adjusted for net unamortized premiums or discounts and net of any allowance for loan losses. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due or when a loan has been individually impaired, at which point the loan is placed on nonaccrual status. Interest previously accrued for loans that have become greater than 90 days past due or individually impaired is reserved for in the allowance for loan losses. Residential loans delinquent more than 90 days or in

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foreclosure are characterized as seriously delinquent. Cash principal and interest that is advanced from servicers subsequent to a loan becoming greater than 90 days past due or individually impaired is used to reduce the outstanding loan principal balance. When a seriously delinquent loan previously placed on nonaccrual status has cured, meaning all delinquent principal and interest have been remitted by the borrower, the loan is placed back on accrual status. Loans that have been individually impaired are placed back on accrual status once the loan is considered reperforming. A loan is considered reperforming when the loan has been current for at least 12 months.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2012

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

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

We reclassify loans held-for-investment 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 pools 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 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;

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Information supporting a borrower's ability to meet obligations;

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

Discounted cash flow analyses.

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

As part of the loss mitigation efforts undertaken by servicers of residential loans owned by Sequoia securitization entities, a growing number of loan modifications have been completed to help make mortgage loans more affordable for certain borrowers. Loan modifications may include, but are not limited to: (i) conversion of a floating rate mortgage loan into a fixed rate mortgage loan; (ii) reduction in the contractual interest rate of a mortgage loan; (iii) forgiveness of a portion of the contractual interest and/or principal 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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2012

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

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 accrued but unpaid interest 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.

Repurchase Reserves

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

In circumstances where we believe that there is a risk of loss due to a loan repurchase demand (i.e., due to an allegation of a breach of representations and warranties) and we do not believe that full recourse to the company from whom we acquired the loan exists or is enforceable, we will review the need for any loan repurchase reserve in accordance with FASB guidance on accounting for contingencies and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability and the amount of loss, if any, can be reasonably estimated.

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 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;

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The most recent financial information 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.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2012

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Based on the assigned 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 updated present value of expected future cash flows discounted at the loan's effective rate, with a corresponding charge to our consolidated statement 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.

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 LTV ratios, and are made to borrowers with higher Fair Isaac Corporation (FICO) scores. Non-prime residential loans are generally characterized by higher LTV ratios and may have been made to borrowers with lower credit scores or impaired credit histories (while exhibiting the ability to repay their loans). Regardless of whether or not the loans backing a mortgage-backed security were designated as prime or non-prime at origination, there is a risk that the borrower may not be able to repay the loan.

Trading Securities

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

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

Available-for-Sale (AFS) Securities

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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(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. Conversely, if none of these three conditions is met, we analyze the expected cash flows, or cost recovery of the security, to determine what, if any, OTTI is recognized through our consolidated statements of income. This analysis includes an assessment of any changes in the regulatory and/or economic environment that might affect the performance of the security.

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

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

Cash and Cash Equivalents

Cash and cash equivalents include non-restricted cash and highly liquid investments with original maturities of three months or less. At March 31, 2012, we did not have any significant concentrations of credit risk arising from cash deposits as all of our cash and cash equivalents were invested in FDIC-insured bank products.

Restricted Cash

Restricted cash primarily includes principal and interest payments that are collateral for, or payable to, owners of ABS issued by consolidated securitization entities. Restricted cash may also include cash retained in the Acacia or Sequoia securitization entities or in the resecuritization entity prior to the payments on or redemptions of outstanding ABS issued. At March 31, 2012, we did not have any significant concentrations of credit risk arising from restricted cash deposits as all of our restricted cash was held in custodial accounts or FDIC-insured bank products.

Accrued Interest Receivable

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

Derivative Financial Instruments

Derivative financial instruments we currently utilize include contractual interest rate agreements, financial futures contracts, and To Be Announced (TBA) contracts. 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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2012

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

instruments 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 market valuation adjustments, net. 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. 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 liability.

We will discontinue cash flow hedge accounting if (i) we determine that the hedging derivative is no longer expected to be effective in offsetting changes in the cash flows of the designated hedged item; (ii) the derivative expires or is sold, terminated, or exercised; (iii) the derivative is de-designated as a cash flow hedge; or, (iv) it is probable that a forecasted transaction associated with the hedged item will not occur by the end of the originally specified time period. To the extent we de-designate a cash flow hedging relationship 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 liability.

Interest Rate Agreements

Interest rate agreements that we currently utilize include swaps, swaptions, and caps. 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.

Eurodollar Futures, Treasury Futures, and TBA Contracts

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. Treasury futures are futures contracts on benchmark U.S. Treasury rates. TBA contracts are forward contracts to purchase mortgage-backed securities that will be issued by a U.S. government sponsored enterprise (GSE) 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.

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

Deferred Tax Assets

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Our deferred tax assets are generated by temporary 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

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REDWOOD TRUST, INC. AND SUBSIDIARIES
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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

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. We did not have a deferred tax asset at March 31, 2012 or December 31, 2011.

Deferred Securities Issuance Costs

Securities issuance costs are expenses associated with the issuance of long-term debt, the resecuritization we engaged in during 2011, and the ABS from the 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 accounted for under the fair value option are expensed as incurred. ABS issuance costs associated with liabilities reported at cost are deferred. Deferred ABS issuance costs are reported on our consolidated balance sheets as deferred charges (an asset) and are amortized as an adjustment to interest expense using the interest method, based upon the actual and estimated repayment schedules of the related debt and ABS issued.

Other Assets

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

MSRs

We recognize MSRs through the acquisition of servicing rights released by third parties or through the retention of MSRs associated with residential loans which we have acquired and subsequently transferred to third parties. Typically our MSRs are directly acquired from loan originators or created through the transfer of loans to a Sequoia residential 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. MSRs are initially recognized and carried at their estimated fair values. Changes in the fair value of MSRs are reported in mortgage banking activities, net, a component of our consolidated income statements.

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

Short-Term Debt

Short-term debt includes borrowings under master repurchase agreements and other forms of borrowings that expire within one year with various counterparties. These facilities may be unsecured or collateralized by cash, loans, or securities.

See *Note 11* 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. 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.

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

March 31, 2012

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Asset-Backed Securities Issued

The majority of the liabilities reported on our consolidated balance sheets represents ABS issued by bankruptcy-remote entities sponsored by Redwood. Sequoia, Acacia, and the resecuritization assets 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.

Sequoia ABS Issued

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

Acacia ABS Issued

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

Resecuritization ABS Issued

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

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 determined based upon a floating rate equal to the three-month London Interbank Offered Rate (LIBOR) plus a margin until it is redeemed in whole or matures at a future date.

See *Note 13* 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 statements of consolidated comprehensive income. Net unrealized gains and losses on securities and interest rate agreements held by our taxable subsidiaries that are reported in other comprehensive income are adjusted for the effects of taxation and may create deferred tax assets or liabilities.

Noncontrolling Interest

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Noncontrolling interest represented the aggregate limited partnership interests in the Fund held by third parties and may appear in financial statements for periods prior to the first quarter of 2012. The noncontrolling interest is shown as a component of equity on our consolidated balance sheets, and the portion of income allocable to third parties is shown as net income (loss) attributable to noncontrolling interest in our consolidated statements of income. Equity attributable to noncontrolling interest is disclosed in our consolidated statements of changes in equity and our statements of consolidated comprehensive income.

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2012

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

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

See *Note 15* for further discussion on equity.

Incentive Plans

In May 2010, our shareholders approved an amendment to our previously amended 2002 Redwood Trust, Inc. Incentive Plan (Incentive Plan) for executive officers, employees, and non-employee directors. The amendment provided for an increase in the number of shares available for distribution under the plan. The Incentive Plan authorizes our Board of Directors (or a committee appointed by our Board of Directors) to grant incentive stock options (ISOs), non-qualifying stock options (NQSOs), performance stock units (PSUs), deferred stock units (DSUs), restricted stock, performance shares, performance units (including cash), stock appreciation rights, limited stock appreciation rights (awards), and dividend equivalent rights (DERs) to eligible recipients other than non-employee directors. These awards generally vest over a three- or four-year period. Non-employee directors are also provided annual awards under the Incentive Plan that generally vest immediately.

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 consolidated financial statements.

Employee Stock Purchase Plan

In May 2009, our stockholders approved an amendment to our 2002 Redwood Trust, Inc. Employee Stock Purchase Plan (ESPP) to increase the number of shares available under the ESPP. The purpose of the ESPP is to give our employees an opportunity to acquire an equity interest in the Company through the purchase of shares of common stock at a discount. The ESPP allows eligible employees to purchase common stock at 85% of its fair value, subject to certain limits. Fair value as defined under the ESPP is the lesser of the closing market price of the common stock on the first day of the calendar year or the first day of the calendar quarter.

Executive Deferred Compensation Plan

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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March 31, 2012

(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 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.

See *Note 18* for further discussion on taxes.

Recent Accounting Pronouncements

In May 2011, the FASB issued ASU 2011-04, *Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. This ASU converges fair value measurement and disclosure guidance in U.S. GAAP with the guidance concurrently issued by the International Accounting Standards Board. While the amendments in ASU 2011-04 do not modify the requirements for when fair value measurements apply, they do generally represent clarifications on how to measure and disclose fair value under ASC 820, Fair Value Measurement. This ASU is effective for interim and annual periods beginning after December 15, 2011 and should be applied prospectively. Our adoption of ASU 2011-04 in the first quarter of 2012 increased our disclosures related to fair value measurements, but did not have an effect on our consolidated financial statements.

Note 4. Principles of Consolidation

GAAP requires us to consider whether securitizations and other transfers of financial assets should be treated as sales or financings, as well as whether any variable interest entities (VIEs) – 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.

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****March 31, 2012****(Unaudited)****Note 4. Principles of Consolidation (continued)***Analysis of Consolidated VIEs*

The VIEs we are required to consolidate include certain Sequoia securitization entities, the Acacia entities, and the entity formed in connection with the resecuritization transaction we engaged in during 2011 (resecuritization). 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. The following table presents a summary of the assets and liabilities of these VIEs. Intercompany balances have been eliminated for purposes of this presentation.

*Assets and Liabilities of Consolidated VIEs at March 31, 2012***March 31, 2012**

(Dollars in thousands)	Sequoia Entities	Acacia Entities	Resecuritization	Total
Residential loans, held-for-investment	\$ 3,347,952	\$ -	\$ -	\$ 3,347,952
Commercial loans, at fair value	-	12,103	-	12,103
Real estate securities, at fair value	-	253,573	332,291	585,864
Restricted cash	243	15,452	-	15,695
Accrued interest receivable	7,155	1,959	940	10,054
Derivative assets	-	1,929	-	1,929
Deferred securities issuance costs	5,186	-	1,043	6,229
Other assets	5,515	122	-	5,637
Total Assets	\$ 3,366,051	\$ 285,138	\$ 334,274	\$ 3,985,463
Accrued interest payable	\$ 3,576	\$ 2,852	\$ 52	\$ 6,480
Derivative liabilities	-	59,703	-	59,703
Accrued expenses and other liabilities	5	227	-	232
Asset-backed securities issued	3,259,684	236,925	207,173	3,703,782
Total Liabilities	\$ 3,263,265	\$ 299,707	\$ 207,225	\$ 3,770,197
Noncontrolling interest	\$ -	\$ -	\$ -	\$ -
Number of VIEs	34	10	1	45

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. During 2010 and 2011, we sponsored three residential jumbo mortgage securitizations through our Sequoia program totaling \$908 million. We recorded the assets and liabilities of these entities on our consolidated balance sheets, as we did not meet the sale criteria at the time we transferred financial

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assets to these entities. Additionally, we determined that we are the primary beneficiary of these VIEs as our ongoing loss mitigation and resolution responsibilities provide us with the power to direct the activities that most significantly impact the economic performance of these entities and our significant investment interests provide us with the obligation to absorb losses or the right to receive benefits that are significant.

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

We consolidate the assets and liabilities of the resecuritization as we did not meet the sale criteria at the time the financial assets were transferred to this entity and we are the primary beneficiary. We transferred residential senior residential securities to Credit Suisse First Boston Mortgage Securities Corp., which subsequently sold

Table of Contents**REDWOOD TRUST, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****March 31, 2012****(Unaudited)****Note 4. Principles of Consolidation (continued)**

them to CSMC 2011-9R, a resecuritization entity. In connection with this transaction, we acquired certain subordinate securities and variable rate, interest-only senior certificates. We engaged in this resecuritization primarily for the purpose of obtaining permanent non-recourse financing on a portion of our 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 the first loss position in the structure.

During the first quarter of 2012, we sold variable interests in certain Sequoia securitization entities issued between 2001 and 2003 and determined that upon completion of an accounting analysis we should derecognize the associated assets and liabilities of these secured borrowings for financial reporting purposes. We deconsolidated \$307 million of residential loans and other assets and \$307 million of ABS issued and other liabilities, for a realized gain of \$7 million, which was recorded on our consolidated statement of income for the three months ended March 31, 2012. These gains were comprised of both recoveries of excess provisions for loan losses as well as cash raised by selling our interests in these entities. We maintained our intent to hold our economic interests in all remaining consolidated Sequoia entities at March 31, 2012.

Analysis of Unconsolidated VIEs Sponsored by Redwood

In the first quarter of 2012, we transferred residential loans to SEMT 2012-1 and SEMT 2012-2, which are Sequoia securitization entities sponsored by us. These transactions were accounted for as sales for financial reporting purposes as we surrendered control over the transferred assets. 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, we recorded MSR's on our consolidated balance sheet at March 31, 2012, and classified those MSR's as Level 3 assets. We also retained senior and subordinate securities in both securitizations that we classified as Level 3 assets.

The following table presents information related to the SEMT 2012-1 and SEMT 2012-2 securitization transactions.

Securitization Activity Related to Unconsolidated VIEs Sponsored by Redwood

(Dollars in Thousands)	SEMT 2012-1 January 2012	SEMT 2012-2 March 2012
Principal balance of loans transferred	\$ 415,728	\$ 327,538
Trading securities retained, at fair value	11,938	9,238
AFS securities retained, at fair value	25,991	13,459
Gain on sale	1,812	5,553
MSR's recognized	570	1,009

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

March 31, 2012

(Unaudited)

Note 4. Principles of Consolidation (continued)

Our continuing involvement in these securitizations is limited to our receipt of the servicing fee income, advancing servicing fees to the securitization trust when a loan becomes delinquent