REDWOOD TRUST INC
Form 10-Q
August 08, 2013
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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: June 30, 2013
OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)**

OF THE SECURITIES EXCHANGE ACT OF 1934
For the Transition Period from __________ to __________.

Commission File Number 1-13759

REDWOOD TRUST, INC.

(Exact Name of Registrant as Specified in Its Charter)

Maryland	**68-0329422**

(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
One Belvedere Place, Suite 300	
Mill Valley, California	**94941**
(Address of Principal Executive Offices)	(Zip Code)

(415) 389-7373

(Registrant s Telephone Number, Including Area Code)

Not Applicable

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

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

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 x 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 x

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

Common Stock, $0.01 par value per share	82,325,219 shares outstanding as of August 5, 2013

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REDWOOD TRUST, INC.

2013 FORM 10-Q REPORT

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Data)

(Unaudited)		**June 30, 2013**		**December 31, 2012**
ASSETS				
Residential loans, held-for-sale (includes $1,220,490 and $556,283 at fair value)	$	1,221,098	$	562,658
Residential loans, held-for-investment		1,998,178		2,272,812
Commercial loans, held-for-sale (includes $149,470 and $0 at fair value)		149,470		8,500
Commercial loans, held-for-investment		345,353		304,510
Real estate securities, at fair value		1,314,305		1,108,753
Mortgage servicing rights		43,098		5,315
Cash and cash equivalents		207,694		81,080
Total earning assets		5,279,196		4,343,628
Restricted cash		405		383
Accrued interest receivable		16,111		12,442
Derivative assets		43,341		2,972
Deferred securities issuance costs		15,976		9,293
Other assets		80,383		75,380
Total Assets [(1)]	$	5,435,412	$	4,444,098
LIABILITIES AND EQUITY				
Liabilities				
Short-term debt	$	1,445,961	$	551,918
Accrued interest payable		8,682		4,592
Derivative liabilities		29,571		51,081
Accrued expenses and other liabilities		83,998		26,902
Asset-backed securities issued		2,214,296		2,529,941
Long-term debt		443,591		139,500
Total liabilities [(1)]		4,226,099		3,303,934
Equity				

Common stock, par value $0.01 per share, 180,000,000 and 165,000,000 shares authorized; 82,331,736 and 81,716,416 issued and outstanding		823		817
Additional paid-in capital		1,754,658		1,744,554
Accumulated other comprehensive income		118,283		138,332
Cumulative earnings		759,235		633,052
Cumulative distributions to stockholders		(1,423,686)		(1,376,591)
Total equity		1,209,313		1,140,164
Total Liabilities and Equity	$	5,435,412	$	4,444,098

(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 June 30, 2013 and December 31, 2012, assets of consolidated VIEs totaled $2,573,802 and $2,901,214, respectively, and liabilities of consolidated VIEs totaled $2,216,586 and $2,532,916, respectively. See Note 4 for further discussion.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(In Thousands, Except Share Data) (Unaudited)	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Interest Income				
Residential loans	$ 18,845	$ 21,243	$ 36,469	$ 44,622
Commercial loans	9,623	5,534	19,794	10,881
Real estate securities	29,114	32,732	54,831	62,726
Cash and cash equivalents	137	14	149	35
Total interest income	57,719	59,523	111,243	118,264
Interest Expense				
Short-term debt	(4,686)	(2,299)	(8,494)	(4,126)
Asset-backed securities issued	(10,297)	(24,203)	(21,309)	(50,655)
Long-term debt	(6,480)	(2,379)	(10,014)	(4,755)
Total interest expense	(21,463)	(28,881)	(39,817)	(59,536)
Net Interest Income	36,256	30,642	71,426	58,728
Reversal of provision for loan losses	3,272	1,340	1,233	1,065
Other market valuation adjustments	(4,616)	217	(4,895)	(708)
Other-than-temporary impairments (1)	(1,642)	(303)	(1,666)	(635)
Other market valuation adjustments, net	(6,258)	(86)	(6,561)	(1,343)
Net Interest Income After Provision and Other Market Valuation Adjustments	33,270	31,896	66,098	58,450
Mortgage banking activities, net	58,531	(3,607)	104,552	1,324
Operating expenses	(23,644)	(15,165)	(43,241)	(29,799)
Realized gains, net	556	6,995	12,823	20,615
Net income before provision for income taxes	68,713	20,119	140,232	50,590
Provision for income taxes	(3,140)	(592)	(14,049)	(600)
Net Income Attributable to Redwood Trust, Inc.	$ 65,573	$ 19,527	$ 126,183	$ 49,990
Basic earnings per common share	$ 0.78	$ 0.24	$ 1.50	$ 0.62
Diluted earnings per common share	$ 0.71	$ 0.24	$ 1.40	$ 0.61
Regular dividends declared per common share	$ 0.28	$ 0.25	$ 0.56	$ 0.50

Basic weighted average shares outstanding	82,123,823	78,815,313	81,729,014	78,606,336
Diluted weighted average shares outstanding	96,171,713	78,815,313	91,647,400	79,965,406

(1) For the three months ended June 30, 2013, other-than-temporary impairments were $1,642, none of which were recognized in Accumulated Other Comprehensive Income. For the three months ended June 30, 2012, other-than-temporary impairments were $411, of which $108 were recognized in Accumulated Other Comprehensive Income.

For the six months ended June 30, 2013, other-than-temporary impairments were $1,666, none of which were recognized in Accumulated Other Comprehensive Income. For the six months ended June 30, 2012, other-than-temporary impairments were $892, of which $257 were recognized in Accumulated Other Comprehensive Income.

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

STATEMENTS OF CONSOLIDATED COMPREHENSIVE INCOME

(In Thousands) (Unaudited)	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Net Income	$ 65,573	$ 19,527	$ 126,183	$ 49,990
Other comprehensive (loss) income:				
Net unrealized (loss) gain on available-for-sale securities	(38,012)	1,374	(28,982)	42,075
Reclassification of unrealized (gain) loss to net income	(242)	337	(12,249)	414
Net unrealized gain (loss) on interest rate agreements	13,585	(16,453)	21,025	(3,260)
Reclassification of unrealized loss on interest rate agreements to net income	69	1,098	157	2,134
Total other comprehensive (loss) income	(24,600)	(13,644)	(20,049)	41,363
Comprehensive Income Attributable to Redwood Trust, Inc.	$ 40,973	$ 5,883	$ 106,134	$ 91,353

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

For the Six Months Ended June 30, 2013

(In Thousands, Except Share Data) (Unaudited)	Common Stock		Additional	Accumulated Other		Cumulative	
	Shares	Amount	Paid-In Capital	Comprehensive Income	Cumulative Earnings	Distributions to Stockholders	Total
December 31, 2012	81,716,416	$ 817	$ 1,744,554	$ 138,332	$ 633,052	$ (1,376,591)	$ 1,140,164
Net income	-	-	-	-	126,183	-	126,183
Other comprehensive (loss) income	-	-	-	(20,049)	-	-	(20,049)
Issuance of common stock:							
Dividend reinvestment & stock purchase plans	321,120	3	6,043	-	-	-	6,046
Employee stock purchase and incentive plans	294,200	3	(5,454)	-	-	-	(5,451)
Non-cash equity award compensation	-	-	9,515	-	-	-	9,515
Common dividends declared	-	-	-	-	-	(47,095)	(47,095)
June 30, 2013	82,331,736	$ 823	$ 1,754,658	$ 118,283	$ 759,235	$ (1,423,686)	$ 1,209,313

For the Six Months Ended June 30, 2012

(In Thousands, Except Share Data) (Unaudited)	Common Stock		Additional	Accumulated Other		Cumulative	
	Shares	Amount	Paid-In Capital	Comprehensive Income (Loss)	Cumulative Earnings	Distributions to Stockholders	Total

December 31, 011	78,555,908	$ 786	$ 1,697,979	$ (13,151)	$ 501,283	$ (1,294,313)	$ 892,584
Net income	-	-	-	-	49,990	-	49,990
Other omprehensive ncome	-	-	-	41,363	-	-	41,363
ssuance of ommon stock:							
Dividend einvestment & tock purchase lans	384,005	4	4,429	-	-	-	4,433
Employee stock urchase and ncentive plans	322,915	3	(1,914)	-	-	-	(1,911)
Non-cash quity award ompensation	-	-	5,217	-	-	-	5,217
Common ividends eclared	-	-	-	-	-	(40,498)	(40,498)
une 30, 2012	79,262,828	$ 793	$ 1,705,711	$ 28,212	$ 551,273	$ (1,334,811)	$ 951,178

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands) (Unaudited)	Six Months Ended June 30, 2013	2012
Cash Flows From Operating Activities:		
Net income attributable to Redwood Trust, Inc.	$ 126,183	$ 49,990
Adjustments to reconcile net income to net cash used in operating activities:		
Amortization of premiums, discounts, and securities issuance costs, net	(11,780)	(12,953)
Depreciation and amortization of non-financial assets	224	1,612
Purchases of loans	(5,457,558)	(998,906)
Proceeds from sales of loans	4,635,630	754,175
Principal payments on loans	5,169	4,102
Net settlements of derivatives	9,784	(17,160)
Reversal of provision for loan losses	(1,233)	(1,065)
Non-cash equity award compensation	9,515	5,217
Market valuation adjustments, net	(84,560)	12,959
Realized gains, net	(23,854)	(33,452)
Net change in:		
Accrued interest receivable, deferred tax assets, and other assets	(10,871)	(701)
Accrued interest payable and accrued expenses and other liabilities	61,186	16,606
Net cash used in operating activities	(742,165)	(219,576)
Cash Flows From Investing Activities:		
Purchases of loans held-for-investment	(54,539)	(95,508)
Proceeds from sales of loans [1]	440	386,143
Principal payments on loans	284,076	287,996
Purchases of real estate securities	(298,946)	(409,788)
Proceeds from sales of real estate securities	31,195	101,662
Principal payments on real estate securities	81,250	95,536
Proceeds from deconsolidation	-	6,386
Net increase in restricted cash	(22)	(3,566)
Net cash provided by investing activities	43,454	368,861
Cash Flows From Financing Activities:		
Proceeds from borrowings on short-term debt	3,989,557	707,051
Repayments on short-term debt	(3,095,514)	(679,688)
Proceeds from issuance of asset-backed securities	-	96
Repayments on asset-backed securities issued	(313,848)	(322,000)
Deferred securities issuance costs	(9,184)	-

Proceeds from issuance of long-term debt		304,100		-
Repayments on long-term debt		(9)		-
Net settlements of derivatives		(5)		(12,195)
Net proceeds from issuance of common stock		3,064		292
Taxes paid on equity award distributions		(5,741)		-
Dividends paid		(47,095)		(40,498)
Net cash provided by (used in) financing activities		825,325		(346,942)
Net increase (decrease) in cash and cash equivalents		126,614		(197,657)
Cash and cash equivalents at beginning of period		81,080		267,176
Cash and cash equivalents at end of period	$	207,694	$	69,519
Supplemental Disclosures:				
Cash paid for interest	$	37,581	$	59,152
Cash paid for taxes		1,097		155
Transfers from residential loans to real estate owned		2,687		3,406

(1) For the six months ended June 30, 2012, the proceeds from sales of loans included in investing activities related to loans that were reclassified from loans held-for-investment to loans held-for-sale during the fourth quarter of 2011.

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, 2013

(Unaudited)

Note 1. Redwood Trust

Redwood Trust, Inc., together with its subsidiaries (Redwood, we, or us), is an internally-managed operating company focused on engaging in residential and commercial mortgage banking activities and investing in mortgage- and other real estate-related assets. We seek to generate fee and gain on sale income through our mortgage banking activities and to invest in real estate-related assets that have the potential to generate attractive cash flow returns over time.

Our investment portfolio includes investments in residential mortgage-backed securities issued in Sequoia securitization transactions, as well as residential securities issued by third parties. We may also invest in other assets, securities, and instruments that are related to residential real estate, such as, mortgage servicing rights (MSRs). Our investment portfolio also includes investments in commercial loans that are originated through our commercial mortgage banking activities and may also include investments in commercial mortgage backed securities (CMBS) or other forms of commercial real estate financing originated by others. We assume a range of risks in our investments and the level of risk is influenced by, among other factors, the manner in which we finance our purchases of, and derive income from, our investments.

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, 2013 and December 31, 2012, and for the three and six months ended June 30, 2013 and 2012. 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.

Beginning in the second quarter of 2013, we are presenting market valuation changes for our retained Sequoia interest-only (IO) securities in mortgage banking activities and have conformed the presentation of prior periods for consistency of comparison. This change better aligns our reported results with the economics underlying our residential mortgage banking activities as we utilize our retained Sequoia IO securities as an economic hedge to manage interest rate risk on our inventory of residential mortgage loans held for future sale and those indentified for purchase. Certain other prior year amounts have been reclassified in the consolidated financial statements and the related footnotes to conform to the 2013 presentation.

Organization

For tax purposes, Redwood Trust, Inc. is structured as a real estate investment trust (REIT). 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. Our consolidated subsidiaries include both qualifying REIT subsidiaries and taxable subsidiaries. References to the REIT include Redwood and its qualifying REIT subsidiaries, excluding taxable subsidiaries.

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(Unaudited)

Note 2. Basis of Presentation (continued)

Financial Information About Industry Segments

FASB ASC 280, *Segment Reporting*, establishes standards for reporting financial and descriptive information about an enterprise s reportable segments. We currently evaluate all of our residential and commercial real estate-related investments and management activities as one reportable industry segment, and, accordingly, we do not report distinct segment information.

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 securitization entities where we maintain an ongoing involvement, as well as an entity formed in connection with a resecuritization transaction we engaged in during 2011 (Residential Resecuritization), and an entity formed in connection with a commercial securitization we engaged in during the fourth quarter of 2012 (Commercial Securitization). Prior to December 31, 2012, we consolidated the assets and liabilities of certain Acacia securitization entities. 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 a sponsor, manager, or depositor of these entities or as a result of our having sold assets directly or indirectly to these entities.

For financial reporting purposes, the underlying loans and securities owned at the consolidated Sequoia entities, the Residential Resecuritization entity, and the Commercial Securitization entity are shown under residential and commercial loans and real estate securities on our consolidated balance sheets. The 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 at these 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 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,

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Other relevant observable inputs, including nonperformance risk and liquidity premiums.
After considering all available indications of the appropriate rate of return that market participants would require, we consider the reasonableness of the range indicated by the results to determine an estimate that is most representative of fair value.

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

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

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

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 loans we anticipate selling to Sequoia securitizations or third parties and for financial instruments that may not perform

similarly to our traditional real estate investments or are particularly volatile or complex in structure.

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

Real Estate Loans

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.

Residential and Commercial Loans Lower of Cost or Fair Value

Residential and commercial loans, except for those where we have elected the fair value option, 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 an individual loan or pool of loans held-for-sale is lower than its amortized cost basis, this difference is reported through our consolidated statements of income as a negative market valuation adjustment in mortgage banking activities, net for residential loans and as a negative other market valuation adjustment for commercial loans. 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 at which point it is placed on non-accrual

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

status. 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 Fair Value

We have elected the fair value option for certain residential and commercial loans held-for-sale. Coupon interest is recognized as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due. Changes in fair value are recurring and are reported through our consolidated statements of income in mortgage banking activities, net for residential and commercial loans held at fair value.

Residential and Commercial Loans Held-for-Investment

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

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

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

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

Residential Loans Allowance for Loan Losses

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

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

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 at Sequoia securitization entities, a 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 allowances for loan losses and assessed for impairment on an individual basis based upon any adverse change in the expected future cash flows resulting from the modification. This difference is recorded to the provision for loan losses in our consolidated statements of income.

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

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

Commercial Loans Allowance for Loan Losses

For commercial loans classified as held-for-investment, we establish and maintain a general allowance for loan losses inherent in our portfolio at the reporting date and, where appropriate, a specific allowance for loan losses for loans we have determined to be impaired at the reporting date. An individual loan is considered impaired when it is deemed probable that we will not be able to collect all amounts due according to the contractual terms of the loan.

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

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

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

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

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

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Note 3. Summary of Significant Accounting Policies (continued)

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

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 current present value of expected future cash flows discounted at the loan s effective rate or if a loan is collateral dependent, we reduce the carrying value to the fair market value of the loan, with a corresponding charge to provision for loan losses on our consolidated statements of income.

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

- Historical loss rates and past performance of similar loans in our own portfolio, if any;
- Publicly available third-party reference loss rates on similar loans; and,
- Trends in delinquencies and charge-offs in our own portfolio and among industry participants.

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

Repurchase Reserves

We do not currently maintain a loan repurchase reserve and management is not aware of any outstanding repurchase claims that would require the establishment of such a reserve.

We do not originate residential loans and believe that the risk of loss due to loan repurchases (i.e., due to a breach of representations and warranties) would generally be a contingency to the companies from whom we acquired the loans

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 repurchase demand would result in a liability and the amount of loss, if any, can be reasonably estimated.

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

Real Estate Securities, at Fair Value

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Trading Securities

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

Available-for-Sale Securities

AFS securities may include certain residential and commercial 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 changes in 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.

For an AFS security where its estimated fair value at the reporting date is 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, in our consolidated statements of changes in 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 estimated fair value is deemed to be the non-credit component of the OTTI and 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.

MSRs

We recognize MSRs through the acquisition of servicing rights released by third parties or through the retention of MSRs associated with residential loans that 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 mortgage securitization sponsored by us that meets the GAAP criteria for sale accounting.

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

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

underlying our MSRs. 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 statements of income.

See *Note 17* for further discussion on MSRs.

Cash and Cash Equivalents

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

Restricted Cash

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

Accrued Interest Receivable

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

Derivative Financial Instruments

Derivative financial instruments we typically utilize include 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 positive fair values to us are reported as assets and derivatives with negative fair values to us are reported as liabilities. We classify each of our derivative financial 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 other market valuation adjustments, net. The valuation changes related to derivatives used to manage certain risks associated with the residential and commercial loans we own or plan to acquire and sell or securitize are excluded from other market valuation adjustments, net, and are included in mortgage banking activities, net, on our consolidated statements of income. Changes in the fair values of derivatives accounted for as cash flow hedges, to the extent they are effective, are recorded in accumulated other comprehensive income, a component of equity. Interest income or expense, and any ineffectiveness associated with these derivatives, are recorded as a component of net interest income in our consolidated statements of income. We measure the effective portion of cash flow hedges by comparing the change in fair value of the expected future variable cash flows of the derivative hedging instruments with the change in fair value of the expected future variable cash flows of the hedged item.

We will discontinue 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 or terminate a cash flow hedging relationship and the associated hedged item continues to exist, any unrealized gain or loss of the cash flow hedge at the time of de-designation remains in accumulated other comprehensive income and is amortized using the straight-line method through interest expense over the remaining life of the hedged item.

REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 3. Summary of Significant Accounting Policies (continued)

Interest Rate Agreements

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

Eurodollar Futures, Financial 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 to interest rate volatility.

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

Deferred Tax Assets

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

tax, the deferred tax liability is reduced.

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

Deferred Securities Issuance Costs

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

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Other Assets

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

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

See *Note 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 borrowings may be unsecured or collateralized by cash, loans, or securities. If the value (as determined by the applicable counterparty) of the collateral securing those borrowings decreases, we may be subject to margin calls during the period the borrowings are outstanding. In instances where we do not satisfy the margin calls within the required time frame, the counterparty may retain the collateral and pursue any outstanding debt amount from us.

See *Note 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, and is paid semi-annually for our convertible debt. For borrowings where we have elected the fair value option, the associated accrued interest on these liabilities is measured at fair value. For financial liabilities where we have not elected the fair value option, the associated accrued interest carrying values approximate fair values.

Asset-Backed Securities Issued

The majority of the liabilities reported on our consolidated balance sheets represent ABS issued by bankruptcy-remote entities sponsored by Redwood. Sequoia, Acacia, the Residential Resecuritization, and the Commercial Securitization 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

Prior to the fourth quarter of 2012, we consolidated certain Acacia securitization entities. Acacia ABS issued were accounted for under the fair value option and carried at their estimated fair values. Changes in fair value (gains or losses) were reported in our consolidated statements of income through other market valuation adjustments, net.

Residential Resecuritization ABS Issued

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Commercial Securitization ABS Issued

Commercial Securitization 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

Commercial Borrowings

Commercial borrowings include borrowings under a master repurchase agreement that expires in more than one year with a financial institution counterparty. These borrowings are collateralized by commercial loans. If the value (as determined by the applicable counterparty) of the collateral securing those borrowings decreases, we may be subject to margin calls during the period the borrowings are outstanding. In instances where we do not satisfy the margin calls within the required time frame, the counterparty may retain the collateral and pursue any outstanding debt amount from us.

Convertible Notes

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

Trust Preferred Securities and Subordinated Notes

Trust preferred securities and subordinated notes are carried at their unpaid principal balance. This long-term debt is unsecured 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 (Loss)

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.

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 allocable to common shareholders, less income allocated to participating securities (as described herein). 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 share-based payment awards and the assumed conversion of convertible notes to common shares.

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

See *Note 15* for further discussion on equity.

Incentive Plans

In May 2013, our shareholders approved an amendment and restatement to our previously amended 2002 Redwood Trust, Inc. Incentive Plan (Incentive Plan) for executive officers, employees, and non-employee directors. The amendment provided, among other things, 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, stock appreciation rights, limited stock appreciation rights (awards), and dividend equivalent rights (DERs) to eligible recipients other than non-employee directors. Long-term incentive awards granted under the Incentive Plan generally vest over a three- or four-year period. Awards made under the Incentive Plan to officers and other employees in lieu of the payment in cash of a portion of annual bonuses earned generally vest immediately, but are subject to a three-year mandatory holding period. Non-employee directors are also provided annual awards under the Incentive Plan that generally vest immediately.

For equity awards granted after December 1, 2008, the cost of the awards is amortized over the vesting period on a straight-line basis.

Employee Stock Purchase Plan

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

Executive Deferred Compensation Plan

In 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.

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 record tax benefits only if tax positions meet a more-likely-than-not threshold in accordance with FASB guidance on accounting for uncertainty in income taxes. We classify interest and penalties on material uncertain tax positions as interest expense and operating expense, respectively, in our consolidated statements of income.

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

See *Note 19* for further discussion on taxes.

Recent Accounting Pronouncements

In December 2011, FASB issued Accounting Standards Update (ASU) 2011-11, *Disclosures about Offsetting Assets and Liabilities*. This ASU requires the presentation of gross and net information about transactions that are (1) offset in the financial statements or (2) subject to an enforceable master netting arrangement or similar agreement, regardless of whether the transactions are actually offset in the statement of financial position. The ASU is effective prospectively for fiscal years beginning on or after January 1, 2013. We adopted ASU 2011-11 in the first quarter of 2013 and, as a result, presented disclosures on financial assets and liabilities subject to master netting agreements, which can be found below in this *Note 3*.

In February 2013, the FASB issued ASU 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*, which adds new disclosure requirements for items reclassified out of accumulated other comprehensive income. The ASU does not amend any existing requirements for reporting net income or other comprehensive income in the financial statements and is effective prospectively for reporting periods beginning after December 15, 2012. We adopted ASU 2013-02 in the first quarter of 2013 and, as a result, expanded our disclosures related to items reclassified out of accumulated other comprehensive income. These disclosures can be found in *Note 15*.

Balance Sheet Netting

Certain of our derivatives, warehouse, and repurchase agreements are subject to master netting arrangements or similar agreements. Under GAAP, in certain circumstances we may elect to present certain financial assets and liabilities and collateral subject to master netting arrangements in a net position on our consolidated balance sheet. However, we do not report any of these financial assets or liabilities on a net basis, and instead present them on a gross basis on our consolidated balance sheet.

The table below presents financial assets and liabilities that are subject to master netting arrangements or similar agreements categorized by financial instrument, together with corresponding financial instruments and corresponding collateral received or pledged at June 30, 2013 and December 31, 2012.

Offsetting of Financial Assets, Liabilities, and Collateral

June 30, 2013 (In Thousands)	Gross Amounts of Recognized Assets (Liabilities)	Gross Amounts Offset in Consolidated Balance Sheet	Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet	Gross Amounts Not Offset in Consolidated Balance Sheet (1)		
				Financial Instruments	Cash Collateral (Received) Pledged	Net Amount
Assets (2)						
Interest rate agreements	$ 34,358	$ -	$ 34,358	$ (11,092)	$ (19,796)	$ 3,470
TBAs	8,655	-	8,655	(1,139)	(4,624)	2,892
Futures	328	-	328	(328)	-	-
Total Assets	$ 43,341	$ -	$ 43,341	$ (12,559)	$ (24,420)	$ 6,362

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

Liabilities [2]						
Interest rate agreements	$ (27,785)	$ -	$ (27,785)	$ 11,092	$ 15,444	$ (1,249)
TBAs	(1,139)	-	(1,139)	1,139	-	-
Futures	(647)	-	(647)	328	319	-
Loan warehouse debt	(1,082,726)	-	(1,082,726)	1,082,726	-	-
Security repurchase agreements	(363,235)	-	(363,235)	363,235	-	-
Commercial borrowings	(16,591)	-	(16,591)	16,591	-	-
Total Liabilities	$ (1,492,123)	$ -	$ (1,492,123)	$ 1,475,111	$ 15,763	$ (1,249)

December 31, 2012 **(In Thousands)**	**Gross Amounts of Recognized Assets (Liabilities)**	**Gross Amounts Offset in Consolidated Balance Sheet**	**Net Amounts of Assets (Liabilities) Presented in Consolidated Balance Sheet**	**Gross Amounts Not Offset in Consolidated Balance Sheet** [1]		**Net Amount**
				Financial Instruments	**Cash Collateral (Received) Pledged**	
Assets [2]						
Interest rate agreements	$ 2,972	$ -	$ 2,972	$ (2,210)	$ -	$ 762
TBAs	-	-	-	-	-	-
Futures	-	-	-	-	-	-
Total Assets	$ 2,972	$ -	$ 2,972	$ (2,210)	$ -	$ 762
Liabilities [2]						
Interest rate agreements	$ (50,476)	$ -	$ (50,476)	$ 2,210	$ 48,266	$ -

TBAs	-	-	-	-	-	-
Futures	(607)	-	(607)	-	607	-
Loan warehouse debt	(179,982)	-	(179,982)	179,982	-	-
Security repurchase agreements	(371,936)	-	(371,936)	371,936	-	-
Total Liabilities	$ (603,001)	$ -	$ (603,001)	$ 554,128	$ 48,873	$ -

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

(2) Interest rate agreements, TBAs, and futures are components of derivatives instruments on our consolidated balances sheets. Loan warehouse debt, which is secured by residential mortgage loans, and security repurchase agreements are components of short-term debt on our consolidated balance sheets. Commercial borrowings are a component of long-term debt on our consolidated balance sheet.

With respect to each category of financial instrument set forth in the table above, the assets and liabilities resulting from individual transactions between Redwood and a counterparty are subject to a master netting arrangement or similar agreement that provides for all such individual transactions to be treated as a single transaction and, in the event of the termination and close-out of such transactions, to be settled on a net basis and for settlement to include the proceeds of the liquidation of any corresponding collateral, subject to certain

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 3. Summary of Significant Accounting Policies (continued)

limitations on termination, settlement, and liquidation of collateral that may apply in the event of the bankruptcy or insolvency of a party which limitations should not inhibit the eventual practical realization of the principal benefits of the transactions or the master netting arrangement or similar agreement and any corresponding collateral.

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 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.

Analysis of Consolidated VIEs

The VIEs we are required to consolidate include certain Sequoia securitization entities, the Residential Resecuritization entity, and the Commercial Securitization entity. Each of these entities is independent of Redwood and of each other and the assets and liabilities are not owned by and are not legal obligations of ours, although we are exposed to certain financial risks associated with our role as the sponsor or manager of these entities. Prior to the fourth quarter of 2012, we were also required to consolidate certain other securitization 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 June 30, 2013

June 30, 2013

(Dollars in Thousands)	Sequoia Entities	Residential Resecuritization	Commercial Securitization	Total
Residential loans, held-for-investment	$ 1,998,178	$ -	$ -	$ 1,998,178
Commercial loans, held-for-investment	-	-	270,449	270,449
Real estate securities, at fair value	-	294,771	-	294,771
Restricted cash	148	2	138	288

Accrued interest receivable		3,461		751		1,939		6,151
Other assets		3,965		-		-		3,965
Total Assets	$	2,005,752	$	295,524	$	272,526	$	2,573,802
Accrued interest payable	$	1,509	$	33	$	748	$	2,290
Asset-backed securities issued		1,920,614		134,156		159,526		2,214,296
Total Liabilities	$	1,922,123	$	134,189	$	160,274	$	2,216,586
Number of VIEs		24		1		1		26

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

We consolidate the assets and liabilities of the Residential Resecuritization entity as we did not meet the GAAP sale criteria at the time the financial assets were transferred to this entity based on our role in the entity s inception and design. We transferred senior residential securities to Credit Suisse First Boston Mortgage Securities Corp., which subsequently sold them to CSMC 2011-9R, the

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(Unaudited)

Note 4. Principles of Consolidation (continued)

Residential Resecuritization entity. In connection with this transaction, we acquired certain senior and subordinate securities that we continue to hold. We engaged in the Residential Resecuritization primarily for the purpose of obtaining permanent non-recourse financing on a portion of our senior residential securities portfolio.

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

Analysis of Unconsolidated VIEs with Continuing Involvement

During 2012 and the six months ended June 30, 2013, we transferred residential loans to 14 Sequoia securitization entities sponsored by us and accounted for these transfers as sales for financial reporting purposes. We also determined we were not the primary beneficiary of these VIEs as we lacked the power to direct the activities that will have the most significant economic impact on the entities. For the transferred loans where we held the servicing rights prior to the transfer and continue to hold the servicing rights, we recorded MSRs on our consolidated balance sheet at June 30, 2013, and classify those MSRs as Level 3 assets. We also retained senior and subordinate securities in these securitizations that we classify as Level 3 assets.

The following table presents information related to securitization transactions that occurred during the three and six months ended June 30, 2013 and 2012.

Securitization Activity Related to Unconsolidated VIEs Sponsored by Redwood

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	**2013**	**2012**	**2013**	**2012**
Principal balance of loans transferred	$ 1,802,058	$ 293,590	$ 4,042,710	$ 1,036,856
Trading securities retained, at fair value	40,642	5,610	91,850	26,786

AFS securities retained, at fair value	92,367	17,267	207,095	56,717
Gains on sale	-	4,243	-	11,609
MSRs recognized	16,148	1,029	28,614	2,608

Our continuing involvement in these securitizations is limited to customary servicing obligations associated with retaining residential MSRs (which we retain a third-party servicer to perform) and the receipt of interest income associated with the securities we retained. The following table summarizes the cash flows between us and the unconsolidated VIEs sponsored by us for the three and six months ended June 30, 2013 and 2012.

Cash Flows Related to Unconsolidated VIEs Sponsored by Redwood

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	**2013**	**2012**	**2013**	**2012**
Cash proceeds	$ 1,705,504	$ 277,269	$ 3,859,354	$ 972,073
MSR fees received	2,099	137	3,075	154
Funding of compensating interest	(145)	(13)	(263)	(16)
Cash flows received on retained securities	9,883	2,071	14,950	3,099

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(Unaudited)

Note 4. Principles of Consolidation (continued)

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

MSR Assumptions Related to Unconsolidated VIEs Sponsored by Redwood

	Issued During			
	Three Months Ended June 30,		Six Months Ended June 30,	
At Date of Securitization	**2013**	**2012**	**2013**	**2012**
Prepayment speeds	5 - 12 %	5 - 21 %	5 - 14 %	5 - 19 %
Discount rates	12 %	10 %	12 %	9 %

The following table presents additional information at June 30, 2013 and December 31, 2012, related to unconsolidated securitizations sponsored by us during 2012 and the six months ended June 30, 2013.

Unconsolidated VIEs Sponsored by Redwood

(In Thousands)	**June 30, 2013**	**December 31, 2012**
On-balance sheet assets, at fair value:		
Interest-only securities, classified as trading	$ 123,591	$ 10,409
Subordinate securities, classified as AFS	318,789	113,681
Maximum loss exposure [1]	442,380	124,090
Principal balance of loans outstanding	5,383,219	1,736,331

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

The following table presents key economic assumptions for assets retained from unconsolidated VIEs and the sensitivity of their fair values to immediate adverse changes in those assumptions at June 30, 2013 and December 31, 2012.

Key Assumptions and Sensitivity Analysis for Assets Retained from Unconsolidated VIEs Sponsored by Redwood

June 30, 2013

(Dollars in Thousands)	**MSRs**	**Senior Interest-only Securities**	**Subordinate Securities**
Fair value at June 30, 2013	$ 43,098	$ 123,591	$ 318,789
Expected weighted-average life (in years)	8	6	13
Prepayment speed assumption (annual CPR)	8 %	13 %	14 %
Decrease in fair value from:			
10% adverse change	$ 1,367	$ 4,275	$ 844
25% adverse change	3,284	34,398	1,974
Discount rate assumption	12 %	5 %	6 %
Decrease in fair value from:			
100 basis point increase	$ 1,822	$ 5,931	$ 28,365
200 basis point increase	3,309	11,357	52,835
Credit loss assumption	N/A	0.22 %	0.22 %
Decrease in fair value from:			
10% higher losses	N/A	$ 39	$ 1,128
25% higher losses	N/A	98	2,816

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(Unaudited)

Note 4. Principles of Consolidation (continued)

December 31, 2012

(Dollars in Thousands)	MSRs	Senior Interest-only Securities	Subordinate Securities
Fair value at December 31, 2012	$ 5,315	$ 10,409	$ 113,681
Expected weighted-average life (in years)	3	3	10
Prepayment speed assumption (annual CPR)	33 %	29 %	24 %
Decrease in fair value from:			
10% adverse change	$ 351	$ 724	$ 858
25% adverse change	812	1,674	1,909
Discount rate assumption	12 %	17 %	6 %
Decrease in fair value from:			
100 basis point increase	$ 121	$ 20	$ 901
200 basis point increase	235	40	1,791
Credit loss assumption	N/A	0.48 %	0.47 %
Decrease in fair value from:			
10% higher losses	N/A	$ 5	$ 578
25% higher losses	N/A	12	1,446

Continuing Involvement with VIEs with No Economic Interest

During 2012, we sold all of our remaining economic interests in Acacia entities and, pursuant to an accounting analysis, deconsolidated the Acacia entities and derecognized the associated assets and liabilities for financial reporting purposes. We maintain limited continuing involvement through our role as collateral manager for all but one of these Acacia entities. Our role as collateral manager has, under the terms of the applicable management agreements, been significantly curtailed or eliminated with respect to the Acacia entities, as all but two of these entities have experienced events of default. Additionally, we will continue to receive the collateral management fee for these entities, which has decreased significantly and will continue to do so as the balance on which the fee is determined continues to decline.

Analysis of Third-Party VIEs

Third-party VIEs are securitization entities for which we maintain an economic interest but do not sponsor. Our economic interest may include several securities from the same third-party VIE, and in those cases, the consolidation analysis is performed in consideration of all of our interests. The following table presents a summary of our interests in third-party VIEs at June 30, 2013, grouped by collateral type and ownership interest.

Third-Party VIE Summary

June 30, 2013

(Dollars in Thousands)		**Fair Value**
Residential real estate securities at Redwood		
Senior	$	481,190
Re-REMIC		154,167
Subordinate		384,176
Total Investments in Third-Party Real Estate Securities	$	1,019,533

We determined that we are not the primary beneficiary of any third-party residential or commercial entities, as we do not have the required power to direct the activities that most significantly impact the economic performance of these entities. Specifically, we do

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(Unaudited)

Note 4. Principles of Consolidation (continued)

not service or manage these entities or otherwise hold decision making powers that are significant. As a result of this assessment, we do not consolidate any of the underlying assets and liabilities of these third-party VIEs we only account for our specific interests in them.

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

Note 5. Fair Value of Financial Instruments

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

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

The following table presents the carrying values and estimated fair values of assets and liabilities that are required to be recorded or disclosed at fair value at June 30, 2013 and December 31, 2012.

	June 30, 2013		December 31, 2012	
(In Thousands)	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Residential loans, held-for-sale				
At fair value	$ 1,219,368	$ 1,219,368	$ 553,576	$ 553,576
At lower of cost or fair value	1,730	1,807	9,082	9,324
Residential loans, held-for-investment	1,998,178	1,801,052	2,272,812	2,062,352
Commercial loans, held-for-sale				
At fair value	149,470	149,470	-	-
At lower of cost or fair value	-	-	8,500	8,500
Commercial loans, held-for-investment	345,353	349,212	304,510	309,547
Trading securities	141,615	141,615	33,172	33,172
Available-for-sale securities	1,172,690	1,172,690	1,075,581	1,075,581
Mortgage servicing rights	43,098	43,098	5,315	5,315
Cash and cash equivalents	207,694	207,694	81,080	81,080
Restricted cash	405	405	383	383
Accrued interest receivable	16,111	16,111	12,442	12,442
Derivative assets	43,341	43,341	2,972	2,972
REO (1)	3,965	4,971	4,245	5,540
Margin receivable (1)	55,926	55,926	63,424	63,424
Other collateral posted (1)	5,000	5,000	-	-
Liabilities				
Short-term debt	$ 1,445,961	$ 1,445,961	$ 551,918	$ 551,918
Accrued interest payable	8,682	8,682	4,592	4,592
Derivative liabilities	29,571	29,571	51,081	51,081
ABS issued	2,214,296	1,991,401	2,529,941	2,372,971

Commercial borrowings	16,591	16,591	-	-
Convertible notes	287,500	283,547	-	-
Other long-term debt	139,500	104,625	139,500	90,675

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

We elected the fair value option for $41 million and $92 million of residential senior securities and $2.53 billion and $5.07 billion of residential loans (principal balance) that we acquired during the three and six months ended June 30, 2013, respectively. During the three months ended June 30, 2013, we also elected the fair value option for $150 million of commercial senior loans we acquired. We anticipate electing the fair value option residential senior securities and all future purchases of loans that we intend to sell to third parties or transfer to Sequoia securitizations. We have historically elected the fair value option for certain commercial loans and trading securities, as well as certain third-party residential securities.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

The following table presents the assets and liabilities recorded that are reported at fair value on our consolidated balance sheets on a recurring basis at June 30, 2013, as well as the fair value hierarchy of the valuation inputs used to measure fair value.

Assets and Liabilities Measured at Fair Value on a Recurring Basis at June 30, 2013

June 30, 2013 (In Thousands)	Carrying Value	Fair Value Measurements Using Level 1	Level 2	Level 3
Assets				
Residential loans, at fair value	$ 1,219,368	$ -	$ -	$ 1,219,368
Commercial loans, at fair value	149,470	-	149,470	-
Trading securities	141,615	-	-	141,615
Available-for-sale securities	1,172,690	-	-	1,172,690
MSRs	43,098	-	-	43,098
Derivative assets	43,341	8,983	34,358	-
Liabilities				
Derivative liabilities	29,571	1,786	27,785	-

The following table presents additional information about Level 3 assets and liabilities measured at fair value on a recurring basis for the six months ended June 30, 2013.

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

	Assets			
(In Thousands)	Residential Loans	Trading Securities	AFS Securities	MSRs
Beginning balance - December 31, 2012	$ 553,576	$ 33,172	$ 1,075,581	$ 5,315
Principal paydowns	(2,486)	(31)	(81,218)	-
(Losses) gains in net income, net	(19,601)	33,558	26,722	9,169

Unrealized losses in OCI, net	-	-	(41,230)	-
Acquisitions	5,154,352	91,850	207,096	28,614
Sales	(4,465,558)	(16,934)	(14,261)	-
Other settlements, net	(915)	-	-	-
Ending Balance - June 30, 2013	$ 1,219,368	$ 141,615	$ 1,172,690	$ 43,098

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

The following table presents the portion of gains or losses included in our consolidated statements of income that were attributable to Level 3 assets and liabilities recorded at fair value on a recurring basis and held at both June 30, 2013 and 2012. Gains or losses incurred on assets or liabilities sold, matured, called, or fully written down during the three and six months ended June 30, 2013 and 2012 are not included in this presentation.

Portion of Net Gains (Losses) Attributable to Level 3 Assets and Liabilities Still Held at June 30, 2013 and 2012 Included in Net Income

	Included in Net Income			
	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2013	2012	2013	2012
Assets				
Residential loans, at fair value	$ (59,649)	$ -	$ (59,641)	$ -
Commercial loans, at fair value	-	111	-	122
Trading securities	31,354	10,585	30,866	43,019
Available-for-sale securities	(1,642)	(303)	(1,665)	(635)
MSRs	9,450	(476)	9,532	(482)
Liabilities				
Derivative liabilities	-	(195)	-	(1,090)
ABS issued - Acacia	-	(12,973)	-	(45,026)

The following table presents information on assets recorded at fair value on a non-recurring basis at June 30, 2013. This table does not include the carrying value and gains or losses associated with the asset types below that were not recorded at fair value on our balance sheet at June 30, 2013.

Assets and Liabilities Measured at Fair Value on a Non-Recurring Basis at June 30, 2013

June 30, 2013	Carrying	Fair Value Measurements Using			Gain (Loss) for	
					Three Months Ended	Six Months Ended
					June 30,	June 30,
(In Thousands)	Value	Level 1	Level 2	Level 3	2013	2013
Assets						
Residential loans, at lower of cost or fair value	$ 1,122	$ -	$ -	$ 1,122	$ 37	$ 42
REO	2,117	-	-	2,117	(368)	(459)

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REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

The following table presents the components of market valuation adjustments, net, recorded in our consolidated statements of income for the three and six months ended June 30, 2013 and 2012.

Market Valuation Adjustments, Net

(In Thousands)	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Other				
Residential loans, at lower of cost or fair value	$ 38	$ 405	$ 78	$ 498
Commercial loans, at fair value	-	111	-	122
Trading securities	(4,140)	16,349	(4,707)	49,824
Impairments on AFS securities	(1,642)	(303)	(1,665)	(635)
REO	(558)	(162)	(331)	(144)
Other derivative instruments, net	44	(3,513)	64	(5,982)
ABS issued - Acacia	-	(12,973)	-	(45,026)
Total other	(6,258)	(86)	(6,561)	(1,343)
Mortgage banking activities				
Residential loans, at fair value	(41,405)	-	(6,535)	-
Commercial loans, at fair value	(345)	-	(345)	-
Trading securities	36,336	(5,363)	38,265	(4,674)
MSRs	8,827	(527)	9,169	(544)
Derivative instruments, net	49,544	(3,282)	50,567	(6,398)
Total mortgage banking activities	52,957	(9,172)	91,121	(11,616)
Total Market Valuation Adjustments, Net	$ 46,699	$ (9,258)	$ 84,560	$ (12,959)

Valuation Policy

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

Valuation Process

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

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 5. Fair Value of Financial Instruments (continued)

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

Fair Value Methodology for Level 3 Financial Instruments

June 30, 2013 (Dollars in Thousands)	Fair Value	Unobservable Input	Range	Weighted Average
Assets				
Residential loans, at fair value				
Loans priced to securitization	$ 1,047,686	Discount rate	4 - 4 %	4 %
		Prepayment rate	10 - 10 %	10 %
		Default rate	1 - 1 %	1 %
		Loss severity	22 - 22 %	22 %
		Credit support	7 - 7 %	7 %
Loans priced to whole loan market	171,682	Pool fallout assumption	0 - 5 %	4 %
		Fallout assumption price discount	0 - 5 pts	4 pts
Residential loans, at lower of cost or fair value	1,122	Loss severity	15 - 28 %	21 %
Trading and AFS securities	1,314,305	Discount rate	5 - 18 %	7 %
		Prepayment speed	1 - 40 %	14 %
		Default rate	0 - 37 %	10 %
		Loss severity	20 - 64 %	38 %
		Credit support	0 - 59 %	6 %
MSRs	43,098	Discount rate	12 - 12 %	12 %
		Prepayment rate	6 - 50 %	8 %
REO	2,117	Historical loss adjustment	0 - 40 %	10 %

Determination of Fair Value

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

Residential loans

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

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Note 5. Fair Value of Financial Instruments (continued)

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

Commercial loans

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

Estimated fair values for commercial senior mortgage loans are determined by an exit price to securitization. Certain significant inputs in the valuation analysis are Level 3 in nature. Relevant market indicators that are factored into the analyses include third-party CMBS sales, pricing points for secondary sales of CMBS, yields for synthetic instruments that use CMBS bonds as an underlying index, indexed swap yields, credit rating agency guidance on expected credit enhancement levels for newly issued CMBS transactions, and interest rates (Level 3). In certain cases, commercial senior mortgage loans are valued based on third-party offers for purchase into securitization (Level 2).

Real estate securities

Real estate securities include residential, commercial, and other asset-backed securities that are generally illiquid in nature and trade infrequently. For real estate securities, we utilize both market comparable pricing and discounted cash flow analysis valuation techniques. 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 into 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). These cash flow models use significant unobservable inputs such as a discount rate, prepayment rate, default rate, loss severity and credit support. The fair value of our securities would generally decrease in value based upon an increase in serious delinquencies. Conversely, the fair value of our securities would generally increase if the prepayment rate or credit support inputs were to increase.

As part of our securities valuation process, we request and consider indications of value from third-party securities dealers. For purposes of pricing our securities at June 30, 2013, we received dealer price indications on 76% of our securities. In the aggregate, our internal valuations of the securities for which we received dealer price indications were 3% lower than the aggregate dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis. In circumstances where relevant market inputs cannot be obtained, increased reliance on discounted cash flow analysis and management judgment are required to estimate fair value.

Derivative assets and liabilities

Our derivative instruments include interest rate agreements, TBAs, and financial futures. Fair values of derivative instruments are determined using quoted prices from active markets, when available, or valuation models and are supported by valuations provided by dealers active in derivative markets. TBA and financial futures fair values are generally obtained using quoted prices from active markets (Level 1). Our derivative valuation models for interest rate agreements require a variety of inputs, including contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates, and correlations of certain inputs. Model inputs for interest rate agreements can generally be verified and model selection does not involve significant management judgment (Level 2).

For other derivatives, valuations are based on various factors such as liquidity, bid/ask spreads, and credit considerations for which we rely on available market inputs. In the absence of such inputs, management s best estimate is used (Level 3). At June 30, 2013 and December 31, 2012, we had no Level 3 derivatives.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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Note 5. Fair Value of Financial Instruments (continued)

Cash and cash equivalents

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

Restricted cash

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

Accrued interest receivable and payable

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

MSRs

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

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

REO

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

Margin receivable

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

Short-term debt

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

ABS issued

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 5. Fair Value of Financial Instruments (continued)

value based upon a decrease in default rates and would generally decrease in value if the prepayment rate or credit support input were to decrease.

As part of our ABS issued valuation process, we request and consider indications of value from third-party securities dealers. For purposes of pricing our ABS issued at June 30, 2013, we received dealer price indications on 38% of our ABS issued. In the aggregate, our internal valuations of the ABS issued for which we received dealer price indications were 1% higher than the aggregate dealer valuations. Once we receive the price indications from dealers, they are compared to other relevant market inputs, such as actual or comparable trades, and the results of our discounted cash flow analysis. In circumstances where relevant market inputs cannot be obtained, increased reliance on discounted cash flow analysis and management judgment are required to estimate fair value.

Commercial borrowings

Commercial borrowings include our commercial loan repurchase agreement that matures in more than one year. Fair values approximate carrying values (Level 1).

Convertible notes

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

Other long-term debt

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

Note 6. Residential Loans

We acquire residential loans from third-party originators. During the six months ended June 30, 2013, we purchased $5.07 billion (principal balance) of residential loans primarily in connection with our Sequoia securitization program, for which we elected the fair value option. The following table summarizes the classifications and carrying value of the residential loans owned at Redwood and at consolidated Sequoia entities at June 30, 2013 and December 31, 2012.

June 30, 2013

(In Thousands)	Redwood		Sequoia		Total	
Held-for-sale						
Fair value	$	1,219,368	$	-	$	1,219,368
Lower of cost or fair value		1,730		-		1,730
Held-for-investment		-		1,998,178		1,998,178
Total Residential Loans	$	1,221,098	$	1,998,178	$	3,219,276

December 31, 2012

(In Thousands)	Redwood		Sequoia		Total	
Held-for-sale						
Fair value	$	553,576	$	-	$	553,576
Lower of cost or fair value		9,082		-		9,082
Held-for-investment		-		2,272,812		2,272,812
Total Residential Loans	$	562,658	$	2,272,812	$	2,835,470

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(Unaudited)

Note 6. Residential Loans (continued)

We do not currently service any residential loans, although at June 30, 2013, we did own MSRs that provided us with the rights to service $1.25 billion (principal balance) of consolidated residential loans purchased from third-party originators.

Residential Loans Held-for-Sale

Residential Loans at Fair Value

At June 30, 2013, there were 1,645 residential loans at fair value, with an aggregate outstanding principal balance of $1.26 billion and an aggregate fair value of $1.22 billion. During the three and six months ended June 30, 2013, we recorded $41 million and $7 million of negative valuation adjustments, respectively, on residential loans for which we elected the fair value option through mortgage banking activities, net, a component of our consolidated income statement. At December 31, 2012, there were 685 residential loans at fair value, with an aggregate outstanding principal balance of $533 million and an aggregate fair value of $554 million.

Residential Loans at Lower of Cost or Fair Value

At June 30, 2013, there were 10 residential loans at lower of cost or fair value with $2 million in outstanding principal balance and a carrying value of $2 million. At December 31, 2012, there were 17 residential loans at lower of cost or fair value with $10 million in outstanding principal balance and a carrying value of $9 million. During the three and six months ended June 30, 2013, we recorded valuation adjustments for residential loans held-for-sale of positive $38 thousand and positive $78 thousand, respectively. During the three and six months ended June 30, 2012, we recorded valuation adjustments for residential loans held-for-sale of positive $405 thousand and positive $498 thousand, respectively.

Residential Loans Held-for-Investment

The following table details the carrying value for residential loans held-for-investment at June 30, 2013 and December 31, 2012. These loans are owned at Sequoia securitization entities that we consolidate for financial reporting purposes.

(In Thousands)	**June 30, 2013**	**December 31, 2012**

Principal balance	$	2,001,544	$	2,278,069
Unamortized premium, net		19,784		23,247
Recorded investment		2,021,328		2,301,316
Allowance for loan losses		(23,150)		(28,504)
Carrying Value	$	1,998,178	$	2,272,812

Of the $2.00 billion of principal balance and $20 million of unamortized premium on loans held-for-investment at June 30, 2013, $832 million of principal balance and $13 million of unamortized premium relate to residential loans acquired prior to July 1, 2004. During the six months ended June 30, 2013, 9% of these residential loans prepaid and we amortized 18% of the premium based upon the accounting elections we apply. For residential loans acquired after July 1, 2004, the principal balance was $1.20 billion and the unamortized premium was $7 million. During the six months ended June 30, 2013, 14% of these loans prepaid and we amortized 9% of the premium.

Of the $2.28 billion of principal balance and $23 million of unamortized premium on loans held-for-investment at December 31, 2012, $912 million of principal balance and $16 million of unamortized premium relate to residential loans acquired prior to July 1, 2004. For residential loans acquired after July 1, 2004, the principal balance was $1.37 billion and the unamortized premium was $8 million.

Credit Characteristics of Residential Loans Held-for-Investment

As a percentage of our recorded investment, 98% of residential loans held-for-investment at June 30, 2013, were first lien, predominately prime-quality loans at the time of origination. The remaining 2% of loans were second lien, home equity lines of credit.

REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 6. Residential Loans (continued)

The weighted average original LTV ratio for our residential loans held-for-investment outstanding at June 30, 2013, was 65%. The weighted average FICO score for the borrowers of these loans was 734 at the time the loans were originated.

We consider the year of origination of our residential loans held-for-investment to be a general indicator of credit performance as loans originated in specific years have often possessed similar product and credit characteristics. The following table displays our recorded investment in residential loans held-for-investment at June 30, 2013 and December 31, 2012, organized by year of origination.

(In Thousands)	June 30, 2013	December 31, 2012
2003 & Earlier	$ 1,017,135	$ 1,131,200
2004	545,935	569,379
2005	67,266	71,792
2006	157,349	164,333
2007	-	-
2008	-	-
2009	37,823	58,628
2010	121,581	197,964
2011	74,239	108,020
Total Recorded Investment	$ 2,021,328	$ 2,301,316

Allowance for Loan Losses on Residential Loans

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

Activity in the Allowance for Loan Losses on Residential Loans

The following table summarizes the activity in the allowance for loan losses for the three and six months ended June 30, 2013 and 2012.

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	**2013**	**2012**	**2013**	**2012**
Balance at beginning of period	$ 29,064	$ 59,155	$ 28,504	$ 66,881
Charge-offs, net	(1,751)	(1,991)	(2,545)	(5,139)
Reversal of provision for loan losses	(4,163)	(1,715)	(2,809)	(1,715)
Deconsolidation adjustment	-	-	-	(4,578)
Balance at End of Period	$ 23,150	$ 55,449	$ 23,150	$ 55,449

During both the three months ended June 30, 2013 and 2012, there were $2 million of charge-offs of residential loans that reduced our allowance for loan losses. These charge-offs arose from $5 million and $4 million of defaulted loan principal, respectively. During the six months ended June 30, 2013 and 2012, there were $3 million and $5 million of charge-offs of residential loans, respectively, that reduced our allowance for loan losses. These charge-offs arose from $7 million and $14 million of defaulted loan principal, respectively.

Residential Loans Collectively Evaluated for Impairment

We establish the collective component of the allowance for residential loan losses based primarily on the characteristics of the loan pools underlying the securitization entities that own the loans, including loan product types, credit characteristics, and

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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June 30, 2013

(Unaudited)

Note 6. Residential Loans (continued)

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

The following table summarizes the balances for loans collectively evaluated for impairment at June 30, 2013 and December 31, 2012.

(In Thousands)	June 30, 2013	December 31, 2012
Principal balance	$ 1,993,690	$ 2,272,104
Recorded investment	2,013,694	2,295,471
Related allowance	22,520	27,891

The following table summarizes the recorded investment and past due status of residential loans collectively evaluated for impairment at June 30, 2013 and December 31, 2012.

(In Thousands)	30-59 Days Past Due	60-89 Days Past Due	90 + Days Past Due	Current	Total Loans
June 30, 2013	$ 22,968	$ 9,909	$ 65,476	$ 1,915,341	$ 2,013,694
December 31, 2012	29,345	17,593	62,937	2,185,596	2,295,471

Residential Loans Individually Evaluated for Impairment

As part of the loss mitigation efforts undertaken by servicers of residential loans owned at Sequoia securitization entities, a number of loan modifications have been completed to help make mortgage loans more affordable for qualifying borrowers and potentially reduce a future impairment. For the six months ended June 30, 2013 and 2012, the loan modifications determined to be TDRs were either: (i) conversions of a floating rate mortgage loan into a fixed rate mortgage loan; (ii) reductions in the contractual interest rates of a mortgage loan paired with capitalization of accrued interest; or (iii) principal forgiveness paired with interest rate reductions.

The following table presents the details of the loan modifications determined to be TDRs for the three and six months ended June 30, 2013 and 2012.

(Dollars in Thousands)	Three Months Ended June 30, 2013	Three Months Ended June 30, 2012	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
TDRs				
Number of modifications	4	2	7	6
Pre-modification outstanding recorded investment	$ 1,031	$ 884	$ 1,795	$ 2,672
Post-modification outstanding recorded investment	1,145	626	1,941	2,425
Loan modification effect on net interest income after provision and other MVA	(140)	(118)	(309)	(597)
TDRs that Subsequently Defaulted				
Number of modifications	1	2	3	4
Recorded investment	$ 178	$ 603	$ 587	$ 1,702

If we determine that a restructured loan is a TDR, we remove it from the general loan pools used for determining the allowance for residential loan losses and assess it for impairment on an individual basis. This assessment is based primarily on whether an

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 6. Residential Loans (continued)

adverse change in the expected future cash flows resulted from the restructuring. The average recorded investment of loans individually evaluated for impairment for the three months ended June 30, 2013 and 2012, was $7 million and $15 million, respectively. For the three months ended June 30, 2013 and 2012, we recorded interest income of $10 thousand and $149 thousand, respectively, on individually impaired loans. The average recorded investment of loans individually evaluated for impairment for the six months ended June 30, 2013 and 2012, was $7 million and $15 million, respectively. For the six months ended June 30, 2013 and 2012, we recorded interest income of $21 thousand and $259 thousand, respectively, on individually impaired loans.

The following table summarizes the balances for loans individually evaluated for impairment, all of which had an allowance, at June 30, 2013 and December 31, 2012.

(In Thousands)	June 30, 2013	December 31, 2012
Principal balance	$ 7,854	$ 5,965
Recorded investment	7,634	5,845
Related allowance	630	613

The following table summarizes the recorded investment and past due status of residential loans individually evaluated for impairment at June 30, 2013 and December 31, 2012.

(In Thousands)	30-59 Days Past Due	60-89 Days Past Due	90 + Days Past Due	Current	Total Loans
June 30, 2013	$ 1,021	$ -	$ 195	$ 6,418	$ 7,634
December 31, 2012	160	645	-	5,040	5,845

Note 7. Commercial Loans

We invest in commercial loans that we originate and service as well as loans that we acquire from third-party originators. The following table summarizes the classifications and carrying value of commercial loans at June 30, 2013 and December 31, 2012.

(In Thousands)	June 30, 2013	December 31, 2012
Held-for-sale		
Fair value	$ 149,470	$ -
Lower of cost or fair value	-	8,500
Held-for-investment	345,353	304,510
Total Commercial Loans	$ 494,823	$ 313,010

Commercial Loans Held-for-Sale

Commercial loans held-for-sale include loans we originate and intend to sell to third parties.

Commercial Loans at Fair Value

At June 30, 2013, there were 10 commercial loans at fair value, with an aggregate outstanding principal balance of $150 million and an aggregate fair value of $149 million. During the three and six months ended June 30, 2013, we recorded less than $1 million of negative valuation adjustments on commercial loans for which we elected the fair value option through mortgage banking activities, net, a component of our consolidated income statement. At December 31, 2012, there were no commercial loans at fair value.

REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 7. Commercial Loans (continued)

Commercial Loans at Lower of Cost or Fair Value

At June 30, 2013, there were no commercial loans held at the lower of cost or fair value. During both the six months ended June 30, 2013 and 2012, we did not record a valuation adjustment on commercial loans held-for-sale. At December 31, 2012, there was one senior commercial loan held-for-sale with $9 million in outstanding principal balance and a lower of cost or fair value of $9 million. During six months ended June 30, 2012, we did not record a valuation adjustment.

Commercial Loans Held-for-Investment

Commercial loans held-for-investment include loans we originate and preferred equity investments we make or, in either case, acquire from third parties. Through June 30, 2013, these loans have typically been mezzanine loans that are secured by a borrower s ownership interest in a single purpose entity that owns commercial property, rather than a lien on the commercial property. The preferred equity investments are typically preferred equity interests in a single purpose entity that owns commercial property and are included within, and referred to herein, as commercial loans held-for-investment due to the fact that their risks and payment characteristics are nearly equivalent to commercial mezzanine loans.

The following table provides additional information for our commercial loans held-for-investment at June 30, 2013 and December 31, 2012.

(In Thousands)		**June 30, 2013**		**December 31, 2012**
Principal balance	$	353,898	$	312,400
Unamortized discount, net		(2,885)		(3,806)
Recorded investment		351,013		308,594
Allowance for loan losses		(5,660)		(4,084)
Carrying Value	$	345,353	$	304,510

At June 30, 2013, there were 48 commercial loans held-for-investment with an outstanding principal balance of $354 million and a carrying value of $345 million. Of the $351 million of recorded investment in commercial loans

held-for-investment at June 30, 2013, 16% was originated in 2013, 45% was originated in 2012, 34% was originated in 2011, and 5% was originated in 2010. At December 31, 2012, there were 35 commercial loans held-for-investment with an outstanding principal balance of $312 million and a carrying value of $305 million. Of the $309 million of recorded investment in commercial loans held-for-investment at December 31, 2012, 53% was originated in 2012, 38% was originated in 2011, 9% was originated in 2010, and less than 1% was acquired in 2004.

Allowance for Loan Losses on Commercial Loans

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

Activity in the Allowance for Loan Losses on Commercial Loans

The following table summarizes the activity in the allowance for commercial loan losses for the three and six months ended June 30, 2013 and 2012.

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	**2013**	**2012**	**2013**	**2012**
Balance at beginning of period	$ 4,769	$ 882	$ 4,084	$ 608
Charge-offs, net	-	-	-	-
Provision for loan losses	891	376	1,576	650
Balance at End of Period	$ 5,660	$ 1,258	$ 5,660	$ 1,258

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(Unaudited)

Note 7. Commercial Loans (continued)

Commercial Loans Collectively Evaluated for Impairment

We record an allowance for loan losses based on our estimate of credit losses inherent in our portfolio at the reporting date. Our estimate of credit losses is informed by loss rates and delinquency trends. At June 30, 2013 and December 31, 2012, all of the commercial loans collectively evaluated for impairment were current and were assigned an impairment status of Pass. The following table summarizes the balances for loans collectively evaluated for impairment at June 30, 2013 and December 31, 2012.

(In Thousands)	June 30, 2013	December 31, 2012
Principal balance	$ 353,898	$ 312,400
Recorded investment	351,013	308,594
Related allowance	5,660	4,084

Commercial Loans Individually Evaluated for Impairment

We did not have any loans individually evaluated for impairment at either June 30, 2013 or December 31, 2012.

Note 8. Real Estate Securities

We invest in mortgage-backed securities. The following table presents the fair values of our real estate securities by collateral type at June 30, 2013 and December 31, 2012.

(In Thousands)	June 30, 2013	December 31, 2012
Residential	$ 1,314,305	$ 1,094,684
Commercial	-	14,069
Total Real Estate Securities	$ 1,314,305	$ 1,108,753

Our residential securities are presented in accordance with their general position within a securitization structure based on their rights to cash flows. Senior securities are those interests in a securitization that have the first right to cash flows and are last in line to absorb losses. Re-REMIC securities, as presented herein, were created through the

resecuritization of certain senior interests to provide additional credit support to those interests. These re-REMIC securities are therefore subordinate to the remaining senior interest, but senior to any subordinate tranches of the securitization from which they were created. Subordinate securities are all interests below senior and re-REMIC interests.

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Note 8. Real Estate Securities (continued)

Trading Securities

We elected the fair value option for certain securities and classify them as trading securities. At June 30, 2013, our trading securities included $141 million of interest-only securities, for which there is no principal balance, and $242 thousand of residential subordinate securities. The unpaid principal balance of residential subordinate securities classified as trading was $12 million at both June 30, 2013 and December 31, 2012. The following table presents trading securities by collateral type at June 30, 2013 and December 31, 2012.

(In Thousands)	June 30, 2013	December 31, 2012
Senior Securities		
Residential prime	$ 123,591	$ 10,409
Residential non-prime	17,525	22,134
Total Senior Securities	141,116	32,543
Subordinate Securities		
Residential prime	354	468
Residential non-prime	145	161
Total Subordinate Securities	499	629
Total Trading Securities	$ 141,615	$ 33,172

AFS Securities

The following table presents the fair value of our available-for-sale securities held at Redwood by collateral type at June 30, 2013 and December 31, 2012.

(In Thousands)	June 30, 2013	December 31, 2012
Senior Securities		

Residential prime	$	410,159	$	466,523
Residential non-prime		224,687		245,266
Total Senior Securities		634,846		711,789
Re-REMIC Securities		154,167		163,035
Subordinate Securities				
Residential prime		381,631		184,528
Residential non-prime		2,046		2,160
Commercial		-		14,069
Total Subordinate Securities		383,677		200,757
Total AFS Securities	$	1,172,690	$	1,075,581

Of the senior securities shown above at June 30, 2013 and December 31, 2012, included $154 million and $172 million, respectively, of prime securities, and $141 million and $152 million, respectively, of non-prime securities that were financed through the Residential Resecuritization entity, as discussed in *Note 4*.

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

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Note 8. Real Estate Securities (continued)

At June 30, 2013, there were $3 thousand of AFS residential securities with contractual maturities less than five years, $3 million of AFS residential securities with contractual maturities greater than five years but less than ten years, and the remainder of our real estate securities had contractual maturities greater than ten years.

During the first quarter of 2013, we sold all of our commercial AFS securities, resulting in a realized gain of $12 million. The following table presents the components of carrying value (which equals fair value) of residential AFS securities at June 30, 2013 and December 31, 2012.

Carrying Value of Residential AFS Securities

(In Thousands)		June 30, 2013		December 31, 2012
Principal balance	$	1,453,596	$	1,277,401
Credit reserve		(190,410)		(187,032)
Unamortized discount, net		(235,846)		(203,421)
Amortized cost		1,027,340		886,948
Gross unrealized gains		158,883		176,929
Gross unrealized losses		(13,533)		(2,365)
Carrying Value	$	1,172,690	$	1,061,512

The following table presents the changes for the three and six months ended June 30, 2013, in unamortized discount and designated credit reserves on residential AFS securities.

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

	Three Months Ended June 30, 2013			
(In Thousands)		Credit Reserve		Unamortized Discount, Net
Beginning balance	$	190,690	$	220,568

Amortization of net discount		-		(8,153)
Realized credit losses		(4,117)		-
Acquisitions		3,495		23,102
Sales, calls, other		(338)		(633)
Impairments		1,642		-
(Release of) transfers to credit reserves		(962)		962
Ending Balance	$	190,410	$	235,846

	Six Months Ended June 30, 2013			
(In Thousands)		**Credit Reserve**		**Unamortized Discount, Net**
Beginning balance	$	187,032	$	203,421
Amortization of net discount		-		(15,847)
Realized credit losses		(11,965)		-
Acquisitions		8,397		54,523
Sales, calls, other		(338)		(633)
Impairments		1,666		-
Transfers to (release of) credit reserves		5,618		(5,618)
Ending Balance	$	190,410	$	235,846

REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 8. Real Estate Securities (continued)

Credit Characteristics of Residential AFS Securities

Of the $190 million of credit reserve on our residential securities at June 30, 2013, $50 million was related to residential senior securities, $44 million was related to residential re-REMIC securities, and $96 million was related to residential subordinate securities. The loans underlying our $410 million of prime residential senior securities totaled $8 billion at June 30, 2013, and the loans underlying our $225 million of non-prime residential senior securities totaled $4 billion. Serious delinquencies on loans underlying our senior securities at June 30, 2013, were 10.08% of outstanding principal balances. The loans underlying our residential re-REMIC securities totaled $5 billion at June 30, 2013, and consisted of $5 billion prime and $106 million non-prime credit quality collateral at time of origination. Serious delinquencies on loans underlying our re-REMIC securities at June 30, 2013, were 9.70% of outstanding principal balances. The loans underlying our residential subordinate securities totaled $16 billion at June 30, 2013, and consisted of $16 billion prime and $431 million non-prime credit quality at time of origination. Serious delinquencies on loans underlying our subordinate securities at June 30, 2013, were 4.18% of outstanding principal balances.

Residential AFS Securities with Unrealized Losses

The following table presents the components comprising the total carrying value of residential AFS securities that were in a gross unrealized loss position at June 30, 2013 and December 31, 2012.

	Less Than 12 Consecutive Months			12 Consecutive Months or Longer		
(In Thousands)	Amortized Cost	Unrealized Losses	Fair Value	Amortized Cost	Unrealized Losses	Fair Value
June 30, 2013	$ 299,244	$ (11,837)	$ 287,407	$ 13,974	$ (1,696)	$ 12,278
December 31, 2012	22,803	(293)	22,510	26,729	(2,072)	24,657

At June 30, 2013, after giving effect to purchases, sales, and extinguishments due to credit losses, our consolidated balance sheet included 294 AFS securities, of which 47 were in an unrealized loss position and nine were in a continuous unrealized loss position for 12 consecutive months or longer. At December 31, 2012, our consolidated balance sheet included 284 AFS securities, of which 22 were in an unrealized loss position and 14 were in a continuous unrealized loss position for 12 consecutive months or longer.

Evaluating AFS Securities for Other-than-Temporary Impairments

When the fair value of an AFS security is below its cost basis, we evaluate the security for OTTI. Part of this evaluation is based upon adverse changes in the assumptions used to value the security. The table below summarizes the significant valuation assumptions we used for our AFS securities at June 30, 2013.

Significant Valuation Assumptions

	Range for Securities	
June 30, 2013	**Prime**	**Non-prime**
Prepayment rates	4 - 50 %	3 - 10 %
Loss severity	22 - 56 %	30 - 58 %
Projected losses	0 - 38 %	3 - 24 %

For an AFS security where its fair value has declined below its amortized cost basis, we evaluate the security for OTTI. The credit component of OTTI is recognized through our consolidated statements of income as a component of other market valuation adjustments, net, while the non-credit component of OTTI is recognized through accumulated other comprehensive income, a component of equity. The following table details the activity related to the credit component of OTTI (i.e., OTTI in either current earnings or retained earnings) for AFS securities that also had a non-credit component and were still held at June 30, 2013 and 2012. The balance of the credit component of OTTI at June 30, 2013 and 2012, includes all market valuation adjustments recorded through

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Note 8. Real Estate Securities (continued)

the income statement for securities still held on our balance sheet at June 30, 2013 and 2012, as well as a portion of OTTI previously recognized in other comprehensive income.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	**2013**	**2012**	**2013**	**2012**
Balance at beginning of period	$ 45,611	$ 73,698	$ 50,852	$ 78,126
Additions				
Initial credit impairments	-	55	-	161
Subsequent credit impairments	-	91	-	91
Reductions				
Securities sold, or expected to sell	(2,191)	-	(2,191)	-
Securities with no outstanding principal at period end	(746)	(6,790)	(5,987)	(11,324)
Balance at End of Period	$ 42,674	$ 67,054	$ 42,674	$ 67,054

The credit component of OTTI is reduced if we sell, intend to sell, or believe we will be required to sell previously credit-impaired debt securities. Additionally, the credit component of OTTI is reduced if we receive or expect to receive cash flows in excess of what we previously expected to receive over the remaining life of the credit-impaired debt security, the security matures, or the security experiences an event (such as full prepayment or principal losses) such that the outstanding principal is reduced to zero.

Gross Realized Gains and Losses on AFS Securities

Gains and losses from the sale of AFS securities are recorded as realized gains, net, in our consolidated statements of income. The following table presents the gross realized gains on sales and calls of AFS securities for the three and six months ended June 30, 2013 and 2012.

(In Thousands)	Three Months Ended June 30, 2013	2012	Six Months Ended June 30, 2013	2012
Gross realized gains - sales	$ 193	$ 6,989	$ 12,231	$ 14,774
Gross realized gains - calls	333	-	333	113
Gross realized losses - sales	-	-	-	(1,600)
Gross realized losses - calls	-	-	-	-
Total Realized Gains on Sales and Calls of AFS Securities, net	$ 526	$ 6,989	$ 12,564	$ 13,287

REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 9. Derivative Financial Instruments

The following table presents the fair value and notional amount of derivative financial instruments held by us at June 30, 2013 and December 31, 2012.

	June 30, 2013		December 31, 2012	
(In Thousands)	Fair Value	Notional Amount	Fair Value	Notional Amount
Assets - Risk Management Derivatives				
Interest rate swaps	$ 32,742	$ 1,044,000	$ 739	$ 147,000
TBAs	8,655	345,000	-	-
Futures	328	30,000	-	-
Swaptions	1,616	615,000	2,233	575,000
Total Assets	$ 43,341	$ 2,034,000	$ 2,972	$ 722,000
Liabilities - Cash Flow Hedges				
Interest rate swaps	$ (27,566)	$ 139,500	$ (48,581)	$ 139,500
Liabilities - Risk Management Derivatives				
Interest rate swaps	(219)	20,500	(1,893)	357,500
TBAs	(1,139)	105,000	-	-
Futures	(647)	238,000	(607)	234,000
Total Liabilities	$ (29,571)	$ 503,000	$ (51,081)	$ 731,000
Total Derivative Financial Instruments, Net	$ 13,770	$ 2,537,000	$ (48,109)	$ 1,453,000

Risk Management Derivatives

To offset, to varying degrees, risks associated with certain assets and liabilities on our consolidated balance sheet, we may enter into derivative contracts.

Certain Risks Related to Unsecuritized Residential and Commercial Loans at Redwood

In order to manage certain risks associated with residential and commercial loans we own or plan to acquire, at June 30, 2013, we were party to interest rate agreements with an aggregate notional amount of $1.7 billion, TBA contracts sold with an aggregate notional amount of $450 million and financial futures contracts with an aggregate notional amount of $268 million. Net market valuation adjustments on risk management derivatives related to unsecuritized loans we own or plan to acquire were positive $50 million and negative $3 million for the three months ended June 30, 2013 and 2012, respectively. Net market valuation adjustments on risk management derivatives related to unsecuritized loans we own or plan to acquire were positive $51 million and negative $7 million for the six months ended June 30, 2013 and 2012, respectively.

Derivatives Designated as Cash Flow Hedges

To hedge the variability in interest expense related to our long-term debt and certain adjustable-rate securitization entity liabilities that are included in our consolidated balance sheets for financial reporting purposes, we designated interest rate swaps as cash flow hedges during 2010 and during the second quarter of 2011 with an aggregate notional balance of $165 million. During the first half of 2012, we unwound swaps with an aggregate notional balance of $26 million that had been designated against certain adjustable-rate securitization entity liabilities.

For the three months ended June 30, 2013 and 2012, these cash flow hedges increased in value by $14 million and decreased in value by $16 million, respectively, which was recorded as an increase and decrease, respectively, to accumulated other comprehensive income, a component of equity. For the six months ended June 30, 2013 and 2012, these cash flow hedges increased in value by $21

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 9. Derivative Financial Instruments (continued)

million and decreased in value by $3 million, respectively. For interest rate agreements currently or previously designated as cash flow hedges, our total unrealized loss reported in accumulated other comprehensive income was $27 million and $48 million at June 30, 2013 and December 31, 2012, respectively. For the three months ended June 30, 2013 and 2012, we reclassified $69 thousand and $1 million, respectively, of unrealized losses on derivatives to interest expense. For the six months ended June 30, 2013 and 2012, we reclassified $157 thousand and $2 million, respectively, of unrealized losses on derivatives to interest expense. Accumulated other comprehensive loss of less than $1 million will be amortized into interest expense, a component of our consolidated income statements, over the remaining life of the hedged liabilities.

The following table illustrates the impact on interest expense of our interest rate agreements accounted for as cash flow hedges for the three and six months ended June 30, 2013 and 2012.

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

(In Thousands)	Three Months Ended June 30, 2013		Three Months Ended June 30, 2012		Six Months Ended June 30, 2013		Six Months Ended June 30, 2012	
Net interest expense on cash flow interest rate agreements	$	(1,470)	$	(1,437)	$	(2,934)	$	(2,953)
Realized income (expense) due to ineffective portion of hedges		-		5		-		(34)
Realized net losses reclassified from other comprehensive income		(69)		(1,098)		(157)		(2,134)
Total Interest Expense	$	(1,539)	$	(2,530)	$	(3,091)	$	(5,121)

Derivative Counterparty Credit Risk

We incur credit risk to the extent that counterparties to our derivative financial instruments do not perform their obligations under specified contractual agreements. If a derivative counterparty does not perform, we may not receive the proceeds to which we may be entitled under these agreements. Each of our derivative counterparties must maintain compliance with International Swaps and Derivatives Association (ISDA) agreements (or receive a waiver of non-compliance after a specific assessment) in order to conduct derivative transactions with us. Additionally, we review derivative counterparty credit standings, and in the case of a deterioration of creditworthiness, appropriate remedial action is taken. To further mitigate counterparty risk, we exit derivatives contracts with counterparties that (i) do not maintain compliance with (or obtain a waiver from) the terms of their ISDA agreements with us; or (ii) do not maintain their status as a primary government dealer or affiliate by the U.S. Department of Treasury or do not meet internally established guidelines regarding credit worthiness. Our ISDA agreements currently require full bilateral collateralization of unrealized loss exposures with our derivative counterparties. Through a margin posting process, our positions are revalued with counterparties each business day and cash margin is generally transferred to either us or our derivative counterparties as collateral based upon the directional changes in fair value of the positions. We also attempt to transact with several different counterparties in order to reduce our specific counterparty exposure. We consider counterparty risk as part of our fair value assessments of all derivative financial instruments. At June 30, 2013, we assessed this risk as remote and did not record a specific valuation adjustment.

At June 30, 2013, we had outstanding derivative agreements with six counterparties and were in compliance with ISDA agreements governing our open derivative positions.

REDWOOD TRUST, INC. AND SUBSIDIARIES

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Note 10. Other Assets

Other assets at June 30, 2013 and December 31, 2012, are summarized in the following table.

Other Assets

(In Thousands)	June 30, 2013	December 31, 2012
Margin receivable	$ 55,926	$ 63,424
Investment receivable	12,076	153
Other pledged collateral	5,000	-
REO	3,965	4,245
Prepaid expenses	1,219	1,684
Fixed assets and leasehold improvements	859	494
Income tax receivables	306	4,762
Other	1,032	618
Total Other Assets	$ 80,383	$ 75,380

REO consists of foreclosed properties received in satisfaction of defaulted real estate loans. The carrying value of REO at June 30, 2013, was $4 million, which includes the net effect of $3 million related to transfers into REO during the first half of 2013, offset by $2 million of REO liquidations, and less than $1 million of negative market valuation adjustments. At June 30, 2013 and December 31, 2012, there were 21 and 24 REO properties, respectively, recorded on our consolidated balance sheets, all of which were owned at consolidated Sequoia entities. Properties located in Ohio, Florida, Georgia, Illinois, and Michigan accounted for 76% of our REO properties at June 30, 2013.

Margin receivable resulted from margin calls from our swap, master repurchase agreements, and warehouse facility counterparties that required us to post collateral.

Note 11. Short-Term Debt

We enter into repurchase agreements, bank warehouse agreements, and other forms of collateralized (and generally uncommitted) short-term borrowings with several banks and major investment banking firms. At June 30, 2013, we had outstanding agreements with 11 counterparties and we were in compliance with all of the related covenants. Further information about these financial covenants is set forth in Part I, Item 2 *Management s Discussion and Analysis of Financial Condition and Results of Operations* of this Quarterly Report on Form 10-Q. The table below summarizes the facilities that are available to us and the balances of short-term debt at June 30, 2013 and

December 31, 2012, by the type of collateral securing the debt.

(Dollars in Thousands)	June 30, 2013			
	Number of Facilities	Outstanding	Limit	Maturity
Collateral Type				
Residential loans	4	$ 1,082,726	$ 1,350,000	7/2013 - 1/2014
Real estate securities	7	363,235	-	7/2013 - 8/2013
Total	11	$ 1,445,961		

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Note 11. Short-Term Debt (continued)

(Dollars in Thousands)	Number of Facilities	December 31, 2012 Outstanding	Limit	Maturity
Collateral Type				
Residential loans	4	$ 179,982	$ 800,000	1/2013 - 11/2013
Real estate securities	7	371,936	-	1/2013 - 3/2013
Total	11	$ 551,918		

Borrowings under these facilities are generally charged interest based on a specified margin over the one-month LIBOR interest rate. At June 30, 2013, all of these borrowings were under uncommitted facilities and were due within 364 days (or less) of the borrowing date. The fair value of residential loans and real estate securities pledged as collateral was $1.20 billion and $455 million, respectively, at June 30, 2013. For the three and six months ended June 30, 2013, the average balance of short-term debt was $1.05 billion and $954 million, respectively. For the three and six months ended June 30, 2012, the average balance of short-term debt was $474 million and $418 million, respectively. At both June 30, 2013 and December 31, 2012, accrued interest payable on short-term debt was $1 million.

Characteristics of Short-Term Debt

The table below summarizes short-term debt by weighted average interest rates and by collateral type at June 30, 2013 and December 31, 2012.

	June 30, 2013			December 31, 2012		
(Dollars in Thousands)	Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity	Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity
Collateral Type						
Residential loan collateral	$ 1,082,726	1.76%	120	$ 179,982	1.76%	212
Real estate securities collateral	363,235	1.76%	22	371,936	1.83%	23

Total Short-Term Debt	$ 1,445,961	1.76%	95	$ 551,918	1.81%	84

Remaining Maturities of Short-Term Debt

The following table presents the remaining maturities of short-term debt at June 30, 2013 and December 31, 2012.

(In Thousands)	**June 30, 2013**		**December 31, 2012**	
Within 30 days	$	663,659	$	362,279
31 to 90 days		5,726		48,848
Over 90 days		776,576		140,791
Total Short-Term Debt	$	1,445,961	$	551,918

Note 12. Asset-Backed Securities Issued

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

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(Unaudited)

Note 12. Asset-Backed Securities Issued (continued)

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

The carrying value of ABS issued by consolidated securitization entities we sponsored at June 30, 2013 and December 31, 2012, along with other selected information, are summarized in the following table.

Asset-Backed Securities Issued

	June 30, 2013			
(Dollars in Thousands)	**Sequoia**	**Residential Resecuritization**	**Commercial Securitization**	**Total**
Certificates with principal balance	$ 1,935,113	$ 134,156	$ 159,526	$ 2,228,795
Interest-only certificates	4,903	-	-	4,903
Unamortized premium	-	-	-	-
Unamortized discount	(19,402)	-	-	(19,402)
Total ABS Issued	$ 1,920,614	$ 134,156	$ 159,526	$ 2,214,296
Range of weighted average interest rates, by series	0.40% to 4.20%	2.21%	5.62%	
Stated maturities	2014 - 2047	2046	2018	
Number of series	24	1	1	

	December 31, 2012			
(Dollars in Thousands)	**Sequoia**	**Residential Resecuritization**	**Commercial Securitization**	**Total**

Certificates with principal balance	$	2,207,851	$	164,746	$	171,714	$	2,544,311
Interest-only certificates		7,769		-		-		7,769
Unamortized premium		921		-		-		921
Unamortized discount		(23,060)		-		-		(23,060)
Total ABS Issued	$	2,193,481	$	164,746	$	171,714	$	2,529,941
Range of weighted average interest rates, by series		0.41% to 4.16%		2.21%		5.62%		
Stated maturities		2014 - 2047		2046		2018		
Number of series		24		1		1		

The actual maturity of each class of ABS issued is primarily determined by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption prior to the stated maturity according to the terms of the respective governing documents of each ABS issuing entity. As a result, the actual maturity of ABS issued may occur earlier than its stated maturity. At June 30, 2013, $2.18 billion of ABS issued ($2.19 billion principal balance) had contractual maturities of over five years and $38 million of ABS issued ($38 million principal balance) had contractual maturities of one to five years. Amortization of deferred ABS issuance costs was less than $1 million and $1 million for the six months ended June 30, 2013 and 2012, respectively.

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Note 12. Asset-Backed Securities Issued (continued)

The following table summarizes the accrued interest payable on ABS issued at June 30, 2013 and December 31, 2012. Interest due on consolidated ABS issued is payable monthly.

Accrued Interest Payable on Asset-Backed Securities Issued

(In Thousands)	June 30, 2013	December 31, 2012
Sequoia	$ 1,509	$ 2,103
Residential Resecuritization	33	40
Commercial Securitization	748	832
Total Accrued Interest Payable on ABS Issued	$ 2,290	$ 2,975

The following table summarizes the carrying value components of the collateral for ABS issued and outstanding at June 30, 2013 and December 31, 2012.

Collateral for Asset-Backed Securities Issued

	June 30, 2013			
(In Thousands)	Sequoia	Residential Resecuritization	Commercial Securitization	Total
Residential loans	$ 1,998,178	$ -	$ -	$ 1,998,178
Commercial loans	-	-	270,449	270,449
Real estate securities	-	294,771	-	294,771
Restricted cash	148	2	138	288
Accrued interest receivable	3,461	751	1,939	6,151
REO	3,965	-	-	3,965

Total Collateral for ABS Issued	$	2,005,752	$	295,524	$	272,526	$	2,573,802

	December 31, 2012							
(In Thousands)		**Sequoia**		**Residential Resecuritization**		**Commercial Securitization**		**Total**
Residential loans	$	2,272,812	$	-	$	-	$	2,272,812
Commercial loans		-		-		283,610		283,610
Real estate securities		-		324,606		-		324,606
Restricted cash		147		-		137		284
Accrued interest receivable		4,484		839		2,132		7,455
REO		4,245		-		-		4,245
Total Collateral for ABS Issued	$	2,281,688	$	325,445	$	285,879	$	2,893,012

Note 13. Long-Term Debt

Commercial Borrowings

At June 30, 2013, we had one commercial loan repurchase facility with an outstanding balance of $17 million and a total borrowing limit of $150 million, with a remaining maturity of 27 months. Borrowings under this facility are generally charged interest based on a specified margin over the one-month LIBOR interest rate. For the three and six months ended June 30, 2013, the average balance of this commercial borrowing was $17 million and $11 million, respectively. The fair value of commercial loans pledged as collateral was $26 million at June 30, 2013. The interest expense yield on this borrowing was 5.50%

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(Unaudited)

Note 13. Long-Term Debt (continued)

and 5.59%, respectively, for the three and six months ended June 30, 2013. There was no balance on this warehouse facility at December 31, 2012.

At June 30, 2013, we were in compliance with all of the covenants related to our commercial loan repurchase facility. Further information about the financial covenants under this facility is set forth in Part I, Item 2 *Management s Discussion and Analysis of Financial Condition and Results of Operations* of this Quarterly Report on Form 10-Q.

Convertible Notes

In March 2013, we issued in a public offering $287.5 million principal amount of 4.625% convertible senior notes due 2018. These convertibles notes require semi-annual interest distributions at a fixed coupon rate of 4.625% until maturity or conversion, which will be no later than April 15, 2018. After deducting the underwriting discount and offering costs, we received approximately $279 million of net proceeds. Including amortization of deferred securities issuance costs, the interest expense yield on our convertibles notes was 5.53% and 5.48%, respectively, for the three and six months ended June 30, 2013. At June 30, 2013, the accrued interest payable balance on this debt was $4 million.

Our convertible senior notes are convertible at the option of the holder at a conversion rate of 41.1320 common shares per $1,000 principal amount of convertible senior notes at June 30, 2013 (equivalent to a conversion price of $24.31 per common share). Upon conversion of these convertible senior notes by a holder, the holder will receive shares our common stock.

Trust Preferred Securities and Subordinated Notes

In 2006, we issued $100 million of trust preferred securities through Redwood Capital Trust I, a Delaware statutory trust, in a private placement transaction. These trust preferred securities require quarterly distributions at a floating coupon rate equal to three-month LIBOR plus 2.25% until the securities are redeemed, which will be no later than January 30, 2037. The interest expense yield on our trust preferred securities was 2.65% and 2.91% for the six months ended June 30, 2013 and 2012, respectively. Including hedging costs and amortization of deferred securities issuance costs, the interest expense yield on our trust preferred securities was 6.89% and 6.88% for the six months ended June 30, 2013 and 2012, respectively. The earliest optional redemption date without penalty was January 30, 2012. In December 2010, we repurchased $500 thousand principal amount of these trust preferred securities.

In 2007, we issued an additional $50 million of subordinated notes. These subordinated notes require quarterly distributions at a floating interest rate equal to six-month LIBOR plus 2.25% until the notes are redeemed, which will be no later than July 30, 2037. The interest expense yield on our subordinated notes was 2.65% and 2.91% for the six months ended June 30, 2013 and 2012, respectively. Including hedging costs and amortization of deferred securities issuance costs, the interest expense yield on our subordinated notes was 6.89% and 6.88% for the six months ended June 30, 2013 and 2012, respectively. The earliest optional redemption date without a penalty was July 30, 2012. In July 2009, we repurchased $10 million principal amount of this subordinated debt.

At both June 30, 2013 and December 31, 2012, the accrued interest payable balance on this long-term debt was less than $1 million. Under the terms of this long-term debt, we covenant, among other things, to use our best efforts to continue to qualify as a REIT. If an event of default were to occur in respect of this long-term debt, we would generally be restricted under its terms (subject to certain exceptions) from making dividend distributions to stockholders, from repurchasing common stock or repurchasing or redeeming any other then-outstanding equity securities, and from making any other payments in respect of any equity interests in us or in respect of any then-outstanding debt that is *pari passu* or subordinate to this long-term debt.

Note 14. Commitments and Contingencies

Lease Commitments

At June 30, 2013, we were obligated under four non-cancelable operating leases with expiration dates through 2021 for $12 million. In the second quarter of 2013, a new lease for our Denver-based operations became effective. We do not have a 2013 rent obligation for this lease due to an abatement period through the first quarter of 2014. The total rent obligation through 2020 is $1.9 million. During the second quarter of 2013, we also entered into an amendment to this lease to expand the original premises. The 2013

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)

Note 14. Commitments and Contingencies (continued)

rent obligation related to this amendment is $88 thousand, and the total rent obligation through 2021 is $2 million. Operating lease expense was less than $1 million for both the six months ended June 30, 2013 and 2012.

The following table presents our future lease commitments at June 30, 2013.

Future Lease Commitments by Year

(In Thousands)		June 30, 2013
2013 (six months)	$	975
2014		2,294
2015		2,302
2016		2,056
2017		2,111
2018 and thereafter		2,384
Total	$	12,122

Leasehold improvements for our offices are amortized into expense over the lease term. There were $12 thousand of unamortized leasehold improvements at June 30, 2013. For the six months ended June 30, 2013 and 2012, we recognized a negligible amount of leasehold amortization.

Loss Contingencies Litigation

On or about December 23, 2009, the Federal Home Loan Bank of Seattle (the FHLB-Seattle) filed a complaint in the Superior Court for the State of Washington (case number 09-2-46348-4 SEA) against Redwood Trust, Inc., our subsidiary, Sequoia Residential Funding, Inc. (SRF), Morgan Stanley & Co., and Morgan Stanley Capital I, Inc. (collectively, the FHLB-Seattle Defendants) alleging that the FHLB-Seattle Defendants made false or misleading statements in offering materials for a mortgage pass-through certificate (the Seattle Certificate) issued in the Sequoia Mortgage Trust 2005-4 securitization transaction (the 2005-4 RMBS) and purchased by the FHLB-Seattle. Specifically, the complaint alleges that the alleged misstatements concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the

properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Seattle Certificate. The FHLB-Seattle alleges claims under the Securities Act of Washington (Section 21.20.005, et seq.) and seeks to rescind the purchase of the Seattle Certificate and to collect interest on the original purchase price at the statutory interest rate of 8% per annum from the date of original purchase (net of interest received) as well as attorneys fees and costs. The Seattle Certificate was issued with an original principal amount of approximately $133 million, and, as of June 30, 2013, the FHLB-Seattle has received approximately $113.0 million of principal and $11.0 million of interest payments in respect of the Seattle Certificate. The claims were subsequently dismissed for lack of personal jurisdiction as to Redwood Trust and SRF. Redwood agreed to indemnify the underwriters of the 2005-4 RMBS for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. The FHLB-Seattle s claims against the underwriters of this RMBS were not dismissed and remain pending. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

On or about July 15, 2010, The Charles Schwab Corporation (Schwab) filed a complaint in the Superior Court for the State of California in San Francisco (case number CGC-10-501610) against SRF and 26 other defendants (collectively, the Schwab Defendants) alleging that the Schwab Defendants made false or misleading statements in offering materials for various residential mortgage-backed securities sold or issued by the Schwab Defendants. With respect to SRF, Schwab alleges that SRF made false or misleading statements in offering materials for a mortgage pass-through certificate (the Schwab Certificate) issued in the 2005-4 RMBS and purchased by Schwab. Specifically, the complaint alleges that the misstatements for the 2005-4 RMBS concern the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2005-4 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, and (4) ratings assigned to the Schwab Certificate. Schwab alleges a claim for negligent misrepresentation under California state law and seeks unspecified damages and attorneys fees and costs. The Schwab Certificate was issued with an original principal amount of approximately $14.8 million, and, as of June 30, 2013, Schwab has received approximately $12.6 million of principal and $1.3 million of interest payments in respect of the Schwab

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(Unaudited)

Note 14. Commitments and Contingencies (continued)

Certificate. SRF has denied Schwab s allegations. This case is in early stages of discovery, and no trial date has been set. We believe that this case is without merit, and we intend to defend the action vigorously. Redwood agreed to indemnify the underwriters of the 2005-4 RMBS, which underwriters are also named defendants in this action, for certain losses and expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

On or about October 15, 2010, the Federal Home Loan Bank of Chicago (FHLB-Chicago) filed a complaint in the Circuit Court of Cook County, Illinois (case number 10-CH-45033) against SRF and more than 45 other named defendants (collectively, the FHLB-Chicago Defendants) alleging that the FHLB-Chicago Defendants made false or misleading statements in offering materials for various RMBS sold or issued by the FHLB-Chicago Defendants or entities controlled by them. FHLB-Chicago subsequently amended the complaint to name Redwood Trust, Inc. and another one of our subsidiaries, RWT Holdings, Inc., as defendants. With respect to Redwood Trust, Inc., RWT Holdings, Inc., and SRF, the FHLB-Chicago alleges that SRF, Redwood Trust, Inc., and RWT Holdings, Inc. made false or misleading statements in the offering materials for two mortgage pass-through certificates (the Chicago Certificates) issued in the Sequoia Mortgage Trust 2006-1 securitization transaction (the 2006-1 RMBS) and purchased by the FHLB-Chicago. The complaint alleges that the alleged misstatements concern, among other things, the (1) loan-to-value ratio of mortgage loans and the appraisals of the properties that secured loans supporting the 2006-1 RMBS, (2) occupancy status of the properties, (3) standards used to underwrite the loans, (4) ratings assigned to the Chicago Certificates, and (5) due diligence performed on these mortgage loans. The FHLB-Chicago alleges claims under Illinois Securities Law (815 ILCS Sections 5/12(F)-(H)) and North Carolina Securities Law (N.C.G.S.A. §78A-8(2) & §78A-56(a)) as well as a claim for negligent misrepresentation under Illinois common law. On some of the causes of action, the FHLB-Chicago seeks to rescind the purchase of the Chicago Certificates and to collect interest on the original purchase prices at the statutory interest rate of 10% per annum from the dates of original purchase (net of interest received). On one cause of action, the FHLB-Chicago seeks unspecified damages. The FHLB-Chicago also seeks attorneys fees and costs. The first of the Chicago Certificates was issued with an original principal amount of approximately $105 million and, at June 30, 2013, the FHLB Chicago has received approximately $70.3 million of principal and $23.8 million of interest payments in respect of this Chicago Certificate. The second of the Chicago Certificates was issued with an original principal amount of approximately $379 million and, at June 30, 2013, the FHLB Chicago has received approximately $251.8 million of principal and $79.9 million of interest payments in respect of this Chicago Certificate. SRF, Redwood Trust, Inc., and RWT Holdings, Inc. have denied FHLB-Chicago s allegations. This case is in early stages of discovery, and no trial date has been set. We believe that this case is without merit, and we intend to defend the action vigorously. Redwood agreed to indemnify the underwriters of the 2006-1 RMBS, which underwriters are also named defendants in this action, for certain losses and

expenses they might incur as a result of claims made against them relating to this RMBS, including, without limitation, certain legal expenses. Regardless of the outcome of this litigation, Redwood could incur a loss as a result of these indemnities.

We cannot determine the outcome of any of the above-referenced litigation matters at this time or predict the results with certainty. We cannot be certain that any of these matters will not have a material adverse effect on our results of operations in any future period, and any loss or expense related to any of this litigation could have a material adverse impact on our consolidated financial statements.

In accordance with FASB guidance on accounting for contingencies, we review the need for any loss contingency reserves and establish reserves when, in the opinion of management, it is probable that a matter would result in a liability, and the amount of loss, if any, can be reasonably estimated. Additionally, we record receivables for insurance recoveries relating to litigation-related losses and expenses if and when such amounts are covered by insurance and recovery of such losses or expenses are due. If, with respect to a matter, it is not both probable to result in liability and the amount of loss cannot be reasonably estimated (as is the case for each of the above-referenced litigation matters), FASB guidance on accounting for contingencies provides that an estimate of possible loss or range of loss be disclosed unless such an estimate cannot be made. There are numerous factors that make it difficult to meaningfully estimate possible loss or range of loss at this stage of these litigation matters, including that: we are no longer a party to the FHLB-Seattle matter, the proceedings to which we are a party are in relatively early stages with no trial dates set, there are significant factual and legal issues to be resolved, information obtained or rulings made during the lawsuits could affect the methodology for calculation of the available remedies, our belief that these litigations are without merit, and our intent to defend these actions vigorously. In addition, with respect to claims where damages are the requested relief, no amount of loss or damages has been specified. We also may have additional rights and/or obligations pursuant to indemnity agreements, representations and warranties, and other contractual

REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 14. Commitments and Contingencies (continued)

provisions with other parties relating to these litigation matters. These rights and obligations could offset or increase our potential losses. We are unable at this time to estimate the potential amount of any such offset or loss.

Although we believe the above-referenced litigation matters are without merit and we intend to defend vigorously the actions to which we are a party, in the ordinary course of any litigation matter, including the above-referenced matters, we may engage in formal or informal settlement communications. While we have not had any settlement discussions in the above-referenced matters that cause us to determine that a material loss is probable or be able to estimate an amount or range of material loss liability, future settlement discussions relating to these matters could result in our concluding to establish loss contingency reserves or make additional disclosures regarding an estimate of possible loss or range of loss with respect to one or more of these matters. Any settlement agreements could have a material impact on our consolidated financial statements.

Note 15. Equity

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

Changes in Accumulated Other Comprehensive Income by Component

Three Months Ended June 30, 2013 **(In Thousands)**	**Net unrealized gains on available-for-sale securities**	**Net unrealized losses on interest rate agreements accounted for as cash flow hedges**
Balance at beginning of period	$ 183,603	$ (40,720)
Other comprehensive (loss) income before reclassifications	(38,012)	13,585
Amounts reclassified from other accumulated comprehensive income	(242)	69
Net current-period other comprehensive (loss) income	(38,254)	13,654
Balance at End of Period	$ 145,349	$ (27,066)

Six Months Ended June 30, 2013 **(In Thousands)**	**Net unrealized gains on available-for-sale securities**	**Net unrealized losses on interest rate agreements accounted for as cash flow hedges**
Balance at beginning of period	$ 186,580	$ (48,248)
Other comprehensive (loss) income before reclassifications	(28,982)	21,025
Amounts reclassified from other accumulated comprehensive income	(12,249)	157
Net current-period other comprehensive (loss) income	(41,231)	21,182
Balance at End of Period	$ 145,349	$ (27,066)

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REDWOOD TRUST, INC. AND SUBSIDIARIES

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(Unaudited)

Note 15. Equity (continued)

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

Reclassifications out of Accumulated Other Comprehensive Income

(In Thousands)	Affected line item in the statement where net income is presented	Amount reclassified from accumulated other comprehensive income Three Months Ended June 30, 2013	Six Months Ended June 30, 2013
Net realized gains (losses) on AFS securities			
Other than temporary impairment	Other market valuations, net	$ (133)	$ (124)
Gain on sale of AFS securities	Realized gains, net	(109)	(12,125)
Loss on sale of AFS securities	Realized gains, net	-	-
		$ (242)	$ (12,249)
Net realized gains on interest rate agreements designated as cash flow hedges			
Amortization of deferred gain	Interest expense	$ -	$ -
Hedge ineffectiveness	Interest expense	69	157
		$ 69	$ 157

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2013

(Unaudited)

Note 15. Equity (continued)

Earnings Per Common Share

The following table provides the basic and diluted earnings per common share computations for the three and six months ended June 30, 2013 and 2012.

Basic and Diluted Earnings Per Common Share

	Three Months Ended June 30,				Six Months Ended June 30,			
(In Thousands, Except Share Data)		**2013**		**2012**		**2013**		**2012**
Basic Earnings Per Common Share:								
Net income attributable to Redwood	$	65,573	$	19,527	$	126,183	$	49,990
Less: Dividends and undistributed earnings allocated to participating securities		(1,830)		(538)		(3,819)		(1,491)
Net income allocated to common shareholders	$	63,743	$	18,989	$	122,364	$	48,499
Basic weighted average common shares outstanding		82,123,823		78,815,313		81,729,014		78,606,336
Basic Earnings Per Common Share	$	0.78	$	0.24	$	1.50	$	0.62
Diluted Earnings Per Common Share:								
Net income attributable to Redwood	$	65,573	$	19,527	$	126,183	$	49,990
Less: Dividends and undistributed earnings allocated to participating securities		(1,175)		(538)		(2,527)		(1,336)
Add back: Interest expense on convertible notes		3,856		-		4,933		-

Net income allocated to common shareholders	$	68,254	$	18,989	$	128,589	$	48,654
Weighted average common shares outstanding		82,123,823		78,815,313		81,729,014		78,606,336
Net effect of dilutive equity awards		2,222,440		-		2,274,311		1,359,070
Net effect of assumed convertible notes conversion to common shares		11,825,450		-		7,644,075		-
Diluted weighted average common shares outstanding		96,171,713						